Full Year 2017 QBE Insurance Group Ltd Guidance Call

Company Participants

- Patrick C. Regan, Group CEO & Executive Director

Other Participants

- Andrew Buncombe, Insurance and Diversified Financials Analyst
- Brett Le Mesurier, Analyst
- Daniel P. Toohey, Executive Director
- David J. Humphreys, Senior Research Analyst of Financials
- James Coghill, Executive Director, Deputy Head of Research of Australia and New Zealand. And Insurance Analyst
- Nigel Pittaway, MD of Insurance and Diversified Financials Equity Research and Lead Insurance Analyst
- Siddharth Parameswaran, Research Analyst
- Toby Langley, Research Analyst
- Unidentified Participant, Analyst

Presentation

Operator

Thank you for standing by. Welcome to the QBE Market Update Conference Call. (Operator Instructions)

I would now like to hand the conference over to Mr. Pat Regan, group CEO. Please go ahead.

Patrick C. Regan {BIO 15131018 <GO>}

Good morning, everybody. I've also got with me our group CFO, Michael Ford; and our Head of Investor Relations, Tony Jackson.

I just wanted to give you some additional color on today's market announcements. Obviously, I should note that we're still going through our full year year-end processes and close processes. And therefore, the Q&A today will be really limited to the matters we've got in the announcement. And there's really got 2 buckets of things I wanted to talk about. One is an update on weather activity and the second is the financial results of the review I've been doing over the last 2 or three months.

The first update is on the combined ratio, what we now expect -- the group now expects a full year combined ratio of around 104%, up from the previous 100% to 102% target. And there's really 2 main items impacting our combined ratio. Firstly, obviously, everybody in the industry saw substantial cat activity in Q4, obviously, on top of the substantial cat activities over Q3. And in our case, obviously, above our allowances for the Fourth Quarter. And in our case, that's largely due to the California wildfires, the significant late December storms we saw in Australia and we're also seeing some small net increase in our estimates for Maria, which as you remember, was easily the most difficult ones of the hurricanes to estimate at the time because of the difficulty getting access to Puerto Rico.

Those 3 items together have added around $130 million to the group's net cost of large risk and cat claims, which is now for the full year, around $1.85 billion or around 15% of NEP. And what that means is all of that adds about 1% to the Group's full year combined ratio expectations.

Secondly, we've been -- we just completed a detailed review of our year-end claims reserves. And as you would expect me to, we pay particular attention to North America and Asia Pacific to make sure we're really properly set up for the future. And following completion of that review, we've decided to strengthen claims provisions by just over $100 million. That's really in a couple of places, primarily in North America in our casualty lines within this in REIT business and then some additional reserves in our Hong Kong workers' comp portfolio. And the event has also added just over 1 points to the full year combined ratio expectations.

We've also increased the group's PoA, which is expected to be 90% at 31 December 2012, up from 89.5% previously. And there's some other small movements in the combined. We've had some additional non-cat small weather claims in North America, hailstorms, that kind of stuff, a bit higher current year combined ratio of the Hong Kong workers' comp. And some other bits and pieces have added about 0.5 point to the group's full year combined expectation.

Turning back to the noncash items in today's announcements. But firstly, on goodwill, we've decided to revise the long-term combined ratio we use in the carrying value of the North American goodwill test, which results in a one-off noncash impairment of around $700 million. We've discussed sometime, the headroom calculation is very tight and very sensitive to changes in those assumptions. And the change we made today reflect an increase in that combined ratio assumption, which is consistent with the updated business plan for North America and uses a long-term combined of the -- in the high 95% combined. So it's a 95 point -- and brings that long-term combined we're using closer to the current underlying performance of the North American business. And that's certainly not to say that we -- I don't think we can improve our North American result from here, I think we can. And we'll give you more detail on those improvement plans on the 26th of February. And second noncash item which we flagged previously was the -- obviously, the U.S. government revised the corporate tax rate down to 21% and that gives a $230 million, again, one-off noncash write-down of the deferred tax asset for North America.

A worth of noting that both of those -- obviously, both of those noncash items don't have any impact on the group's capital position. One additional factor just to note is on the cat for the year, they primarily impacted the results of Equator Re and North America, where we don't get tax relief. And, therefore, that has a distorting effect on this year's 2017's group effective tax rate, resulting in tax expense notwithstanding the fact we have that pretax loss.

