Q3 2014 Sales and Revenue Call - Interim Management Statement

Company Participants

- Anthony Jonathan Reizenstein
- Paul Robert Geddes
- Steven Maddock

Other Participants

- Andrew J. Crean
- Andy Hughes
- Fahad U. Changazi
- Gordon Aitken
- Greig N. Paterson
- Marcus P. Rivaldi
- Oliver G. Steel
- Ravi Tanna
- Will F. Hardcastle

MANAGEMENT DISCUSSION SECTION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the Direct Line Group 2014 Quarter Three Results Conference Call. At this time, all participants are in a listen-only mode. There will be a presentation followed by a question-and-answer session. I must advise you that this conference is being recorded today, Friday, the 31 of October, 2014.

I would now like to hand the conference over to your first speaker today, Paul Geddes. Thank you, sir. Please go ahead.

Paul Robert Geddes {BIO 2474781 <GO>}

Thank you and good morning, everybody, and welcome to our Q3 update. You've all had a chance to read the statement which we issued this morning. And you've noted the usual disclaimer in our IMS about forward-looking statements, which, obviously, equally applies to this call.

In line with the approach back in Q1, there's no formal presentation today, instead I'm going to run you through the business highlights of the quarter, give you a brief update on the headline financials before sharing my observations on the UK Motor and Home markets, and then we're going to take your questions. As usual, I'm joined by John Reizenstein and other members of my management team.

So, starting with the business highlights, you'll see from the announcement, it's been another busy quarter as we focused on improving our capabilities and propositions in what's continued to be a competitive marketplace. Year-to-date, we've launched new Motor websites, significantly improved the quote-and-buy journey to our customers. We've refreshed and differentiate the Direct Line proposition. We rolled out smartphone technology into the claims process.

Our telematics offering, which as you know now includes self-install, continues to grow. And behind the scenes, we're good way through delivering the 30 or so pricing projects we identified for this year. The combination of all these initiatives has helped us to improve our competitiveness, which allowed us to trade a bit harder in the third quarter.

Outside of the UK, we've recently announced the sale of our International business system, Mapfre, which completes the strategic review announced early this year. The total cash proceeds of €550 million are 1.9 times 2013, that's asset value, represented good result for all our stakeholders. And we confirm that substantially all of the net proceeds will be returned to shareholders as soon as practicable post-completion.

Before I talk about the UK Motor and Home markets, let me take you through the headline financials. Ongoing GWP was £820 million, down 4.2% against the same quarter last year, and a small improvement on the 4.7% reduction observed in Q2. Note, we are now excluding International and this will be treated as discontinued.

In-force policies were down 2.6% versus the end of December and 0.5% in the quarter. And I'll come on to that in more detail in a moment. We made further progress on costs in Q3. Total costs were £241 million, which represent a 7% reduction versus last year. And within that, staff costs were down 20%. Year-to-date total cost was £737 million, 6% lower than last year with reductions in staff costs and marketing costs, partially offset by higher depreciation and amortization charges. Overall, we are on track to achieve our £1 billion cost target this year.

Moving on to investments, we continued to see improving returns as a result of the actions we've taken around the mix of our investment portfolio. In the third quarter, we increased our holdings in the UK Commercial property and securitized credit and securities within the corporate debt portfolio rated at BBB. We've recently agreed two new asset classes, namely UK infrastructure debt and private placements of investment grade credit, which we plan to build up in the fourth quarter this year and the first quarter of 2015, respectively.

Investment income of £48 million was up 4.6% on last year and year-to-date investment income was more than 9% ahead of last year. The annualized income yield at the end of

Q3 was 2.3%, which is 20 basis points higher than for the first nine months of 2013.

Investment gains were slightly lower in the third quarter, but year-to-date remain ahead of the prior year mainly as a result of unrealized property gains. This gave us a total investment return of £175.7 million for the first nine months, which was 11.3% higher than the same period last year, a good result given our assets under management have been falling during the year.

Now for more detail on GWP including an update on the UK Motor and Home markets. So, in the UK Motor market, there are four things I'd like to cover, pricing, current claims trends, reserving and regulation. All these are clearly linked and the message I'd like to take away is that whilst we've seen some stabilization in market pricing, but structurally deflationary impact from LASPO has now worked its way through. So, based on historical trends, we'd expect to see underlying claims inflation return to the market.

Starting with pricing. As you all have seen, the external survey so far appointing to broadly flat pricing in the third – in the quarter and we'd agree with those surveys. Our prices were flat in Q3 2014 versus Q3 2013. And this is the second successive quarter of flat pricing. For us, risk mix was, again, down a little bit, but in line with the trends which we saw in previous quarters.

Our GWP reduction in Q3 was less than the previous quarters as our prices were more competitive in a stable market. We also continued to see the benefits and improvements in our pricing and our claims capability.

Now, on to claims where currently our trends have been a little mixed in the year with high and large bodily injury volatility, partially offset by good experience in small bodily injury. In terms of small BI, from looking at portal stats, we believe we continue to outperform the market albeit that the market levels of claims have edged up.

Putting all of these together, we expect our current-year loss ratio for Motor in the second half of the year to be in line with the first half. Still a good result in the context of the market price deflation seen over the last two years and reflecting our disciplined pricing strategy, claims transformation as well as LASPO. And as I said earlier, LASPO has now worked through the system, so we expect underlying inflation to return to the market.

We've completed our third quarter reserve review, which included large bodily injury. And these confirm the strength of our reserve position and our expectation of significant reserve releases in 2014, both in the ongoing business and the runoff segment. Levels of reserve releases are expected to be lower in future years albeit still significant.

