S1 2021 Earnings Call

Company Participants

- Neil Manser, Chief Financial Officer
- Penny James, Chief Executive Officer

Other Participants

- Freya Kong, Analyst
- Greig Paterson, Analyst
- Ming Zhu, Analyst
- Oliver Steel, Analyst
- Thomas Bateman, Analyst
- Will Hardcastle, Analyst

Presentation

Penny James {BIO 15157212 <GO>}

Good morning, everyone, and welcome to our Half Year Update. A few weeks ago, we took you through the competitive advantage we believe our claims capability gives the group. Today, I want to update you on what has been a really strong first half, but also build on the claims conversation by bringing to life the momentum in our strategic execution and by showing you how that's already reaping rewards and where it will take us next.

So starting with our key highlights, first, we've delivered a strong financial performance with profit of GBP370 million. The benefits of our diversified business model can be seen with growth in direct own brands for all lines aside from motor. Here, the deflationary market conditions, driven by abnormally low claims frequency, stabilized in the second quarter.

Second, we're delighted to have won a new partnership with Motability, which is expected to increase our motor customer base by around 15% to 4.5 million customers. It's evidence of the quality of our customer service, vehicle repair expertise, and digital claims capability and we look forward to welcoming both Motability customers and our new colleagues.

Third, we successfully launched our new Motor system, which aims to deliver a step change in our pricing capability and operational efficiency, providing a platform for future growth.

Fourth, we remained focused on digitalization, personalization, and preparing the business to win as the transition to a green economy takes place.

And finally, our strong financial performance and capital generation in the first half has enabled us to grow our interim dividend and confirm the GBP50 million second tranche of our share buyback. We are in an excellent position. Our strategy remains the right one as we've become an increasingly agile company underpinned by great tech that is fully digitally enabled.

I'll now hand over to Neil for the financials.

Neil Manser {BIO 5571223 <GO>}

Thanks, Penny, and good morning everyone. It's great to be here to talk you through an excellent first half. I'll begin with the highlights on slide five. Now, as Penny has already mentioned, it's a strong financial performance with operating profit of GBP370 million, well ahead of last year. We grew our direct own brand policy count by 1.3% with continued momentum across commercial, home, and Green Flag Rescue.

And we made further progress on reducing our cost base. Together, this performance means we now expect to beat our combined operating ratio target for this year by 3 points, which we now expect to be in the range of 90% to 92%. And we've increased the interim dividend by 2.7%. So overall, a successful start to the year.

Let's turn to the financial summary on slide six. Here you can see the GBP370 million operating profit, GBP105 million better than last year, leading to a combined operating ratio of 84% or 86% when normalized for weather and a return on tangible equity of 30%, all very strong metrics.

I'll first talk to some of the specific factors affecting in 2021 and then come back to the underlying message. There are three main trends that account for most of the increase in operating profit. First, COVID related effects. Here, we saw a non-repeat of the travel claims from the last year and a reversal in the investment losses we suffered. This accounted for around half the variance and is normalizing one-offs from last year. As you'd expect, we also had a benefit in motor claims frequency. Now, this was broadly in line with 2020 and so had little impact on the H1 profit change, but was still below normal levels.

Secondly, we experienced strong prior-year reserve releases, up from the low watermark from last year, and lastly, weather conditions were favorable.

Now, whilst these factors are important, understanding the shape of the first half result, what is most important is that we continue to make progress on the underlying profitability with a reduction in our operating expenses, good current year trading across the book, and strong prior-year reserve releases. And this sets us up well for the future. So overall, a very strong set of results, delivering against our financial targets.

So turning to the detail, starting on slide seven with policy count and premiums, and this is where our diversified model is really showing through. If I look across both charts, there are three key trends to pull out. First, motor. In a deflating market, we traded with discipline, pricing to our best view of risk, and have reduced rate by less than the market. This means we did lose some competitiveness, but the benefit being a higher quality portfolio. As the market stabilized in Q2, so as our performance with Q2 GUP down only 1.5%.

Secondly, other direct own brands and NIG. The diversification delivered by these areas more than offset motor. In home, growth has come from a focused and improved competitiveness across PCW, together with an attractive proposition for Direct Line. In Green Flag, we returned to growth in Q2 as driving levels and therefore new business picked up. And in commercial, we saw the benefits of our transformation come through across Direct Line, Churchill and NIG.

Now, lastly we have seen greater than normal movement in other personal lines. This primarily reflects the low levels of travel in 2021, which impacted partnerships, both the average annual premium we charge partners as well as the level of upgrade premium we receive from customers. And both of these factors should reverse to some extent in 2022. So overall, whilst premium was down in the first half, we grew by 1.6% in Q2, and this sets us up well for the rest of the year.

So let's start with the segments before I look at the -- and before I look at the individual results, I want to spend a bit of time on slide eight, on motor claims trends as context. What the graph on the left shows is the level of the miles driven through the last 18 months. And there are two key items to pull out.

