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Bloomberg Transcript

Q4 2016 Earnings Call

Company Participants

- John D. Neal, Group Chief Executive Officer
- Patrick Charles Regan, Group Chief Financial Officer and interim Chief Executive Officer, Australian and New Zealand Operations
- Tony Jackson, Group Head-Investor Relations

Other Participants

- Brett Le Mesurier, Analyst
- Daniel P. Toohey, Analyst
- David Spotswood, Analyst
- James Coghill, Analyst
- Kieren Chidgey, Analyst
- Nigel Pittaway, Analyst
- Ross Curran, Analyst
- Siddharth Parameswaran, Analyst
- Tim Lawson, Analyst
- Toby Langley, Analyst

MANAGEMENT DISCUSSION SECTION

Tony Jackson {BIO 1729093 <GO>}

Good morning, ladies and gentlemen. Welcome to QBE's 2016 Annual Result Briefing. My name is Tony Jackson. I'm Head of Investor Relations at QBE. This morning's briefing and the formal side of the presentation from Pat and John will run for approximately 30 to 35 minutes, which should leave quite a lot of time, plenty of time for questions and answers afterwards.

Before I hand over to the Group CEO, John Neal, if I could just ask everyone to mute their phones, please. And without any further ado, John?

John D. Neal {BIO 15681439 <GO>}

Thank you, Tony, and morning, everyone. Pat Regan, our Group CFO, and I are delighted to present QBE's 2016 full year results this morning.

There's a fair amount to review with the result, and I wanted to use this slide to pull out a few clear highlights. So, if we look at the slide left to right, the discount rate adjusted combined operating ratio of 93.2% is the best underwriting result we've presented for six years. And for the first time in a long while, we're showing some modest growth in the top line, so 1% up for gross written premium and 2% up for net earned premium on a constant currency basis.

Significantly, our North American operations achieved underlying growth for the first time in many years. And we continue to see growth from our franchise in the emerging economies of the world. Growth in our European Operations division was muted as we maintained underwriting discipline in very difficult trading conditions. And of course, across the group, we continue to pursue our strategic imperative to improve business retention rates by at least 1% each and every year.

So, the middle bar graphs point to important components of the combined operating ratio. Despite a deterioration in the Australia & New Zealand attritional claims ratio, notably in the first half of 2016, and some FX impact in Europe, our claims ratio actually improved by 2.6%, due to a very pleasing level of positive prior accident year claims development, some of which actually reflects the early benefits from our strategic claims initiatives.

So, on the right-hand side of the slide, we're pleased to be presenting an insurance profit margin of 9.7%, which is at the top end of our target range, and as a result of two factors, being the improved combined operating ratio, as mentioned, coupled with a higher investment return, which benefited from foreign exchange gains.

We can report that, in 2016, all key performance measure improved on the prior year. Excluding the impact of discount rate movements, the combined operating ratio improved to 93.2% from 94.3% in 2015. Our insurance profit margin improved to 9.7% from 9.0% in 2015, and towards the upper end of our 8.5% to 10% target range. And pleasingly, the return on equity increased to 8.1%, up from 7.5% this time last year.

We've made really solid progress on our operational areas of activity. Pat and his team have developed a comprehensive remediation plan in Australia & New Zealand, where the successful execution of this is evident in the 340 bps improvement in attritional claims ratio in the second half of 2016. So, whilst insurance portfolio remediation takes time, a combination of price increases, underwriting discipline, and claims focus should see the attritional claims ratio return to acceptable levels by the end of this year, being 2017.

The turnaround in performance in North America, initiated by Dave Duclos, has continued under Russ Johnston's leadership, with the division's underwriting profit more than doubling in 2016. Despite underwriting losses in commercial auto, a second consecutive strong crop performance and continued profitable growth in our specialty business contributed to a very pleasing 2% improvement in the combined operating ratio.

We have completed two reinsurance tractions – transactions to sell roughly a quarter of our outstanding claims liabilities in North America at book value, and this includes our problematical program run-off reserves. This improves the quality of the balance sheet in

North America and removes substantial uncertainty from our reserve position in this division.

We met our 2016 cost savings targets of $150 million, and planning is well underway to deliver a further $150 million in savings by 2018. And whilst growth is challenging in today's market conditions, we are making solid progress in each of the six strategic areas of focus we discussed with the market at our investor update in May 2016.

The profit uplift we're reporting today, coupled with strong cash flow generation, has allowed the board to both increase the final dividend by 10% to AUD 0.33, as well as announce an on-market buyback of up to AUD 1 billion over a three-year period.

So, this slide provides the results the company by operating divisions and in summary. In a moment, Pat will provide a more detailed update on the progress we've made in North America and in Australia & New Zealand. So, I will keep my comments brief in respect to these two divisions.

So, North America, the 2% growth in top line largely came from the development of our specialty businesses. And as I mentioned earlier, our underwriting profit nearly doubled that of 2015, which of course, is evidenced in the 2% improvement in the combined operating ratio.

Our European business under Richard Pryce's leadership continues to present strong underwriting profits and in the most challenging of marketplaces. So, once again, a 90.2% combined operating ratio is supported by a strong contribution of positive prior year claims development. And equally importantly, and on a constant FX basis, our attritional claims ratio in Europe is flat at 45.4%.

Gross written premium is down by 3%, reflecting the tough pricing conditions. And you will recall, we completed a further reinsurance transaction in the first half of the year to continue our move of selling claims reserves where we think it is beneficial to the shareholder and the P&L to do so.

