Q4 2018 Earnings Call

Company Participants

- George Quinn, Group Chief Financial Officer
- Mario Greco, Group Chief Executive Officer
- Richard Burden, Head-Investor Relations & Rating Agency Management

Other Participants

- Andrew J. Ritchie, Analyst
- Farooq Hanif, Analyst
- James A. Shuck, Analyst
- Johnny Vo, Analyst
- Jonny Urwin, Analyst
- Michael Huttner, Analyst
- Niccolo C. Dalla Palma, Analyst
- Nicholas Holmes, Analyst
- Peter D. Eliot, Analyst
- Vinit Malhotra, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Ladies and gentlemen, welcome to Annual Results 2018 Conference Call. I'm Cher, the Chorus Call operator. I would like to remind you that all participants will be in listen-only mode and the conference is being recorded. The presentation will be followed by a Q&A session. The conference must not be recorded for publication or broadcast.

At this time, it's my pleasure to hand over to Mr. Richard Burden, Head of Investor Relations and Rating Agency Management. Please go ahead, sir.

Richard Burden {BIO 1809244 <GO>}

Thank you. Good morning, good afternoon and welcome to Zurich Insurance Group's full year 2018 Q&A call. On the call today is our Group CEO, Mario Greco; and our Group CFO, George Quinn. Before we start with the Q&A, can we kindly ask you to keep your questions to a maximum of two, and if we have time at the end we'll obviously come back around to you for further questions. And with that, I'd like to pass over to Mario to make some introductory remarks before we start the Q&A.

Mario Greco {BIO 1754408 <GO>}

Good day everybody. Thank you very much for joining us. Before we get into the Q&A session, I just want to provide you with a few remarks from my side. First of all, we're very pleased with our full year results. It demonstrates further progress against the targets and the priorities that we outlined in November 2016, and they have been achieved despite a challenging financial market in the latter part of the year and continued elevated natural catastrophe activity.

Particularly pleasing has been the strength of the results in our Life business. Even adjusting for positive foreign exchange movements, they increased by 23% year-on-year. The results also show the high quality of our Life business. 90% of revenues are coming from either technical margins or fees and loadings and there is very little reliance on investment results. This underlines the success of our consistent strategy of focusing on protection, unit-linked, and corporate products. We continue to execute on this strategy over 2018 where 86% of the APE came from these products and 100% of new business value was from those products.

Our Property & Casualty business also performed well. We saw an improvement in the accident year combined ratio. This was driven by improvements in the accident year loss ratio with our commercial business also seeing improvement in very tough market conditions. Our reserves remain strong as demonstrated by the continued positive prior year development at slightly above 102.2% guidance. As in 2017, 2018 demonstrated the effectiveness of our underwriting with below natural share of elevated natural catastrophe events in the U.S. Investment income in Property & Casualty has also stabilized as reinvestment yields have continued to improve. Looking forward, we expect our underwriting performance to be upper end of the 95% to 96% range as the impact of business mix shift, rate increases, and expense reductions continue to earn through.

Farmers has continued to demonstrate solid growth in their chosen areas and in their ability to innovate with new business offerings like the commercial rideshare business with Uber and like Toggle which is insurance on-demand quite successful last year. Their customer focus strategy is also continuing to drive improved customer metrics, and this has been achieved with an improved underwriting performance. After many years, Farmers has a double-digit combined ratio and we're very proud and satisfied with that. These trends should continue to support growth in Farmers Management Services.

Our balance sheet is strong and the Z-ECM ratio is at 125% despite the impact of financial markets in the latter part of the year, and this reflects the strong operating capital generation within our businesses. Importantly, we continue to turn this capital generation into usable cash remittances to the group with a further $3.8 billion of remittances in 2018, bringing the cumulative total over the past two years to $7.5 billion which is well on track to exceed the $9.5 billion target for the end of 2019. This ability to generate cash underpins our dividend which has been increased by 6% to CHF 19 per share, and this represents a 76% pay out which is in line with our stated dividend policy.

2018 has also seen us continue to deliver against our key strategic priorities. We have further strengthened our leadership positions in the faster-growing regions in Asia and

Latin America, and we have built out our leading position in the fast-growing travel and assistance business through targeted acquisitions while also continuing to build additional distribution partnerships.

We have continued to invest in innovation. In 2018, we had the inaugural Zurich Innovation World Championship, which saw a wide range of interests covering all aspects of the insurance business with the winners announced last week. We look forward to working with the winners to bring new and innovative solutions to our business.

We've also continued to roll out other innovative customer offerings with the launch of our first application under our cooperation with CoverWallet; the launch of Klinc, an innovative provider of on-demand coverage for personal possession; as well as announcing a strategic collaboration to use Snapsheet's virtual claims technology across the group. These initiatives will help ensure that our customers benefit from simpler interaction with our businesses and greater levels of customer service, while delivering very greater levels of efficiency.

Overall, these results and development give us confidence that we're well on track to fully deliver against our current targets and position us well for the next phase of our development, which I look forward to presenting to you later this year, actually in November in London.

With this, I would pass back the line to you for Q&A.

Q&A

Operator

We will now begin the question-and-answer session. The first question is from Peter Eliot, Kepler Cheuvreux. Please go ahead.

