# Q4 2018 Earnings Call

## Company Participants

- George Quinn, Group CFO & Member of the Executive Committee
- Mario Greco, Group CEO & Member of the Executive Committee
- Richard Burden, Head IR & Rating Agency Management

## Other Participants

- Andrew James Ritchie, Partner, Insurance
- Farooq Hanif, Head of Insurance Research in Europe
- James Austin Shuck, Director
- Johnny Vo, MD
- Jonathan Peter Phillip Urwin, Director and Equity Research Insurance Analyst
- Michael Igor Huttner, Senior Analyst
- Niccolo Cornelis Modesto Dalla-Palma, Research Analyst
- Nick Holmes, Equity Analyst
- Peter Eliot, Head of Insurance Sector Research
- Vinit Malhotra, Banca di credito finanziario S.p.A., Research Division

## Presentation

### Operator

Ladies and gentlemen, welcome to the annual results 2018 conference call. I'm Jen, the Chorus Call operator. (Operator Instructions) The conference must not be recorded for publication or broadcast.

At this time, it's my pleasure to hand over to Mr. Richard Burden, Head of Investor Relations and Rating Agency Management. Please go ahead, sir.

### Richard Burden {BIO 1809244 <GO>}

Thank you. Good morning. Good afternoon. Welcome to Zurich Insurance Group's Full Year 2018 Q&A Call. On the call today is our group CEO, Mario Greco; and our group CFO, George Quinn.

(Operator Instructions) And with that, I'd like to pass over to Mario to make some introductory remarks before we start the Q&A.

### Mario Greco {BIO 1754408 <GO>}

Good day, everybody. Thank you very much for joining us. Before we get into the Q&A session, I just want to provide you with a few remarks from my side.

And first of all, we're very pleased with our full year results. They demonstrate further progress against the targets and the priorities that we outlined in November 2016. And they have been achieved despite a challenging financial market in the latter part of the year and continued elevated natural catastrophe activity.

Particularly pleasing has been the strength of the results in our life business. Even adjusting for positive foreign exchange movements, they increased by 23% year-on-year. The results also show the high quality of our life business. 90% of revenues are coming from either technical margins or fees and loadings. And there is very little reliance on investment results. This underlines the success of our consistent strategy of focusing on protection, unit-linked and corporate products.

We continued to execute on this strategy over 2018, where 86% of APE came from these products and 100% of new business value was from those products.

Our Property & Casualty business also performed well. We saw an improvement in the accident year combined ratio. This was driven by improvement in the accident year loss ratio with our commercial business also seeing improvements in a very tough market conditions. Our reserves remain strong, as demonstrated by the continued positive prior year development at the slightly above 1.0 -- 2.2-point guidance.

As in 2017, 2018 demonstrated the effectiveness of our underwriting with the below natural share of elevated natural catastrophe events in the U.S. Investment income in Property & Casualty has also stabilized as the reinvestments have continued to improve.

Looking forward, we expect our underwriting performance to be upper end of the 95% to 96% range, as the impact of business mix shifts, rate increases and expense reductions continue to earn through.

Farmers has continued to demonstrate solid growth in their chosen areas and in their ability to innovate, with new business offerings like the commercial ride-share business with Uber and like Toggle, which is insurance-on-demand quite successful last year.

Their customer-focused strategy has also continued to drive improved customer metrics. This has been achieved with an improved underwriting performance. After many years, Farmers has a double-digit combined ratio and we're very proud and satisfied with that. This trend should continue to support growth in Farmers Management Services.

Our balance sheet is strong and the Z-ECM ratio is at the 125% despite the impact of financial markets in the latter part of the year. And this reflects the strong operating capital generation within our businesses.

Importantly, we continue to turn this capital generation into usable cash remittances to the group, with a further $3.8 billion of remittances in 2018, bringing the cumulative total over the past two years to $7.5 billion, which is well on track to exceed the $9.5 billion target for the end of '19.

This ability to generate cash underpins our dividend, which has been increased by 6% to CHF 19 per share and this represents a 76% payout, which is in line with our stated dividend policy.

2018 has also seen us continue to deliver against our key strategic priorities. We have further strengthened our leadership positions in the faster-growing regions in Asia and Latin America and we have built out our leading position in the fast-growing travel and assistance business through targeted acquisitions while also continuing to build additional distribution partnerships.

We have continued to invest in innovation. In 2018, we had the inaugural Zurich Innovation World Championship, which saw a wide range of interests covering all aspects of the insurance business with the winners announced last week. We look forward to working with the winners to bring new and innovative solutions to our business.

We've also continued to roll out other innovative customer offerings with the launch of our first application under our cooperation with CoverWallet; the launch of Klinc, an innovative provider of on-demand coverage for personal possession; as well as announcing a strategic collaboration to use Snapsheet's virtual claims technology across the group.

These initiatives will help ensure that our customers benefit from simpler interaction with our businesses in greater levels of customer service while delivering very greater levels of efficiency.

Overall, these results and development give us confidence that we're well on track to fully deliver against our current targets and position us well for the next phase of our development, which I look forward to presenting to you later this year; actually, in November, in London.

With this, I would pass back the line to you for Q&A.