So I'll just give you a few brief comments on each of the division's results. Just on the North America, the full year combined for North America is likely to be around 109%. And obviously, that was significantly impacted by the second half cats, HIM as well as those Fourth Quarter wildfires, all of which added about 7 points to the North American combined ratio. As I mentioned in the second half, we did strengthen reserves in North America. That was about $100 million, just over. And so if you think about the North American results, without those items, if you do think about it without those items, the combined for 2017 is in that 97% to 98% range. I think it is also important to note that we did a -- effective the 31st of December, we executed another loss portfolio transfer, where we reinsured at this time the commercial auto reserves. Last year, remember, we did a reinsurance transfer for our program reserves, this time for the commercial auto reserves. And I think that together with that second half reserve strengthening sets us up much better for the future in terms of reserving those.

On Europe, our combined ratio of European operations is expected to be around 95%, which is higher than last year, obviously, partly due to the cat losses from HIM and lower positive prior year development.

On Australia and New Zealand, I'm pleased to say that the remediation activities we started some 18 months or so ago continue to deliver an improved performance. And the division is expecting a combined ratio of around 92%. And we've seen a further improvement in the ANZO attritional claims ratio, notwithstanding the fact that we've seen an ongoing normalization in the LMI combined ratio. So despite the LMI combined ratio getting a bit higher, we've still seen a decent improvement in the ANZO attritional loss ratio.

In Asia Pacific, we expect the combined ratio to be around 115%, which really reflects that extra reserving in Hong Kong workers' comp portfolio.

Latin America is expected to be around 114%. And as I mentioned earlier, we're well on with a strategic review of our Latin American business.

And lastly, obviously, the Equator Re result was heavily impacted by the extreme cat activity in 2017.

A preliminary assessment of our reg capital position shows that while our capital position is obviously a bit lower because of the impact of the cats, at 1.6x PCA, it's still pretty strong. But I guess, kind of standing back from all of that, 2017 has been a challenging year for QBE, both from the cat activity, which has been pretty much unprecedented in the insurance industry. But also from the underperformance of some of our businesses.

I'll let you do the maths of what you think our, if you like, adjusted performance looks like. We've obviously got the 104% combined. That includes about 6 points of excess cat claims. And you probably got some other one-off type items, some of that weather -- extra weather-related smaller attritional claims in North America, Hong Kong workers' comp, et cetera, et cetera, which probably adds up to another point or so on the combined. But even, if you were to allow for that, our results clearly need to improve in 2018 and beyond.

Over the last few months, I have been conducting a detailed review of our businesses. We do have some businesses with strong market positions that are performing well. But we also have some businesses that need to improve. But on the back of this, we're implementing a comprehensive plan to improve the underwriting performance, simplify the group's operations and reduce risk and somewhat similar to the program that I put in place in ANZO 18 months ago.

February 26 is going to be about giving you much more detail on that performance improvement program. But just give you a flavor of it. It'll all be backed up by the so review process we put in place in ANZO, I described quite a bit to you before about how we went about that. In ANZO, we're now putting that in place fully right across QBE. We'll be implementing a program of what I call brilliant basics, that's the brilliant basics and underwriting of risk selection, pricing and claims and making sure we do those consistently well everywhere across QBE. We certainly do have some areas of expertise and strength in there that we can build on. But we need to make sure they are consistently high standard right across QBE.

Improving efficiency and reducing cost, simplifying our portfolio and reducing risk. And as I mentioned, one component of this is completing that strategic review of the Latin American business. It's also worth noting that as a start on that, we've now sold our Thailand business. Although we continue to drive improvements in North America, where lots of good work has already been completed here, we've executed a number of underperforming portfolios, we've completed those loss portfolio transfers on some of the more difficult reserves and made other underwriting improvements, more work needs to be done and will be done. And lastly, executing the comprehensive profit improvement program in Asia Pacific. And as I mentioned, we'll give you more detail on all of this on February 26.

Finally, with respect to the group's 2018 outlook, we're anticipating a target combined ratio range of 95% to 97.5%, which is, obviously, a wider range than QBE has used before. But I think, as with everything else I've talked about today, this is all about setting us up better for the future to deliver against our expectations.

With that, I will hand the call over to Q&A.

Questions And Answers

Operator

(Operator Instructions) Your first question comes from Daniel Toohey from Morgan Stanley.

Q - Daniel P. Toohey {BIO 16751863 <GO>}

Pat, just in regard of the write-downs to goodwill and the like -- the sort of 1 point or close to $1 billion, I guess, the gearing in S&P rating, is there any impact?