Q - Peter D. Eliot {BIO 7556214 <GO>}

Thank you very much. The first question was I guess on the sort of the underlying earnings that you're seeing. I mean, there's lots of moving parts in the numbers including some positive one-offs. But considering the sort of the high level of nat cats we've seen and restructuring costs, my sort of calculation of sustainable earnings gets me to a couple of hundred million higher than you reported. And I mean the fact that you've reported for a dividend close to 75% of NIAS kind of implies that you think NIAS is a good estimate of the sustainable run rate. I'm just wondering if you could sort of comment on that or whether I am (00:08:27)?

And the second question is on the impact of the P&C portfolio mix changes. And we've seen the commission ratio hike of 3 percentage points over the last three years which just seems quite a lot, I mean. I'm just wondering if you can sort of give us some clarity numbers around sort of the proportion of the business and the extent to which that's driving and I guess will continue to drive it. And I guess your guidance of flat P&C

premiums next year on the back of the portfolio mix change, I'm just wondering if you can sort of say when we should expect to see the end of this and when we could maybe start to see premiums starting to pick up? Thank you.

A - George Quinn {BIO 15159240 <GO>}

Peter, thanks. This is George. So on the first one we actually have a slide in the investor deck today. I don't recall the precise number; 9, 10, something like that. In that, we've tried to break out both for last year and for this year. What we see is the – I hate to use the phrase underlying earnings, but certainly if you take out some of the obvious one-offs and as you may have seen from that slide already we would see it substantially higher than just $200 million.

There's two obvious things we would adjust for. So one is the extra point in nat cats sort that we have in the year. So a bit more than $260 million. And the second thing is the element of simplification that we have within the operating profit. If you adjust for both of those, you got a number that's a bit north of $5 billion for operating profit.

There are other items that are one-offs. And so, for example, I'm sure you're aware of the conversations with the IR guys today that there are certainly one-offs in the Life result that are positive. But equally you'll find other one-offs that are negative, for example, around hedge fund. So we tend to net the rest of it to pretty much zero. So if I were doing a normalization calculation, I'd be adding back something between $400 million and $500 million as opposed to $200 million.

On the second point around the portfolio changes, I mean, we covered that a bit at the half year and the picture hasn't really changed certainly so much from then. I mean, obviously it's driven by – we talked about three things at the half year. So we have the travel business with Cover-More, and I think as everyone knows that's a pretty high acquisition cost business given the characteristics of the type of product and the low volatility nature that it brings.

Second was the finance and insurance business in the U.S. So that business grew pretty substantially in the first half of the year. So that was just a driver of that 1.1 percentage point increase you really saw in the first half of the year. And then, of course, LatAm where we've been pretty successful in finding new distribution agreements particularly around the retail side in Brazil; that's also exerted some upward pressure on the acquisition cost ratio.

I don't expect it's going to change markedly in the short-term. I think the one thing to bear in mind though is that, I mean, we obviously don't normally look at the commission ratio. What we're trying to say when we like the business is the overall performance. So for us, I mean, if we do have to trade a slightly higher commission ratio to further improve the characteristics of the book, i.e. better margin with lower volatility characteristics, that's something we would continue to do. I don't immediately see that in our future but, I mean, I couldn't entirely rule that out. So, I mean, for me I think you need again to look at the overall technical performance and we've talked before about, I mean, over time I expect to see a trade between the loss ratio and the commission ratio.

Q - Peter D. Eliot {BIO 7556214 <GO>}

Thanks a lot. And in terms of sort of the overall premiums volume, when we might just start to see a pickup or the pressure from portfolio mix go away?

A - George Quinn {BIO 15159240 <GO>}

So on the third question...

Q - Peter D. Eliot {BIO 7556214 <GO>}

Sorry.

A - George Quinn {BIO 15159240 <GO>}

Yeah. So for us, I mean, if you look at what happened last year, I mean, the trend that we've been on certainly continued. Probably the reduction in commercial slowed down a bit, so we dropped by, I mean, very low single-digit. The retail portfolio, and I guess you understand the definition of retail for us, so it includes SME and the higher volume commercial type exposures, I mean, that's growing at a level that's, I mean, closer to double-digit. But we have bought more reinsurance. We talked about it during the course of last year especially around casualty, so that obviously has some impact to knock back that higher gross rent premium. At this point, in terms of the last year reinsurance that we do certainly on quota share basis, I don't expect that we're going to be changing that in the short-term. So I would expect that this year at flattish. I mean, there's a possibly if we can find the right opportunity on the retail side we will grow. I think the challenge is the market on commercial, I mean, a bit hard I suppose to imagine today. Just given the profitability characteristics of that part of the portfolio, it would be a high priority in Europe.

Q - Peter D. Eliot {BIO 7556214 <GO>}

Thanks a lot.

Operator

Next question is on Andrew Ritchie, Autonomous. Please go ahead.

Q - Andrew J. Ritchie {BIO 18731996 <GO>}

Hi there. First question just on pricing. I just was looking for a bit more granularity mostly in North America. Some of your competitors have been sort of focusing on rate increases ex-workers' comp if we accept the workers' comp is soft but the claims environment is also soft. But ex-workers' comp, I'm interested in what rate you're getting on the problem lines which continue to be, it seems, a lot of liability lines, particularly commercial auto. So what kind of rate you're seeing in that and whether that's moderating or still hard.

