

**European Embedded Value (EEV)
Analyst Briefing
12 October 2005**

Slide 1 – Cover

Good morning Ladies and Gentlemen.

Last time I was standing here, England had just won the ashes – I am rather less confident about tonight's footballing prospects – even if we have qualified already! But enough of sport, on to the more exciting subject of EEV!

Slide 2 – Basis of Preparation

On the slide are the normal caveats on forward looking statements which you can read at your leisure.

Slide 3 – Agenda

The purpose of this presentation is to communicate the restated

- embedded value
- value of new business; and
- profit of Friends Provident

for the year ended 31 December 2004, under the European Embedded Value approach.

As part of the 29 July seminar we gave a brief overview of the EEV methodology we are adopting, and guidance on the results. The numbers we are announcing today are consistent with that guidance, although the increase in the value of new business is more than the 10% we indicated.

After my introduction, my colleague, Greg Norton, will talk you through the results in more detail. I will then pick up the commercial implications for Friends Provident – what the results mean for the way we run our business.

To help me at least, with those curve ball questions you have no doubt prepared, sitting in the front row are Brian Harrison and Jon Paykel, who managed our EEV project.

So what does EEV mean for Friends Provident?

Slide 4 – What EEV means for Friends Provident

The key difference between EV and EEV is how risk is treated.

We believe that the “bottom up” market-consistent methodology we have adopted is both robust and meaningful, providing an objective and transparent approach to the allowance for risk.

Greg will explain in detail what a market consistent approach to EEV means. But let me summarise it:

- We use an appropriate discount rate for every individual cash flow.

- That discount rate is consistent with the market's view of the investment risk in the cash flow.
- Thus if the only risk in a cash flow over, say a month, is the investment return we expect to make on the reserves, then we discount it back at the same rate as we accumulate it, i.e. with no effect.
- I.e. for an equity based cash flow £100 of equity is worth £100! This was not the case under the old EV methodology.

This has a consequence for low risk new business like unit linked – the implied discount rate is much lower – lower than say, our WACC. But this lower discount rate is totally appropriate for the risks faced in that line of business.

Perhaps the key conclusion from adopting this methodology is that it matches the way we have been managing our business for sometime, for example through hedging of the With Profits Fund risks, but now we are aligning the reported embedded value with the internal management of the business. This forms another important part in our risk management processes.

We continue to believe the embedded value profits provide a more representative reflection of the performance of long-term business than IFRS, reflecting fully the shareholders' interest in the in-force portfolio.

So what does adopting EEV mean for our key financial indicators?

Slide 5 – Key Financial Indicators

The contribution to profits from new business increases substantially by 26%, reflecting the relatively low investment risk in the new business we are writing.

The embedded value falls slightly, principally due to allowing fully for the cost of options and guarantees in the With Profits Fund.

Underlying profits increase by 16% to £398m in large part due to the fruits of our risk management approach, reflected both in:

- the increase in the value of new business; and
- through the experience variance line, because of the impact of the hedging activity during 2004.

There are also increases due to the changed economic assumptions and higher expected returns – arising from higher implied risk discount rate and investment risk premiums.

Slides 30 and 31 in the appendix give full details of the Life & Pensions profit changes.

As always I've kept the easy bits, for the rocket scientists in the audience, Greg will now talk you through the changes in methodology and impact on results in more detail.

Slide 6 – Details of EEV methodology

Thank you Philip

I have the hard part of taking you through some of the detail of EEV which involves some fairly complex financial economics. What I will do though is try and keep the

technical jargon to a minimum. As Philip said, we are available to take questions at the end of this presentation and during lunch.

As you know, there are 12 Principles underpinning the EEV methodology. Like most companies the key area of development for Friends Provident has been in the allowance for risk and it is on this aspect of the methodology that I will spend most of my time. In particular I will cover:

- The market-consistent approach to the allowance for risks
- How we determine EEV and the implication this has for derived risk discount rates
- Our approach in allowing for options and guarantees
- Our approach to determining required capital and the cost associated with holding that capital
- And finally how we have allowed for non-market risks in the market-consistent EEV

I will then pick up on other methodology changes, show the impact on Lombard and talk briefly on disclosures.

Slide 7 – A robust methodology

We have worked closely with our advisors Tillinghast and have undertaken a detailed review of our methodology and have developed a **market-consistent** approach to allow for risk. KPMG have also audited our EEV results.

The methods and models are not new.