A - Patrick C. Regan {BIO 15131018 <GO>}

Thanks, Dan. Gearing, yes. I mean, that will just become max (inaudible) of -- our gearing will be closer to 40%. And those really don't, if either, as I say, affects our group capital position or our S&P position. So there's not an issue from an S&P perspective in that. Our gearing will be max higher -- it will be higher at the max. But we think we can, over time, reduce that again, partly through earnings accretion and perhaps through some of the portfolio moves I mentioned.

Q - Daniel P. Toohey {BIO 16751863 <GO>}

Okay. Then just on the overall reserving. So you talked about the 1% top-up. When you take into consideration Europe, was the FY '17 result an overall net strengthening of reserves or flat or...

A - Patrick C. Regan {BIO 15131018 <GO>}

It actually was a small positive, Dan. So I think the exact number is around $40 million for the full year '17. So we had a release in the first half and the strengthening of just over $100 million in the second half giving a net for the full year of a positive around -- release of around $40 million.

Q - Daniel P. Toohey {BIO 16751863 <GO>}

And you surprised us to be -- sort of strengthening casualty lines in the U.S.?

A - Patrick C. Regan {BIO 15131018 <GO>}

So I think -- as you think about our U.S. business, obviously, we've done a couple of things over time and including right to the end of 2017. Just as importance as reserve strengthening has been these loss portfolio transfers. We stopped writing a lot of this, things like commercial auto, Deep South, the program business. And certainly, writing it was an important move for us. But it's been actually also during the loss portfolio transfers, it has also been a really important to increase, if you like, reserving confidence. And I just wanted to make sure we were really well set up leaving '18 and going into -- sorry, leaving '17 and going into '18. So having done those loss portfolio transfers, we just want to make sure that whatever of a longer tail business we've got, that we were really well reserved on.

Q - Daniel P. Toohey {BIO 16751863 <GO>}

Okay. Then just finally, if we go back to February 2017, I think, we had 93.5% to 95%, set as the COR. We then had the EM downgrade. We went to 94.5% to 96%. Then at the August result, we went to closer to 96%. And obviously, the cats rolled through with the downgrade in October. But this -- is it sort of the 94.5% to 96% we should be looking at sort of how that rolls through to, I guess, the '18 of 95% to 97.5%? And if that's the case, where is the point of softness? I mean, you do talk to Asia continuing to have higher attritional losses. But just across the group, the sort of transition from that sort of, I guess, 94.5% to 96%, which might be more of a like-for-like with the 95% to 97.5%, where are the areas where you're seeing sort of deterioration?

A - Patrick C. Regan {BIO 15131018 <GO>}

So I think, I mean, obviously, the biggest move we've had in the second half that kind of accounts the most -- almost all of it since it's a cat stuff. The second topic really is what's kind of new is the emerging markets businesses both in Latin America and Asia. And I think there's sort of 2 different topics. On Asia, as I say that we're putting in place a comprehensive improvement program. We left 2017 with combined ratio of 115%, which is clearly completely unacceptable. But some of that was caused by -- probably almost half the underwriting loss comes from that Hong Kong workers' comp portfolio. And again, we wanted to make sure that we left that really well reserved. And actually, some of the sort of -- we had to improve our claims, having to improve our claims currently on that to make sure we get better claims outcomes. So Asia is a big part of that. We need to improve Asia very significantly from 115% going forward. That will take a little bit of time to do. But LatAm, I've sort of kind of hinted to you that there might be a different solution to that going forward as well. But simply we can't afford to be posting results in either Latin America or in Asia that is in the hundred and teens going forward.

Operator

Your next question comes from James Coghill from UBS.

Q - James Coghill {BIO 14006200 <GO>}

A couple of questions. Just starting on that reserving change, could you provide some more color over what's actually happened in Europe and Australia and New Zealand to arrive -- to ultimately lead to 110% in strengthening?

A - Patrick C. Regan {BIO 15131018 <GO>}

So we had to -- we did have some positive -- small amounts of positive in Europe, just a little bit less we've had in the first half. We had a little bit of positive in ANZO in the second half. So they did have both have positives. Then, obviously, we booked up a little bit more than 100% in North America, the amount in Asia and some cats and dogs around the rest of the group as well.

Q - James Coghill {BIO 14006200 <GO>}

Okay. I mean, that just seems to be relatively small numbers for both Europe and Australia and New Zealand relative to what you recognized in the first half, particularly for Europe. And could you provide some color on the outlook for how you've been thinking about reserve releases in those regions into next year?