And the second question on reserves, I note that for this year the group reserve release is a bit higher than that from the divisions. I'm assuming that is partly to do with the 2017 caps which would be close to group reinsurance level or is it there's something else going on? And linked to reserves which may be linked to my first question, the U.S. – North America had a fairly weak or weaker PYD in the second half of 2018 versus last year. Was there some strengthening again of commercial auto in that line? Thanks.

A - George Quinn {BIO 15159240 <GO>}

Yeah. Thanks, Andrew. So on the first one, pricing, the pricing dynamic I think we talked certainly earlier. I mean, we anticipated that things would probably slow down once we were through the renewal of loss affected accounts. If you look at the U.S. in detail, if you look at it from the full year perspective, I think we see the U.S. markets' pure rates – we can come on to loss cost inflation in a second – a bit north of 3.5 points powering through the year. I mean, it was pretty stable through the first three quarters. It's dropped off a bit on Q4 so we are beneath 3 points in terms of rate increase. Within it, I mean, property has come down a bit so we are about 2 points.

If you look at commercial, so we can take motor, the one that you asked for. So Q2, Q3, Q4 pretty stable so we're seeing it in the high single-digit range. And as you point out, workers' comp is a bit soft. So despite the events of last year, workers' comp continues to be a very profitable line and there is more competition there. But the rate that we see on commercial also seems okay for us at the moment albeit it still does require some portfolio adjustment to try and drive the kind of returns that we need.

From a claim perspective and inflation perspective which of course is a really important partner to this, so inflation around the commercial auto line is still fairly high, so maybe not as high as we saw it last year but, I mean, it's still well in the mid-single-digit range. So the rate at which the margin is expanding is considerably less than maybe the headline rate would apply and it certainly doesn't make it anything like attractive enough to want to jump back in with both feet although workers' comp is soft and the inflationary stats around the claim side of workers' comp are still very benign to put it mildly. I mean, overall picture, things have slowed down a bit which was entirely what we expected just given the way that portfolio was renewing. And I think as we look forward, the pricing trend by line of business probably will be quite distinct, so the broad market movement and response to a bit of the claim expense of 2017 I think at this stage is partially behind us.

On the reserve topic, so why do you see a group reserve release. So it's a combination of factors. So for example, things like the EL transaction that we did back in December, we held some additional reserves around that line of business up top. Obviously, given that it's going that's no longer required. There was a small difference between the way the Group Re were seeing things in some of the countries and we held at a prudential margin. We've been working on that over the last couple of years and we've reached the level of comfort that allowed us to remove it. I don't think it's the cat topic. I mean, cat is mainly embedded in the local business. I don't think we have anything significant at all on cat.

U.S. expense in the second half on PYD, I mean, nothing really to point out there. I mean, probably the only thing we did do in the reserve in the second half of the year around the U.S., we did a normal detailed review I think around – I think it was already end of Q3, but of course given we don't have Q3 numbers it would've been visible externally. But the workers' comp business was very strong. By and large, we've taken the opportunity to strengthen, more recent years, both on workers' comp and on liability more generally. But I don't recall commercial auto being a particular topic in that regard.

Q - Andrew J. Ritchie {BIO 18731996 <GO>}

Just to put a round off, so we're not sort of misinterpreting. I mean, you say, the prudential margin, I think was the language you used, at the group level, you felt you no longer need it, but presumably there still is a prudential margin of some kind, is there or...

A - George Quinn {BIO 15159240 <GO>}

Yes, absolutely. So to be very specific, the prudential margin related to that one (00:20:18).

Q - Andrew J. Ritchie {BIO 18731996 <GO>}

Oh, okay.

A - George Quinn {BIO 15159240 <GO>}

So, the overall group reserve strength, as we assess it, from beginning to end of last year, they excel at the same percentile.

Q - Andrew J. Ritchie {BIO 18731996 <GO>}

Thank you. Great. Thanks very much.

A - George Quinn {BIO 15159240 <GO>}

Thank you.

Operator

Next question comes from the line of James Shuck from Citi. Please go ahead.

Q - James A. Shuck {BIO 3680082 <GO>}

Hi. Good morning, good afternoon. So, I had three questions, but I'll restrict it to two. But if you don't answer the first one, then, can I ask a replacement?

A - George Quinn {BIO 15159240 <GO>}

Oh, well, okay. Keep going then, James.

Q - James A. Shuck {BIO 3680082 <GO>}

Well, first question I'm just interested in what the absolute combined ratio was in both crop and workers' comp please for 2017 and 2018. For workers' comp, ideally, I'd like the workers' comp ex PYD. So, that's my first question. Perhaps you could tell me if you're going to answer that one, if not I'll choose a different one.

A - George Quinn {BIO 15159240 <GO>}

All right. So I'm not just to save you time. I'm happy to give you color around it, but I'm not get into the very detail where you asked for it. So, I'll give you half a question; I'll give you half an answer.

Q - James A. Shuck {BIO 3680082 <GO>}

I'll replace with half a question as well then. Go ahead with the color then please. Thank you.

A - George Quinn {BIO 15159240 <GO>}

If you looked all of last year, crop, another strong year for us. I mean, not as strong as it was in 2017. No player is strong with some of the figures I've seen from competitor disclosure. So, I mean maybe we are 6, 7 points better than we would ordinarily expect to see the business run at. So, I mean, that clearly has benefited the performance, but it's not at the level that we saw in 2017.

