Q4 2016 Earnings Call

Company Participants

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

Other Participants

- Andreas Evert Cornelis van Embden, Analyst
- Andrew J. Crean, Analyst
- Arjan van Veen, Analyst
- Dhruv Gahlaut, Analyst
- Kamran Hossain, Analyst
- Oliver Steel, Analyst
- Thomas Seidl, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, ladies and gentlemen, and welcome to the Direct Line Group 2016 Preliminary Results Presentation and Conference Call. I will now hand you over to Paul Geddes, CEO of Direct Line Group, to take you through the results. Thank you.

Paul Robert Geddes {BIO 2474781 <GO>}

Thank you, and good morning, everyone. Welcome to our full year results, a week later than originally planned. Thanks to the – waiting for the (00:25) announcement which I think given the events was a good delay.

So, here, you can see on the chart our 2016 highlights, another successful year that demonstrated the benefit of our multiyear transformation program towards our mission to make insurance much easier and better value for customers.

As a great retailer, we increased our competitiveness across distribution channels increasing our own brand policy count by over 200,000 policies. Having written the highest volume of new business since the IPO in a high shopping market. Motor premiums were up almost 9.4% in 2016 following a very strong year for our market-leading Direct Line brand which I'm going to share in a lot more detail later.

As a smart and efficient manufacturer, in 2016, we expanded our own repair work. We extended our Home and Private Insurance partnership with RBS for a further three years and we extended the Nationwide Travel partnership. We're also disciplined on costs and through our efficiency improvements offset additional levies, investment in the business and funded new business growth.

Finally, to lead in this this type (01:36) of market, we continue to grow our share of the direct commercial market, and we demonstrated our determination to stay at the forefront of new car technology with a series of new relationships. And I'll say more about these also later.

All this enabled us to improve our underlying COR to 91.8%, which after adjusting for weather was 93.5% towards the bottom of the 93% to 95% range we set at the start of 2016. Post-Ogden, the combined ratio is still comfortably below 100%. Return on tangible equity was 20.2% before adjusting for Ogden and 14.2% after.

As a result of our strong balance sheet and proven (02:19) reserves, we delivered 5.4% growth in the final regular dividend. We did pay a special to remind you (02:25) at the half year and our capital position is strong at 165% which is above the middle of our range. Then (02:33) we've taken in our stride, we think the challenges from IPT rises, the Ogden rate decision, Flood Re, sterling devaluation to name a few and we're now confident, we can take any opportunities that results in the market in our stride.

Over to John for some numbers.

Anthony Jonathan Reizenstein

Thanks, Paul, and good morning everybody. We decided to present you with both our reported figures and the underlying results pre the Ogden change as we felt this would be more useful. In our statement last week, we outlined the one-off impact of moving to the new rate which we believe doesn't affect our underlying position going forward.

I'm going to cover the headline results first, and then I'll explain the specific Ogden impact and then I'll talk to the business segment excluding Ogden as I think that's more instructive as to our future prospects. I'll move back to capital which clearly will reflect Ogden. And in the appendix, we've included the usual segmental P&Ls, again both pre and post, the Ogden adjustment, hopefully for transparent (03:27).

Starting with the financial summary here, as Paul said, we think it's a strong set of results. We grew premiums by almost 4% in 2016 helped by particularly strong growth in Motor. Pre Ogden, ongoing operating profit was £578.6 million. 11% ahead of 2015.

There, of course, are a number of moving parts which I'll come on to later, but in summary, the biggest movement was a £70 million increase in underwriting profit which reflects lower weather-related claims cost and a higher prior year releases. This was offset by higher cost in commissions. Secondly, installment and other income increased to £168 million due to higher written volumes while investment return was £27 million lower than prior year on lower assets under management and fewer unrealized property gains.

Ongoing COR of 91.8% was a couple of points better than 2015. Adjusted for weather, that would have been 93.5% in line with our guidance. Total costs were £924 million in 2016, that's £39 million higher than prior year.

It includes an additional £24 million Flood Re levy and £39 of million non-cash impairments. We believe the underlying position is reasonably good, particularly in the context of our strong new business growth. At a segmental level, better weather in 2016 led to a significant increase in Home and Commercial profit and that was partially offset by Motor and Rescue and other personal lines.

Here, we come to Ogden. And I want to take a moment to explain the impact to our business from the reduction to the discount rate announced last week. In summary, we've booked a one-off hit of £217 million in 2016, but we expect very small impact to our earnings going forward.

This takes account of the change to the rate which for us is from 1.5% to minus 0.5% along with the estimated impact on PPO propensity. Our reinsurance was renewed at 1st of January and we maintain a cover of £1 million. So, our cost and coverage are protected during 2017. And we continue to hold a significant margin above the ABE having maintained our reserving strength post the Ogden change.

I'll go to the P&L, balance sheet and Solvency in that order for both 2016 and our expectations for 2017. 2016 is pretty straightforward. We took a charge, £217.3 million of which £12.1 million relates to 2016 (05:48) year. As for 2017, there are a few effects but they're all small.

The first one is, we expect a small earned-through (05:58) effect from business already written, but the impact should be smaller than the £12.2 million impact you see there for 2016. So, 2017 impact smaller than the £12.2 million you can see for 2016 from the earned-through. (06:11)

The second point, which has had (06:13) a bit of attention, is that in recent years, we have been recognizing prior year releases, as we have provided for claims at 1.5%, but these were settled at 2.5%. We estimate that this would have been – this would've given us a release of about £10 million in 2016, perhaps a little lower in 2017.

We no longer expect to get that release going forward. However, we do expect this will be offset somewhat by movement in the current accident year, as we'll no longer be adding a 1% prudent provision to current year claims, i.e., we'll be booking at minus 0.75%, not at minus 1.75%.

The net impact of these two items, those two little bullets in 2017, we think will be very small. Now, clearly, so all those three things together, we think will be small in the context of a very large business with high profitability. But clearly, obviously, the underlying 2017 current year performance will depend on market conditions.

So, moving down to the balance sheet, this is quite simple, we have higher claims liabilities and lower retained earnings. We maintained our reserve strength overall despite Ogden. We see no material impact in 2017.

And then moving on to Solvency II. In broad terms, the Ogden impact was £180 million reduction in eligible own funds which is pretty similar to the IFRS charge post tax. And the SCR also increased by approximately £80 million and that's due to higher claims liabilities as a result of Ogden, plus a reduction in tax benefits due to lower 2016 profits.

Importantly, it doesn't take account any implications of uncertainty around possible changes we can still have to the discount rate, because that's still up for grabs.

So, overall, our position is, we've absorbed the hit, remain focused on trading, that's what's important to us in 2017. We're going to have a very little carry through from what's happened in 2017, and we believe we're well positioned to trade.

Let's go to more positive things, the policy count on slide 8. And it's down a little over the year. However, this marks another year of growth across our own brand portfolio and in particular the direct channel which gained momentum during 2016.

We believe this is a result of offering customers better propositions combined with our improved trading and sharper pricing. Our improved digital capabilities have a been a key enabler to this growth as well, allowing customers to purchase our products quickly and easily by their chosen channel be it direct through our website, call centers or through price comparison websites.

Starting with Motor, which is predominantly own brand, Motor grew volumes by 4.5% in total. Direct Line, Churchill and Privilege together grew by 5.3% over the year. And the majority of this growth was driven by the Direct Line brand.

