OLD MUTUAL
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Old Mutual Group plc
Presenters: Julian Roberts, Philip Broadley

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Operator

Good day and welcome to the Old Mutual Q1 Interim Management Statement Analyst call. Today's conference is being recorded. At this time I'd like to turn the conference over to Mr. Julian Roberts. Please go ahead sir.

Julian Roberts

Thank you very much. Good morning everybody. Let me start with an apology for the fact that the call has been delayed for 15 minutes. The technology systems that we were using broke down and therefore we had to go to a backup, so my apologies.

Let me start. You've joined us on the Quarter 1 IMS conference call, hopefully you have had maybe an extended look at the statement that we issued this morning. Let me run through a few of the headlines before opening the call to your questions and as you'd expect Philip Broadley is here with me in the room.

Let me start by saying that it was another tough quarter. The JSE All Share Index fell 5% from December to March and during the quarter touched as low as 16% below its year end level. The FTSE 100 fell 20% below its year end level, though rallied a little towards the end of the quarter. Both indices are 31% lower than they were at the same time last year. I start with that information of course because as you know our revenues, our profits are affected by the level of the market and that gives a little bit of guidance towards our half year results. But against the market background I am pleased with our performance in the quarter. I think we've had fairly resilient performance and not least, let me start with the position of our capital. Our position has strengthened at the end of Q1. We had an FGD surplus of approximately £900 million. The near 20% improvement from the end of the year position is primarily due to the addition of profits, as well as around £40 million from a Nedbank subordinated debt issue. We are now substantially hedged against the JSE and the sterling/dollar exchange rate. The overall impact on FGD of currencies and markets in the quarter was broadly neutral. Philip explained in March that the main exposure we have to cover with our surplus is the risk of US corporate defaults. I'm pleased to be able to report that we suffered no defaults in the quarter and indeed there have been no defaults since the quarter end. Our individual businesses remain well capitalised with no major changes to the year end position.

Turning now to sales, both long-term savings, life sales and group unit trust sales were down 14% compared with the first quarter of 2008. I think that's a pretty resilient performance in this environment. As expected economic conditions depressed the market for life single premium sales and unit trust sales have been affected by the fall in consumer confidence which has resulted in a move towards lower risk savings products. Despite the challenging environment, OMSA delivered a strong performance, life sales were up 2% with a 9% increase in recurring premium sales, only partially offset by the lower single premium sales. Last year's investments in the sales force contributed to an 18% increase in life sales in the retail mass segment and institutional sales were up by 20%. Unit trust sales in OMSA were up by 24% and for South Africa in total, were up 27% due to the performance of the Rest of Africa operations.

In Europe, sales in the Nordic region continued to be excellent, continuing that momentum that we generated in 2008 through our investment in brand product range and the relationship with brokers and distributors. Nordic life sales in the quarter were up 21% compared with the first quarter of 2008. In the UK, life sales were down 28% on the same period of last year, but were in line with the fourth quarter of 2008. A decline in sales in the more traditional sector was partially offset by a 62% increase in sales on the Skandia platform, driven largely by the re-price last September. I put that number in, as you know, that a major driver of ours and a major opportunity in the future, we believe, is through our very significant Skandia platform. You'll see in our supplementary disclosure pack that, for the first time, we are showing the International business separate from Skandia UK. The International business is now a significant business. It performed well, particularly on recurring premium sales, which are up 20% on the comparative quarter. In ELAM single premium sales held out relatively well and were in line with the fourth quarter, but the market for recurring premium sales was constrained. Overall life sales in ELAM were down by 41% year on year.

We said in March that we were taking actions to simplify our portfolio and this has been a feature of our activities in the US life onshore business, where we have undertaken an extensive programme of product rationalisation. We have reduced our annuity product range by two thirds and our life range by three quarters, with a revised focus on more profitable sales and products with lower new business capital strain. Our achieved sales of $30 million on an APE basis exceed our revised targets, based on the new simpler product range. We regard this as the new base level of sales consistent with our $650 million gross sales target for the full year, and we expect to continue in line with the lower level. We have taken a lot of costs out of the business, most particularly through headcount reductions, which are now complete. We believe the business is now appropriately sized for its sales plans going forward. You know that we have closed Bermuda to new business; accordingly we are now reporting it as a legacy business, not as part of long term savings. And references to US Life will in future include just the onshore business. Our emphasis in Bermuda is on managing the existing book in an optimal manner. In March we told you that we had increased hedge effectiveness from around 78% for the full year to 92% in the fourth quarter alone. That improvement has continued and we are now achieving around 95% effectiveness. This is a level we are comfortable with. In order to protect it, we are executing a soft-close programme on funds available to existing clients; that means that we will restrict their access to funds that we find difficult to hedge. Overall, across both US Life and Bermuda, our net unrealised losses at the end of the quarter were $3.1 billion. The increase from the year end figure of $2.6 billion is in line with the market. At the end of April our net unrealised losses were $2.9 billion as a result of the narrowing of credit spreads during the month. We took gross impairment of $43 million in the first quarter and as I've said previously, there were no defaults.

