Conference Call Transcript

AGN.AS - Q2 2011 AEGON N.V. Earnings Conference Call

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Ladies and gentlemen, welcome to AEGON’s second quarter 2011 results conference call for analysts and investors on Thursday August 11, 2011. (Operator Instructions). I will now hand the conference over to Alex Wynaendts. Please go ahead sir.

Alex Wynaendts - AEGON NV - Chairman and CEO

Good morning and thank you for joining our call this morning on Aegon’s second quarter results for 2011. Also joining me today are Michiel van Katwijk, Executive Vice President, Daryl Button, our CFO of the Americas, and Willem van den Berg, Head of Investor Relations. Before getting started let me just remind you to take a moment to review our disclaimer on forward-looking statements which is at the end of this presentation. As usual after the presentation we will be happy to take your questions.

During the quarter we made solid progress on our key strategic objectives. In June, as you know, we completed full repayment to the Dutch state, a very significant achievement for AEGON. The repayment put the crisis now firmly behind us and allows us to turn our full attention to the future. However, as you all know, we continue to experience a volatile and challenging economic environment.

But unlike in 2008 AEGON is today in a much better position to deal with financial turmoil. Over the past three years we've taken extensive measures to strengthen and to protect our balance sheet and these include increasing equity hedging for variable annuities in the US, hedging of our guarantees in the Netherlands, reducing our exposure to credit and interest rate markets, and then, as you're well aware, we've taken quite a
number of decisions to exit or run off businesses that did not fit with our long term strategy of improving our risk profile. At the same time we sharpened our focus on reducing expenses across all our businesses and improving our cash flows.

This past Tuesday we finalized the divestment of Transamerica Reinsurance and this represents an important milestone in our restructuring program and supports our decision to focus on our core lines of business. I need to make clear that the process of reviewing our businesses continues with the objective of determining where best to deploy our capital inline with our strategic objectives.

At the same time we're continuing to reposition our businesses toward more fee income versus spread-based business. Particularly strong sales of variable annuities and pension products in the US well demonstrate this shift.

We’re also pleased with the progress underway in AEGON's newer growth markets which are critical to our aim of achieving a greater geographical balance to our earnings, particularly in Turkey and Hungary, new Life sales were very strong during the quarter and in Spain we are further expanding our distribution reach and we've recently finalized an agreement with Unnim, a leading savings bank with over 600 branches in the more prosperous north eastern region of the country.

In terms of earnings for the second quarter, clearly the weaker US dollar had a significant impact, but I'll come back to this in more detail in just a moment.

Turning to slide three and assume that you're well aware of the new financial targets we set. We announced these just six months ago and reiterated our confidence in achieving them at our recent investor conference in June. These are new medium term targets which our senior management and entire organization are aligned and incentivized to achieve. We will continue to provide you with regular updates on our progress. However, let me again emphasize that, the strategic priorities we continue to pursue fully support these targets and our confidence in achieving them.

Let me turn to slide four to underlying earnings for the Group. As you well know, the continued weakening of the dollar against the euro had a significant impact on AEGON's reported results. The dollar declined from an average of $1.27 against the euro in the second quarter of 2010 to $1.44 in the second quarter this year. That's a depreciation of 13%. And given that big part of AEGON's earnings are generated in US dollars, this translates into a negative impact of EUR44m of underlying earnings compared to the year ago same second quarter and a negative impact of EUR18m compared with the first quarter of this year.

Fixed annuities in the US contributed less to earnings and this is consistent with our strategy to manage balances lower in light of the persistent low interest rate environment.

Underlying earnings have also been negatively impacted by our earlier decision to increase provisioning for longevity in our Dutch business and this quarter the additional provision amounted to EUR23m. In the UK we're working hard to complete our customer redress program by the end of this year, in the second quarter this led to a negative impact of EUR14m. And our businesses in new markets continued to perform well, generating an increase in earnings of EUR19m which are included in the other category shown in the graph on slide four.

Here on slide five we provide the earnings by country unit. And compared with last year underlying earnings from the Americas were lower mainly due to the lower fixed annuity earnings, and I'll come back to the Americas on the next slide in more detail.

In the Netherlands the solid earnings from Life and Savings resulting from favorable mortality and a higher contribution from mortgages were more than offset by the higher provisioning for longevity and pensions. And as communicated with our Q1 results, the clear trend of increased longevity in the Netherlands has led us to take the decision to take an additional provision of EUR20m on average per quarter or EUR80m for the year. In the second quarter the impact to underlying earnings totaled EUR23m.

In the UK underlying earnings were mainly impacted by the costs associated with the execution of the customer redress program. I should also mention that we are on track to deliver on the expense reduction program underway, something I'll come back to a bit later in the presentation.

And underlying earnings before tax in new markets increased by 48% and this was mainly due to strong earnings from Central and Eastern Europe, Spain, but also AEGON's asset management securities.

Slide six and taking a more detailed look at underlying earnings in the Americas. Earnings from Life & Protection were lower compared to last year due to unfavorable persistency, lower spreads, while the second quarter 2010 included some reserve releases.
Underlying earnings from Individual Savings & Retirement reflect our strategic shift to fee generated earnings in line with our strategy. Balances within our spread fixed annuity business and their contribution to earnings continued to decline, which I've already covered. Earnings from variable annuities, on the other hand, were especially strong. This is the effect of increased net inflows and increased balances. I want to mention here that we continue to have good margins on our VA business and in the second quarter our margin was 82 basis points.

Earnings from our Employer Solutions & Pensions Group, another of our key businesses in the US, increased as well due to the further growth of the business. This is a business that continues to perform extremely well by consistently strong inflows, something we expect to continue.