For example, the market-consistent approach underlies the realistic balance sheet of the With Profits Fund. The end 2004 realistic balance sheet was audited and published. We have derived our EEV results for this WP business from the same model, focusing instead on shareholder value as opposed to demonstrating the capital adequacy of the fund.

So how have we allowed for risk?

Slide 8 – Allowance for Risks

It is Principle 3 that requires us to allow for the aggregate risks in the covered business.

We stated in our presentation on 29 July that there are three areas in which we have addressed the allowance for risk:

- In the risk discount rate;
- In the cost of options and guarantees; and
- In the cost of required capital that is held to cover all risks

For each of these areas, we have chosen the **market-consistent** approach to allow for risk. We have also allowed appropriately for non-market risks.

I will come back to each of these in turn in more detail and will describe how we have allowed for non-market risk in a market-consistent world. Before I do though I would like to talk a little more about the mechanics of the market-consistent approach.

Slide 9 – What is Market-Consistent Embedded Value

The market-consistent embedded value is the market value of assets less market-consistent value of liabilities less cost of required capital. That is to say that assets and liabilities are valued in line with market prices and are consistent with each other. In principle, each cash flow is valued using the risk discount rate consistent with that applied to such a cash flow in the capital markets.

For example, an equity cash flow is valued using an equity risk discount rate, and a bond cash flow is valued using a bond risk discount rate. So if we assume a higher return for equities, we discount the equity cash flow at this higher return.

In practice of course, we do not use cash flow specific discount rates. For business which does not contain financial options or guarantees we apply a short cut method known as the certainty equivalent approach where we assume all assets earn the risk free rate and discount all cash flows using the risk free rate.

For business with financial options and guarantees shareholder cash flows can be highly asymmetric as markets move. We value these by calibrating stochastic investment scenarios to replicate the market prices of equivalent traded options.

Finally, we have made a robust allowance for non-market risk, by ensuring we have an appropriate choice of best estimate assumptions where the impact on shareholder value of fluctuations in experience is symmetric and by making adjustments where the impact is asymmetric. We will come back later to discuss the details of how we have done this.

Slide 10 – Economic assumptions as at 31 December 2004

This slide sets out the key economic assumptions, used to calculate the EEV and the derived average EEV risk discount rates, and compares them with the basis used for Achieved Profits reporting.

Risk-free rates are based on gilts – 4.6% at end 2004 for most durations. However, we do allow for the shape of the yield curve where this impacts value significantly; for example, annuity and with profits business.

We have reviewed our equity and property risk premiums and have changed them as above to reflect our current view of expected returns on these asset categories. The revised assumptions are in line with other UK companies and, as such, aid comparison.

Under the market-consistent approach, these assumption changes do not affect the reported EEV since assets are assumed to earn a risk-free rate and cash flows are discounted at the same risk-free rate. These assumptions only affect the derived EEV risk discount rates.

We have already calculated what the correct EEV amount is. What we then do is project forward cash flows under the traditional approach, making allowance for expected investment returns, and calculate the risk discount rate which discounts these cash flows to this EEV amount.

We have derived average risk discount rates – they vary by product line, by in force and new business and vary over time.

Slide 11 – Derived Risk Discount Rates by Product Type – EEV

This table shows the benefit of the bottom up approach. Unlike the top down approach, it provides average risk discount rates varying by product type (reflecting different risk profiles), for in-force and new business (reflecting differing product mixes) and for UK and International business. I will come back to the top down approach in a moment.

In aggregate, the average RDR applying to the in force business is 8.0%, higher than the Achieved Profits discount rate of 7.1%. This is mainly due to the explicit allowance for market risks within each of the product types, the cost of options and the additional allowance for non-market risk. I will come back to the details of these adjustments in a later slide.

The table highlights that with-profits and annuity business are subject to much more investment risk than the remaining business, and so the appropriate risk discount rates are higher.

With profits business is also riskier because of the potential cost in adverse scenarios of meeting options and guarantees. We will come back to this.

Annuity business is riskier as a result of the gearing effect arising from the credit spreads on corporate bonds backing the annuity business. We have provided further information on this in the Appendix. For annuitant mortality, we have used our best estimate assumptions. The uncertainty (volatility) surrounding this risk is reflected in the burn-through cost in the With Profits Fund and through the cost of holding economic capital in respect of this business. I will talk more about this in later slides.

Of course, as long as investment markets perform at or above expectations in future, what we will see is that these products with higher risk discount rates will achieve greater returns going forwards. What we are doing is recognising these higher returns as we achieve them, and not before.

