FY 2018 Guidance Call

Company Participants

- Patrick Charles Regan, Group Chief Executive Officer & Executive Director

Other Participants

- Andrew Buncombe, Analyst
- Brett Le Mesurier, Analyst
- Daniel P. Toohey, Analyst
- David Humphreys, Analyst
- David Spotswood, Analyst
- James Coghill, Analyst
- Nigel Pittaway, Analyst
- Siddharth Parameswaran, Analyst
- Toby Langley, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Thank you for standing by and welcome to the QBE Market Update Conference Call. All participants are in a listen-only mode. There will be a presentation followed by a question-and-answer session.

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

Patrick Charles 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 announcement. 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 – there are two 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 two or three months. The first update is on the combined ratio, where the group now expects a full year combined ratio of around 104%, up from the previous 100% to 102% target. And there's really two 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 for Q3. And in our case, obviously above our early (00:01:40) allowances for the fourth quarter and, in our case, that was largely due to the California wildfires, the significant late December storms we saw in Australia. And we've also seen some small net increase in our estimate for Maria, which as you'll 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 three items together have added around $130 million to the group's net cost of large risk 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 decided to strengthen claims for regions by just over $100 million. That's really in a couple of places, primarily in North America in our casualty lines within the Assumed Re business, and then some additional reserves in our Hong Kong workers' comp portfolio. And that (00:03:06) has also added just over 1 point to the full year combined ratio expectations.

We've also increased the group's PoA, which is expected to be now 90% at 31 December 2012 (sic) [2017] (00:03:20), up from 89.5% previously. And there were 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; [ph] a little bit higher coverage combined ratio for (00:03:35) Hong Kong workers' comp; and some other bits and pieces [ph] that have added about 0.5 a point (00:03:41) to the group's full year combined expectation.

Turning then to the noncash items in today's announcement. And 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. So, we've discussed sometime that the headroom calculation is very tight and very sensitive to changes in those assumptions.

And the changes 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 – in the high 95% combined so 95 points. And bring (00:04:32) 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 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 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. And worth noting that both of those, obviously, both of those noncash items don't have any impact on the group's capital decision.

One additional factor just to notice on the cat of the year, they primarily impacted the results of Equator Re and North America where we don't get tax relief. And then all that has a distorting effect on this year's, 2017's group effective tax rate resulting a tax expense notwithstanding the fact we have that pre-tax loss.

I'll just give you a few brief comments on each of the division's results. So, starting with North America, the full year combined for North America is likely (00:05:56) to be around 109%. And obviously, that was significantly impacted by the second half cats, HIM [Harvey, Irma and Maria] as well as those fourth quarter wildfires, all of which added about 7 points to the North American combined ratio. So, 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's also important to note that effective the 31st of December, we executed another loss portfolio transfer where we reinsured at this time the commercial auto reserves. Last year, you remember, we did a reinsurance transfer to the old 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 reserve inputs (00:07:00).

On Europe, our combined ratio of European Operations is expected to be around 95%. So, it's 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 continued to deliver 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 (00:07:46) despite the LMI combined ratio getting a bit higher, we're still seeing a decent improvement in the ANZO attritional loss ratio.

In Asia Pacific, we expected the combined ratio to be around 115%, which really reflects that extra reserving in Hong Kong workers' comp portfolio. Lastly, America's 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's heavily impacted by the extreme cat activity in 2017.

A preliminary assessment of our reg capital position shows that while our capital position's obviously a bit lower because of the impact of the cats, at 1.6 times PCA, it's still pretty strong. And I guess current standing back (00:08:45) 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 each of 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've probably got some other one-off type items, some of that extra weather-related smaller attritional claims in North America, Hong Kong workers' comp, et cetera, et cetera, which probably adds up to another point also 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've 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. And 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 to give you a flavor of it, it'll all be backed up by the sale (00:10:15) review process we put in place in ANZO. I described that quite a bit to you before about how we went about that in ANZO. We're not 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 in underwriting and 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 (00:11:10) continued to drive improvements in North America where lots of good work has already been completed here, we've exited 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.

Q&A

Operator

Thank you. Your first question comes from Daniel Toohey from Morgan Stanley. Please go ahead.