First, our claims frequency has generally been better than implied by miles driven alone. Whilst we can't prove it, we believe it's down to the nature of our book and the change in the pattern of driving away from peak commuter times. Having said that, in July, frequency is now almost back to the level assumed in our pricing. And secondly, the frequency we experienced across the first half of 2020 and the first half of 2021 were actually quite similar on average, albeit the mix in the quarters was very different.

On the previous slide, I spoke about the premium deflation we saw across the market in Q1 before prices stabilized in Q2. The key drivers of this have been claims frequency, but also the impact of the whiplash reform. It's impossible to unpick a market level how much of the deflation is whiplash related, but it is interesting to note the young drivers where the impact is greatest have seen some of the largest price reductions, and in Scotland, where the reform doesn't apply, prices have increased.

Now, finishing on damage inflation. As we entered 2021, we have been running above 3% to 5%, medium term expectations due to one-off factors such as cleaning costs and higher used car prices. We have seen some normalization in these factors and damage inflation returned to around the top end of our expected range during the first half. As we told you last month, we believe we have a competitive advantage through our repair network and supply chain and this will become increasingly important as the economy unlocks.

Looking ahead to the rest of 2021, as frequency normalizes and the impact of the whiplash reforms works through, market pricing should be expected to more closely resemble underlying claims inflation.

Now let's move on to how that translates into a strong motor result on page nine. As I said on the last slide, lower claims frequency similarly impacted both 2020 and 2021, leaving motor operating profit broadly flat at GBP231 million.

I talked about how we traded the first half already, and this can be seen in average premium down 1.7%, which we think will compare favorably with the market. From the demand side, new car sales remain lower than normal and fewer new drivers enter the market. Although these factors are starting to reverse and you can see that in direct own brands gross premium, which was down 10% in Q1 and only 1.5% in Q2.

The current year loss ratio was relatively stable compared to last year at 67%. Now looking forward, we would expect the second half current year loss ratio to increase back to closer to underlying 2020 levels. And as a reminder, we estimated this was around 79%. And prior-year releases were higher at GBP101 million, benefiting from favorable experience in large bodily injury and I'll come back to this in a bit more detail later. So a very strong first half for motor.

Turning to home on slide 10, where again we delivered a strong result with an operating profit of GBP75 million, supported by benign weather and higher prior year releases. Own brand average premiums reduced by 3.5% and this reflected our continued mix shift towards lower average premium PCW business, alongside pricing actions to take advantage of a buoyant new business market and to support retention. And this delivered premium growth across both PCW and Direct Line. Attritional current year loss ratio remained stable compared to last year with claims trends in line with expectations.

Now, as you know, in July, we've seen some flooding, but this has been a localized and so not material to date. As you recall, we said last year prior-year reserve releases were lower in home and they've increased this year, largely driven by favorable development on escape of water claims. So all of this delivered a headline COR of 79%, and when normalized for weather, around 86%, an excellent result.

Looking forward, we are preparing for the upcoming pricing practice reforms. Now we have a final rule set that focuses on being ready ahead of the go-live date and we are confident we can achieve this. So overall, a very positive first half of the year for home.

Moving to rescue and other personal lines on slide 11. Headline operating profit improved by GBP37 million and returned the segment to profit in H1 with a combined operating ratio of 93%. And this was predominantly driven by the non-repeat of the COVID impact on travel in the first half of last year. On the right of the slide, you can see that rescue delivered operating profit of GBP29 million, increasing 20% over 2020, an excellent result.

As I said at the year-end, rescue is well positioned and this is coming through continued Green Flag direct growth despite low shopping [ph] in Q1, better indemnity control following the launch of the new claims system, and cost efficiency. Green Flag remains a real challenger in the rescue market and we believe with more to come.

Finally, let me turn to commercial on slide 12 where the results demonstrate the transformation this unit has been on for a number of years. It has grown both top line and operating profit in the first half and is building a really meaningful market position. Double-digit premium growth was delivered across all of its brands, direct, PCW, and broker.

And whilst the reasons for the growth are different in each channel, the consistency is around giving customers and brokers the right propositions backed up by great service. We continue to co-rate and have seen some modest rate hardening in the upper end of the market. This is pushing more business to market and I'm excited that we have a great team of underwriters to capitalize on this.

Overall, operating profit grew by GBP18 million to GBP44 million. This mostly reflected benign weather, but importantly, we are now seeing growth earned through the book. So positive first half from commercial with a positive outlook.

Moving back to the group result, I'd like to start with prior year reserve releases on slide 13. At the full year results, I said that changes to our reinsurance levels back in 2012 and 2013 have now worked through the system and said 2020 represented a low watermark for prior year reserve releases. And from this 2020 base, we would expect modest upside over the next couple of years. This statement still holds true. The first half, we saw strong releases across motor, home and commercial. Importantly, these primarily came from more recent accident years. Now we don't expect releases to be as high in the second half with overall releases between the level we saw in 2019 and 2020. And this is reflected within the revised 90% to 92% core expectation for this year.