Workers' comp, nothing particularly special to point out. I've mentioned in response to Andrew's question that we did move this out around a bit. The line still seems to throw off quite a bit of positive development. And to the extent that it's reasonable, we're trying to hold that back on the more recent years. So, PYD, I don't actually have a figure for PYD for workers' comp in my head. But given what we did, I think you can assume that on a net basis, there would be some positive point, not very large.

Q - James A. Shuck {BIO 3680082 <GO>}

Okay. Great. Thank you. So, another question is then – on the combined ratio and the kind of guidance was the upper end of the range, so the 96% in 2020. So, I mean, it looks like you're normalizing in 2018 around 97.2%, if I give you the benefit of the one-offs for expenses. So, you got at least 1.2% improvement to come. Expense delivery's about 75% done. It looks like most of that improvement is set to come from commercial lines, just given the starting point for resale and other. Can you just elaborate a little bit about your confidence in achieving that?

We've seen recently rate is slowing. Some of the peers in the U.S. are being quite cautious about their guidance for next year. You're likely to get some headwinds on workers' comp. So, perhaps, you could just expand a little bit on where that improvement is coming from. And I suppose kind of linked to that. Is kind of that top end of that range, is that including 1.5 points of PYD, or is it including a different number, because I think you only guide to kind of 1% to 2%?

Second question is just really a quick one.

A - George Quinn {BIO 15159240 <GO>}

This is smart.

Q - James A. Shuck {BIO 3680082 <GO>}

I just wanted to understand what the potential is for you to do share buybacks, because you have a Z-ECM range, you have a target range of 100% to 120%. We've seen some volatility in Q4. That volatility would have reversed. The range you have should allow for that volatility.

And, obviously, you've got other binding constraints, such as S&P and what have you. So it does seem as if you're running with a level of capital that is kind of above where you need to be. You did do a buyback quite recently, but essentially dilutive. Could you just help us understand a little bit whether 2019 is a possibility for a buyback or whether is it more of a medium-term question? Thank you.

A - George Quinn {BIO 15159240 <GO>}

Thank you. So that is a complex, multi-nested question. So I'm going to start at high level, and then maybe we can descend into them on detail. So I think the way that you had looked at things, so you normalize, you come at around 97.2%. You pointed out that we have expense delivery anticipated this year, which is absolutely correct.

I'm not sure that it'd be completely reasonable to assume that it's all going to drop into commercial. I mean, just given the areas where the expense action is taking place this year, it's certainly in what I would describe as one of a more retail-heavy regions. So I would expect you to see expense improvement on both retail and commercial.

Having said that though, the 97.2%, I guess, is connected to the PYD topic. So back at – and I forget whether it was half year or the Investor Day, we guided that – I mean, just given the pressures that we see and I mean the positive pressures for the avoidance of doubt, we would see PYD around the upper end of our guidance. And that's what I anticipate we'll see in 2019.

So if you're trying to look at underlying, I agree that the 2.3% that we've seen for 2018 is maybe a touch high, but I wouldn't knock it all the way back to 1.5%. And in fact, just to keep the math simple for me, I'd probably knock it back to about 2%. If I do that, then I guess compared to you, I'm ending up somewhere around the 97% for the year. And, of course, you guys know what we were at the half year, which was roughly 97.5%. So I mean the calculation of what the second half must have been is not so difficult. So, I mean, I would see us running as we leave the year somewhere in the mid-96%.

Now, that clearly still requires further delivery to get what we need to get to. Expenses will be the largest part of that for sure. But as far as the market conditions are concerned, I mean, from the very beginning, we never planned that the market would be a positive driver here. I mean, look, just going back to answer I gave Andrew on pricing, if anything, I mean if there was margin expansion, it's narrowing because of this reduction in the headline rate and maybe inflation picking up slightly in the lowest cost.

But I mean it's just not dependent on – for us, we've demonstrated that we are completely focused on profitability. We would always like to expand the portfolio, but that's only possible when we can achieve the right returns. And if we can't achieve the right returns, we've also demonstrated that we're prepared to take capital away where it's required. So I mean we still have work to do this year, but it's not 97.2% to 96%.

Q - James A. Shuck {BIO 3680082 <GO>}

That's very helpful. Thank you.

A - George Quinn {BIO 15159240 <GO>}

On the capital topic and volatility – so you're absolutely right, we see it the same way. The range that we have already and the target capital range is designed to address volatility. We've got a bit of it in Q4, a bit more of it than maybe we expected. Some of it is actually self-inflicted. So the piece of it which, of course, is the market which everyone can see, we actually made a bet on model change and at time, I guess, we felt we were richer that we ended up being. But I mean we still end up in a very strong place. And I think even if you were conservative today, you pointed out at least a couple of points back. So capital is good for us.

So what does that mean? We've obviously just made the decision for the immediate future around capital. So we're not coming forward with a proposal there. Our priorities are pretty much unchanged. We have an acquisition, which will close at least, to the best of our knowledge, at this stage sometime around the middle of the year, so that will be a piece of it. And we would still prefer to try and use the capital to support organic or inorganic. But again, if that's not possible, I mean, we will look at alternatives. So I mean we don't rule anything out or anything in at this stage. But I mean we have some short-term uses for some of that capital.

A - James A. Shuck {BIO 3680082 <GO>}

Thank you very much.

Operator

Next question comes from the line Michael Huttner, JPMorgan. Please go ahead.