# Questions And Answers

## Operator

(Operator Instructions) The first question is from Peter Eliot, Kepler Cheuvreux.

## Q - Peter Eliot {BIO 7556214 <GO>}

The first question was, I guess, on the sort of the underlying earnings that we're seeing. I mean, there's lots of moving parts in the numbers, including some positive one-offs. But considering the sort of high level of nat cats we've seen and restructuring costs, my sort of calculation of sustainable earnings gets me to a couple of hundred million higher than you reported. I mean, the fact that you've reported dividend -- or for a dividend close to 75% of NIAS kind of implies that you think NIAS is a good estimate of the sustainable run rate. I'm just wondering if you could sort of comment on that or whether I'm -- it's just a statistic. The second question is on the impact of the P&C portfolio mix changes. We've seen a commission ratio hike of 3percentage points over the last three years, which just seems quite a lot to me. And I'm just wondering if you can sort of give us some clarity in numbers around sort of the proportion of the business and the extent to which that's driving it and I guess, will continue to drive it? And I guess, your guidance of flat P&C premiums next year on the back of the portfolio mix change. I'm just wondering if you can sort of say when we should expect to see the end of this and when we could maybe start to see premiums starting to pick up?

## A - George Quinn {BIO 15159240 <GO>}

Peter, thanks. It's George. So on the first one, we actually have a slide in the investor deck today. I don't recall the precise number, 9, 10, something like that. In that, we've tried to break out both for last year and for this year what we see as the -- I hate to use the phrase underlying earnings because it's only if you take out some of the obvious one-offs. So as you may have seen from that slide already, we would see it substantially higher than just $200 million. There are 2 obvious things we would adjust for: so one is the extra point in nat cat so that we have in the year. So a bit more than $260 million; and the second thing is the element of simplification that we have within the operating profit. If you adjust for both of those, you got a number that's a bit north of $5 billion for operating profit. There are other items that are one-offs. So for example -- I'm sure you are aware from the conversations with the IR guys today that there are certainly one-offs in the life results that are positive. But equally you'll find other one-offs that are negative, for example, around hedge funds. So we tend to net the rest of it to pretty much zero. So if I were doing the normalization calculation, I'd be adding back -- I mean, something between $400 million and $500 million as opposed to $200 million. On the second point around the portfolio changes, maybe -- we covered that a bit at the half year. And the picture hasn't really changed so much from then. I mean, obviously, it's driven by -- we talked about three things at the half year. So we have the travel business with Cover-More. And I think as everyone knows, that's a pretty high acquisition cost business given the characteristics of the type of product and the low volatility nature that it brings. Second, was the finance and insurance business in the U.S. So that business grew pretty substantially in the first half of the year. So that was just a driver of that 1.1% increase you already saw in the first half of the year. Then, of course, LATAM, where we've been pretty successful in finding new distribution agreements, particularly on the retail side in Brazil, that's also exacted some upward pressure on the acquisition cost ratio. I think -- I don't expect it's going to change markedly in the very -- in the short term. I think the one thing to bear in mind though is that -- I mean, we don't -- we obviously don't normally look at the commission ratio where we're trying to say when we like the business' -- the overall performance. So for us, I mean, if we do have to trade at a slightly higher commission ratio to further improve the characteristics of the book, i.e. better margin with lower volatility characteristics, that's something we would continue to do. I don't immediately see that in our future. But I mean, I couldn't entirely rule it out. So I mean for me, I think you need again to look at the overall technical performance. And we've talked before about -- I mean, over time, I expect to see a trade between the loss ratio and the commission ratio.

## Q - Peter Eliot {BIO 7556214 <GO>}

And in terms of the overall premium volume, when we might -- should start to see that pick up? Will the pressure from portfolio mix go away?

## A - George Quinn {BIO 15159240 <GO>}

So I understand the question...

## Q - Peter Eliot {BIO 7556214 <GO>}

Sorry.

## A - George Quinn {BIO 15159240 <GO>}

So for us, I mean, if you look at what happened last year, I mean it's the trend that we've been on -- I mean, firstly, continues. Probably the reduction in commercial has slowed down a bit. So we dropped by, I mean, very low single digits. The retail portfolio -- and I guess you understand the definition of retail for us. So it includes SME and the higher-volume commercial-type exposures, I mean that's growing at a level that's -- I mean, closer to double digits. We have bought more reinsurance. We talked about it during the course of last year, especially around casualty. So that, obviously, has some impact and knocked back that higher gross rent premium. At this point, in terms of the large reinsurance that we do, certainly on a quota share basis, I don't expect that we're going to be changing that in the short term. So -- I mean, I would expect that this year, flattish. I mean, there's the possibility, if we can find the right opportunity on the retail side, we would grow. I think the challenge is -- I mean, the market on commercial -- I mean it's a bit hard, I suppose, to imagine today that -- just given the profitability characteristics that that's a part of the portfolio would be a high priority to grow.

## Operator

Next question is from Andrew Ritchie, Autonomous.

