Q2 2017 Earnings Call

Company Participants

- Anthony Jonathan Reizenstein, Chief Financial Officer & Executive Director
- Jazz Gakhal, Head of Direct Line for Business
- Jonathan Paul Greenwood, Managing-Director Commercial
- Paul Robert Geddes, Chief Executive Officer & Executive Director

Other Participants

- Alan Devlin, Analyst
- Andrew J. Crean, Analyst
- Dhruv Gahlaut, Analyst
- Dominic O'Mahony, Equity Research Analyst
- Edward Morris, Analyst
- Iain Pearce, Analyst
- Ravi Tanna, Analyst

MANAGEMENT DISCUSSION SECTION

Paul Robert Geddes {BIO 2474781 <GO>}

Welcome everybody, to our First Half Results here at Morgan Stanley. I'm as usual, joined by John Reizenstein; and in the audience, many of my executive team that I'm sure you can ask questions of or see in the break after.

So, very pleased to be standing here today, five years after the Analyst Presentation for our IPO and share these excellent results; they're the product of a huge amount of work by our dedicated people. We're reporting our best first-half operating profits since becoming a listed company. Three out of our four businesses grew with premiums up 5% overall, and our own brand premiums are up nearly 10%, powered by the continued momentum of our Direct Line brands.

We've delivered a very strong 88.9% combined ratio, and these strong results continue the momentum we've built. And that's given the board confidence to rebase the interim dividend up 39% to £0.068, with growth thereafter expected to follow the growth of our business. Finally, we ended the first half having strengthened the Solvency II ratio to 173% after that rebased dividend, interim.

So turning now to slide 5. These excellent results continue the already positive momentum we've built over recent years. We've made many improvements across all areas of the business, driving growth, improving our efficiency, improving our core, and generating capital. And the great news is that, we believe there's still more to come, and I'll talk you through some of the actions we're taking a little bit later.

But today, we're a business with momentum in our brands delivering good margins, and a cost base we can both improve and leverage. And this gives us the confidence to share with you, today, some refreshed medium-term targets. And these targets are: to continue to reduce our cost ratio and our commission ratio; to maintain a 93% to 95% combined ratio throughout the medium-term; to grow the rebased dividends in line with the business; and finally on capital, we're now targeting to be in the middle of our 140% to 180% Solvency II risk appetite range; and of course, we maintain our long-term ambition to achieve at least 15% a RoTE.

With that, I'm going to hand over to John to highlight the key drivers behind the excellent results.

Anthony Jonathan Reizenstein

Thanks, Paul, and good morning, everyone. Today, I'll just give an overview of the main trends of the first half results. As usual, you'll find all the detail in the statement. As you can see from the charts on slide 7, it's another very strong set of results. Starting with premiums, our own brands continue to grow across all of our Personal Lines products and Commercial, partly due to another very strong period for the largest of our own brands, Direct Line.

We reduced our expense and commission ratios in the first half, reflecting growth, business mix, and lower payments to partners. Our combined ratio of 88.9% is 0.7 points better than last year, and well-below the 93% to 95% guidance that we gave reflecting seasonality, benign weather and an Ogden rate. Finally, annualized return on tangible equity was 26.1%, which is 3 points better than the first half last year.

Turning to premiums on slide 8, we've seen continued momentum across the portfolio in the first half with 5% growth overall, mainly driven by Motor. Motor premiums grew by 10% due to a combination of pricing, strong new business growth and improved retention, particularly in Direct Line.

Home was down 4% due to partner business, while own brands were broadly stable, and that's despite pricing actions taken to mitigate claims experience. Rescue and other Personal Lines continue to grow premiums; they were up 8%, as growth in Green Flag more than offset a reduction in Rescue partners. Finally, in Commercial; Direct Line for Business grew premiums 13% in first half, and NIG was also up a little reflecting positive rating actions. Overall, Commercial premiums were up 2%.

Turning to expense and commission ratios on slide 9; stable costs and growing premiums have provided us with a leverage to reduce expense ratio in the first half. The expense ratio including Flood Re was 0.7 percentage point lower than last year at 24.6%. This is in line with our ambition to reduce the ratio over time.

We also saw a significant improvement in the commission ratio, which was down 2 points to 8.9%. Part of this was due to lower payments to our Home partners, and that reflects lower prior-year releases and higher current year claims costs. The underlying commission ratio improvement is about 1%, reflecting changes to business mix and new partnership arrangements. Overall, we're pleased with the ratio improvement we delivered in the first half, and are confident we can deliver lower year-on-year ratios on an ongoing basis.

Moving on to the loss ratio on slide 10. The headline loss ratio increased by 2 points to 55.4% due to lower prior year releases. And for the current year attritional loss ratio, which excludes weather, this is broadly stable as Escape of Water claims inflations you've seen in Home was offset by an improvement in the Motor current year loss ratio. I'm particularly proud of our track record on current year attritional loss ratio, which is clear on this slide.

Prior year releases remain significant at £216 million or 14% of net earned premiums. This was lower than first half of last year in line with our guidance. Note, the prior-year releases tend to be weighted towards the first half due to the timing of our actuarial reviews. We expect reserve releases to be lower in the second half.

I'd also flag that we benefited from £50 million of releases related to the Ogden discount rate after detailed individual case review, which indicates we need to reserve less than our top-down year-end best estimate suggested. So weather was benign with just £9 million incurred to-date, this is £22 million below what we'd expect for the first six months, and £4 million lower than the previous year.

Overall, when you take into account the improvements we've made in our cost and commission ratio and attrition loss ratio, we're delivering on what we set out to do, mainly to improve current year profitability. We expect this trend of improving current year profit to continue. Over time, the balance between current year and prior year will shift within the 93% to 95% core target. The point where this rebalancing reaches maturity is several years away.