I want to update on the regulation front. The CMA published its final report on the private motor market in September. We're pleased with many of the measures outlined, which, on balance, should be good for customers including the banning of most wide and most-favoured nation clauses, a change that should encourage competition between PCWs. However, we were disappointed that CMA wasn't able to find a solution for credit hire. But overall, we don't expect these changes to have a significant impact on our business.

So, in summary, a second quarter stable prices in Motor, but this should be set against the market where structural claims deflation has now pretty much worked its way through the system.

So now, on to UK Home. In Home, year-to-date IFPs were down 4.3%, and within that own brands, we're down 3.7% with partners down 5.8%. This reflects an increasingly competitive market and changes in distribution trends as well as lower new business volumes in partners. As partners continue to evolve their sales journeys, we expect to see a relative increase in own brands versus partners going forward.

In the first quarter, in-force policies were down only 0.9%, an improvement compared with a 2% reduction in Q2, whilst GWP was down 5% in the third quarter versus the third quarter last year, which is in line with the trend in the prior year.

On the back of strong underlying claims performance, which reflected the benefits from recent pricing and claims initiatives, we chose to trade a bit harder in the quarter. Home retention continued at good levels.

While I'm on the subject of Home, let me give you a brief update on weather costs. It was another benign quarter, so total weather-related costs year-to-date remain unchanged at £64 million compared with around £5 million in the first nine months of 2013. Commercial was also unchanged at £16 million.

In Rescue and other personal lines, underlying GWP was up 3.7% year-to-date, although the headline showed a 4.4% reduction as the prior year includes some life premiums. Rescue have continued to grow GWP and IFPs with premiums up 5.6% in the first nine months due to improved competitive propositions and customers purchasing higher levels of cover.

Outside of UK personal lines, Commercial continues to grow with IFPs up 3.9% year-to-date and GWP up 2.8%. Within this we saw double-digit growth in eTrading and Direct Line for Business products, excluding van, partially offset by Commercial van, which similar to personal motor has been highly competitive.

So, to wrap up the key messages, we reiterate our 95% to 97% combined operating ratio target based upon normal weather claims. Within this, we expect our current year loss ratio in Motor in the second half to be in line with the first half and also to include significant reserve releases.

Commercial remains on track to achieve a sub 100% COR, again, assuming normalized weather claims and large losses and these CORs are underpinned by our £1 billion cost target in 2014, which we are on track to achieve.

In terms of the market, we saw another quarter of stable prices in UK Motor whilst in Home we saw further deflation. Against this backdrop, we are busy driving forward our strategic initiatives by further developing customer propositions, driving greater efficiency and improving our underwriting capabilities.

With that, I'm going to hand back to Rose for questions.

Q&A

Operator

Thank you, sir. And your first question, sir, comes from the line of Gordon Aitken. Please ask your question.

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

Good morning, Gordon.

Q - Gordon Aitken {BIO 3846728 <GO>}

Morning. Three questions please. First, your costs are down 6% year-on-year, and just at the end of September, if you can update us on how many people you have and how many sites you're running with? Secondly on telematics, obviously, good progress here. Can you just update us on some penetration rates and maybe talk a little bit about profitability, although I know it's early days really to the non-telematics business? And just third on brands, you obviously mentioned something about your own brands relative to the other brands, just how are each of the brands performing at the moment?

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

Great. Thanks, Gordon. Three big questions there. Let me do them in reverse order. So, I mean, starting with the brands, the big news, I guess, is all the stuff which we've done on Direct Line, obviously the splashiest thing, the most notable thing that people see is the new advertising campaign. We researched it extensively, researched really, really well. And the initial response has been absolutely in line with the pre-research. So the brand metrics are moving forwards. We're pleased with the sales performance.

So I think the new advertising is capturing people's imagination and again, moving people's perception as the brand forward. The key thing about advertising is, of course, advertising is there to catch the attention for the messages and we continue to move forward the proposition. One of the things which we've got on air, allowing people to report claims using their smartphone or digital and then for urgent items like TVs to get those on their way within eight hours of the claim being notified.

So we've got some really propositions and we've got a pipeline of future propositions to come because it's not just about the advertising format albeit the advertising format is really good. And we're piloting lots of other cool things on Direct Line in terms of, for example, the contact center model. So, we have a product where we're allowing agents to sell multiple products for one brand, whereas at the moment we have agents selling one product for lots of brands. So that should help cross-sells going forward.

So we're really excited about Direct Line. Churchill is on our stat for 2015 to do a similar sort of exercise on Churchill. And Privilege is a bit of unsung hero in our portfolio. Privilege is a really good value brand and we're pleased with its performance. So I think we're doing a nice job.

Again, there's no point of having three brands if they're all identical, appealing to same customers with the same propositions. And I think, again, behind the scenes, we think we're doing a better job of sorting out which brands and for which customers, differentiating the propositions so that we appeal to more customers than we could with just one brand.

The partner brand trend, I think you've picked up on and I think that's just a comment on – and I'm not the first to report this. There are clearly some changing dynamics in the partner sales models and so they're important part of our book, but we're seeing slightly changing trends between the brands – our own brands and other partners.

On telematics, I think the new news, telematics book grew 50% in the quarter. So that's just hard. I think we're in the early stages. It's growing fast. The encouraging thing for us is the uptick we've seen on Web participation. So we're taking the messages which we've learned matter to people on the phone and I now put those on the website. So we're seeing a really good uptick now on the Web penetration not just on the phone.

