Q4 2014 Earnings Call

Company Participants

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

Other Participants

- Alan G. Devlin, Analyst
- Andrew J. Crean, Analyst
- Anthony Araujo Da-Costa, Analyst
- Dhruv Gahlaut, Analyst
- Fahad U. Changazi, Analyst
- Gordon Aitken, Analyst
- James A. Shuck, Analyst
- Marcus P. Rivaldi, Analyst
- Oliver G. Steel, Analyst
- Ravi Tanna, Analyst

MANAGEMENT DISCUSSION SECTION

Paul Robert Geddes {BIO 2474781 <GO>}

A very good morning ladies and gentlemen. Thank you so much for coming to our Third Full-Year Results Update as a listed company. We do have a change of scene this year. Thank you very much to the generosity of Morgan Stanley for giving us the free venue again. And I'm joined as always by our CFO, John Reizenstein. I'm going to begin with a brief overview of the key highlights and then come back later to give a full update on our strategy.

So let me start with the highlights on slide 3. 2014 has been another successful year, and we achieved a number of important milestones. We've now met or exceeded all of our published targets, which we set at the IPO and targets which we set subsequently, including costs, combined ratio, commercial combined ratio, and RoTE. The investments we've been making in the business are starting to come to fruition. We are now a more competitive business than we were a year ago, and that's demonstrated by the improved trading in the second half and the fourth quarter in particular.

We announced the sale of our International division for £430 million, an excellent result for our stakeholders and our shareholders. We've established a good track record of returning excess capital to shareholders, including 2014 final and special dividends. That makes 32% of the IPO share price returned to shareholders, 32%. We're now focusing on our strong well diversified UK portfolio with a clear strategy to make insurance easier and better value for our customers. And I'm going to tell you a lot more about that later.

So without further ado over to John.

Anthony Jonathan Reizenstein

Thanks, Paul. Let's start with the financial highlights for 2014. The ongoing numbers now exclude International, which has been reclassified as discontinued. Overall ongoing operating profit was

£506 million, that's broadly flat against 2013. And we consider that to be a good outcome, given how tough the UK Motor and Home markets have been.

GWP was 3.8% lower than 2013, reflecting our disciplined approach to underwriting in Motor and Home. Within that we did see improving quarterly trends through the year. Underwriting profit of £148 million was broadly in line with the prior year. Good news on lower costs and a better loss ratio, but they were offset by lower earned premiums and a slight increase in commissions.

Overall the COR was 95% in 2014, which is 0.2 percentage points better than 2013 and at the bottom of our target range.

Installment and other income was 14.7% lower, largely due to the sale of Tracker. And installment income was lower driven by lower volumes. We have strong investment returns of £210.6 million, up 14%. And within this we achieved a higher investment income yield as a result of further diversification and saw significant unrealized property gain.

At a segmental level apart from Motor all divisions increased profit in 2014. Putting all of this together we achieved a RoTE of 16.8%, comfortably ahead of our 15% target. This includes International. If you exclude International RoTE was 17.9%.

Look at top line. In the lower half of the slide you can see our improving quarterly GWP trend. In the fourth quarter overall GWP was flat versus the prior year. This improving trend was driven by performance across Motor and Home own brands. You can see from the bars on the top right that we saw a small increase in Motor own brand IFPs in Q4 whilst Home own brands were stable.

In Motor we saw improvement in quarterly GWP versus the prior year with 2.5% year-on-year growth in GWP in the fourth quarter. Home GWP was down 4.7% for the full year, but sharper pricing helped to hold our own brand policy count flat in the final quarter. We saw good growth in Rescue and Other Personal Lines, including Life, which ended the year up 6.8% and 3%, respectively. And Commercial continues to grow GWP and IFPs, GWP was up 2.6% with growth across all channels.

Turning over to current year underwriting result. It has been another year of improvement in current year attritional loss ratio, down 0.5 percentage points to 70.8%. And actually we've seen continued improvement over the last few years. If you remember in 2012 you'll see why attritional loss ratio was 72.9%.

The red bars show we experienced lower claims from major weather events in Home. The number was £63 million in 2014 all from the first quarter. It was also another year of significant prior year reserve releases with £398 million in 2014. This is equivalent to 13.3% of NEP and is a function of our prudent approach to reserving, which I'll talk about in a moment.

Looking at costs we've achieved all our cost targets since the IPO. In 2014 the headline costs were down £58 million to £974 million. Note this includes International, and the improvement is similar if you exclude International. We've achieved this through gradually becoming more efficient, but there is more that we can do.

The ongoing expense ratio was broadly flat at 23.6%, as our expense savings were offset by lower earned premiums. So if you go over the page you can see a bit more detail on costs.

The majority of savings come from staff and marketing costs. Staff costs were down 16.9% in 2014, and average head count was down 11% during the year. We have been reducing the number of relatively expensive people across the business.

Marketing costs were down 22.2% (sic) [22.1%] (5:55) despite having rolled out new marketing campaigns for Direct Line and Green Flag. In my job it goes with the territory to be a bit skeptical about marketing costs. But when you think about our new campaign and the better sales picture for the group, I mean no doubt we're getting more efficient in our marketing spend.

As predicted depreciation and amortization increased during the year, reflecting our investment in improving our business, and we expect that to continue. But overall we're looking to reduce costs again in 2015.

Let's look at segmental performance, starting with Motor. The Motor operating profit of around £300 million represents a reduction of £50 million versus 2013. IFPs and GWPs were at a headline level down year-on-year. But as discussed we saw marked improvement in trading in the second half of the year, particularly across own brands. And we ended the year in a better position. We've split the IFPs here between own brands and partners to highlight the different trends. Own brand policy count was only down around 1.5% over the year and was broadly flat in the second half, while partners were down 13% during the year.

Underwriting profit was down £48.3 million. Within that prior year releases were down a bit to £278 million, still a significant number as we continue to see prior year claims develop favorably. The current year loss ratio on the other hand was 3.2 percentage points higher, primarily due to volatility and large BI claims. And I'll get into that in a bit more detail in a moment.

The core of 96.2% was 3 percentage points higher than 2013, a combination of the higher loss ratio, a slightly higher commission ratio due to partner commissions driven by prior year releases, and expense ratio was also up slightly, mainly due to the impact of lower earned premiums.

Installment and other income of £103 million was lower than prior year, due to the sale of Tracker, and lower installment income reflecting lower premium. And of course Motor benefited from higher investment return.

Here you can see our usual chart of Motor price and risk mix. At Q3 you'll remember we said prices had been relatively stable in that quarter. In Q4 there was some improvement in the pricing environment, although it's a low-volume quarter.

So having held our pricing relatively flat during the year, our prices in Q4 were about 2% higher than a year before. The combination of a better trading environment and our actions meant we were able to hold policy count pretty flat in Q4, And so GWP was up versus the prior year despite a slightly lower risk mix.