Supporting our aim to enhance customer loyalty in the Americas we have announced a more focused brand proposition. We are now bringing together all of our North American retail businesses under the strong Transamerica brand. And you'll be seeing more of this with the launch of our advertising campaign in September and we will of course update you on the strategic brand positioning during our December investor conference in New York.

Turning to slide seven now, to net income. EUR404m in net income for the quarter was positively impacted by gains on investments which mainly reflect our strategic reallocation of equities into fixed income in our Dutch investment portfolio.

Impairment charges amounted to EUR100m for which EUR53m were related to the US mainly residential mortgage backed securities. Exchange offers on specific holdings of European banks led to impairments of EUR40m in the UK. Impairments in our Greek Sovereign debt holdings were just EUR2m, reflecting AEGON's very limited exposure. I will come back to our peripheral European exposure on the next slide. So currently annualized impairments in our US fixed income portfolio amount to 29 basis points, somewhat below our long term expected average of 30 to 35 basis points.

Let me now review on slide eight with you peripheral European exposure. Here on this slide we provide you AEGON's total exposure to all fixed income securities related to peripheral European countries. As we made clear, exposure to the peripheral European sovereigns is very limited and was reduced further in the second quarter.

In addition to AEGON's limited exposure to sovereigns, our exposure to other peripheral European assets such as banks, corporates and RMBS is also very limited, totaling just 3.5% of total general investments. I want to further emphasize that of this percentage half is invested corporate bonds in a particular and relatively defensive sectors such as utilities. We will of course continue to closely monitor our exposure to the peripheral European countries but also with an eye towards identifying potential opportunities.

Given the recent attention to the US situation I would like to add that AEGON's exposure to US treasuries is also limited at EUR2.7b at June 30.

One slide nine, consistent with our aim to enhance operational excellence we are continuing identifying and pursuing cost efficiencies across our businesses. At the same time it is essential that we make the necessary investments to improve operations and position our businesses for the developing opportunities.

Excluding restructuring charges and at constant currency rates, operating expenses remained level during the quarter and, as we shared with you during our investor conference this past June, we're implementing plans to substantially reduce costs in each of our established markets.

In our Dutch business we'll be reducing costs by EUR110m by 2012 from the 2009 base and in the UK we are on track to achieve our cost reduction target of GBP80m by the end of 2011. In the Americas we aim to grow our Life & Protection business faster than the industry average while at the same time keeping operational expenses flat. This of course requires pursing continuous expense reductions.

But restructuring naturally comes at a cost and during the second quarter operating expenses were impacted by a restructuring charge of EUR58m, mainly related to the measures we've taken in the UK, something I'll return to on the next slide, but also related to the steps we're taking to restructure our businesses in the both the US and the Netherlands. This slides shows the EUR30m in cost reduction achieved already in the first half of the year and keep in mind we also continues to make necessary investments in our new businesses and our growth markets around the world.

Let me now briefly provide here on slide 10 with some further details on our progress in the UK. As I've already indicated, operating expenses within AEGON UK were impacted by the following exceptional items. The ongoing restructuring program to reduce expenses, which totalled GBP13m in the second quarter, GBP7m for the development of our new platform to position our business for the post-RDR environment, and GBP6m of costs involved with the execution of our customer redress program. These items are on top of the charges of GBP12m already recorded which relate to the customer redress program.
As the activities related to these exceptional items will continue in the second half of the year, we expect that they will lead to additional charges as well during the remainder of 2011. But again I want to emphasize that the provisioning we are taking for the customer redress program, as well as the expense reduction program, will be completed as planned by the end of 2011. As a result as of 2012 the cost base of the Life & Pension business will decrease by GBP80m from the 2009 base.

Turning to slide 11 I would like now to briefly review the sales development for the quarter. Again here currency movements also had a considerable impact on our new Life sales and deposits. Just to give you an example, if you consider total sales at constant currency the decline would have been much less, would have been 7%, while deposits would have only declined by 2%. The lower sales volume is a direct result of our decision to re-price products both in the UK and in the Americas, given the current low interest rate environment.

And in the Netherlands new Life sales were slightly lower by 2%. The lower pension sales were due primarily to competitive pricing in the market. AEGON was one of the first companies to adjust its pricing policy to reflect updated mortality tables. However, we continue to grow our Dutch mortgage business and achieved a market share of almost 9% during the quarter. This supported sales of individual Life products which increased by 19% and further increased our market share to over 11%.

In Central and Eastern Europe, new Life sales were particularly strong, with an increase of 25% and this helped to offset the negative impact of new pension legislation in both Hungary and Poland.

At constant currencies gross deposits declined by just 2% as deposits in the Americas increased by a strong 11% compared with the same period last year, and on the next slide we’ll provide you further details. And reported in euros gross deposits for the Group were 11% lower and this is again mainly as a result of the weaker US dollar, but also lower asset management deposits which are volatile as well as lower deposits in the Netherlands given less competitive rates which AEGON has been offering on a savings account.

Turning to slide 12, the Americas, our pension business achieved solid results. The EUR4.9b in second quarter deposits is a strong increase of the same quarter last year. It's worth noting here that you typically see higher deposits in the first quarter due to the fact that this is a natural time when clients mature their assets.

The strong variable annuity deposits, which I covered, were helped by the introduction of our new Retirement Income Max rider and increased productivity of our wholesaling team. I'm pleased to report here that our business in the second quarter achieved the higher production of variable annuities in eight years, while at the same time generating strong new business margins.

As you know, one of our targets is to increase earnings from the fee businesses to between 30% and 35% of our underlying earnings by 2012 and we've been able to double this percentage of earnings from fee income to 30% since the second quarter of last year, and this is of course as a result of both higher fee income but also lower spread earnings.