We're early now into the renewal season and all I'd say is the encouraging thing for us is overall renewal levels are up. But most pleasingly, renewals amongst the drivers, which we now want as a result of seeing their driving behavior, really are improved. So we are seeing good retention of better drivers. I think the full set of profit characteristics of that, we're going to have to have a bit more time to bed in, but we are really pleased to be on – I think on the right side of the telematics trends and we see that whilst still small I think doing everything that we'd expect and hoped and we expect to keep that momentum up over the next few quarters. I'm going to hand across to John on costs.

A - Anthony Jonathan Reizenstein

Yeah. Just I think the facts on that. Excluding International, we've got just below 11,000 FTE and 11 COR sites. I think that was the question. (15:25)

Q - Gordon Aitken {BIO 3846728 <GO>}

Yeah, super. Thanks.

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

Okay. Rose?

Operator

Yes. Thank you, sir. Your next question comes from the line of Ravi Tanna. Please ask your question.

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

Hi, Ravi.

Q - Ravi Tanna {BIO 16926941 <GO>}

Hi. Good morning. This is Ravi from Goldman. Just three questions please. The first one is on the home insurance market. Earlier in the year, you had mentioned that some of the increase in competition that resulted from the spillover effects from motor players coming in and becoming a bit more aggressive. Are you still seeing that? Do you expect that to reverse as the motor market stabilizes? And can you just speak a little bit more about whether the home insurance competition is more structural, cyclical?

And the second question is could you perhaps just elaborate a little bit in terms of – you've talked about this mix shift from partner distributions to own brands? Can you perhaps just remind us a little bit more about the profitability through each of those channels and any differences there?

And then thirdly and finally, on the Motor book, you've de-risked a little bit over the course of the quarter. Could you just speak a little bit about your attitudes towards potentially at what stage you would think about re-risking the book or what the considerations have been in that segment of the market?

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

Fine. Okay. Let me do them in reverse order. So, I would – nothing would please me more than see a slight uptick in risk mix because we would only do that if we did it safely. We're not going to suddenly kind of chase higher risk business. But I think we're getting in place, many of the tools to increase the risk mix.

I mean actually, the fact that risk mix kind of ticks downwards is partly also a function of the mix between retention and new business. If you do more retention than new business, every year your book kind of gets safer because as cars get older and people have a year's extra driving experience. So, that's a bit of a drag when we've been going through the sort of period we were going through with less new business.

What I mean by the tools, some of our 30 pricing models or pricing projects are specifically to try and work out the sub segments of attractive higher premium business and we've got some good early leads on that. So, that should come through. Telematics is another tool helping us get out to some of those higher premium business. So, I would really like to see just as the IFP trends market permitting, looking – we've got some positive trends even within the quarter in terms of the IFP trends, obviously, the next frontier is then to get the AVP to get the stability in the top line, which should be a nice outcome, not our objective, an outcome of all the hard work that we're doing.

On Home, I'm going to be a bit bashful on profitability of partners because that is something they wouldn't want us to disclose. But a generic point obviously, partners want to make a return on it and within these arrangements, I think, it's well-known that obviously the distribution, obviously, is a very profitable business to be in. So, you can make your own kind of observation. So that's probably all I can say. I can't be drawing any further on that.

I think, in terms of the – what's causing the Home marketplace to be more competitive? I think there's two things. So, we are seeing panels taking – having a big role and sitting behind the panels, probably some reinsurance capacity. And I think you know about the state of the reinsurance market. So, as you can judge well that's cyclical or structural. I'm sure you know a lot more about the reinsurance profit signals than I do.

And then, the second thing is, yes, some of the motor competitors are trying to grow their home books. And again, if they're being successful not profitable, I guess that probably is something they'll continue to do.

Said against that, I guess my tonality is slightly more positive than it was a quarter ago because a few things have happened. I mean, we do make our own knock on (19:20) Home. We've got – we continue to improve the claims process both giving customer benefits and in terms of indemnity costs, a lot of these pricing projects, the 30 pricing projects are giving us good improvements in underlying performance in Home. We've continued to move forward our propositions. We continue to refresh our marketing. And that is translating through to two things I'm really pleased about. First of all, our retention rates are staying at very, very good levels. I'm very pleased with our retention rates on Home and that's obviously very important.

What's new in the third quarter is we used some of the fire powers we've got, some of the fuel which we've generated by all these initiatives to turn that into us trading a bit harder. And again, the IFP trend even within the quarter was quite positive on our own brands. So, we are not taking a more competitive market line down. We're very, very active in the marketplace. And I was quite pleased with some of the trends in Q3, albeit in the context of the market that goes down 1 percentage point on new business a month.

Q - Ravi Tanna {BIO 16926941 <GO>}

Great. Thank you very much.

Operator

Thank you. And your next question comes from the line of Andy Hughes. Please ask your question.

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

Morning, Andy.

Q - Andy Hughes {BIO 15036395 <GO>}

Look, I have some – hi – a few questions if I could. The first one is about the 95% to 97% guidance for the year. Obviously, that's normal weather conditions and we're probably a bit more benign than that. But the problem I've got is obviously you've got exceptional reserve releases this year coming through. And even though you've got the exceptional reserve releases, you haven't reduced the guidance for your expected combined ratio for the year. Could you kind of perhaps explain why and what that means possibly for the combined ratio next year? Are you kind of signaling that you expect the 95% to 97% to be worse next year as a result of lower reserve releases?

Third question is, I guess, it's two years since the IPO now. So, it'd be quite good to get a view of where we are on the restructuring two years on. It still feels like many of the issues are still there, declining vehicle count, pressure in the markets, expenses have been reduced, but they still feel quite high. I'm just trying to get a feel as to how you think things are going? Whether they're going as well as you hoped for? Certainly, on the current year combined ratios, I would have expect them to be a lot lower by now. And certainly, peers are reporting much lower current year numbers. So, maybe you can talk about that?