A - Patrick C. Regan {BIO 15131018 <GO>}

Yes. That's a good question, James. I think -- so do we feel that we're well reserved in Europe and in Australia? Yes. I think, what we've said before on Europe is, is it reasonable to expect some of the reserve releases going forward? Yes. Is it quite -- going to be quite at the level we've seen over the last 2 or three years? Probably not. We've seen varied, 6%, 7%, 8% reserve releases in Europe. So we're probably not going to see that level of reserve releases. But we still think we're well reserved there and in ANZO.

Q - James Coghill {BIO 14006200 <GO>}

Okay. A question on capital -- a couple on capital. So your coverage of PCI is 1.7 and the first half -- I haven't actually worked through all the numbers. But I presume it is only the retained loss that actually led to the PCI coverage dropping to 1.6. And is it possible to just comment on whether there are any other key changes in the actual charges making up that and -- that calculation? And are there any other unusual items that are washed through to lead to 1.6x coverage there?

A - Patrick C. Regan {BIO 15131018 <GO>}

Not really, James. It's really -- I mean, essentially, those cat losses washing through. As I mentioned to you that because they're in Equator and North America. They're largely pre; and post-tax. So the impact is almost entirely that.

Q - James Coghill {BIO 14006200 <GO>}

And that is no comment on the buyback in the release. You have to make a comment on that now?

A - Patrick C. Regan {BIO 15131018 <GO>}

I think what we said in the release is the board will -- so exact phrase we'll use, we said the board's going to consider the quantum of the final year dividend and buyback expectations in the February meeting. I think the only thing I'd say on that, James, obviously, the board recognizes the importance of that going forward. So we'll come back more definitively on that on February 26.

Q - James Coghill {BIO 14006200 <GO>}

Okay. And one last one for me, just on your broad outline of this plan to fix QBE yet again. And could you just comment on how significant cost out is going to be in that? I presume all your previous targets on cost out and are largely redundant and that -- should we be anticipating a one-off charge for that? And obviously, can't be as part of the February result because you would have had to disclose it now. How do you intend going about that cost out? Is it just generating synergies with cost savings? If you could just comment on that as well, please.

A - Patrick C. Regan {BIO 15131018 <GO>}

Yes, I mean, kind of improving efficiency and reducing cost is an important thing for us. We did some small restructuring costs that are included in the numbers, I don't know if they're included in the combined ratio I described today. So we've reduced our regional costs as you would expect in both Latin America and in Asia. So we've included that in the numbers today, James. And I think going forward there's 2 or 3 things. We need to reduce our cost in emerging markets. That's our highest expense ratio. We talked about before, it remains true today, we need to continue to reduce cost in North America, both in dollar terms and as a ratio. But I think more broadly across the group, whether you talk about Europe or Australia that there are lots of opportunities to improve our process efficiency. Use technology better. QBE is not unique on that. So some of that will, I don't see that as a big kind of one-off charge to our margin. That's a continual improvement of focus on process quality, focusing on therefore cost outcomes and reducing cost over time. So we'll talk to you a bit more about that in February.

Operator

Your next question comes from Andrew Buncombe from Macquarie Group.

Q - Andrew Buncombe {BIO 19921333 <GO>}

Just 2 questions from me, please. The first one, just a question, has a business-wide review of goodwill been completed? Or is it just for North America?

A - Patrick C. Regan {BIO 15131018 <GO>}

We do, do business-wide reviews of all the goodwill when we go through our year-end close processes. And there's lots of headroom on the other goodwill amounts.

Q - Andrew Buncombe {BIO 19921333 <GO>}

Okay. Sure. Then the second question, with more strengthening reserves in North America, does this change the view on further growth in that market?

A - Patrick C. Regan {BIO 15131018 <GO>}

That's an interesting question. I think kind of more broadly. So can we grow in North America? Can we grow elsewhere in QBE over time? Yes. Do I want to give you growth targets? Probably not right now. What I really want to do is, it's what I said, improve underwriting performance of the business, improve our consistency of delivery. Now when we went through that in ANZO, we ended up actually being able to grow a little bit, which surprised me slightly. But that was sort of a secondary outcome rather than the primary outcome, which is to improve interest and loss ratio, the underwriting performance and the consistency. So I think, over time, we do think we can grow in North America. But first and foremost is to improve underwriting performance and consistency there and elsewhere.

Q - Andrew Buncombe {BIO 19921333 <GO>}

Yes. That makes sense. Then the last one. Everybody has, obviously, seen the announcement out of AIG for Validus overnight. Does that -- how do you guys think of acquisitions and maybe some of the U.S. tax changes playing into acquisitions in the Bermudan market and the consolidation that could come off at the back of that?