Now, let's take a look at operating profit on slide 11. Ongoing operating profit increased by 9.5% to £354 million, which as you can see is due to Motor. This is all the more impressive when you consider the first half of 2016 was a strong comparative.

Motor profit was up £65 million to £234 million due to the Ogden release, a 2.9 percentage point improvement in the current year loss ratio, and higher installment and other income. In Home, the picture's a little different, mainly due to having a particularly strong result last year. Despite lower prior-year releases and higher claims inflation in the current year, Home still managed to deliver a sub-50% loss ratio, which is another great result.

Commercial held profit at flat at £30 million. Lower prior-year releases were offset by a better attritional loss ratio and lower commissions. Rescue and other Personal Lines profit was also stable as a better Rescue result was offset by lower profits from other Personal Lines.

To focus now on the major moving parts in the half, starting with Motor on slide 12. Motor pricing was very strong in the first half as our risk-adjusted prices which exclude IPT were up 11%, a little higher than the latest ABI figure. We took pricing actions to manage both normal claims inflation, which remained around the top of the range, plus the change to the Ogden discount rate.

We deployed our pricing changes to reflect our actual experience on large bodily injury, which meant younger drivers saw the biggest increase. We increased prices more than the market for these younger drivers, and as a result, our risk mix reduced in the first half. The strong trading momentum, particularly in our Direct Line brand continued throughout the first half. We wrote good volumes and retention remains strong, all of which helped to deliver Motor premium growth of 10%.

In Home, the picture's different although the result is still robust. Escape of Water continues to drive high claims inflation, well above our long-term expectation. We took a range of actions to mitigate this rising cost through pricing, underwriting, and claims management.

Overall, we increased our own brands prices by 2% in the first half, with greater rating action taken on new business, meaning we wrote fewer, new business policies. However, we continue to protect the value of our back book and our retention remains strong; this meant that overall, premiums are broadly stable, while policy count increased a little. The pricing environment in Home continued to lag (09:22) claims inflation in Q2. Although there was some signs that the market has started to respond to Escape of Water claims inflation.

Not a great deal to say on investments. You can see, we generated income of £93 million below AUM, a little better than last year due to slightly high gains. The higher gains occurred in the first quarter this year; the outlook is unchanged on gain. We don't expect material gains in the second half.

The income yield was 2.5% in the first half, although we expect to come in near a 2.4% for the full year. Our investment strategy is defensive at present given the uncertain market and political outlook. We've a long cash position on the expectation; some might say, hope that yields will rise.

Finally, a few words on capital and dividends, starting on slide 15. As you can see, we generated around £280 million of capital in the first half, which is broadly in line with IFRS operating profit post-tax. There was a small movement in the SCR, which was due to some minor modeling adjustments. So we finished the half with an overall surplus at just over £1 billion post the interim dividend.

Turning to dividends on slide 16, as Paul said earlier, we rebased the regular dividend to reflect our confidence in the group's ability to continue to deliver strong profit and capital generation. We've rebased the regular by 39% increasing interim dividend at £0.068. Going forward, we expect to grow the regular dividend by 2% to 3% per annum in line with our business growth.

Finally, our solvency ratio on slide 17. Paul mentioned, that in normal circumstances, we will target the middle of our risk appetite range. As you know, we consider special dividends at the year end. In that context, it's encouraging to report a ratio of 173% post the interim dividend.

So despite being up against a tough set of comparatives, and the challenging team's (11:18) environment in Home, we again outperformed and delivered excellent results in the first half, albeit with a tailwind. Paul?

Paul Robert Geddes {BIO 2474781 <GO>}

Thank you, John. As I said at the start, it's been five years since our IPO Analyst presentation. And I'm really proud that we've delivered excellent service for our customers, and great returns for our shareholders.

With that in mind, we thought it was worth taking some time this morning to update you on the DLG proposition and share with you some of the latest initiatives that we're working on.

Our proposition starts with the customer. As you can see on slide 19, we have the two leading general insurance brands in the UK with Direct Line and Churchill.

We've delivered a step-change in our Net Promoter Scores by improving our phone and digital journeys and through investing in our people. We've given our customers innovative superior propositions that are unique in the market, and we work extremely hard on our pricing, step-changed our price competitiveness, while still hitting our target loss ratios.

In combination, our own brands have been growing strongly, in particular, Direct Line, where you can see on right-hand-side, we've just celebrated passing through 4 million customers. And we still have a lot more ambition.

On slide 20, we outline the attractions of the DLG proposition. Our scale and our own brand momentum forms the first part of proposition. Second, we have a proven track record of disciplined underwriting, claims excellence and cost control, which has enabled us to write this business at good returns.

Thirdly, our business is highly cash generative, supported by a very simple and high-quality balance sheet. And this means we have been able to generate the capital to deliver high dividends and to rebase the regular dividend. Finally, the diversity of our business, and the investments we're making for the future means we can adapt to meet the ever-changing needs of our customers.

And over the next few slides, I'm going to give you some insights on the actions we're taking to grow current year profitability and support the growth in our dividends. It's split into three areas. First, we plan to maintain steady revenue growth by investing across our products, channels and brands, and by exploring adjacent opportunities.

Secondly, costs remain central to our plans, and we are investing to improve our cost competitiveness. Third, we constantly strive to improve our underwriting claims and pricing capabilities and have numerous exciting initiatives here too.

Let's start with revenue growth on slide 22. As you know and as shown here, we went through a period where we right sized the company, we shed unprofitable business and started to build the capabilities needed to grow profitably. And having turned the corner, we've been consistently growing at attractive margins. And our target is to continue to leverage our competitive advantages and grow our valuable owned brands and the overall business. We never stopped investing throughout our rightsizing, building our capabilities on PCWs, reversing our Direct Line brands and building our new Direct Line for Business offering.