The remaining business classified as “Other UK” in this table consists of a mixture of unit-linked and protection business.

Slide 12 – New Business by APE 2004

Let me just remind you of the new business product segments we are in.

Our new business strategy for some time has been to focus on protection and unit-linked business where the investment risks are lower and priced appropriately.

Slide 13 – Derived Risk Discount Rates by Product Type – New Business

Here we can see the impact of our new business strategy, an average risk discount rate for new business of 6.6%.

This is lower than the average risk discount rate for our in-force business, which was 8.0%. The market-consistent approach that recognises the high investment risks in the in-force business, from annuities and with profits, also recognises the low investment risks of our unit linked and protection new business.

Our International business as at 31 December 2004 is primarily unit-linked business producing similar derived RDRs to the UK.

Slide 14 – Top down vs. bottom up approaches

In our discussion on RDRs we referred to the alternative top-down Weighted Average Cost of Capital (WACC) approach to allowing for risk. The average bottom-up risk discount rates, of 8.0% for the value of in-force and 6.6% for the value of new business, can be compared with the WACC that could be derived from market data for the Group as a whole.

There are a variety of assumptions that need to be made for the WACC formula. Of particular difficulty is the choice of beta. At 31 December 2004, a variety of betas can be accessed from Bloomberg, depending on the length of measurement period, whether this is in weeks or months, and whether the beta is adjusted or unadjusted. We show here the range of derived betas being roughly from 1-2. Our beta over recent years has reduced to closer to 1 averaged over 1-year time period.

Using the 3% equity risk premium and other EEV economic assumptions, we could derive the Group unadjusted WACC to be in the range 6.7% to 8.9%. And our average derived risk discount rate of 8.0% lies well within this range. This applies at the Group level and we would need to make a number of adjustments to get a rate appropriate for the covered business included within our EEV calculations. These would be fairly subjective and would include allowing for asset management business, franchise value, free surplus, and any adjustment for non-market risks.

In summary we prefer the bottom up market-consistent approach to the top-down WACC approach because the bottom-up approach:

- provides more granular information about risk by product type
- is better aligned to the way we manage and price our business e.g. market risks are priced objectively from market data;
- does not require subjective judgments about betas and elements of the business which are not included in the covered business

Slide 15 – Financial Options and Guarantees

EEV Principle 7 requires you to allow for the impact of options and guarantees.

The key financial options and guarantees for Friends Provident arise from GAOs and the mismatch between the fixed guaranteed amounts on WP business and the backing assets, much of which are equity-type assets. The time value of the cost **to shareholders** of these options and guarantees or 'burn-through' cost reflects the fact that, while only gaining a small share of the upside in a with-profits fund via 1/9th of the full cost of bonus, shareholders may be exposed to meeting the full cost of policyholder guarantees if there are insufficient policyholder assets.

Given this asymmetry this cost needs to be modelled stochastically.

We have adopted the market-consistent approach to assess the burn-through cost, i.e. a stochastic model calibrated to market conditions at the valuation date. It is derived from the audited realistic balance sheet model and, as such, provides an objective result and also aligns the way we report the cost with the way we manage the With Profits Fund.

In particular this approach reflects the benefit of the hedging activities we have performed. The impact on the EEV of burn-through cost was £109m at end 2003 and £77m at end 2004. Burn-through reduced over 2004 due largely to further hedging of the market risks.

Importantly, we have also made an explicit allowance for non-market risks in the burn-through cost of the With Profits Fund, as these also have an impact on the burn-through cost. The main non-market risks are longevity, operational and lapses, and we have allowed for these by considering the impact of extreme non-market risk scenarios. The end 2004 cost shown here is split £44m market risk £33m non-market risk.

As Friends Provident no longer writes significant volumes of with profits business there is no material impact on the value of new business from burn-through cost.

Slide 16 – Allowance for Non-Market Risk

I will now talk about how we have allowed for non-market risk in our EEV calculations.

An investor can diversify away the uncertainty around the return on non-market risks such as mortality and expenses, and so the allowance for non-market risk is made through the appropriate choice of best estimate experience assumptions and the impact of non-market risks on the level, and hence the cost, of capital.