## Q - Andrew James Ritchie {BIO 18731996 <GO>}

First question, just on pricing. I just was looking for a bit more granularity, mostly in North America. Some of your competitors have been sort of focusing on rate increases ex workers' comp. If we accept that workers' comp is soft. But the claims environment is also soft. But if you ex workers' comp, I'm interested in what rate you're getting on the problem lines, which continue to be, it seems, a lot on the liability lines and particularly commercial auto. So what kind of rate you're seeing in that and whether that's moderating or still hard. And the second question on reserves. I note that for this year, the group reserve release is a bit higher than that from the divisions. I'm assuming that is partly to do with the 2017 cats, which would be collected at the group reinsurance level or is that something else going on? And linked reserves, which may be linked to my first question, the U.S., North America had a fairly weak -- or a weaker PYD in the second half of '18 versus last year. Was there some strengthening again of commercial auto in that line?

## A - George Quinn {BIO 15159240 <GO>}

Yes. Thanks, Andrew. So on the first one, pricing. I mean the pricing dynamic, I think we talked -- I mean certainly earlier in the year that, I mean, we anticipated that things would probably slow down once we work through the renewal of the loss effect or the gains. If you look at the U.S. in detail, if you look at it from the full year perspective, I mean we see the U.S. market's pure rates -- we can come on to loss cost inflation in the second -- a bit north of 3 -- almost 3.5 points powering through the year. I mean, it was pretty stable through the first 3 quarters. It has dropped off a bit at Q4. So we are beneath 3 in terms of rate increase. Within it -- I mean, Property has come down a bit. So we are above 2. If you look at commercial. So Zurich motor is the one that you asked for, I mean, since Q2, Q3, Q4, pretty stable. So we're seeing it in the high single-digit range. And as you point out, workers' comp is a bit soft. So I mean, despite the events of last year, workers' comp continues to be a very profitable line and there is more competition there. But the rate that we see on commercial auto seems okay for us at the moment, albeit it still does require some portfolio adjustment to try and drive out the kind of returns that we need. From a claim perspective and inflation perspective, which of course is a really important partner to this. So inflation around the commercial auto line is still fairly high. So maybe not as high as we saw it last year. But I mean, it's still well in the mid-single-digit range. So the rates at which the margin is expanding is considerably less than maybe the headline rate would imply and it certainly doesn't make it anything like -- attractive enough to want to jump back in with both feet. Although workers' comp is soft and the inflationary stats around the claim side of workers' comp are still very benign, to put it mildly. So I mean, overall picture, things have slowed down a bit, which is entirely what we expected, just given the way that portfolio was renewing. And I think as we look forward, the pricing trend by line of business is going to probably be quite distinct. So the broad market move in response to the -- a bit of the claim expense of '17 I think is, at this stage, largely behind us. On the reserve topic of why do you see a group reserve release. So it's a combination of factors. I mean. So for example, things like the EIL transaction that we did back in December. We held some additional reserves around that line of business up top and obviously, given that it's going, that's no longer required. There was a small difference between the way the Group RE was seeing things in some of the countries. And we held a prudential margin. We've been working on that over the last couple of years. We've reached the level of comfort that allowed us to remove it. I don't think it's the cat topic. I mean, cat is mainly embedded in the local business. We didn't -- I don't think we had anything significant up top on cat. The U.S. experience in the second half on PYD. I mean, nothing really to point out there. I mean, probably the only thing we did do in the reserve in the second half of the year around the U.S., we did a normal detailed review, I think, around -- I think it was already end of Q3. But of course, given we don't have Q3 numbers, it would have been visible externally. But the workers' comp business was very strong. I think by and large, we've taken the opportunity to strengthen more recent years, both on workers' comp and on liability more generally. But I don't recall commercial auto being a particular topic in that regard.

## Q - Andrew James Ritchie {BIO 18731996 <GO>}

Just to round off. So we're not sort of misinterpreting. I mean, did you say the prudential margin, I think was the language you used, at the group level, you felt you no longer needed? But presumably, there still is a prudential margin of some kind, isn't it? Or...

## A - George Quinn {BIO 15159240 <GO>}

Yes. Absolutely. So to be very specific, the prudential margin related to that one (single) raise. So the overall group reserve strength as we assess it from beginning to end of last year is exactly the same percentile.

## Operator

Next question comes from the line of James Shuck from Citi.

## Q - James Austin Shuck {BIO 3680082 <GO>}

So I had 3 questions. But I'll restrict it to 2. But if you don't answer the first one, then can I ask a replacement?

## A - George Quinn {BIO 15159240 <GO>}

That's okay. Keep going then, James.

## Q - James Austin Shuck {BIO 3680082 <GO>}

Well the first question, I'm just interested in what the absolute combined ratio was in both crop and workers' comp, please, for 2017 and 2018. For workers' comp, ideally, I'd like the workers' comp ex PYD. So that's my first question. Perhaps you can tell me if you're going to answer that one. If not, I'll choose a different one.

## A - George Quinn {BIO 15159240 <GO>}

All right. I'm not. Just to save you time. I mean, I'm happy to give you color around it. But I'm not going to go into the very detailed way you asked for it. So I'll give you -- it's half the question, I'll give you half an answer.

## Q - James Austin Shuck {BIO 3680082 <GO>}

I'll replace it with half a question as well, then. Go ahead with the color then, please.