In Home, it's also been a good year for own brands which were up 2.3%. This was due to improved trading across both Direct and PCW channels. In Home partners, which account for around half of Home policies, volumes we're down 4.7% during the year.

But the Direct growth story continued in Green Flag and Commercial as well. Green Flag policies we're up 7.4% and in Commercial, our Direct Line of business brand, reported a 6.4% increase in policy. This growth in our own brands in a high-shopping environment demonstrated that we're doing the right thing for customers.

Turning to premiums, which just to remind you all exclude IPT. Gross written premium increased by 3.9%, largely driven by Motor. Motor premiums were up 9.4% due strongly to business growth particularly in Direct Line.

Home premiums were 3.7% lower in 2016, primarily due to partnership volumes. Written premiums for own brands, Direct Line Churchill and Privilege were down little in 2016 in Home, although Direct business – although we did see some growth in own brands in Q4.

Overall, Rescue and other premiums were up a little. Within that, Rescue was broadly flat, but Green Flag direct business grew premiums by 11%. Commercial premiums were up 3% on last year, mainly due to growth in Direct Line for Business.

Moving on to combined ratio. This improved by 2.2 points to 91.8%, normalizing for weather the COR would've been 93.5%, which is in line with our guidance and pretty similar to the prior year. Overall, we improved the loss ratio, but this was offset by higher expense and commission ratios. Starting with the loss ratio on the top-right, which improved 4.5 points to 55%, the current year attrition loss ratio improved yet again, continuing the trends since the IPO.

In 2016, we levied another 0.7 percentage point reduction as the results improved underwriting. The contribution from prior years was higher yet again, continuing the trends since the IPO – sorry, continuing the (11:05) higher than we expected in 2016 and £51 million more than in 2015. This was mainly due to positive development from the storms at the end of 2015. Finally, the majority of the loss ratio improvement, i.e., 2.5 points was due to better weather in 2016.

Moving to expenses and commissions. The expense ratio was 25.3%, up 1.7 points due to two items. First, the Flood Re levy of £24 million, which equates to roughly 0.8 of a percent. And secondly, the intangible asset impairment, which we flagged at Q3, which came in at £39.3 million or 1.3 points.

Absent these items, the expense ratio would've improved by about 0.4 of a percent. The commission ratio increased a bit to 11.5% as a result of sharing better weather and prior-year development with our partners.

Stepping back, we believe that achieving a 93.5% normalized COR, improving the current year attritional loss ratio whilst supporting strong levels of new business growth and investing in the business and absorbing high levies represent good results.

Let's move on to the ratio trends at a segmental level starting with Motor. A good set of results for Motor, strong top-line growth and disciplined underwriting delivered an improved current-year loss ratio. Overall, pre-Ogden, the Motor combined ratio increased to 95.1%, mainly due to a higher expense ratio.

Moving from left to right, Motor delivered a further 1.7 points of improvement in the current-year attritional loss ratio to 85%, impressive in the context of the growth we've achieved. The improvement in current year was offset by lower prior-year releases in line with our guidance.

The 2-point increase in the expense ratio is all due to the intangible impairment. But as you can see from the waterfall, our run rate expense improved. Commissions were up a little due to a true-up on partnership business. And excluding the impairment charge, Motor made good progress year-on-year, an impressive result when we consider we were at the highest point with own brand new business since the IPO.

Now, for more color on Motor pricing and claims. In 2016, Motor took market share at attractive margins, having grown policy accounts and premiums while improving the CY attritional loss ratio. Starting with pricing, we've changed our disclosures here a bit, replacing price and risk mix metrics with average premium movements, which we believe is an easier metric to understand.

Average written premiums increased by 6.3% in 2016 over the year, while the risk in our portfolio declined modestly. Our pricing reflected our claims experience and also enabled us to improve our current-year performance and support investments in customer propositions.

These investments in propositions, particularly in Direct Line, have resonated well with customers, enabled us to benefit from the high levels of shopping. And this has resulted in strong new business growth. And despite the high levels of shopping in the market, our strong retention rates remained stable.

On the claims where trends are broadly in line with what we've previously said, taking bodily injuries first, Ogden aside, it was another benign year for large bodily injury claims, which performed better than our expectations. Small bodily injury continued to perform well, and you can see that in the usual chart with our RTA Portal stats, which we've included in the appendix.

Damage claims, on the other hand, continued to develop adversely. The majority of the adverse performance was driven by increased severity. We expected some damage inflation from our investments in proposition such as seven-day repair and damage to entire (14:32) car. But most comes from general inflation, the cost of parts, paint and labor along with other factors. Taken all this together, we believe claims inflation is running at the top end of the long-term 3% to 5% average.

Now, we've made a change to our reserving chart here as we thought a net view is more useful than gross given the changes to our reinsurance program over the years. You'd probably be getting your rulers out in comparing the two charts but, essentially, the overall trend is the same as it is pre the change, the Ogden rate. Prior accident years continues to develop favorably, which is a reflection of the conservative approach to reserving and operational improvement in the way we handle claims. The initial current year net loss ratio of 83.4% for 2016 is lower than prior year, consistent with our headline Motor results.

Looking ahead, our message remains unchanged. Assuming current claims trends continue, we expect the contribution from prior years will be significant in 2027 (15:31) albeit we'd expect it to reduce over time as it did a bit in 2016.

Moving to Home performance on slide 14. Home combined ratio improved significantly in 2016 to 85.0%, driven by lower weather losses and higher prior year releases. The current year loss ratio deteriorated by two points, but at 47.8% is still a good number. The year-on-year increase is partly driven by claims inflation and partly due to changes in tenure and channel mix away from partners to PCWs which I'll come onto.

Prior year releases were higher in 2016 as Home recognized favorable development on the 2015 storms. The expense ratio increased by 1.9 points due to the additional Flood Re levy in 2016 although we were able to partially offset the cost of that in other efficiency measures. The higher commission ratio in 2016 reflects profit shares associated with stable weather and prior year development.

Now, for more color on Home pricing and claims. In Home, we maintain competitiveness across our strong own brand portfolio growing policy count by 2% to 3.3% (16:41) over the year. In our Home business, we seek to protect our valuable own brand portfolio and ensure a strong position in all the main channels.

The Home market remained very competitive in 2016 as shopping rates were high, price comparison sites continued to grow market share. We wrote higher volumes of new business through our own website and through PCWs while the impact of deflation does flow through the back book. The change in channel mix and tenure led to a 3.9% reduction in own brand average written premiums in 2016.

We saw some underlying improvement in the market later in 2016. After many periods of deflation, you'll recall we highlighted some stabilization in prices in Q3. And this improvement continued in Q4 where we were able to increase new business prices a little albeit not enough to keep pace with claims inflation.

And on claims, the claims experienced in Home has been pretty benign over the last few years. And at the half year, we said overall inflation was below the long-term average. In the second half, we saw an increase in claims costs, which we believe reflects inflationary pressure in the building trade. This pressure on margins is reflected in a higher current year attritional loss ratio in 2016, although do remember that 2015 was the best year on current year loss ratio we've had for some time.

Overall, we believe the Home market is becoming tougher due to rising claims inflation, and it remains very competitive. Against this backdrop, we continue to balance between margin and volumes aiming to deliver a long-term value.

