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Q2 2016 Earnings Call

Company Participants

- Anthony Jonathan Reizenstein, Chief Financial Officer & Executive Director
- Jose Vazquez, Chief Risk Officer
- Paul Robert Geddes, Chief Executive Officer & Executive Director

Other Participants

- Alan G. Devlin, Analyst
- Andreas van Embden, Analyst
- Andrew J. Crean, Analyst
- Andy Hughes, Analyst
- Dhruv Gahlaut, Analyst
- Edward Morris, Analyst
- Gordon Aitken, Analyst
- Greig N. Paterson, Analyst
- James A. Shuck, Analyst
- Jon M. Hocking, Analyst
- Oliver George Nigel Steel, Analyst
- Ravi Tanna, Analyst

MANAGEMENT DISCUSSION SECTION

Paul Robert Geddes {BIO 2474781 <GO>}

Well, good morning, everybody. Welcome to our Half-Year Results. Welcome to Goldman's. This room, some happy memories for us as a business. This is where we did our analyst presentation a little bit more than four years ago, the run-up to the London Olympics. So, we've got happy memories in this room. I hope you have as well. I'm, as usual, joined by John Reizenstein, CFO. And my executive team is also here for any questions or context after.

We are going to spend quite a lot of time today. It's going to effectively be a John show with quite a lot of focus on capital and Solvency II. I don't want that to be confused with any lack of progress or focus elsewhere in the business, albeit I've kept my updates on that relatively brief in the interest of time. I also expect that Solvency II and capital may make up many of your questions, whilst it's understandable, again, I don't want it to take focus from other achievements in the business.

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So, let me start with a few of them on slide 3. So, this shows some of the stuff we've done at the start of 2016. And I think the first-half performance generally in 2016 represents a good snapshot of where the group is and its strong position. And it's perhaps at times like this that the value of Direct Line's business model is particularly clear. The benefits of our multi-year transformation program are evidenced in our competitiveness across distribution channels. And our differentiated propositions are resonating well with customers, which is demonstrated by the strong growth in our own brands which you're going to hear a lot more about through the presentation.

Sitting behind this is a strong balance sheet. In June, we received approval from the PRA to use our internal Solvency II model, which allows us to measure, monitor and run our business in the most appropriate way. At the half year, our solvency ratio post dividends was a healthy 184%. John will update you on this fully later.

We're also making progress in partnerships. And we recently signed a three-year extension to our RBS Home and Private Insurance partnership reflecting our investment in digital and customer experience. This is an important milestone for us and represents a key staging post in our partnership capabilities. We've also recently agreed a contract extension for Nationwide extending our travel arrangements until 2018.

The combination of all of these has helped deliver another strong set of midyear results. Combined ratio was 89.6%; normalized for weather, 91%, which compares favorably with the normalized number last year. Today, we're reiterating our 93% to 95% target. However, if current trends continue, we'd expect to come in towards the lower end of this range, as usual assuming normal annual weather.

RoTE of 23.1% is well above our 15% target. Finally, our shareholders are also showing their success with growth in the regular dividend and an additional one-off special dividend of £0.10 following our transition to the internal model. It remains our core mission to make insurance much easier and better value for our customers and I'm proud of the platform we've built as a competitive retailer, with differentiated and successful propositions, strong manufacturing capabilities and backed by a strong balance sheet.

So, let me now hand over to John for the numbers.

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Anthony Jonathan Reizenstein

Good morning, everyone. Let's start with the highlights on slide 5. Overall, it's another strong set of results. Gross written premiums were up almost 4% versus prior year. Within that, we've grown motor premiums by close to 10%. The combined ratio was 89.6% on a par with last year's strong result, and that's just by incurring an additional £24 million of Flood Re levy and £30 million of home weather in the first half of this year. These headwinds were largely offset by an improvement in the current-year loss ratio and higher prior-year reserve releases, including some positive run-offs on the storms, which occurred at the end of last year.

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As we indicated at the full year, total costs were up in the first half as we absorb the Flood Re levy. We expect total costs to be slightly below 2015 levels for the full year. Investment returns reduced by £19 million to £91 million due to lower gains, although our investment team maintained investment income in line with prior year, with income yield of 2.5%. Installment and other income was up, reflecting higher volumes. Ongoing operating profit was down a little at £323.6 million as a result of the lower investment gains. At the segmental level, all divisions were profitable, with an improvement in Commercial due to lower weather and large losses.

If we turn to IFPs on slide 6. At first glance, the waterfall chart on the top of the slide might look a little gloomy, with total IFPs down mainly as a result of Rescue and other personal lines where we continue to see reductions across partners and packaged bank accounts. However, this masks the very strong performance across our own brand portfolio, which you can see at the bottom. Our Motor own brands grew 3.1%, and it was a particularly strong half for Direct Line new business sales, which we believe is the result of the strength and success of our propositions.

In Home, our own brand IFPs were up 2.8%, again reflecting improved propositions and technical pricing. New business sales were strong particularly through PCWs, following improvements we've made to the customer journey. In Rescue, it was another good half for Green Flag, which grew policy count by 6.8%. And also, in Direct Line for Business, we had a very strong performance, with IFPs up 9.6%.

Turning to premiums on slide 7, which show the same detail on our own brands. Gross written premiums grew 3.9%. And within this, Motor nearly 10%, reflecting strong growth in IFPs and also price increases. Home premiums fell 3.5% due to lower IFPs and lower prices. Although in the second quarter, we saw signs of prices stabilizing.

Rescue premiums were up 1.6%, reflecting the better mix of business. And within that Green Flag, our direct brand, grew premiums by 10.8%. And finally, a good performance in Commercial, premiums up 2.3%, with another great performance from Direct Line for Business which was up 8.2%.

Let's go to the combined ratio. The headline combined ratio was broadly in line with a very strong first half last year, just 0.2 percentage points higher, 89.6%. Underwriting profits were stable and the normalized combined ratio improved to 91%.

Moving to the top-right chart, the reported loss ratio improved 0.8 percentage points to 53.4%. We are pleased within that with the improvement in the current-year loss ratio of 0.6 points. And within that, a mix of movements with Motor, Home and Commercial all improving and Rescue impact moving the other way. And we'll talk more about that later.

In relation to the current-year loss ratio improvement, prior-year releases continue to be healthy at £236 million, an increase of £21 million versus the first half last year. Home weather losses were £13 million in the first half compared to none in the first half of last year.

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Moving down to cost and commissions, the headline operating expense ratio of 25.3% was 1.7 percentage points higher, largely due to the additional £24 million Flood Re charge that you can see on the bottom right. The commission ratio improved by 0.7 percentage points to 10.9% due to profit commission arrangements. So, in aggregate, there are a number of ups and downs but, overall, a strong underwriting performance in the first half.

Now, I'm going to cover the ratio trends across the segment starting with Motor and Home. Overall, a good result in both Motor and Home with current-year loss ratios having improved in both segments. In Motor, we saw lower prior-year releases although this was partially offset by our actions on underwriting and costs as well, which helped by improving operating leverage as the higher premiums began to run through.

Moving down to Home, the current-year loss ratio also improved by 2.5 percentage points reflecting benefits from our underwriting actions and lower claims handling costs, plus a continuing benign claims environment. Home prior-year releases benefited from our observing prudence over the December floods which saw some releases this half.

Weather losses of £13 million were below what we would normally expect but above prior year. While I'm on the subject of home weather, we've reduced our estimates of normal annual weather losses down from £80 million to £72 million on average in line with lower business volumes. Earnings were higher as a result of the Flood Re charge – expenses were higher as a result of the Flood Re charge, although underlying expense ratio marginally improved. Home's commission ratio improved as a result of profit commission movements, as I mentioned before.

Now, let's turn to Rescue on slide 10 and also other personal lines and Commercial. In Rescue and other personal lines, the combined ratio worsened to 92.7%. While there are a number of moving parts in here, the deterioration of the current-year loss ratio was due to a premium adjustment in Pet, which as you can see was offset by higher prior-year releases in Travel. The higher expense ratio reflects phasing of Green Flag Rescue marketing spend.

And Commercial has performed well, continue to see improvement in both top and bottom line. The current-year loss ratio improved 4.7 percentage points, due to better large claims experience. Normalizing for large claims and weather, the combined ratio would have been around 98%, a little bit better than last year. There's more segmental information in the appendix, which includes the usual segmental P&Ls with more detail on Rescue.