## A - George Quinn {BIO 15159240 <GO>}

All right. So the -- if you look at all of last year, crop, another strong year for us. I mean, not as strong as it was in '17 and not quite as strong as some of the things I've seen from competitors' disclosure. So I mean, maybe we are 6, 7 points better than we would ordinarily expect to see the business run at. So I mean that, clearly, has benefited the performance but it's not at the level that we saw in 2017. Workers' comp, I mean, nothing particularly special to point out. I've mentioned in response to Andrew's question that we did move this out around a bit. The line still seems to throw off quite a bit of positive development. And to the extent that it's reasonable, we're trying to hold that back in the more recent years. So PYD, I don't actually have a figure for PYD for workers' comp in my head. But I mean, given what we did, I think you can assume that on a net basis, it would be some positive point, not very large.

## Q - James Austin Shuck {BIO 3680082 <GO>}

Okay. Great. So my other questions then were just on the -- so on the combined ratio and the kind of guidance was the upper end of the range. So the 96% in 2020. So it -- I mean, it looks like you're normalizing in 2018 around 97.2%, if I give you the benefit of the one-offs for expenses. So you got at least 1.2 of improvement to come. Expense delivery is about 75% done. It looks like most of that improvement is set to come from commercial lines, just given the starting point for retail and other. Can you just elaborate a little bit about your confidence in achieving that? We've seen recently, rate is slowing. Some of your -- the peers in the U.S. have been quite cautious about their guidance for next year. You're likely to get some headwinds on workers' comp. So perhaps, you could just expand a little bit on where that improvement is coming from? And I suppose, kind of linked to that, are you -- is kind of that top end of that range, is that including 1.5 points of PYD? Or is it including a different number? Because I think you normally guide to kind of 1 to 2. Second question, just really a quick one...

## A - George Quinn {BIO 15159240 <GO>}

This is smart.

## Q - James Austin Shuck {BIO 3680082 <GO>}

I just wanted to understand what the potential is for you to do share buybacks. Because you have a Z-ECM range, you have a target range of 100% to 120%. We've seen some volatility in Q4. That volatility would have reversed. The range you have should allow for that volatility. And obviously, you've got other binding constraints, such as S&P and what have you. So it does seem as if you're running with a level of capital that is kind of above where you need to be. You did do a buyback quite recently. But it's essentially dilutive. Could you just help us understand a little bit whether 2019 is a possibility for a buyback or whether is it more of a medium-term question?

## A - George Quinn {BIO 15159240 <GO>}

Thank you. That's a complex, multi-nested question. So I'm going to start at a high level. And then maybe we can descend into a bit more detail. So I think the way that you had looked at things. So you normalize, you come out around 97.2%. And you pointed out that we have expense delivery anticipated this year, which is absolutely correct. I'm not sure that it would be -- completely be able to assume that it's all going to drop into commercial, I mean, just given the areas where the expense action is taking place this year. And it's certainly in the what I would describe as one of our more retail-heavy regions. So I would expect you to see expense improvement on both retail and commercial. Having said that though, the 97.2%, I guess, is connected to the PYD topic. So back at -- and I forget whether it was at the half year or the Investor Day now, we guided that -- I mean, just given the pressures that we see -- I mean, the positive pressures, for the avoidance of doubt, we would see PYD around the upper end of our guidance. And that's what I anticipate we'll see in 2019. So if you're trying to look at underlying, I agree that the 2.3 that we've seen for 2018 is maybe a touch high. But I wouldn't knock it all the way back to 1.5. And in fact, I mean just to keep the math simple for me, I'd probably knock it back to about 2. If I do that, then I guess compared to you, I'm ending up somewhere around the 97% for the year. And of course, you guys know where we were at the half year, which was roughly 97.5%. So I mean, the calculation of what the second half must have been is not so difficult. So I mean, I would see us running as we leave the year somewhere in the mid 96%. Now that clearly still requires further delivery to get us to where we need to get to. Expenses will be the largest part of that, for sure. But as far as the market conditions are concerned, I mean, we -- I mean we haven't planned -- from the very beginning, we never planned that the market would be a positive driver here. I mean, look, just go back to the answer I gave Andrew on pricing: if anything, I mean, if there was margin expansion, it's narrowing because of this reduction in the headline rate and maybe inflation picking up slightly in the loss costs. But I mean, it's just not dependent on -- for us, we've demonstrated that we are completely focused on profitability. We would always like to expand the portfolio. But that's only possible when we can achieve the right returns. And if we can't achieve the right returns, we've also demonstrated that we're prepared to take capital away, where it's required. So I mean, we still have work to do this year. But it's not 97.2% to 96%. On the capital topic, on volatility, I mean. So you're absolutely right, we see it the same way: the range that we have already in the target capital range is designed to address volatility. We got a bit of it in Q4. And a bit more of it than maybe we expected. Some of it is actually self-inflicted so there was a piece of it, which of course is the market, which everyone can see. We actually made a bit of a model change at a time, I guess, we thought we were richer than we ended up being. But I mean, we still end up in a very strong place. And I think even if you were conservative today, you pointed out, at least a couple of points back. So capital is good for us. So what does that mean? We've obviously just made the decision for the immediate future around capital. And so we're not coming forward with a proposal there. I mean, our priorities are pretty much unchanged. We have an acquisition which will close, at least to the best of our knowledge at this stage, sometime around the middle of the year. So that will ease a piece of it. And we would still prefer to try and use the capital to support organic or inorganic. But again, if that's not possible, I mean we will look at alternatives. So I mean, we don't rule anything out or anything in at this stage. But I mean we have some short-term uses for some of that capital.