Finally, let me comment on US Asset Management. Difficult market conditions have continued to impact sales, the primary focus for management here is aggressive cost containment to support lower business volumes. Headcount is being cut, expenses are being tackled and, in fact, we have a hiring freeze in place across our affiliates. In addition, the business is looking to develop distribution relationships and products that will enable it to participate effectively in the market recovery. We are committed to improving the profitability of this business and will take action where necessary. For example, last week we announced the decision to close one of the affiliates, Clay Finlay. That business has been loss making for the last three years; we've had several attempts to turn it round and re-invigorate it, and now, quite frankly, we are not prepared to continue with the level of losses that it is incurring.

Now, to conclude briefly on net client cash flows and funds under management. Net client cash flows were negative for the quarter, mainly due to the R22 billion withdrawal of funds by the PIC, which we flagged in our March announcement, as well as outflows in our US investment boutiques. Net client cash flow in Europe remained positive, a pleasing result in difficult markets. In OMSA, excluding the PIC withdrawal, net client cash flows continued to improve on 2008, although remained marginally negative. Total funds under management were down just 6% from the same time last year. A good result, given that over the period markets have lost around a third of their value.

So, in summary, I don't need to tell you, it's a tough environment but we have enhanced our capital position, we have suffered no defaults in the year to date. Sales in OMSA and Nordic remain strong, although depressed markets dampened performance in other areas, including the UK and the US. We have closed Bermuda to new business and have continued to improve hedge effectiveness. We are continuing to concentrate on running our business well; we are becoming more focused, leaner and more efficient, and are positioning ourselves for a return to growth when markets recover. I'm happy to hand over to questions.

Operator

Thank you sir. The question and answer session will be conducted electronically. To ask a question, please press *1 on your telephone keypad at this time, and we will take as many questions as time permits and proceed in the order you signal us. A voice prompt on your phone line will indicate when your line is open to ask a question. Please state your name before posing your question. Once again, please press *1 if you wish to ask a question, and we will now take our first question. Please go ahead.

Jon Hocking, Morgan Stanley

Good morning everyone, it's Jon Hocking from Morgan Stanley. I've got a few questions on the US if I may. Firstly on the unrealised loss position, I think looking at the US life companies which have reported in the last few weeks, most of them have actually seen fairly stable unrealised losses for the first quarter on fourth quarter, and although you've seen a little bit of improvement in April, there's been an increase in your unrealised losses. I wonder if you could give us some colour please in terms of where those unrealised losses have moved out across the portfolio, is it the BBB portfolio, is it the hybrid portfolio, is it from some of the structured credit? Secondly still on the US, in terms of rating migration, again the US Life companies have generally seen some rating migration in the first quarter, if you can comment on the portfolio that you've got in the States? Then finally, can you give us an update please on the RBC position at the end of the first quarter?

Philip Broadley

Morning Jon, it's Philip. The movement in the quarter has come mainly from the corporate bonds and from the prefs. The collateralised mortgage obligations, both commercial and residential hardly moved at all in the quarter, so that's where it's come from. Some ratings migration, not significant and as a result of which overall, although we are not disclosing an RBC figure at the quarter, it's not significantly different from where it was at the end of the year.

Jon Hocking, Morgan Stanley

Ok, excellent. Thank you.

Operator

Thank you. We will now take our next question. Please go ahead.

Blair Stewart, Bank of America Merrill Lynch

Thank you, good morning, it's Blair Stewart from Bank of America Merrill Lynch. Two questions, one following on from Jon who I consistently fail to beat to the first question, so well done again Jon. Just following on from Jon's question, given the increase in the unrealised losses, up about 20% and given what you have seen in the portfolio, have you revised in any way your expectations of the ultimate losses or impairments that will come through on that book? The second question is more operational in the US; you talk about a $650 million target which I assume roughly translates to about $65 million of APE. You've done almost half of that in Q1 so are you suggesting that there's going to be a slowdown through the year? As a follow on to that, just how quickly have you managed to get costs out – obviously a big reduction in the new business writing appetite in capacity, just how much costs, if you can quantify it in some way, have you managed to take out of the US business? Thank you.