We will continue to invest in these areas and we plan to deliver even more new and unique propositions for our Direct Line customers, as well as supercharging our Churchill brand for the PCW market. Our Green Flag Rescue business has delivered double-digit growth and we plan to continue this. Having just appointed a new managing director, we're ready to challenge the two market leaders in this space and we recently launched a highly competitive new TV advertising campaign.

Aside from these brand activities, we see many new opportunities to leverage our strength. In Commercial, we're making things easier for our SME customers and more of this in a moment. It will make easy for our existing customers to meet more of their insurance needs with us by our Next Best Action initiative. We also see opportunities to expand our quote footprints from our existing model to quote in new areas.

Finally, we're also pushing into adjacent categories, where we think we can use our capabilities and scale to make things easier and better value for customers, such as our investment in Roadserve, which will help us to provide affordable and convenient car servicing to our motor insurance customers. Overall, we expect these actions to support 2% to 3% growth in our own-brand policies.

Moving now to costs which remain a major component of the plan. As we rightsize the business, we reduced our costs and that allowed us to maintain our expense ratios. Now, we have growth momentum, we can start to leverage our platform, open the jaws and improve our cost ratios. As you know, we're targeting to reduce both our commission and expense ratios in 2017 and beyond. This is key to us growing the current year profit contribution.

We outlined here just some of the many actions we've taken to drive further efficiencies through our flexible and agile technology and process. We're using robotics for high volume repetitive tasks (16:47) and we're targeting to automate 35 processes by the end of this year. We're going to continue offshoring where appropriate using both South Africa for voice services and India for back-office services. And now, we have over 1,000

FTEs overseas. Enabling our customers to do more for themselves has been an important part of our improved efficiency. In the past 12 months, we doubled the number of customer online interaction. But there's still a lot more we can do here.

We're also investing our own capabilities with some key senior hires in the past 12 months from outside the insurance industry, bringing best practice and expertise into the group. Last year, we brought in a new Chief Procurement Officer. He's already delivering significant savings on IT contracts and on claims indemnity spend.

As part of our upgrade to our IT infrastructure, our new CIO is undertaking a redesign of our operating model with an ambitious cost reduction plan by retirement of old expensive legacy systems and more efficient ways to procure capacity for our new IT estate. We still have significant investment to get where we want to be, but we are moving into an exciting phase.

Our third and final priority is delivering excellence in pricing and underwriting. We believe we're good at this already as demonstrated by our strong financial results. We've improved our attritional loss ratio to a really attractive level, and we intend to remain (18:13) this whilst increasing our competitiveness to support further growth.

Having created a competitive position in PCWs over the past five years, we believe we can see more on this channel. And this opportunity is underpinned by forward initiatives and even greater use of third-party data.

Amongst the long list of claims initiatives, we're seeking to further expand our accident repair network, which gives us real cost and service control whilst still allowing us to support some unique customer propositions. We're also investing in new initiatives for the long term. As part of our IT transformation, we're implementing a latest generation pricing in June, which will allow us to respond quickly and creatively to new opportunities and to new data sources.

In the medium term, we're also building an entirely new pricing approach from our existing model. We intend to run this alongside our existing pricing model to expand our competitive quote footprint. This will take time to build and test, but it's an exciting prospect for us to build from scratch with the newest techniques (19:15) data and technology available.

Now before I wrap up, I'm going to share with you in a bit more detail one of the initiatives I've spoken about and that's Direct Line for Business. You may recall the Direct Line virtuous circle from the full-year results, shown here on page 25, showing how Direct Line have high-value customers allowing us to invest in better service and unique propositions, attracting high-value new customers and keeping the existing. And so, the virtuous circle continues.

All of these things are equally true for Direct Line for Business. Indeed, the two sides of the business have many of the same customers.

So, turning to slide 26. The DL4B as we call it launched just under 10 years ago. We started by offering the obviously adjacent categories of van and landlord insurance, where we leveraged our Personal Lines in Motor and Home expertise. As you can see from the chart the DL4B has grown rapidly over its 10-year history and now accounts for over £100 million of premiums and over 450,000 policies. Today, over 85% of the business comes from landlord and van and here we still see significant growth opportunity from unique new propositions, and they also continued both the benefit from many of the same initiatives growing our Home and Motor businesses in Personal Lines.

The remaining 15% of the DL4B is made up of targeted small and micro business shown here in yellow. And we believe there's significant opportunity for us to grow our share of this market. We're excited about the prospects for the direct market and smaller microinsurance. The total market will continue to grow driven by economic technology and lifestyle trends. And within this, we believe that about £3 billion of the total market have the characteristics to go Direct. And we want DL4B to be instrumental in creating, in growing and in taking a good share of this market.

The smaller micro segment is a heterogeneous market made up of many different trade segments from builder to shopkeepers, hairdressers to web designers, consultants to cake makers, butchers to B&Bs and everything in between. And whilst these businesses are very different, there are four common features that cut through and will drive customers to buy their insurance Direct.

Firstly, many small business owners believe that commercial insurance is complex and so can be a little a daunting to do on their own. Having a strong familiar brand in Direct Line is a great asset. And we're going to add to that specific marketing to show that we understand each market and profession that we enter.

Second, we recognize that many small businesses need help in understanding the type of cover they need. Looking for example at the Hair and Beauty profession, there are 10 different product covers needed to cater for all the potential requirements. And so, it can be hard to understand which ones you need, especially if they're written in insurance language.