The waterfall below shows the movement in the current year attritional loss ratio for Motor, which increased from 85.3% to 88.5%. As I mentioned this is mainly due to volatility and large BI claims. We did highlight that at Q3, and you can see it accounted for around 2.6 percentage points, a little bit more than we had expected.

Let's get into the Motor claims trends. Improving economic conditions and lower fuel prices contributed to the first increase in road traffic since 2011. We haven't seen any impact on claims frequency from that, at least not yet.

Let's start with small BI, which accounts for around a third of Motor claims costs. The usual RTA portal stats on the top right continue to show that we have outperformed the wider market, which we believe is a good evidence of our improved pricing and risk selection.

As I mentioned 2014 was a volatile year for large BI claims. These are low frequency, high severity, and the notional (9:47) number does create volatility from year to year. We don't see any systemic factors at play here beyond the normal inflation trend. You can see for example from the charts of the bottom left that the increasing frequency wasn't skewed towards younger drivers particularly. And we've run similar checks by geography, brand, incept year and other factors. Accordingly we'll be vigilant. But at this point we're viewing the increase in large BI as a blip.

You'll recall that we bought more in reinsurance in 2014, which has reduced the impact of this volatility, albeit that some of the claims attached to our earlier 2013 program. For 2015 I'm pleased that we've maintained our reinsurance deductible at the £1 million level.

Taking all this together we see market claims inflation running at around 3% to 5%. This reflects the market picture on both BI and damage, the latter being driven by the cost of paint, parts, labor, and used cars. Of course we will aim to outperform market claims by our program of initiatives.

Let's look at reserving. And we've got our usual chart at top of slide 13, which shows the motor book loss ratio or management best estimate. This highlights the conservatism in our initial loss pick with 2014 starting higher than 2013, despite the positive improvement on earlier accident years. This higher pick reflects our large BI experience which I mentioned, the actuarial review of current claims and inflation trends, and movements in average premium. Of course it's on a gross basis, so net the difference would be smaller between the years.

The level of prior year releases has continued to be substantial, reflecting a degree of conservatism in our current year actuarial best estimate and booked loss pick. The chart on the bottom right shows that the releases in 2014 were driven by a positive development on more recent accident years. Although it's hard to take the sugar out of the tea, we believe that much of the positive runoff is due to claims improvements and better risk selection, as well as our conservative reserving approach.

The reserve releases we have reported since the IPO have primarily been driven by changes in the actuarial best estimate, as this moves down towards ultimate. At the same time the margin of our actuarial best estimate has strengthened. The ongoing positive trend in prior year development gives us increased confidence in the conservatism of our initial loss pick.

Going forward we will therefore make an adjustment in our approach, whereby we will still reflect a level of conservatism in our initial book to current year loss pick. But provided the risk outlook remains reasonably stable, we will not look to add much margin above an already conservative initial actuarial best estimate.

This means over time we'd expect a proportion of profit to shift more towards the current year, while continuing to see significant prior year releases, assuming current claims trends continue. Overall we continue to take what we consider to be a prudent view on reserving. And our margin remains strong, currently above the 7% we reported at the time of the IPO.

Look at Home. It has been a competitive year in the home insurance market as well with significant new businesses premium deflation. Against this backdrop we focused on improving our pricing and proposition and delivered a healthy profit of £114 million. The IFPs were down 5.2% during the year. Within that our own brands were down 3.1% with partners down 6.9%. Our own brand IFPs performed better as we went through the year. And in the fourth quarter policy count was flat partly due to market conditions and partly to our own actions on pricing and proposition.

Partner IFPs continue to reduce, largely due to changes in the customer journeys across bank partners. It's worth noting that our long running partnership with Nationwide is currently up for renewal, and no doubt both partners will be very commercial in this process.

Moving down to current year attritional loss ratio, this improved by 2 percentage points to 49.3%, reflecting improved risk selection and good underlying claims trends. As mentioned weather-related costs were slightly lower in 2014. Prior year releases totaled £50 million, reflecting underlying favorable claims development. This gave a reported loss ratio of 50.8%, 3.1 percentage points better than 2013.

Home COR was down 1.1 percentage points to 92.7%. And within that the loss ratio was better and expense ratio was broadly flat. The commission ratio was higher in 2014. We shared the benefits of good results with our partners.

Let's look at Rescue and Other Personal lines. Starting with Rescue, which makes up the bulk of this category. It has been another good year for our Rescue business. We grew policy count, premiums, and profit. IFPs were up 3.3% over the year and GWP by almost 7% with a number of positive trends driving this performance.

We saw growth in Direct, following a successful new marketing campaign. We also saw continued improvement in linked sales. We improved retention levels off the back of a strong 2013, and more new business customers are now purchasing higher levels of cover at the higher average premium.

Rescue COR of 81.5%, they're better than the prior year. And profit was up almost 9% to £41.5 million.

Briefly on the rest of Other Personal Lines, which is mainly pet and travel. Other Personal Lines GWP was up 3%. That excludes Life as well as Rescue. Operating profit for the year was £6.5 million, down a bit on 2013.

And overall Rescue and Other Personal Lines together, COR remained broadly stable at 92%. Profit was up 3.2%. Growth in Rescue was partially offset by the loss of the Life profit.

Finally, let's turn to Commercial. Commercial beat its COR target and made a profit of £47 million, a very substantial improvement. Commercial continues to grow GWPs and IFPs across all its main channels. IFPs were up 4.8%, mainly driven by growth in Landlord as a result of successful marketing and also Tradesmen product.

GWP was up 2.6% with growth across all channels, particularly eTrade and DL4B [Direct Line for Business] other than the Van. The current-year loss ratio improved by 4.9 percentage points with reductions across all products. It was a normal year in terms of weather and large losses.

Prior year releases were broadly stable and continue to be feature of commercial results. This gave us a COR of 98.8%. And within that we've seen an improvement in expense ratio as a result of a number of efficiency program. And a reduction in the commission ratio, reflecting the shift towards direct customer (16:48).

Let's turn to group and in particular, investments. Starting on the bottom left, we ended the year with higher investment returns and actions to diversify the portfolio took effect. The income yield was 2.4%. That's 30 basis points higher than 2013. We put money into UK commercial property, securitized credit, short-duration high yields within our corporate debt portfolio, and infrastructure debt.

The better yield and higher grade gains, mainly unrealized gains on investment property, produced an investment result up £26 million to £210.6 million. The overall investment return was 2.9%, up from 2.4% in 2013.

Here we've updated the outlook for investment yield, taking into account our new asset allocations and changes to the forward yield curve with rates now expected to remain lower for longer. The previous outlook was 2.5% by the end of 2015, and that's unchanged. We now also expect to achieve 2.7% by the end of 2016.

The impact of reinvestment rates has deteriorated from 0.1% uplift to flat in terms of the current running yield. But that has been more than offset by a higher expected increase from our actions, up from 0.1% at the half year to 0.3%, mainly due to the ramp up of infrastructure debt to 6%, and the start of a new asset class investment grade private placement with a benchmark allocation of 4%.