Now, let's take a look at Motor on slide 11 with the familiar pricing and claims trend data. Starting with claims, you'll recall at the half year last year, we said claims inflation was running slightly ahead of the long-term average but that it would settle back towards the top of the range by the year-end. Overall, that position didn't change much in the first half. Although there are some movements within it.

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Taking bodily injury first. The trends on large and small BI are largely in line with our expectation with some signs of improvement emerging. The shorter tail damage risk, on the other hand, is showing a number of adverse developments, with severity trends running higher than expected. Some of this is driven by our investment in propositions, such as seven-day repair and guaranteed hire car, which are also driving growth, particularly in Direct Line. We remain keenly focused on monitoring and pricing for these developments. In summary, claims inflation has been around the top of our long-term expectations, with damage and severity trend showing a sign of rising.

And that leads us on to pricing. We increased our risk-adjusted prices by 9.5% in the second quarter year-on-year, which we believe is tracking a few percentage points ahead of claims inflation. In terms of the delta, the way to think about this is we've shown a point of improvement in our current year performance and we expect this to continue in the second half. We've also invested in proposition enrichment, as I've just mentioned, which has supported growth in IFPs.

We go now to the familiar Motor booked loss ratio development chart. The prior year continued to develop favorably, a combination of our reserving approach and operational improvements within claims. The table on the bottom left shows total Motor prior-year releases were £134 million this half, £12 million lower than last year, in line with our expectations.

On the far right, you can see 2016's initial loss ratio pick (11:38) is lower than 2015, which is consistent with the year-on-year pricing improvements. You'll notice a small uptick in the 2015 accident year loss ratio. This reflects the change we implemented last year when we stopped automatically adding reserving margin to current-year claims. While we stopped adding to current year, we do still distribute the existing margin across all prior years. This creates a step-up you see when our current year grows up and becomes a prior year. It gets its share of the total of margin.

However, as you will see from the pullout box below on an actuarial best estimate and that's the basis of Solvency II, the underlying development is in line with what we'd expect and we're happy with how these accident years are developing. Discuss more about that in our Solvency II discussion shortly. Looking ahead, our message remains unchanged. Assuming current claims trends continue, we expect the contribution from prior years to remain significant, albeit we'd expect it to reduce in future years.

Turning to Home pricing on slide 13. Here you can see our own brand premium movement split into price and risk/business mix. After many periods of premium decline, in the first half, we've seen some signs of the market stabilizing. In Q2, although market prices were slightly down year-on-year, they were up versus Q1. We think that may be influenced by the cost of Flood Re to the industry. Overall, of course, it remains a very competitive market. Shopping continues to rise with more customers buying through price comparison websites.

The risk and business mix was down by 5.1% in the second quarter. Improvements in the customer journey have enabled us to grow on PCWs as well as Direct. This, together with better risk analytics and strong new business sales, have led to lower average premiums. As usual, we've been disciplined and are happy with the level of growth and profitability across both channels.

In addition to strong new business sales in our own brands, we maintained our high retention levels. This was helped by our attractive propositions and competitiveness. As a result, we have grown policy count in our own brands by 2.8% since June last year and all of that we believe are positive signs.

Our underlying claims picture in Home, excluding the major weather, has been good with overall inflation running at the lower end of the long-term average. We believe that our ability to protect value and grow in Home is as a result of our high retention rates, strong propositions and continued investment in pricing and claims.

Let's look at investments on slide 14. Starting with assets under management on the top left, headline AUM stood just under £6.6 billion at the end of June, 3.3% lower than the previous year. This is largely as a result of the special dividend paid in the second quarter and consistent with the direction we've indicated at the start of the year. Investment income was broadly stable as the reduction in AUM was offset by an improvement in the income yield, 2.5%, in line with our guidance at the start of the year.

In the table on the bottom left, you can see the losses we reported in Q1 were reversed in Q2 and overall gains stood at £8.3 million in the first half versus a high £26.8 million last year. We've received one or two queries on our investment property portfolio in recent weeks, so we've included some further details in the appendix. You can also find the usual table of reinvestment rates and durations there.

Our investment portfolio is diversified and it's established to meet the cash flow requirements of the business. In summary, the real estate portfolio, which currently stands at £349 million, is prime and it's held for cash flow purposes against our PPO liabilities. It's diversified by region, lease duration and type. We've been fortunate that since we started building the portfolio in 2012, the value of the properties has risen by just over £50 million (15:35). We're long-term holders and we recognize these valuations can go up and down in any given period, and we're comfortable with that within the context of our strong solvency.

So let's look at the outlook on investment income in a post-referendum world. Starting with AUM, which has been declining over recent years due to lower volumes and capital management actions, looking ahead, we continue to expect that trend. In terms of yield, you'll recall that the start of the year, we guided to 2.5% for this year and 2.6% for 2017. Year-to-date, as you know, the gilt yield curve has fallen by close to 100 basis points. While we cannot predict the future, running current market expectations through our portfolio suggest a yield in 2017 of around 2.4%. This assumes base rates are reduced to 2.25% in August this month, that is August 2016, and remain there through next year. And we don't anticipate any further significant net investment gains in 2016.

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Just a moment on slide 17 because then we can get on to capital, which I'm sure you're waiting for. This table shows how we get from ongoing profit of £323.6 million to profit after tax of £235.9 million. Just a couple of points to make here. Run-off profit continues to perform well, with ongoing positive development on large bodily injury claims. Restructuring/other one-off costs mainly reflect costs we incurred in moving to downsize our Bristol base.

Looking ahead, we iterate our expectation that restructuring and other one-off costs will offset the profit from run-off over the three-year period from 2015 to 2017. After all that, profit after tax was £236 million, down 5% versus prior year after excluding the gain on International. This reflects another strong underwriting result, with the reduction largely driven by lower investment gains.

Today, we present for the first time our Solvency II capital position under our partial internal model. Over the next few slides, I'll cover our current solvency, our risk appetite range, a walk from IFRS to Solvency II balance sheet, our capital structure, key sensitivities, and finally, dividends. In June, we are pleased to announce that we have received PRA approval for the use of our internal model. This was in line with our expectations, but nevertheless, it's an important milestone for the group.

The internal model covers UKI, the group's main insurance entity. UKI represents 90% of the group's own funds and 98% of the group's solvency capital requirement. The rest of the business is captured on a standard formula basis. As is indicated, Direct Line's a fairly simple group with good capital fungibility, and as such, the Solvency II position is central to our dividend paying capability.

The start of the year under the standard formula, our solvency capital requirement was £1.7 billion. As you can see from the chart, the midyear solvency capital ratio requirement under our internal model has come down to £1.4 billion. The reduction was substantially due to the transition to the internal model. As of the half year, we estimate our Solvency II position under the internal model to be at 199% before any dividends. And after the ordinary and special dividends, this comes down to 184%. Now, as you'll notice, that puts us above the top of our target range at the midyear point and I will come back to that shortly. But that's our current position, which we believe is strong.

I'm on slide 18 now for those on the phone. At the start of the year, I told you that we didn't expect to see a step change in the level of capital we need to hold under the internal model. This is because the risk we face as a business haven't changed, albeit the way we measure them has changed.

For this reason, we continue to hold broadly the same level of capital. The only real change is the removal of the uncertainty over the internal model approval. Despite the relative simplicity of our business, we still need to juggle our operating, regulatory and rating agency requirements when setting our capital levels, especially in these volatile and uncertain markets.

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Taking all this into account, the board has decided that a range of 140% to 180% of the solvency capital requirement is appropriate for our business. We believe this range allows us to operate on an appropriate capital level to meet the requirements of our external stakeholders. It also allows us flexibility to invest in our business, whether organically or inorganically.

As you're turning to slide 19, I'm sure you've seen similar charts to this from other companies and from us based on the standard formula. And we've updated that based on our internal model. And some of these adjustments were very familiar to you from other companies, but I'll just take a moment to highlight the key items for us. So, looking at point A in the chart, goodwill and intangibles were removed completely. As you'll know, goodwill has always been included from our capital calculation, so there's no change there.