Now onto expenses on slide 14. We continue to make progress on our cost agenda with operating expenses of GBP363 million, reducing GBP9 million compared to 2020. In the waterfall, you can see that our costs before levies and amortization were down GBP30 million in H1. In 2020, we incurred around GBP9 million of Force for Good initiatives. If I exclude this, costs are down around GBP21 million on this basis. And these savings more than offset the expected higher amortization costs, but also offset the market-wide increase in levies.

I talked a lot at the full year results about a number of cost initiatives we have in trade, new systems, digitalization, our agile operating model, and the property restructuring. And this is all contributing to our longer-term efficiency plans and gives us confidence in reiterating the 20% expense ratio target for 2023. For 2021, we expect to exit this year on a run rate of less than GBP700 million.

Now moving on to investment return on slide 15, which had a better than expected first half. Investment return increased by GBP27 million to GBP68 million, and this was driven by two key elements. First, we had a reversal of the mark-to-market losses we saw on the investment property portfolio last year. The value of this portfolio is now back to pre-pandemic levels. And this is testament to both the high-quality portfolio we hold and to the actions we took to reduce the retail exposure a couple of years ago.

Secondly, we saw a modest amount of realized gains on our credit portfolio in 2021 compared to the losses in 2020.

Investment yields were down, but have held up slightly better than we expected and we are now targeting 1.6% for 2021 versus 1.5% previously. So overall, the portfolio remains sound and we are staying relatively short duration ahead of any sustained pickup in rates.

A few words on capital on slide 16 before outlook and targets. As I said in March, I'm proud of our long-term track record of returning capital to shareholders and I'm pleased that we can continue that today with the second GBP50 million tranche of the GBP100 million buyback we announced in March together with an increase in the regular interim dividend of 2.7%. After these distributions and adjusting for the Tier 2 debt callable in 2022, this leaves us with a pro forma capital coverage ratio of 177%.

As you'll notice, this is towards the upper end of our target range, and there are a few reasons for this. First, we always tend to have a higher capital coverage at half year because the final dividend is ordinarily twice the level of the interim. Secondly, we've had some tailwinds in the first half of the year, particularly the deferred tax asset uplift, benign credit markets, and the earnings effects of benign weather and prior year reserve timing. We might see some of these reversing a little in the second half.

And thirdly, we generally only look at additional capital return at year-end when we will look to move back towards the middle of the range. So overall, I remain confident on the group's capital position, albeit the half year paints a slightly more optimistic picture than likely at year-end.

So let me move on to targets and outlook on slide 17 before handing back to Penny. The strong first half result and particularly the low level of motor frequency means we expect to beat the core target for 2021. We now expect this to be up to 3 points better in the range of 90% to 92%. Beyond 2021, we reiterated our existing targets for the combined operating ratio, the 2023 expense ratio, and return on tangible equity.

Now there are clearly some significant changes going through the market at the moment in relation to COVID, whiplash and the upcoming FCA pricing practice reforms. And whilst there will inevitably be some market volatility through this transition, we have run numerous scenarios, and this together with the health of the business gives us confidence in our ability to achieve these targets.

I'll now hand back to Penny to talk you through how excited we are about the future of the business.

Penny James {BIO 15157212 <GO>}

Thanks, Neil. I want to begin by giving you a feel for where we are in our journey and why we are so excited as we look ahead. As I said before, our journey has three overlapping phases, each involving different parts of the business moving at a different pace.

The first has been building the key technology blocks after years of underinvestment. It's characterized by very high investments and run costs along with constrained expenditure on organizational change or in existing systems that are set to be phased out. Well, I'm delighted to say that having successfully rolled out our new motor system, we're now largely through the heavy lifting of the tech transformation.

The second phase is business transformation. Here, we expect to materially improve our cost position as we reduce double-run costs and improve efficiency to increase the accuracy and speed of our pricing and underwriting, and as a result, improve our competitiveness, to improve the agility at which the organization responds to and delivers change and to continue to improve our customer experience further through digitalization and product personalization.

Anyone that's tried knows it's not just about technology. It's about partnering technology with the right cultural mindset to deliver for customers at pace. And that will bring us to the third phase, which is business growth. Now I'll come back to this later, but first, I want to explore the business transformation in more detail.

Turning then to slide 20, like many data-driven consumer markets, ours is digitizing fast. Future success will be on -- will be predicated on combining customer focus, efficiency and innovation with the insurance specialisms of pricing and claims expertise. If we get it right, these attributes become self-reinforcing and we believe deliver sustainable growth at attractive margins.

The key to achieving this is pace and agility, which means continually removing friction from the system, and combined with an underpin of great technology and data. Now we start from a position of strength with leading customer service, strong brands with unique propositions, and market-leading claims capabilities.

In contrast, our biggest cause of friction has been our IT systems. The tech transformation aims to address this, giving us tools that we believe are as good as any in the market. Our pricing teams and data scientists are working to leverage the data and tools now available to them and deliver a step change in our pricing and underwriting capabilities.