So, we thought an interactive cover with it using plain English to ask simple questions that are built on the previous answers that the customer gives. At the end of the wizard, shopping basket and paying for cover modules reflect their business and their need.

Thirdly, our extensive research has revealed the insight that each business owner feels their business is truly unique. Traditionally, small businesses have been offered packaged products with little flexibility to add or move section, which can leave customers either with too little or too much cover.

So we've build modular products, so the customer can create a truly bespoke policy that exactly meets the needs specific to their business. And finally like any Direct Line product, customer expects a really easy purchase process and good value. So, our brand new end-to-end digital solution that allows customers to pay their business insurance in minutes and at the competitive price including easy payments and documents online.

In April, we launched a pilot product on our new platform for the Hair and Beauty trade. And we've asked Jazz. She's in the room with us. Runs Direct Line for Business. She'll run you through how quick and easy and good value it is to buy a Hair and Beauty policy on your smartphone. Play the video.

Jazz Gakhal

Our customer starts from the Hair and Beauty insurance landing page and clicks to get an online quote. This brings her to the insurance wizard where she's asked four questions in plain English about her business that she can answer. This is helping her to personalize her policy. She's a hairdresser and runs a mobile business and has no employees. She can see that the policy has already started to be personalized, because she's not presented with building all contents covered and she runs a mobile business and not from a salon.

She's interested in taking effective (24:14) taking covers, is a bit unsure about what this cover this. So, she clicks on the question mark, which brings her help facts in plain English. She would like to take the cover, so clicks. She moves out the basket, an icon she's familiar with from many of the retail websites, and sees that she's got mandatory public and product liability cover as well as the effective (24:33) taking that she's just added. She clicks to continue. This takes her to the risk capture where she'll provide the rest of the information. She can see that the system has retained the information that she's provided in the insurance wizard such as the fact that she's the head of a – she proceeds to complete the rest of the fields.

The system has retained the information that she's a mobile business, so she didn't have to repeat this. And also the fact that she has no employees. She selects her liability limit from the drop-down list and provides the information required for effective (25:23) takings. She reads and agrees that she can comply with the important statements, and confirms that she's had no previous losses in the last five years.

She's pleased with the price that she receives, and the fact that the price and the excess is broken out under each cover section. This provides transparency that she needs to decide whether each section is value for money. She decided that she'd like to see the price without effective (25:51) takings, so a click from the bin icon to remove this cover.

This updates the price automatically. She also sees when she scrolls down that she still has the option to select the covers that were presented to her in the insurance wizard that she's rejected at the time. She can also see the effective (26:11) takings have been added, so she could re-add this at any point. She's completed her quote.

Paul Robert Geddes {BIO 2474781 <GO>}

All on the smartphone slightly speed it up, Jazz, yeah. Slightly or a very quick typist. We've had fantastic feedback from customers recognizing both the ease of the journey and the ability to create their own tailored policy. A quote for me perfectly captured it. This is interactive and more fun to do because you're picking up the things and putting them into a bundle yourself like a shopping basket. You almost feel as if you're building something yourself. I've never come across anything similar to this before.

So, we're offering SME the opportunity to confidently find the right cover for their unique business at the right price. We're going to transform the way customers buy insurance Direct and watch this space as we plan to further – to roll out further products from later this year.

So that was just one of the many initiatives we believe will help support future growth. And today, we are a business with momentum in our brands, delivering good margins at a cost base we can both improve and leverage.

So, to sum up. As John has outlined, we've delivered another half of excellent results, and the business has real momentum. And having shared some exciting plans, you can see why I'm hugely energized by the prospects for our business. This gives us the confidence to extend our combined ratio target beyond our usual 12 months target and to materially increase our regular dividends by 39%.

With that, I will hand over to questions.

Q&A

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

All right. Give us a second. Excuse me. All right. Start over; actually we don't need microphones (28:06).

Q - Dhruv Gahlaut {BIO 16209870 <GO>}

Good morning. Dhruv Gahlaut, HSBC. Three questions. Firstly on Solvency II, you talked about targeting to run the business in the middle of the range. What's the timeframe then, if you have to look at – as in terms of direction of travel, how quickly we reach there?

Secondly, on Commercial Lines business. Is it possible to get the split of combined ratio between the NIG book and the Direct business you have? You've also talked about – and third is on the Commercial business itself, the expense ratio still looks fairly high. So then, how should we think of this business in terms of the long-term on combined ratio total as well as the expense ratio side? Thanks.

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

So, I'll – in reverse order, that's normal. So, Jon here runs the Commercial business, I think he'd agree that the expenses remain an opportunity.

A - Jonathan Paul Greenwood {BIO 17958326 <GO>}

As across all over the group, yes. Yeah. We don't specifically split out the profitability of the two bits of business. Suffice to say and I think we said this previously, DL4B is comfortably ahead of our group RoTE targets. And with Neil, Neil's task is to get the NIG business towards it. Already operating at its own we think is attractive for us in terms of generating real profit. But it's still not quite at the group's target. So, Neil is busy executing real underwriting and pricing discipline and getting right away in the commercial market.

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

Yeah. On the new policy on the target capital (29:41), we're going to operate in all sense of it at the middle of the range, well, it's from now. And why haven't we taken it down to 160 now? Well the answer to that is because, as previously stated, we talked about specials once a year at the year-end when we've got the full results and we've got the business plan. So the first time, we'll consider it special is then, but the 160 applies straight away.

(30:06). Yes.

Yeah. A couple from me please. I was just curious on your IT program expenses. What's the updated timeline for that? When do you expect those to fall away? And then you mentioned that you're looking for a steady footprint expansion as a revenue opportunity, just wondering if that's primarily driven by Direct Line for Business or there's other footprint expansion in the other segments as well?