In terms of intangibles, the full cost of our investments we've made in our IT systems to date have already now been deducted from our solvency position, although any future investments will immediately be charged to capital, not amortized over their usual life as they will under IFRS.

Next, point B, we have adjustments for our other assets and liabilities, which are predominantly fair value adjustments to property, plant and equipment. Next, the various changes to the valuation of technical provisions, point C, which amounts to just £114 million net. Within this, however, are some large offsetting items. They are the usual things, such as discounting of reserves, the risk margin required on the Solvency II, and adjustments for premium provisions. More so than IFRS, factors, such as interest and inflation rates, will cause valuations to move causing greater volatility.

Under Solvency II, we're required to hold our technical provisions at best estimate. So, within this bucket, the green, we also add back the prudent IFRS reserves that we hold above the actuarial best estimate. So, I'd like to spend a few moments on this point so this benefit is not double counted.

Under Solvency II rules, own funds already include the capital benefit from removing the prudence margin. Over time, some of that prudence margin might be released. This would generate profit under IFRS but will have no impact on our Solvency II capital generation. Of course, we'd still have the risk margin as described by Solvency II. As I said before, our prudence margin above ABE was about 7% at IPO and it's grown a little each year since.

Final point, obviously, are the foreseeable dividends. So, to bring all these together, it's a reasonably simple set of adjustments to get to our Solvency II Tier 1 capital. Overall, we'd expect IFRS earnings and Solvency II capital generation to broadly tack on and track one another in the long term. But we also expect it to vary year-on-year for a number of reasons, including the timing of investment spend versus IFRS amortization, the potential release for prudence margins and the inherent market sensitivity. Coupled with our strong capital position, our ability to pay dividends is essentially unchanged.

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Now, capital is not just a matter of quantity but quality as well. As you can see, the group's solvency capital requirement is comfortably covered by unrestricted Tier 1 capital with a ratio of 130%. The lower solvency capital requirement under our internal model versus the standard formula means that Tier 2 and Tier 3 capacity is a little under 50% of the SCR. This means it's essentially fully utilized. We, therefore, have no more capacity for conventional Tier 2 debt. But overall, we believe we have a strong high-quality solvency coverage.

On to slide 22 (sic) [slide 21] (23:33), some of the sensitivities under Solvency II. As you'd expect of our business model, sensitivities to financial markets risks are quite low. We've seen this in practice over the past weeks. We'll also show some sensitivities to real-world insurance events seen in the UK over the past 30 years, a scenario which could well happen. Each of these occurrences in isolation would leave us comfortably in our range. But like buses, when an event occurs, it could easily be followed by another one. In summary, we believe our strong balance sheet and modest economic sensitivities are strengths, particularly in the current economic climate.

Now, to dividends. Today, we're building on our track record of having delivered good capital returns to shareholders. The regular interim dividend of £0.049 represents 6.5% growth on the previous year and is consistent with our policy of seeking to grow regular dividends in real terms where appropriate. Please don't get too excited by the slightly elevated growth rate. That's just a consequence of rounding.

But with regards to special dividend, it remains our approach that where the board considers the group has capital that is surplus to its requirements for a prolonged period, it would intend to return this to shareholders. As far as timing is concerned, today, we're announcing that in the future, the board expects to make this appraisal at the year-end. And therefore, we only expect to announce any additional distributions alongside the full-year results.

In doing this, we will harmonize our major capital management decisions with our annual planning process and our full-year earnings. And we think this makes sense. Therefore, in the normal course of events, we don't anticipate making additional capital returns at midyear relating to earnings as we've done once way back in 2014. In the future, this might mean we sit above our risk appetite at the midyear point.

Like the disposal of International last year, the change to our internal model is not a normal event. Therefore, following the approval of and transition to the group's internal model, we've announced a special dividend of £0.10. To be clear, this special dividend arises from the removal of the uncertainties surrounding Solvency II model approval. It doesn't relate to the capital we generated in the first half of the year or any anticipation of our annual planning process. That appraisal will get to come (25:52).

So, in the situation we outlined above, where our solvency coverage is a little bit above the top of our target range. Per our new policy, the board will consider whether or not there is capital surplus to our requirements for a prolonged period. And hence, whether

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or not there is any scope for a special dividend again with the 2016 year-end results. And it was expected to only undertake that appraisal annually thereafter.

I know I've covered quite a lot, so I just like to wrap up this section with a brief summary. Our capital position remains strong with a solvency ratio of 184% post dividends. We've recalibrated our risk appetite range, which is now 140% to 180% of solvency capital requirements. We're bringing the regular interim dividend to 6.5%. We've also announced the £0.10 special dividend following the approval of and transition to our internal model.

Looking ahead, we're harmonizing our major capital, planning and earnings exercises, which means the board will only expect to consider whether or not to declare special dividends at the year-end and it remains our policy not to hold on to surplus capital for a prolonged period.

The move to our internal model increases our solvency ratio. But we believe our ability to pay dividends going forward is essentially unchanged. Overall, we've again delivered attractive cash returns to shareholders while retaining a strong and high-quality balance sheet.

Before I hand back to Paul, let's just summarize some of the key financial metrics on slide 24. The first half of 2016 continues to show improvements. We improved the current year attritional loss ratio again, while also growing IFPs. Our total cost base was up including Flood Re, but we expect cost for the full year to be slightly lower than 2015.

Return on tangible equity was a healthy 23.1%. We also increased the regular dividend again and announced a special dividend, while maintaining a strong solvency position.

Let me hand back to Paul.

Paul Robert Geddes {BIO 2474781 <GO>}

Thank you, John. These great results, which John has talked about, a result of hard work across the whole business. And all of that starts with a strategy, which we rearticulated last year. Hopefully, therefore, you'll be familiar with this slide. It remains the foundation of our strategic actions, which have helped us deliver further growth this half year in a highly competitive market.

Given the time we've taken rightly to deep dive on capital this morning, I'm going to keep this update really short. But don't make any mistake that this is anything other than time-saving, because we still have huge amount of focus and traction on delivery of our busy agenda.

So, let me give you that brief snapshot. We continue to differentiate our brands through investment and our propositions, and continue to improve our digital and phone customer journeys. We're particularly proud of the success of our own brands having

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delivered the highest growth for a number of years. In particular, we continue to invest in delivering unique propositions to Direct Line customers, which they can only get coming direct to us.

This half, we've added to this propositions the launch of a new three-hour emergency plumber service. Combination of the improvements to our phone and digital customer experience and refinements to our pricing have delivered a marked increase in quotes and new business volumes. This, together with the high retention across Motor and Home, enabled us to grow our own brand portfolio yet again.

In digital, we've increased Home quotes generated through mobile phones by 95% and doubled the amount of sales via mobiles over the past year. I'm really pleased that we've extended our contract with RBS Home and Private Insurance for three years through to 2020. This encapsulates our innovative three-year fixed pricing proposition, system investment and development of digital capability to support the RBS customer-led strategy.

We continue to partner with RBS offering travel and rescue to packaged account customers. And as these contracts expire, we expect to participate in a tender process for these in due course. In addition to the good news in RBS, we've also agreed an extension with Nationwide to provide travel insurance to its packaged account holders.

Finally, our quest to disrupt the market and to be at the forefront of developments continues. We launched our Green Flag Alert Me app early this year. Our telematics policy count grew another 17% in the first half and Commercial won the best eTrading provider for the second year running.

So, now on to the outlook for the rest of the 2016 on slide 28. The markets in which we operate were competitive in 2015 and have remained so in early 2016. And the increase in insurance premium tax has contributed to more customers shopping around.

Taking each division in turn, Motor premiums have increased, but this should be viewed in the context of rising claims cost, which John discussed earlier. Our own brands' growth in this environment is encouraging. In Home, the market is showing some initial indications of flattening out, it remains highly competitive and again, our growth in own brands in this environment is pleasing.

In the Rescue and Commercial markets, we observed high competitor activity, although the successes of Green Flag and Direct Line for Business have continued. Against this backdrop, the group will continue to adopt a flexible but disciplined approach to managing the tradeoffs between margin and volumes.

For investment returns in 2016, we expect to be able to maintain the 2.5% income yield, but we expect assets under management to continue to decline and don't expect material investment gains in the second half. We expect total cost to be slightly lower in 2016 than in 2015 as we absorb the cost of Flood Re levy. We will continue to invest in building future capability. Our reserves are strong and we expect prior year releases to remain a significant feature of our results, albeit will reduce over time.