This table on slide 19 shows how we get from headline ongoing operating profit of £506 million to net profit after tax of £372 million (sic) [£373 million] (18:31). Run off profit of £55 million was down slightly versus 2013. The run-off result is primarily made up of prior year reserve releases from large bodily injury claims.

Restructuring and other one-off costs of £69.6 million were considerably lower than 2013, mainly due to the non-repeat of one-off costs in the prior year. This is also lower than the £80 million guidance as some of these costs will be deferred into 2015.

Profit before tax was up 12% to £456.8 million. The results of the International division are now treated as discontinued and reported net of tax. This brings us to profit after tax, which was up 19% versus the previous year.

Reported EPS of £0.24 was up 15.4%, mainly due to lower restructuring costs. And adjusted EPS, which is based on ongoing operating profit plus International after tax and finance costs were £0.255, up 2% versus the prior year.

Looking ahead we expect 2015 restructuring and other one-off costs of around £50 million, as we conclude IT migration, as well as costs associated with our ongoing cost reduction initiatives, including one already announced despite exit (19:43). And over the next few years we expect profit from the runoff business will broadly offset these restructuring costs.

Turning to capital on slide 20. We end the year with a strong capital position with capital held at 148.2%, towards the top end of our risk appetite range. This is after the final dividend and second special of £0.04.

We believe it's appropriate to hold capital at this level, given there is still some uncertainty around Solvency II, and while the business is still subject to change and investment. As we've said before we're on track to our plan to deliver Solvency II. We expect to adopt the standard formula for at least the first six months of 2016, while we finalize the internal model approval. During 2015 we'll also be recalibrating our risk appetite to align with Solvency II, and we'll keep you informed on that.

Given all the moving parts the board is likely to next consider any return of capital alongside the full year results of 2015, when we'll look at this in light of the then circumstances. At that point we'll take into account group's requirements on a Solvency II basis, and in line with our existing policy, we'll consider capital requirements over a prolonged period.

And let's look at dividends quickly. We're announcing the final dividend for 2014 and a second special. The regular dividend goes up – is £0.132 including a final. That's 5% growth or just below – 4.8% growth on the previous year. The second special of £0.04 is in line with our approach to return capital where we believe it's excess. That means a total dividend for the year of £0.272 versus £0.206 in 2013.

As we've already announced following completion of the sale of International, we expect to return substantially all of the net proceeds via special dividend. As is normal practice following the sale of a significant business unit, we're going to accompany the dividend with a share consolidation. This is designed to maintain comparability of per-share data.

Please note we'll pay the final dividend as an interim dividend this time around. This is to accelerate payment, which creates space for the International dividend which will follow on. This should avoid potential delays to the International dividend, which would otherwise occur.

Quickly on book value. NAV and TNAV are broadly flat as you can see from the table with a small increase in intangibles, a positive move in unrealized gains. At the year these stood at £116 million net of tax. And excluding International that number is £94 million. Excluding dividends paid during 2014 TNAV would have increased by around 18% to £2.694 billion.

Finally, let me summarize before I hand back to Paul some of the financial trends. We think it has been another year of improvement across all our key metrics, with the current year attrition loss ratio down 0.5 percentage points. Total costs down for the third consecutive effective year, investment income yield increased again, and we've increased the dividend again while capital remains strong.

So thank you for listening. I'll hand back to Paul.

Paul Robert Geddes {BIO 2474781 <GO>}

Thank you, John. So, I'm going to cover three things today. Firstly is through the excellent progress we've made in 2014 and the strong profitable franchises that we built. The strong foundation leads me on the second part, which is to walk you through how we see the strategy shaping up over the next few years. And then I'm going to touch on current trading and the outlook for 2015.

So as you'll remember this time last year, we set ourselves a very busy agenda for 2014. And over the next few pages I'm going to take you though some of the achievements under the - in our familiar headings.

Turning to distribution and pricing on slide 26. Our progress in distribution and pricing as shown by some of the interesting stats on the top of the slides or on the slide has helped us to maintain our current year loss ratio against a backdrop of premium deflation, whilst stabilizing our own brand policy counts in second half.

In distribution we've been busy improving our efficiency and effectiveness by focusing on digital capability and on customer value. We rolled out new websites across motor, and re-engineered and optimized the quote and buy journey, making it easier for customers to buy, particularly through tablets and smartphones.

I'm pleased with our progress on telematics. We launched our self-install device back in April and ended 2014 with over 39,000 telematics policies. Take-up rates have continued to grow and having ramped up some scale, we are now getting insights that can give us a real competitive advantage going forward.

We further differentiated our Direct Line customer propositions in 2014 with a number of unique claims propositions supported by new marketing. And during 2014 we made major progress in pricing sophistication. The first programs we delivered covered both technical and market pricing and have contributed to our underwriting performance.

In Motor we started to use telematic-generated data to inform pricing decisions for telematics and non-telematics customers. This gives us another rich and valuable data source, allowing us to reward customers who are driving better in ways that traditional rating factors simply can't recognize.

And we are pricing for up to a 40% spread for the safest drivers versus conventional rating factors alone. Our pricing projects cover renewals, as well as new business. And through improvements to customer pricing journey, we've increased retention rates across Motor and Home own brands during 2014 with rates I'm really proud of. Motor own brand retention is around 80% and Home own brand, 81%.

2014 we've made a real step change in our pricing capabilities. And we will continue to identify technical pricing opportunities to support our loss ratio performance going forward. Our actions in distribution and pricing have delivered real improvements in customer experience, agility, and trading capability.

Turning now to claims and costs on slide 27. For 2014 we continue to build on our market-leading claims service. We've been rolling out the use of smartphones to improve our customers' payment experience. Straightforward claims can now be advised by photo and video taken on your smartphone. And around 81% of eligible Home customers have taken up this option to manage claims in this way, and they have seen a step change in settlement fees.

We continue to focus on improving our fraud detection techniques, building on our market-leading performance. The latest ABI data indicates that we detected 2.6 times more fraud than the market average.

Through effective use of our supply chain, we've strengthened our Direct Line claims propositions and rolled out three new claims initiatives across Motor and Home, including seven-day repair proposition for cars, sourcing replacement car in the event of a total loss, and replacement of some household items ready in just eight hours.

Moving across to costs. I'm encouraged with the progress we've made on the efficiency of our business and reduced overall costs, but there is more to do. We've beaten our cost target and reduced the total cost base by a further 6% in 2014. This was achieved through a 17% reduction in our staff costs and rigorously controlling our discretionary spend.

We've improved marketing efficiency and reduced marketing spend by around 22%, whilst rolling out new ads in support of our enhanced propositions. We progressed substantially in migrating our IT applications from RBS Group infrastructure and expect to complete it in 2015. As part of this program we rolled out new desktop and voice infrastructure, which we expect to lead to future operational efficiencies. So we've developed further self-help initiatives across claims and costs.