Now, back to segmental with Rescue and other personal lines. Total Rescue and other personal lines combined ratio increased to 93.3%. Profit was down by around £6 million. The main movement in this category was a 2.5 point increase in the current year loss ratio, which was mainly due to timing of pricing changes to partnership travel policies.

Taking Rescue on its own, you can see from the table that Rescue combined operating ratio increased a little to 83.4%. Rescue remains the biggest driver of profit in this segment, contributing £42 million to £46 million to the segment as a whole in 2016 and please see the appendix for more details on that.

Last but certainly not least, Commercial. It's a great set of results in Commercial in 2016, the best results since the IPO. Headline combined ratio was 93.2% and underwriting profit was £30.6 million, really with some very favorable tailwinds namely low weather and large losses, but – and some favorable development on the 2015 accident year.

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Normalizing for weather and large losses, Commercial COR would have been three points better than 2015 due to higher prior year, but also some current year improvement. So, moving left to right, starting with the current year loss ratio, this improved by 9.5 points. As I've said, some of these improvements was due to better weather and fewer large losses, but Commercial did deliver over a point of underlying attritional current year improvement due to better pricing and risk selection.

And also, Commercial also benefited from higher prior year releases, some of which related to favorable development from the storms at the end of 2015. The expense ratio was up a little in 2016 due to marketing activity while commissions were flat. Commercial made £66.6 million of operating profit in 2016, more than three times more than 2015. And in the appendix, we've got the usual segmental P&Ls, again, pre- and post-Ogden.

Now, let's come back to cost for the Group as a whole. 2016, our total cost base was £924 million, £39 million higher than 2015, which is all due to an impairment on intangible assets. The impairment charge of £39 million was a non-cash item, reflects the large volume of work we're doing on IT projects to enhance our digital offering, customer experience and operational efficiencies. Excluding this non-cash item, we held our cost broadly flat, having fully absorbed an additional £24 million Flood Re levy in the first half, and achieved a 5% year-on-year reduction in the second half. The latter, due mainly to lower claims handling expenses.

This is a pretty good result when you consider we've also absorbed inflation, again, keeping staff costs flat year-on-year. And flat costs also means we've effectively managed costs associated with the higher fee business growth we've had since the IPO. Our marketing cost were down another 4% in 2016, lowest spend since the IPO. Overall, we made significant progress on cost over the last five years, whilst investing in our capabilities and propositions. It's this investment that's driving our strong brand performance and these numbers demonstrate our discipline on cost.

In ratio terms in 2016, our expense ratio was 25.3% and 24% ex the impairment. Looking ahead, we see further opportunity to improve efficiency, so we can continue investing in the business and improving our competitiveness. We, therefore, aim to reduce the expense ratio in 2017 along with a commission ratio, normalized for weather and we aim to reduce further – both ratios over time.

In 2016, we delivered a robust investment result against the backdrop of increased financial market uncertainties and further yield compression. Starting at the top left, headline assets under management stood at £6.6 billion at the end of December, 3.5% lower than the previous year. On the top right, you can see the income yield increased a bit to 2.5% in 2016, helping to offset the impact of lower AUM to maintain – enabling us to maintain investment income of £165 million. The investment return yield held to 2.6% in 2016 as we recognized gains of just £3.5 million compared with £29 million in the previous year, and that's due to pure unrealized property gains in 2016 per our guidance.

Looking at the asset allocation in more detail, on next page, as part of the ongoing review of our investment strategy, we decided to exit securitized credit during Q3 2016. We also sold two investment properties in 2016, realizing a small gain above unrealized fair values. Investment in three new mandates commenced with the subordinated financial debt and global credit at their benchmarks. The third is commercial real estate, loans which aim to be fully funded by the end 2017. Debt securities make up the majority of our portfolio with £4.7 billion of assets, of which 69.9% are rated A or above.

In terms of outlook, ongoing yield compression is reflected in our 2017 guidance of 2.4% income yield. That's based on the current yield curve and assumes interest rates remain unchanged.

This slide shows, I'll be getting from the headline ongoing operating profit of £578.6 million pre-Ogden to profit after tax of £452.6 million. The Run-off segment at £69 million pre-Ogden was slightly lower than prior year. But again, it more than offset restructuring costs. Looking ahead, we expect to incur a further restructuring cost and these will be substantially offset by run-off profit over the four-year period 2015 to 2018. Diluted earnings per share of ongoing operations increased by 23.7% – 23% to £0.327 pre-Ogden and was down versus prior year after adjusting for Ogden.

Now, we'll turn to coverage, the capital. You'll recall we transitioned to our internal model at the half year, following PRA approval for our model in June. At the half year, our Solvency II ratio under the model was 184%, slightly above our 140% to 180% target range, which we also set out at the time. This was a strong starting position and it's meant that we were able to comfortably absorb the Ogden charge, pay our ordinary dividend and still remain above the midpoint of our target range at 165%.

Our solvency ratio fully recognizes the new Ogden discount rate of minus 0.75%, although it doesn't take into account the implications from the uncertainty arising from the new government consultation. The impact of the change in the Ogden discount rate cost us 24 points on our Solvency II ratio. As we showed earlier, this was approximately a £180 million reduction in owned funds and an £80 million increase in solvency capital requirements. Overall, we think we have a strong solvency position and this strength remains a key enabler to our strategy. And we'll submit our final solvency calculations in May along with the rest of the industry.

Let's go through some of the moving parts. Slide 25, we've broken out the moving parts – sorry, slide 23, in our own funds calculation. This is the first time we provided a slide and the numbers shouldn't be too surprising. At a high level of Solvency II world looked quite similar to the IFRS world in 2016. We don't expect the IFRS and Solvency II worlds to align every year, but we do expect the two to broadly reflect each other over time.

During 2016, the Group's own funds decreased from £2.47 billion to £2.34 billion. First, we had a one-off movement due to the change in treatment of the risk margin as we moved from standard formula to Solvency II. We benefited from mark-to-market movements in 2016, as interest rates fell and credit spreads narrowed. We generated approximately £490 million of Solvency II capital in the year, which was reduced by the Ogden rate change of approximately £190 million. Capital expenditure continued at around £100 million per annum, reflecting investments we continued to make into the business. And finally, we continued to return significant dividends to our shareholders totaling £340 million in 2016.

Moving to dividends on slide 24, as you've heard, we've announced today our final regular dividend of £0.097 per share, takes the regular dividend to £0.146 for the year at 5.8% growth in the year, and it's in line with our ambition to grow the regular dividend annually, including the special dividend we paid at the half year but excluding the impact of international in 2015. Year-on-year, we've increased capital distributions by 8.8% from £0.226 to £0.246 per share. In terms of earnings, although we don't target a payout ratio, we declared £338 million of dividends in 2016 which is over 100% of our net income for the year.

Before I move to the outlook, let me just summarize some of the financial highlights. 2016 marks another year of progress. We grew premiums and improved the current year loss ratio again. Our underlying cost base was flat, having offset the Flood Re levy and costs associated with new business growth through improving our underlying efficiency.

We grew our investment income yield to deliver robust result against the backdrop of market volatility. We grew the regular dividend again, in line with our policy of earnings growth, this in real term. And finally, our capital position post dividend remains strong despite the charges from Ogden.