However, best estimate assumptions may fail to represent the full impact on shareholder value in areas where the impact of fluctuations in experience is asymmetric i.e. where the impact of downsides in experience have a higher impact on shareholder value than the upsides do. In particular:

1. The Burn-through cost: As described earlier, £33m of the burn-through cost is due to non-market risk. This allows for risks including lapses, operational and annuitant longevity within the With Profits Fund.
2. Operational risk: We have also set up a £50m provision for operational risk in the shareholder funds. We have calculated this by comparing the mean impact of variations in operational risk distributions, as modelled in our economic capital calculations, with the existing allowance for operational risk contained within specific accounting provisions and embedded value projection assumptions. This provision is equivalent to a 0.4% addition to the discount rate for UK business and 0.8% for overseas, recognising the higher operational risks in overseas business.

Slide 17 – Required Capital and Cost of Capital

We have calculated our required capital as the greater of economic capital and regulatory capital.

Regulatory capital requirements include prudent reserves as well as solvency margin. Economic capital is determined from Friends Provident's internal models and sets aside capital to meet adverse fluctuations in experience with a prescribed confidence level consistent with the risk appetite established by the Board.

In aggregate, currently FP's economic capital requirements are approximately £100m in excess of its regulatory capital requirements. At a product level, economic capital is higher for some parts of the business, including With Profits and annuities. For annuities, this is despite Friends Provident having one of the strongest regulatory capital bases in the industry. Economic capital is lower for protection and unit-linked business. In aggregate, for new business, economic capital requirements are lower than regulatory requirements.

Of course, the cost of capital depends on both the level of required capital and the cost per unit capital.

Within the market-consistent approach we have now captured market risks explicitly elsewhere, and here we allow only for the frictional costs of capital. These are the tangible costs of holding capital, and consist of taxation and investment expenses on the locked-in shareholder capital.

We have not allowed for any agency cost adjustment. This represents the potential markdown to value that investors may apply because they do not have direct control over their capital. Any adjustment would be subjective and different investors will have their own views of what, if any, adjustment should be made.

Slide 18 – Allowance for Risks – Impact on EEV 31 December 2004

The results on this slide and thereafter include the impact on both the UK Life & Pensions business and Friends Provident International. They do not include Lombard which I will come back to later.

The increase of £19m as shown allows for the bottom up approach to setting the RDR, together with allowing for the frictional costs of capital.

We have discussed the amounts for the cost of options and non-market risks earlier.

The embedded value reduces by £8m as a result of the cost of holding a higher level of required capital.

As a result of using the market-consistent approach to allow for risk the embedded value reduces by **£116m, or 3.6%**, from the Achieved Profits basis.

Slide 19 – Allowance for Risks – Impact on 2004 NB profit

As a result of using the market-consistent approach to allow for risk the value of new business increases substantially, from the Achieved Profits basis.

The reason why the value of new business goes up so much is that there is much lower investment risk in the new business products. We no longer sell much annuity and with profits business, instead focusing on unit linked and protection business.

These results do allow for the impact of non-market risks; the increased risk discount rate reducing new business profits by £(12)m.

Other than risk, there have been various other changes to the methodology as a result of EEV.

Slide 20 – Other EEV Methodology Decisions

First, the areas where there have been no changes from the Achieved Profits basis:

Covered business

The covered business incorporates the Life & Pensions business defined as long-term business by UK and overseas regulators. This does not include F&C Asset Management.

F&C service fee profits in respect of covered business

In particular, in the Life & Pensions EEV we have not capitalised the profits arising from F&C managing the assets of the covered business, as the arrangement with F&C is on an arm's length basis and a separate business segment of the Group.

Instead, the value of these profits in F&C is brought into the pro-forma embedded value at market value, and the profits arising are brought into the consolidated profit & loss account on an IFRS basis.

Pension scheme

As previously, the net pension scheme position of Friends Provident Pension Scheme is brought into the EEV using the FRS17 / IAS19 basis.

Now for the changes from Achieved Profits and their impact.

Slide 21 – Impact of other methodology decisions – EEV 31 December 2004

Corporate Costs

Under EEV, £6m of the holding company or corporate costs are classified as ongoing corporate costs and are capitalised within Group embedded value, reducing EEV by £48m. This is a change from the Achieved Profits basis, where no corporate costs were capitalised.

Debt deducted from shareholders' net worth at market value

The shareholders' net worth includes allowance for the corporate debt of Friends Provident. This debt has been valued at market value, consistent with the EEV Guidance. This is a change of methodology from the Achieved Profits basis, which valued debt on a UK GAAP/IFRS basis, and reduces EEV by £35m.