Taking all these together, we maintain our core guidance for 2016 of 93% to 95%, assuming normal annual weather claims. If current trends continue in the second half, we expect core for the full year to be towards the lower end of this range, reflecting improved trading and higher-than-expected prior-year releases in the first half. Finally, of course, our 15% RoTE target remains ongoing.

So, let me leave you with a few key messages. We talked about a lot about our strong solvency coverage of 184% even after having grown the dividend and announced £0.10 special. Our multi-year investment program is delivering improved competitiveness, which is showing through a strong policy and premium growth with excellent loss ratios driving a sub 90% (32:22) core and 23% RoTE.

We've made progress in our partnership capability, signing a three-year extension with RBS on Home, another strong performance delivered for our customers and giving me a great deal of confidence in our future.

Thank you very much, ladies and gentlemen. We'll now take questions in the room and also on the phones, where I'm told, you have to press star one to join. Right, we will go – we'll do kind of clockwise motion. Grieg, you start off.

Q&A

Q - Greig N. Paterson {BIO 6587493 <GO>}

Thank you. Unusually for me to be first. Actually, I've got four quick questions. One is in March, you mentioned and you were talking about your internal model. Looking forward, you're saying that you would have a desire to move to the mid part of the targeted range and I thought that was a reference to internal model. I wonder if you can comment on that. There seems to be an absence of that comment now.

Second point is looking through the removal of the margin in Motor, the paid to incurred on the Motor, initial picks (33:14) has been rising for three years in a row. Is that because you've been weakening your best estimates assumptions here? Wonder if you can talk about that.

Third one is, it was a comment or maybe some throw-away comment but you said you'll have sufficient capital for organic or inorganic growth. What do you mean by that? Are you going to acquire something that's in an acquisitive policy?

And the last one is, when you're talking about the RBS terms, you made a comment about a three-year fixed pricing. I wonder if you can just explain what the pricing is in that new deal. Thank you.

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A - Paul Robert Geddes {BIO 2474781 <GO>}

Yeah. Let me just do four and three, and then, let John do one and two. So, the RBS is a consumer proposition, which is the consumer can get flat prices for three years on Home, which is what their positioning in their branches, which fits with their stance on other products in terms of new business pricing.

Organic or inorganic, there's no news in that statement, so both a generic statement – we don't comment on anything. But we have an excellent organic franchises as demonstrated here, so there's no implicit announcement in there, other than, obviously, you'd expect us (34:31) opportunities. But, that said, we've got a huge amount to do and value to create in the existing organic business as it is.

A - Anthony Jonathan Reizenstein

Yeah. I don't recall saying that we expected to be in the middle of the range then. We wouldn't even name what it was. So, I don't think I made a statement like that. But let's answer the question why aren't we in the middle of the range, why are we at the top of the range or slightly higher. This is increasing (34:59), doesn't reflect the earnings that we talked about. We'll make that judgment at the end of the year when we look at the plan and everything else. But where we to be at the top of the range today, I'd say now is probably a sensible time to be at the top of the range.

It's a pretty uncertain situation out there on certain markets. Solvency is quite volatile; new measures. There are lots of opportunities for us in our business, mostly organic. And Paul has mentioned inorganic. And we're delivering very good returns and delivering cash returns as well. So, I think everything points to now is a sensible time to be conservative, to be strong, and that's where we are today. Now, in the future, we will look at that frequently, and I'm sure we'll move around within the range over time. So, hope that that will answer a few questions we may still get probably on people's minds. But that's the reason where we want to be strong at this point in time. But I think, Greig, that – we may have had misunderstandings. I don't think we've ever said we'd expect to be in the middle of the range moving into the internal capital model.

In terms of paid versus incurred, we don't see any change in our reserving policy or anything in that in terms of our actual best estimate, and we maintain strong margins. The actual best estimate needs to be conservative and to run off favorably over the years. Our initial pick for 2016 is better than for 2015. And nothing has particularly changed in terms of reserving.

Now, in terms of case estimation and management claims versus – a lot of that has, over the last few years, improved, sped up, and that caused us some changes to some of the numbers. But there's nothing that we are worried about in any of those data. I think we probably answered those.

Q - Greig N. Paterson {BIO 6587493 <GO>}

Yeah. Good. Thank you.

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A - Paul Robert Geddes {BIO 2474781 <GO>}

(36:50)

Q - Oliver George Nigel Steel {BIO 6068696 <GO>}

Oliver Steel, Deutsche. So, two questions, at least as far as I can think of them at the moment. The first is, can you repeat what you said about the sort of the impact on the Motor combined ratio going forward? Because you talked about 9-odd-percent price increases and then, implicitly, sort of 5% claims increases, and I think you said that only 1% of that would come through to the loss ratio and the rest was – I didn't really catch the rest. So, perhaps, you can talk about that in a little bit more detail.

Second question is Tier 2 and Tier 3 in your solvencies near as down at 50%. So, how are you then thinking about that? Because if you can grow the top line – I mean, I have been fierce in the past, that if you grow the top line, that'll then constrain the dividend-paying ability. But equally, I mean, it seems to me that you can increase debt, Tier 2 debt, if you grow the top line. So, as I say, just any thoughts you've got on that 50%.

A - Paul Robert Geddes {BIO 2474781 <GO>}

Okay. Let me start with the Motor bridge and then, John can do the capital. So, what we're effectively saying is we start with the 9.5% pricing and you then – you talked about our – our underlying claims inflation we're saying is around the top of the range. Let me bridge a little bit. So, bridging up from the claims inflation, we've chosen to invest a little bit propositionally in that guaranteed hire car, which makes our claims cost a little bit higher than it would otherwise be. That would see huge benefits from those propositions in the market in terms of how particularly Direct Line is doing. So, we think that's a good investment. So, that makes the gap a little bit less.

Now, of that gap, we've banked 1% as the current year loss ratio improvement, which I think is very positive. We need, in our plan, our current year loss ratio to improve to help offset reduction in the prior year. Now, some of the benefit, though, isn't yet in the numbers because, obviously, pricing is on a written basis and loss ratio is on an earned basis. So, some of it is still to come as we earn the premiums. And the other point is as conservative reservers, some of it will go into some reserving conservatism. So, what we're saying is quite a lot of the benefits of the pricing over claims inflation is still to come in the results and you should see a bit more in successive halves.

A - Anthony Jonathan Reizenstein

Yeah. On the Tier 2, Tier 3, well first of all, under Solvency II, growing profitably uses capital quite efficiently because we get credit for the profit of it as well as some debit for the exposure. So, that's one of the positives about Solvency II, actually. If you're trading profitably and growing profitably, it's not that expensive to do growth. Now, yeah, if the Tier 1 rises, your capacity to do Tier 2 and 3 rises. But the Tier 2 market is very lumpy. You can't do little jibs and jabs.

Tier 3, we've been quite conservative on Tier 3. We've taken some of the deferred tax benefits you can take there or other ones, which I think are quite hard to take but some

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companies have taken that potentially there's a bit of benefit now. But I don't think this is a major change coming in terms of Tier 2 and Tier 3.

A - Paul Robert Geddes {BIO 2474781 <GO>}

Okay. Yes?

Q - Alan G. Devlin {BIO 5936254 <GO>}

Thank you. Alan Devlin from Barclays. A couple of questions. First of all on the Solvency II, you just stressed that there's a 10-point decline in water pricing. Wonder if you could talk about how that works through the calculations. And conversely, if pricing continues to increase, does that benefit the solvency ratio?

And then, second on the comments on the partnerships and on the RBS deal. You said you've – I mean, now you've turned the corner, you said your typical release have improved. At the full year talked about a prudent proposition, is it where you wanted to be now? Thanks.

A - Paul Robert Geddes {BIO 2474781 <GO>}

Yes. Let me do the partnerships one first. The gestation period is pretty slow in partnerships, so you have to going to get on to people's shopping lists and then you're going through a process and then it takes time as we've seen from our own process with Nationwide, it takes some time. So, don't expect immediate overnight, we're going win lots of stuff on Home. But I think it does demonstrate, we think we won this in the context of our current proposition, which we think is pretty competitive. So, we would hope to be on more shopping lists and win some more business in the years ahead, but it's not going to be an immediate announcements or – and then, there'll be some time for that to come on to the books if we win something.