The new systems also enable us to significantly reduce our cost to serve our customers through increased digitalization, self-serve, and automation, alongside the ability to make changes to systems and products much faster. This is all underpinned by our move to Agile, which is developing maturity and which, by its very design, works to remove friction from the system.

These are the attributes you need to win today, but they are also needed to thrive once the FCA's pricing practices reforms come in. Put simply, customers will still value strong brands, great service and a claims operation that delivers what it promises.

Moving to slide 21, commercial is furthest through its transformation journey and is a great example of what can be achieved if we get all the elements of the flywheel working together. As you can see from the charts, over recent years, it's driven strong growth and improved margins with only a small proportion of this growth driven by market hardening.

Now, commercial has all the elements; strong brands in Direct Line, NIG and Churchill; great customer service and improved pricing tools, both supported by new platforms in NIG and DL4B launched in the past three years. And with agile ways of working, this has driven the strong growth you see here, which is across all major product lines.

Over the last three years, broker and affinity has delivered 4% compound annual growth, rising to 16% growth in the first half of this year. Over in commercial direct, we've been innovating with new products designed for small and micro businesses, and this has led to strong growth with a CAGR of almost 9%. And this gives us confidence in our ability to deliver organic growth in motor as we leverage our core strengths combined with its new technology.

And those core strengths in claims management and great customer service have been key in helping us secure a new partner. I am really delighted that Motability have chosen to work with us. Our vision of insurance is personal, inclusive and a force for good is fully aligned with Motability's purpose of giving their customers access to affordable, worry-free mobility. We just can't wait to get started.

This partnership is primarily about delivering brilliant service and claims capability to Motability's customers. It's expected to deliver around GBP500 million of premium and grow our motor customer base by 15%, adding scale to our leading claims management service. Motability underwrite all but 20% of the risk themselves. It gives us further insight on the fleet of modern vehicles with 600,000 customers. And it's a great fit where we can combine our vehicle repair expertise and digital customer service over the course of a 10-year contract.

Moving on to slide 23, earlier, I spoke about how our technology has been our biggest area of friction. Now in motor, we've been operating with one arm tied behind our back with the new systems overcoming impediments that we have faced in the past and set us up for the future.

A quick reminder then of what we've delivered. We now have a much greater resource of external data to draw on and the capability to integrate it through the Guidewire InsuranceSuite and Radar Live pricing engine. We've created a more efficient, intuitive platform for our frontline colleagues, consolidating over 20 applications and providing them a 360-degree view of our customers.

Our new systems create a comprehensive digital offering, including customer documentation and self-serve. And importantly, and where we've moved ahead of the market, the tech stack is modular in design and fully cloud-based, which makes it dynamic. We can plug in new products when we want to. We can update pricing engines at speed or even introduce completely new ones. And as it is in the cloud, we aren't limited by the amount of data we can store, making it an increasingly powerful asset year-on-year.

So where do we and our customers expect to see the benefits of this technology upgrade? Well, you can see the outcomes on slide 24, but I'd highlight just three main points. First is customer choice and efficiency. Some changes catches up with the market. We can offer tailored products and we're now able to offer customers tiered motor cover across all three brands.

But self-serve capability is delivering real results. We've seen customer take-up rates increase in motor to over 50% across service transactions alone. And the system allows us to automate up to 80% of motor back office workarounds, freeing up time for our consultants and delivering our cost targets. We also know our customers love it, with 90% of them scoring us with a 9 or 10 out of 10 in customer feedback surveys.

The second benefit is pricing and underwriting sophistication. At every stage, our processes will improve, getting faster and leading to greater accuracy because we can integrate more granular data.

Finally, we can innovate for growth. Our new systems are designed to get new products to market faster, to onboard new books of business quickly and to allow us to focus on untapped segments.

To summarize, we've successfully built the tech, removing barriers that hindered our progress, and now have greater freedom to deliver the commercial outcomes.

Moving to slide 25, today, I've focused on the benefits of our new tech. The future success is predicated on some broader trends as well. Firstly, digitalization, data and AI. We're confident about what our digital investments can bring customers because we've already had success elsewhere in the business. For example, our digitally enabled brand Darwin is going from strength to strength. It now has 90,000 policies, tripling in size over the last 12 months. Our in-house developed counter-fraud systems and total loss identification use AI and are improving financial outcomes and customer experience already. We've got a great foundation from which to build.

Secondly is product personalization. Whilst many customers may choose to purchase relatively homogenized products through price comparison as they do today, we believe many customers will want an experience that reflects their changing needs. Over time, we'll look to use the flexibility we have in our customer journeys to offer an increasingly personalized experience that will only be available by coming to us direct. For instance, we've just released our new cycling product and we're aiming to release further products in the second half as we expand the direct line offering.

Thirdly, car technology. We consider this a major strength. As many of you heard at our recent claims insight session, we believe our vertically integrated model gives us real competitive advantage. And we continue to expand our DLG auto services network, having purchased our 22nd site.