Philip Broadley

In terms of the ultimate view, I don't think our assessment has particularly changed, as you'll note from the Release, we have done an impairment exercise again at the end of the first quarter and the gross impairments were just over $40 million, so the portfolio continues to perform. We have seen debt serviced, we've also seen some maturities at par. So, the ultimate performance of the portfolio clearly does depend on market wide developments in the US, of which at least one is a fairly important announcement at noon today. So far as the sales are concerned, we've set, as you say, a target, that does not necessarily mean that we will stick rigidly to that target, and slow sales in the second half of the year, if we've reached it, it will depend on market conditions, and I think it's worth commenting on that, that there is a scarcity of capital across the US sector, a lot of carriers, a lot of companies have cut the amount of capacity that they are putting into the market, so there continue to be opportunities to write new business at profitable levels. We ourselves have significantly reduced commission on products that we are writing. Cost base has significantly reduced, bear in mind that much of our processing is outsourced, so that is on a variable cost basis in any case, and, so far as the fixed costs of our structure are concerned, we have completed a number of rounds of reduction in headcount as the business has been reduced. As mentioned in the Release, we have closed the Atlanta office, we've significantly reduced our sales and marketing staffing to reflect the new levels of business and so the cost level, I think, has at least halved, and we'll update you more on the run rate at the half year.

Blair Stewart, Bank of America Merrill Lynch

Just coming back on the $650 million Philip, is that a number that was calculated based on the amount of capital you are prepared to allocate to the US, or is it something different?

Philip Broadley

No, it is largely a capital based decision and it's around the view that we do expect the new business to effectively be self-sustaining, and therefore the capital allocated has been reduced on that basis.

Blair Stewart, Bank of America Merrill Lynch

Great. Thanks very much.

Operator

Thank you. We now move to our next question. Please go ahead.

Francois du Toit, JP Morgan

Hello it's Francois du Toit from JP Morgan. Just a quick further question on the impairments, on the bond losses that have gone up from $2.6 to $3 billion, and yet we've seen impairments reduce significantly from the fourth quarter. Fourth quarter impairments is $250 million and it's down to below $50 million in the first quarter. Has there been any changes in your internal or otherwise rules for recognising impairments and what sort of level do you expect going forward, and also does pretty much any impairment have to be met by capital injections into the years, obviously offset by surplus generation, operational surplus generation. Then if you can give us some guidance in respect of the US asset management earnings for 2009 and give us an idea of how much the losses in Clay Finlay was say in the second half of last year? Is the second half of last year's run rate a reasonable projection for 2009 in terms of earnings? Also if you could give us an idea of the FGD surplus level at the 30th April given the strong rand during April, we expect it to be quite a bit stronger. Can you confirm that?

Philip Broadley

Let me take the capital questions. I'm sure Julian will comment on the US asset management. There was no change in the basis under which we calculate impairments. Our methodology for the first quarter is the same at the end of the year. We look at all securities that are trading at less than 80% of book value for more than six months and review them for evidence of impairment. I'm afraid I'm not going to give you a forecast for full year impairment levels, as I've said in response to Blair's question, there's so much of it, so much of the outcome will depend on economic events across the US as a whole. Third, in terms of impact on capital, the RBC ratio is calculated on a statutory basis, so it is actual default and impairments would be a deduction from capital, earnings in the quarter are obviously additive to capital, and so, as said earlier, there is no material change to capital position at the end of the quarter. Sorry, I've forgotten the last of your – oh, the FGD, yes. You are correct that the FGD position will have continued to improve over the quarter of April, and an approximate estimate at the end of April would be that at that point it would have been above £1 million.

Francois du Toit, JP Morgan

The US asset management guidance as well.

Julian Roberts

If I can just comment on that. The anticipated losses for Clay Finlay are high single digits of millions of dollars. There will be a cost to closure, which broadly therefore will be in similar amounts to the losses that we would expect. I'm not giving any guidance I'm afraid on the profitability that you could expect this year. I think you know the proportion of the performance fees that we had at the end of the year and with the markets being low, certainly that amount is not going to go up and it's very much linked into the level of assets under management. So, that's really the guidance I would give.