I think, the other point to say is don't just in your – will (41:32) only think partnerships only equals banks. So we are open-minded on what partnerships are like a teacher. We're talking to Motor manufacturers quite seriously about what partnerships could look like in a connected car world. So that has particular interest and resonance for us.

The other thing is partnership isn't just Home. We've reported (41:48) today we're going to be in the process for the further partnerships in later years on Rescue and on Travel. And in particular, Rescue, we have very competitive partnership proposition. We already partnered with each esure for example. We do that (42:02) Rescue and we'd like to win some more of that sort of business as well. John?

A - Anthony Jonathan Reizenstein

Yeah. Alan, thanks. First of all, price reduction. So that's a 10-point price reduction with no improvement in underlying claims cost. It's an unjustified and unwarranted price reduction and it goes straight to profit and straight to capital.

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Now, in terms of what's the positive side, if you can get more pricing away, well, the way that would work, I think, is it would go into our plan, in our business plan as stronger capital generation. So, when you look forward, your plan would show more capital generation and that would be, obviously, very positive.

And kind of that takes us to a topic very much on our agenda for the next few months, which is what additional metrics can we bring to bear, both internally and externally, to show the drivers for capital generation and start to focus very much on that. Well, obviously, we already are. So costs, clearly, current year and so on. But I think we're putting more focus on some of those metrics and I think we're pointing in that direction.

A - Paul Robert Geddes {BIO 2474781 <GO>}

Okay? Yeah.

Q - Dhruv Gahlaut {BIO 16209870 <GO>}

Good morning. Dhruv Gahlaut, HSBC. Couple of questions. Firstly, within the Solvency II capital requirement. Could you quantify how much is for the legacy portfolio? And how should we think of this over the next two years? Do we expect a major change there? Secondly, could you reconfirm? I'm not sure if I heard it correctly about the reserve margin. Is it still sitting around 7%? Because – and also just tied in with the slide 12, where it seems that over the last two years, you have been loading the booking of the reserve margin.

And thirdly is on the Home book, there was a fair bit of reserve release. Could you quantify how much was that one-off which came from last year? Thanks.

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A - Anthony Jonathan Reizenstein

Sure. Will do. So, the run-off, I think you (44:02) run-off I think is what you mean. So, there's an amount of capital in our £1.4 billion for that. And there's a much bigger amount in the risk margin, which is a liability but it sort of affected the capital. And when you add those things together, it's in the sort of £150 million to £200 million area for the back – for that book. But it will run off very slowly, very slowly because most of the capitals held a long-term liability (44:25).

In terms of margin, we have to be clear. So, yes, 7% in this room. I think it was 7.11% back in 2012. And we've said it's gone up year-by-year since then. We haven't published the number but we said it's gone up year-by-year since then. That's the position there.

And Home weather, yes, we did have some releases from the reserve we made for the storm, which arrived at the end of last year. It's always very awkward to book for weather right up to New Year's Eve, which is what we had. We've had about £25 million into the Home business and a little bit into Commercial from there, £20 million or £25 million.

A - Paul Robert Geddes {BIO 2474781 <GO>}

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So, the reserve margin (45:22). So, anything we talked about is perspective, not anything we've done today.

A - Anthony Jonathan Reizenstein

The reserve margin...

A - Paul Robert Geddes {BIO 2474781 <GO>}

So, the 7% going up. I'm saying that hasn't...

A - Anthony Jonathan Reizenstein

No. It's just up – yeah...

A - Paul Robert Geddes {BIO 2474781 <GO>}

Yeah.

Q - Dhruv Gahlaut {BIO 16209870 <GO>}

(45:36-45:42)

A - Anthony Jonathan Reizenstein

Well, we do tend to get both on the margin and the ABE. Over time, we do tend to get positive run-off and we'd be focused probably more in the future on the ABE because that's the thing that will drive our capital generation and for the reasons we've explained. And in terms of current-year loss ratio, we – our plan, as Paul said, is to get that current-year loss ratio to come down. And that's one of the biggest and most challenging things, but we've been successful this year.

A - Paul Robert Geddes {BIO 2474781 <GO>}

Okay.

Q - Edward Morris {BIO 16274236 <GO>}

Hi. Ed Morris at JPMorgan. Two questions, please. The first is on the combined ratio guidance for the full year. You've kept it at sort of 93% to 95% and sort of saying that we might be towards the bottom end of that. Given you've had a very strong start of the year, that appears quite conservative. And I'm just wondering if you can talk through what you're thinking for the second half, please.

And the second question is just on Flood Re. Can you remind me if you get anything in return on Flood Re? And is there a – particularly in a year, where you might see higher weather losses, should we expect any difference from previous experience? Thanks.

A - Paul Robert Geddes {BIO 2474781 <GO>}

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Yeah. I mean, listen, well, I'll take conservatism (46:55) particularly on the range. And listen, we'll give you another update in Q3. So...

A - Anthony Jonathan Reizenstein

And just remember that depending on the timing of recognition of pricing, PI, CI, that gap, it might come next year in BPY (47:11) that time. And if it comes this year, great. It'll help our core this year, but it might be next year that it happens. And the timing, that will depend on the patterns and trends and what recognition – what our team is seeing. So, that's that point.

A - Paul Robert Geddes {BIO 2474781 <GO>}

So Flood Re, the conceit of Flood Re was in levy, which is everybody pays a bit to help this household. And what we've said kind of – and what we've said is, it may be that that's kind of how it's happened. So, it maybe you can associate it. We can't correlate it. (47:47) but the market has been more stable at the time that the Flood Re cost has gone in. So, it could be that actually the consumers end up effectively paying for it. Albeit it's helped the market – the underlying market has kind of gone down. So, in which case, you could argue that actually – you could argue (48:08) cost-neutral is in levy and we have seen there're some risks into the scheme. Those tend to be very, very high flood risks because, as I said, the tariff to join the scheme is quite high and the normal home wouldn't put in, but it's got to be a very flood-risked home and obviously, we won't see if there's future floods. The profile of those sometimes is going to affect the homes you expect and otherwise, it can be the first time the home is destroyed in 100 years. So, we'll see how that develops. So, we might see some upside in the future on that, or less downside on the future.

The other thing is, as a market dynamic, there was some kind of things – suddenly, all these people in (48:46) is going to suddenly move. And I think as I said at that time, what seems to happen is that insurers have passed on the benefits to their customers. And therefore, their customers are happy, they're not shopping around particularly as we've done to our customers. So, I don't think it's necessarily shaping up the market. And again, you should set Flood Re against the alternatives to – worse alternatives available given those are problem here that need business solution. So, I think we're generally please with how that's working.

Okay. Ravi and then we'll go there. Yeah.

Q - Ravi Tanna {BIO 16926941 <GO>}

Thank you. Ravi Tanna, Goldman Sachs. I have three questions, please. The first one was on the dividend policy. And I guess given some of the differences that you've already outlined around Solvency II capital generation versus IFRS earnings, I was just wondering, when the board sets the dividends go forward, will the policy purely be based on capital generation of Solvency II or there'll be a consideration of IFRS reserves?

The second one was just around home insurance distribution and the fact that you picked up sales by price comparison sites. Has there been any change in the marketing or

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branding strategy or is that price-driven and is there any kind of step-change in your treatment around price comparison sites?

And then, the third one was on costs. Clearly, the run rate at the first half was slightly less favorable and I was just wondering what levers you plan to pull on to get to the low absolute cost level by the end of the year? Thank you.

A - Paul Robert Geddes {BIO 2474781 <GO>}

Okay. Let me deal with the price comparison site one first. So, we've always been pretty competitive on price comparison sites. We've had a bit of a breakthrough this time with the biggest, I should say the leading, but that's – we log them all equally. The biggest of the price comparison sites and our customer journey, and our customer journey we've harmonized and that's given us a big uptick on that. But generally, we are pleased with that and we're also pleased with Direct, so those strategies are working well. John?