A - Patrick C. Regan {BIO 15131018 <GO>}

Yes. I mean, it's the time to really look at any detail of the AIG announcement other than to say it's happened. What I would say (inaudible) I can't comment on them is, we've got a really full suite of good work to do that can improve QBE. I feel that we've got good line of sight of what that work should be. I feel confident that work can make a meaningful difference to our underwriting performance and our consistency of delivery. And we're much better off focusing on that.

Operator

Your next question comes from David Humphreys from JCP Investment Partners.

Q - David J. Humphreys {BIO 18797143 <GO>}

A couple of questions, if I may. You haven't provided a GWP target in your outlook. Can you just comment on what you see as normal growth? Or should we just use the current year as the base?

A - Patrick C. Regan {BIO 15131018 <GO>}

I think probably the last of those, I think, we actually did -- we did end up growing 1% or 2% in 2017. The good news is nobody has read the pricing environment commentary from October expectations, we're going to see a big increase to a little bit more muted now. I think what you could say is, it's a better pricing environment than it was 12 months ago, whether it's quite as good as people expected in October, probably not. But it's a better pricing environment. I'm probably not going to give a GWP guidance going forward because I really don't want our teams to be focused on that any more than they need to be. What they really need to be focused on is making sure we're doing improvement in underwriting performance and improvement in consistency of our delivery. I would hope that we can keep our retention somewhat stable and benefit from at least a kind of a flat to moderately positive pricing environment.

Q - David J. Humphreys {BIO 18797143 <GO>}

Okay. Second question, in your commentary, you've talked about simplifying and reducing risk. If you look at your -- the cat outcomes this year, it led to lower your retentions in the program and did you get a (wide) of the final component of your '18 program that you hadn't done back in October?

A - Patrick C. Regan {BIO 15131018 <GO>}

Yes. So we have completed that, yes. That's all been successfully placed now. I think it's an interesting question on the cat. So the -- what the industry overall experienced was a series of medium-sized events. Obviously, Harvey, the Maria, wildfires. And that tends to be more impactful than kind of one extremely large event, which hits directly at your cat towers. So we've got the -- we've got the both our cat program, our large risk program and the aggregate treaty in place for '18. That -- what that means is it buys us a little bit of time to have a look at things fresh. So I kind of want to do that, just to see what the right protection is going forward. And that will include both the reinsurance protection and whether -- for the sake of saying it whether we should be in all of the places, where you get much higher cat exposure to the premium pool you collect.

Q - David J. Humphreys {BIO 18797143 <GO>}

My last question is on your, I guess, your objective of improving efficiency and reducing costs. Is your experience in Australia was that the efforts that had been implemented required you to reverse them and the number was 200 claims people had to be reemployed in Australia and New Zealand. Are you concerned that once you start to apply the same lenses elsewhere, you don't need to put cost back in, in the first place?

A - Patrick C. Regan {BIO 15131018 <GO>}

It's an interesting question. I'll candidly tell you that in terms of the last 18 months, did we do a lot of stuff to improve efficiency in Australia, probably not though. To your point, our focus was really elsewhere, was all about the pretty basic stuff, the performance improvement stuff. The example you are using to sort of everybody else instead, we are bringing about 200 claims rolls back from the Philippines to Australia. These were the more complex property claims. That example doesn't exist elsewhere. That was particular to Australia. I do think there's lots of opportunity to be more efficient in Australia than everywhere else. We definitely need to reduce cost in Asia. And as I say, we've taken some steps to do that. We need to reduce cost in Latin America and in North America. Will we need to invest in some stuff as we go through that? Yes, I'm sure we will as well. So there's no direct equivalent example, I think, to the 200 rolls in Australia.

Operator

Your next question comes from Nigel Pittaway from Citigroup.

Q - Nigel Pittaway {BIO 3406058 <GO>}

Pat, just wondering with such a wide range now for the combined ratio guidance in FY '18, can you give us a feel for sort of the kind of key factors you think are important to mean whether or not you swing towards the bottom or top of that combined ratio target range?