A - Anthony Jonathan Reizenstein

Yeah. Absolutely. So, it's both for the products on the DL4B, but actually important in Personal Lines, there's still part of the market we don't quote competitively or quote at all. Quote at all is going to be not just one initiative we know we need to go carefully. So, there's a number of initiatives behind that.

And then quote competitively is another opportunity, which we mentioned the alternative pricing approach for the bunch of very, very clever people doing lots of very exciting maths and with new models. And our objective there is to think about that as an additional pricing model so that we can increase. Because at the moment, our limitation of our competitive quote footprints are single pricing engines behind our multiple brands. So if we can get a second alternative, non-correlating alternative pricing model, that could significantly increase our portion of the market that (31:22) competitive because quoting at all is less important than quoting competitively.

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

Our key program is a multiyear thing, and this thing we've launched today is quite a big deal. The Direct Line for Business platform is complete end-to-end new solution, I encourage you to all go on it and where I (31:40) tend to be helping these professionals for the day and get a quote on it. So, that's fantastic. This is going to be a multiyear program in terms of the cost, John, therefore, what they're for?

A - Anthony Jonathan Reizenstein

I think we said before it's the same, we're in the sort of £80 million to £100 million a year investment. Much of which gets capitalized, but not all and that's probably going to continue for a while. But eventually, we will get through much of that and then it should reduce somewhat. But it'll still be – we're still be spending tens of millions in a business of this size, which is becoming quite a hi-tech business.

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

Okay. Thanks John.

Thanks. Just two questions if I may. Firstly on the medium-term target, can you give a bit of idea of what medium term, is it three years or a bit longer? And then, what gives you the enhanced confidence to put out these targets for multiyear, in particular in an environment where next year, we may see some changes around Ogden rate and with tax reforms, et cetera, and volumes could come down. So, maybe a point to fact is that maybe you got cost ratios coming down, that gives you a bit of flex should pricing come down or do you caveat it, depending on what happens?

The second question is on the Ogden release, which is about a quarter of the charge you took six months ago. You highlight that it's individual bottom up. But can you give more color in terms of what specifically drove the releases and how we can sort of maybe read that a bit forward. And I'm (33:03) released still reserve that negative 0.75% to 1.08%.

(33:07)

A - Anthony Jonathan Reizenstein

Yeah. Well, the period of medium term appears to be taxed off (33:11) our businesses plan, our business plan extends to 2020 at the moment. The – I'll do the Ogden one, anyone do the Confidence (33:20) one. The Ogden one – I'll give you an example of one of the things that we discovered when we did the bottom-up review because we got more than 2,500 multiples in injury claims. And remember that the best estimate we gave at the year-end was done under very tight conditions, very ratable conditions.

So, just to give you one example, the impact of the interest rate change, yeah, (33:51). Just to give you one example of one of the differences that we observed. The impact of reduced longevity at minus 0.75% is much greater than it is at high rates and there's a real complexity there. And you really only see the impact of that when you get into every individual case and look at the longevity of those cases as opposed to a model, a model group. That's just one; there are a few others like that which came through. And obviously, we are conservative in our reserving. We have been for quite several years and we were with Ogden as well.

So that's really to explain that. We still reserve at minus 0.75%. We still price at minus 0.75%. And so, hopefully that answers your question. You want to deal with this?

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

Yeah, I think on looking at it a bit further. I mean it's probably there is – we got a good run at delivery in the last five years. I think part of what's driven our confidence is that we keep trying out the good 93% to 95% or better cost and our business has now been growing for a while and I'll say we got a bunch of new initiatives coming through which we continue to feed that.

Now, clearly, we're not totally unaffected by market cycles. So, a few words on that. I think the first thing is we think 93% to 95% is kind of setting appropriate balanced level of profitability that we think can grow at. Growth is always a secondary target to us to value, the 93% to 95%, and long term 15% is what kind of guides us. So, should the – we always reserve the right to shrink in a market or pull back from market if we don't think we can get the value that we want. How to protect the 93%, 95%, you have to go get on costs. And again, we've got a good track record of doing the costs, to maintain the expense ratio that we need to hit. So, that's what we're doing in a downturn. Yeah, (35:44)

(35:47), Deutsche Bank. Three questions for me, please. First, I think, John, you mentioned that capital generation is kind of in line with IFRS profit. I was just wondering in terms of development of capital expenditure in the second of the year, so it's £38 million in the first half and last time it was some surprise that number was a bit higher than usually expected?

Secondly, are you able to provide some sensitivity of your solvency ratio to change in personal injury discount rate? And finally, I think, on solvency. Can you tell what assumption you have made for PPO propensity in your Solvency II post Ogden? I think one of your peers reduced the PPO propensity assumption by half after the event?

A - Anthony Jonathan Reizenstein

I'll deal with the first and third. I'm going to go ask you about the second one again because I didn't get it. We said – yeah, CapEx, certainly, I mean, you're right. In the first half, we said, £80 million to £100 million, it could be a bit high in the second half, but it's going to be within that range, £80 million to £100 million.

Propensity, we are now at 16%. Checking with Paul (36:45) over there, it was higher, so we did reduce it, as a result of the Ogden rate. But it wasn't double, so it comes down by some 10% but it hasn't halved.

Do you want to ask the second one again?

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

Yeah, the second one was, are you able to give any sensitivity of your solvency ratio to change in Ogden rate?

A - Anthony Jonathan Reizenstein

We've got some sensitivities there. I can't remember the whole time whether we've got the one with (37:09) Yeah, we haven't got it. We haven't got it.

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

We'll take that away, and come back to you.

A - Anthony Jonathan Reizenstein

Yeah.