On slide 13, one of the other key financial targets we have set is to increase operational free cash flows by 30% by 2015 from the normalized 2010 level of EUR1b to EUR1.2b. And during the second quarter operational free cash flows totaled EUR283m. Moreover, we experienced strong earnings from the in-force business which included the positive impact of realized gains on investment in the Netherlands. These were offset, however, by the effect of low interest rates in the US. The release of required surplus was impacted by low interest rates.

But generating new business, as we know, comes at a cost. However, compared to the first quarter expenses in the second quarter were generally stable. Although we experienced lower pension sales in the Netherlands and the US than in Q1, variable annuity sales were considerably higher. As a result, the effect, the overall effect was neutral.

I'm now turning to slide 14 to discuss AEGON's capital position at the end of the second quarter. Of the EUR2.3b of total excess capital, EUR1b was maintained at the holding level. This amount slightly exceeds our ambition to hold a minimum of around EUR900m at the holding company.

Cash flows from our business continue to be strong. The EUR1.4b upstreamed from our operating units to the holding during the quarter more than offset the EUR1.125b we paid to the Dutch state at the end of June to complete full repayment. Then again, as I have noted, we continued to make further investments in our businesses during the quarter, particularly in our new growth markets.

And finally the cash proceeds from the divestment of Transamerica Reinsurance is core, which we just completed his week, are expect to remain in our US operations and will be accounted for in the third quarter.
Slide 15, during the quarter shareholders equity remained stable at EUR16.8b. The book value per common share amounted to EUR7.82 per share. The positive impact resulted from retained earnings as well as from the higher revaluation reserve which related to the fact that risk-free rate fell during the quarter, as we all well know. And the final repayment to the Dutch State included the premium of EUR375m which was charged directly to equity. And of course the weakening of the US dollar against the euro during the quarter also had a negative effect on shareholders' equity.

Another of our new financial targets is to achieve a return on equity of between 10% and 12% by 2015 and year to date we have achieved an 8% return, a slight improvement compared to the same period last year.

Overall our capital position continues to be strong with an IGD ratio of around 200% and an RBC ratio of around approximately 375%. The sale of Transamerica Re is not included in these numbers whereas the repayment to the Dutch State is and the proceeds of the sale will further increase our capital buffer. And finally we are on track on our target to achieve a capital base ratio of 75% by the end of 2012.

So before turning to your questions let me again reiterate that we are pleased with the progress on a number of our key strategic objectives. The completion of repayment to the Dutch State and the successful divestment of our life reinsurance business are significant achievements for AEGON. Furthermore, the strong variable annuity and pension sales in the US is a clear evidence of the strategic repositioning of our business to increase the proportion of earnings from fee generated business while at the same time reducing further fixed annuity balances.

We continue to make key investments to strengthen distribution and accelerate the growth of our newer businesses. This is consistent with our objective to ensure that their contribution to AEGON's earnings increases proportionally over time. We are fully committed to completing the restructuring of our established operations in order to improve the overall cost base and increase returns. We have identified clear opportunities in each of our established markets and are working hard to complete the transformation of our business in order to fully capture these.

In what remains a volatile and challenging environment our strong capital position and the steps we have taken to fortify our balance sheet against persistent economic and market turmoil support our confidence that AEGON is and will continue to be in a strong position going forward.

Thank you and I'm looking forward to your questions.

**QUESTION AND ANSWER**

Operator

Thank you sir. (Operator Instructions). Our first question comes from Duncan Russell from JP Morgan. Please go ahead with your question.

Duncan Russell - JP Morgan - Analyst

Guys, good morning.

Alex Wynaendts - AEGON NV - Chairman and CEO

Good morning.

Duncan Russell - JP Morgan - Analyst

A couple of questions please. The first one is on fixed annuities in the US. Could you just give us a bit of color on the coinsurance agreement, the $1.5b, what that was?

And then also on the fixed annuities, the underlying spread dropped 13 basis points, the gross spread only dropped 3 basis points, so just the difference between the underlying and the gross please.
The second question was on the institutional business, the withdrawals, the run off book, the withdrawals were a bit low in the second quarter and I'm just wondering if they're still progressing as planned. Do they change at all in a low rate environment?

And a third question on interest rates. The DAC, the coverage ratio of the DAC at the full year was about 175% broadly. Is there any sensitivity you can give to that were interest rates to remain at current levels into perpetuity, assuming no management actions so no cost cuts etc., where would that coverage ratio end up? On the back of an envelope it looks fine to me but I'm just wondering what kind of sensitivities you could give, if any? Thank you.

Alex Wynaendts - AEGON NV - Chairman and CEO

Duncan, thank you for your questions. Your first question was about the coinsurance. As you know, this is consistent with our strategy to deemphasize the fixed annuity and spread based business. We have executed a coinsurance transaction which we were able to execute at attractive conditions. We continue to look at the opportunities which are available in the market and this one made a lot of sense for us.

Duncan Russell - JP Morgan - Analyst

Can you give any color on the age of the book you coinsure? Is it older policies, newer policies, any color on that at all?

Alex Wynaendts - AEGON NV - Chairman and CEO

So, as you know, it's $1.5b but for the details I will ask Darryl to give you the answer and also ask Darryl to give you an answer on the second question, the difference on the spread and fixed annuities between gross and underlying.

Duncan Russell - JP Morgan - Analyst

Okay.

Darryl Button - AEGON NV - CFO, Americas

Yes, hi Duncan. It's a fairly mature book in terms of, as Alex has already said, it's $1.5b, fairly mature business. I'm not sure I can say a whole lot more than that.

On the difference between the underlying and the gross spreads the difference is the impact on fair value assets, assets that are carried on a mark-to-market basis. The underlying spread removes the fair value volatility from that spread number whilst the gross number has that mark-to-market in it.

Duncan Russell - JP Morgan - Analyst

Okay. And the DAC?