It provides the perfect environment to test and learn new capability before rolling it out across our broader managed network. And we want to remain at the forefront of car technology. It's why we built a tech center during lockdown, our very own in-house training facility where we can upskill our technicians in ADAS calibration and electric vehicle repair. And we continue to engage with other sectors and governments to support the adoption of electric vehicles because we know the car park's set to change.

And finally, I want to turn to our vision of insurance as a force for good. When we talked about this last year, we were focused on our support for customers and the most vulnerable in society as well as our people's well-being. And our community fund continues its great work, supporting many fantastic causes through the UK. We've also offered millions of customers the permanent option of adjusting their mileage levels, and have offered others a refund or donation to any of three great causes, Mind, NSPCC or the Sepsis Trust and thus far, they have donated nearly GBP950,000.

But we're now focused on climate change and how the green transition can give us a competitive edge. We want an approach that is good for the planet and good for the business. We signed up for the Race to Zero campaign and are active in areas such as the ABI, Climate Change Roadmap, and the Sustainable Markets Initiative.

Engaging is non-negotiable. Every government, CEO, leader and individuals simply has to do their bit. So we're working to encourage the industry's supply chain to reduce its carbon footprint. We want our investments to have influence. And as a major motor insurer, our green USP should be to ensure fixed and rescue EVs and to do this whilst aiming to be the most energy-efficient repair network in the UK. And our auto services colleagues are doing great work on this. So in the first half of 2020, we'll be running an ESG investor insights session outlining our progress on science-based targets and the investments that we're making across our operations.

So in conclusion, I hope today has given you a feel for the sheer scale of change and innovation that is going on across the business and why we're so excited and confident as we look ahead. We have great momentum after a successful rollout of our new motor platform, our technology transformation is largely complete, and we're firmly on to our business transformation. And commercial has shown, through its sustained growth, what can be achieved when we add new technology to our existing core strengths in claims expertise and customer service, underpinned by agile ways of working.

It certainly hasn't been an easy period to navigate with a challenging market backdrop and a huge amount of delivery from remote working environment, but our first half results show both strong financial results and real strategic progress. And this is a testament to the commitment and resilience of our people. So I really can't thank them enough.

Thank you for listening. And both myself and Neil are happy to answer any questions you may have, and I'll hand back to Jess to coordinate the Q&A. Thank you.

Questions And Answers

Operator

(Operator Instructions) And the first question comes from the line of Freya Kong from Bank of America. Please go ahead.

Q - Freya Kong {BIO 20097488 <GO>}

Hi, good morning, guys. Thanks for taking my questions. I've got two questions, please. So you've upgraded your combined ratio guidance by 3 points. Could you walk us through the moving parts of this between your current year loss ratio, which was very strong in H1, higher (Technical Difficulty) expenses?

My second question is on damage inflation, which is now back within the 3% to 5% range that you had expected, but this is materially better than the high single digits at the start of the year. Where has most of this improvement comes from? And is there something that the rest of the market is seeing?

A - Penny James {BIO 15157212 <GO>}

Brilliant. Thanks, Freya, Do you want to take the first one on outlook?

A - Neil Manser {BIO 5571223 <GO>}

I would. Yeah, Freya -- good morning, Freya. I'll take first one on COR guidance. I think if you look at -- I mean, the simplest way through it is actually most of the upgrade of the 3 points is really current year motor frequency in the first half. That is the majority of it. Clearly, there is a pretty strong prior year reserve movement in there as well and (inaudible) expenses. But as I said, most of the movement is really motor current year in the first half.

A - Penny James {BIO 15157212 <GO>}

Thanks, Neil. And severity damage inflation, you're right. So we flagged at Q1 that we were running higher than our sort of normal 3% to 5% guidance range, in particular, on accidental damage. And we kind of pointed at several COVID-related effects, so things like cleaning costs, people driving the smartest car on the drive rather than cheaper car on the drive. So the sort of nature of vehicles that are crashing changed and moved up the scale. And probably the single biggest effect was that the secondhand market prices had risen due to lack of supply in the market. So write-off costs, total losses have increased quite considerably.

What we've seen in Q2 is that start to normalize back to the -- to somewhere around the top of our range. And some of that, I think, is some of those COVID effects, not all of them, but some of those COVID effects starting to normalize. Plus the team has been doing a lot of work, in particular, in the total loss space to try and tighten up the position and get some better deals on the way. So a little bit of self-help, but probably largely the COVID position starting to normalize again.

Thanks, Freya. Hopefully, that deals with those ones.

Operator

The next question comes from the line of Will Hardcastle from UBS. Please go ahead.

A - Penny James {BIO 15157212 <GO>}

Good morning, Will. How are you?

Q - Will Hardcastle {BIO 16346311 <GO>}

Very well. Good morning, everyone. A couple of quick ones, really, I think. On the installment income, just trying to understand the drivers of this. I guess is there anything -- any change in propensity for customers to pay in installments or is there a mix shift? Anything sustainable here or should we be expecting a bit of a (inaudible)?