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

Thank you. Good morning, Pat, just in light of the write-downs to goodwill and the like, the sort of close to $1 billion I guess, the gearing and S&P rating, is there any impact?

A - Patrick Charles Regan {BIO 15131018 <GO>}

Thanks, Dan. Gearing, yes, I mean that will just be kind of (00:12:59) of – our gearing will be closer to 40% and those really don't, as I say, affect (00:13:09) our good capital position or S&P position. So, there's not an issue from an S&P perspective and that our gearing will be higher (00:13:19). But we think we can over time reduce that again but partly through earnings accretion and perhaps through some of the portfolio moves that I just mentioned.

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

Okay. And then just on the overall reserving, so you talked about the 1% top-up. When you take into consideration Europe, was the FY 2017 result an overall net – strengthening your reserves or flat or?

A - Patrick Charles Regan {BIO 15131018 <GO>}

Yes. It actually was a small positive, Dan, so I think the exact number's around $40 million for the full year 2017. So we had a release in the first half on the strengthening of just over $100 million in the second half, giving a net for the full year of a positive of around – a release of around $40 million.

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

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

A - Patrick Charles 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 price (00:14:27) at the end of 2017. Just as important 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 stopping writing it was an important move for us.

But actually also during the loss portfolio transfers, it's also been really important to increase, if you like, reserving confidence. And I just wanted to make sure we were really well set up leaving 2017 and going into 2018. So, having done those loss portfolio transfers, we just wanted to make sure that whatever other longer-tail business we've got that we were really well reserved on.

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

Okay. And 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, it went to closer to 96% and, obviously, the cats rolled through with the downgrade in October. But is it sort of the 94.5% to 96% we should be looking at sort of how that rolls through to, I guess, the 2018 of 95% to 97.5%, and if that's the case, where are the points 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 Charles Regan {BIO 15131018 <GO>}

So, I think I mean, obviously, the biggest move we have had in the second half kind of accounts for almost all the burden (00:16:23) is the cat stuff. The second topic really is – what's kind of new is the Emerging Markets businesses, both Latin America and Asia. And I think they're sort of two different topics. On Asia, as I say, the – we're putting in place a comprehensive improvement program. We left 2017 with combined ratio 115%, which is clearly completely unacceptable.

Now, 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'd left that really well reserved. And actually, some of the – we've had to improve our claims – are having to improve our claims handling on that to make sure we get better claims outcomes.

So, Asia's 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. Latam, I sort of kind of hinted to you that there might be a different solution to that going forward as well. But simply that (00:17:26) we can't afford to be posting results in either Latin America or in Asia that is in the 100 and teens going forward.

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

Okay. Thank you.

Operator

Thank you. Your next question comes from James Coghill from UBS. Please go ahead.

Q - James Coghill {BIO 14006200 <GO>}

Good morning, guys. A couple of questions. Just starting on debt reserving change, could you – Pat, could you provide some more color over what actually happened in Europe and Australia and New Zealand to ultimately lead to $110 million and strengthening?

A - Patrick Charles Regan {BIO 15131018 <GO>}

So, we did have some small amounts of positive in Europe, just a little bit less than we've had in the first half. And we had a little bit of positive in ANZO in the second half. So, it did have both have (00:18:24) positives. And then, obviously, we booked up a little bit more than $100 million in North America, that 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 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'd be thinking about reserve releases in those regions into next year?

A - Patrick Charles Regan {BIO 15131018 <GO>}

Yeah. Yeah. I mean good question, Jim. So I think - so do we feel like 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 level of reserve releases going forward? Yes. Is it going to be quite at the level we've seen over the last two or three years? Probably not. And we've seen very - 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 be better. (00:19:31)

Q - James Coghill {BIO 14006200 <GO>}

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

A - Patrick Charles Regan {BIO 15131018 <GO>}

No, not really, James. It's really I mean essentially those cat losses washing (00:20:17) through, as I mentioned to you there because there in Equator and North America, they're largely pre- and post-tax, so the impact on book is almost entirely flat. (00:20:24)

Q - James Coghill {BIO 14006200 <GO>}

And that is no comment on the buyback in the release. Are you happy to make a comment on that now?