Alex Wynaendts - AEGON NV - Chairman and CEO

DAC, sorry Duncan, you asked about withdrawals, if there was a different pattern, if the pattern was impacted by interest rates. What I can tell you is that the pattern is as planned. There's a whole plan and that is not every quarter linear so you will see some changes there.

In terms of interest rate sensitivity what I would like to give you is some guidance in terms of the impact on earnings. What I can say is that if we would assume a 100 basis points decrease of interest rates compared to the end of June 30, and when I say a drop of 100 basis points I would say a shock, so in another words it stays there, then that would have an impact of EUR20m to EUR25m per quarter.
Okay, thanks.

Operator

Thank you. Our next question comes from Farooq Hanif from Morgan Stanley. Please go ahead with your question.

Farooq Hanif - Morgan Stanley - Analyst

Good morning. I've actually got three questions if that's alright. Firstly, what's going on respectively with the spreads and fixed annuities? My understanding was you actually raised your spread because you want to deemphasize the product, but what's happening is that that's going down. Could you just give us a glide path for what factors are going to affect that going forward and what numbers we should look for? So are we going to go very quickly back to 100 basis points underlying spread, for example, and by when?

Secondly, actually still related to that, do you think the sales of fixed annuities are going to go up in the industry because of the current market environment and are you going to participate in that?

Second area is these persistency issues in Life & Pensions. You had good numbers in Life & Protection in the Q2, Q3, Q4 last year, which I'm guessing is related to reserve releases. So should we assume that the current margins that you're making are better guide going forward to what you're going to make?

And the last question is, the US downgrade, what's your expectation of the kind of proportion of your corporate bond and asset-backed securities in the US that will be affected by that and what could that do to the impairment rate versus your 30 basis point to 35 basis point average? Thank you.

Alex Wynaendts - AEGON NV - Chairman and CEO

Thank you. Thank you for your questions. I think on the fixed annuity what you see happening really in the spread is the effect of lower interest rates, so that is what has been having most of the impacts on the spreads of our existing book of fixed annuities.

In terms of sales going forward, with this low interest rate environment I don't expect that we will see in the industry in general a big increase in sales, and certainly not for AEGON. We do not expect to actually be actively participating in this market because we just don't feel there is good value for us in there. So we stay where we are, consistent with our strategy.

You were asking, your third question was in the Life & Protections, the trend. What we see in this quarter, as we mentioned, is that persistency clearly has negative impact. As you probably have seen, this seems to be also broader in the industry, it is a trend which we're starting to see, to observe, and which clearly our peers are also observing. It is still new so we need to analyze and understand better to what extent the economic environment has an impact.

As you know, this 10 year term life, which means that premiums are fixed for 10 years and then after 10 years the premiums then usually go up. And particularly in a low interest rate environment the premiums go up even more because the interest rates are low. So that is probably one of the reasons why you're seeing more persistency and we're clearly not the only ones who are seeing that. But it all depends on the environment, but I think this is a trend we shall have to take into account.

And interest rates also play a role. So based on this I would expect that our quarter, this second quarter, is a better guide for the future in terms of the -- assuming the environment doesn't change, but based on this environment.

And you asked me about the downgrade. What I know is that the downgrade has effectively no impact on our impairment rates. What's also important, it has no impact on our capital ratios, our RBC ratios. As been announced already, it's not going to be affected by the down grade to AA+. And, as such, I don't have it will have a big impact directly on our business, our capital position.

Having said that, I think we also have to look at the more secondary impact and the downgrade will probably put more pressure now on the US government and the politicians to come to an agreement to resolve this whole discussion about the debt position and the spending, which
effectively has only been partially resolved very recently. And that will lead to a rather more stricter discipline and that's not going to supportive of growth. So there I can see an indirect impact on the longer term.

Farooq Hanif - Morgan Stanley - Analyst

Actually may I come back please on the fixed annuity question? I can see that the lower yields have an impact but I'm just -- what's slightly worrying me is that you've had very good spreads in fixed annuities, probably well above target for quite a while now. What worries me is that do we need to assume that the underlying spread goes back to 100 basis points very quickly in our model because that could have a massive impact?

Alex Wynaendts - AEGON NV - Chairman and CEO

I understand your question. I thought I'd given you some guidance but I'll ask Darryl to jump in and give you a bit more detail.

Darryl Button - AEGON NV - CFO, Americas

Yes, hi Farooq. It's Darryl.

Farooq Hanif - Morgan Stanley - Analyst

Hi Darryl.

Darryl Button - AEGON NV - CFO, Americas

Yes, the short answer is that spreads are not going back to where they were and the current levels are much better guidance going forward than where they were.

There's been some spread compression as we run off this book. I will say that some of the earnings that are compressing in the fixed annuity earnings are actually showing up in the, below the line, in the run off earnings. This gets to the yield transfer that took place on the asset transfer we has between the institutional book and the fixed annuity book. So there is a bit of a crossover there as those assets mature and that yield transfer subsides.

So there has been some spread compression related to that. There's been some spread compression just from de-risking of the book and raising some cash and liquidity to fund the run out of the fixed annuity book. So compression is something that we just have to live with inside this book and current levels are a much better indication going forward than where we were.

Farooq Hanif - Morgan Stanley - Analyst

So if yields remain where they are as of today or close to where they were at June 30, then 120 is fine? So you're in a range between 120 and maybe a bit lower if you'll go down further?

Darryl Button - AEGON NV - CFO, Americas

Yes. I think there's still some modest compression as we look forward given the rate environment that we're in right now.

Farooq Hanif - Morgan Stanley - Analyst

But your target spread than 100, is that correct?

Darryl Button - AEGON NV - CFO, Americas
Pardon me?

**Farooq Hanif - Morgan Stanley - Analyst**

Your target underlying spread is 100 basis points?