In Australia & New Zealand, gross written premium is up by 5%, and whilst a combined operating ratio of 92.4% is 1.3% worse than the prior year, we're pleased to present a significant improvement in the second half attritional claims ratio with a much improved performance from our Trade Credit and Surety business, and the New South Wales' compulsory third-party portfolio, following rate increases in year of around 18%.

David Fried and the Emerging Markets team provided growth of 10% on a constant currency basis in 2016, and all this was achieved with a stable combined operating ratio. The division retains a strong focus on profitable growth across specialty, commercial, SME, and personal lines via strategic partners. And all this is supported by a single strategy across the division to drive and improve productivity, efficiency, and some cost reduction initiatives. Whilst we have more work to do to improve performance, most notably, Latin America, we're well positioned to benefit as the favorable long-term economic outlook for Emerging Markets leads to additional trade and investment in infrastructure.

Equator Re plays a critical role in assisting all of our operating divisions to manage their balance sheets and capital requirements through the provision of excess of loss reinsurance and some proportional covers. So 2016 was another successful year for Equator with an improved combined operating ratio of 78.9%, and where positive prior accident year claims development was a significant contributor to the result.

There are a number of important features in our 2016 result that for us point to our ability to continue to provide predictable and improving returns into 2017 and beyond. We are presenting a 5th consecutive period of positive prior accident year claims development, and we believe this pattern can continue into 2017. This result has been achieved while simultaneously strengthening our balance sheet and in a period where we've seen our probability of adequacy increased by 0.5% to 89.5%.

We are maintaining or improving our underwriting performance in each division, even in the most challenging market conditions, and most notably, in North America, where the division continues its trajectory to a mid-90s combined operating ratio by 2018.

Equally importantly, we continue to position all components of our balance sheet conservatively, and this includes the manner in which we elected to buy reinsurance. And notably, to protect ourselves against the frequency of large individual risk and catastrophe claims, we have consciously sought to eliminate unpredictability for this category of claim and the evidence of this action can be seen notably where the gross cost of large individual risk and catastrophe claims actually increased appreciably in 2016, but the net cost is essentially unchanged from 2015.

Similar protections are already in place, not only for 2017, but also for 2018, and will ensure that the cost of such claims is locked-in at around 9.5% of net earned premium. We're encouraged by our expense and cost reduction initiatives in 2016, and can confirm that plans and activities are already in place to generate a further $150 million reduction in costs across 2017 and 2018, as previously communicated to the market.

Now, I'd like to hand over to Pat to discuss our results in further detail, and in particular to add some progress and color to the story in Australia & New Zealand, and North America. Pat?

Patrick Charles Regan {BIO 15131018 <GO>}

Thanks, John. Good morning, everybody. As John said, in addition to my usual run through of the Group results, I'm going to give you a little bit more detail on what we've been up to in Australia.

Starting with the Group results, first of all, the Group reported a net profit after-tax of $844 million for the year, up some 5% versus our adjusted net profit after-tax for 2015. On a constant currency basis, that was a 16% increase versus 2015, and that improvement was due to our investment income and improved underwriting result, offset by a discount rate movement and a lower tax rate in 2016 as well.

Cash profit after-tax was $898 million, which is up some 12% on a constant currency basis. GWP on a constant currency basis was up 1%. Emerging Markets grew by 10%, largely driven by Brazil and Argentina. Australia & New Zealand grew by some 5% through a combination of both starting writing South Australian CTP, and by our rate increases in the second half of the year. And that offset the small decline in our European Operations as we focused very much on margin versus volumes there.

Excluding discount rate impacts, the combined was 93.2%. And interestingly, we said to you a few times before that we expect the second half combined to be lower than our first half combined. In fact, we'd expect that again in 2017. And our second half combined for 2016 was 92.5%, reflecting another half year of positive prior year development, a good crop result, and a decently improved attritional claims ratio in Australia.

Also worth noting, in the second half, we increased the PoA from 89% at the half year to 89.5% to the full year. The significantly adverse discount rate movements at the half year largely have been now completely reserved - reversed in the second half. And we recorded an $80 million pre-tax negative impact for the full year. Notwithstanding some pretty volatile investment markets in 2016, our investment return overall came in at 2.4%. And all of that meant our insurance margin, even after the adverse discount rate movement, came in at 9.7% towards the upper end of our 8.5% to 10% range.

The volatility of FX rate, particularly around the Brexit votes, combined with our usual hedging programs, gave us a larger-than-usual FX gain in the second half. And finally, our full year tax rate at 21% was lower than 2015. Primarily now because we're generating profits in the U.S., we're using tax losses there.

I'm now going to give you a little bit more detail on what we've been up to Australia & New Zealand, and where I spend most of my time since we got together at the half year. What we've been doing is designing and implementing a remediation plan. And overall, I've been really pleased with the progress we've made so far. To give you a little bit of color about how we've gone about that, we've subdivided the business into just under 50 sub-business units, or as we call them sales.

To give you an example of that, direct motor would be a sale, direct household would be a sale, travel would be a sale, commercial packages would be a sale, et cetera. Each of the sales has a clear business owner. And each of the sales now has a customized remediation plan. In the early days, we spent all of our time really making sure we understand any root causes for deterioration and performance on a sale-by-sale basis, and then making sure we constructed the right plan to make it better again.