Finally, Commercial and International on slide 28. It has been a really good year for Commercial with a substantial improvement in profitability, achieving a COR of 98.8%, meeting the sub 100% target. We achieved this through disciplined underwriting and tight cost control.

Our eTrade platform continued gaining traction. And we feel we are one of the leaders in this part of the market. We've added product and continue to improve propositions. We saw the number of eTrade users grow by 25% with around £80 million of premiums now working through this channel, an increase of 7% on last year.

Direct Line for Business grew GWP excluding Van by 11.2%. We enhanced the Direct Line for Business customer websites in 2014 with new digital functionality and extended our price comparison website distribution for the Van business through Churchill for Business. Overall strong growth across eTrade and direct channels demonstrates I believe that we're well placed to take advantage of the changing distribution in the commercial SME market.

Finally, the sale of international represents a good result for our customers, employees, and shareholders. As a reminder gross sale proceeds of €550 million represents 1.9 times 2013 net asset value. The net pre-tax gain is expected to be around £160 million. And we've stated that we expect that substantially all the net proceeds will be returned to shareholders.

So let me wrap up this section with a review of how the investments in the business have improved our financial performance, enabled us to deliver against our targets on slide 29.

We achieved a combined ratio of 95% in 2014, or 95.7% including International, which is within target range we set out. Commercial achieved a big improvement in COR to 98.8%, hitting its target and showing an improvement of 14 points since 2011. Further progress on costs, £160 million of net savings delivered in three years. And RoTE increased for third consecutive year to 16.8% in 2014 and that would be 17.9% excluding International.

The result of this improvement and the competitiveness of our Personal Lines business, together with the turnaround of Commercial and the disposal of International, leaves us now with a very-different-looking portfolio. Back in 2012 three of our divisions – Motor, Home, and Rescue – were achieving returns above 15% but were declining. Commercial and International were growing but were a major drag on group RoTE with CORs well above 100%.

Today we now have four sizable franchises, each of which is stable or growing and generating an economic profit.

We're the UK's number one Personal Lines insurer with leading positions in Motor and Home. Both these businesses have significantly improved their competitiveness over the last few years and are now profitable with stable own brand volumes in the second half.

Rescue is the third largest in this market and aims to be a challenger brand to the AA and the ROC. It's gaining share in direct and grew profit and policy counts in 2014.

And I'm particularly pleased that we stuck with Commercial, a franchise that's now generating top-line growth and good returns as we invest behind changing distribution trends. We believe we are already the second largest direct Commercial insurer in the UK. I think this channel has a strong growth potential

So as we've now achieved the targets we set out for the business at the time of the IPO, is it the right time for a profound change in our objectives or strategy? The answer is no. We have no intention on changing our primary focus on delivering strong and sustainable returns. Similarly we remain committed to achieving excellence in distribution, pricing, claims, and costs, as these are the key drivers of performance in general insurance. And importantly these are still areas where we see significant opportunity for us.

We do believe though that it's a good time for us to move on in the expression of our strategy, in particular to maintain the energy of our people for another busy phase of delivery ahead. So what I'm about to share with you is therefore not a change in direction, but really a more engaging and specific articulation of our strategy that should help us shift up a gear in delivery.

Start point for our strategy is our mission to make insurance much easier and better value for our customers. Why? Because insurance today can be complicated and stressful for customers. And that translates into a wasteful and costly model for insurers. And we're going to fix this. Having customers firmly at the center of our mission fits well with our increasingly external focus and willingness to start challenging some of the norms of the industry and innovating in the marketplace with a bit of attitude. In the words of Winston Wolf, we're on it. Let's see some of our recent ads.

[Video Presentation] (33:01 - 34:05)

No need for applause.

Behind our new mission to make insurance much easier and better value for our customers are three strategic pillars. Our famous own brands, DirectLine, Churchill, Privilege, and Green Flag, together with our rich customer data give us a head start as a great retailer, the first of our pillars.

Each brand can be targeted to specific customer groups, to whom we can offer a compelling combination of channel, product features, service, and value. This will help us get closer to these groups and develop deeper relationships. And as you can see in other customer sectors, building customer relationship means owning more of the economic value than those lower in the food chain.

Also in the future we may choose to retail more product that we don't manufacture ourselves as we do today with white-labeled life.

For core products we'll also be a smart and efficient manufacturer, leveraging our scale to deliver a flexible range of product, tradings, and customer experience at a lower cost for our own brand and for our partners.

Finally, we aim to lead and disrupt the market by maximizing existing growth opportunities whilst creating and driving future areas of value. In order to deliver these we need strong underlying capability to underpin our different brands, channels, and offers. And these foundations are based in technology, culture, and capability, and risk and capital management.

As we are now setting out our multi-year strategy, we're also setting a long-term ambition that when we have these elements in place, we can be a 15% RoTE business that can also grow. In the near term whilst we're building all these capabilities, we expect the business to be pretty stable, albeit with the potential for some further top line reduction from our partnerships. Of course day to day, quarter-to-quarter, we'll continue to trade the market as we find it and grow where conditions allow as we did in Q4, 2014, or indeed pull back a little to protect value.

Now I know that putting out strategic pictures like this doesn't do it for some of you. At least like to reassure you that no consultants were used in the construction of this image. But these things do matter a lot to our people. This engagement makes a measurable difference to our progress. However the purpose of a strategy like this is to drive action. So let me share with you some of the initiatives this strategy is going to drive in 2015.

Starting with great retailer. The way we started re-launching our brands with Direct Line last year, and we also continue to differentiate Direct Line, and we will go forwards in 2015 with further new propositions for Direct Line and also refreshing Churchill in 2015. We'll support this with a renewed focus on making our product easy to buy and getting it right first time, which we're confident will achieve a significant uplift in customer experience, help us reduce frictional costs, and reduce the level of complaints.

And like other great retailers we wanted to be agile traders, staying close to the market and using our deep knowledge of customers to maximize our sales, cross-sales and retention, whilst optimizing our margin.

Smart and efficient manufacturer. We have more in the tank in terms of pricing and claims initiatives. And successful deployment will help us to compete in the competitive markets in which we operate. We are increasingly a smart manufacturer, but we are by no means an efficient one.

And we will relentlessly continue to reduce our costs with short, medium, and long-term initiatives, many of which will also improve the customer experience.

Lead and disrupt the market. We are well placed to take advantage of our existing growth opportunities, and we'll continue to look at further areas of value. Our plans here cover the entire portfolio, but taking just three. Following a successful year of growth in Rescue, we plan to continue momentum in 2015 and continue to disrupt this market. We plan to invest in our commercial SME products with greater focus on direct, where we see future channel growth. And telematics is a great example of how we're using technology to disrupt the market. And in 2015 we aim to build on the growth achieved in 2014 and double the number of telematics policies.

Data and technology. Harnessing the power of technology remains a key enabler. And in 2015 we aim to complete the migration of our IT infrastructure and continue to implement the next generation of systems. We are implementing a range of prudent technologies in a modular approach. These technologies provide us with a low-risk route to re-platform our core system and build out the investments we've already made.