A - Patrick Charles Regan {BIO 15131018 <GO>}

No, I think what we said in the release is the board will - so exact phrase we used. 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, is obviously the board recognizes the importance of that going forward. So we'll come back more definitively on that on February 22.

Q - James Coghill {BIO 14006200 <GO>}

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

A - Patrick Charles Regan {BIO 15131018 <GO>}

Yeah. I mean kind of improving efficiency and reducing cost is an important thing for us. We did some small restructuring (00:21:46) costs that are included in the numbers (00:21:50) included in the combined ratio I've just got 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 our (00:22:03) – there's two or three things, we need to reduce our costs in Emerging Markets. That's our highest expense ratio. We've talked about before and it remains true today, we need to continue to reduce costs in North America both in dollar terms and just the ratio. And I think more broadly across the group, maybe you're talking about Europe or Australia that there were lots of opportunities to improve our process efficiency, use technology better. QBE's not unique on that, so some of that will. I don't see that as a big kind of one-off charge time item. That's a continual improvement of a focus on process quality, focusing on, therefore, cost outcomes and reducing costs over time. So, we'll talk to you a bit more about that in February.

Q - James Coghill {BIO 14006200 <GO>}

Thank you.

Operator

Thank you. Your next question comes from Andrew Buncombe from Macquarie Group. Please go ahead.

Q - Andrew Buncombe {BIO 19921333 <GO>}

Hi, guys. Just two 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 Charles Regan {BIO 15131018 <GO>}

We do got (00:23:07) 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 amount.

Q - Andrew Buncombe {BIO 19921333 <GO>}

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

A - Patrick Charles Regan {BIO 15131018 <GO>}

Look, I said 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 huge growth targets? Probably not right now. What I really want to do is, it's what I've said, is improve the underwriting performance of the business and improve our consistency of delivery.

Now, when we went through that at 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 was to improve the attritional loss ratio, the underwriting performance and the consistency. So, I think, over time, we do think we can grow in North America, but the first and foremost is to improve underwriting performance and consistency there and elsewhere.

Q - Andrew Buncombe {BIO 19921333 <GO>}

Yeah. That makes sense. And then the last one, everybody's 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 the back of that?

A - Patrick Charles Regan {BIO 15131018 <GO>}

Yeah. I mean it's - I haven't had the time to really look at - in any detail, at the AIG announcement other than to see it's happened. What I will always say about those so I can't comment on them is we've got a really full suite of good work to do that could 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 on focusing on that full (00:25:12).

Q - Andrew Buncombe {BIO 19921333 <GO>}

Excellent. Okay. Thanks. That's it from me.

Operator

Thank you. Your next question comes from David Humphreys from JCP Investment Partners. Please go ahead.

Q - David Humphreys {BIO 18797143 <GO>}

Yeah. Good morning. 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 nominal growth, or should we just use the current years of both (00:25:43)?

A - Patrick Charles Regan {BIO 15131018 <GO>}

I think probably the latter, David. I mean I think we did end up growing 1% or 2% in 2017. Look, the good news is everybody's read the pricing environment commentary from October expectations we're going to see a big increase to a little bit more mooted now. I think what you could say is it's the 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 – improving underwriting performance and improving the consistency of our delivery. I would hope that we can keep our retention somewhat stable and benefit from at least kind of more flat to moderately positive pricing environment.

Q - David Humphreys {BIO 18797143 <GO>}

Okay. Second question. In your commentary, you've talked about simplifying and reducing risk. If you look at the cat outcome this year, you need to lower your retentions in your program and did you get away the final component of your 2018 program that you haven't done back in October?

A - Patrick Charles Regan {BIO 15131018 <GO>}

Yeah. So, we have completed that. Yes. That's all been successfully placed now. I think it's an interesting question on the cat. So, what the industry all experienced was a series of medium-sized events – obviously, Harvey, Irma, Maria, wildfires – and that tends to be more impactful than kind of one extremely large event which hits directly at your cat towers (00:27:33). So we've got the plant (00:27:36), we've got both our cat program, our large risk program and the aggregate treaty in place for 2018.

What that means is it buys us a little bit of time to have a look at things afresh. So, I kind of want to do that, just to see what the right protection is coming forward other (00:27:51) than that. We'll include both the reinsurance protections and whether – (00:27:57) whether we should be in all of the places where you get much higher cat exposure to the premium pool you collected (00:28:04).