As you'd expect, the actions do vary on a sale-by-sale basis. But to give you a sense of the main actions we put in place, obviously, premium rate increases - come back to that in a minute - revise and tighten underwriting selection. So, for example, the type of property risk we're writing or the type of trade credit business we're underwriting; tighten delegated authorities for our teams, our underwriters in the field; change terms and conditions, so that might be deductible levels; and particularly, tighten our practices and governance around our claims processes, so that could be better use of our approved suppliers, enhance recovery processes, or better fraud prevention techniques. And then, we've monitored all of those actions on an actual versus expected basis each month for each of our 44 sales.

And I'm pleased to say after all of that, we actually did see some improvement in the second half of 2016, when the claims ratio improved – our attritional claims ratio improved from 62% in the first half to 58.6% for the second half, standalone. And that improvement, as you would expect, was particularly evident in the fourth quarter.

All right, picking up couple of the sales, New South Wales CTP, over the last 12 months or so, we've increased rates by some 18%. And that flowed through to an improved attritional ratio in the second half. And on trade credit, we really focused on different risk selection and underwriting practices. They are the type of business – the industry types that we provided in trade credit, too. And that really paid dividends with a much improved attritional claims ratio in the second half; as well as CTP and trade credit, we also made good progress in things like commercial packages, public liability, household, and travel.

On the premium rate increases you can see on this slide, we've ended 2015 down some 2% or 3%. Started this year with a negative. And I'm pleased to say we got that to 4.5% increases in the fourth quarter. And in January, we managed that 5.5% increase for the month of January. Despite this, we were pleased to see that retention held pretty stable, above 80% for most of the year, and even in the fourth quarter still roughly at an 80% at a policy level.

We also saw continued positive prior year development. With $64 million of positive prior year development in the second half, and given our long track record of positive claims development in ANZO, I'm confident that we're reserving our current accident year takes (19:04) conservatively. And overall, while we put together a good set of plans and our remediation activities to-date are encouraging, there remains quite a bit of work still to do. We need to continue to improve the ANZO results into 2017, but I'm confident that we'll do so.

I just wanted to talk for a couple of minutes on LMI, broadly what I'm going to say is that the trends we're seeing are much in line with what we discussed with you at Investor Day. So, on the top line, as you recall, we expected a decline in premium, due to – primarily due to tighter lending conditions. And we've seen a 22% drop in GWP, but just a 5% drop in NEP, partly due to the long earning patterns in LMI, and partly due to reinsurance savings.

On our claims, worth remembering the 85% of the portfolio is owner occupied, just under 15% is investors, just 3 percentage low doc loans, and just 1% of portfolio is in mining areas. That said, as – broadly as we expected, we did see an uptick in the – at arrears levels, as we went through the year, primarily in Western Australia. But overall, claims levels were actually flat in 2016 versus 2015.

Notwithstanding that, we did take the opportunity to book our loss ratio and combined ratio a bit more cautiously at the end of 2016, more in line with our long-term average there and we've actually assumed a further slight increase in claims ratio in our plan for 2017.

Turning to North America, and the team there have delivered a further improvement in 2016, doubling the underwriting profit from 2015. And that was despite significantly higher both (21:09) cat and large risk losses, but also a problematic commercial auto book. And profitability improved on the back of a lower expense ratio, a market-leading crop result and strong growth in our specialty franchise.

The crop business had another excellent year. And while it was a good year for crop industry overall, the benefits of our data analytics driven farm-by-farm selection (21:36-21:45) in 2015, due to both the continued expense reduction efforts there and the sale of the (21:50) expense heavy mortgage and lender services business. And that gave an expense ratio decreases of some 190 basis points.

And as John mentioned, we would expect further expense savings in both dollars and expense ratio into 2017 in North America. Perhaps most importantly, they also did two significant pieces of risk reduction or portfolio change. Firstly, we terminated a number of loss-making commercial auto programs including one major standalone program all of which together lost us about $100 million in North America in 2016.

By the way the outstanding claims reserves for those commercial auto programs to tidy things up, we reinsured those into Equator. Secondly, we also successfully reinsured all of that old program run-off book to a third party at book value, thereby eliminating the risk of any adverse development what's a potentially volatile set of liabilities there. Those two transactions gave a onetime reduction in NEP North America for about $600 million.

On investment performance, and it was certainly an interesting year to be managing investments with the geopolitical events, Brexit, U.S. election, yield moves, FX rates. And we took the decision early in the year to stay defensively positioned. And our growth assets stayed less – decently less than 10% for most of the year. And we decided only to extend our duration as and when yields increased. And in this context, our annualized investment returns of 2.4% was a sound outcome.

Our blended asset – blended growth asset return was just under 5% for the year. And we did increase our growth assets to 10% at year-end and a little more than that since year-end. Similarly, when yields increased, we did extend duration up to one-and-a-half years at year-end. And again, we've extended that a bit further since year-end. We think that what this means now was we can reasonably comfortably generate investment income for 2017 in excess of 2.75%.

Notwithstanding those volatile markets and economics, we enhanced our already strong capital position in 2016. We now have capital equivalent of more than 1.3 times the capital needed for an S&P A rating and our PCA multiple at 1.79 times is right at the top of our 1.6 to 1.8 range.

The other key metric for a global business like ours is the cash remittances you get from the business units to the center, and that was up some 55% to $1.1 billion. Obviously, that's an important measure of coverage of our external dividend. And we had cash coverage there of just under 2 times.