Now, let's look at the outlook for 2017. We'll talk about this in segments, as well at the crude level, starting with Motor. The Motor market is facing significant change following the Ogden rate decision and forthcoming IPT increases and other regulatory actions. The high levels of customer shopping in 2016 looks set to continue in 2017 and we believe this represents an opportunity. In terms of prior year reserve releases, we expect the contribution will be significant in 2017 albeit will reduce over time.

In Home, after years of premium deflation, we saw some improvement in the new business market in Q4 albeit not enough to keep pace with claims inflation. We continue to aim to protect our valuable and own brand portfolio seeking to balance value and volume to deliver sustainable long-term value. Our partnership with Nationwide was due to terminate in June 2017. Their plans are currently being reviewed and this may result in the migration moving later, into the second half 2016.

Now, while I'm on the subject of partners let me just mention the Prudential, had long-term relationship. That deal came to an end this year. We have a new deal, where we will be paying them a brand license, but commissions we will not be paying anymore. So we'll keep that a net-net that's favorable. It's one of the reasons why we see commission ratios going down in the future as we said. Finally, in Home the weather load for 2017 has reduced to around £65 million, reflecting lower volumes. In Rescue and other personal lines, we'll continue to enhance the Green Flag customer experience building on the growth we achieved in 2016.

In the rest of personal lines, we plan to roll out new initiatives in Pet and Travel, help drive profitable GWP growth there. Prior releases in Rescue and other personal lines are expected to be significantly lower in 2017 following one-off benefits and adjustments in recent years. Finally commercial, we're aiming to build on the excellent progress we made in Commercial direct market through delivery of further improvements to our trading capabilities and Direct Line for business. While in NIG, we have a number of operational initiatives and training designed to deliver effortless trading to our brokers to differentiate us from the competition.

Turning to what this means for Group results, in 2017 we're targeting a combined ratio in the range of 93% to 95% assuming normal annual weather and no further change in the Ogden discount rate. Within that, as I said, we are aiming to reduce both the expense ratio and the commission ratio in 2017. Moving across to investments, our 2017 guidance of 2.4% income yield is based on the current yield curve, and assumes interest rates remain unchanged. We continue to expect assets under management to decline modestly. Finally, we continue with our ongoing target to deliver sustainable growth at a 15% or better return on tangible equity.

With that, I'll hand over to Paul.

Paul Robert Geddes {BIO 2474781 <GO>}

Thank you, John. The success that John just described means that we've taken the Ogden impact in our strive, and we believe we are well placed to succeed in the market results. But over the next 10 minutes or so I'm not going to mention the O word, but instead deep dive into two things I'm really proud of to bring our strategy to life; starting with great retailer, and sharing with you the story of our fantastic turnaround in our biggest, most profitable and important brand, Direct Line. For us, being a great retailer is about building compelling brands, and we believe in owning powerful retail brands and owning our customers which not only puts the space of our business firmly in our own hands, but we also believe this is where most of the economic value lies in the insurance value chain.

We also believe that owning multiple brands means you can better meet the diverse needs and preferences of customers. We've done a lot to improve our brands over the last seven years. We started by retuning the basics supporting all our brands, regaining excellence in pricing and claims and improving our cost base. With these basics in place, the next urgent task was to get competitive on PCWs through our Privilege and Churchill brands. And working with the PCWs themselves in optimizing our marketing, products and pricing for the channel, we really turned this around and it worked. Privilege and Churchill turned around their competitiveness and started to grow. And today, they successful compete against the most competitive and efficient players in this channel.

Our next task was to turnaround Direct Line where a multifunctional team was charged with reinventing the brands for both personal and SME customers with a launch in August 2014. So I'm really proud to put up this slide showing the turnaround we've achieved in Direct Line together with some of the many initiatives that delivered it. This chart shows the sequential change in the number of Direct Line Home and Motor policies, showing an improving trend in policies almost immediately after the relaunch in August 2014, and then a happy day in September 2015 where the brand finally went into growth. The chart plots the many initiatives along the bottom and just some of the financial and other benefits flagged (33:09) above.

Clearly, a lot of individual components to this success, but let me start by telling you the strategy behind it. Our start point, as you can see on the left-hand side here, was the recognition of the inherent value of the Direct Line customer. They like the direct relationship, they valued service, experience and brands. They bought more products. They stayed longer. And adjusting for everything else, they simply have a better claims performance. We believe that by investing some of that additional value back into the business, we could make our existing customers even happier and so further increase their retention in product holding. And we could also recruit new customers with similar characteristics and similarly higher value. And so it proved.

Through this reinvestment, we pretty much made everything better. Here are just some of the improvements. We gave customers better insurance with unique features such as seven-day car repair promise, guaranteed hire car and our emergency plumber proposition. We gave them better value such as by removing mid-term amendment fees and through competitive pricing. And we also gave them a better experience such as introducing digital claim services, a motor claims tracking portal, as well as investing in completely retraining over 4,000 front-line staff with new skills to give customers more empathetic service, and our Net Promoter Scores have climbed ever since. All this communicated the drama and wit with our award-winning marketing using our Fixer campaign.

There has been a huge amount of work across our 10,000 people, and I'd really like to emphasize how hard this is to replicate. Firstly, delivering these propositions isn't easy, and it really helps to have both scale and to be vertically integrated. And we take, for example, a seven-day car repair proposition. Delivering it is really helped by our early direct contact with our customers and our ability to get them to share photos and videos from their phones so we can be ordering parts immediately. It's also really helped by owning body shops. We are 19 now and growing, making us the second largest body shop owner in the UK, and the largest insurer-owned repairer in the UK. This means we can have state-of-the-art centers and we can fast track Direct Line repairs.

But having differentiated propositions would be hard to justify unless you can tell new and existing customers about it. It's hard for PCW brands to justify this investment when their main means of explaining their product to customers is simply ticks on a PCW site. No wonder there is such homogeneity in the propositions of PCW brands. But no such problem for Direct Line. Our leading brand and award-winning capabilities in social, digital and customer experience capabilities mean that we get to interact directly with millions of customers. We generate about 4.5 million direct quotes a year from our own websites and our own call centers, meaning that we can directly explain our propositions to our customers.

All this hard work and investment has generated tangible benefits. We've achieved high new business sales, up 31% across Motor and Home in 2016, and an 8.2% uplift in Direct Line for Business growth. We've also seen high persistency up between 4 percentage points and 5 percentage points, and all done at lower marketing spend with greater efficiency. This additional value completes the virtuous circle. More value for customers generating more customers and more valuable customers. And so the flywheel starts to turn. And we've already recognized the increased value with further investments in proposition and in price. This has in turn improved our marketing efficiency to such a degree that we can now acquire a new Motor policy direct for a lower cost than we can via PCW, a great asset going forward. Let me end this section by showing you the two latest ads that are about to go on air for two brand-new propositions, which of course, come on top of all the propositions we've given our customers already. These two for SME and for Motor. We also have a very, very secret one on Home that's too secret to share with you today.