A - Patrick C. Regan {BIO 15131018 <GO>}

Yes. Thanks for the question. And obviously, we are using a wider range than before. And part of that just maybe kind of giving us a better opportunity to make sure we deliver against our expectations and deliver against what we said we do, which is kind of vital for us going forward. There's all the usual kind of swing factors. So obviously, kind of normally that wouldn't really be cat for us. 2017 was an extremely unusual year in that we went through the top of the aggregate treaty normally wouldn't expect that to be a swing factor. So how well we can deliver on our attritional and how much kind of positive prior year we get would be the 2 biggest factors of that. And probably the kind of linked to first of those just kind of how much the pricing environment helps or doesn't help.

Q - Nigel Pittaway {BIO 3406058 <GO>}

All right, okay. So the guidance will include any sort of anticipation of prior year releases and effect.

A - Patrick C. Regan {BIO 15131018 <GO>}

It will, yes. I'm not going to be any more specific even we get to February about what that is. But it will include anything for prior years.

Operator

Your next question comes from David Spotswood from (inaudible) Funds Management.

Q - Unidentified Participant

Just a few questions. I mean, obviously, QBE is a big complex business scattered throughout the globe. I mean, how confident do you feel in terms of your review or kind of rebasing the business going forward? First question. Second question, did you say that you're anticipating rate to be flat up a little bit sort of globally in 2018, not sure if I got that. And these investment returns of 2.5% to 3%, can -- you what have you assumed in terms of what markets are doing in cash rates and (inaudible)?

A - Patrick C. Regan {BIO 15131018 <GO>}

Great. Thanks, David. So from the complex point, I sort of agree with you. I mean, I think, we need to simplify the group somewhat and reduce risk, whether that be in -- whether that be in substance and in form. I think we -- part of the program we work we're doing now is exactly aimed to doing that. We executed Thailand (inaudible) clearly we've flagged that Latin America is under review as part of that. So I think, you should expect kind of the QBE going forward is smaller a little bit more focused and less complex from the QBE today. Just on rates. Obviously, we've got 3 main blocks of rates in Europe, North America and ANZO. The rate environment here actually continues to have good momentum here in Australia. So that carries a bit of positive into 2018. The rate environment in -- the rate environment in Europe and North America had started kind of moderately positive. But I think, whether QBE or anywhere else, you just wait to see how that plays out during the year. So for North America and Europe, it is kind of a flat to moderately positive and then we're seeing how that develops post what normally holds as we get later in the year. On the investment income. So obviously in 20 -- we said in the results, 3.2% investment return in 2017. And that benefitted really from the principal thing was what good equity markets was a narrowing of credit spreads going forward. So what we've assumed going into 2017 is really no movements on credit spreads going forward, (inaudible) started well actually where the equity markets (inaudible) we've not really assumed any incremental gain on that. On interest rates, we sort of gain and lose, obviously, we pick up, our running yield gets higher. But you get a mark-to-market impact as well in those. So as and when rate increases go through, you do make -- that helps the ongoing yields going forward, obviously. And it's a positive. But you get a small mark-to-market impact in the same year as well. So it's -- ends up not being a huge positive to the annual investment income, if that makes sense.

Operator

Your next question comes from Toby Langley from Merrill Lynch.

Q - Toby Langley {BIO 15924432 <GO>}

Pat, I was hoping to get your comments on when would we be able to see a cleaner representation of what the group can do from a combined ratio perspective. It feels like you've spend 5, 6, seven years for the company in something of a transition. The 95% to 97.5%, seemingly there's some overhang there from restorative action, corrective action following this year. How should we think about the sort of larger moving parts to the trajectory of the combined ratio beyond '18 and even in '18?

A - Patrick C. Regan {BIO 15131018 <GO>}

Yes. So 2018 versus 2017 and 2019 versus 2018, they've been making it overly simplistic. At a high level, we need to improve '18 versus '17 on our performance. We need to improve '19 versus '18. What are our big levers to do that. I mean, you've got ANZO and Europe performing kind of reasonably well. It will help Europe being in a slightly better pricing environment. They've obviously been fighting pricing headwinds the last 2 or three years, more than 2 or three years. So actually even getting to a small positive is kind of good for them. So they're going to -- as ever, the trick for us is to improve North America and to significantly improve emerging markets. So what we're setting out to achieve in '18 is to make '18 better than '17. Then obviously, we want to continue that. And I think we can continue by improving '19 versus '18. By geography, obviously, that's -- we can't afford to be posting something in the hundred and teens in either LatAm or Asia. And we really ought to be able to improve that. And the team feel good about our ability to continue to improve in North America.

Q - Toby Langley {BIO 15924432 <GO>}

Okay, cool. If I can ask another question about the goodwill write-down and the sensitivity, in the year-end notes last year, the sensitivity, I think, was about $240 million impairment charge for 1% increase in the combined ratio.