Francois du Toit, JP Morgan

Thank you.

Operator

Thank you. We'll now move to our next question. Please go ahead.

Raghu Hariharan, FPK

Hi there, morning gents, this is Raghu Hariharan from Fox-Pitt Kelton. I have three questions, if I may please. The first one is to just follow up on the unrealised losses. I am still struggling to understand the deterioration quarter over quarter. If you look at bond spreads in the US, corporate bond spreads, they've actually narrowed, between 40 to 60 bps on investment grade and have actually narrowed 100 bps on BBB, and about 40% of your corporate bond portfolio higher is BBB. So, I'm just struggling to understand why do you see an acceleration of unrealised losses? That's question one. The second one in the US is in February I guess you mentioned that you transferred capital to the US in February of $225 million. I was wondering if there were any other capital transfers that you had to make to the US in terms of your RBC ratio. The third question was on lapses in the US. Obviously you had one-off events last year, I was wondering, given the impact of the actions you're taking in the US where you are repositioning your business, can you give us a sense of how lapses are behaving and what actions are you taking to ensure that you don't have to take the unrealised losses on your bonds

Philip Broadley

I'm not sure how much more I can help you with the unrealised loss position. It is a case of working through the portfolio, bond by bond as we have done, and I think at high level rationalisations perhaps aren't as effective. As I said, most of the movement in the unrealised loss position came from our holdings in financial bonds and in preference shares. And, so far as the collateralised mortgage obligations are concerned, they hardly moved. So, I'm not sure I can help more than that. As I say, it's a case of looking through the portfolio line by line as we do. For your second question, there have been no further capital transfers to the US in the quarter. And as far as lapses are concerned, and I think there are a number of trends in the US, you referred to obviously the change in our business, the reduction in sales. We retain links with all of our key distributors who are continuing to sell our new business. As we mentioned in the Release, we are continuing to hold significant levels of cash in our portfolio, which enables us to fund surrenders, whether they are at maturity or before that. One should bear in mind that over the coming months, the level of surrenders that we see will be affected by, amongst other things, levels of unemployment in the US, customers with annuities, whether written by us or others, may have the need to surrender those policies to provide cash if they are made unemployed. So we continue to watch lapses very closely and we continue to actively monitor them and we have initiatives in place to conserve our business, including direct customer contact with customers seeking to surrender, to make sure they fully understand the consequences of the actions they are taking, the penalties they incur and so on.

Julian Roberts

I think we went through in the past, at the year end, the surrender penalties that people have got. So as Philip says I think we are anticipating that with the higher level of redundancies that we think will come through in the US, that if people are short of money then we may see an increase in lapses. That is why we have built up and we continue to build up the amount of cash in the portfolio, so as you know, we therefore make it more remote that we have to trigger any short term unrealised losses on the bond portfolio.

Raghu Hariharan, FPK

Thanks. Just on the unrealised losses if I may, I know this is irritating but should we think of…if the portfolio are fully diversified enough, is that because of concentration risk effects that you've seen such a skew?

Philip Broadley

I don't think the portfolio is particularly concentrated actually. Again we provided the breakdown at the end of the year. I think there are only 10 holdings that are more than $100 million in terms of exposure to single issuers. As I said with a significant part of the unrealised loss movement coming from the preference shares and hybrids and so on, there is perhaps a concentration in that element of the portfolio which is giving rise to the unrealised movement. But, as we also say in the release, we haven't significantly felt that we should significantly change the portfolio with sales in the quarter.

Raghu Hariharan, FPK

Ok, thank you very much for your answers.

Operator

Thank you. We now move to our next question. Please go ahead.

Mike Christelis, UBS

It's Mike Christelis here from UBS. Just a couple of questions if I may. Following on briefly on what Raghu just asked. In terms of the portfolio, I'm actually thinking more a little bit longer out. If you are in a position where you are using cash that's coming in to pay out lapses and surrenders, that's all good and well, but what impact does that have on the duration matching of the portfolio? Are you in a position where you are struggling to manage that portfolio's duration because you are not able to sell portfolios that are perhaps below what you bought them at? Can you just give some comment on that. Then, are you still planning to be cash neutral in 2009 in the US business in terms of capital? That's the next question: Is there any strategy to wind down the Bermudan book, what I mean by that, are you looking to offer another accelerated guarantee option to policyholders? Then if I can do one more, getting off the US and looking at South Africa. I'm a little bit disappointed at the level of individual life sales given the trouble we had last year in terms of the power crisis, in terms of public holidays in March with Easter etc. I was expecting a pick up in sales actually quarter over quarter because of those factors. Now are you concerned given the publicity around Old Mutual in the last six months or the last year that sales are going to deteriorate in South Africa as a result of that? Is there some sort of client confidence issue there in South Africa at all?