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

Yeah. (37:19) you show a price change with 11% for Motor. You say claims inflation at the top end. So, how much do you think you can pocket in terms of underlying loss ratio improvement going forward, although considering the upcoming reinsurance review?

The second one is related to this. I'm a bit confused by the messaging on page 10, as well you said the mix is going to change more underlying less reserve releases, but then on page 24, you say you maintain attritional loss ratio. What is now the story? Is it stable or improving? And why the decrease is improving?

And then on the reserve release on page 37, you switched from a gross to a net picture and you show quite a sharp break in 2014. So, why did you switch your reporting? What do you want to tell us with this, showing quite significant break in reserve releases on a net base?

Good. (38:16) rate. So, we priced on a like-for-like basis about 11%, slightly ahead of what the ABI set the markets on. The ABI 11% increase IPT. So, if you want, on a like-for-like basis, we're a bit ahead.

So, let me tell you the inbound pressures. So underlying claims inflation is, say, running around 3% to 5%, Ogden gross cost, we're saying, is about 7% to 8%. So, that might say are we price enough. Going the other way, we've got some good trends on bodily injury. So, we are confident that we are the right side of pricing claims inflation for us.

Now, also remember that's gross – re-pricing gross claims costs. So, obviously we are – we'll a little bit better than that in 2017 where of course, it's largely reinsured. Our view is – our forward-looking view is for a rational re-pricing of reinsurance arrangements and it's very too early to say whether it will be rational. Clearly, if it's not rational for us, it won't be for the rest of the market. And obviously that will have pricing implications.

We also have the optionality that some others don't have to negotiate half of the reinsurers because we don't need to buy every single layer just to sort of having a balance sheet. So we're working (39:38) those negotiations, I think, confidently.

So, confident that the attritional Motor improves from this price?

Yeah. I mean obviously we price gross Ogden now. So, unless the reinsurers are going to jump in (39:56) kind of what I would regard is irrational, we already priced Ogden where the right side of loss ratio aligned given both Ogden and the underlying currency inflation, partly explained the fact we're doing well on body injury.

A - Anthony Jonathan Reizenstein

Just on the second question then, so we're distinguishing between our expectation on attritional loss ratio and our expectation on currently operating contribution. So, we're saying on the latter that if you look at the past, we're saying this will continue. We've got – we're targeting to improve our current-year performance and the totality of our current-year profit will improve. And that obviously reflects growth. It reflects what we're doing, expenses and commissions, and so on and other income, everything except prior year.

Now, on attritional loss ratio, we've been very stable. It's come down and have been very stable. We're very proud of that. Looking forward, we will continue to invest in improving it where we can, but we also see a few – the obvious headwind. So, when we – in the relation with Nationwide, for example, that will cause an uptick in our Home attritional loss ratio because their performance is very good on a loss ratio basis.

So, we're not saying we'll get dramatic improvement in our attritional loss ratio for the group as a whole, although we'll be doing our best to protect it, but the other ratios will improve. And I think as we grow, we'll get that improvement now as well.

On the third one, 2014, we went from a £3 million deductible on the insurance to £1 million, as part of our general derisking over time. And we're showing net, so you can see the impact of that. Now what you could reduce from that slide is maybe we are buying too much reinsurance or overpaying or overestimating the risks of those layers and we shouldn't be doing that. That only shows one dimension, which is the loss ratio dimension. Of course, there's another dimension, which is capital utilization. So, the reason or a big reason we buy more insurance is for capital management purposes and we look at it very much on a return on equity basis.

And obviously, the higher layers cause new capital consumption for the long-term. So, the higher layers give you the PPOs and that will – you might get your loss ratio better one year, but you're going to then have that drag on your RoTE for 20, 30, 40 years, which is why this is not probably only dimension we look at that. But hopefully that does answer that particular question. Now in addition to 2014, certainly when we first reserve for it, it looks like a bad year time, it's actually performing better than we thought.

Q - Edward Morris {BIO 16274236 <GO>}

Thanks. Ed Morris, JPMorgan. Two questions, please? The first is on sort of technology investments you're making and how it relates to cost savings. Some of the techniques you showed looked quite advanced. It would be helpful if you could bring to life some of the areas where you think you're not so advanced, where you should improve, what capabilities do you not have that should get better.

And the second thing is the Churchill brand, you talked about supercharging that. Can you just explain how the strategy is slightly different for Churchill; because it sounded like it's more about price rather than differentiating your brands from the market?

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

Yeah. I'll try and take both. So, Churchill has a slightly different job to do as a brand than Direct Line. Direct Line needs to say to everybody, every month; whenever they're in their insurance purchase cycle, remember to come to the shop called Direct Line. Churchill, we don't have that task to do. Churchill just needs to – when someone's go to the shop, call the price comparison website, at shelf edge, persuade people to spend a little bit more money on a better brand. So its marketing channel is a bit different than that.

It's still a brand. It still have benefit as a brand. The fact that customer is choosing a brand for a bit more money, tell us a lot about the quality of the customer, and that's what's valuable for us to do that.

So it's a slightly simpler task, it'd be a less expensive, less elaborate thing than Direct Line reboot, but still worth having. Remember, we didn't talk much about Privilege, but Privilege is our kind of price rising brand that's there, where we'd want to see a kind of – towards the top of the competitiveness in price comparison website.

So we just think that, as a brand, sometimes just need a bit of extra love (44:02). And we've got fantastic award-winning marketing team that progressively say, okay, let's try and reboot Direct Line, most recently within Green Flag and the next point of call will be Churchill.