A - Anthony Jonathan Reizenstein

Yeah. So, dividend policy, I mean, the policy for the regular earnings (50:50) is pretty clear and it's not going to change. The policy for specials has really driven off capital position. So, yeah, ultimately, will be capital generation starting with, obviously, a very favorable position. That favorable position, clearly now reflecting some of the differences between IFRS and capital generation. So, it kind of brought forward those margins that might have come out later into the capital now.

So, I suspect – we can't predict exactly how the board will behave, but I expect we'll stick around and we'll look at the capital position and the plan going forward. Yeah, I mean, how much we've generated, we expect to generate on capital will be important. But actually, the stock will be pretty important, too, against the plans we got for the future and the capital generation in the future.

I think, there can be years where your capital generation could be less or more than your dividend for that year. And actually, we've seen that under IFRS. We paid more than 9% at one year and less than 9% on other years on IFRS. I think the same will be true.

In terms of costs, so H2, my predictions for H2 versus H1, I think staff cost will come back to more like where they were last year. Marketing, we're expecting to spend less. Obviously, we've done very well on the first half. We've got lots of momentum coming through and trading conditions are good. We also think we're getting savings on claims handling. IT will probably be a bit more, but, net-net, we'll deliver what we've said.

A - Paul Robert Geddes {BIO 2474781 <GO>}

Okay. Yeah. And then (52:18)

Q - Andreas van Embden {BIO 1795530 <GO>}

Andreas van Embden with Peel Hunt. Two questions. One on slide 34. It shows that Direct Line over time has had much better frequency experience than the industry average.

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What is the key reason for that and how sustainable is this? Is this temporary or will it revert to the mean?

And second question is on slide 42 – I'm sorry, 43, where you split your SCR by risk type. When you're running your new internal model, what was the biggest surprise on the risk side? Was it the underwriting and which element or the market risk? What was the most surprising part when you're running your model? Thanks.

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A - Paul Robert Geddes {BIO 2474781 <GO>}

Okay. So, this slide, which we used to put up every time and we haven't stopped putting it up because it's sort of showing a great trend as risk selection and claims management expertise. And we're proud of both. John, (53:19)?

A - Anthony Jonathan Reizenstein

Yeah. I'd love to give an easy answer to the question, Andreas, on what surprises us. Just being it's so embedded in all our hearts and mind over so many quarters and years, hard to know. It gradually happened. I don't think we've been that surprised of our (53:36) who led all this work and he's shaking his head. He wasn't surprised. So, I'd love to give you a nice handy answer. But to be honest, we've just grown to love it.

A - Paul Robert Geddes {BIO 2474781 <GO>}

Perhaps, we're just paid not to be surprised. My job description. That's right. Yes. Of course, we're going to go back to Andrew first, and then Gordon.

Q - Andrew J. Crean {BIO 16513202 <GO>}

Hello. So it's Andrew from Autonomous. A few questions if I can. Firstly, how much of the premium is the packaged bank accounts? What's been happening there, and what's the future of that? It's slightly under threat. Secondly, could you say of the £236 million of prior-year releases, how much is coming from very old years, I mean years more than three accident years back?

Further question, on the return on tangible equity target of 15% which was set yonks ago, I mean you've given an enormous amount of capital back, which should obviously lift the return and has done so. Why do you stick with 15% and – or elevated? Is that because you're concerned the prior-year releases will come down? And then finally, within the £1.4 billion of capital requirement, how much is risk margin?

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A - Paul Robert Geddes {BIO 2474781 <GO>}

Okay. So, let me do a couple. I mean, I think on RoTE, I think having a target is not being a constraint as we've seen this time. To the degree to which it drives our choices, so it's not been a barrier to us achieving more. The RemCo keep it under review that they uplifted our targets by 50 basis points of benefit that we got from not having International in the portfolio.

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So, I'd say it's under review but, Andrew, (55:21) I think 15% – there's nothing bad to be imputed by it. I think it's not a target we should set out to chop and change all the time. It's a bit of a North Star, which we base some commercial decisions on. If you were to lower it – I'm sorry, if you were to increase it, we'd just do some less – we'd do less business. So, not a constraint. I think we get paid – RemCo keeps it under review on one end and, as I say, if we've got a different number in our internal models of how we judge writing business, we'd write less business which I think would be a mistake.

Packaged bank accounts, it's an industry-wide phenomenon. We are a distributor – sorry, we're a manufacturer of products to the banks and they've made a number of changes on packaged bank accounts over the last few years and we respond to that.

Q - Andrew J. Crean {BIO 16513202 <GO>}

(56:14).

A - Paul Robert Geddes {BIO 2474781 <GO>}

It's not a huge amount of premiums. I mean, again, one of the things which we talk about on both Travel and on...

A - Anthony Jonathan Reizenstein

Rescue.

A - Paul Robert Geddes {BIO 2474781 <GO>}

...Rescue, one of the reasons we like to get this business is it's good volume. It runs at very low margins. Volume is not an unhealthful thing if you're running a Rescue business or a Travel business. It means you can have more people learn more languages and more vehicles on the roads, but it's not a particularly material part of the profit number.

A - Anthony Jonathan Reizenstein

Yeah. Run-off, pre-2012, pre-2012 accident year, it's about half of Motor of those years. It's about half of the Motor releases, which were £134 million are pre-2012 accident years, and obviously, the run-off as well would be.

A - Paul Robert Geddes {BIO 2474781 <GO>}

Again, I think we deserve – not we're in this debate, but I mean I think actually running off old years in itself requires, we have very, very expert teams that work the files and make sure that we are resolving liability in the right way.

A - Anthony Jonathan Reizenstein

Yeah, because...

A - Paul Robert Geddes {BIO 2474781 <GO>}

So it's not just a kind of free gift. Part of it is just some work that...

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A - Anthony Jonathan Reizenstein

And we've had one or two old PPOs where we had high – before we had £1 million-ish (57:20), when we had £5 million or £10 million reinsurance in it, where we'd be managing very actively and got a win.

A - Paul Robert Geddes {BIO 2474781 <GO>}

Then we had a fourth question I think from Andrew. What was your fourth one, Andrew?

Q - Andrew J. Crean {BIO 16513202 <GO>}

How much was the £1.4 billion in the SCR (57:32)?

A - Anthony Jonathan Reizenstein

Well, it's quite a big number, but it's not – we aren't, at this point anyway, disclosing the makeup of the £1.4 billion between all the various bits. But it's quite a big number.

Q - Andrew J. Crean {BIO 16513202 <GO>}

(57:44)

A - Anthony Jonathan Reizenstein

Yes, in the own funds, yeah, in the own funds. The risk management in the own funds because it's part of a technical provision, it's a big – kind of gets added last of the technical provisions. It's quite a big number, but I don't think we've disclosed it separately.

A - Jose Vazquez {BIO 17879347 <GO>}

It's not in the SCR (58:00).

A - Anthony Jonathan Reizenstein

Not in the SCR. Thanks, Jose.

A - Paul Robert Geddes {BIO 2474781 <GO>}

I think coffee with Jose after will be helpful, no?

A - Anthony Jonathan Reizenstein

Right. (58:05)

A - Paul Robert Geddes {BIO 2474781 <GO>}

Gordon, the last. Yes. (58:08)

Q - Gordon Aitken {BIO 3846728 <GO>}

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Thanks. Gordon Aitken from RBC. Three questions, please. Just on the new IT system, you talked about that eventually driving a step-down in staff costs and numbers. It's not come through yet. When would we expect that to come through? And second on Gibraltar, you previously talked about that being an unlevel playing field but the Solvency II would level that playing field. We're six months into Solvency II now. Has the playing field been leveled or is there more to go?

And just finally on pricing, I mean you just talked about 30 pricing initiatives in Motor. I mean, clearly, that's helped and that's allowed you to price ahead of the market, while you're also retaining your customers. I mean, what have you got on now and can you further differentiate yourself from peers or it's just you can't do anymore?

A - Paul Robert Geddes {BIO 2474781 <GO>}

Yeah. I mean, the last one's really easy. So, A, we believe outperforms the market in terms of growth and loss ratio performances, pricing and claims initiatives and proposition and marketing and a number of other things. Price is certainly in there. I think we've got as long a list, whether it's 30 or not, we've got as many pricing people working as hard as we did on new stuff.