And the final point is on the large claims. I think you mentioned for the first time – I think you mentioned in the half year, but certainly in this statement today, you're talking about increased number of large claims. Is that something that happened in Q3? And can you maybe perhaps discuss what's going on there? Thank you.

A - Anthony Jonathan Reizenstein

Sure, Andy. (22:03).

John here. Firstly, weather, benign third quarter, not very benign first half, overall normal, pretty normal year-to-date. I don't know what's going to happen the rest of the year, certainly normal until 30 September, been very nice in the last few days.

What 95% to 97%, yes, we're going to have slightly higher reserve releases than we thought when we set the 95% to 97%. And I guess, yes, our current year will be a little bit worse than we thought we'd be getting. And why is that? Well, the main reason is that normally or in the last couple of years, we've had CY improve over the year. And that's probably not going to happen in the second half, which is why we made the – given the guidance of the current year that the second half will be similar to the first half.

And why is that not happening? Well, I mean, that's a combination of a few things that have happened like the spike and I will call it the spike in BI claims, which I'll come back to in a minute, and general trading conditions. So, we aren't quite going to make the CY we wanted. I think the other point on the CY is that we do each reserve in a very conservative way and so we haven't fully taken into account, LASPO frequency benefits, for example. We've still got quite a bit of that to come through. And that continues to be relatively slow recognition. So, that's the reason why the CY hasn't improved much in the second half or improved in the second half.

Let's talk about the BI cases and then maybe say something about next year. The BI cases, we're talking about a lot of small numbers and these are the top end of the range of size bands and we get very few, but we get a few more than very few. That's quite a bumpy random spike.

We do not think it's a trend. We've looked at all the individual cases in the greatest detail. They're always in risk appetite. There's no connections to any risk mix activity or anything like that. It does feel to us is totally random, but it's going to have an impact. Now, the impact is going to be mitigated by the reinsurance reform, which obviously is better than we had in previous years.

So, we think that is I would like to say one-off. It's certainly a bit of random volatility. About the GWP, the third party data which just came out looks like years up to 2013 were quite random and there's a bit of randomness for us anyway 2014.

What does it mean for next year? Well, there's obviously some bits to it. Starting with the prior year, we're saying that prior year won't be as good and coming off obviously a very high level. So that will still be significant and still be significant in the future years, too.

We will work hard. We are determined to get our current year down and through actions we're taking on claims, on pricing and so on. We will do things on cost as well. Although we can't always commit that our cost ratio will be better period-on-period. We managed to do that so far. We can't commit it will always do that, but we will drive our cost down.

So, it's going to be hard work, but we will give some perhaps some guidance at the year-end about our COR. Now, it's probably a bit early to start talking about that.

Now, you did ask a broader question about looking back the last two or three years and we think we've done a good job on that. And Paul maybe is the right person to comment on that.

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

Yeah. I think we've got confidence from the last two years that we can execute staff and I think I'm really proud of lots of things that we've done. Yeah. I think our claims performance is kind of market leading now. I think our pricing's really getting there. I think that we've done a good job on costs albeit with very high starting point. And I think they're starting to get on to the front foot on technology, telematics and marketing and propositions and brands.

Now, am I in a state of saying anything other than we've got still a load more opportunity in this business to go at, absolutely, we have. So £1 billion is absolutely not the end destination on costs. There is a lot of opportunity to drive our cost down and we will. We just might not do require a target for reasons I've explained previously, which is there are downsides to setting out the targets, but don't mistake that for my determination to get our costs down. There's still a lot of scope for our cost to get better and that's certainly firmly in our sights.

I think in terms of the IFP trends, we are trading harder. We are slightly – the mood of the business has changed a bit. So (26:38) with Mike Holliday-Williams here. He's trading this business harder and our marketing is working. We've got some really good things going on and we've got a long list of things we're working on.

So, I think don't mistake anything I've said for any sign of complacency, but we have confidence about us, I think, from what we've achieved over the last two years and there's a lot more to do in the next – in the coming years and we're up for it.

Q - Andy Hughes {BIO 15036395 <GO>}

Okay. Thank you.

Operator

Thank you. And your next question comes from the line of Will Hardcastle. Please ask your question.

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

Hi, Will.

Q - Will F. Hardcastle {BIO 16346311 <GO>}

Hey there, guys. You've touched on the Home market a fair bit there, but overall, just a quick one on it. You're increasing your competitiveness. Headlines, generally, are pretty negative on that market. Is it your cost savings that gives you so much confidence and your new systems is being put in place? And is it a fair reflection for us just to be thinking, if you're being more competitive, we might see IFP grows, but possible margin deterioration here. So year-on-year, we shouldn't be expecting much improvement overall.

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

Yeah. That's right. I think the – what we've said about this is, as of – so pretty much the end of last year, we were pulling off some fantastic thing, which we were keeping our policy count flat at market-leading levels and keeping our profitability flat at market-leading levels. And that was the picture.

Now, what we've said is the market competitiveness means that keeping exactly both exactly flat is very challenging. And we've made trading choices, which are either probably in favor of one or other on a daily, weekly basis. What I've seen in the third quarter is a much, much more stable, and especially within the quarter, top line picture supported by very, very good retention and a much more aggressive stance in the new business marketplace, and at still attractive loss ratios. Whether we can keep loss ratios exactly as low as they have been, that may not be possible, but we're going to optimize between the two and retain much of the book and retain pretty much all of the book in own brands and keep a very attractive level of profitability. That's some of the goals we seek for that business.