And all of this gave the board confidence to both increase our final dividend by 10% to AUD 0.33 per share, representing an 8% increase in our full year dividend, and to establish a three-year on market share buyback facility of up to AUD 1 billion.

Back to John.

John D. Neal {BIO 15681439 <GO>}

Thanks, Pat. So, returning to our outlook, QBE's built on the strength of our underwriting performance, and this will always remain our overarching focus. And we are far from complacent. We've more work to do to execute on the remediation plans in Australia & New Zealand, as Pat's discussed. We've more work to do to continue the improvement in our North American property and casualty lines. And we need to be robust in the actions we take in developing our Emerging Markets business, particularly Latin America.

So, whilst the competitive environment did not support significant growth in 2016, our cross-cycle gross written premium target remains unchanged at 3%. In renegotiating our reinsurance treaties for 2017, savings of more than $350 million were achieved. And those savings are split roughly equally between the excess of loss reinsurance contracts and the proportional treaties. So, let's be very clear that in so doing, we have not added more risk to the portfolio.

So, our 2016 expense savings targets of $150 million was met. And as I mentioned earlier, our planning is well advanced to deliver a further $150 million of expense savings by the end of 2018. And some of these further savings will be reinvested in technology. So this should result in a further 1% reduction in our expense ratio by 2018.

We anticipate that half of our 2018 target of $200 million in claims savings will be achieved by the end of this year in 2017. Initiatives to combat claims fraud, being smarter in a way in which we achieve claims recoveries, and in our optimization of the claims supply chain are all giving encouraging early results.

At the same time, we're looking at our IT strategy and technology to ensure that the company is set for the long-term. And after establishing our data and analytics capability as a global function in 2016, including the development of our offshore support in India, our focus in 2017 will be directed towards projects that support portfolio remediation, claims initiatives and customer analysis. And for the first time in 2017, we will be investing a minimum of $50 million in partnering with insurtech companies, but those that have a particular focus in the data and analytics field.

The Group's Shared Service Centers in the Philippines continue to give us significant flexibility in a way in which we manage and balance onshore and offshore operational support in a cost-effective and efficient manner. Our dividend policy is designed to ensure that we reward shareholders relative to cash profit, as well as maintain efficient capital for further investment and growth in our business.

While 2016 performance has supported a further increase in all of our key capital metrics and in recognizing both the quality of our balance sheet, and importantly, the confidence of our forward plans, the board has not only looked to increase dividend payments, but also to establish a three-year cumulative AUD 1 billion on market share buyback facility.

So we anticipate that the market backdrop will remain challenging in 2017, although there are indications of some modest improvement, particularly where the rate of decline in global insurance premium pricing is easing. There will always be variations market-by-market. And whilst we believe price increases in Australia will be maintained, elsewhere we expect pricing to be broadly flat. In light of this competitive backdrop and some exchange rate volatility, we're anticipating gross written premium will similarly be broadly flat in 2017, albeit the reinsurance savings achieved should support a modest uptick in net earned premium.

So whilst our base case combined operating ratio expectation for 2017 allows for only a modest level of prior accident year claims development, a higher level of positive development could contribute towards a combined operating ratio at the better end of our target range.

Some of you may have seen our UK and global peers make reference to Ogden table changes in the UK in their results in the past fortnight, the timing is unfortunate, but we expect the UK Ministry of Justice will announce a downward revision in discount rates for UK personal injury claims tonight, our time, in Sydney. Sadly, any change has zero benefit for claimants, but necessarily will require an increase in claims reserves, and therefore, a hike in price to the detriment of the UK customer.

While we've allowed for a 1% reduction in the discount rate or roughly a $33 million impact in our risk margins as at the 31 December, 2016, should the UK Ministry of Justice announce a bigger reduction in the discount rate than the impact on QBE will obviously be greater.

If you have a look on page 24 of the annual report, we've provided sensitivities for potential outcomes. And depending on where the discount rate lands, we would be inclined to take the whole impact through the P&L at the 2017 half-year result, and maintain our Probability of Adequacy at 89.5%. Please note that the P&L impact related to this regulatory issue is not currently allowed for in our 2017 target combined operating ratio range.

So looking at investment markets, we're targeting an investment yield of between 2.5% and 3.0% for 2017. So please bear in remind the numbers on the slide are the investment yield, not the contribution to margin. So if you multiply that number by 1.35 roughly, you get the contribution to the margin. But based on our early year performance, we are actually hopeful of getting closer to the upper end of this range.

So this slide actually repeats the investor thesis we presented in May last year, and remains as valid today as it was then. And our targets out to 2018, including an ability to exceed return on equity of 10%, are unchanged. Through the second half of 2014 into 2015, and now in 2016, we have executed effectively to our targets and plans, and are confident in our ability to meet the performance targets we've set out in the market today for 2017, and importantly, our ability to continue to improve our business through the medium term.

(33:03-33:10)

We continue to buy reinsurance protections with the downside risk of running an insurance company in mind. Our claims provisions have shown consistent improvement for five consecutive reporting periods. And the board's confidence in our plans is reflected in both a healthy increase in dividend payment and the announcement of an on-market share buyback facility.

So, thank you very much. And now, Pat and I will be very happy to take questions.