[Video Presentation] (37:50-38:51)

I will agree that both these ads tick all the boxes; insightful, engaging, dramatizing a relevant insurance event and memorably demonstrating where Direct Line outperforms other insurers in fixing customer's problems. And now to lead and instruct the market. In the interest of time, I'm going to keep this to a single slide on the topic of connected and autonomous cars, but this belies all the focus and energy we're putting in to understanding and influencing the future of motoring. We believe the time to act is now even if the real world impact will take a few years or even decades to fully develop. That's because decisions taken today like the recently proposed changes to UK law for Automated Driving Systems will profoundly influence the future.

It's also the reason we've spent time working closely with motor manufacturers on connected and autonomous cars. I'm delighted that we're able to extend our successful motor insurance partnership with Peugeot Citroën in the UK for a further four years. This partnership packages insurance including telematics with car finance. We now have to build on the success and create propositions based on technology already fitted into the car, and so avoiding the need to retrofit black boxes. Similarly, through our relationship with the flow, we're also looking to use data connected by Renault's R-Link multimedia platform.

On to autonomy, we're working with Tesla to understand the specific characteristics of electric cars, and the role of advanced technology and driving aids can play in enhancing road safety, and therefore insurance. This year, Tesla became introduced point of representative able to refer customers to Direct Line so we can ensure the customers of Tesla. And in 2016, we kicked off a partnership called MOVE_UK with the UK Government, technology providers and car manufacturers to accelerate the development market readiness and deployment of automated driving systems. With ADS systems observing and recording in the background, whilst MOVE_UK vehicles are driven normally, we're learning how ADS technology would respond in real life situations with over 200 different channels of data collected from each vehicle.

So (40:55) we've given you a deeper insight into two of our key strategies, helping you understand why we're so confident to our ability to win in the current market, and to sustain it into the next. Our strategy is delivering results with benefits coming through multiple areas, yet we still remain excited by the significant opportunities we see to improve. Here, we give you the usual level of detail of our 2017 priorities, in the interest of time, I'll let you read these at your leisure. Of course, you can come back to ask your questions. So some key messages from me before we go to questions. Against the backdrop of a shopping market, we are winning in the marketplace by giving our customers more of what they want at a competitive price.

Our solvency is strong at 165%, and has comfortably absorbed the cost of lower Ogden discount rate, whilst to reserve our reserve strength, and we expect prior releases to be largely unaffected by the Ogden decision, and to remain a significant feature of our results, albeit they will reduce over time. Looking forward, improving efficiency remains core to our strategy, and we aim to improve both our expense and our commission ratios in 2017. But we're also going to continue to invest in our future capability as I've just taken you through. With this in mind, we are aiming for a 2017 core in the range of 93% to 95%. This, of course, assumes normal annual major weather claim costs for Home and Commercial, and assumes no further change in the Ogden discount rate. (42:24).

And our 15% RoTE target remains ongoing. You may have seen today that our long-term incentive plans have been increased for the next grant to 15% to 18% range, keeping us in line with our shareholders and keenly focusing on maintaining the Group's strong returns. Finally, the multi-brand, multi-channel strategy that brought us success in the shopping markets of 2016 means we're well-placed to win in the disruptive markets of 2017.

Thank you, ladies and gentlemen. And we'll now take your questions, first, in the room, and then Rosie on to the phones.

Q&A

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

Good. Well, actually we'll do a somewhat (43:00). Microphones please.

Q - Arjan van Veen {BIO 5197778 <GO>}

Thank you. Arjan van Veen from UBS. If I may ask a couple of questions around pricing post the Ogden change, some of your competitors already moved (43:18). Can you maybe give a bit of color around what's happened so far? Secondly, your confidence in being able to push through the price increases you need. And thirdly, given your retentions are quite a bit lower than some of our competitors, did that obviously creates potentially an opportunity should you wish to take a bit of market share? So maybe if you could comment a little bit on that as well (43:40).

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

Okay. So let me have a go, and I normally disappoint on future-looking pricing statements because we don't actually talk about future pricing for all sorts of reasons, including we don't know what's going to happen in competitive markets. But listen, we've taken some pricing action as we said we would. Remember, of course, we're shielded, as you point out, by reinsurance as are many of our competitors. The level of shielding both in terms of deductible and date is variable in the market. We think we're in pretty good shape with £1 million and all of 2017 covered.

So in a way, we've got a low level, we've got some shielding. So obviously, as John pointed out, there is some inbound cost pressure already this year. But there'll be more, depending on the outcome of two things really, the reinsurance renegotiation for 2018. And of course, we are not planning or betting on it, but there is an expedited consultation going on with indications that should that consultation recommend a change that there could be some expedited law making. And of course, that may, that could theoretically come into effect within 2017. So really, I think the big impact – there's a lot of unknowns, and therefore, what will happen in pricing I think is still to be seen. Yeah.

Q - Thomas Seidl {BIO 17755912 <GO>}

Thanks. Thomas Seidl from Bernstein. First, again, on this Ogden price change, so when you say it has little impact for 2017 and forward, so does it assume that you expect the market to all increase the price in line, and hence, there's little impact going forward? First question. And second on Home. You lost little bit of volume last year through expenditures driven by PCW, and what is your outlook, how can you be competitive given the primarily rising penetration in the segment?

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

Okay. So listen, our comment on 2017 is, a lot of it is about the reinsurance protection we have in 2017. So we're saying that there is obviously a net – there's a net cost as well, and as you know, I can't comment on future pricing, but we do work back from the loss ratios to underwrite that. So what I'm saying is there's more uncertainty about what the 2018 outcome – as I've said, for lots of reasons including, by the way, there is something going in our favor which is the whiplash reform coming in in October is going back in the other direction. So there's quite a lot of moving parts for 2018. Does the rate change again theoretically in 2017? What happens on reinsurance, which obviously impacts people before us, and we'll see the impact of that in the marketplace. And as I was saying 2018, we've also got in the other direction the whiplash. So there's just more uncertainty in 2018. But our stance in that uncertainty, is we work back from the loss ratios we want to write that, and then we take the volume that we can. 2017, there's less uncertainty.

A - Anthony Jonathan Reizenstein

(46.29) our guidance for core, for the current year for 2017, 93% to 95%. There's very, very little impact to Ogden in there. It's the pre-Ogden, if they change the rate, obviously, that would change. So we're not assuming any great benefit. We're not assuming any great hit. We've told you a little bit about some of the small impacts we're getting. We're going, in this year, as almost as in every other year, but it's going to be a very exciting year because a lot of people are impacted in different ways and there are lots of things going on, and that kind of uncertainty continues through 2018. That's really the message. We're feeling pretty confident going as we are already trading in 2017.

So on Home, we are just (47:05) clear, and this is also (47:07) we're competitive on all channels. What I was saying is we've done a great turnaround in our PCW competitiveness, and now we lay it on top of that growth in Direct Line's fantastic combination, and the same is true in Home. And actually, we are very successful in winning business on price comparison websites in Home. Some of the deterioration of loss ratio you've seen is that, for some of it is risk and some of it is mix, and that mix is channel mix. So the characteristics of the PCW channel is it's slightly with loss ratios that has other characteristics. Now, there's another thing going on in Home, which is a more of a cyclical. So the secular thing or the mix shifts towards PCWs, which were competitive and we're happy with, there's a cyclical thing going on at Home which is building cost as John talked about, did go up, and we towards the end of the year priced for that, (47:58) to recover that. So that's our normal business which is we look at – with target loss ratios.

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

Yes, Andreas?