Q - Michael Huttner {BIO 1556863 <GO>}

Fantastic. Thank you very much. I listened also to the lovely Bloomberg video this morning, and I was struck by two things: the focus on delivery and on cash flow; and dividends of course. On cash flow, the $3.8 billion, can you maybe walk us through a potential like waterfall chart? What could it look like? If you normalized sort of various items that you have in the BOP calculation, the $5 billion, or just to get a feel for where we might be including the OnePath deal. That would be hugely helpful for 2019?

And then, the other question is on a different topic. And I'm probably asking a completely wrong question, but I noticed, and I may be wrong, but there's a lower nat cat projection or higher expected nat cat weigh on the solvency ratio by about 2 points. And I wonder how that squares with your aim to have less volatile earnings and maybe revert to the 3% in terms of expected nat cats, but – yeah. Thank you.

A - George Quinn {BIO 15159240 <GO>}

Thanks, Michael. So apologies in advance, I can't give you a forecast for 2019 for cash. I mean, you've seen today that we're well ahead of baseline run rate. We have a number of items that are one-off positive, one-off negative. But I mean in comparison to last year, I think when we guided people down around cash to maybe around the $3.3 mark, I don't think I would do that today.

I mean, we've had some – for example, I think people are aware that we have the impact, at least partially, of the hurricanes in 2018. So that caused down the P&C number. We've also got some, let's call it, optimization we did around the Life businesses, so the cash flow there is very strong. But I mean you can assume that worst case, those two things offset each other. So very strong delivery on cash last year because of the business. What could it look like this year, if you think of what happens with OnePath.

So, OnePath timing of course is really important here. So, if you go back to when we announced the transaction we were very transparent around returns and around cash flows. At this point, I mean, again, to the best of our knowledge, it's likely to close around the middle of the year. But I mean to be completely frankly but not entirely in control of that, it depends on a relatively complex operation that's taken place on the other side of the transaction.

And also, one thing that's different from what we had before, I mean, previously, we had the restructuring quarter in the old year, and then we have a clean run in the New Year. We're going to have a bit of a restructuring at OnePath also this year. So, I mean, I expect if it does close in the middle of the year, it will be positive, but I wouldn't take the guidance that we gave back in the Investor Presentation and simply prorate it. I mean, overall, I'm very happy with where cash is. It's clearly not an issue for – the group has done a great job on extracting the earnings as cash from all of it.

On a nat cat topic, so, well supported, you're absolutely right. So there's a small a pick-up. It's not such a small number, I mean turned into capital. We've got a small retail business that has expanded lately its exposure to nat cat in a particular area. I mean, the amount of premium volume involved, I think, might surprise you, if I gave it to you.

But I mean, consistent with comments we've made before. I mean, we have bought more nat cat coverage in 2019. We are not looking to raise our exposure to nat cat. And in fact – I mean, just given the general pricing trends, I guess, what you hear from players that are maybe more expert in that area than we might be, I mean, it's still not an area where you would want to expand capacity. So, I mean, you can assume that through the course of this year, I mean, we are not looking to grow it and there' still the possibility that we might shrink the exposure that we have for them.

Q - Michael Huttner {BIO 1556863 <GO>}

Fair enough. That's helpful. Thank you very much. Thanks, George.

Operator

The next question comes from the line of Farooq Hanif, Credit Suisse. Please go ahead.

Q - Farooq Hanif {BIO 4780978 <GO>}

Hi, everybody. Thanks very much. There's more of an emphasis in your presentation, and also Mario, on your initial comments on innovation now. So, you talked about Snapsheet and CoverWallet.

I was just wondering if you take this in a package with the improvements that you want to make in commercial in the U.S. So, looking beyond 2019 where consensus are already quite close to a 96%. I'm kind of thinking, I mean, are you sort of happy with the idea that there are further improvements in profitability that can be achieved from this innovation and from still moving the mix in the U.S.? So, just qualitatively, can we expect better from the combined ratio going forward?

And sorry, the second question is, on your reinsurance, looking at slide 38, where you give the program, I mean, it looks like you've actually made few tweaks as more kind of out of the money protection. If you could just comment on that, that would be helpful. Thanks.

A - Mario Greco {BIO 1754408 <GO>}

Look, on innovation, I think we mentioned it, because it is becoming relevant for us, but not necessarily to improve combined ratio in U.S. But if you look at, for example, Cover-More today, Cover-More came short of CHF 900 million of revenues last year. So it is becoming sizable, and it keeps on growing, and we're sure that growth will be very strong in 2019, too. So, we want to put a light on that because this is starting to become visible.

The biggest source of growth that we had in Spain this year was through CoverWallet and SMEs. And that's why we thought also to extend this into Switzerland starting this year. And again, this is why we mentioned it, not just – I mean it didn't move the combined ratio, but it is becoming a relevant source of growth and possibly stronger in 2019. Snapsheet, we have an agreement with them to use them in Europe. So, we don't plan, and I don't think we can even use them in U.S. But we're quite interested to see if that can help improving service and eventually cost of claims in Europe.

So, we mentioned them, because they're becoming relevant for us. And we want you guys to get familiar with and to start also looking at the progressive numbers that we achieved on these different innovations. But none of them frankly is strictly impacting the combined ratio in commercial U.S., which is more I think benefiting from the portfolio shifts that we have been making over the last two years.