Julian Roberts

Ok, Philip, do you want to pick up the first two and then I'll deal with Bermuda and South Africa.

Philip Broadley

Yes. So far as the duration is concerned, it has not changed significantly. Clearly that is one of the many factors that we need to look at in constructing the portfolio, but it's not an area of concern to us at the moment. Secondly our plans in terms of cash flow for the US business, really as I said in a response earlier, we are not setting out to predict or forecast the level of impairments that might be incurred in the year. We do wish to maintain the capital ratio of the US business, so…

Mike Christelis, UBS

What do you mean by no further impairments in a normal world, for example?

Philip Broadley

Well, I think one would always expect some level of impairments, but equally, as I said, we expect the new business to provide addition to statutory capital. So the level of capital support that we need to provide will depend on the level of impairments at the end of the year and that's not a number I can forecast.

Julian Roberts

The question coming on to Bermuda. We haven't ruled out the fact that we might make another offer. There are no plans to do so, so the major thing that we have just done is to restrict the number of funds that people can invest in. So, that means that if they want to transfer out of the current funds that they are in, there are now a significantly reduced number that they can come into. Again, that means that the hedge effectiveness works much better for us. As time goes on, if we think it is the right thing to do to make another offer, we will do so but, as I say, there are no current plans.

If you come back to South Africa and the question of individual sales, there is no doubt that our competitors have been playing up, if you like, the adverse publicity that the Group has had, we don't think that that has had a significant impact. I think the major impact that we see is a lot of money is going into money market funds and a lot of money is being kept in the banks and is not going into the equity market. That is a challenge for our business and we see that continuing. I think the other thing I would add is if you look at our EB smoothed funds and the level of bonuses in there, it is quite tough on that type of business, not just for us, for our competitors where the level of surplus in these funds are narrowing down. So, what we have done is we've launched a new bonus series for absolute growth portfolios. No other change in any of the products as funding levels for the other products are ok. But we are hoping that that may be more marketable to bring out a new bonus series which we have done.

Mike Christelis, UBS

Great, thanks guys, I appreciate the answers.

Operator

Thank you. We now move to our next question. Please go ahead.

James Pearce, Cazenove

Good morning everybody, it's James Pearce at Cazenove. You say in the statement that strengthening the capital position is the key priority, what do you have in mind by that? Is that about earnings retention, is it about capital raising, is it about disposals or what please?

Julian Roberts

Well I think the first thing, which is quite clear, is I've been quite transparent that I would like to have our capital at the higher end of our target range, so we'd like to be in a billion plus. We get to that sort of level, all things being equal, by the fact of the decision the board has made not to pay a dividend. So we believe that through the action we are taking by not paying a dividend, we build the capital level up to what we want. It is quite clear as well that, as we tidy up the portfolio for non-core assets, we should also get a boost to our overall capital position. There are no plans for any external raising, as I said we don't feel we need to do it, but naturally all options are kept open.

James Pearce, Cazenove

Thank you very much

Operator

Thank you. We now move to our next question. Please go ahead.

Larissa van Deventer, Deutsche Bank

Hi, this is Larissa from Deutsche Bank in Johannesburg. Two quick questions please. The first, just a quick one on the US bond portfolio whether the industry holdings and the different classifications between the types, AAA, A, BBB have changed since year end substantially? The second question, if you can please comment on your operating profit guidance for the year.

Philip Broadley

Let me deal with the first one. As we say in the release, no major asset purchases or sales have occurred since the end of the year, so from that you can take it that the mix between the various assets classes hasn't moved significantly. You'll notice that the IMS does not have either an outlook statement or a forecast of earnings.

Larissa van Deventer, Deutsche Bank

Can you elaborate on that or not at this time?

Julian Roberts

I think the issue you can deduce is we are in line in the range with analyst consensus and therefore, there is no need for us to make on a trading up date any comments on profit.

Larissa van Deventer, Deutsche Bank

Fair enough, thank you kindly.

Operator

Thank you. We are now moving to our next question.