And second one is just I know there is lots of moving parts on both the home and motor pricing dynamics that we're going through at the moment with the FCA or remedies with the whiplash reforms. I guess just the action you're seeing at the moment, is it as you anticipated? Or is it (Technical Difficulty) now. I know there's some early signs, it sounds like. And then on the back of that, thinking about the FCA [ph] remedies, just give us a bit of color (Technical Difficulty) you're confident that you said to be a long-term potential (Technical Difficulty)

A - Penny James {BIO 15157212 <GO>}

Thanks, Will. I'm sure that's more than two, but I think we can work with them. Why don't I talk a bit about motor first and let's perhaps come onto pricing practices and perhaps Neil can do installment income in a second.

I'm just going to step slightly back and kind of do a bit of what's happened in the market and therefore where is it set as we kind of enter the second half, which I think hopefully will help. The backdrop, as always, is the amount of mileage that people are driving. And we know through the lockdown last year that that dropped dramatically. It picked up through the rest of the year, but to nowhere near pre-pandemic levels, fell back again as we come into the third lockdown. But by the time we get to the end of Q2, mileage levels are pretty much back up to pre-pandemic levels.

Now, in terms of frequency throughout that period, frequency has lagged the miles driven. We think that's due to customer behavior, people working from home, may also have a bit to do with the nature of our book relative to others, difficult to see. But certainly, it has lagged and continues to do so.

So what's premium done through that period largely? You saw mix changes through last year that continued into this year, so less young drivers in the market, less midterm amendments and so on that pulled average premium down. And then as we entered the -- and it became clear we were going into another lockdown. You saw prices come down across the market. We took a few points out. I think the market went further than us, and you can see that in some of the GWP figures.

But in Q2, a lot of that came back again or sort of at least flattened off. So whereas average premium was down about 5% in Q1, about half of that down due to those risk mix factors. By half year, it's only down a couple of points, so you can feel those things starting to reverse. And the play through to GWP of all of that is, I think as Neil said in his presentation, we were 10% off on -- in Q1, about 1.5 points off in Q2. So again, you can see and feel the market stabilizing through that as we get to the end of the second quarter.

So as we look forward then, well, which I think is where the thrust of your question is going and how we're feeling about it, we've obviously projected what frequency levels will do. We believe they won't return to the levels that they were pre-pandemic relative to miles driven. And they are now kind of approaching the level that we've got reflected in our pricing. You can feel, as I said to Freya, that severity NAD is starting to come back into shape, so not fully unwound yet, but starting to come back into shape. And you've obviously got the whiplash reforms coming in and it's too early really to see what's going on there, just not enough claims through the system. But we will all across the market have taken a view on what whiplash reform means.

When I put all of that together, what we'd say is that broadly the assumptions on all of those things are hanging with our pricing assumptions at the moment. And whilst there's some uncertainty at how those things will actually land as we get towards the end of the year kind of means that in loss ratio terms, we expect to be back somewhere around our 2020 underlying as we move through the back end of the year relative to -- and that's about, what, 79%, I think it was, in 2020 relative to the 67% we saw in the first half. So I think, in summary, both the markets stabilizing and things starting to move back into line with sort of core pricing assumptions.

I'll pause there. You can do installment income and then I'll come back to FCA.

A - Neil Manser {BIO 5571223 <GO>}

Yeah. Good morning, Will. So you're right, installment income is down half year on half year. It tends to track premiums, but it also tracks mix as well. So a higher average premium business would tend to have a higher installment income penetration. As you know, there's a few young drivers in the marketplace. So if you take those factors, that should explain the change. I don't think there is an -- there's no underlying change in propensity at the kind of cohort level going on there.

A - Penny James {BIO 15157212 <GO>}

And FCA pricing practices, look, I think the first thing is we've got the rules now, which is actually a big advantage over where we were in Q1 when we spoke to. So we and everyone else in the market will be flat out sort of working on delivery according to them and so on. But I think what it tells you is that what I've always said that having a variety of brands, channels, and products is an advantage in this space. I mean, ultimately, we will -- and I suspect others will be segmenting their book to work out where the right price point is for each segment and cohort of business. And that can happen at quite a granular level. And as we do that, we have plenty of options and levers across the brands and channels to pull. And that's why, as we look at it, and we've done -- modeled, numerous scenarios on what the market might do as you imagine. But as we look at those scenarios, we think we can navigate through within the 93 to 95. Obviously, some have different effects to others, but broadly, we see ourselves in that range. And that's why we kind of expressed the confidence that we do.

Operator

Yes. So the next question comes from the line of Greig Paterson from KBW. Please go ahead.

A - Penny James {BIO 15157212 <GO>}

Good morning, Greig.

Q - Greig Paterson

Good morning, everybody. Can you hear me?

A - Penny James {BIO 15157212 <GO>}

We can. Yeah.

Q - Greig Paterson

Two quick -- I'll be two and a half. How's that? Motability, the 80% reinsured element, do you have a profit share kickback in the contract for the reinsurance element? Second is, you talked about business transformation effect. When do you expect that to complete? And then two and a half, what -- do you still have a differential in home between renewal and new business pricing? Thank you.