Q&A

Q - Nigel Pittaway {BIO 3406058 <GO>}

Hi, John and Pat. It's Nigel Pittaway here from Citi. First question, just in the pack, in terms of guidance, you have sort of reiterated the 93% combined target for FY 2018. Previously, though, you said that was pre-reserve releases, whereas this time there's no mention of prior year releases. So, can you just clarify what you're exactly saying in respect to that?

A - John D. Neal {BIO 15681439 <GO>}

Yeah, I think as I said in my closing remarks, it includes an anticipation of a modest level of prior accident year release 2017 and 2018.

Q - Nigel Pittaway {BIO 3406058 <GO>}

Thank you. Okay. Next question, on crop, although the result was obviously very good, one noticeable thing was that the premium split was 57% first half, 43% second half, which is quite a reversal from what has been in prior years. Can you sort of explain whether or not that's an ongoing feature or is it particularly due to factors that existed this year?

A - Patrick Charles Regan {BIO 15131018 <GO>}

A good spot, Nigel. It was an unusual feature for this year because the combined was very good. You actually end up ceding part of the premium back to the government. That happens right at the top end of the range and right at the bottom. So, it meant that - actually slightly unexpectedly, we ceded premium, net earned premium, to the U.S. federal government. And that reduce earned premium in the second half. But you wouldn't expect that to happen next year.

Q - Nigel Pittaway {BIO 3406058 <GO>}

Okay. And then, maybe just one on LMI, I think, obviously, you had I think a combined 34.9% for the full year. That was already sort of high 20s – that was high 20s in the first half. So, it obviously deteriorated quite a bit in second half. And if you do look at the sort of the claims ratio, sort of picture you had on the strategy day, it does suggest that the claims ratio is around a bit higher than that. So, is all that you're saying conservative booking or have you really seen a deterioration in those trends where WA was, in fact, worse than expected?

A - Patrick Charles Regan {BIO 15131018 <GO>}

Yeah. I mean, it's an interesting question. We have seen higher arrears in WA, but not really a lot more than we were expecting, a little bit more. Whether you look at house prices, whether you look at unemployment rates, whether you look at the kind of individual arrears and individually affected areas, none it's kind of wildly different what we expected. We just spoke to it a little bit more conservatively at the year-end.

Q - Nigel Pittaway {BIO 3406058 <GO>}

Okay. Thank you.

Q - Daniel P. Toohey {BIO 16751863 <GO>}

Thanks. Daniel Toohey from Morgan Stanley. Just a few questions. First one is to follow up to Nigel's. I think in FY 2016, you talked about modest reserve releases of magnitude around 1% to 2%. And clearly, you've come in well above that. We don't have the hangover from the U.S. commercial auto and the outlook. So, does modest imply 1% to 2%? Or is it...

A - John D. Neal {BIO 15681439 <GO>}

Modest implies less than 1%.

Q - Daniel P. Toohey {BIO 16751863 <GO>}

Less 1%. Thank you. Second question, just on the New South Wales CTP, you've had obviously some pricing benefit come through, hoping, on the attritional line. Can you comment whether you would expect to be a beneficiary under the proposed risk equalization scheme reform or a payer?

A - John D. Neal {BIO 15681439 <GO>}

I think we'll be broadly neutral. So, I think we were following the spirit of what was intended at the way CTP pricing works. So, I don't expect it to be greatly altering how we do things either way.

Q - Daniel P. Toohey {BIO 16751863 <GO>}

And just finally, on the cash remittances to group, how much of that is coming through from the LMI business?

A - John D. Neal {BIO 15681439 <GO>}

So, I think we mentioned before – I think we mentioned at Investor Day that we're still a little bit lumpy with it. We'd like to be a little bit more even. So, we're still slightly over reliant on Australia, and Equator. And within the two of those, you capture the LMI elements of it. North America is coming back on stream now when we're still a little bit underrepresented in Europe. So, we'll have benefited by a couple of hundred from LMI in 2016 equally, as I say, work of underway and what we would consider a normal dividend from Europe as such.

Q - Daniel P. Toohey {BIO 16751863 <GO>}

(38:21). Thank you.

Q - Kieren Chidgey {BIO 7268946 <GO>}

Kieren Chidgey, UBS. Just a question on the impact of the reinsurance savings coming through this year, you've called out $350 million plus. I think you said half is in excess of loss, so if we call that $175. Also note on slide 33, your retention is up around $100 million on the aggregate next year. So, should we view the net benefit that, that drops through the P&L is about $75 million around that excess of losses? Is that the way to think about it?

A - John D. Neal {BIO 15681439 <GO>}

Sadly, it's a bit more complicated than that. You're right. So, half is excess of loss. So the actual P&L benefit that will come through from that we'd estimated about $20 million to $25 million. The balance is really through restructuring of the crop quota share contracts predominantly. So, that's the second part of the saving. When you get to the slide that's on the final slide in the deck slide 33, yes, you're seeing some increase in the risk retention and some increase in the first retention of account, significantly reduced to second. But all of that's captured in the aggregate.

So, any increase in retentions falls to that aggregate treaty at the back-end. So, if you follow the math through of increased retention capturing the aggregate, the net position for us is broadly unchanged at around about 9.5% of net earned premium for large risk and cat claims. So, a little bit of P&L benefit, $20 million to $25 million. But actually, the restructuring gives us net-net no increase in exposure.