**Darryl Button - AEGON NV - CFO, Americas**

Yes. And I would say that as, the other thing to keep in mind, that as the fixed annuity book runs off you get a different mixture of new business and old business. We don't need to maintain the same gross spread to maintain the same return on capital because we're not amortizing acquisition cost. And as [last year's] are low and the book is extending, which is what's happening, that causes some of the gross spread compression. But the amortization of the acquisition expenses is not there so we can get by with a lower spread component and still maintain the same return on capital.

**Farooq Hanif - Morgan Stanley - Analyst**

Right. Okay. Thank you very much.

**Darryl Button - AEGON NV - CFO, Americas**

You're welcome.

**Alex Wynaendts - AEGON NV - Chairman and CEO**

Thank you Farooq.

**Operator**

Our next question comes from Hans Pluijgers from Cheuvreux. Please go ahead with your question.

**Hans Pluijgers - Cheuvreux - Analyst**

Yes, good morning gentlemen. Three questions, if I may. First of all on your impairments, you saw some increases quarter on quarter. Could you give some guidance with respect to what you see the impairments going forward in Q2 -- sorry, Q3 and Q4?

Secondly on the impact of the capital you're still keeping for the run-off business in the US. Could you give some feeling on how much capital you still have in the underlying and when do you expect that impact, negative impact on your ROE to disappear?

And lastly on your cash flow, looking at your slide on the cash flow, was a quite significant impact from release of required surplus compared to Q1. How do you see that going forward? Do you expect more releases on the required surplus in the coming quarters? Could you give some feeling on that?

**Alex Wynaendts - AEGON NV - Chairman and CEO**

Thanks Hans. Let me start with impairments effect in the US. We see a positive trend in impairments. As I mentioned in the presentation, we've been running on a 59 basis points basis for the US portfolio. What we expect actually is to see a further decline in impairments in our US portfolio, in particular in our RMBS. By the end of the year we expect lower impairments going forward in Q4.
What you see also in this quarter is some other very specific situation related to European banks, should say to European banks based in the peripheral European countries where there was an exchange offer. And that has led us to impair the bonds at the level of the exchange offer. It's difficult obviously to predict if we'll see much more of those, but based on what we see right now, I don't have -- we're not in a position to believe that we'll see many more of those coming forward. But again this is going to depend on an environment which I think we all know and all seen has been extremely volatile and unfortunately somewhat unpredictable.

Your second question on the exact amount of the capital in the run-off business, IR will follow up directly with you, give you the exact numbers.

And you were asking about cash flows. They were effectively primarily impacted by lower interest rates in the US. And at current rates, if we assume the rates stay where they are, we believe that this cash flow is probably a good indicator for going forward.

**Hans Pluijgers - Cheuvreux - Analyst**

In Q4?

**Alex Wynaendts - AEGON NV - Chairman and CEO**

Yes, Q3, Q4, yes.

**Hans Pluijgers - Cheuvreux - Analyst**

Yes. Okay.

**Alex Wynaendts - AEGON NV - Chairman and CEO**

And this is in line with what we said also earlier where our normalized level was 2010 and it's clear that we should improve, but clearly the lower interest rates have had an effect on our required surplus.

**Hans Pluijgers - Cheuvreux - Analyst**

Okay. Thank you.

**Operator**

Thank you. Our next question comes from Michael van Wegen from Bank of America - Merrill Lynch. Please go ahead with your question.

**Michael van Wegen - Bank of America - Merrill Lynch - Analyst**

Yes, morning. Michael from Bank of America - Merrill Lynch. Couple of questions effectively on the US. You already discussed your Life & Protection business there and the fact it seems to be under a bit of pressure. But could you talk a little bit through the persistency issue and to what extent you can start to re-price products? As you mentioned, it's a 10-year product largely.

And to what extent the persistency versus the low interest rate environment affects the earnings, could you split that out?

And then second question on your variable annuity profits, they're up considerably compared with last year and in line with Q1. I suspect that that's largely driven by the fact that hedging cost for your guarantees, year to date, are much more favorable than they were last year. If we continue to see the current volatility, could you give us some sense of what that means for your variable annuity earnings going forward?

And finally, your US retirement service business had good sales and stable value, but for the core business I would say of retirement services, your sales were for the first time down in a long time. Is that part of the re-pricing strategy or is it just happens to be a weak quarter because of maybe lumpiness or whatever. Could you talk us a little bit through the development there? Thank you.
Alex Wynaendts - AEGON NV - Chairman and CEO

Michael, let me give you in general a couple of -- make a couple of remarks and then I'll ask Darryl to jump in and to give you more detailed answers. I think on the Life & Protection, what it says about the persistency was that it particularly affected the 10-year term life and that we see this as a trend in the sector. And clearly the economic environment and low interest rates have an impact. But I'll ask Darryl to come back to you and give you a little bit better indication of the split between the two.

In terms of variable annuities, I think there are a couple of things we should take into account. We have implemented a strategy in our variable annuity business to sell products which we feel are products we are comfortable selling. And one of the important features is that there is very flexible re-pricing, and that means that we can adjust our pricing with market changes. And that has actually helped us and supported us in terms of getting good margins on this business.

So when rates go up and down, you have always a little bit of flexibility, but the quicker you can react to market changes, especially when they are adverse, if they're favorable you might want to react a bit later and gain a bit of additional earnings in there or margins in there, but the quicker you can react when the market conditions are against you, the better you are able to protect your margins. And that's what we're seeing here. This is the result of, I would say, a very clear strategy.

I will ask also Darryl to give you a little bit more in terms of the cost of the hedging and the volatility and how he sees this quarter going further based on the environment we're seeing right now.