In terms of tax and cost savings, yeah, we talked about doubling the amounts of customer interactions online. It's still not where we think it can be. And we do think there's opportunity for customers as they kind of expect now, they do more and more things straight, direct on the smartphone. And you saw an example in Direct Line for Business, how simple it is if you can get it right. It's kind of, for many instances, the way people would like to interact.

We don't see, by the way, the demise of people in the equation. We do have a fantastic contributor, which we'll continue to invest in, are fantastic at understanding and meeting customers' needs and product expertise, being empathetic when people have a cold. But there are some tasks where our person isn't adding much value, and it could be done direct both in claims and in terms of sales. So, that's one of the kind of key areas.

And then, there's some back-office things; we can be more efficient how we deploy prices, for example, in these systems.

Yeah, (45:08).

Q - Dominic O'Mahony

Hi, Dom O'Mahony from Exane BNP Paribas. Thank you. So three questions if I may; and the first is on combined ratio guidance. So if I remember correctly, excluding the Ogden write-back, you're running at about 92%, and obviously, your guidance this year is 93% to 95%. Is that explained entirely by the fact your reserve review cycle is in the first half of the year or rather specifics, would actually, do you think, take you back to that range or is indeed it's just a sort of a way of providing leeway, seems to be diverse to me (45:41)?

The second question is just on the pricing, pricing in Ogden. As you say, you've priced in Ogden, I think entirely, it's my temptation what you said (45:51) coming to the market as well, more broadly. And the reason I ask is this, there was some view in the market that the pricing would gradually increase as the reinsurance cycles kick in. And with that point of the question, will it suffice if it wasn't already, and then your reinsurance kicks in 2018, does that mean you actually headwind into 2018? So is there a headwind?

And then finally on Direct Line brand in Motor, which as I understand is powering a lot of the growth. Just want to understand where that growth is coming from. Is that coming from taking share within sort of the direct channels, or from the Avivas, for example, of this world? Why is it actually pushing back on the share of PCW as the share of channel? Thank you.

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

Very good. So on (46:41) I mean, I don't think customers wake up every morning and say, I'm a PCW customer, I'm a Direct customer. (46:46) customers will probably go on price comparison website and check prices, and then go online and bought Direct Line very simply.

So these are not two kind of parallel universes. Certainly, PCWs are still three quarters weighted by most insurance today was for us – it's about half that for us, so it's about kind of 36 for us (47:10). So that ratio – so there deal successes also coming from both; these are kind of fungible populations of people.

What we tend to find, what we said last time is by someone choosing to come to direct to us, they are going to find themselves (47:25) values quality that values brands, and that tell us it's a valuable customer who can then afford to get (47:31). So that's a really nice thing before going on Direct Line.

And as we get confident, as it works, as we can acquire customers Direct as we can on PCW is we keep feeding it. There's a real success story, and we haven't listed this with awards, but we continue to win awards in Direct Lines customer service for marketing globally outside insurance. It's a fantastic success story which we'll continue to pour you with on subsequent months.

The market has – so I don't think we've got the headwinds, because we've done what we need to do on Ogden. As I said, the only thing is, if the reinsurers are irrational on how they price it, we're going to have to look at the cover we buy or wrap up. But I would say to our guidance that we've – Ogden, we think, we've dealt with on pricing.

Our competitors, I can't really speak for them because, obviously, their input costs might be different to ours. We said we've got the offset from the fact we're doing well on bodily injury. So, we'll have to wait and see.

And then, we've obviously taken a slightly differently view to the market on where the Ogden costs should fall in terms of, we think, young drivers are disproportionately affected, because they tend to have their own passengers that are disproportionately affected by that long term.

A - Anthony Jonathan Reizenstein

For vehicle?

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

Sure, Yeah.

A - Anthony Jonathan Reizenstein

So again, you're right on reserving, and that's one thing. And the other thing is weather because we assume that we take until 31st of December, we could get all the way, all the year's weather, right. So we began to see the level, it's now going to be average, for the rest of the year, we assume it's going to be getting colder for the rest of the whole year.

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

Yes. Ravi?

Q - Ravi Tanna {BIO 16926941 <GO>}

Thanks. It's Ravi Tanna from Goldman Sachs. I just have one question please on the home insurance. And you've referenced that you could upgrade just quite a lot of the Escape of Water claims inflation, and therefore, your policy count come down a little bit. Can you give us a sense as to kind of the broader competitive dynamics in Home Insurance market others are growing by the cross-comparison channel? To what extent is that also impacting top line and is this capable to inflation, kind of industry-wide trend from what you're observing?

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

Yeah.

A - Anthony Jonathan Reizenstein

So, do you think it's industry-wide? The market has priced a bit, which most of this kind of background trend is positive. We priced a bit overall. We priced more significantly on new business, and that hits our new business volumes.

And pricing is only one of the three elements that we're going to use to tackle the Escape of Water. Some of it's underwriting, and some of it's also claims initiatives. Our aim is to get back to where we want to get to for 2018, as I said. So all of it went by in 2017.

We think it's industry-wide, as we said, caused by the trades. This is water coming through ceiling, that's a plumber, that's an electrician, that's a chippy, that's a general builder and those are inflating trades. And we had a little bit one quarter doesn't (50:16) make a summer, we've had one quarter slightly better trend on Escape of Water, but still early.

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

Yes.

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

Good morning. It's Andrew Crean, Autonomous Research. Firstly, you gave in Commercial that you're above a 15% resi (50:35) in Direct Line for Business, and below NIG. Could you do the same thing in your Motor account between the Direct Line, direct brand and your PCW (50:46)?

Secondly, a high-spec couple of questions, you can dodge it if you want. If...

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

I can talk to the first one (50:57).

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

Ogden may or the Commission may suggest that Ogden is over £1 million, this is going down the PPO route, what would be the impact of that on your Solvency II capital position?