Two examples of this, firstly, a new policy and billing system that will harmonize with our existing claims systems to provide significant product flexibility and enable us to unlock further efficiencies across the business. We're also updating our pricing engine, which should enable us to be much more agile with our processing and allow an even greater use of our own data and external data. These systems will also provide us with a single view of customers, which should help us build a competitive advantage in the fast-evolving digital landscape.

Culture and capability. The focus on energy of our people has been key in our success. Culture and capability is about unlocking and accelerating their potential. We have a very busy people agenda, support with initiatives around leadership, people management, and developing the key skills required to take advantage of our systems investment.

Finally, we believe we have established a strong foundation in capital and risk management. And the focus of 2015 is to be ready for Solvency II, including submitting our internal model to approval from the regulator. So a very busy year ahead.

So almost there. Let me wrap up with a brief summary of where we are and the outlook for 2015 on slide 34. The UK Motor and Home markets remain highly competitive with recent market conditions characterized by periods of price deflation and of stability. Early 2015 has seen some additional market pressure in Motor with one major competitor cutting rate significantly in January, although this could just be seasonality.

We believe prices overall are slightly up versus Q1 last year, but the increase is less than claims inflation over the period. As a result we have remained disciplined and our policy count is off marginally year-to-date.

The Home picture is a little more stable. Against this backdrop the group will continue to adopt a flexible but disciplined approach to managing the trade-off between margin and volume.

We've made good progress on costs, and this remains a focus for us going forwards. As John said earlier, in 2015 we aim to reduce our cost base again, our total cost base again.

Our reserves are strong, and we expect prior releases to remain a feature of our result, albeit at lower levels. But as John explained earlier we would expect the proportion of profits to shift more towards the current year.

At the same time we're investing in building future capability as I've just taken you through.

Taking all of this together, we've updated our COR guidance for 2015 aiming to achieve a COR in the range of 94% to 96%. This of course assumes no more weather claims, with the spread reflecting the uncertainty surrounding claims inflation versus market pricing in Motor. Finally of course our 15% RoTE target remains ongoing.

So to close a reminder of the highlights. We've established a good track record of delivery and improved capability across the business. We've generated good returns for our shareholders, whilst maintaining a strong capital position. We have a strong UK franchise and a clear and exciting strategy.

So again, I thank you very much. I open the floor to your questions. And if people can lean into their microphone, so people on the Web can hear you. We'll start solidly.

Q&A

Q - Dhruv Gahlaut {BIO 16209870 <GO>}

Good morning. Dhruv Gahlaut, HSBC. A couple of questions. Firstly, on the Nationwide portfolio you have mentioned that could be coming up for renewal at the end of 2015. Could you say as in how does the profitability of that book compares with your overall Home portfolio, as in the Home book?

Secondly, in terms of reserving you're making these changes in terms of how you're booking the ultimate loss – as in the initial loss ratios. Could you say then how much will the change be as in going forward as in how many points are you – would be changing that? Thanks.

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

Okay thank you. So let me start with NBS. It's about 22% of our Home top line, but not of our Home bottom line. Part of it is showing the profitability of it. And as I alluded to before the first person who owns the customer owns most of the profit. Reizenti? (42:50)

A - Anthony Jonathan Reizenstein

Yeah. Obviously I have an opportunity – the first thing we expect to happen is that we won't get a repeat of the BI, the large BI, so that's not meant to be reserving practice, but it's a thing we expect to happen. Assuming we're right about that, that being a spike.

And then in terms of the impact of the sort of – looks like their margining. We're probably talking about a small number of points. I don't want to give a precise number, but it's not going to be a massive thing, but it will be notable. And we'll point it out when it happen, and it should happen – it should start to happen in the half year.

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

Okay. Yeah?

Just to be clear on that Motor spike, is what you're saying is that it's at 2.6 points above normal levels in the year? And also then on the expense sides, can we kind of get a rundown? I'm assuming that most of the buckets are going to stay broadly stable year-on-year. I guess the one that's interesting is the IT migration cost. It sounds like there has been double-counting in 2014. Can we get an idea of how much that additional amount was of double-counting?

A - Anthony Jonathan Reizenstein

Yeah. The BI excess is above normal. In terms of the costs going forward, yeah, we've said we expect we will be looking to get most categories down, but the one category we won't get down is the depreciation and amortization, which has gone up quite a bit and will still go up. It won't go up forever, and we think it will probably get to a kind of stable point, a still sort of peak point in the next couple of years. And then over time unless we have to reinvest – continue to reinvest at those levels, which I doubt, it should then start to come down over time.

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

But the first spend on IT is coming down.

A - Anthony Jonathan Reizenstein

Yeah.

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

(44:36)

A - Anthony Jonathan Reizenstein

In terms of migration costs, obviously you've got the one-off that's in the – is below the line, which I think we've always being quite clear about. We've got a little bit left to do. In terms of double-running there probably has been a little bit of double-running cost, but it's not that significant. It might be a few million pounds in 2014.

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

To follow-up on that expenses, on the head count you said it's 11% on average lower year-on-year. Can we get an idea of at end-of-year 2014 versus end-of-year 2013?

A - Anthony Jonathan Reizenstein

Well not offhand, but I'll dig around and try and get that to you.

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

And I think the other thing I'd say are our costs, which is I think quite a good achievement, given a 17% reduction in staff costs. Our engagement this year on average actually has gone up. So I've talked about we have to do this with our people. We consider this as (45:32). But I think we have some benefits in doing it the way we've done it. Ravi?

Q - Ravi Tanna {BIO 16926941 <GO>}

Morning. It's Ravi Tanna from Goldman. Two questions, please.

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

You've got to speak a bit louder for the...

Q - Ravi Tanna {BIO 16926941 <GO>}

Two questions please. The first is on the reserving initial book loss ratio change. I'm just wondering what if any conversations have there been with the PRA around that change in reserving starts? And in particular bearing in mind that presumably this has implications for the Motor pricing cycle and the competitive environment, should people start to register current year profitability at greater levels.

And then the second one was just around your reference to growth plus a 15% RoTE. Can you just elaborate a little bit more around the areas where you expect to see growth from? Is it going to be Commercial?

A - Anthony Jonathan Reizenstein

Yeah. On the first point there's just nothing really to say about the regulator. They know. They see all our numbers through our projections. We discuss everything with them. And everything's okay.

And there shouldn't be an impact on pricing, because they've always said, our pricing process is distinct from our reserving process. And our pricing process reflects our latest view on the true cost of claims. It's a view of the ultimate now. And it takes our actuaries a long time to catch up with that.

I guess we're saying that at a sort of group level we'll catch up a bit faster now. But the pricing process is unchanged, and I don't think it will have an impact on really that or on the cycle.

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

So on growth – sorry, do you want to come back on that?