In the US, our business, our pension business, our retirement business is just doing very well. Yes, we had a strong quarter on [stable] value. I also mentioned that the sales of big pension contracts are lumpy. Keep in mind, the bigger we get, the bigger you need a bigger contract in order to have significant impact, and that is of course also increasing a little bit to lumpiness. I can tell you that based on the business reviews we had with that division, this is really an element of lumpiness and certainly no indication of a change or an impact of re-pricing because effectively re-pricing didn't have a lot of impact here. And we remain very comfortable and very confident about the future.

So I'd like to pass it to Darryl. If you want to give a little bit more about the color and some financial indication in relation to Life and persistency split between the impact from persistency and low interest. And do you want to add something on the pricing please, Darryl?

Darryl Button - AEGON NV - CFO, Americas

I'd be happy to. Hi Michael. It's Darryl. On the Life issue, the persistency issue relates to term, as Alex already said. Primarily we're seeing experience on 10-year level term product coming in and the lapses are much higher at the end of the level term period than what we had anticipated and built into our models. We've taken that information and moved that over and changed all of our pricing as it relates to new product going forward. There's really not much we can do on the existing in-force in terms of re-pricing that. So the re-pricing reflects or, I would say, is meant to describe what we're doing on our new business going forward.

In terms of the low interest rate environment, that's where we have been making some fairly substantial increases to prices on our universal life product, which is more interest-sensitive. And we can see the impact coming through on sales. And in the last couple of quarters we've actually shut off a couple of our single premium products that do not perform well in a low interest rate environment and substantial price increases on our traditional channel products there.

In terms of -- I think the other question was on, just on the VA profits and margins. Definitely on a year-over-year basis it's really growth. And we actually took some advantage last, towards the end of last year to do some re-pricing and trade off profit over, profited margins over volume. And we actually had the margins growing significantly in the new business we were selling last year and into the early part of this year.

With the recent drop in yield curve and the substantial if that sustains, we will have to come back with some product changes. We were priced to cover probably about half the level of drop that we saw, but given where interest rates are right now that's gone through the corridor in our pricing and we're going to have to come back and react with product unless we see some rate increases, some interest rate increases.

Finally, just to reiterate what Alex said on the pension side, it's definitely the latter. It's the lumpiness of the business, not a re-pricing strategy. The pipeline is still pretty full on our pension business. I'm expecting still a good strong year on the pension business.
Michael van Wegen - Bank of America - Merrill Lynch - Analyst

Perfect. Thank you.

Alex Wynaendts - AEGON NV - Chairman and CEO

Thanks Darryl.

Operator

Thank you. Our next question comes from Nick Holmes of Nomura. Please go ahead sir.

Nick Holmes - Nomura - Analyst

Hello. Good morning. I had a couple of questions. First one is your excess capital is building up and holding back your ROE, and I wondered what you're thinking of doing about this. And in particular with your H2 dividend, might you possibly increase this above the projected EUR0.10?

And then second question is looking at variable annuities again. I wondered if you could tell us a bit more about the target market for your new rider, the Retirement Income Max. Thank you very much.

Alex Wynaendts - AEGON NV - Chairman and CEO

Nick, on excess capital, as I said in my introduction, I'm actually very happy that we have this excess capital position now. We have a strong capital position. We are in, again, a very turbulent time right now. I can assure you that we feel very comfortable that we have the excess capital position, and not only do we have the amount of capital, but that we've taken a lot of measures, which is the hedging of the VA guarantees and putting in places effectively through hedging of our guarantees in the Netherlands so that we're well protecting our balance sheet against significant fluctuations. And we are seeing very significant fluctuations. So at this point of time I think that I can say very clearly we are happy with this level of capital.

Now you asked me also what are you going to do in relation to a dividend. What we said is that we intended to pay a EUR0.10 dividend over the second half of 2011. I really would like to answer this question after we've seen 2011 through. What we see now is again unprecedented volatility and at the end of this year obviously we'll be looking at all the elements. So I think this question is not for now. This question is for really at the end of this period.

Nick Holmes - Nomura - Analyst

Okay. Fair enough.

Alex Wynaendts - AEGON NV - Chairman and CEO

Yes, in terms of the target market, as I think I said, we have clearly developed products which are very focused on the retirement market. We're looking at customers who need safety for the future, who really need guaranteed withdrawals, can't afford not receiving the income they need to achieve to live. This is an important part of our business because it does really address for us the aim of providing financial security to our customers more than purely only investment. It brings in this insurance element.

And I'm pleased to see how step by step we are regaining our market position in this market. But we're doing this in a disciplined way. We're building our distribution, expanding our wholesaling organization, but also making sure that the flexibility we have now in our product allows us to adjust very quickly to market circumstances, both up and both down.

Darryl, is there anything you'd like to add on the target market and the question there from Nick?
Darryl Button - AEGON NV - CFO, Americas

Yes, just that specifically, Nick, our Retirement Income Max was designed to focus on the income now segment of the market so it carries a higher withdrawal percentage than our other products and than some of the other competitive products in the marketplace. And it offers that by offering a less risky fund strategy and some innovation in terms of, what we call, a VIX adjustment, and it's an adjustment that reduces the equity content automatically if the volatility index in the marketplace goes up. So by being innovative with the fund strategies and the volatility index, we can offer a higher withdrawal percentage. And it's really to go focus on the income now segment of the market.

Nick Holmes - Nomura - Analyst

Okay. And just a quick follow-up. How do you see competition developing in the VA market at the moment? Is it getting worse or is it improving a bit?

Darryl Button - AEGON NV - CFO, Americas

Actually I would say that it has rationalized a fair bit when you get outside of the top three or four in the marketplace. I've spoken about that fairly regularly in the past. I think it'll be interesting to watch what the competitive landscape does in reaction to the recent drop in interest rates. There really aren't any of the products out there that are priced for the current level of 10-year treasuries where we sit today. So I think everybody will be back to the drawing board, looking at product and strategy and also taking a close look at what's going on in terms of where interest rates are going here over the short to medium term.