And in future periods, when we talk about rewind our strategy forward, there's still plenty of risks we don't write, there's still plenty of customers we don't currently offer a great – our risk models don't suit. So, we've got as many pricing initiatives, I would say, or as many people working on new pricing initiatives as ever. And we move on from standard stuff to looking at quite advanced statistical things, and we could (59:47) on it and maybe we'll find a forum to do that, but there's plenty still to come on pricing.

I think on Gibraltar, we're talking on a pre-Brexit world and all I'm saying is it was one of the factors which we associated but couldn't directly correlate with the market, which was relatively saying, we observed some players that were domiciled in Gibraltars, (01:00:07) historically, were being very, very, very cheap and seeing their behavior change. That set what I think (01:00:15) for an interesting conversation, which was what's going to happen now in the post-Brexit world.

Certainly, I think still there's so many questions still to be answered on exactly what happens in the post-Brexit world. But one of the things we highlighted in the future is there might be some other things like VAT deltas, which might emerge in time which has to keep us reviewing this. Maybe in a post-Brexit world, some of those threats recede (01:00:40). So, we keep an open eye on it, but I think, so far, so good on the Solvency II delta.

Now, you had a – oh, sorry, IT. Yeah. So what we're effectively saying here is that we're trading really well and making lots of digital improvement. Our customer experience is getting better and better. We're in no rush to have to switch on new stuff. We are right in the middle of testing it. We're deliberately not putting a date on our selling our first policy. Having a date like that might force you to go early or to not launch it in the right way. So, that's on the timing of it.

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I think in terms of the ambition, which we have is to enable customers to do more things themselves, that ambition remains. We have a number of other streams of technology – automation, robotics, offshoring – which, again, should improve the efficiency of our customer operations. So, it's one of the components that will, over time, we think make our people more efficient in the UK. Yes.

Q - Jon M. Hocking {BIO 2163183 <GO>}

Thank you. Jon Hocking from Morgan Stanley. Two questions, please. Firstly, the comment that John made about the severity uptick from some of the new customer propositions, are those propositions designed to be a sort of margin negative but contribution positive to the extent you're getting high volume or is that too simplistic? That's the first question.

And the second question, just to be clear, given the current environment, should we think of excess capital as being anything in excess of 180% (01:02:07) or is that too hirsute (01:02:09)? Thank you.

A - Paul Robert Geddes {BIO 2474781 <GO>}

Yeah. Listen, some of the propositions, we guarantee (01:02:13) and we say we give you a guaranteed hire car, we'll repair your car in seven days, we'll give you a emergency plumber. So, there's investment in – which we'll give to new and existing customers. There's an investment in the proposition. There's investment in the marketing. That comes through as see your customer's happy, customer's (01:02:28) retention rate, new business sales. We're very, very – we're delighted actually with how those initiatives have worked out for us.

We had a hunch that not all customers just wanted a race to the bottom in terms of product specifications and brand. I really think that we haven't directly picked out stats today because we don't have (01:02:48) but that we've got some great stats on how Direct Line in particular is performing. We're delighted with the investments that we've made. Business case looks pretty good on that.

A - Anthony Jonathan Reizenstein

I think, capital-wise, on the 180% (01:03:01), obviously, ultimately, you don't have a range then that sits at the top all the time because why would you have a range. And so we have to believe that over time – and, obviously, that's the killer question is when. But over time, we would move around within the range. So, knowing our board, they won't want to be down in the 140%s (01:03:24).

And I think your assumption is based on our recent behavior. You can't argue with it. But it can't be forever, can it? I mean we can't commit the board. We can't predict exactly what will happen, (01:03:36). There'll be lots of considerations. But based on recent behavior...

A - Paul Robert Geddes {BIO 2474781 <GO>}

(01:03:43)

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A - Anthony Jonathan Reizenstein

Yeah.

A - Paul Robert Geddes {BIO 2474781 <GO>}

What's the percentage now, John?

A - Anthony Jonathan Reizenstein

Well, we've returned about 70% since the IPO. But we have a good track record. That's kind of a difficult question what you're asking. Our track record on risk appetite is you've observed.

A - Paul Robert Geddes {BIO 2474781 <GO>}

Okay. We need to – yeah, we'll do first (01:04:05). There's two here and then we'll take one on the phone, we have? We'll get one more and then I think we should – yeah.

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

Thanks. It's James Shuck from UBS. I had three questions, please. One just returning to slide 12. Because my understanding was that you – on new business, I wasn't really aware that you kind of seem to be increasing your reserve conservatism a little bit. If I look at the 2015 booked year, the booked year actually deteriorated in 2015, the year-on-year, which I think you explained but I didn't quite follow that. But if I look at the gap between the booked loss ratio in 2015 and the actuarial best estimate, that gap seems to have widened. So, can you just help me understand that widening of that gap, please? That's my first question.

Secondly, on the Solvency II capital generation, I mean I think what you're saying is that there's going to be a high level of reserve releases coming through the IFRS earnings and those releases will not automatically lead to an increase in the retained capital over the year because it's released at the margin. So, therefore, can you give me an indication of what your organic capital generation is in a normal year, if possible splitting that currently between the back load (01:05:19) generation and then the increase in required, if there's anything at the moment? That's my second question.

And then thirdly, it's actually a specific one on – essentially, it's a question on Home insurance. Of your own brands policies now, can you give me a split of how much that comes from price comparison versus Direct? And I'm interested to hear more about this customer journey improvement through PCW because it seems you're growing in low-risk segment, judging by what's happened on the premium price. Thank you.

A - Anthony Jonathan Reizenstein

So, I'd deal with the – do you want to...

A - Paul Robert Geddes {BIO 2474781 <GO>}

Yeah. You can deal with the capital ones.

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A - Anthony Jonathan Reizenstein

So, just we'll do the capital ones first. So there's two elements of prior-year releases. There's releases from ABE which would go to solvency capital generation and releases from margin which wouldn't. That's (01:06:10) to be clear about that.

Secondly, we've sort of said long term, we'd expect broadly organic capital generation under Solvency II to be tracking IFRS earnings broadly. And we'll probably see more of that at the year-end, but that's kind of the message.

And in terms of requirements, we don't anticipate massive changes in requirements. We have lots of run-off then we might get reduced requirements. We've got lots of growth. We've got a bit the other way. But requirements probably, as we model it forward and we do our next plan, so our future planning will be much more Solvency II-orientated than it was, such as the IFRS plans were (01:07:00), but we'll probably see – I suspect we'll see rather stable SCR and more volatile own funds is my expectation, and therefore, capital generation is volatile. But long term, we're saying we think the two will broadly track. There'll be timing differences on – sorry. You've got another question.

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

(01:07:18) I just want to understand a little bit. If you can just help me understand a little bit why the Solvency II capital generation is similar to the IFRS earnings because the IFRS earnings include realized gains, which won't be capitalized to include a high level of releases, the majority of which won't be capital, so I'm left with a kind of much lower number. So, how do I bridge those two?

A - Anthony Jonathan Reizenstein

Well, no. So, it's moving parts. If you imagine a steady state, where we are investing and amortizing at the same sort of level, so as we build up our IT, those two will also cancel out. Secondly, we have some margin which may come out, and if that comes out and it's part of one and not the other, okay, that'll be a difference. But it's not massive and it's not going to last forever. We don't plan to get many gains. We just said we won't get many gains this year. So, sure, IFRS movements will have an impact, but that's just volatility we can't sort of control while we have what we believe is an optimal investment policy. So, if you look way forward and you project that on a kind of steady state – now, we'll never ever have a steady state. In any year, it won't be a steady state, but that's how we think about it.

And I've talked about requirements. In terms of the reserving chart, I didn't – I think the 2015 blip on the top there is – I can go through it again one-on-one, but it's really to be disregarded. It's just the movement of margin, which go less and less important as we've discussed, but it's to move margin between years. It's not an underlying strengthening of that year. You've got to access – you've got a margin. You've got to attach it to some years and we attach a bit to every year. That's what that is. The line below is a much better indication and the trends in recognition of ABE (01:09:15) have been similar.

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

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But why is the actuarial – why has (01:09:19) the gap in actuarial best estimate widened in 2015 versus 2014?

A - Anthony Jonathan Reizenstein

The gap, it's probably a scale thing. That's not to scale with that.