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

Andreas van Embden, Peel Hunt. Ogden again, would it be possible to do a walkthrough from gross to net with your Ogden reserve addition of £205 million, including how much reinsurance absorption there was? Any use of the risk margin? And the assumptions you made on PPO propensity, it seems from your sensitivities that not much has changed on the PPO sensitivity. I just wonder how much you use there. Second question, could you run your thoughts on why you skipped the final (48:40) special, and tie that to your solvency range of 140% to 180%? And then finally, on the comments you made about having lower acquisition costs within Direct Line versus PCWs, how much lower are they? Thank you.

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

We don't want to disclose the last one. But I mean, even – we've often said, well, if you take PCW versus direct, we'll have to direct channel for all sorts of reasons, be it (49:10) cross-border holdings and everything like that. But the problem is they're expensive to acquire. We've often said that. I'm now no longer saying that. So that is, to even get the same level is a really impressive progress, and I think strategically gives us a real edge at a shopping market. And as I say, whatever happens in Ogden, there's a lot hitting the customer this year, and we think it would be a shopping market again. There's another IPT going through.

There's going to be ultimate changes going through. It's going to look like a shopping market. 2016 was shopping market driven by IPT and other factors, renewal price disclosure and input as well. So there's a lot of shopping. We did really well in the shopping market in 2016, which is why we're optimistic we're going to do well in the shopping market in 2017. And the Ogden hit, as John say, is kind of, is in the past. And a relative size of our Ogden hit is, as John says, it wasn't about 2016, it's kind of a historical size thing, and that's behind us. So we really are on terms with anybody else. And in fact, with our reinsurance position, I think it's going to be pretty strong in the market. John?

A - Anthony Jonathan Reizenstein

Should I do some of these other one? I'll do my best. In terms of growth to net, probably the single number to give you is ceded reserves have gone up by £320 million year-on-year – Ogden, £320 million. On the risk margin, the risk margin improved a bit because the PPOs are particularly costly to risk margin. So that pure change makes the risk margin better, but the increase in reserves is partly offsetting factor. And then obviously, year-on-year, you got the thing I mentioned earlier, which is that we moved from the low risk margin standard model to the higher risk margin internal model in June. So you've got a few movements. But the pure Ogden one is favorable because of the net impact of that PPO point.

On the PPO propensity, we do assume that as the Ogden rate goes down, there'll be fewer and fewer PPOs. Obviously, below zero, there's a point at which from profit perspective, the PPO is better, if you like, for our profit, than at zero, because we discount real zero than a negative discount rate. But from a capital perspective, it's worse. And that's an interesting thing. Obviously, we don't get a choice normally. The claimant may have a choice, and we'll see what happens when the government comes out with a consultation. But certainly as you come down, you get fewer PPOs. And we've had, in particular, a relief from our PPO margin because we had a propensity margin. You're worried they might go the other way previously. We had a relief from that. We no longer need to carry that. So (52:03) I've answered (52:04) questions. But on the special, today we showed you that the impact of Ogden was 24 points on the ratio. So if we hadn't had Ogden, I would have thought, we were never ever certain.

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

We will recommend it to the board.

A - Anthony Jonathan Reizenstein

Because we can have a hypothetical board meeting. But as management, we would probably recommend it to the board there should be a special at the year-end. That was 189% post regular, so very – quite likely. And I don't think anyone will be that surprised, but 165%, they wouldn't be. And I think people would like to know much more about the future of special dividends, so I'd love to be able to say. But obviously, our board will decide each year based on the current – the then current – the conditions that are obtained then. And we've said, normally, it's going to be once a year around this time when we do the final results, when we look at our business plan and look at opportunities and so on. That's what we'd expect.

Now, as you think about our profitability, and we've said that, over time our IFRS profits and our Solvency II capital generation should be broadly aligned, not every year, but broadly aligned every time. And clearly, our IFRS profits do exceed our regular dividend by some considerable margin. We aim to grow our regular dividend. But even further, there's a margin there. And therefore, all other things being equal, you'd expect over time there'd be some years when we generate a special dividend, certainly. But (53:34) already said, when we started our post-IPO special is special, and a regular is a regular.

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

Yeah. Oliver?

Q - Oliver Steel {BIO 6068696 <GO>}

Oliver Steel of Deutsche Bank. You'll be relieved, I'm not going to ask about Ogden, but I might mention it. So first question is, I don't know how far we can push you on this solvency range. Somebody said to me this morning, which I thought was intellectually quite a rigorous comment is how can you pay a special, if you're actually not above the top end of your target range? So, again, can we sort of say if we can push you a bit on how comfortable you feel with 165%? Would you expect that 165% suddenly to move up over the next few years? If so, how long do you think that's going to take and so on?

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

(54:25) parts of question.

Q - Oliver Steel {BIO 6068696 <GO>}

(54:27)?

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

Why don't you do all your questions?

A - Anthony Jonathan Reizenstein

Oh yeah. Sorry.

Q - Oliver Steel {BIO 6068696 <GO>}

So, the other two questions, much easier. First of all, the commission ratio seemed to be a bit higher than expected. You mentioned some of that in Home being – profit commissions being paid out. You also talked about the true-up on the Motor partnership. Numbers was up, I think. So, how exceptional was that commission rate increase? And then, finally, your cash percentage of the investment, 16% against your target of 9%. So, perhaps, you can just sort of talk about what you're doing on that?

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

All for you, John.

A - Anthony Jonathan Reizenstein

Yeah. So, I think, on the dividend, I don't think, I'm not going to add too much. I'd love to, but I'm not sure, but I'll try. So, (55:14) special below 180%. And, actually, if you go back, there were times when we paid a special below top end of the range. We didn't – we kept them at top of the range while we're waiting for Solvency II to land. We made that clear and then – and Solvency landed and we did. So, I think it's quite possible for us to pay a special below 180%, but that will be decided each year by the board against the points I made.

Could it be paid at 166%? I can't answer that one. It will have to depend on the (55:48) time. But as they trend, the dynamics of it are – because you asked about that as well, if you grow – you can model this. I mean, if you grow – you got a model for our profit. And if you grow our regular dividend, it's been growing at around 5%, 6%. So, if you grow that – you'll see that we built surplus. And, therefore, we've given you an indication of the CapEx and those kind of things. You can make an assumption about mark-to-markets and those sorts of things. I mean, I think your model would show that 165% growing and that's encouraging, clearly, from a dividend perspective. Probably what we can, well, that's my view, but sure your model will be incredibly accurate.

Q - Oliver Steel {BIO 6068696 <GO>}

Commission ratio?

A - Anthony Jonathan Reizenstein

Commission ratio. Yeah. I know most of the things very small. The big things in there are weather – so, in terms of the Home business, we profit share obviously the good and bad weather with the partners. And in this case, they had or we shared good weather from the current year 2016, hardly any weather cost at all. And in 2015, where we shared the hit as we reserved on 31st December for the storms of around that time, we've had a relief from that, and that – so you can see our own Home prior year is up a lot. And we've shared – that's half the sharing, quite a lot of that with them. So, its very weather related in this case. So then you can probably work, extract that and say that's not normal.