Q - Ravi Tanna {BIO 16926941 <GO>}

Yeah. More what I was getting at was that presumably this happens on an industry-wide basis. Then it has an impact on kind of profitability across the market, which presumably pushes back a turn in the cycle.

A - Anthony Jonathan Reizenstein

Well I mean we're not saying it's going to have a big impact on our profit. We're just saying there's going to be shift remember, and I couldn't comment on the market. Everyone is slightly different, aren't they?

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

So on growth I think by putting in four business units you kind of – I'm not sure what you saw, but when you see it, you go, okay, you've got two businesses there, giving off £100 million between them that have really good growth prospects in terms of Commercial and Rescue. So we like our prospects in those two businesses.

We're pleased with the stability which we've got in Motor and Home in terms of the own brand, which is where most of the value is. But I don't just want to be tied. We've got a lot of execution in the next couple years.

I think our competitiveness in those businesses is kind of – were pretty stable right now. If the market is kind of kind we can grow. If the market is kind of neutral, we'd kind of stable. If the market would get a bit worse, we might shrink a little bit more. That's kind of the next couple years for me. That's – we're going to be in that zone, because we're putting a huge amount of investment behind the scenes and a lot of capability. And I gave you little bit of a flavor for that. But we really are building state-of-the-art systems. We're going to use our data. We're doing great things with our brands, great stuff on digital.

So we're trying to build a machine that those core franchises is strong, would be a place where we could grow. But for these next couple years there's probably going to be more Commercial and Rescue driving it. Yeah?

Q - Anthony Araujo Da-Costa

Hi, Anthony Da-Costa of Peel Hunt. Slide 12 shows claims cost by peril. How will these claims cost proportions develop over time? For example will BI increase as a proportion? And what key measures will Direct Line implement control the level of claims mix?

Next question is given the investment in the group digital platform and a significant increase in policies purchased on a smartphone, has Direct Line seen a significant change in the distribution mix? Thank you.

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

Yeah. On – let me do the second one. So distribution mix is being – actually not that much changed over the last year. So on Motor the mix that we've seen, slightly more price-comparison websites, slightly less on the phone. Despite that I'd remind you we have 80% retention. So people talk about our brands. I think our brands are an asset. We're a business which does lot of business on price comparison websites, and yet we have 80% retention. So that again is testament to our brands and our experience.

Our web has been pretty flat. So our direct web has been pretty flat. And again that's I think, again testament to the investment which we have made to make that experience slick. And I do compel you to try it. It's a really good experience. And then that's even before claim, and Steve has experienced this (49:59) brilliance as well.

Our Home our mix of sales channel has been quite interesting actually. Price comparison websites, as we said have grown. Again despite that retention up to 81%, I think is pretty good. Actually and proportionately we grew on the phones. We did some offers aimed at phone customers. So the phone channel isn't dead.

So we think an omni-channel, multi-channel business is right. A lot of our technology is going to enable us to be really slick at handing off between channels, between mobile and call center. And we think that's the way forward. I think most industry speaker would agree with that.

A - Anthony Jonathan Reizenstein

Yeah. Just coming back to you on the claims, perils and where they might be going. I think – we do think overall, just cars getting safer. And that people talk about extreme cases of that and autonomous cars and so on. But we certainly think that cars are getting safer all the time. And that should impact all of these. But over a long period, it's not in quick bursts I don't think.

And obviously which ones will be impacted will depend on the technology that the car manufacturer choose to deploy. And we closely follow that, because of relationships with car manufacturers that we have.

Specifically obviously we've seen the biggest change in small bodily injury, because of government legislation. We think that probably the effort on that is coming to a close, certainly under – given the government change. But there's a bit left in terms of MedCo that could give us a little bit of benefit. We don't think that will be massive in terms of whiplash, that would be on BI path (51:30).

In terms of what we do about it are distinct from what might happen externally. It's constantly in our agenda to improve the way we handle claims. We've done a lot so far, but we never give up. And so we'll always be looking to improve our legal claims process management, trying to make it more efficient, faster, and more accurate. And the same with buying, with purchasing. We're a big purchaser of many things. And you've seen some of that in our propositions. And we'll continue to improve the way we do that as well.

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

Good morning. Andrew Crean with Autonomous. Three questions if I can. Coming to (52:15) the change in reserving policy. Can you say how much of the 94% to 96% combined ratio targets in 2015 relates to changing that reserving policy?

Secondly, could you talk a little bit about costs? I mean you say that you hope to get them down in pounds millions terms. There's a sense from quite a lot of what you've been saying that the reduction in costs this year will be substantially less than we've seen in the past. Would that be a fair comment or not?

And then thirdly, could you talk a little bit about – you talk about your systems and how you're revolutionizing them. They're quite a lot. And I'd like to get a sense of where you think you currently are related to your competitors? Not having a single view of your customer isn't particularly modern.

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

Okay. This might be the answer. So let me start on systems. We do have a single view of the customer to the extent that we give people multi-product discounts. Augmenting that is a (53:25) whole level of new sophistication. I think, yeah, this is a topic we'll return to I think at the half year. We'll do a much more extensive presentation on what we're building.

But what we're building is cutting-edge and will give us tools I don't think they're widely available in the market. It's initially a combination of the world's best systems. The CRM pricing policy gives us huge flexibility. And we're still kind of a year off going live with it. So I don't want to drum up too much business for it yet. So we'll say more about that.

So I think today now, listen 37% of our Motor sales are into multi-car policies, when we sell a policy. So we're pretty good at cross-sales there. About 35% of our Home policies are into Motor customers, about 20% of our Motor policies take a Rescue policy with it. So we're no slouch, we're no slugs at this. But we think we can be a whole lot better, because those metrics haven't been going up massively over time since the IPO. So we have a lot of ambition still left on that.

On costs we absolutely – we probably got more effort and energy on cost this year than last. I'm not turning it into a pounds for you, but we don't feel like we've done costs, and we're going to move on. We've got huge amounts of opportunity still in costs. We're going to try and bring it down. We obviously – depending on where the top line goes, we need to bring it down to help support the 94% to 96%, which – John.

A - Anthony Jonathan Reizenstein

Yeah. Maybe the best way to get at your first question is just to think about the 94% to 96%. So obviously in 2014 we produced 95%, which is kind of the middle of that new range. And then we've got some headwinds and tailwinds as usual. Headwinds, lower PY, and then we've got whatever company in the market with premium inflation, claims inflation, which could be a bit of a drag.

On the other hand we've got some tailwinds. We've got as we say the fact that the BI, the large BI, the spikes, we shouldn't get that repeated. We've got this lower margin on the current year, and we're looking at some lower costs. So all those are kind of balancing out if you like. I think that's probably the way to think about how they fit together.

I would say that if market conditions continue to be negative draws on the market premium inflation, market claims inflation, then it's going to be harder to get to the – bettering the lower end of that range or even into the middle, than if they slightly improve. So at the moment we're waiting to see. The first few weeks of the year, a bit bumpy really. But that's the way I think about how it fits together.