And then, thirdly, what is your assumption that sits behind your industry assumption, your market assumption that sits behind the 2% to 3% policy growth? Is that against the market growing 1% or what?

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

Good. Three good questions. I mean, I think we do view our Motor portfolio as a portfolio, so we don't break our RoTE by brands. But you'd be right in thinking if we did directionally, Direct Line will be higher and our PCW brand will be lower; as we've indicated, but I'm not going to tell you against what thresholds.

Ogden?

A - Anthony Jonathan Reizenstein

So I can't give an answer straightaway. I mean, for the future, it wouldn't make that much difference because we'll be insured. As long as we stay at £1 million for reinsurance, we wouldn't get many more of those or in fact, any more of those.

Now, that's a decision we'll only take on an annual basis. But I suspect that if that were the law, then we'd be more likely to keep the £1 million reinsurance than if it wasn't the law where we probably have more discussion and option. So it'd only affect back book, and I think that will only affect the unapproved part of the back book. So we'll go away and have to think about it. Clearly, PPOs are more capital intensive than normal volume, so it will cost some money on capital, you're right.

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

To recap my first answer; when I said higher (52:39) than each other, so I'm really being very unhelpful to answer it. On the industry assumption, I mean, I think, listen, we're in a fairly stable market size, we think, in some policies. The thing which we've indicated, obviously it's car technology, car sharing, autonomous cars. I think if you take it kind of 10, 15, 20 year basis that might change. So I think – but I think, we're relatively safe on a – I'd say, relatively kind of benign on an ISP basis. And in terms of the cycles, we're not prejudging exactly how cycles will play out other than our behavior in previous cycles has been to get the loss ratios that we want to cope with the volume.

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

Policy count.

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

No. I think, policy count, we'll continue to be – I'm just looking at my – two people that run big categories. Yes?

Very gentle growth for this foreseeable future. Very gentle.

Fairly, yeah. Maybe.

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

The SME?

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

SMEs could be more positive.

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

What I'm trying to get to is, sort of 2% to 3% represents market share gain?

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

Yeah, some market share gain, we'll reference some market share gain.

Q - Iain Pearce {BIO 19522835 <GO>}

Hi, Iain Pearce from Berenberg. Just a couple of questions from me. On the Nationwide agreement, you said that all have negative effect on the loss ratio in Home. Could you give us some details on how that affect the commission ratios in Home and whether that will offset and whether you should actually see an improvement in your combined ratio there?

And then also, I think there were some delays that you were talking about in transferring that across (54:18). Can you give us maybe some more details and the time scale of when you expect that portfolio to go across?

And then secondly, on the footprint particularly in Personal Lines Motor, could you give us some details on what your footprint roughly is at the moment, and where you see that potential getting to, and so what the rationale you see for increasing that footprint? Whether you're seeing attractive segments to the market? Mix pricing segments that you were not potentially in at the moment and that sort of – type of things?

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

Yeah. I'm getting the last one. I mean, we're kind of – we're around two-thirds of the market, which we quote. You never want to get to 100%, I don't think you've got much appetite for drunk-drive convictions for example, but I think it could be more.

So, there's definitely headroom and the nice thing is, it's pretty – it should be kind of quite linear. We're going to tackle it in (55:01), the same is true on Home, so we don't dispatch today or – SME we don't to do, I think, buy-to-let with students. Then we have some underwriting restrictions (55:13) in what we said is the competitive quote footprints initiative in alternative pricing.

A - Anthony Jonathan Reizenstein

NBS. On the ratios, yes, the loss ratios, that will make, I'll say a little bit higher, when that goes. Obviously, you will have a beneficial effect on commission ratio. Obviously I can't – you might be able to check it out when it happen, and try and work it out. But it's not something we're going to be able to say because it's not disclosed thing, but it will come down. We also will see commission ratio reduction for, if you like, better reasons than that. We see the business mix and all the changes improving our commission ratio as well as in H1 coming off.

Expense ratio, it provides a bit of a challenge on the expense ratio, because, obviously, the volume goes, but we get – we have some fixed costs that we can't easily remove. And obviously, dealing with that is part of our overall cost plan, and we've said we want our expense ratio to come down over time. So that's part of our plan.

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

And still the very, very end of this year. So, I think our expectation on the timing, that actually means we won't write any GWP next year, it will start with our NEP. Yes, Alan?

Q - Alan Devlin {BIO 5936254 <GO>}

Alan Devlin from Barclays. Two questions; first of all you're your alternative quote engine (56:25). I mean, how exactly does that work? Is that quoting different quoting from different brands or different distribution channels, et cetera?

And then on the – just on the reinsurance, is your working assumption that you keep if pricing is rational that the layers are – you continue the current layers are; given the lower layers are more working now, would you consider everything will matter? Thanks.

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

I mean, I think we always have said there will be layer of reinsurance rationally on a cost to capital basis. So we'll do that again this year. We're just saying, which marketing the cars of our reinsurers is their choice have a bit of those negotiations.

Look, I'm going to say a bit (56:57) in terms of pricing. But – because it's – we're going to do some kind of quite cutting-edge staff, and we've got some extraordinary kind of people working on it, but we're talking about some very interesting things. So I think it will be the subject that probably another one of our like, they also do deep dives and we can announce a bit more.

In terms of brands, we are kind of open minded about exactly how you deploy it whether it's a new brand or you put it under existing brands or whether you do some sort of algorithm to blend the best of the two qualities. So those are still in consideration. But it's very, very exciting and some quite encouraging early modeling results.

Right. Thanks. I think, we've got historic early finish here. So thank you very, very much for coming and we'll see you next time. Join us for coffee. Thank you very much.