And I'm encouraged by the Q3 trends that we can do that more than I was saying in Q2. But that is a very impressive thing, I think, in a market that is, as I've said is going down 1% pretty much a quarter in terms of new business pricing, but we have some very profound assets here. And we're playing a long-term game. So, we recruit customers with a long –

view to their long-term profitability and we have real long-term assets. We have amazing data, which gives us insight into the market. If you're new to the home market, you're new to any of these perils. You don't know about the state of water and flooding and fire and substance and burglary. These are new things which you learn. We have fantastic supply chain in place. We have some great supply chain deals. We have some great technology in place. I think we're starting to get ahead of the market in terms of those propositions. So, we have a lot to give in the Home marketplace and we're going to be very competitive in that.

Q - Will F. Hardcastle {BIO 16346311 <GO>}

Great. Thanks. And just a quick one, on the high retention, has that been improving their retention or is it just remaining at such a high level?

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

Yeah. I think slightly nudging up from very high levels.

Q - Will F. Hardcastle {BIO 16346311 <GO>}

Okay. Very clear. Thanks.

Operator

Thank you. And your next question comes from the line of Andrew Crean. Please ask your question.

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

Good morning, all. A couple of questions. Firstly, I wanted to investigate a bit further on when you're saying we're returning to underlying claims inflation in the motor market. What level of claims inflation would you expect for 2015, in terms of burn cost? And also, to what extent has the oversized reserve releases been a function of falling claims inflation, as it's come through in the last few years? That was one question. The second question is just a mathematical one. Could you give us the level of reserves and/or investments sitting behind your run-off book and the profile of how rapidly you think that that will run off?

A - Anthony Jonathan Reizenstein

Right. Hi, Andrew, it's John here.

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

Hello.

A - Anthony Jonathan Reizenstein

Underlying claims, first of all, we've done a bit of work on sort of taking the pieces – the third party working party material has been updated. And it does look like whatever period you take, claims inflation, severity inflation has been about 5% in whatever period you take.

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

Yeah.

A - Anthony Jonathan Reizenstein

And then there's been some frequency improvements, relatively small frequency improvements. There is also which is maybe that the burning cost inflation will be less than 5%. So, that's the kind of assumption we would use in our own planning for market inflation. We're not making forecast, we're just saying based on history.

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

And also, we have track record. Our ambition is, obviously, to do better than market.

A - Anthony Jonathan Reizenstein

Yeah, absolutely. And then, LASPO has been a very big factor in a huge amount of noise, but we believe (32:06). And therefore, we're assuming more likely that market would return to more like a normal level of inflation. But as Paul said, that's not going to be our inflation or any individual or other company's inflation. So, it depends on what we actually do, which is we're very ambitious to improve on.

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

If the market's looking at 5% burn cost or 4%, 5% burn cost inflation, why isn't it raising rates?

A - Anthony Jonathan Reizenstein

Paul?

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

Yeah. Well, that's the question for other people. I think rates...

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

Okay. Why aren't you raising rates?

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

Well, you can be pleased with rates, I guess, not going down. Also, that it's not going down as much. I think we've been quite clear, which is we have – we've been – I think we've priced down less than the market and we think we have better claims inflation than the market. So, that's a question for other people.

A - Anthony Jonathan Reizenstein

The PY, the prior-year question, which was – I think there was oversized prior-year reserve releases due to falling claims inflation. And yeah, well, it's a combination of that and of conservatism in the first place. And there was something behind the question there.

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

(33:17)

A - Anthony Jonathan Reizenstein

Yeah. (33:18) Did I answer that question?

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

Yeah. No. Just the degree to which the – I mean the level of prior-year reserve release has surprised even yourselves, isn't it, given your forecasts at the beginning of the year.

A - Anthony Jonathan Reizenstein

We thought we'd get a lot...

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

Yeah.

A - Anthony Jonathan Reizenstein

... and we've got more than we thought. And as we've seen in some of those charts and we haven't produced them again this quarter but we probably will at the year-end. We do think there's a lot of built-in conservatism in our reserves. So, it's not surprising we'll get quite a lot of reserve release. We think that's – the significance of those will continue for quite a while, although they will not be maintained at the current level.

And we – part of which is driven by the sheer amount of change that's going on because when our reserving team see change, they will – that may be good or bad, we don't know, but we're not going to just assume it's built-in till it's absolutely clear that it has. And so, I think as we get change, the change is good in terms of claims, we'll tend to get conservatism building up. And it could happen again, but (34:23) I think we'll just come back to you on that one.

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

That'd be great if you would. Okay. Thank you.

Operator

Thank you. And your next question comes from the line of Greig Paterson. Please ask your question.

Q - Greig N. Paterson {BIO 6587493 <GO>}

Good, morning, gentlemen. I just wanted to point out (34:42) you advertised. My wife is pleased that the new adverts don't have any squiggly lines the old Direct.

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

Very good. Thank you.

Q - Greig N. Paterson {BIO 6587493 <GO>}

Yeah. She pointed that out to me the other day. Just three questions. One of your peers mentioned, in terms of regulatory changes, that these independent medical reports still all have to be bid down and they implied there was some benefit there in terms of small BI. I wonder if you'd comment on that.

Second question is you said something in your comments about you're having better pricing – or lower prices than your peers in Rescue, so I want you talk about that. And the third point is, I noted I think the rating agencies had – S&P in particular, had said that you're currently running a AAA capitalization. And they saw that coming down to AA over time, even in the context of your A flat stable rating. I don't know if you want to make some comments about it. To me, that implies that we're going to have special dividends continuously for the next few years because basically, the latter (35:53) take three, four notches off your rating. I don't know if you want to talk about that.

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

Yeah. It's cool. I've got Steve Maddock here, just update on the regulatory.