A - George Quinn {BIO 15159240 <GO>}

If we look on the reinsurance topics, so you're right, there are some changes. I think in a very quick way I trailed some of them at the Investor Day. So, I mean, the global cat treaty stands out we've increased capacity under the global cat treaty. We've actually put a cover in place. It's an April 1 renewal, but we anticipated the capacity increases a change already at the end of last year. So, that's obviously connected back to the conversation we have with Michael earlier on the rise in some of the incoming cat exposure.

But beyond that, I mean, we have a number of things that – I mean, I'm not sure I'm at certain it's tactical, but we talked before, in fact we now have a pretty significant quota share across the liability book. And the intention is that that'll would be a long-term relationship. We view it as strategic, and it's not about the performance on that particular book, it's about the mix that we retain.

We treat a number of other things, so we have a financial lanes program in place that we've tweaked. I think I've talked before that we have an aggregate cover that we put in place back in early 2016 and that was aimed to try and contain some of the volatility that we had suffered from previously. For a variety of reasons, we've never really come that close to actually triggering that contract and we've restructured that with a panel of reinsurers starting this year to try and bring it a bit closer to the money and maybe work a bit harder for us.

General conditions, I mean, the market is – I mean, we're seeing attractive pricing, so risk adjusted, we are paying the same rates as we've paid before. And, in general, I mean, we would continue at the margins to buy a bit more reinsurance cover just given what the market currently offers. That's what we're doing on reinsurance.

Q - Farooq Hanif {BIO 4780978 <GO>}

May I just come back – thank you for that. Can I just quickly come back on the first point? Okay. So, I get it. Your initiatives are more about service volume and capability. But in the U.S. quite apart from innovation, clearly, you carefully set out some quite ambitious targets for commercial indicatively bringing that combined ratio down by 3 points or so. So, again, just more generally beyond the 96%, do you think there's more you can do?

A - Mario Greco {BIO 1754408 <GO>}

Yes. But remember that the combined ratio still depends on market conditions, right?

Q - Farooq Hanif {BIO 4780978 <GO>}

Yes.

A - Mario Greco {BIO 1754408 <GO>}

So is the market going to remain as it is today? Is the market to harden, to soften? Let's not make combined ratio forecasts for 2021, 2022 today, right. I mean, let's get to the end of year, see where we are, see where the market is and then where we reassess it. But, fundamentally, what we have been trying to do in U.S. and also in UK, it's a shift to book out of the upper end of the global corporate customers and the big exposure to long-term liability into the more stable, and usually more profitable and specialty property business and more towards midmarket in SME. That brings a lower and a better combined ratio over time.

Q - Farooq Hanif {BIO 4780978 <GO>}

Okay. Thank you.

A - Mario Greco {BIO 1754408 <GO>}

And this has to progress and deliver results in two years of that and definitely not enough to measure. Although we see movements and improvements in the combined ratio, it's still too early because the books haven't – no development, and these are long-term businesses and takes a while to get rid of those.

Q - Farooq Hanif {BIO 4780978 <GO>}

Thank you very much.

Operator

Next question comes from the line of Nick Holmes, Société Générale. Please go ahead.

Q - Nicholas Holmes {BIO 21515144 <GO>}

Hi there. Thank you very much. I just wanted to come back on the expense ratio to ask, how concerned are you that softening U.S. P&C pricing is going to make it more difficult to reduce the expense ratio? And secondly, is the scope to take out more cost because the expense ratio is I think still pretty high and I'd be interested in your comments on that. Is that something that you would disagree with? Thank you.

A - George Quinn {BIO 15159240 <GO>}

Thank you. So on the pricing expense ratio interaction. So, I mean, we decided at the start that we would not set a ratio target because it can lead you to do things that had nothing to do with expenses. We thought it was clearer for you and for everyone in the company that we set a level of resource that we're prepared to allocate to what we're doing. If P&C pricing softens more than we anticipate today. I mean, that may put a bit of pressure on the ratio but it wouldn't immediately change our expense plans. I mean, we have a plan in place today across all the businesses, across the corporate center. The number one priority is to make sure we deliver on that thing that we have absolute control over.

I think just generally on the P&C pricing topic, I gave a fairly detailed answer to Andrew earlier around the various pricing trends. So, I mean, at this point, I don't see it going negative in the short term. But I mean, we don't control it and it is possible. But I mean, at this point, it's not something we assume is going to impact 2019.

On the second comment around, there's a scope to take out more the perspective that maybe our expense ratio is still high. I think when you look at expense ratio, the thing I would encourage everyone to do and we do it internally, I mean, we obviously we compare it to peers and competitors in the different markets. Ordinarily, we will break out the different components. So there's an acquisition cost ratio in there that is not traditional expense per se. There's also – depending on the practice of the company, some things are at premium tax. Potentially, they include it. Potentially they don't.

And then you have a core part, which I think is generally more comparable, which is in our case the OUE ratio. I mean, the OUE ratio would suggest, I mean, we still have further room to drive efficiency, but nothing like the extent that the headline expense ratio number might suggest if you compare it to the headline numbers of peers and competitors. I mean, we've made a huge step over the course of the last couple of years with one more year to go.

Q - Nicholas Holmes {BIO 21515144 <GO>}

Okay. Thank you. Can I just very quickly follow up with the OUE ratio, I think 13% was you indicated your sort of target. Is that still the case? Presumably, it is.

A - George Quinn {BIO 15159240 <GO>}

We didn't give a target.

Q - Nicholas Holmes {BIO 21515144 <GO>}

No. But an indication.