Then, and we have talked about the commission ratio trends. I'll just maybe say a couple of points about that. We're obviously, when Nationwide goes, them being a big partner, you'd expect our commission ratio to go down. So that's sort of not due to our scale really. We'd love them to stay, they might stay a little bit longer but they're not going to stay long term. But there are other things that we feel more positive about in terms of our commission ratio move that we see over time. So, the Churchill – the deal with Churchill is done with the Pru (57:49). It's favorable to our commission ratio, and favorable net-net, it's a positive.

The growth of Direct Line for Business is obviously favorable to our commission ratio. And just the growth of own brand is also favorable. So, there are lots of things we're doing that are positive. That if you looked at our five year plan, you'll see our commission ratio coming down over the years, including 2017.

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

Just on cash, John.

A - Anthony Jonathan Reizenstein

Cash. Yeah, I mean, it's an interest – its interest rates. We love to find lots of great places to put cash to work, within (58:23). So, it's actually a struggle to find them. Meanwhile, we're also just thinking that one day interest rates might start to rise. And it's better to be in cash than to be in some day (58:35) it will be long term.

We – I forgot, I speak to the coverage fee idea (58:40), it's great. But we think we've kind of done all the things within our risk appetite pretty much, to be diversified, not to take too many risks and to get decent returns. I think, we've done a reasonable job. But we've sort of each sounds as best we can. I think now, we really need those interest rates to rise.

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

Okay. Yeah. Sorry, gentleman, in front of you next.

Q - Kamran Hossain {BIO 17666412 <GO>}

It's Kamran Hossain from RBC. Two questions. First of all, coming back to Ogden again. So, apologies to everyone in the room for that. But you – there was a meeting last week with the Chancellors, the CEOs of a number of insurance companies. Could you give us a flavor of kind of...

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

No.

Q - Kamran Hossain {BIO 17666412 <GO>}

...what the feeling was in the room? And do you believe that somebody in the government might want to correct, (59:28) that minus 0.75% is the right answer? That's the first question.

And the second question, just on the expense ratio, desire to improve that in 2017, what's sort of the right page (59:38) for us to look at that expense ratio, is it 24% or 25%? Thanks.

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

Okay. So it was a Chapel House meeting, but there was – so I'm going to rely on what I say on the two statements: the joint Chancellor-ABI statement; and then, obviously, the original MOJ statement on Monday morning, which we all gathered around the screens, for I'm sure you were as well.

I read into the first – sorry the sequentially the first, the MOJ statement, a sense that they thought it was the right law, minus 0.75%, but they wouldn't enforce them in terms of saying it was the right outcome at minus 0.75%. And therefore, I think even they were saying they felt bound by the law. We disagree, by the way, on them being bound by the law. But in their interpretation, I think that was the approximation. And then, obviously, the Chancellor was quite careful on what he said, urgent consultation, bringing forward necessary legislation at an early stage, which I'm encouraged by.

So obviously, there needs to be a process. There needs to be a consultation. Many of our arguments are well-prepared and we need to update them. And they rest a lot on what the people actually invests these lump sums in which is not IOGS we think, which is – and it's not, we think, have that negative return. So, that's the basis. We obviously need to hear that out and the other side need to have that stuff heard out.

Our desire would be to attach this to some legislation as soon as possible, if the outcome of the consultation is that is there should be a change. And, of course, there are – this is like catching trains, you can do. There are some bills going through at the moment, the Prisons and Courts Bill is an attractive one from our point of view that's going through at the moment. And that would be one if the consultation comes through at the right stage with the right outcome, from our point of view, that would be a candidate, I think. So we are encouraged by that. But I think it's really important to say government have got to run a fair process now. We'd expect nothing less if we were on the other side of it. And it's got to be out in the space.

A - Anthony Jonathan Reizenstein

And on the expense ratio, it's the lower number. It's the 24% number ex-Ogden. Yeah, that's the base.

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

Thanks. Sorry, (01:01:43).

Q - Operator

Yeah. Just a couple on reserves. So, I'm wondering if you could give us an update on how you're reserving now because I understand that last year, you decided – correct me if I'm wrong – but you decided not to put a margin over best estimate. I'm wondering whether you're still doing that going forward. And so, should we then expect the buffer in the reserves to decline over time and subsequently if the reserve releases?

And then secondly, I noted that your reserve releases excluding the impact of Ogden were higher than last year (01:02:14) percentage points. So I'm just wondering where the majority of that is coming from?

A - Anthony Jonathan Reizenstein

I'll deal with the second one first. So we had said that – so yeah, so in 2016 we had like unexpected reserve releases from weather impact from the storms of December 2015 which helped both Home and Commercial and should be regarded as kind of one-off weather event. And that's what really boosted the prior year for 2016 because in Motor, which is the source of most of our prior year and certainly on an ongoing basis, it was slightly lower as we'd predicted. And – so, let's talk about that because the main – when you talk about reserve strength, the main reserve – we do have reserve strengths in many places but the biggest part of it is Motor.

So, you're right. We did stop in Feb 2015 adding more margin to the current year, because we felt that we've reached an adequate point of conservatism on our reserving as a whole. And that's continued, and I expect that to continue.

Over – if you compare end 2016 to end 2015, we're saying that our total reserving strength is overall pretty much maintained. So, still very strong. There are some movements, however, within that between what's happened on the actuarial best estimate and what's happened in the margin. There are actuarial best estimate which is – continue to look very, by far and away, the large part of our (01:04:00) is still very strong. And we look at a variety of measures and we have third-party reviews and so on. And it's clearly very strong, in my opinion. And that's not pre-Ogden and post-Ogden.

Our margin, as a result, we have reduced somewhat. And there are really two impacts in that. One is and – the first impact has nothing to do with Ogden. So, we looked at our total (01:04:28) reserves over the whole portfolio, and we decided there was adequate conservatism in the actuarial best estimate not to tap the whole – much more margin as well. So, we've released some margin from that.

And then post-Ogden, we released this one-off special – I call them binary provision we had for PPO propensity. Because we have a pretty conservative PPO propensity assumption on our ABE. And we had, because we were worried about potential volatility and extra margin in the margin and that's gone. We don't need that. So, we take those two (01:05:01) into account.

Our pure margin has gone down. And if you trace – I'm not going to go through all the numbers, but if you trace some of the numbers on capital generations, there's influence of that in there.

However, the total reserving strength remains very strong as checked out by third party. And in particular, when we look at all the stats and data we get on Motor and particularly large bodily injury and small bodily injury, it looks very favorable which is why we've made (01:05:28).

I think one of the – just to reflect on why this has changed a bit in terms of how we think about it is, obviously, when we IPO-ed, the problem we had in 2008, 2009, 2010 was relatively recent in one's memory. And it conditioned our view about the actuarial best estimate. So, we wanted to have a very big margin (01:05:52) and that grew, as we can see, to worry about it.

And we kept them and, obviously, they stay very separate in accounting terms and how we manage them. But we look to them in two bunches and said, well, we can't assume there's conservatism in the actuarial best estimate. So, any conservatism we want must be in the margin.

Well, I think we've – having many more years of experience, pretty favorable actually. We've now come to the view that there is conservatism and the actuarial best estimate on IFRS basis. And, therefore, we can look at it as a whole rather than just look at the margin.

Q - Operator

And as a whole...

(01:06:29).

A - Anthony Jonathan Reizenstein

As a whole, it is maintained. So, that's the key message.