Greig Patterson, KBW

It's Greig here. Two questions. One is a bit of a multiple one. I would like to get a number for your current holding company cash, your undrawn credit facilities and how much sub-debts you can issue within the rating agencies' tolerances, so I have a clear idea of what is the holding company's current liquidity position. The second one is you've had a whole series of downgrades in the US from the rating agencies. Can I expect further ones in the short term and if you do is it going to hurt your distribution relationships and impair sales or cause a spike in surrenders? So those are the questions, thanks.

Philip Broadley

First Greig, to you question on cash, I'm not going to add to the comment in the release that our cash and facilities haven't changed materially since the end of the year.

Greig Patterson, KBW

Just one thing – how do we determine then if we are trying to see if there is an issue in the US if the holding company can tolerate it, how do we determine that?

Philip Broadley

Well, we told you what the position was at the end of the year and it hasn't changed significantly.

Greig Patterson, KBW

Could you just remind me what that was?

Philip Broadley

We said that we had about £600 million of facilities available to the holding company in cash and undrawn facilities at the end of the year.

Greig Patterson, KBW

Excellent, thank you.

Philip Broadley

As far as sub-debt capacity is concerned, that's never a subject I'd speculate on and as Julian has already said we have no current plans to raise capital. Rating agency actions are a matter for them. You'll have seen that we are on stable outlook from some, so that also gives you an indication of the timescales under which they would normally operate. So far as our position in the US is concerned I referred earlier to the fact that the industry has changed considerably in the US. There is a reduction in capacity to write business for many companies and similarly the ratings situation has changed, there have been multiple downgrades across the sector. So our relative position in the US remains very much as it was. We have a lower rating but so too do our competitors. The fact that we have capacity available means that we have been able to sustain our relationships with our key distributors who do follow something of an 80:20 rule, about 80% of our sales come from our top 10 distributors.

Greig Patterson, KBW

Just on that, if you look at some of the fixed annuity players are AA minuses and I think you're on a BB plus on one and an unrated on S&P, that's significantly lower – is it just you are not competing with them in that space or…?

Philip Broadley

We've never had an S&P rating.

Greig Patterson, KBW

Oh you lost your S&P rating?

Philip Broadley

S&P is not significant in US retailers as I am sure you know that Best is that which is used by most distributors. As I say if you look at our relative position, it hasn't changed as all the key competitors in the fixed index annuity space which is where you'll see most of our business is being written, that relative position has been maintained.

Greig Patterson, KBW

Alright, thank you.

Operator

Thank you. We'll now move to our next question. Please go ahead.

Risto Ketola, Ketola Research

Hi it's Risto here, most of my questions have been asked. A couple of easy ones here; the Fortis saga, I lost patience with that. The China acquisition, is there any update on that?

Julian Roberts

No, nothing more to say, it's still in discussions with the regulator in China. Nothing more to add.

Risto Ketola, Ketola Research

Then also I missed the start of the call. Has there actually been any capital transfers into the US onshore business in the first quarter?

Philip Broadley

As we said in March, we will put capital in during the quarter to maintain the 300% ratio at the end of the year. We've put no capital in since then.

Risto Ketola, Ketola Research

What was the March capital amount announced?

Philip Broadley

It was just over $200 million.

Risto Ketola, Ketola Research

Now, I find that pretty curious. You have quite a bit of excess capital in Bermuda. Is there any way of deploying that into the onshore business?

Julian Roberts

Our capital in the position, we move it around the Group where necessary so it's not a case of where the pockets are. The fact is we haven't, apart from the amount we announced at the year end that we put in in the first quarter, we haven't had the necessity to put anything into the US business.

Risto Ketola, Ketola Research

Ok. A last very quick one is, you mention that the some of the annuity products you are selling now are capital neutral on a statutory accounting basis. Now if that is the case, why limit sales? Why not sell as much as you can of that product?

Philip Broadley

I don't think I said they were capital neutral so if I gave that impression I apologise. They do have a capital requirement, but we get a release from capital as other policies mature, so the business as a whole is intended to be capital neutral. Perhaps I didn't elaborate on that clearly enough.

Risto Ketola, Ketola Research

Ok. I know, that's the reason I asked because it sounded a bit too good to be true.

Philip Broadley

That would be, I think, a little bit like alchemy or inventing perpetual motion. Annuity products in the US do have a capital loading.

Risto Ketola, Ketola Research

Alright, excellent. Thanks.

Operator

Thank you, and we now move to our next question. Please go ahead.