A - Penny James {BIO 15157212 <GO>}

Why don't I take the second two, and then I'll let Neil talk to Motability. I think do we still have a differential on home? Yes, we have some differential, and you won't see that fully flatten until we go into pricing practices. I think the -- we've clearly done a lot of work on the tails of the book over the last few years, as we've told you about. So that range is much tighter than it was a few years ago. And we're very comfortable, if you think about the two aspects of the pricing practices rules, one being the pricing remedy and the other being the fair value test, we're very comfortable that the book as a whole -- in fact across all the products fits in a completely appropriate position from a fair value perspective. And that will sort of confirm that we've dealt with any tails. But actually, because the pricing remedy means you have to flatten entirely through the tenures, if you like, there's still some margin -- some elements to go through those early tenures. So I think you will see in individual segments across the market, some prices go up, some prices go down. And that may vary from segment to segment at quite a granular level as we go through it. So that's the FCA answer.

In terms of business transformation and timing, I think different parts -- as you can tell, different parts of the book are moving at different paces as these things overlap. I think it will take -- if the question really relates to when do the benefits come out of the motor transformation, that element will come as we move the book over about an 18-month kind of time scale. They will evolve. Some of the pricing kind of attributes come immediately and some take a while to work in.

And what I was trying to express is we brought agile ways of working in. Now we give people a new tool set to work with. There was some degree of learning period as you bring that together. So we will get more mature, if you like, in the use of that over the coming months. So that's a sort of shape. I think obviously business transformation never really ends, but it's probably the shape that you're after.

Motability structure, do you want to...

A - Neil Manser {BIO 5571223 <GO>}

Yeah. So thanks, Greig. So hope you understand that I can't give you the entire commercial construct of the deal. What I can say, though, is the 80% -- so 20% is ours, but we'll generate a return on capital, we put up against that. The 80% is Motability's, but of course, it delivers scale into our platform and we can monetize that scale benefits to our advantage.

A - Penny James {BIO 15157212 <GO>}

Thanks, Greig.

Operator

The next question comes from the line of Thomas Bateman from Berenberg. Please go ahead.

A - Penny James {BIO 15157212 <GO>}

Good morning, Thomas.

Q - Thomas Bateman {BIO 21707516 <GO>}

Hi, good morning, Penny. Hi, Neil. One question or point of clarity really. Just on the expenses, you said that you expect to be at a run rate lower than GBP700 million for 2021. Is that an improvement in your guidance there? And if so (Technical Difficulty) about the change? And what's driving the confidence to meet the expense ratio target in 2023 given that's still 5 percentage points (Technical Difficulty)? Second question on (Technical Difficulty). Can you give any color on the kind of rating improvement -- rating increases that you're getting? And what sort of guidance can you give us on the combined ratio? So could we expect that to come to below 90% next year? Thank you.

A - Neil Manser {BIO 5571223 <GO>}

Right. Let me do cost first. So the exit this year at sub-GBP700 million, no change to guidance, same as we said it last year. So that's a run rate at the end of the year. And it's coming in line with the guidance we gave a couple of years ago. We were aiming for GBP700 million, but we're saying -- that's delayed slightly, but at the end of this year, we're still trying to get to a run rate.

If I kind of stand back and look costs more generally, I'm pleased that absolute cost's down in the second half, underlying cost's down in the first half, the expense ratio is down in the first half, and that's against actually a reduction in earned premium because we're making the right trading choices for margin purposes as well. So I think it's a pretty strong first half on costs. We're getting through the change agenda. Penny talked a lot about the motor platform, the benefits coming there, taking 80% of the manual process at the back end, the 20% reduction of cost to serve. There's lots of stuff coming through now as we deliver the technology transformation, technology change, which should give us -- which does give us confidence.

But at the same time though, it's not just about cost reduction on the change. It's also about how do we make change faster, at greater pace for lower cost as well. And that feeds more into growth in the longer term. So we exit -- we saw Q2 actually business grew a bit, 1.6%, albeit against relatively easy comparative. But you've got commercial growing well. We've launched the system capability on motor now. So the business is in pretty good health to grow forward, and we're winning contracts. So we've won the motability partnership. So I think if you take the tech we're landing to take cost out and to grow the business and put all that together, that's why we're confident on the 20%.

A - Penny James {BIO 15157212 <GO>}

Do COR guidance improving next year or not?

A - Neil Manser {BIO 5571223 <GO>}

The COR guidance, I think if I look into next year, this year, 90, 92, confident on that. A lot of that is driven by the metrics in the first half. If I go into next year, the question is much about margin versus growth. So we spent the last three or four years moving this business away from one that was heavily dependent on prior year reserve releases into one where the earnings are much more balanced between prior year and current year. And even the prior year is a much more recent accident year. So it's almost like current year. And we can -- the guidance of 92 to 95 captures that.

I think when we get to that, now we are at that point, actually, the choice we make is probably around growth. So 90 to 95, we're making good margins. You can see the RoTEs we are making at that level, which were strong. So we'll probably now look to grow the business at those margins, rather than continue to drive the margin and actually not have a bigger business.