A - Patrick C. Regan {BIO 15131018 <GO>}

Yes.

Q - Toby Langley {BIO 15924432 <GO>}

And you're attributing $700 million predominately to combined ratio movements. But it doesn't sound like it's as big as perhaps that sensitivity would imply it needed to be. So is there not something else that's at play there?

A - Patrick C. Regan {BIO 15131018 <GO>}

Sure (inaudible) Toby. You start with headroom of -- or ramp slightly a bit over $100 million. So 1% movement giving a impairment of $230 million odd means a movement of $330 million odd. That makes sense. So a 2% movement gives a movement of double that. So add these to the main bulk of it. The second bit is the loss portfolio transfer -- transaction we did on December 31, whilst being good for us on reserving certainty for sure. And that we're kind of confidence about our future combined ratio, also reduces our investment income going forward. So that knocks a bit off as well. That would be the other piece of it.

Q - Toby Langley {BIO 15924432 <GO>}

Okay. So the headline core move is about 2%?

A - Patrick C. Regan {BIO 15131018 <GO>}

Yes, ramping slightly a bit above that. Yes.

Operator

Your next question comes from Siddharth Parameswaran from JPMorgan.

Q - Siddharth Parameswaran {BIO 15037291 <GO>}

Pat, a few questions, if I could. Just -- the first just on your guidance for 2018, the 95% to 97.5% combined ratio. What have you assumed in terms of any benefit from the cycle? Are you basically assuming that there's no benefit in those numbers?

A - Patrick C. Regan {BIO 15131018 <GO>}

We've -- obviously, as we did our business plans, one of the things we have to do was came into the start of 2018 just look at (inaudible) yields, look at the pricing environment. So the 3 big blocks, as I mentioned, in ANZO, there is a bit of positive momentum in rates. So whether we've assumed that. And we've assumed a cautious amount in Europe and North America.

Q - Siddharth Parameswaran {BIO 15037291 <GO>}

Okay. So I'll take the -- I would say, just a very modest impact than across the group, it sounds like?

A - Patrick C. Regan {BIO 15131018 <GO>}

That's correct, yes.

Q - Siddharth Parameswaran {BIO 15037291 <GO>}

Okay. Fair enough. Okay. Then if I could ask a question just on your reserves versus -- I mean, the reserve increases you took in this result. Is there anything that you're actually seeing on the claims front? Or is it basically that you're just trying to make sure that you have enough to, I suppose, allow for any unwanted deterioration which may occur in the future? So just a question around what's really happening with claims and what led to those reserve increases.

A - Patrick C. Regan {BIO 15131018 <GO>}

A different answer to the 2 bits I talked about. On the North American one, I assume really that's just having a bit of extra IBNR for the older years to just that's more certainly put away. So no new kind of claims activity per se. To give an answer on Hong Kong, we -- in the second half of the year, we saw more adverse claims outcomes. Partly that was actually kind of operational issues. We didn't literally have enough people handling those claims. We've dealt with that now. So some of that reserved charge -- some of the reserve charge actually generally in the Hong Kong workers' comp environment, the average claims costs are going up for all the insurance companies. So it's a bit of that and a bit of it was our own claims handling. So a slightly different answer for the 2.

Q - Siddharth Parameswaran {BIO 15037291 <GO>}

Yes. And was there any change in how you reserve the latest accident year? So in terms of just what we think for 2017, did you choose to be a little bit more conservative given the initiatives that we've seen in the past?

A - Patrick C. Regan {BIO 15131018 <GO>}

So yes, in Hong Kong's workers' comp. That was one of the factors in Asia's performance. We did increase the COR actually in Hong Kong workers' comp.

Q - Siddharth Parameswaran {BIO 15037291 <GO>}

But nowhere else in the world?

A - Patrick C. Regan {BIO 15131018 <GO>}

Well (inaudible) elsewhere in the world. But just as I said, you'll get fair attritionals (inaudible) when doing February a bit of an improvement in Australia as I mentioned. And in North America, the biggest movement in North America's attrition is crop actually, which obviously had a super good result last year and a more normal result this year.

Q - Siddharth Parameswaran {BIO 15037291 <GO>}

Okay. Fair enough. And just one last question. Just -- I was just trying to square off a couple of comments that you made around volumes going forward and what we should be assuming. I think into David Spotswood's question, you've mentioned that in terms of how we should think about the future of QBE, we should be thinking a smaller QBE, more disciplined and focused on getting its underwriting right. But I think, to David Humphreys' question, you suggested that we should be assuming a flat trajectory in terms of premium. So just -- I mean, I suppose that all these initiative that you're looking at in terms of -- looking at where you can improve performance, should we be thinking flat or should we be thinking down in terms of GWP?