Q - Kieren Chidgey {BIO 7268946 <GO>}

I mean, maybe just tying that back to the Investor Day, you were talking a number in the order to $50 million to $100 million P&L benefit.

A - John D. Neal {BIO 15681439 <GO>}

Yeah. I think the second component really depends on crop. If the crop business continues to perform as we would expect it to in 2017, then, yes, you'd see a further benefit come through from that crop quota share. So, in effect, we've retained $200 million more of net earned premium in crop in 2017. So if that performs in line with expectations, that's the balance of the number you're looking for.

Q - Kieren Chidgey {BIO 7268946 <GO>}

And you are still seeing 92% as a target combined ratio for crop or has that come down?

A - John D. Neal {BIO 15681439 <GO>}

It's a number we've reflected in our plans. We think it's a little too early to assume that it could be better. But the indications of the use of data analytics and the selection criteria that Pat spoke about, gently tends us to assume that it's a better business than that.

Q - Kieren Chidgey {BIO 7268946 <GO>}

Thanks.

Q - James Coghill {BIO 14006200 <GO>}

James Coghill, UBS. Just a couple of questions on the underlying trends in the business for the attritional loss ratio. So, the first one is on Europe. I mean, you have called out that there was a 90 basis point drag from a mismatch between the earned premium coming through and claims costs from sterling's devaluation. So, I guess, there are two parts to this question. Perhaps you could just explain why that mismatch is there and why underlying claims don't also change. And secondly, just comment on the trajectory for that drag into next year. Is this still something we have to think about for the first half, because I think it is?

A - Patrick Charles Regan {BIO 15131018 <GO>}

Yeah. There'll be a little bit more of that come through into the first half of 2017, but less than we saw in the back half of 2016. And it's to do with the rate that the unearned premium earns through versus the claims earned through. And again, it's a feature of the Lloyd's business where you're writing so many different types of business in different currencies, without making it sound more complicated. And that's basically the explanation. So, there is, as you would imagine, a little bit more flow-through of that into the first half of 2017, but to a lesser extent.

Q - James Coghill {BIO 14006200 <GO>}

Okay. Second one just turning closer to home and Pat is, probably one of the most remarkable and speedy turnarounds in an insurance business that I've ever witnessed given that you didn't even know it had blown up in May last year. So, perhaps more seriously, could you just take us through your thinking around how much of that attritional loss ratio reduction in the first half you think will ultimately reverse into financial 2017? So, I'm referring to the 6.6% reduction in the first half, and I think you mentioned a 1% drag. So, it was, call it, 8%, of which 340 bps - 3.4% has turned into second half. How should we be thinking about that turn into financial 2017?

A - Patrick Charles Regan {BIO 15131018 <GO>}

Yeah, (43:03) question, Jim. I mean, I don't think I'd want you to draw a straight line from - picking a point in the first half, picking a point in the second half and through. I mean, the - as you remember, we defined attritional as $2.5 million, so a little bit more in Aussie dollars. You get - some of it will depend on the amount of claims you get of just under that kind of size. But if your question is, have we made some sustainable changes? Then, it feels like it. Yes. I mean, obviously rates are big indicator of that. We'll get more of that earning through into 2017. We've only picked up really the early parts of that in 2016, whether it be CTP, commercial motor, trade credit.

That reselection is definitely a factor in it. I mean, that's obviously, and something like trade credit that's been a big - and we saw a big improvement in attritional in the second half there. And there's - the claims is the other big one, where - I mean, that's just your average claims payment just tend to jump around a little bit more, albeit we've seen lower levels clearly in the second half of 2016 than we saw in the first half of 2016. So, John said we'd expect to see more improvement in 2017, partly because we're just earning through the rate increases and we're still carrying a little bit more rate in the early part of 2017, than we did in the later part of 2016.

A - John D. Neal {BIO 15681439 <GO>}

And just without wanting to make it more complicated, and you've heard me say this before, an actual year lifts for two years. So, at the half-year, you're a quarter of the way through the life of the year. So, I think when we spoke in August, we felt very confident in our ability to be able to recapture that attritional claims ratio movement.

I think the team had done a nice job in promoting their change in price, change in deductibles. Some portfolios you can fix quite quickly, which is what's happened with trade credit maturity. The rate increases that Pat and the team have put through on the balance of the portfolio, we need to see how that performs through this year. But it encourages us. The other factor I'd say is that don't underestimate the value of those reinsurance treaties. So in (45:13-45:30).

Q - Toby Langley {BIO 15924432 <GO>}

Toby Langley from Bank of America Merrill Lynch. On your capital position, you're knocking on the top end of the range. You've taken a lot of actions to restructure the business, derisk, sold stuff, et cetera, et cetera. How do you feel about the interplay at where that capital position's now sitting in your PCA target range?

A - Patrick Charles Regan {BIO 15131018 <GO>}

I mean, we've talked about before a lot of things that we've done worked better on the more risk-adjusted measures, whether that be around internal capital model or S&P. So it was actually nice to see the PCA also respondent and grow in the period. So they're both sort of right at the top end of our range, and hence, really the board's decision to both grow the dividend and take the opportunity to announce a buyback. So I think kind of the - it was good to see them both respond and they're both right at the top end of where we want them.

Q - Toby Langley {BIO 15924432 <GO>}

Is EBITDA - last point, let me correct it, if you limit yourselves to A$333 million and the dividend you've got today, that PCA is still going to be knocking at that level?