## Operator

Next question comes from the line of Michael Huttner, JPMorgan.

## Q - Michael Igor Huttner {BIO 1556863 <GO>}

I listened also to the lovely Bloomberg video this morning. And I was struck by 2 things: the focus on delivering and on cash flow and dividends, of course. On cash flow, the $3.8 billion, can you maybe walk us through a potential, like, waterfall chart, what could it look like? If you normalize for the various items that you have in the BOP calculation, the $5 billion? Or just to get a feel for where we might be including the OnePath deal. That will be hugely helpful for 2019. Then the other question is on a different topic. And I'm probably asking completely the wrong question. But I noticed. And I may be wrong, that there's a low nat cat projection or higher expected nat cat way on the Solvency ratio by about 2 points. And I wonder how that squares with your aim to be -- to have less volatile earnings and maybe revert to the 3% in terms of expected nat cats. But -- yes.

## A - George Quinn {BIO 15159240 <GO>}

Okay. Thanks, Michael. Apologies in advance. I can't give you a forecast for '19 for cash. I mean, you've seen today that, Mike, we're well ahead of baseline run rate. We have a number of items that are one-off positive, one-off negative. But I think -- I mean, in comparison to last year, I think when we guided people down around cash to maybe around the $3.3 billion mark, I don't think I would do that today. I mean, we've had some -- for example, I think people are aware that we have the impact, at least partially, of the hurricanes in '18. So that coursed down the P&C number. We've also got some, let's call it optimization we did around the life businesses. So the cash flow there is very strong. But I mean, you can assume that, worst case, those 2 things offset each other. So I mean, very strong delivery of cash last year across the business. What could it look like this year if you think of what happens with OnePath. So OnePath timing, of course, is really important here. So if you go back to when we announced the transaction, we were pretty transparent around returns and around cash flows. At this point, I mean again, to the best of our knowledge, it's likely to close around the middle of the year. But I mean, to be completely frank, we were not entirely in control of that. It depends on a relatively complex separation that's taking place on the other side of the transaction. And also, one thing that's different from what we had before, I mean previously we had the restructuring quarter in the old year and then we have a clean run in the new year. We're going to have a bit of a restructuring of OnePath also this year. So I mean, I expect if it does close in the middle of the year, it will be positive. But I wouldn't take the guidance that we gave back in the investor presentation and simply pro rate it. But I mean, overall, I'm very happy with where cash is. It's clearly not an issue for us; the group has done a great job on extracting the earnings as cash from all our businesses. On the nat cat topic. So it's well supported. You're absolutely right. So there was this -- I guess a small pickup -- I mean, it's not such a small number, I mean it turned into capital. We actually have a -- we've got a small retail business that has expanded slightly its exposure to nat cat in a particular area. I mean, the amount of premium volume involved I think might surprise you if I give it to you. But I mean, consistent with commitments we've made before, I mean, we have bought more nat cat coverage in 2019. We hadn't thought looking to raise our exposure to nat cat. And in fact, I mean, just given the general pricing trends, I guess, what you hear from players that are maybe more expert in that area than we might be, I mean, it's just -- it's still not an area where you would want to expand capacity. So I mean, you can assume that through the course of this year, I mean, we're not looking to grow it. And there's still the possibility that we might shrink the exposure that we have further.

## Operator

The next question comes from the line of Farooq Hanif, CrÃ©dit Suisse.

## Q - Farooq Hanif {BIO 4780978 <GO>}

There's more of an emphasis in your presentation and also, Mario, in your initial comments on innovation now. So you talk about Snapsheet and CoverWallet. I was just wondering, if you take this in a package with the improvements you want to make in commercial in the U.S., sort of looking beyond 2019, where consensus is already quite close to 96%, kind of thinking -- I mean, are you sort of happy with the idea that there are further improvements in profitability that can be achieved from this innovation and from still moving the mix to the U.S.? So just qualitatively, can we expect better from the combined ratio going forward? And the last -- sorry, the second question is on your reinsurance, I'm looking at Slide 38, where you give the program. I mean, it looks like you've actually made a few tweaks, it's more kind of out of the money protection. If you could just comment on that, that would be helpful.

## A - Mario Greco {BIO 1754408 <GO>}

Farooq, on innovation, I think we mentioned it because it is becoming relevant for us but not necessarily to improve combined ratio in U.S. But if you look at, for example, Cover-More today, Cover-More came short of $900 million of revenues last year. So it is becoming sizable and it keeps on growing and we're sure that growth would be very strong in 2019, too. So we want to put a light on that because this is starting to become visible. The biggest source of growth that we had in Spain this year was through CoverWallet and SMEs. And that's why we thought also to expand this into Switzerland starting this year. And again, this is why we mentioned it. Not just -- I mean, it didn't move the combined ratio. But it is becoming a relevant source of growth and possibly stronger in 2019. Snapsheet, we have an agreement with them to use them in Europe. So we don't plan and I don't think we can even use them in U.S. But we're quite interested to see if that can help improving service and eventually cost of claims in Europe. So we mentioned them because they're becoming relevant for us. And we want you guys to get familiar with and to start also looking at the progressive numbers that we achieve on these different innovations. But none of them, frankly, is strictly impacting the combined ratio in commercial U.S., which is more I think benefiting from the portfolio shifts that we have been making over the last two years.