Davy Corubolo, Avoir Research

Good morning everyone, this is Davy from Avoir Research. My question relates to a point that you make in your highlights. You say that your cash holdings in the US Life Asset portfolio has increased, you mention that's about 7% of your holdings. I'm trying to reconcile that with the position at the end of December '08. The statutory returns show that 11% of a portfolio was in cash and short dated securities, and at the same time there haven't been any major asset purchases or sales since the end of the year. I wonder if you can help me reconcile that please?

Philip Broadley

I don't have the statutory returns with me but I think it's simply a case of the difference between pure cash if you will, cash at the bank and a figure including cash and short dated.

Davy Corubolo, Avoir Research

When you say short dated, do you mean less than one year or shorter than that?

Philip Broadley

I'm sorry, you defeated me as to what the exact date is. I think it's less than one year. My recollection is that it's a shorter period than that but we will have to confirm that to you.

Davy Corubolo, Avoir Research

Right, ok. Thank you.

Operator

Thanks. We now move to our next question. Please go ahead.

Blair Stewart, Bank of America Merrill Lynch

Hi, it's Blair Stewart just following up. You commented about the level of cash that's being held in the US onshore business to guard against surrenders and lapses. I just wondered, given the nature of that business, what limitations there are on you in holding cash from a matching and a competitive standpoint in terms of structuring the product? Could you just remind us how much cash you do have, what proportion of the roughly $15 billion of assets is held in cash please?

Philip Broadley

Well, it's 7% of $15 billion, which I shall embarrass myself by getting wrong.

Blair Stewart, Bank of America Merrill Lynch

That's fine, I can work that out, thanks.

Philip Broadley

In terms of restrictions, I think, fundamentally our requirement to policyholders, is to provide a minimum crediting rate, and in the case of a fixed index annuity, to provide the specified sharing of equity market returns. From a shareholder perspective, our target is to earn a return of about 12% and, you can construct a trading P&L backwards from there, to say what basis points of spread do you have to earn from your investments to cover the crediting rate, to cover the purchase of the equity derivative, and to cover expenses, and from there you get to a level of investment income that you need to earn, that clearly does require you to have a mix of risk bearing assets as well as cash. So, we are targeting to build up the portfolio, up to something more like 10%, and that coupled then with the yield that we are earning on the securities will be sufficient, both to meet our obligations to the back book of business and to earn our target return on our new business.

Blair Stewart, Bank of America Merrill Lynch

That's very clear, thanks.

Operator

Thank you. We now move to our next question. Please go ahead.

James Pearce, Cazenove

Hi again, it's James Pearce at Cazenove, a couple more. First of all, your solvency improved over the quarter but you say that your cash position hasn't changed since the year end. Could you explain why not? And, second, you seem to be hedging pretty much everything that moves, whether it's the guarantees in Bermuda or the JSE or the dollar rate, but you've left open risk on rand, sterling and I think the krona. Do you intend to hedge those or do you just feel lucky on those particular variables?

Philip Broadley

No, we don't feel lucky. It's a reflection of what can be done cost effectively and those two currency pairings don't have the same ability to hedge efficiently. So far as our cash position is concerned, the capital has grown on a pro-forma basis as a result of accrued profits, those are in a variety of subsidiaries around the Group. They have not been paid up to the centre on a quarterly basis and therefore the capital is generated but the cash flow to the centre lags the profit generation.

James Pearce, Cazenove

So it's a top company cash position that you are talking about, rather than group position?

Philip Broadley

Yes

James Pearce, Cazenove

Ok, thank you very much.

Operator

Thank you, we will now move to our next question. Please go ahead.

Oliver Steel, Deutsche Bank

Morning, it's Oliver Steel from Deutsche Bank. Just to follow on Risto's question. You do actually say in the statement that fixed term immediate annuities in the States will be targeted for growth due to the contribution to capital in the year of sale. Could you just explain that and try to give us what effect that that's had in the US in the quarter.

Philip Broadley

Yes. If I can quickly turn to…I'm pausing if only to return to the schedule to remind myself of the mix of sales. We have sold about $2 million of that product APE in the quarter, it will be part of the mix going forward. The major part of the product sales in the US we still expect to be the fixed index annuity.

Oliver Steel, Deutsche Bank

Ok, so it's tiny?

Philip Broadley

Yes

Oliver Steel, Deutsche Bank

Thank you.

Operator

Thanks, we will now move to our next question. Please go ahead.

Greig Patterson, KBW

Greig Patterson here again. The US, what percentage of the book have guaranteed surrender rates, in other words where you can't apply MVAs to it, of the fixed index annuity book?