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

I guess I just mean if you look at the 2015 booked at the end of 2016 in the middle one at the bottom, the yellow, that number's – that's gone down versus the 2015 booked, but if you look at the actual booked as opposed to actuarial best estimate, that's gone up.

A - Anthony Jonathan Reizenstein

Well, that's because we got to get this margin – that's a small little margin point which had...

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

(01:09:50)

A - Anthony Jonathan Reizenstein

We actually had a debate. Should we not publish the top and just publish the bottom? And then we said just as a – they'll be even more suspicious if we do that. So, let's publish them both. And, yeah, so the answer is poor old 2015 was the current year which we were reserving less conservatively (01:10:06) margin goes into the prior year, got this bunch of margin, every year gets a bit of it, so it goes up. Really, we're not – we're telling you not to worry about it.

A - Paul Robert Geddes {BIO 2474781 <GO>}

And then on the biggest price comparison site, basically, it matters quite a lot how their question set match to our question set, what default product they include in terms of excesses versus R1 (01:10:27). So, their previous way of mapping questions in excesses (01:10:30) in standard products they mapped to didn't flatter our product relative to other people and the new mapping does justice to our product and our value. And we can tell you more in the break if you want to get into more detail about it. So, it's just a pure positive piece of news really and shows how we work closely with our partners. We do regard our PCWs as partners, frenemies or whatever you want to call them.

Good. Guess we'll do – there's not enough time. Actually, should we do a phone call just to break it up a bit and then we'll come back with the room?

Operator

Our next question from the phone line comes from the line of Andy Hughes. Please go ahead.

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Q - Andy Hughes {BIO 15036395 <GO>}

Hi, guys. I thought you said you got rid of me. So, quick question on slide 19 and 46. So, slide 19, obviously, on the change in valuation of technical provisions, you've got £100 million this time, whereas you had £203 million at the year-end. And you're saying that ABE – margin over ABEs increased over the half year. Is that right? And so, what's actually going on here? Obviously, is the risk margin increasing offsetting that?

And the other question was on the movement from the slide 46. If I compare the internal capital model to the – sorry, is this slide 46? It's probably not. If I compare the internal capital model to the previous one, there's quite – slide 43, sorry – the SCR for premium risk and reserve risk have absolutely collapsed from where they were in the standard model. And I guess I'm a little bit surprised with this, so maybe you could kind of explain how the premium risk is driven by market conditions. So, does that move around depending on the current year combined ratio or is it completely independent of that?

And on the reserve risk, I guess the big surprise is, obviously, the £372 million for reserve risk. And last year, the reserve releases were almost that much. So, I guess, the question is given the ABE didn't move negatively last year, was last year £100 million and £200 million (01:12:38) reserve release (01:12:39) in a positive way? Or how should we think about that in a common sense kind of way on some of these charges because it looked rather low relative to the standard model? Thank you.

A - Anthony Jonathan Reizenstein

Okay. Let me deal with the first one first. It's really easy. Thanks, Andy. Well, the year-end was standard formula, and this is internal model, they are completely different, which is actually also part of the answer to the second question. I think that you're right. The risk margin is the main reason why that bit's got not as green as it was before. The risk margin's the biggest thing that changes (01:13:15) when you go from standard to the IECM.

In terms of the – I mean, I wouldn't make comparisons between standard and internal model. They are completely different standards. It's a set of European-wide parameters that are set for a typical company. We're, by no means, a typical company.

A - Paul Robert Geddes {BIO 2474781 <GO>}

(01:13:36)...

A - Anthony Jonathan Reizenstein

Yeah. Motor, it's under wrong cat (01:13:38) and there are various other things. It doesn't cover the PPOs, et cetera, et cetera. So we're starting really afresh with the new one and I don't think it's helpful to make comparisons. And I think it's a great question on aligning a year's PY under IFRS to the premium risk in the SCR. And I'm just going to take that one away and noodle on it, because I didn't want to give a quick answer. It's much too smart a question.

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A - Paul Robert Geddes {BIO 2474781 <GO>}

Thanks, Andy. Very stimulating. We'll go think about that. Good. We're not having second helpings yet. Can we go to – yes, your question then we'll...

Q - Andreas van Embden {BIO 1795530 <GO>}

I am Andreas van Embden, Peel Hunt. How large is the diversification benefit in your SCR and has that gone up, staying the same or come down versus the standard model? Thanks.

A - Anthony Jonathan Reizenstein

Well, again, I think – again, we're not going to make comparisons between the one and the other. And we're also not disclosing our diversification benefit. Obviously, it's significant. We do have natural diversifications in lots of different perils and risks and so it's an important part. But we're not going to – that's not something we've disclosed and we're not planning to do that.

A - Paul Robert Geddes {BIO 2474781 <GO>}

Okay. Final two, Ravi and Greig.

A - Anthony Jonathan Reizenstein

(01:14:57).

Q - Paul Robert Geddes {BIO 2474781 <GO>}

Just two questions. One is, obviously, we've seen some very strong increases in Motor, which indicates that some – arguably indicates that some people out there are having problems with their financials or balance sheets and their providers. And we saw Enterprise Insurance last weekend go belly up, which writes in this market, Gibraltar-based insurer. I wonder what your thoughts are on how quickly we're going to see this market consolidate.

The second point is in terms of telematics, I know there was a high-profile debt in the U.S. automatic driving car. If you contrast that with the piece of regulation that's going through to try and facilitate – not, sorry, telematics is the wrong word – automatic cars.

Yeah.

Yeah. I was wondering what your views are. To me, it seems that this is accelerating very, very quickly. And I've heard some peers argue that you're not going to have a business model in three years' time. Do you want to talk about that?

Sure. So, let me – I'm going to take the question on consolidation of competitors. We focus on what we do. I think I've given enough sense in the earlier Gibraltar question about I think Solvency II from Solvency I, which obviously had a big impact, where we had a bigger impact there than it has here. But I don't want to make any competitive

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judgments on anyone else or talk about consolidation because I've got no clue what will happen.

On autonomous driving, I think the first thing to say is it's going to be quite a long time before it has materiality on, I think, the size of the insurable risk. We can just do that by saying what percentage of cars would have it for what percentage that they're driving, and then you age it from a car park. So, even if you're quite kind of – you can push the problem out beyond the planning horizon or probably and involve working lives (01:16:54) and maybe forget about it.

That's not the stance we're taking because we actually think if we have a stance in the market, that we are optimistic about it. We think cars having fewer accidents is a good thing for the world and that there'll be new business to be done, new products to be launched, new relationships to be forged. That's the space we're in. We're overinvesting in it versus its short-term economic risk because we see potentially some opportunities if we can be the car insurer of choice.

And that's why, for example, we are on the front foot in terms of insuring Teslas. John drives one, not subsidized by the company but we do offer discounts on Teslas. And we are currently sticking with Autopilot, which is the Tesla thing, which help with the accidents (01:17:35) in the U.S. We're working with Tesla to understand an accident and get some more stats behind it.

But we are technology optimists and we think it's all good and interesting and that there will be – we're in this consortia called Drive UK (sic) [Move UK] (01:17:51) with Jaguar Land Rover and Bosch and Transport Laboratories. So, we're on the front foot, I would say, and expect more in this space. We're overinvesting in it versus its short-term consequences to our risk pool.

Good. We'll do one more on the phone I think anyone? No one on the phone. Great. Ravi, last question then.

Q - Ravi Tanna {BIO 16926941 <GO>}

Thanks. Ravi Tanna, Goldman Sachs. Just one very final quick one. There's a reference in your press release on the commercial insurance market to a piece of regulation, Insurance Act 2015 and creation of disruption in the commercial market. I was just wondering is that all operational or is there anything material financially because it's something new to me.

A - Paul Robert Geddes {BIO 2474781 <GO>}

(01:18:32) John?

A - Anthony Jonathan Reizenstein

There's no material financial impact so (01:18:35).

Q - Ravi Tanna {BIO 16926941 <GO>}

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Thank you.

A - Paul Robert Geddes {BIO 2474781 <GO>}

Well, we're hoping for the last difficult questions in Commercial to ask Neil in his new capacity here. So, you can do that over coffee, really hard questions in NIG (01:18:47). Listen, guys, thank you very much for your questioning. Appreciate it was on a wide variety of topics. And we'll see you next time. Thank you very much. Join us for coffee. Thank you.

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