A - Patrick C. Regan {BIO 15131018 <GO>}

Yes, I think I was trying to avoid answering the questions you had actually. I'd rather not give the detailed top line guidance going forward. It's actually the 2 things. On our organic trading, the most important thing now is to improve our underwriting performance and improve our consistency of delivery. It'd slightly help having a positive rate environment as we do that. On the portfolio, we'll come back to you in February. But I do expect a slightly smaller, more focused QBE going forward. But I'll give you a bit more detail on that in February.

Operator

Your next question comes from Brett Le Mesurier from Velocity Trade.

Q - Brett Le Mesurier {BIO 5909278 <GO>}

A couple of questions. As you talked about a relatively flat premium outlook, presumably, that means the commission and expense ratio is going to be difficult to make that smaller than the current level of 32-odd %.

A - Patrick C. Regan {BIO 15131018 <GO>}

So it's an interesting question, Brett. I mean, obviously, as you know, you follow this well for a few years as QBE's reduced cost, it's only partially helps our expense ratio because, obviously, we've had a reducing top line. As I say, I'm going to try and steer away from giving top line guidance. It is important, though, going forward, that over time, we'll take our cost of improved efficiency and we can do that. So I think, we said it was 32.5% expense ratio for '17, I do think over time that we both need to and can improve that.

Q - Brett Le Mesurier {BIO 5909278 <GO>}

On the European business, it looks like the combined operating ratio in the second half was greater than 100%, which would imply some deterioration in the performance of that business. Is that a fair comment?

A - Patrick C. Regan {BIO 15131018 <GO>}

It was around 100%. Brett, yes, that's right. That's obviously impacted in the second half by their share of the HIM, Harvey and the Maria activity that they write quite a bit of business as most (inaudible) market businesses do in North America, et cetera. So it was impacted a bit by that.

Q - Brett Le Mesurier {BIO 5909278 <GO>}

So you're saying that the underlying performance hasn't changed?

A - Patrick C. Regan {BIO 15131018 <GO>}

We had less -- the second feature, as I mentioned, was we had less positive prior year releases in the second half.

Q - Brett Le Mesurier {BIO 5909278 <GO>}

Okay. Lastly, you had a small increase to the reserve, the probability of adequacy on your outstanding claims reserves. The increase that you have put through there, how much did that cost?

A - Patrick C. Regan {BIO 15131018 <GO>}

Well the (inaudible) if you left it at 89.5%, our combined ratio would have been 40 basis points better. But it's not all increase in dollars or risk margin. It's a lot of risk-reduction activity. So things like that loss portfolio transfer help that, things like the aggregate reinsurance treaty help that. So if we're at 89.5%, combined ratio would have been about 40 basis points better. But it wasn't all about putting dollars at risk margin, if that makes sense.

Q - Brett Le Mesurier {BIO 5909278 <GO>}

So the coefficient of variation reduced slightly, I gather from what...

A - Patrick C. Regan {BIO 15131018 <GO>}

Exactly, yes.

Operator

Your next question is a follow-up question from James Coghill from UBS.

Q - James Coghill {BIO 14006200 <GO>}

Pat, it's a very quick one. Your combined ratio for '17, it doesn't include the discount rate adjustment. But that should have been positive over the half. So the 1% and 4%, I just want to confirm that you haven't actually included the DRA in that?

A - Patrick C. Regan {BIO 15131018 <GO>}

No. There's no -- the discount rate is not included in the 104%.

Q - James Coghill {BIO 14006200 <GO>}

But that should have been a positive over the half?

A - Patrick C. Regan {BIO 15131018 <GO>}

It was a small positive in the second half. Yes. You're absolutely right.

Q - James Coghill {BIO 14006200 <GO>}

No. I can...

A - Patrick C. Regan {BIO 15131018 <GO>}

(inaudible) also include opt-in either. You remember that?

Q - James Coghill {BIO 14006200 <GO>}

Yes. Nothing further.

A - Patrick C. Regan {BIO 15131018 <GO>}

Thanks, James. All right. I think that's all of our questions. So we appreciate on a short notice and you all have to read quickly to get on the call. We appreciate that. And we look forward to seeing you all soon and if not before February 26.