A - Penny James {BIO 15157212 <GO>}

Thanks. Jess, have we got any others on the line?

Operator

Yes. So the next question comes from the line of Alex Evans from Credit Suisse. Please go ahead.

A - Penny James {BIO 15157212 <GO>}

Good morning, Alex. Hi Alex. You are on mute. Jess, I think we've lost Alex for the moment. Do you want to see if we've got anyone else we can go to?

Operator

Yes, of course. So the next question comes from the line of Oliver Steel from Deutsche Bank. Please go ahead.

A - Penny James {BIO 15157212 <GO>}

Hi, Oliver.

Q - Oliver Steel {BIO 6068696 <GO>}

Good morning. Hi. So two questions, since I'm told that's all I'm allowed. First of all, the capital requirement just sort of keeps on nudging up even though the premiums and the policy counts aren't really. And I know it's quite small in the last six months, but over the last three years, it's been pushing up quite strongly against premiums. So I'm just wondering what's driving that and what the guidance is about the capital requirement going forward. Secondly, investment income guidance, you've given 1.6% for this year. Are you suggesting 1.6% for next year as well or can it nudge up?

A - Neil Manser {BIO 5571223 <GO>}

So I'll take those. So let me take the second one first. So one point -- so we're still coming off slightly higher levels of investment income. So we're still reinvesting at rates at or -- we are pretty close to where the previous 1.5 guidance was. In the first half of this year, we'd held a slightly higher weighting to higher yield, which has given us a little pickup. So this year, 1.6, I think next year is more likely to be around 1.5 actually as the reinvestment goes through. But I think we're at the point where the reductions have -- the major reductions have reduced. And actually, it's plateauing out. And hopefully, if we see some pickup in rates, either credit or interest, then we should be able to pick back up in the future.

On capital, first half, I think the movement was slow tens of millions. You get this volatility in Solvency II capital models. It doesn't take much to move the number by a small handful of millions. So I wouldn't read too much into that. I think longer term, we would -- sorry, I should also say on the (inaudible), we slightly tweaked the reinsurance program on motor as well, which does require a little bit more capital because we're taking a bit more risk on motor. So that's one of the changes that's come through recently. Longer term, I think we constantly challenge ourselves on capital efficiency, capital optimization, whether there's more we can do, and we'll continue to do that. So I would hope that the ratio of premium to capital won't grow any higher.

A - Penny James {BIO 15157212 <GO>}

Thanks, Oliver. Jess?

Operator

(Operator Instructions) And the next question comes from the line of Ming Zhu from Panmure Gordon. Please go ahead.

Q - Ming Zhu {BIO 17001429 <GO>}

Hi, good morning. Thank you for taking my question. I only got one question, but it's largely around your capital. Given your strong capital position, where it is at half year and sort of look towards the end of the year, and your target, sort of the mid of your target range, does that mean we could -- if the weather plays out normal, does that mean we could be expecting some excess surplus to shareholders after your ordinary dividend? And sorry -- actually, two questions, but it's related. And since the full year, your share price has just been absolutely flat, apart from today, of course, and so your buyback hasn't really worked. I mean, would you consider the special over buyback if there is surplus capital at full year? Thank you.

A - Neil Manser {BIO 5571223 <GO>}

Thank you. Let me kind of do the second one first again. So on the buyback, I think we're pretty pleased in some ways that we've been buying back stock at pretty low prices during the first half of the year. So actually we -- bought back more stock than we thought we would have done with the GBP50 million. When we talk to shareholders, most -- the vast majority of shareholders at this point with the stock where it was trading were supportive of buybacks to special dividends. It's not completely universal, but the vast majority were of that view. So confident in the second half of year, buyback is the right decision. Of course, every time we do this, we'll make assessment on whether this buyback or specialty is the appropriate way to go.

In terms of the capital outlook, I'm not going to predict there's no weather for the second half of the year. I think that's a bit -- for me, it's very optimistic to do that. Having said that, I think the capital position at the half year is strong. You can see that. Of course, as I said, the dividend in the second half is always bigger. It's about 15 points of capital of a dividend in the second half, it was last year. So it's a bigger chunk of capital that comes off in the second half as you pass the dividend through. But I think the reason to be optimistic, we have a good track record returning capital to shareholders. We have -- with the guidance of 90 to 92 for the COR this year, we're generating strong capital. So I think there were a few tailwinds in the first half, but still confident.

A - Penny James {BIO 15157212 <GO>}

Jess?

Operator

We have no further questions in the queue. So I will hand the call back to your host for some closing remarks.

A - Penny James {BIO 15157212 <GO>}

Brilliant. In which case, can I say thank you very much for all the questions and for joining? As you can tell, we're feeling really positive. There's great momentum in the business. We've got some brilliant strategic execution delivery away in the first half, and we're just looking forward to the second half continuing. So thank you very much. And if you got any more questions, as ever, feel free to get in touch with us or Paul direct. Thanks.