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

Just going back on that I think the other questions in the room are all the same. If you're going to change your reserving policy, and you're going to put a target out, it's kind of important to us that you tell us what the impact of that change in reserving policy will be on the combined in the year in which we're doing it. So I think unless you do that, it slightly weakens the forecast, because it - we could take away from the fact that actually it has been done by a sort of slight or reserving hand.

A - Anthony Jonathan Reizenstein

Yeah. So I think the way to think about it is that the BI - assume the BI excess comes out and is not repeated. Then it should be a bit of a - pretty much of a balance between the other factors. I'm not going to be that specific.

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

So that comes out, and what we're then saying is the PY...

A - Anthony Jonathan Reizenstein

Yeah. And then the PY and (56:54), they're going lots of directions, but we can't be exactly sure. I mean I can't plan these things in advance. But that directionally go in the opposite direction, and we're not expecting a massive change in the four.

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

Okay. Gordon?

Q - Gordon Aitken {BIO 3846728 <GO>}

So Gordon Aitken...

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

Can you find the mic there?

Q - Gordon Aitken {BIO 3846728 <GO>}

Gordon Aitken from - okay there's - Gordon Aitken from RBC. A couple of questions please. On your RoTE target, I mean that remains at 15%. And this is a question really on the LTIPs and the targets there. I'm just wondering are your LTIP targets remaining the same as well? I know you're not publishing those today, but I'm presuming they're going to be out in the report in the currents, which we'll see shortly. Just wondering what the base there is? And what the stretch target is? That's the first question.

And the second one on you mentioned, John, the Motor margin has picked up, and it's above the 7% you reported at the time of the IPO. Just wondering if you can tell us a bit more about what exactly it was? And was it a number which was externally calculated like I think by memory, the one - the IPO was a Towers Watson number. Thanks.

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

Yeah. So the LTIPs with REMCO, the point isn't lost on them that we don't have an International business. There was to have a plan to get to 15%, wasn't there today. So they will be strengthening the targets by about 50 bps, that's obviously stretching, I mean by 50 bps more on the RoTE element at the target. Of course our business target at 15% isn't just for Christmas. It's a long-term target. We're just three years into it. So we didn't want to move that. But the carrot is being moved suitably ahead of the horse.

A - Anthony Jonathan Reizenstein

Yes. At the time of the IPO that 7% was reported on by whoever it was, Towers Watson at the time. And we do get external views which we don't publish, to sort of validate or comment, and we get some input from other people, especially if you get - you'll see in the end reports, PwC this year.

The margin at the moment is higher than 7%. That's essentially reflecting views we've taken about quite major risk that could give us (59:12) in our reserving, things like PPI risk, general inflation. I mean we've got a very odd period of monetary easing. We don't quite know how that's going to land. And some of those things have been added to our margin since then. And so it's higher than that 7%. But we're not going to say what that is today.

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

James. Yeah.

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

Thanks. It's James Shuck from UBS. I was just keen to just talk back on the motor retention rates, I couldn't see the numbers in the pack, but I think you mentioned 80% retention. Could you just say what that moved from, to over the year? And what your thought is on going forward? Because a lot of your kind of front – you're dealing with the retail customer, improving the experience is a key part of that experience improving the lapse rate. So where might that go to?

And then secondly, on the standard model and the internal model. I appreciate a lot of this is up for debate and in some clear way it's going to settle down. But could you give at least some kind of indication about how those two models compare?

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

Okay. So retention rate went to around kind of 79% to around 80%, touch about actually 60 bps, without rounding. That's not a bad achievement. Think about the increase in price comparison websites (1:00:35) so that the customers on those will be – if they're attached on price they'll probably go on price again in a year's time. So I think it reflects the strength of our brand and strength of our pricing journeys. As we said before we want to make pricing journeys as smooth as possible for customers. And so I think that's the success of that.

A - Anthony Jonathan Reizenstein

On the Solvency II models...

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

(1:00:54)

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

Yeah?

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

(1:00:56) going forward around that number?

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

Yes. I mean the unknown tradeoff is on margin. So we could have whatever retention rates we wanted. And so we have a – I did that back to myself as a right to trade effectively. So we will – we always optimize. And the optimal level likely to have lower retention and favorable margin.

So but underlying that we have increasing capability, and what we're building for future in terms of pricing capability will again take us to a whole different space in terms of being able to optimize our pricing journey. So it's not a measure you can look at in isolation for margin.

A - Anthony Jonathan Reizenstein

Just moving onto the capital models, standard formula, it's not quite settled. And I saw some things that Reg A hadn't fixed on. But our offense is it's not going to be any higher than our kind of risk-based capital at the moment, than our own risk-based capital requirement. Those are going to be much lower, right? I think they're going to be roughly the same kind of order of magnitude.

And then moving on to the internal capital model, I think that's more subject to change than standard obviously. There's loads of work still needs to be done on validation. And of course in the end you got to have it signed off by the regulator. I mean we think and I've always said this that there is some upside, good upside, some potential for requirements to be lower than under the standard formula. Indeed you might ask, well if they weren't, why would you use it?

So we'll have to see how that lands. And obviously we've got to go through the standard formula period first. There's nothing to - we're worried about in terms of more capital requirements. We think there's some opportunity, but probably more under the internal model than under the standard formula.

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

Could you just perhaps give some insight into what some of the key uncertainties are? I mean one of your peers has recently raised capital due to uncertainties around where Solvency II is going to settle down. So could you just kind of give some insight into where your concerns might be?

A - Anthony Jonathan Reizenstein

Well I guess if we had to raise capital, we'd probably being saying more about why. We're not in that position obviously. So I don't have a story all ready and packaged for you.

I think in terms of the internal model, one issue that's outstanding, I mean it's public, is there's a consultation outstanding from the PRA about to what extent you have to hold capital to ultimate. And obviously under the ICG regime at the moment in UK, you have to hold capital to ultimate.

And there's a debate going on in the industry and with the regulator and body - representative bodies about whether that is repeated in the internal capital model regime under Solvency II? Or whether it's part of risk margin, which is an argument that's being put forwards. There is a bit - that's one of the issues. That's probably one of the biggest issues that's out there.

Other things like to what extent we would be allowed for - able to allow for diversification of risks. That's out there. And I think for a continental insurer that wasn't already in an ITA type of framework, that would be quite a big deal. For us, probably given that we are already in an ITA, we're going at this for years, probably less of an issue, but still to be going through.

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

Yeah.

Q - Marcus P. Rivaldi {BIO 5739374 <GO>}

Hi there. Marcus Rivaldi of Morgan Stanley. So just to come back on this capital calibration point, from your comments just there would suggest that at full-year 2015 reporting, you probably won't be in a position to resize the capital base significantly if broadly speaking standard model is roughly in line with your economic capital requirements at the moment. Does that mean that we have to wait for sort of another six months or so before you shift to the Solvency II internal model perhaps, where you have that real hard look at your capital position versus Solvency II? So that's the first question.