Q - David Humphreys {BIO 18797143 <GO>}

Okay. And my last question is on your, I guess, your objective in 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 (00:28:30) elsewhere, you don't need to put cost back in (00:28:32) in the first place?

A - Patrick Charles Regan {BIO 15131018 <GO>}

It's an interesting question. I'd candidly tell you that in terms of the last 18 months, did I do a lot of stuff to improve the efficiency in Australia? Probably not, no. To your point, our focus was really elsewhere. It was all about the really basic stuff, the performance improvement stuff. The example you are using just for everybody else, (00:28:55) we're bringing about 200 claims roles 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 and 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 costs in Latin America and in North America. Will we need to invest in some stuff as we go through that? Yeah, I'm sure we will as well. So there's no direct equivalent example, I don't think, to the 200 roles in Australia.

Q - David Humphreys {BIO 18797143 <GO>}

Okay. Thanks for that.

Operator

Thank you. Your next question comes from Nigel Pittaway from Citigroup. Please go ahead.

Q - Nigel Pittaway {BIO 3406058 <GO>}

Morning, Pat. So, just wondering with such a wide range now for combined ratio guidance in FY 2018, can you give us a feel for sort of the kind of key factors you think are important, I mean whether or not you swing towards the bottom or top of that combined ratio target range?

A - Patrick Charles Regan {BIO 15131018 <GO>}

Yeah. Thanks for the question, Nigel. And obviously, we're using a wider range than before and part of that is just me kind of giving us a better opportunity to make sure we deliver against our expectations and to deliver, I guess, what we say we'd do, which is kind of vital for us going forward. I mean 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 and then we went through the top of the aggregate treaty. So normally, we wouldn't expect that to be a swing factor. So, it's how well we can deliver on our attritional and how much kind of positive prior year we'd get would be the two biggest factors, I think. And probably the kind of linked to first of those, just kind of how much the pricing environment helps or just help.

Q - Nigel Pittaway {BIO 3406058 <GO>}

All right. Okay. So, the guidance will include any sort of anticipation of prior year releases in effect?

A - Patrick Charles Regan {BIO 15131018 <GO>}

I mean it will, yes. I'm not going to be any more specific even when we get to February about what that is, but it will include anything for prior year, yes.

Q - Nigel Pittaway {BIO 3406058 <GO>}

Okay. Thank you.

A - Patrick Charles Regan {BIO 15131018 <GO>}

Okay.

Operator

Thank you. Your next question comes from David Spotswood from Airlie Funds Management. Please go ahead.

Q - David Spotswood {BIO 17576616 <GO>}

Yes. Thanks. David Spotswood. Just a few questions. I mean obviously QBE (00:31:26) the big complex business scattered throughout the globe. I mean how comfortable 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 rates to be flat to up a little bit sort of globally in 2018? Not sure if I got that. And these investment returns of 2.5% to 3%, what have you assumed in there in terms of what markets are doing in cash rates (00:32:00)? Thank you.

A - Patrick Charles 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 substance and in form. I think part of the program of what we're doing now is exactly aimed to (00:32:23) doing that. We've exited Thailand but it's only tiny. Clearly, we've flagged that Latin America is under review as part of that. So, I think you should expect that the kind of the QBE going forward is smaller, a little bit more focused and less complex than the QBE today.

Just on rates, obviously, you got three 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 kind of positive into 2018. The rate environment in Europe and North America started kind of moderately positive but I think whether you're QBE or anybody else, you just wait and see how that plays out during the year. So, for North America and Europe, it is a kind of a flat to moderately positive, and then we're seeing how that develops post (00:33:24) as we get later in the year.

On the investment income, so obviously in (00:33:33) 3.2% investment return in 2017. And that (00:33:40) from the principal thing as well as good equity markets was a narrowing of credit spreads going forward. So, what we've assumed going into 2017 is really no movement on credit spreads going forward. These (00:33:58) started well (00:33:58) equity markets (00:34:02). We've not really assumed any incremental gain on that.

On interest rates, we kind 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 (00:34:20) helps the ongoing yield going forward. Obviously, that's a big positive but you get a small mark-to-market impact in the same year as well. So, it ends up not being a huge positive to the annual investment income, if that makes sense.