A - Steven Maddock

Yeah. Hi, Greig. I think in terms of the whiplash reforms, I think the first set of reforms that we've seen around the fixed costs and medical reporting, I think certainly when we've looked at this in terms of a market impact, we think that sort of any benefit that you would see from a market perspective is likely to be offset by the composite sort of ban on settlement of claims without a med report. So, we think that's probably from a market perspective, the first set of reforms are likely to be cost neutral.

I think in terms of the second tranche of initiatives around the cab rank approach to medical practitioners, I think we just don't have enough data. And I think whether we see a reduction in cost M&A from that will really lie on the strength of the accreditation process. And I think we just don't have – we're not sighted on that at the moment. So, I think from a market perspective, it's a pretty brave call to say that we're going to see a lot of reduction from that at this point in time.

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

On to Rescue, I mean, I think the first thing about Rescue is, it's not just about price. And if you – it's a bit of an advert for Green Flag, but Green Flag does a very good job of getting to you quickly. If they don't get to you within an hour, we'll give you half the price next year. Misfuelling cover is included in the standards and our normal policy, and it's not in our competitors, and we repair a lot of the road sides and all that stuff.

And as well, we have really great prices. The market is a very profitable market. And therefore, we can have kind of insurgent pricing and still be very profitable. And so, we're quite enjoying that position. So that's that. S&P, John?

A - Anthony Jonathan Reizenstein

Yeah. Talking about the capital side, Greig, yeah, well, it'd be nice to be regulated by S&P only. And we do obviously have very strong capital on their basis. It's a very different methodology from the one that really matters at the moment, which is the ICAS regime.

So, principally, S&P will be a bit heavier on market risk, but a lot lighter on reserving risk. And so, we come out very strong on their measure. But on ICA, I mean we're pretty open about where we are, not exactly with the regulator, but in terms of our own economic capital model, which is pretty similar to the ICA model. And we were around 149% at the last reporting date, which was June. And we talked about what things might move in either direction and what our attitude is to the risk appetite buffer that we hold on a range of that. So I think everyone pretty much should understand that.

I mean, the other factor clearly is the transition to Solvency II. And I said this before, so I hope you don't mind me repeating it, but it's possible to be optimistic about the long-term impact of that on capital requirements because some of the methodology in Solvency II if you go to the internal model is potentially more favorable than the ICA regime. And that may be helpful in the future. However, there's a lot of ground to cover before we get there, including whether you will get your internal model approved, when it'll be ready, how some of the challenges which you'll get from the regulator will operate during that period and so on, and a lot of that is yet to settle. There are a lot of moving parts and uncertainty about that. One thing we do know is we won't be operating on the internal model from day one anyway. It'll take us at least six months to move on to that. And during the initial period, we'll be on the standard formula, which is a lot less – which you can be a lot less positive than about the eventual internal model.

But I don't want you to get worried about it because I'm not worried about the standard formula. We do have strong capital and I'm sure we'll be fine on the standard formula. We might be better on the internal model one day.

So, what does mean in terms of dividends? Well, I think, again, our stance, I think, is hopefully reasonably well understood, i.e., we will be reasonably transparent and we won't hoard and we'll tell you where we are and our risk appetite and why. And if we are holding more than we think we need, we will pay it back and we have.

Q - Greig N. Paterson {BIO 6587493 <GO>}

Just remind me on the timing. When is six months after the internal model? When do you envisage the date in terms of internal model approval, six months after what date?

A - Anthony Jonathan Reizenstein

Yes. So, our most optimistic ambition would be that we would operate on the internal model from the 1 of July 2016.

Q - Greig N. Paterson {BIO 6587493 <GO>}

All right. Perfect.

A - Anthony Jonathan Reizenstein

So most optimistic and there's a lot of work to do. People would have seen what the PRA have been saying to all of us. We're all naughty boys and we're all going to fail. I'm saying we will. We're doing a lot of work and we're on track, but it's a big job and it's not totally in our control. There's a big man down the road who's got their arms around the whole thing and will make some big, big decisions.

Q - Greig N. Paterson {BIO 6587493 <GO>}

Perfect. Thank you.

Operator

Thank you. And your next question comes from the line of Fahad Changazi. Please ask your question.

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

Good morning.

Q - Fahad U. Changazi {BIO 15216120 <GO>}

Hello. Good morning. Just got two very quick follow-up questions, firstly, on Andrew's. Given you were trading a bit harder in Q3 and given your expectation of the claims inflation going forward, how are you planning your strategy to the pricing? Are you going to wait for others to see what they are doing? For example, I do know that Aviva did say that they don't see a major catalyst for a demonstrable increase in rates. So, just some thoughts around that in respect of the environment. And the other question is just on Andy's question. I'm sorry if you already said this and I missed it, but did you say where the claims spike was in terms of relation to the year? And where are you seeing the reserve releases in terms of large claims bodily injuries, as well in terms of years? Thanks.

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

Okay. I mean, in terms of pricing, I'm going to plead the fifth or whatever you say. We are very loath to talk about future pricing. I think it's an inappropriate thing to talk about. But we make trading decisions daily, weekly, monthly and I think we've got a track record of optimizing quite well between value and volume. Yeah. So, I think that's probably what I want to say. John?

A - Anthony Jonathan Reizenstein

Yes. So, the spike is really across the year and starting in about April and then we did the big review. That's obviously a notification thing. And then there's a big review, which we did at Q3. So, the numbers are (43:05) in Q3, but I'd say we think it's a spike. So, let's not spend too much time on it.

On the prior year's bodily injury releases, I don't have the years in front of me. I believe that it's spread across most of the years, including 2013. If I'm wrong, I'll come back to you.