Revised new business/renewal definition

EEV provides guidance on what is new business and what is renewal of existing business. We have revised our definition of new business in this context. As a result, for Group Pensions business we no longer anticipate new entrants replacing leavers and treat them instead as new entrants when they arrive. This reduces EEV by £13m and new business value by £3m in 2004 but will increase new business value in the future in the years that the new entrants arrive. The new business definition in all other respects is unchanged.

IFRS

The EEV allows in full for the impact of implementing IFRS. This results in an increase of £77m in the end 2004 pro-forma EEV. A detailed description of this movement is contained in the interim results document dated 13 September 2005.

The combined impact on EEV of these other methodology changes is a small reduction in embedded value of £19m. Overall, after the changes relating to the allowance for risk, the embedded value reduces by 4%.

Slide 22 – Impact of other methodology decisions – 2004 NB profits

The new business/renewal definition and IFRS changes also impact the value of new business. The IFRS reference is an allowance for share incentives.

The impact on new business profits of these other methodology changes is a reduction of £5m. Overall, after the changes relating to the allowance for risk, the new business profits increase by 26%.

Slide 23 – 2004 New Business Contribution – Life & Pensions

The EEV Principles adopt a revised calculation for new business margins, whereby the volume of new business is shown on a Present Value of New Business Premium, or PVNBP basis, rather than the traditional Annualised Premium Equivalent, or APE basis.

APE equals 100% of annualised regular premium and 10% of single premium. PVNBP equals all the single premium plus the present value of new business regular premiums we expect to receive given our lapse and other assumptions we have made in the EEV.

We have talked about the increase in the contribution from new business previously, and this has a corresponding increase in the margins.

There is also a change in the volume of new business that arises from the change in new business/renewal definition we have made under EEV.

Slide 24 – Lombard

Our discussion so far has excluded Lombard as this was not part of the group as at 31 December 2004. However, in this slide we provide details of the impact of moving to an EEV method on the Lombard's business as at 31 December 2004.

Lombard business is predominantly unit-linked. Adopting a market-consistent allowance for risk leads to an improved position being shown for both embedded value and new business, allowing for the higher operational risks of overseas business. Again this reflects the lower risks in the business written in Lombard.

The derived risk discount rates for in force and new business are also shown.

The lower risk-free rate reflects the lower yields on Euro bonds.

Slide 25 – Improved Disclosure

The focus on our work has been developing a robust EEV methodology. However, we are also disclosing further information than in previous years.

We show a set of sensitivities to the key items that impact embedded value and new business profits. These are shown in the Appendix to this presentation.

We also give further details surrounding our EEV methodology and have disclosed the risk discount rates by broad product groups.

There will be further improvements in this disclosure over time, not least because the CFO Forum will be publishing further guidance on sensitivity and other disclosure requirements in the later part of 2005.

The adoption of a market-consistent approach to EEV together with enhanced disclosure will lead to greater objectivity and transparency of our EEV result.

That concludes the description of the methodology and the impact on the results. Philip will now conclude.

Slide 26 – Conclusion

Thanks Greg.

Before I close on some of the commercial implications of EEV for FP, I would like to touch upon how the implementation of a market-consistent EEV continues our journey of aligning the way we manage our business with reporting and provides us with another risk management tool.

In recent years we have developed:

- realistic balance sheets
- risk based capital measures (both on the FSA's ICAS basis and, more importantly, on our own risk appetite); and
- our understanding of the risks we run and the levels of those risks that we are prepared to accept.

The market-consistent EEV methodology is inextricably linked with these risk based developments. It provides more relevant, transparent and objective disclosures that are based on realistic risk distributions for experience assumptions and economic assumptions calibrated to independent market prices.

The EEV methodology and reporting properly reflects the recent de-risking measures that we have taken and this is demonstrated, in part, by the fact that our restated 2004 underlying profit is up 16%.

Slide 27 – Commercial Implications

To illustrate how EEV reporting much better reflects the way we run our business, I give three examples:

- First, new business: With an implied RDR of 12.4% you can see why we find current market annuity pricing provides an unattractive return on capital employed, and why we write little with profits business other than increments to existing pension schemes.
- Second, in the With Profits Fund the hedging activity is now reflected in our results by way of a lower burn-through cost; and
- Third, M&A. Today's results show even more clearly why we found Lombard such an attractive acquisition and why you haven't seen us chasing closed with profit books!

Going forward we will use these enhanced tools to manage risks within the business in a way that can deliver value to our shareholders. For example, we are developing our pricing methodologies for all new business (not just annuities) to allow for risk at a more granular level.