A - George Quinn {BIO 15159240 <GO>}

We got 55 different targets that we have to achieve across the entire book. I mean, what we said today is that if you look at and you allow for the one-offs, we're about 13.8%. I mean, you guys know how the expense ratio or the efficiency benefits typically fall across the business. And I mean you can relatively rapidly work out where you would expect that to land. But, I mean, we haven't set a target for expense ratio. We've set targets for cost reduction and that's what we are focused on this year.

Q - Nicholas Holmes {BIO 21515144 <GO>}

Okay. Very clear. Thank you very much.

Operator

Next question comes from the line of Vinit Malhotra, Mediobanca. Please go ahead.

Q - Vinit Malhotra {BIO 16184491 <GO>}

Yes. Good afternoon. Thank you very much. So one on the Life guidance really because you remember, George, last year, we were discussing about a mid, right – low to mid or some mid percentage growth number. And even if I clean up for this 125 (00:46:36) one-off this year, we ended up very healthy 14%, 15% growth. I mean is there a sort of conservativeness in there in your thinking about Life or could we have another repeat year of a good or at least better than expected numbers for Life? So that's just on the Life items.

And second question is just on the attrition and loss ratio. I mean, the 2-ish number being below 63, we'll have to go back quite a few years to get that kind sub-63 attritional. Is there something that is worth flagging on maybe that just one business had a very good second half or can we get a bit more excited about this line going forward? Thank you.

A - George Quinn {BIO 15159240 <GO>}

Yeah. Thanks, Vinit. So on the Life topic, I'm conscious that I'm not about to talk down something that I think had a fantastic year, whether you include the one-offs or whether you don't. The Life business for us has been going great. And, I mean, we did give guidance around the middle of the year around that underlying number. And of course, at that stage, we knew already we had some one-off in the number. In fact, we talked about it back at the half-year results principally around the foreign exchange effects that we were seeing in LatAm.

Could we have a better number than the one we guided to? It's possible, but I mean, we're not trying to gain here, we are trying to give you a realistic sense of where we expect it to land. And I think the – I mean, whether there may be differences between us and what people are assuming, I think probably the larger issue is just going to be the timing of OnePath.

I think I mean we tried to indicate broadly when we expected that to close back at the Investor Day in December. I mean, today, I don't know anything more around the middle of this year. If it closes earlier, which I think is unlikely maybe that could have a different impact. I mean, so far, at least that day had been slipping rather than accelerating.

So we're trying to guide you to what we actually expect rather than to give the full sense of the underlying. And to be honest, I mean, if you look at what will be required for the Life business to achieve, what we've indicated, that's still pretty strong growth over the underlying performance of 2018.

On the attritional, I mean, is there something in there that we should get really excited about or something we should isolate and change? I think, again, I said in relation to – I forgot it was Andrew's question that I answered earlier. I think it was James when he talked about how he saw the underlying numbers for the year. I think it's important because of the connection between some of the elements that we run. So we talked already of the impact of acquisition costs versus loss. I guess some of you learned today there was also connection in the expense topic and the loss ratio. I'd look at the whole thing and around.

If you look at the second half, I guess I gave commentary to James earlier that gives you a sense of how we see things. I mean, there are certainly elements of that that are better than we would expect to see continually in the future. Crop would be one example. But at the same time, there are elements of it that are not as good as I would hope to see them in the very near future. One of those examples would be financial lines in one of our key markets.

So I think it's a reasonable starting point as we enter into 2019. Be a bit wary of crop seasonality, but I mean it's not going to have a big impact on this. We need to continue on the path that you've seen from us to deliver on that combined ratio topic that we discussed earlier.

Q - Vinit Malhotra {BIO 16184491 <GO>}

Okay. Thank you very much.

Operator

Next question comes from the line of Jonny Urwin, UBS. Please go ahead.

Q - Jonny Urwin {BIO 17445508 <GO>}

Hi there, thanks. Just one for me. So just on P&C, I mean, we can clearly see the underwriting improvement coming through now. And I know it's work in progress, I know there are some good bits, some less good bits. But I just wondered thinking on a longer term view about how happy are you now with the quality of that U.S. commercial book? And in your minds, where are you on that re-underwriting journey? I'm not talking about just on the way to the 2019 targets. I am just thinking big picture, where do you want to get this business to and basically where are you now? Thank you.

A - Mario Greco {BIO 1754408 <GO>}

Look, the way we're looking at U.S is we need to still continue strengthening our capabilities on mid-market. We did something over the last two years, but we will continue this in 2019 and the next two years. Also, we are improving the underwriting strength that we have especially in UK and U.S. By that, I mean, that we are improving the programs we have for underwriting, the attractiveness that we have for good underwriting. At the end of the day, in UK, in U.S. we compete for the best underwriters and we have to be able to stand high in that competition. So it's a journey. We're not satisfied. There's more to come and there's more to do in U.S. also and the team there knows it very well. And the programs that we have for 2019 and next years reflect that.

Q - Jonny Urwin {BIO 17445508 <GO>}

Okay. Thank you.

A - George Quinn {BIO 15159240 <GO>}

I think it's worth adding, Jonny, that I mean you probably saw at the Investor Day back in December but Kathleen outlined pretty clearly there what our ambition was for that business and that's a very substantial improvement over where we stand today.

Q - Jonny Urwin {BIO 17445508 <GO>}

Yeah. Okay. Thanks, guys.