Q - Fahad U. Changazi {BIO 15216120 <GO>}

That's great. Thank you very much.

Operator

Thank you. And your next question comes from the line of Mark Bensley (43:35). Please ask your question.

Good morning, gentlemen. Just one quick question concerning the sale of the International business. Could you just explain what factors affect the difference between the cash sale proceeds and the net proceeds?

A - Anthony Jonathan Reizenstein

Yeah. Primarily, transaction costs is the answer to that one. Primarily, transaction costs. We don't expect any tax or any significant tax. So it's really just the transaction cost. Maybe (44:06) foreign exchange movement, but it's going to be pretty small.

Q - Operator

So, there shouldn't be very much difference between the two?

A - Anthony Jonathan Reizenstein

There shouldn't.

Q - Operator

Thanks very much.

Thank you. And your next question comes from the line of Marcus Rivaldi. Please ask your question.

Q - Marcus P. Rivaldi {BIO 5739374 <GO>}

Good morning, everybody. Can I ask a couple of questions, please, on the commercial market? I'm talking about that year-to-date. You talked about, I think, weather now normalizing over the course of 2014 year-to-date. Does that mean that potentially your Commercial may deliver a headline combined operating ratio of around 100% by year-end, assuming we get a more normal Q4?

Secondly, if you just talk a little bit about the market dynamics there in Commercial and where pricing is going in some of the major segments there? And then finally, just on investment income. You're talking about re-risking in Q4 further, where do you think the average yield on the portfolio can go from here? Thank you.

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

So, first question, yes. So, if the weather turns out to be normal then it'll be 100% is a target. The other caveat which we've got is some extraordinary kind of large loss profile, but none so far, but still only – we've got fireworks night and Halloween to get through us I suppose.

The – in terms of the trends we're seeing, I think we've kind of given a little bit away in the IMS on that. So, the van market is highly competitive and we are, again, value seeking in that. Even that said, I think we can do better on the van market going forward. We have a lot of kind of key assets there. We've got – all our Motor assets should transfer into the van market. So, I think that's one for the future. But right now, with our current capabilities, we're being a bit cautious in the van marketplace.

I think the positive news for us is on the bits where we're making strategic investments. Direct Line for Business and the eTrading part kind of NIG with – outside the van marketplace growing nicely and we're pleased with the profitability of them. And I think as we said, Commercial have lots of, we think, attractive parts within it and those are the ones which we're targeting.

So, I think, Commercial market – the overall Commercial business I think has done a great job to get to the 100%. We want it to do better than 100% to get towards the 15% RoTE for that business as well. But it's a fantastic staging post and I think we'll obviously be saying more next year about where we go next on Commercial, but it's very great core business and performing well.

Yeah. John, do you want to...

A - Anthony Jonathan Reizenstein

Yeah. Just on the investment side, I'm probably not going to answer your question in a helpful way, I mean, we will probably update on our normal chart at year-end. I mean, I think in the interim, we're – yeah, we're trying to eke out a few basic points here and there, again, with the diversification approach. So, it's not really re-risking within existing – within the kind of conventional debt area. It's by spreading around and finding niches that fit with our maturities or which represent a diversification in some other ways. In private placement, it's re-risking in the sense of – yeah, we're taking liquidity risks rather than extra credit risk. And I think that's probably a good idea because we are very, very liquid. We have loads of gilts and cash. We've done lots of stress testing of multiple weather events and all coming at once with a firework display as well. And I think we got enough cash to pay out. But we can take a bit of liquidity risk so why not? That applies to infrastructure as well.

Rate-wise, return-wise, yes, we're eking that out. We're going to get some pickup from some of these things, but equally the news on the rate – on the yield curve or on risk-free is not particularly positive. I mean, it keeps being longer, and lower and longer and, therefore, I can't promise you that the whole – the totality when we add it up at the year-end will be much better. We'll give you that figure then.

Q - Marcus P. Rivaldi {BIO 5739374 <GO>}

Okay. Thank you. Just maybe just got one quick follow-up. It's just also you were talking about progress you're making in telematics. When you look around the telematics proposition, is there any areas where you feel that you really need to invest by – and I'm talking here more about investing in maybe third-party firms to help you progress the telematics business? I mean, obviously, you have made investments already in The Floow, et cetera? Are there more sizeable investments that you might need to be doing there to really make it work?

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

No. And I think we're really happy with The Floow, great investment, great company, which is doing very well. So, that's good. I mean, I think we've also said, we're relatively device agnostic. We kind of quite like our OBD box, but as technology changes, boxes will change and whether they'll be installed in cars. So, we need to be quite fleet of foot, I think, as technology enables better devices or cheaper devices, because device costs and data costs are barrier to this becoming – we can kind of make it – we can make it work really easily for young drivers down to 1000. We can kind of make it work down to 500. To get it any lower than 500, we need to continue to see innovation in the device and the data costs.

A - Anthony Jonathan Reizenstein

And The Floow helps in there because they are device agnostic – they have a device agnostic business model, so that's why it makes sense. If something else really attractive came along, modest in scale, who knows, we could.

Q - Marcus P. Rivaldi {BIO 5739374 <GO>}

Thank you very much.

Operator

Thank you. And your next question comes from the line of (49:36). Please ask your question.

Morning, chaps. Just another one on telematics. You mentioned in your half year about Commercial fleets and things like that and that you were doing a couple of trials. I wonder whether you're able to talk a little bit more about the progress that you've made with that and whether you've seen any benefit to the business? And also, you're relationship with your suppliers is on all of that sort of stuff. Are you kind of rolling it out in other areas at the moment? I wonder whether you could just sort of talk on that?