Nick Holmes - Nomura - Analyst

Okay. Thank you very much.

Alex Wynaendts - AEGON NV - Chairman and CEO

Thank you, Nick.

Operator

Thank you. Our next question comes from William Hawkins of KBW. Please go ahead with your question.

William Hawkins - Keefe, Bruyette & Woods - Analyst

Thank you very much. I have two questions. First of all, with reference to slide 14, if you were to show the waterfall of Group excess capital rather than holding excess capital, can you help me understand? The aggregate figure has fallen from 3.7 to 2.3. I know there's the 1.1 of repurchase offset by EUR300m of operating free cash flow. But what's the other EUR600m that falls? And why is it quite visibly higher than the EUR200m other than you showed in the first-quarter presentation? If you could just help me understand that.

And then secondly with regards to slide eight and your enhanced disclosure for the peripheral Eurozone, can you just clarify whether any of these figures include the ability to share risk with policyholders or if at the end of the day any movements in unrealized gains or impairments are fully for the shareholder?

And if I can just tag on to that, can you just confirm that there's no synthetic risk behind any of these countries with regards to CDS underwriting?

Alex Wynaendts - AEGON NV - Chairman and CEO
Yes. On slide 14 we are focusing obviously on the excess capital position at the holding and that's why we have given you the waterfall. If you look at the numbers, if you go from A to B, because that's the waterfall you're looking at, yes, we have the repayment to the Dutch state. We get distributions from our businesses. And the number of one-off items which every quarter are in there, I think it would be better, if you would like to understand exact numbers, that I'll ask IR to follow up with you directly. But there's nothing major which has a significant impact.

In terms of the slide -- your question on the sharing risk with policyholders, the answer is no and this is effectively for the shareholders' risk.

And in terms of synthetic, we have no, I would call it, hidden exposure through synthetic risk. It's all direct exposure.

William Hawkins - Keefe, Bruyette & Woods - Analyst

Thank you very much.

Operator

Thank you. Our next question is from Jan Willem Weidema from ABN AMRO. Please go ahead with your question, sir.

Jan Willem Weidema - ABN AMRO - Analyst

Good morning. A few questions. Could you indicate for your capital what the benefit has been from the runoff of your spread-based business in 2Q '11 and what you expect there for the remainder of the year?

On [Envest], we're seeing some revaluations negatively there again. Do you expect these to materialize in the form of impairments later this year?

And finally on investments in subsidiaries, is everything you invest in Spain, was it in 2Q or is there more to come in the second half of 2011?

And do you expect other major investments in subsidiaries for the second half of the year?

Alex Wynaendts - AEGON NV - Chairman and CEO

On the exact amount of the run-off capital, I'll ask also IR to come back to you, Jan Willem.

In terms of Envest, as you know, Envest is effectively investments in real estate. These are residential rented real estate and we do adjust the value on a regular basis. I don't expect any impairments for these direct investments.

And I think in the investment subsidiaries here, we had a small investment in one of our new distribution agreements, the extension of the distribution agreement with Banca Civica and, yes, it's called Banca Civica nowadays, and one if its partners in the new merged entity.

Jan Willem Weidema - ABN AMRO - Analyst

And of those in 2Q? And for what amount was it?

Alex Wynaendts - AEGON NV - Chairman and CEO

I'm not sure if we have disclosed that amount so I will check with IR. If we have disclosed it, I'll ask them to share it with you. But I don't think we've disclosed it. But it's a small amount anyway. It's not a big amount.

Operator

Thank you. Our next question comes from Lemer Salah from SNS Securities. Please go ahead with your question.
Lemer Salah - SNS Securities - Analyst

Good morning gentlemen. Two questions from my side. First of all, can you please elaborate your position regarding pensions in the Netherlands. And when you implement this re-pricing, because I presume at the start of this quarter you won a couple of mandates, pension mandates, for example, [Nutrego]. So please elaborate on this.

Secondly on slide 10, I see that you just mentioned that you're on track to deliver 25% cost reduction there. But it seems that exceptional expenses are increasing while life and pension operating expenses are staying intact. What is happening right there because it seems that a lot of cost, restructuring cost will show up at the end of this year. So elaborate on that slide as well. Thank you.

Alex Wynaendts - AEGON NV - Chairman and CEO

Thank you. Yes, in terms of the pension business in the Netherlands, as I said in my introduction, we were one of the first companies to adjust the pricing to reflect the changed mortality which, as you know, is effectively for the strengthening of longevity. This is a market where we want to remain a significant player. As you know, we have between 20% and 25% market share. We have an excellent track record. But we are not willing to compete at pricing levels which do not reflect the updated longevity tables. And that means you do win some and you do lose others. That's as it is.

And we said that I expect that you'll see a lot of pension funds. As you know, these individual pension funds migrate to insured solutions and I expect also by that time that pricing will have to adjust to reflect the new reality. So I'd rather hold back a bit now in a market where I think the pricing is not yet reflecting the reality, because we will see more than enough opportunities coming forward and at that time we'll be able to execute on pricing.

By the way, Nutrego was 2010. It was indeed a point in 2010.

So your question on the UK, what I can tell you is we are on track on the plans to deliver two things. First of all, a cost restructuring of 25%. Secondly, the customer redress, which are two separate issues which obviously combine and have had an effect on the earnings.

And you're right, your observation that we'll see more restructuring charges at the end of the year is correct because we will see most of the people leaving by the end of the year. So we've had already, as you know, quite a number of people, employees that have left. But the biggest part of the employees are still -- still have to leave. And that's one you will, from an accounting point of view, see also effectively the restructuring charges.

