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Q3 2018 Earnings Call

Company Participants

- Helge Leiro Baastad, Chief Executive Officer
- Jostein Amdal, Chief Financial Officer & Executive Vice President, Finance
- Mitra Hagen Negård, Head-Investor Relations

Other Participants

- Blair Stewart, Analyst
- Jonny Urwin, Analyst
- Kevin Ryan, Analyst
- Niccolo C. Dalla Palma, Analyst
- Sami Taipalus, Analyst
- Steven Haywood, Analyst
- Vinit Malhotra, Analyst
- Wajahat Rizvi, Analyst
- Youdish Chicooree, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good day, and welcome to the Gjensidige Q2 (sic) [Q3] (00:00:05) 2018 Results Presentation. Today's presentation is being recorded.

At this time, I would like to turn the conference over to Ms. Mitra Negård, Head of IR. Please go ahead.

Mitra Hagen Negård

Thank you. Good morning and welcome, everyone, to Gjensidige's third quarter earnings presentation. My name is Mitra Negård and I'm Head of Investor Relations.

As always, we will start with our CEO, Helge Leiro Baastad, who will go through the highlights of the quarter; followed by our CFO, Jostein Amdal, who will run through the numbers in further detail. And we will have plenty of time for a Q&A at the end of the session.

Helge, please.

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Helge Leiro Baastad {BIO 5865247 <GO>}

Thank you, Mitra. Good morning and welcome, everyone. This has indeed been an extraordinary year for Gjensidige. The occurrence of extreme weather events continued into the third quarter, this time with a heat wave we have not seen in Norway in a long time, and the dry summer since 1947. This took us all by surprise and naturally impacted our results significantly, compared with the extraordinary strong results in Q3 last year.

Our results are summarized on page 2. Profit before tax amounted to NOK 964 million in the quarter. This result does not include the pre-tax profit of NOK 93 million from Gjensidige Bank, which is recorded as a discontinued operation from this quarter. We had a premium growth of 1%, 0.8% in local currency. The underwriting result amounted to NOK 573 million and the combined ratio was 90.6%.

For the third quarter in a row, extraordinary weather conditions drove frequency claims high above last year, putting pressure on our underwriting result in Norway. Large losses were also considerably higher partly due to weather adding to the deterioration of results.

Intense heat waves and the drought led to significant crop failure in Norway. Having a significant position in the agriculture sector and customers with crop insurance, we do expect cycle claims currently estimated to NOK 80 million.

Our property insurance line in Norway was hit by fires as well as damages from heavy rainfalls and storms during the quarter. And in general, nice and warm weather leads to higher leisure activity and more accidents. We estimate the weather-related deviation in frequency claims in the third quarter related to property and crops compared with historical third quarter average to be in the range of NOK 130 million to NOK 160 million. This means we have had a total of NOK 530 million to NOK 660 million in claims so far this year related to the extraordinary weather in Norway.

Preparing for unexpected events is part of our business. This is the nature of insurance. But, of course, when several events occur within a short span of time and with such force, it temporarily challenges our results. And listening to the experts in this field, it is prudent to expect more volatile weather conditions and a higher frequency of extreme events going forward. We acknowledge this and will need to reflect it in our pricing as well. This still applies particularly for the property insurance lines which are most exposed to weather effects, meaning price increases will have to exceed the building index to reflect more frequency going forward.

Large losses, they're significantly higher compared with the third quarter last year, reflecting property damages from fires, heavy rains, and storms. Profitability in motor insurance continued to deteriorate, as expected, driven by the lag effects from pricing measures relatively to claims inflation.

I will comment on status for our ongoing mitigation actions on the next slide. Outside Norway, we continue to deliver significantly improved results. Our results were also

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impacted by provisions of NOK 80 million related to restructuring measures. I will come back also to this on the next slide.

Financial results came in at NOK 426 million, corresponding to a 0.8% return. And last, return on equity, year-to-date was 15%. And Jostein will work with more detailed comments on the results.

Then, turning to page 3, some comments on the operational highlights year-to-date. Starting with the recent changes in the group management team, I'm convinced that given the rapidly changing business environment, we are operating within, internal rotation improved dynamics in the group, increases engagements, adds new perspectives, develops management talent, and ultimately leads to a stronger force of innovation and process efficiency.

I'm very pleased with the new team, which is fully dedicated to getting Gjensidige to get back on track in Norway and continuing of a strong progress outside Norway.

We are convinced of the strong rational in selling Gjensidige Bank, allowing us to focus on our core insurance operations, while growing our reach to banking distribution with Nordea. Closing is still expected during the first quarter of 2019.

In Norway, we had continued to raise our prices for motor insurance and we are very pleased to see that our efforts are proving effective. We will continue to increase prices beyond the 6% expected claims inflation in order to close the gap. We are fully committed to stabilize and ultimately also improve profitability for motor insurance in Norway, meaning that we are willing to sacrifice on volume to achieve this, if necessary.

So far, we have been able to put the price increases through without any negative impact on churn, as proof of our strong brands and position in this important market. We still expect the motor profitability in Norway to marginally decrease further to 2018 before seeing a turning point during the first half of 2019.