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

Yeah. It's very early days on Commercial. I mean, conceptually, it works quite well in Commercial because people don't have a choice whether to have it fitted or installed or any of that stuff. And the data is useful to fleet operators on a number of fronts, including driver safety and where people are and all that stuff.

So, conceptually, it's quite a big one for Commercial and most of our effort is currently going into personal line space though. So, we'll kind of – it's a watching brief on Commercial. It's still early days on the pilot. Was there another question there on the personal lines, telematics?

A - Anthony Jonathan Reizenstein

Suppliers.

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

Suppliers.

Q - Operator

So, you've pretty much sort of talked about – you talked about The Floow, presumably, you're going to carry on working with your hardware suppliers as well and roll it out in that respect as well. You're seeing more growth in these areas. Did you say 50% growth in terms of the number of people who'd signed up over the last quarter? Did I understand that correctly?

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

Yeah. I mean, I think, 50% growth, it's off a relatively low base, but growing nicely. And as I said, we're pleased with the boxes we've got at the moment, but we need to respond to whatever trends there are in the marketplace.

Q - Operator

Thank you.

Thank you. And your next question comes from the line of Oliver Steel. Please ask your question.

Q - Oliver G. Steel {BIO 6068696 <GO>}

Hello. Good morning. Just a couple of technical questions to finish up. First, in response to the question on Commercial, you talked about would like to get to 15% RoTE. Should we just be sort of pro rata-ing the net asset value across the different lines to get to a combined ratio, or would you like to give us sort of some indicated combined ratio that that would imply?

And then the other question I've got is, when you return the proceeds from the International division, I think you sort of half-mentioned that you might do a share consolidation at the same time. I was just wondering if you'd had any further thoughts on that?

A - Anthony Jonathan Reizenstein

Thanks, Oliver. I think probably the simple – the rule thumb I would use is mid 90%s COR (52:17) RoTE Commercial. I'm not promising in which year they'll get it, but I'm sure they will. And the other one was share consolidation. Well, yeah, it's something we'll think about. We haven't said anything definitive on what we'll do. I mean it will be something more like special dividend than anything probably more complicated, but share consolidation. If we're hearing feedback from people and advisors that it's a good thing, we'd certainly look at it.

Q - Oliver G. Steel {BIO 6068696 <GO>}

Okay. Thank you very much.

Operator

Thank you. And your next question comes from Andy Hughes. Please ask your question.

Q - Andy Hughes {BIO 15036395 <GO>}

Hi, guys. Just following up from the comment about the PRA reserve risk capital, I thought they allowed reserve prudence to count towards the capital that they assume when doing their ICA+ (sic) [ICAS+] (53:11) stress test. In which case, if you have an exceptional amount of reserve releases in a year, can you really pay dividends from that? Because, actually, what you're doing is moving capital from the reserves to surplus shareholders' equity. Does that make sense that question? Thanks.

A - Anthony Jonathan Reizenstein

Yeah. The way ours works, maybe we're missing something is that the margin we hold and we haven't said what it is since the IPO, but we did say at that point, does count or most of it counts towards capital. But the conservatism in your ABE, which we hold a lot, does not or mostly does not.

Q - Andy Hughes {BIO 15036395 <GO>}

Sorry. The ABE -

A - Anthony Jonathan Reizenstein

The conservatism in our ABE that you haven't recognized as margin...

Q - Andy Hughes {BIO 15036395 <GO>}

Oh. Right, okay. Yeah.

A - Anthony Jonathan Reizenstein

...basically doesn't. I mean, some of it might in your profit forecast for the coming year, whatever, but it doesn't – essentially doesn't. So it's only the margin and we hold more margin (54:10). We've always said that the reserve release we've been showing you have not been from the margin.

Q - Andy Hughes {BIO 15036395 <GO>}

Right.

A - Anthony Jonathan Reizenstein

Yeah. Does that make sense?

Q - Andy Hughes {BIO 15036395 <GO>}

Okay. But the stuff this year, the PPO revision, that will be from the actual underlying reduction in reserve strength won't it?

A - Anthony Jonathan Reizenstein

Well, I don't think we've said – we haven't actually said there's been a PPO revision. I mean, we've said large bodily injury. But wherever it is, it'll be – it's from the (54:34) assessment, not from the margin. Now, the releases, as you get reserve release – as the reserve shrink, you get some reduction in margin. To the extent, elements of our margin are a little bit arithmetic. That's in the elements of our margin. But that's a very small amount of money compared to any releases you see and also small amount of money in terms of the balance of conservatism we hold both in the margin and in the ABE. Is that helpful?

Q - Andy Hughes {BIO 15036395 <GO>}

Yeah, kind of. I think I follow it. So you're saying the reserve releases you're doing in H2 is not a review of the PPO provisions that's leading to a large exceptional reserve release?

A - Anthony Jonathan Reizenstein

It's not particularly PPOs, it's more just bodily injury, bodily excess we call it, bodily injury excess.

Q - Andy Hughes {BIO 15036395 <GO>}

Okay. Thank you.

A - Anthony Jonathan Reizenstein

(55:20) PPOs in there, but it's not the bulk of it.

Q - Andy Hughes {BIO 15036395 <GO>}

Okay. Thank you very much.

Operator

Thank you. There are no further questions at this time, sir. Please continue.

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

Okay. Thank you very much, everyone, for very thorough questioning. And we will be back with you in start of March, and I'm sure we'll see many of you in the meantime. Thanks very much.

Operator

Thank you. Ladies and gentlemen, that does conclude your conference for today. Thank you all for participating. You may now disconnect. Speakers, please stand by.