Philip Broadley

I'm afraid I don't have that percentage to hand Greig.

Greig Patterson, KBW

I would guess that even though you are monitoring sales that it's a significant percentage, because it's obviously a risk?

Philip Broadley

Yes. The exact proportions of surrender penalties and guarantees and so on I don't have with me.

Greig Patterson, KBW

The reason I was asking the question, if you look at your main competitor in the space, Amerus or Aviva US, they have managed to apply MVAs to most of their book so I was just wondering if that's not the case in your example.

Philip Broadley

Most of our products have surrender charges and in the early years the surrender charge…

Greig Patterson, KBW

For commission, right, that's fine, thank you very much.

Operator

Thanks. We move to our next question now. Please go ahead.

Raghu Hariharan, FPK

Hi. Raghu Hariharan from Fox-Pitt Kelton. Just two more questions if I can. I was just wondering, can you help us with any reclassification to IAS39 or is it at the same level as at year end which is $972 million I believe. The second one is just a clarification, in your IGD capital what level of excess do you carry on from the US? Do you take it at 100% minimum or do you take it at single A rating which is 300%?

Philip Broadley

The first question, reclassification hasn't changed significantly since the end of the year. As I said earlier the methodology hasn't changed so that those numbers haven't. Our target surplus, again, I'm sorry, I wasn't perhaps expecting quite so many questions on the US position so I'm afraid I don't have that number to hand and I'd hate to quote it on the call and get it wrong. So we will have to come back to you on that.

Raghu Hariharan, FPK

Ok, thank you.

Julian Roberts

I've got an AGM that's coming up fairly soon, so could we make this next question the last one please operator.

Operator

Thank you sir. So we will now move to our last question today. Please go ahead.

Francois du Toit, JP Morgan

It's Francois again. Just some clarity on the US bonds, yet another question on that. It's clear that market values reduced by about $0.4 billion but can you give an idea of how much spreads on your portfolio relative to risk free assets improved by? It was 690 bps at year end. Then second question, clearly you cannot hedge your rand exposure due to South African exchange rate controls because you'd have to short the rand, but can you borrow more in South Africa and repay some of your overseas obligations that way?

Philip Broadley

On the first question, again I'm afraid I can't provide that number, I will only say in my defence that I think we've answered a lot more questions on our US Life portfolio than a number of our competitors chose to do, so please forgive me on that. On the second question about raising debt in South Africa, presumably if we were to do so, I'm looking at Julian, it would be subject to exchange control.

Julian Roberts

It is, and we have limited flexibility unfortunately the way that the rating agencies look at the interest cover of costs in South Africa. Also there has been and I would need to refresh my mind, there used to be some issues on our overall banking arrangements for the proportion of debt that we could raise in South Africa. So it is quite hard for us to do.

Francois du Toit, JP Morgan

But surely given that almost all of your free cash gets generated in South Africa, the rating agencies should look very positively at such a restructure, at least at plc level.

Julian Roberts

I think you would understand that if we were able to have done that in the past we would naturally to reduce the currency exposure have done it. I have to say I'm slightly out of touch with our overall banking covenants that we've got in place, but we have a limited amount of borrowing in South Africa because it's difficult to do. Let me come back and give a more…

Francois du Toit, JP Morgan

But surely, it's even more difficult now overseas?

Julian Roberts

Well at the moment as I say we've got adequate borrowing and adequate facilities that we need with nothing coming up for renewal. So we're not in a position where we require to add more facilities to us, and so it therefore comes down to the overall issue of what we have within our covenant.

Francois du Toit, JP Morgan

Thanks.

Operator

Thank you. As we have no further questions I'd like to hand the call back to you gentlemen for any additional closing remarks.

Julian Roberts

Ok, thanks very much. No surprise to me that we are still very much focused on questions on the US and on our capital position. So, let me summarise. We are making good progress, no defaults in the US Life, we've rationalised, reduced the expenses in the US Life business. Bermuda is in better control than it was before and a small level of impairments. So we are pleased with the progress that we are making in the businesses in the US. If you come back to the overall trading update, sales in South Africa, sales in Nordic continue to be good and I believe our UK sales are certainly very much in line with what we have from our peer group in the UK. So overall the conditions are tough, we expect the conditions to continue to be tough but I think the Group is making good progress on what we are trying to do.

Thanks very much indeed everyone.

Operator

Thank you. That will conclude today's conference call. Thank you for your participation ladies and gentlemen. You may now disconnect.