## A - George Quinn {BIO 15159240 <GO>}

Farooq, on the reinsurance topic. So you're right, there are some changes. I think in a very quick way, I trailed some of them at the Investor Day. So I mean, the global cat treaty stands out. We've increased capacity under the global cat treaty. We've actually put a cover in place. It's an April 1 renewal but we anticipated the capacity increase. So we changed it already at the end of last year. And that's obviously connected back to the conversation I had with Michael earlier on the rise in some of the incoming cat exposure. I mean, beyond that -- I mean, we have a number of things that -- I mean, I'm not sure I'd consider this tactical. But we've talked before about the fact we now have a pretty significant quota share across the liability book. The intention is that that'll be a long-term relationship. We view it as strategic. And -- but it's not about the performance of that particular book, it's about the mix that we retain. We've tweaked a number of other things. So we have a financial lines program in place that we've tweaked. I think I've talked before that we have an aggregate cover that we put in place back at -- in early '16 and that was aimed to try and contain some of the volatility that we had suffered from previously for a variety of reasons. We've never really come that close to actually triggering that contract. And we've restructured that with a panel of reinsurers starting this year to try and bring it a bit closer to the money and maybe work a bit harder for us. General conditions, I mean the market is -- I mean, we are seeing -- I mean, attractive pricing. So risk adjusted, we are paying the same rates as we've paid before. And in general, I mean, we would continue at the margins to buy a bit more reinsurance cover just given what the market currently offers. That's what we did on reinsurance.

## Q - Farooq Hanif {BIO 4780978 <GO>}

May I just come back -- can I just quickly come back on the first point? Okay. So I get it that your initiatives are more about service volume and just capability. But in the U.S., quite apart from innovation, clearly, Kathleen set out some quite ambitious targets for Commercial, indicatively bringing that combined ratio down by 3 points or so. So just -- so again, just more generally, beyond the 96%, do you think there's more you can do?

## A - Mario Greco {BIO 1754408 <GO>}

Yes. But remember that the combined ratio also depends on market conditions, right? So is the market going to remain as it is today? Is the market too hardened, too softened? Let's not make a combined ratio forecast for 2021, '22 today, right? I mean, let's get to the end of the year, see where we are, see where the market is and then we reassess it. But fundamentally, what we have been trying to do in U.S. and also in U.K. is to shift the books out of the upper end of the global corporate customers and the big exposure to long-tail liability into the more stable and usually more profitable specialty property business and more towards mid-market and SME. That brings a lower and a better combined ratio over time. And this has to progress and deliver results in two years of that, definitely not enough to measure. Although we see movements and improvements in the combined ratio, it's still too early because the books haven't -- no development. And these are long-tail businesses and it takes a while to get rid of them.

## Operator

Next question comes from the line of Nick Holmes, Societe Generale.



## Q - Nick Holmes {BIO 3387435 <GO>}

I just wanted to come back on the expense ratio to ask how concerned are you that softening U.S. P&C pricing is going to make it more difficult to reduce the expense ratio? And secondly, is there scope to take out more costs? Because the expense ratio is, I think, still pretty high. And I'd be interested in your comments on that. Is that something that you would disagree with?

## A - George Quinn {BIO 15159240 <GO>}

Thanks, Nick. So on the pricing-expense ratio interaction. So I mean, we decided at the start that we would not set a ratio target because it can lead you to do things that have got nothing to do with expenses. And we thought it was clear for you and for everyone within the company that we set a level of resource that we're prepared to allocate to what we're doing. If P&C pricing softens more than we anticipate today, I mean that may put a bit of pressure on the ratio. But it wouldn't immediately change our expense plans. I mean, we have a plan in place today across all the businesses, across the corporate center and the #1 priority is to make sure we deliver on that thing that we have absolute control over. I think just generally on the P&C pricing topic, I mean, I gave a fairly detailed answer to Andrew earlier around the various pricing trends. So I mean, at this point, I don't see it going negative in the short term. But I mean, I -- we don't control it and it is possible. But I mean at this point, it's not something we assume is going to impact 2019. On the second comment around is there scope to take out more the perspective that maybe our expense ratio is still high. I think when you look at expense ratio, the thing I would encourage everyone to do; we do it internally, I mean, we obviously, we compare it to peers and competitors in the different markets. Ordinarily, we will break out the different components. So there's an acquisition cost ratio in there that it's not traditional expense per se. There's also -- depending on the practice of the company, some things are in premium tax, potentially, they include it, potentially they don't. Then you have a core part which I think is generally more comparable which is, in our case, the OUE ratio. I mean, the OUE ratio would suggest, I mean, we still have further room to drive efficiency. But nothing like the extent that the headline expense ratio number might suggest if you compare it to the headline numbers of peers and competitors. I mean, we've made a huge step over the course of the last couple of years with one more year or 2.