Q - David Spotswood {BIO 17576616 <GO>}

Yeah. Thank you.

Operator

Thank you. Your next question comes from Toby Langley from Merrill Lynch. Please go ahead.

Q - Toby Langley {BIO 15924432 <GO>}

Good morning. Thanks for having my question. Pat, I was hoping to get your comments on when will we be able to see a cleaner representation of what the group can do from a combined ratio perspective. It feels like we've spent five, six, seven years with a company in something of a transition. The 95% to 97.5% it's seemingly the sort of overhang there from a 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 2018 and even in 2018?

A - Patrick Charles Regan {BIO 15131018 <GO>}

Yeah. So, 2018 versus 2017, I meant (00:35:34) 2019 versus 2018, they've been making it overly simplistic. At a high level, we need to improve 2018 versus 2017 on our performance and we need to improve 2019 versus 2018. What are our big levers to do that? I mean you've got ANZO and Europe performing reasonably well. It'll help Europe (00:35:58) slightly better pricing environment. They've also been fighting pricing headwinds in the last two or three years, more than two or three years. So, actually, even getting to a small positive is kind of good for them.

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 2018 is to make 2018 better than 2017. And then, obviously, we want to continue that, and I think we can continue that improving 2019 versus 2018. By geography, obviously, that's - we can't afford to be posting something in the 100 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 Charles Regan {BIO 15131018 <GO>}

Yes.

Q - Toby Langley {BIO 15924432 <GO>}

And you're attributing $700 million predominantly to combined ratio movements, but it doesn't 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 Charles Regan {BIO 15131018 <GO>}

No, I'm glad you asked that, Toby. So you start with headroom of around slightly a bit over 100%. So, 1% movement giving a impairment of 230-odd means a movement of 330-odd (00:37:31), if that makes sense. So, a 2% movement gives a movement of double that. Flat is the main bulk of it.

The second bit is the loss portfolio transfer transaction we did on December 31 was being good for us on reserving certainty for sure, and therefore, kind of confidence around future combined ratio, also reduces your 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 COR movement (00:38:05) is about 2%?

A - Patrick Charles Regan {BIO 15131018 <GO>}

Yeah. It's ramping slightly a bit about that, yeah.

Q - Toby Langley {BIO 15924432 <GO>}

Okay. Cool, thank you.

Operator

Thank you. Your next question comes from Siddharth Parameswaran from JPMorgan. Please go ahead.

Q - Siddharth Parameswaran {BIO 15037291 <GO>}

Hi, Patrick. A few questions if I could. 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 Charles Regan {BIO 15131018 <GO>}

No. We've – obviously, we did our business plan, so one of the things we had to do was as we (00:38:44) came into the start of 2018, just look at one more (00:38:49), look at the pricing environment. So, the three big blocks, as I mentioned, in ANZO, there is a bit of positive momentum from rate so whether (00:39:01) we'd have assumed that and then we'd have assumed a cautious amount in Europe and North America.

Q - Siddharth Parameswaran {BIO 15037291 <GO>}

Okay. Okay. So, I'll take - obviously, just a very modest impact then across the group, it sounds like.

A - Patrick Charles Regan {BIO 15131018 <GO>}

That's correct. Yeah.

Q - Siddharth Parameswaran {BIO 15037291 <GO>}

Okay. Fair enough. Okay. And 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, I suppose it's just a question around what's really happening with claims and what led to those reserve increases.

A - Patrick Charles Regan {BIO 15131018 <GO>}

A different answer to the two bits I talked about, Sid. On the North American one, the Assumed Re, that's just having a bit of extra IBNR (00:39:52) that's more kind of certainly kind of put away. So, not 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 reserve 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 two.

Q - Siddharth Parameswaran {BIO 15037291 <GO>}

Yeah. 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 Charles Regan {BIO 15131018 <GO>}

So, yes, in Hong Kong workers' comp, that was one of the factors in Asia's performance. We did increase current accident year, Hong Kong workers' comp.

Q - Siddharth Parameswaran {BIO 15037291 <GO>}

But nowhere else in the world?