And then second just to clarify. You talked about the cost base going down in absolute terms in 2015. Is the starting point for that the £928 million? So that's the number of ex-International? Thank you.

A - Anthony Jonathan Reizenstein

Yeah. Quickly you're right. The £928 million is the cost number which we want to go down from. And I think what you painted on the capital management side is a scenario. So there are quite - there are other scenarios.

And what we hope to do when we've done our internal work is have it - is present to you our sense of risk appetite and how that relates during a transitional period to both our internal capital model, as it develops from the ITA type of RBC that we're using at the moment to the new capital model, which won't be fully finished in a year's time but we'll be making progress on it, but also against a standard formula. We're not really running our business on a standard formula even though we have to comply with it.

So it's kind of out there, but it's we will be running - we're already been running our business for years on an internal capital model. We're not going to change that to go back to something that's more arithmetic. So all that's got to be developed this year. But you've outlined one scenario. And I think it's too early for us to say whether that's likely pessimistic or optimistic. It's a possible scenario, yeah.

Q - Marcus P. Rivaldi {BIO 5739374 <GO>}

Can you talk about the level in the period of time or the (1:06:05) capital requirements again, is that just in thinking you want flexibility in business as well?

A - Anthony Jonathan Reizenstein

Well we've always said, when we've - we've said that if our capital was above 150% for a prolonged period, we would repay it. So yeah if it was - if let's say at this year-end it had been 154%, but it was going to come down because of some investment thing we were doing or whatever to 144% quite quickly, we'd have told you - we'd have said, look it's 154%, but on a prolonged period it's not.

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

The prospect of a prolonged period rather it being (1:06:38).

A - Anthony Jonathan Reizenstein

So we look at it then, and it certainly over the last little while when we haven't been growing particularly. We looked at our prolonged period of planning, and it at times has been lower. So we've been able to pay out. At the time when we look at it and gain a year, we'll tell you what it is then.

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

Okay. More? Yeah?

Q - Fahad U. Changazi {BIO 15216120 <GO>}

(1:07:00 - 1:07:04) All right. Fahad Changazi from Nomura. Just a quick follow-up from the comments you've already made. Given how you always run your business on the internal model, will the board consider where other peers are landing on Solvency II in terms of any capital return going forward? Or are you still going to potentially stick with...

A - Anthony Jonathan Reizenstein

I'm sure we'll look, because you're always looking at what other people are doing. But that doesn't really tell you much, does it? I mean we will look, but we won't decide based on what other people are doing.

We've got a commitment to not holding capital and being quite open. So I think we've - hopefully we've met that commitment. And being your own business (1:07:42). So that's what we'll try and do.

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

Okay. We've got one final question.

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

Hello. I'm Alan Devlin at Barclays. A couple of questions. First of all your long-term target is attainable growth at a 15% RoTE. Obviously your RoTE is well above that. Would you be willing to give up profitability in order to grow more aggressively?

And my second question, half of your improvement in expenses came from reducing the marketing spend. Given your potential growth aspirations, how do you view the marketing spend going forward? I know you mentioned you got more efficient in it, et cetera, but how will you view that?

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

That's a great question. So the answer is our average profitability as we said is 17.9%. That's not obviously the profitability at the margins, where we would write the last piece of new business. So we want to be value creating.

So the way to write more business and lower your RoTE would be at the margin throughout, and profit the business, which is not something which we want to set out to do. So we don't want to dilute, lose value on it.

So if only it was that simple. But we have some principles, and we have an approach. So that's what I'd say. So the marginal profitability that matters in terms of the size and the growth of the business.

I think marketing is going - continues to go through changes as consumption changes. So I think - I look to Mike (1:09:07) here, but I think we still think that we can be even more efficient on marketing.

Also there is again tied in with our systems, when we can really have the sophistication, which we're going to have with knowledge of customers, knowledge of our interactions, the ability to market to our base, which is obviously a very powerful place. If we can start going even deeper into our own customer base. That's much cheaper market (1:09:29) existing customers.

So I think we still see opportunity and of course great creative at the heart of that. And you'll be seeing some great new adverts, including this weekend I think on Churchill. More of that next time.

A - Anthony Jonathan Reizenstein

Phone? Question on the phone?

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

Oh, yes. Sorry. On the phone. Sorry. I forgot.

Operator

The first question we have is from Oliver Steel from Deutsche Bank. Please go ahead, Oliver.

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

Hi, Oliver.

Q - Oliver G. Steel {BIO 6068696 <GO>}

Hello. Sorry. Sorry not to be there in person. Three questions actually from me. First of all, what sort of extra capital requirement you envisage from the change in investment mix? The second one is just understanding the runoff profits offsetting future one-off costs over the next three years. I was a bit muddled by that, because I didn't realize you had quite so many - or quite so much in the way of restructuring costs planned over the next three years. And then the third question is have you hedged the proceeds from International?

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

Right. Oliver, I think (1:10:52). We have hedged the proceeds from International, yeah. So and I'm glad we have. And I probably would have said that whatever happened, but I'm certainly particularly glad we have.

In regards sort of runoff versus restructuring. Yeah, obviously we've got some migration costs left to spend, which are a part of restructuring cost in 2015 and that will then finish. But when we make certain restructurings particularly to reduce costs in our business, e.g., sizable redundancy programs should there be any and also when we leave buildings cycle buildings, then we would see those restricting costs falling in that category, all those costs falling in that category. And when we report them, it'll be transparent.

And we do believe as we seek to become a smarter and more efficient manufacturer that we will see some of those situations arising, some of those costs arise. And in fact we've already announced a big building closure this year, and that's part of the $50 million that we said would be the restructuring costs for this year.

Now we've estimated - obviously we have a view on what our runoff will be but not precision. And we have a view on what those restructurings may be over next three years. And we don't have position on that either. And we're just saying that on balance fortunately they pretty much - one will pay for the other. And that will be - they'll be bumpy. Both of those will be lumpy. It won't be year-by-year exactly the same. And indeed I can't guarantee it will be exactly the same in total. We're just giving you some guidance on that.

In terms of investment mix, yes, when we look into a new asset class, we do look at the marginal capital that's needed to support that asset class. And we look at whether we're making a decent return on that margin capital. And we look at it both in terms of the internal capital model and also in terms of the rating agency model, which is actually more onerous when it comes to investments than the internal capital model. And we only do the extra asset class if it works on both of those.

In total in the internal capital model, the changes we've made in 2014 won't make much difference. It might be a few tens of millions but no more than that.

Q - Oliver G. Steel {BIO 6068696 <GO>}

Thank you very much.

Operator

At the moment we have no further questions from the phone lines, so I'll hand you back to your host.

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

Very much look of relief in the room. Thank you very much, indeed, everyone, for your questions. We'll, as normal, the team will be around. So if you have any further questions, there might even be coffee if you paid extra for it. Thank you very much for coming. See you next time.

Operator

Thank you for joining today's call. You may now replace your handsets.