## Q - Nick Holmes {BIO 3387435 <GO>}

Okay. Can I just very quickly follow up with the OUE ratio? I think 13% was, you indicated, your sort of target. Is that still the case? Presumably it is.

## A - George Quinn {BIO 15159240 <GO>}

So the -- we didn't give a target.

## Q - Nick Holmes {BIO 3387435 <GO>}

No. That's an indication.

## A - George Quinn {BIO 15159240 <GO>}

We've got 55 different targets that we have to achieve across the entire -- but I mean, what we said today is that if you look at and you allow for the one-offs, we're about 13.8%. I mean, you guys know how the expense ratio of the efficiency benefits typically fall across the business. And I mean, you can relatively rapidly work out where you would expect that to land. But I mean, we haven't set a target for expense ratio. We have set a target for cost reduction. And that's what we are focused on this year.

## Operator

Next question comes from the line of Vinit Malhotra, Mediobanca.

## Q - Vinit Malhotra {BIO 16184491 <GO>}

So one on the life guidance, really, because you remember, George, last year we were discussing about a mid -- low to mid or some mid-percentage growth number and even if I clean up for this 125 one-off this year, we end up with a very healthy 14%, 15% growth. What's the -- I mean, is there a sort of conservativeness in there in your thinking about life that -- or could we have another repeat year of a good -- or at least better-than-expected number for life? So that's just on the life guidance. And second question is just on the attritional loss ratio. I mean, the 2-ish number being below 63, we'll have to go back quite a few years to get that kind of sub-63 attritional. Is there something that is worth flagging on -- maybe just one business had a very good second half? Or can we get a bit more excited about this line going forward?

## A - George Quinn {BIO 15159240 <GO>}

Yes. Thanks, Vinit. So on the life topic, I'm conscious -- I'm not about to talk down something that I think has had a fantastic year, whether you include the one-offs or whether you don't. I mean, the life business for us has been going great. And I mean, we did give guidance around the middle of the year around that underlying number. And of course, at that stage, we knew already we had some one-off in the number. In fact, we talked about it back at the half year results, principally around the foreign exchange effects that we were seeing in LATAM. Could we have a better number than the one we guided to? I mean, it's possible. But I mean, I think we're trying -- we're not trying to game you, we are trying to give you a realistic sense of where we expect it to land. And I think the -- I mean where there may be differences between us and what people are assuming, I think probably the larger issue is going to be the timing of OnePath. I think -- I mean, we tried to indicate broadly when we expected that to close, back in the Investor Day in December. I mean, today, I don't know anything more around the middle of this year. If it closes earlier, which I think is unlikely, maybe that could have a different impact. I mean. So far, at least that day has been slipping rather than accelerating. So we're trying to gauge you to what we actually expect rather than to give you a false sense of the underlying. And to be honest, I mean, if you look at what would be required for the life business to achieve what we've indicated, that's still pretty strong growth over the underlying performance of 2018. On the attritional -- I mean, is there something in there that we should get really excited about or something we should isolate and change? I think again, as I said in relation to -- I forgot if it was Andrew's question or what I answered earlier. I think it was James, when he talked about the -- how he saw the underlying number for the year. I think it's important because of the connection between some of the elements that we run. So we talked already, I believe, the impact of acquisition cost versus loss. I guess, some of you learned today there's also a connection between the expense topic and the loss ratio. I'd look at the whole thing in the round. If you look at the second half, I guess, I gave commentary to James earlier that gives you a sense of how we see things. I mean, there are certainly elements of that, that are better than we would expect to see continually in the future. Crop would be one example. But at the same time, there are elements of it that are not as good as I would hope to see them in the very near future. And one of those examples would be financial lines in one of our key markets. So I think it's a reasonable starting point as we enter into 2019. Be a bit wary of crop seasonality. But I mean it's not going to have a big impact on this. We just need to keep -- we need to continue on the path that you've seen from us to deliver on that combined ratio topic that we discussed earlier.

## Operator

The next question comes from the line of Jonny Urwin, UBS.

## Q - Jonathan Peter Phillip Urwin {BIO 6126952 <GO>}

Just one for me. So just on P&C. I mean, we can clearly see the underwriting improvement coming through now. Then I know it's work in progress, I know there are some good bits, some less good bits. But I just wondered, thinking on a longer-term view, like how happy are you now with the quality of that U.S. commercial book? And in your minds, where are you on that re-underwriting journey? I'm not talking about just on the way to the 2019 targets. I'm just thinking big picture, where do you want to get this business to and basically, where are you now?

## A - Mario Greco {BIO 1754408 <GO>}

Look, what we are -- the way we're looking at U.S. is we need to still continue strengthening our capabilities of mid-market. We did something over the last two years. But we will continue this in '19 and the next years. And also we are improving the underwriting strength that we have, especially in U.K. and U.S. By that, I mean that we are improving the programs we have for underwriting, the attractiveness that we have for good underwriting. At the end of the day, in U.K., in U.S., we compete for the best underwriters and we have to be able to stand high in that competition. So it's a journey. We're not satisfied. There's more to come and there's more to do in U.S. also. And the team there knows it very well. And the programs that we have for '19 and next year's reflect that.