Jan Willem Weidema - ABN AMRO - Analyst

Okay. Thank you.

Operator

Thank you. Our next question comes from Albert Ploegh from ING. Please go ahead with your question.

Albert Ploegh - ING - Analyst

Yes. Good morning all. Yes, a few questions from my side. First one is on the capital solvency position and the IGD is now at 200%. Have you made any changes towards your hedging strategies in terms of protecting solvency given what's happening in the market? And could that also potentially have a negative impact on the underlying earnings growth for the second half? So is basically protecting solvency now more on top of the agenda than it was a few months ago?

Secondly, on the UK, of course very fee-sensitive business with the collapse in the equity markets right now. How could that impact your back book and are there any risks on DAC there for the second half as well? Thank you.

Alex Wynaendts - AEGON NV - Chairman and CEO
Okay, They're good questions because the markets obviously have been coming down so violently. We're around, what, between 15% and 20% down since the beginning of the quarter. We are down around 100 basis points in the US, US treasury. It's more like 50 basis points in European spreads. Maybe what I'd like to do here is first of all say that obviously our priority number one remains in protecting our balance sheet, our ratios.

As you know, if I start in the Netherlands, for example, we have hedged the guaranteed part from an equity point of view and an interest rate point of view. So therefore I don't expect a lot of impact going forward. However, in the UK, you're right. The drop in the market will have a direct impact on earnings. Having said that, the way that we have protected also our DAC recoverability ratio is that at a level where we are right now, there is absolutely -- we're not even getting close to any risk on DAC. So you do not need to be worried about that.

Just to summarize, because I think I've given part of these numbers along this discussion and I think the first question was from Duncan, Duncan Russell. To give you an idea what I shared, 100 basis points decrease in interest rates, which we have seen 100 in the US and around 50 in Europe, would lead to around EUR20m to EUR25m negative impact per quarter. But it would also have an impact on our [NAC] ratio in the US, which then feeds back into the IGD ratio. I'd like to give you an indication for the US. What I would expect is 100 basis points would probably lead to 40% to 45% lower NAC ratio.

In terms of equity markets, the impact actually of a 20% decrease on the whole markets, assuming that bond markets haven't changed, because what you see of course is that bond values have gone up at the same time. So if I only isolate the equity part of it, I would expect that the impact on earnings of a 20% decrease in equity markets, and the equity market staying at that level, let's say the shock decrease, would be approximately EUR40m to EUR50m per quarter.

And I would expect a limited impact on our capital position in the Netherlands, a little bit in the UK. But we will see that actually the unhedged fees part and the impact on alternative investments, which are directly related to the equity markets, would also have an impact on RBC ratio, a bit lower than what is mentioned on interest rates, but around 35 basis points -- 35 points on RBC ratio.

Albert Ploegh - ING - Analyst

Okay. That's very helpful. Maybe one follow-up question. So in the end of Q2, in Q2 at least some changes have been made in the portfolio in Holland. You see it more out of equity into fixed income. But can you maybe describe a bit in general where new money is now being invested? It's of course very difficult in these markets. It would also be helpful if you change your asset mix a bit given the current markets.

Alex Wynaendts - AEGON NV - Chairman and CEO

Yes, as you know, consistent with our strategy of automatizing our ALM, we had effectively sold, I would say, some of the large -- the last part of equities which we had in our Dutch general accounts, and we have invested in fixed income and in credit. That's consistent with our strategy.

So where do we invest new money? Yes, we invest new money in fixed income markets. As you know, we focus on high-quality fixed income markets. Having said that, with the Germans right now, what we're seeing it's clearly getting more difficult. But the focus really is new money on high-quality investments where I believe that corporates now are giving us actually the best opportunities. The corporates in general, if you look at the US but also in Europe, they are cash-rich. They have strong balance sheets. So they offer now in our view the best investment opportunities for our new money.

Albert Ploegh - ING - Analyst

And maybe one final question is related to Solvency II. With now discussion on the matching premium concept, how would that impact basically your business? Would that be more favorable compared to the illiquidity premiums and in that case fine for what's suggested? Maybe you can give some comments on them.

Alex Wynaendts - AEGON NV - Chairman and CEO

So I'd love to make comments, but then I'd probably need at least a half an hour and I don't intend to do it. Let me tell you the following. The discussions around matching premium, liquidity premium term is now being replaced by counter-cyclicality premium. It's now very much in the
hands of the European Commission together with the industry. We have the European parliament, national government. At this point in time there is absolutely no clarity as to where it will end.

What I can tell you is that we are working closely together as an industry to come up with proposals which we believe are the right proposals for the long term in the industry. And again the crisis of today shows that there needs to be some other counter-cyclical mechanism because some of the countries of course where we see spreads go up very dramatically, and we've seen that in Italy, we've actually also seen a kind of attempt yesterday on France, are only reminders that the Solvency II system needs to have a mechanism which deals with the counter-cyclical element or a dampening factor of whatever the term is.

The exact terminology is still in debate. And matching premium has now been put on the table as a solution in some of the countries. It's too early to give you what the outcome will be. But I think what is important is that we feel that we have a good dialogue and we're going in the right direction and the environment now reminds everybody who needs to be reminded that we need to have a dampening factor or a counter-cyclical mechanism in the whole approach.

Albert Ploegh - ING - Analyst

Okay. Thank you very much.

Alex Wynaendts - AEGON NV - Chairman and CEO

Thank you.

Operator

Thank you sir. We have no further questions at this time. Please continue with any further points you wish to raise.

Alex Wynaendts - AEGON NV - Chairman and CEO

Thank you very much.

Operator

Ladies and gentlemen, this concludes today's AEGON second-quarter 2011 results conference call for analysts and investors. Thank you for participating. You may now disconnect.