A - Patrick Charles Regan {BIO 15131018 <GO>}

It's – we're still going to be capital strong as we go forward. And I think that it's good to be capital strong in that.

Q - Toby Langley {BIO 15924432 <GO>}

Okay. With regard to your actions in Australia, Pat, and is that project just about restoring businesses that you have? Or are you leaving other options on the table, i.e. will you consider disposing sales or injecting to beef up parts of the business that maybe could good do with being bigger?

A - Patrick Charles Regan {BIO 15131018 <GO>}

No, it's much, much the former. It's about improving what we've got. It's actually – it's an interesting – the business has got great market positions in most of what it does, and I've been lucky to inherit those. So a lot of what we're doing, we've got very good strong distribution partnerships. We've got very strong position in the market. Therefore, that's allowed us to make some of the changes, maybe a little bit quicker than I thought we could do. So no, it's very much more about making the changes we said, actually growing where we can. Some of the portfolios are performing well, and where we can, growing as well.

Q - Toby Langley {BIO 15924432 <GO>}

Thank you.

Q - Ross Curran {BIO 15090587 <GO>}

Hi, gents. It's Ross Curran from Deutsche. Two quick questions. Circling back to James' question on attritional losses in Australia. Pat, you mentioned that much of the remediation happened later in the half. Is there much difference on a quarterly basis? Is the fourth quarter attritional performance dramatically different from the second half attritional performances, John?

A - Patrick Charles Regan {BIO 15131018 <GO>}

It's better. Yes. I mean, I'll refrain from giving your attritionals kind of on a quarter-by-quarter or month-by-month basis because it does jump around a little bit. But yeah, the fourth quarter is better than the third quarter or the second half alone is yes.

Q - Ross Curran {BIO 15090587 <GO>}

Can we get a comment on the exit rate of attritional losses into the year?

A - Patrick Charles Regan {BIO 15131018 <GO>}

I'll repeat my earlier one. Refrain from giving you month-by-month or quarter-by-quarter.

Q - Ross Curran {BIO 15090587 <GO>}

Sure. Then, can we have a comment on the amount of capital in the Australian LMI business and how much the capital lease from that over the next three or four years helps underwrite that buyback?

A - Patrick Charles Regan {BIO 15131018 <GO>}

I mean, we've talked a bit about having just over AUD 1 billion, I should prefix in the LMI business. But actually, as Toby said, we're very capital strong anyway. The two things for us of what our overall Group capital looks like. And is it fungible enough? Are we getting good capital flows? And actually, in both – but we're strong on both sides. And any capital release from LMI is sort of an icing on the cake in that sense.

Q - Ross Curran {BIO 15090587 <GO>}

So you're not dependent on capital coming out of LMI to fund the buyback?

A - Patrick Charles Regan {BIO 15131018 <GO>}

No.

Q - Brett Le Mesurier {BIO 5909278 <GO>}

Brett Le Mesurier from Velocity Trade. Question on your deferred reinsurance cost. They fell from about $1 billion at the end of 2015 to about $600 million end of 2016. You recall the reason for that?

A - John D. Neal {BIO 15681439 <GO>}

Because we've aggregate reinsurance treaties on a two-year basis, you book the cost of the two years upfront and earn it over the two-year period. So that's the reasons for the fall.

A - Patrick Charles Regan {BIO 15131018 <GO>}

So last year was unusual rather that this year being unusual, Brett, in this sense.

Q - Brett Le Mesurier {BIO 5909278 <GO>}

So there is not much in that deferred reinsurance costs for business not yet written, I presume.

A - Patrick Charles Regan {BIO 15131018 <GO>}

No. As John said, we – so last year, we would have actually essentially written, if you like, two years' worth of the deferred reinsurance costs. So it's a – you end up with – I think it's $1 billion versus $600 million or $500 million, something like that. And the delta is in that.

Q - Brett Le Mesurier {BIO 5909278 <GO>}

Yeah. But in the – last year you had – I think it was a couple of hundred million dollars relating to business not yet written.

A - John D. Neal {BIO 15681439 <GO>}

It's – if you book it upfront – so if we buy a treaty for two years, the accounting standard requires us to book the premium in full upfront even though in the year in question we will only write half of the business we would expect to. So that's why you end up with deferred cost. And then, obviously in year two, you earn that cost through against the business that you're writing. It's as simple as that.

Q - Brett Le Mesurier {BIO 5909278 <GO>}

Yeah. So that would have reduced that figure.

A - John D. Neal {BIO 15681439 <GO>}

Correct. And you'll see the same, again, in 2017 because in effect, we bought the same treaty for two years. You'll see the same pattern of earning.

Q - Siddharth Parameswaran {BIO 15037291 <GO>}

John and Pat, it's Siddharth Parameswaran from JPMorgan. A couple of questions if I can. Firstly, just on the premium rate environment, could you just comment on how premium rates are tracking in your various regions against inflation? Is there any pressure on a region on the combined ratios?

A - John D. Neal {BIO 15681439 <GO>}

Yeah. It's good question against inflation. If I turn the question around, if there is one thing that we're keeping a close eye on it, it is just that. It is inflation. We saw it, as you know, in Australia for the first time for – in a long while through the early part of last year. And we're alert to it in the UK. An output of Brexit you would think would result in inflation coming through the claims line. We are actually only seeing it on motor at the moment. We're not seeing it more broadly. Claims inflation on motor is running at about 8% to 9%. So you won't be surprised to hear that the level of rate increase is in excess of that.