Q - Operator

Good. Thank you.

A - Anthony Jonathan Reizenstein

Oh, I'm sorry. Looking forward, because you asked that as well, we think for Motor we're saying it will still be significant because the actuarial best estimate is still conservative, even though we don't have margin, but we do expect it to reduce over time, and why is that? Well, partly because we're still getting releases from very old years, and that will stop at some point. It's outperformed our expectation and it's not all due to (01:07:01) over reserving, some of it is due to actual activity by Steve and his team, but it will eventually stop.

Secondly, obviously, we've reduced our reinsurance deductible consistently, so (01:07:12) will get less. And thirdly, we'd had a runoff, so there's the reason why it reduced. But we track it very carefully and we can predict it, I think, better than we could before, if I could put it like that, which is why for the first time, I actually did produce a lower PY on Motor, albeit only a little, as I had guided, which I will not take any credit. (01:07:36) Andrew.

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

Morning. It's Andrew Crean for Autonomous. Three questions. Could you give us some guidance on the unrealized and realized gains which dropped off a lot this year? Could you also give us on an accident year basis the impact of Ogden on the different accident years please?

So, you can see behind that. And then thirdly, actually this is a request, you're making a big thing and I can see why the power in the engine is really – a lot of it is in the Direct Line brand, which it does differentiate you from other players in the industry. Could we get some sense of the scale of that business by premium and how much profitability is coming from there?

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

Okay. So, I'll give John time to think about the first two. So, it's about half our policy for more than half our premiums, and I'm not going to disclose the profitability, don't want to go down there, particularly around (01:08:37). It is as I've said intrinsic and it's more valuable, and has been more valuable even after investing some of it back, still more valuable. So, a lot of our confidence now (01:08:49) today is by turning that around that's a big deal for us. John?

A - Anthony Jonathan Reizenstein

Yeah. Gains. Well, I think, we really (01:08:58) expect to get as big property gains that we've had. We were quite lucky with the timing, it wasn't just fantastic skill. We wanted to make property investments to back PPOs as a long-term thing. We happen to invest a good time and we made lots of gains and we were a bit worried with all the Brexit stuff. They might reverse. They haven't reversed. Actually, we've been able to sell a couple of properties even slightly above that, but do we expect that clinging (01:09:20) forever? I don't think we can predict that, that will happen.

And on the bonds, we will get some gains as we, sort of, try and optimize the portfolio but we don't, in general, expect much in the way of gains. On Ogden, accident years, I do have some information. Did you warn me about it (01:09:40)?

So, the biggest Ogden hit by accident year was 2014. And the – but they do, but it's actually – it goes – there's a hit, there's an impact on all years right back to 2009 and prior. The biggest of all is 2014. There's probably a...

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

Can we get the figure, please?

A - Anthony Jonathan Reizenstein

Can we give it? We'll try and – we'll see if we can provide the figures, but I can't think of a reason why not. But we'll – if we can find them.

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

If you think of a reason why not (01:10:25).

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

(01:10:26).

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

Yes. Great. I think, we need to, I guess, there are some people on the phone but just a couple more in the room please. Yeah.

Q - Dhruv Gahlaut {BIO 16209870 <GO>}

Dhruv Gahlaut, HSBC. Three questions. Firstly, could you say more in terms of the cost reduction from the admin side? What areas are you're looking at, et cetera. And how should we think of it over the next two years or three years?

Secondly, going back to the question on the solvency ratio. From a standalone basis, as in if I look at the target range, it's still higher than some of the other players. The 165% ratio still sits okay. Would that be a good level to operate the business from a management standpoint? Second. Thirdly on the nationwide deal as in what has led to the delay there? Thanks.

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

I think the last one, I think you have to ask them (01:11:13) provider. Yeah. We're there to help in any transitions.

A - Anthony Jonathan Reizenstein

Do you want to deal with the dividends? It's your turn, the solvency.

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

No. No. I think you're doing so well.

A - Anthony Jonathan Reizenstein

Well deal with the cost first. You're trying to get me on to that one. So, just to give you some things that happened in 2016 on cost, we closed the site, well we downsized the site. Actually we moved from a big site in Bristol to a small site in Bristol. We offshored a large chunk finance. We offshored more claims. We set up a second offshore center in South Africa. It's doing well in terms of sales and service. So it's pretty active.

We're going to need procurement function. There's a lot of things going on in – they're not dramatic things. They're just continuing progress. We look at our footprint off sites. We look at our – we've got five high turnover staff, can we actually replace one for one. All those things you'd expect, marketing has gotten more efficient, so we expect improvement in a number of those things.

How do we feel about the 165%? Well, look I think, as management, I didn't think that regular dividend was ever in question. So, I don't think it's a huge test of that but – so, I don't want to overdo this, but it's of some encouragement to me that the board are happy at 165% at this point. That doesn't mean that it'll be 165% or lower at the end of this year.

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

Terms and conditions (01:12:51).

A - Anthony Jonathan Reizenstein

It might be...

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

Home is at risk.

A - Anthony Jonathan Reizenstein

And it's not out of our hands, I mean, it's for us to recommend. And we'll look at the risks then. There's often risk out then, because the (01:13:02) it should have been taken into account. If the Ogden rate stays as it is, with the possible worsening, there's all sorts...

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

(01:13:12) into account. I said too much. I withdraw everything I said.

A - Operator

All right. I think in that case, (01:13:19) to the phone actually. Can we go to the operator on the phone?

Yes. Thank you. Okay. Looks like we have no questions coming through on the telephone lines. So, Paul, I'll hand the call back to you.

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

Okay. Any last ones in the room? Yes. Oliver, last one.

Q - Oliver Steel {BIO 6068696 <GO>}

So, coming back to Solvency and Ogden. So, the – assume a sensitivity on your solvency so the 10 point rate reduction would reduce your solvency rate by about 14 points. So, that makes me think that implicitly you have a price expectation in your mind in reaction to Ogden, implicit in your solvency assumptions. So, I'm thinking if prices do go up over the next 12 or 18 months, does that help your rate – sorry, does that help your solvency ratio?

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

Well, yeah. So, every time we do a business plan, we take into account what we think will happen and the actions we're taking. And more profitable business whether it be the same profit, more volume or more profit, same volume is beneficial to your Solvency II capital position. So, yes, that would be a plus. And you look at it on a, sort of, 18 month basis on the Solvency II. You then have to protect your balance sheet out till the end of that period and see what the risks you think will be there then. But, yeah, it would be positive.

Q - Oliver Steel {BIO 6068696 <GO>}

But then...

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

Per pound basically.

Q - Oliver Steel {BIO 6068696 <GO>}

But implicitly, that means that you have an assumption in there about how much you can offset the ongoing effect of (01:15:12).

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

Well, we've had to – yes, we've had to work with that and we haven't had a lot of time to do it. So, there is some assumption in there and it's quite an important assumption. And, yes, there's upside and possibly downside from that (01:15:26) We work forward from our loss ratios. I mean, that's our guiding principle, always has been.

Very good. Listen, thank you very much, indeed. We've got – the people who actually delivered this result, might, kind of, team in here and would love to join you over coffee. Thank you very much for all of your questioning and we'll see you next time. Thank you very much.

Operator

Ladies and gentlemen, thank you for joining today's conference. You may now replace your handsets. Thank you.