Operator

Next question comes from the line of Johnny Vo, Goldman Sachs. Please go ahead.

A - George Quinn {BIO 15159240 <GO>}

Johnny?

Operator

Mr. Vo, your line is open.

Q - Johnny Vo {BIO 5509843 <GO>}

Hello. Can you hear me? Sorry.

A - George Quinn {BIO 15159240 <GO>}

Yeah.

Q - Johnny Vo {BIO 5509843 <GO>}

Yeah. Sorry. Just a couple of quick questions. Just the reserve redundancy that you've built in ZIC or the Group reinsurance business has been quite substantial over the year. So, I know that you're talking about the upper end of the range in terms of reserve release, but are we going to see reserve, you just running down the reserves that you've built up essentially over time? And how long are we expected to do that? Or will that just come through your assessment of the reserve strength of the underlying businesses as a whole? That's the first question.

And then the second question is just in terms of M&A. I mean, obviously you've done a lot of transactions. You filled in a lot of gaps. Are we coming to a natural conclusion in terms of the M&A activity that you've been undertaking? And then, I know you've spoken about capital returns but how does that feed into – if I look at your balance sheet, there is a bit of balance sheet slack. How will that translate into potentially capital returns to shareholders?

A - George Quinn {BIO 15159240 <GO>}

Thanks, Johnny. So on the reserve redundancy topic, again, I think it was Andrew's question from earlier, it would be a bit disturbing if all that we did around PYD is simply drained the reserve strength of the group. As you can imagine, I mean, not only would I not want to do that but there's a number of controls in place that even if I did would stop me. So, for example, this is a topic that we spent a lot of time with the group audit committee. It's a responsibility of the group's chief actuary. We have a policy around where we target in terms of percentile and the reserve range, and there's a band around that and if we wanted to deviate from it, that would require approval.

And I think I've tried to comment both this year and last year trying to fairly frequently that, I mean, when we see the types of reserve release that we saw last year, that did not come at the expense of reserve strength. And in fact, I mean this is an internal company measure, so I appreciate you need to take it with a pinch of salt. But if we try and measure as objectively as we can the reserve strength at the beginning of the year and the end of the year with everything and including all of the potential margins that we have, we are in exactly the same place. So we just do not intend that that PYD comes at the expense of some additional future risk.

On M&A, I mean, I think it's important to recognize that on M&A, we'd not only filled in many gaps, we've also addressed some positions that just didn't make sense for us. So you've seen us certainly up to the ANZ deal, I mean essentially disposed or released capital in roughly same amount as we had invested. That's a process that for us is probably continuous. I mean, we can take a look at the portfolio on a regular basis to ask whether or not it fits with strategy, whether the market is offering the right types of returns, we have the right type capabilities in place. And if we don't, you'll see us do what we've done in the past around, let's say, like Morocco, Taiwan, the annuity business in the U.S. and the UK.

And I think I mean, you all know from prior conversations that we've had that there are parts of the capital base that are currently locked up in risks that we don't think are well remunerated. And this was a topic I highlighted at the Investor Day that this will be a priority for us in 2019 and not just in the context of legacy or noncore as it's referred to publicly, but across the entire portfolio. This is another year where we're going to devote ourselves to looking at the capital allocation and seeing what steps we can take to improve the overall portfolio. How does that fit into capital return? I can't add more on that topic beyond the answers I gave to the earlier question to James.

Q - Johnny Vo {BIO 5509843 <GO>}

Okay. Clear.

Operator

Next question is from Niccolo Dalla Palma from Exane. Please go ahead.

Q - Niccolo C. Dalla Palma {BIO 16052945 <GO>}

Hi, good afternoon. Two questions left for me. One on the Z-ECM model changes. Is this bringing the view closer to the rating view as it's closing the gap between the two. And therefore, is it a group guide for that at this stage? And secondly, a bit more practical on the capital gains that come through outside BOP. And given where the AFS reserves have fallen, what can you tell us to help us getting our heads around the structural part of gains versus what may have been a bit in excess of normal? Thank you.

A - George Quinn {BIO 15159240 <GO>}

Thanks, Niccolo. So, answer to the first question, no. I wish it was yes but it's no. I think the – I mean, that was a change that we made to how we look at subordinated debt. I think the change is justified. We've been looking at it for some time. It would have been more convenient to do it when the markets didn't move but the markets moved as we did it. But we think it's the right thing to do.

On the capital gains outside BOP, I mean, it's tough to tell you in any given year the number is going to be X because of course it's a function of not just that EFS starting point, it's a function of how much the portfolio turns over, a function of how the markets perform in the year. For me what we tend to guide people is that, I mean, from a medium, longer term perspective, I mean you can assume and we assume that the numbers about 400 maybe slightly higher. That's the level that we typically implying.

Q - Niccolo C. Dalla Palma {BIO 16052945 <GO>}

Thank you.

A - Richard Burden {BIO 1809244 <GO>}

Thank you very much everybody for dialing in today. We are aware that there are a couple of questions outstanding but unfortunately we've run out of time for this call now. The IR team will reach out to you and follow-up with the further questions. If you've got any other questions obviously the IR team is available, you know where to reach us. Thanks very much.

Operator

Ladies and gentlemen, the conference is now over. Thank you for choosing Chorus Call. And thank you for participating in the conference. You may now disconnect your lines. Goodbye.