I think when the Ogden changes go through, goodness knows what the level of rate increase will be on motor in the UK. Not seeing any unexpected inflation in the U.S., actually, as yet. But again, we're looking for it. Natural output of the new administration's policies is positive in the main, but you would think inflationary. So, that's the view on inflation.

In terms of rate, obviously, as Pat referred to here, nice lever rate increase, knocking through the fives in the early part of the year. As we came through, our 1-1 renewals in Europe, actually reasonably encouraged was a relative comment. Reinsurance pricing was off by less than 1%. Property and casualty pricing was literally flat. And the same was true in the U.S. macro, albeit our rates in the U.S. were up by just over 1% on 1-1 renewals. So, hence, our assessment is broadly flat pricing, ex-Australia. And on the inflation point, we're keeping a weather eye on inflation.

Q - Siddharth Parameswaran {BIO 15037291 <GO>}

So, basically, no margin pressures, then arguably see benefits coming from Australia?

A - John D. Neal {BIO 15681439 <GO>}

No. Correct.

Q - Siddharth Parameswaran {BIO 15037291 <GO>}

Okay. Great. Thank you. And then, it – and maybe it ties into the second – to my second question, which is just around your guidance, which you've given on the combined ratio. When I look at your attritional ratio, it seems to have deteriorated at about 2.5 points ex-crop in the preceding year, but your guidance is actually improved on the combined ratio versus what you gave for 2016. So, just I mean, maybe it is that you're seeing a better environment. I'm just trying to marry up those two trends. Should we take it that you're more conservative last year or...

A - John D. Neal {BIO 15681439 <GO>}

I think – if you look at us this year, as I've sort of said in closing remarks, we're very confident in our ability to execute on plan. The only watch I've got on the combined ratio is the prior question, what's actually happening with market conditions? Does that put us under a bit of undue pressure? At the better end, we've got two, three areas of the business we have to improve still. I'm very happy with the trajectory in Australia. Very happy with the degree of improvement in North America. So, those are all positive factors in terms of performance.

And per Nigel's earlier question, it's right for us to assume some prior accident year development positively. But I think, again, we've been reasonably cautious in what that might be. So, there is a challenge. Market conditions aren't great. We're not seeing price increases everywhere. But there is some opportunity for upside.

Q - Tim Lawson {BIO 3280691 <GO>}

Tim Lawson, Macquarie Securities. Just in terms of the buyback, just any internal and external considerations around the three-year timeframes into long period?

A - John D. Neal {BIO 15681439 <GO>}

Sorry. I missed that.

Q - Tim Lawson {BIO 3280691 <GO>}

So, the timeframe to put out a three-year buyback announcement in over that period. So, why not do a one-year and follow it up? What are you thinking about for a three-year period in terms of the business operating conditions and what the external environment might look like over that period?

A - John D. Neal {BIO 15681439 <GO>}

We're just trying to balance the best means of returning capital to shareholders. The reality is that as our business performs in line with expectations across the geographies, our franking credits in Australia reduce. So, historically, we've had franking credits of around 50%. They will naturally fall to 30%. So, just simply increasing dividend is not necessary the best answer for the shareholder, hence, the ability to buy back shares.

Our view on that is that in almost all circumstances, any forward buyback is ROE accretive. But clearly we're going to be sensitive to the share price and ensure that we get the balance between buyback and dividend right for the shareholder. So, there's no absolute view on how much buyback we'd conduct in any one year. But I think if you were to assume it evenly over the three years, that's probably appropriate.

Q - Tim Lawson {BIO 3280691 <GO>}

And an overall payout ratio then including dividends and buyback?

A - John D. Neal {BIO 15681439 <GO>}

So, the payout ratio is purely for dividend. That's 65% up to...

A - Patrick Charles Regan {BIO 15131018 <GO>}

I think we have a question on the telephone. David Spotswood?

Q - David Spotswood {BIO 17576616 <GO>}

Thanks. Just a couple of quick questions. The interest cost of $294 million, that is bit of a jump from last year. Is the $294 million a reasonable number to assume going forward? The tax rate you called out was 21%. Will that revert to something higher, 24%? Or should we issue 21% going forward? And just a comment on the interest rate sensitivity, if interest rates – discount rates go up 1% across the board, the flow-through to the P&L on that? Thanks.

A - John D. Neal {BIO 15681439 <GO>}

Thanks, David. On the first one, the $294 million was a little bit higher. We had – I think I mentioned that we exited a number of our commercial auto programs in U.S. And we had a one-off payment to exit those. So, our run rate of interest cost is closer to around $250 million, which is a bit more similar to what is in 2015.

The tax rate, because we've got profits coming through in the U.S., and we're using the tax losses, you would expect that 2016 rate to be more the long term go forward. If anything, it might be even be slightly lower than that. And then, the impact of discount rates movements, where 1% movement in discount rate has an impact on liabilities, what about, 350 (57:38) pre-tax.

I guess the new news is because we now have a longer duration of our assets, that would be largely, but not completely, offset on the asset side. So, we're closer to that being offset. There would still be a mismatch, but to a much lower extent than we've had in the past.

Q - David Spotswood {BIO 17576616 <GO>}

Thank you.

A - John D. Neal {BIO 15681439 <GO>}

Okay. If there are no further questions, thanks, everyone. We'll close there. Thanks for joining us.