Over time we will complete our integrated financial management framework, covering risks, capital and rewards, to apply to the organisation from top to bottom in a way that allows us to continue to improve risk weighted returns – to the benefit of our investors.

Finally, in the Appendix to your packs you will find more slides covering:

- an analysis of the impact on profits
- some sensitivities
- a brief note on the expected impact on 2005 Interim results; and
- why EEV has such an effect on annuities

3 groups public speaking course joke (so I can be sure at least three quarters of you enjoyed our presentation even if you did not understand it!).

Thank you for your attention – we will be happy to take some questions.

Appendix – Impact on underlying profits – Life & Pensions

Contribution from new business: an increase on moving to a market-consistent EEV basis reflecting the low investment risks of our unit linked and protection new business mix.

Profit from existing business – expected return: A revised methodology whereby this item is the difference between the expected return on the assets backing the liabilities and the expected change in the market-consistent value of the liabilities. Effectively, this approach is similar to the traditional approach of applying an unwind in the risk discount rate to the value of the in-force at the beginning of the year. However, the risk discount rate to be used is a rate appropriate over the period of return only, which is not necessarily equal to the overall in-force risk discount rate averaged across all future durations. Effectively, this item has increased in part because a higher risk discount rate is being shown under EEV than Achieved Profits.

Profit from existing business – experience variances: an increase largely as a result of positive experience from the further hedging of market risks in the With Profits Fund over 2004.

Profit from existing business - operating assumption changes: we have made the same changes in operating assumptions as the Achieved Profit basis, but the revised market-consistent valuation method places a different emphasis on each assumption change than under Achieved Profits.

Development costs: a small IFRS related change.

Expected return shareholder net assets: a small change reflecting the increase of ½% in the assumed equity return, offset by a small reduction of ½% in the expected property return.

Appendix – Impact on EEV profit before tax – Life & Pensions

Investment variances: There is a corresponding reduction in investment return variances from the increases in the expected return items in underlying profit that arose from an increase assumed equity return. However, this was more than offset by equity market rises in the With Profits Fund during 2004 reducing the burn-through cost. These largely arose before the further hedging exercises undertaken in 2004.

Economic assumption changes: This change reflects the revised approach to risk allowance. The effect of economic assumptions on the market-consistent liabilities now more accurately reflects movements in the market prices of risk-free assets. This predominantly relates to annuities and arises because the Achieved Profit basis allowed for a simple reduction in risk-free rates over 2004 of 0.2%, whereas the EEV basis also reflects the change in the shape of the yield curve.

Appendix – EEV Sensitivities

The table shows the sensitivity of the embedded value and the contribution from new business to changes in assumptions. For each sensitivity other assumptions remain unchanged, except where changes in economic conditions directly affect them.

1. Although not directly relevant under a market-consistent valuation, where the risk discount rate is a derived disclosure only, this shows the impact of a change in the average derived risk discount rate to enable adjustments to be made to reflect differing views of risk.
2. As a market-consistent approach is used, equity and property expected returns only affect the derived risk discount rates and not the embedded value or contribution to profits from new business.
3. Movement in embedded value is from an £81m decrease in shareholders' invested net assets and £55m from a reduction in the value of in-force Life & Pension business.

Appendix – Annuities: understanding the market-consistent approach (1)

In these two slides we set out a simplified numerical example to illustrate the certainty equivalent approach we have adopted to value business without significant financial optionality.

This also highlights why the EEV risk discount rate for annuities of 12.4% (see slide 8) is so much higher than the Achieved Profit risk discount rate.

This slide sets out the assumptions underlying this example.

It also shows that under Achieved Profit, the VIF of the annuity contract is 5.3 units.

Appendix – understanding the market-consistent approach (2)

This shows that, in this numerical example, the market-consistent VIF of the annuity contract is 3.6 units, over 30% lower than the traditional embedded value VIF.

We show two different approaches available to arrive at this result, the certainty equivalent approach we have used, and an alternative approach – setting VIF equal

to market value of assets less market-consistent value of liabilities. These different approaches lead to equivalent results.

The risk discount rate in the traditional embedded value model (see previous slide) required to arrive at the market-consistent VIF of 3.6 is 11.8%, significantly higher than the original assumption of 7.5%.

This difference is a result of the asset liability mismatch risk to shareholders arising from investing in AAA corporate bonds.

As the value of annuities is so much more sensitive to the corporate bond return assumption than the risk discount rate, a high risk discount rate is required to compensate for the additional risk associated with the corporate bond credit spread.