## A - George Quinn {BIO 15159240 <GO>}

I think, it's worth adding, Jonny, that if -- I mean, you probably saw at the Investor Day back in December that, I think, Kathleen outlined pretty clearly there what her ambition was for that business. And that's a very substantial improvement over where we stand today.

## Operator

Next question comes from the line of Johnny Vo, Goldman Sachs.

## A - George Quinn {BIO 15159240 <GO>}

Johnny?

## Q - Johnny Vo {BIO 5509843 <GO>}

Can you hear me? Sorry. Just a couple of quick questions. The reserve redundancy that you built in ZIC or the reinsurance -- group reinsurance business has been quite substantial over the year. So I know that you're talking about the upper end of the range in terms of reserve release. But are we going to see reserves -- you just running down the reserves that you've built up essentially over time and how long are we expected to do that or will that just come through your assessment of the reserve strength of the underlying businesses as a whole? That's the first question. Then the second question is just in terms of M&A. I mean, obviously, you've done a lot of transactions. You filled in a lot of gaps. Are we coming to a natural conclusion in terms of the M&A activity that you've been undertaking? Then I know you've spoken about capital returns. But how does that feed into -- if I look at your balance sheet, there is a bit of balance sheet slack. How will that translate into potentially capital returns to shareholders?



## A - George Quinn {BIO 15159240 <GO>}

Thanks, Johnny. So on the reserve redundancy topic, again, I think it was Andrew's question from earlier, it would be a bit disturbing if all that we did around PYD is simply drain the reserve strength of the group. And you can imagine, I mean, not only would we -- would I not want to do that, there's a number of controls in place that even if I did, would stop me. So for example, this is a topic that we spent a lot of time with, with the Group Audit Committee. It's a responsibility of the group's chief actuary. We have a policy around where we target in terms of percentile and the reserve range and there's a band around that; and if we wanted to deviate from it, that would require approval. And I think I've tried to comment, both this year and last year; and I'm trying to do it fairly frequently, that I mean, when we see the types of reserve release that we saw last year, that did not come at the expense of reserve strength. And in fact -- I mean, this is an internal company measure. So I appreciate you need to take it with a pinch of salt. But if we try and measure as objectively as we can, the reserve strength at the beginning of the year and at the end of the year, with everything -- including all of the prudential margins that we have, that we are in exactly the same place. So I -- we just do not intend that, that PYD comes at the expense of some additional future risk. On M&A, I mean, I think it's important to recognize that on M&A, we not only filled in many gaps, we've also addressed some positions that just didn't make sense for us. So you've seen us -- certainly up to the ANZ deal, I mean, essentially disposed or released capital in roughly the same amount as we had invested. That's a process that for us is probably continuous. I mean, we continue to look at the portfolio on a regular basis, I mean to ask whether or not it fits with strategy, whether we -- the market is offering the right types of returns, we have the right types of capabilities in place. If we don't, you'll see us do what we've done in the past around -- let's say, like Morocco, Taiwan, the annuity business in the U.S. and the U.K. And I think -- I mean, you all know from prior conversations that we've had that there are parts of the capital base that are currently locked up in risks that we don't think are well remunerated. And this is a topic I highlighted at the Investor Day that this would be a priority for us in '19. And not just in the context of legacy or noncore, as it's referred to publicly. But across the entire portfolio. This is another year where we're going to devote ourselves to looking at the capital allocation and seeing what steps we can take to improve the overall portfolio. How does that feed into capital return? I mean -- I can't add more on that topic beyond the answers I gave to the earlier question to James.

## Operator

Next question is from Niccolo Dalla-Palma from Exane.

## Q - Niccolo Cornelis Modesto Dalla-Palma

Two questions left for me. One on the Z-ECM model changes. Is this bringing the view closer to the rating view? Is it closing the gap between the two? And therefore, is it a good guide for that at this stage? And secondly, a bit more practical, on the capital gain that come through outside BOP. Given where the FX reserves have fallen, what can you tell us to help us getting our heads around the structural part of gains versus what may have been a bit in excess of normal?

## A - George Quinn {BIO 15159240 <GO>}

Yes. Thanks, Niccolo. So the answer to the first question, no. I wish it was yes. But it's no. I think the -- I mean, it was a change that we made to how we look at subordinated debt. I think the change is justified. We'd been looking at it for some time. Just it would've been more convenient to do it when the markets didn't move. But the markets moved as we did it. But we think it's the right thing to do. On the capital gains outside BOP, it's tough to tell you in any given year the number is going to be X, because, of course, it's a function of -- not just our (AFS) starting point, it's a function of how much the portfolio turns over, a function of how the market's perform in the year. I mean, what we tend to guide people is that -- I mean, from a medium, longer-term perspective -- I mean, you can assume and we assume that the number's about 400, maybe slightly higher. That's the level that we have typically in planning.



## A - Richard Burden {BIO 1809244 <GO>}

Thank you very much, everybody, for dialing in today. We are aware that there are a couple of questions outstanding. But unfortunately we've run out of time for this call now. The IR team will reach out to you and follow up with the further questions. If you've got any other questions, obviously the IR team is available, you know where to reach us. Thank you very much.

## Operator

Ladies and gentlemen, the conference is now over. Thank you for choosing Chorus Call. And thank you for participating in the conference. You may now disconnect your lines. Goodbye.