A - Patrick Charles Regan {BIO 15131018 <GO>}

We're on to that (00:41:00) elsewhere in the world. So I mean, let's say, you get from the attritionals when we're doing separate (00:41:03) a bit of an improvement in Australia, as I mentioned. And in North America, the biggest movement in North America (00:41:12) 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. Just one last question. 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 about a smaller QBE, more disciplined and focused on getting its underwriting right.

But I think to David Humphrey's question, you suggested that we should be assuming a flat trajectory in terms of premium. So, just - I mean I suppose that all these initiatives 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 Charles Regan {BIO 15131018 <GO>}

Yeah. I think I was trying to avoid answering the questions here actually.

Q - Siddharth Parameswaran {BIO 15037291 <GO>}

Okay.

A - Patrick Charles Regan {BIO 15131018 <GO>}

I'd rather not give a top line guidance going forward. It's actually two things. On our organic trading, the most important thing now is to improve our underwriting performance and improve our consistency of delivery. It's slightly helpful 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.

Q - Siddharth Parameswaran {BIO 15037291 <GO>}

Okay. Great.

A - Patrick Charles Regan {BIO 15131018 <GO>}

Thank you.

Q - Siddharth Parameswaran {BIO 15037291 <GO>}

Thank you very much.

Operator

Thank you. Your next question comes from Brett Le Mesurier from Velocity Trade. Please go ahead.

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

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

A - Patrick Charles Regan {BIO 15131018 <GO>}

It's an interesting question, Brett. I mean, obviously, you follow this world for a few years. As QBE has reduced cost, it's only partially helped our expense ratio because, obviously, we've had a reducing top line. I'd just say I'm going to try and steer away from giving top line guidance. It is important though going forward that, over time, we take out cost to improve efficiency and we can do that. So, I think we said it was 32.5% expense ratio for 2017. 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 Charles Regan {BIO 15131018 <GO>}

It was around 100%, Brett. Yeah, you mentioned about rate. That's obviously impacted in the second half by their share of the HIM – Harvey, Irma, Maria activity. They write quite a bit of business as most lender 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 Charles Regan {BIO 15131018 <GO>}

Well, we had less – the second features are, as I mentioned, was we had less positive prior-year releases in the second half.

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

Okay. And, lastly, I had a small increase to the probability of adequacy on your outstanding claims reserves fee. The increase that you've put through there, how much did that cost?

A - Patrick Charles Regan {BIO 15131018 <GO>}

Well, the maths is if you'd left it at 89.5%, our combined ratio would have been 40 basis points better. But it's not all increasing dollars of risk margin. It's a lot of risk reduction activity so things like that loss portfolio transfer helped that, things like the aggregate reinsurance treaty helped that. So, if we were 89.5%, combined ratio would've been about 40 basis points better, but it wasn't all about putting dollars of risk margin in, if that makes sense.

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

Right. So, the coefficient of variation reduced slightly, I gather from what you're saying.

A - Patrick Charles Regan {BIO 15131018 <GO>}

Exactly. Yeah.

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

Great. Thank you. That's all the questions I have.

A - Patrick Charles Regan {BIO 15131018 <GO>}

Thanks, Brett.

Operator

Thank you. Your next question is a follow-up question from James Coghill from UBS. Please go ahead.

Q - James Coghill {BIO 14006200 <GO>}

Hi, Pat. It's just a very quick one. Your combined ratio for 2017, it doesn't include the discount rate adjustment, but that should've been positive over the half. So, the 104%, I just want to confirm that you haven't actually included the DRA in that?

A - Patrick Charles 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've been a positive over the half?

A - Patrick Charles Regan {BIO 15131018 <GO>}

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

Q - James Coghill {BIO 14006200 <GO>}

Small. Okay.

A - Patrick Charles Regan {BIO 15131018 <GO>}

And, of course, (00:46:13) – it doesn't also include Ogden either, if you remember that.

Q - James Coghill {BIO 14006200 <GO>}

Yes. Nothing further. Thank you.

A - Patrick Charles Regan {BIO 15131018 <GO>}

Thanks, James.

All right. I think that's all of our questions. So, we appreciate it. I know it's short notice and you all had to breathe quickly to get on the call. We appreciate that. We look forward to seeing you all soon and, if not before, on February 26.

[Abrupt End]