We are very pleased to see that customer retention in Norway continues to be high, meaning low distribution costs. In the Private segment, we have the retention rate above 92% among our affinity and loyalty customer, which represents around 85% of the premium volume.

Our position in this segment was further proven by renewal of our partnership agreement with Tekna recently. We are also very happy with our strong retention rates for the Commercial segment currently at around 90%.

Our operations outside Norway have gone through nothing less than a transformation, and there is more to come. Our achievements so far are evident in the numbers we have presented today. We have put strong efforts in improving our risk selection and risk pricing, pruning and repricing our portfolios. This has somewhat reduced volumes.

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However, we have managed to improve our portfolio quality significantly. Although our focus is profitability before growth, we are starting to reach the profitability level where we, to a larger extent, can participate in the market's overall growth going forward. We will continue to implement cost efficiency measures, gradually bringing profitability closer to the overall group target.

We have a strong focus on efficiency across the whole value chain and continuously seek value enhancing measures. In the third quarter, we have decided to close further eight branches in Norway; and in Denmark, we have discontinued the use of external sales representatives.

Gradually moving distribution from physical to call centers and online is still on our agenda. Some restructuring is also made in the Swedish distribution, and all in all, we have made a provision of NOK 80 million related to the restructurings and reduction of 58 FTEs.

By constantly bringing down the underlying cost base, we create room for investments in technology, brand, and skills within our cost ratio target. As communicated earlier, we are planning to upgrade our core IT system to be head of development, securing improved internal efficiency, and long-term competitiveness.

A new system will provide us with greater agility and enable us to quickly adapt to new technology and changes in products, markets, and completely new ecosystems. We are introducing a blueprint version of the new core system as we speak and planning to launch in Denmark first before moving on to Sweden. Investments will be made within the limits of our cost target.

Then, turning to page 4, I'm very proud to present the results of this year Ipsos Reputation Survey related to last release last week. Once again, we ranked number 1 in terms of reputation in the Norwegian financial industry, and we also achieved the best scores in our sector in the category social responsibility and moral.

We have had a steady increase and the highest ranking in our industry since 2009. Independent of sectors, Gjensidige ranks number eight and among the top 10 companies in Norway for the third year in a row. And we are very pleased to know that 7 out of 10 Norwegians have a good overall impression of Gjensidige.

And with that, I will leave the word to Jostein to present the Q3 results in more detail, as well as talk about the update on our capital strategy and financial targets.

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Jostein Amdal {BIO 19939645 <GO>}

Thank you, Helge, and good morning, everybody. I will start on page 6. We report a profit before tax of NOK 964 million in the third quarter. Starting from this quarter, Gjensidige Bank is recognized as a discontinued operation and thus moved to a separate line in the P&L, after tax. The results are, therefore, not included in this table.

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Including Gjensidige Bank, the pre-tax result would have closer to NOK 1.1 billion. The decline in the pre-tax profit for continuing operations compared with last year was primarily driven by the underwriting result. The underwriting result was significantly impacted by the extraordinary weather conditions, driving claims in both the Private and Commercial segments in Norway. The result also includes a provision of NOK 80 million related to the restructuring measures Helge mentioned. We estimate the weather-related deviations in frequency claims in the third quarter compared to the historical third quarter average to be in the range of around NOK 130 million to NOK 160 million.

The results in Norway were also impacted by the continued situation in motor profitability, as has been the case over the past quarters. Results also in Norway continue to improve. The increase in Denmark was a result of lower large losses, higher run-off gains and lower operating expenses, partly contracted by a weaker underlying frequency claims development.

Our Swedish operations generated significantly improved results for the quarter, reflecting lower underlying frequency claims and a favorable cost development, partly contracted by higher large losses and lower run-off gain.

The Baltics reported considerably higher underwriting results, driven by an improvement in underlying claims and cost development, as well as higher run-off gain. The Pension business reported record quarterly earnings again. The financial results from our investment portfolio declined, reflecting our asset allocation and market development.

Turning to page 7, premiums are also 1% compared to the third quarter of 2017 and 0.8% adjusted to currency effects. All the main product lines in Norway recorded higher premiums during the quarter, mainly driven by premium increases. We continue to increase prices for motor insurance in Norway, in line with what we have communicated, and this is reflected in our numbers for the quarter.

Our common theme outside of Norway is that when measured in local currency, we see negative top-line growth. This is an effect of various pricing and portfolio pruning measures, aimed at creating long-term profitability in all segments. In Denmark, the measures have been most pronounced in the Commercial lines. In Sweden, the effect in Q3 was most evident in Private lines, whereas in the Baltics, it concerns both Private and Commercial lines.

Turning over to page 8, we can see that the loss ratio rose from 66.3% to 75.1% year-on-year. To start with, it is important to remind you that Q3 was a very strong quarter, making comparison challenging. Large losses were significantly up, but still not far from the normal level we normally expect, resulting in a 4 percentage point increase in the loss ratio.

Run-off gains normally higher than expected and a positive impact of 1.5 percentage points in the loss ratio compared with Q3 last year.

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A more adverse underlying frequency claims development was the main driver for the increase in the loss ratio, and this was mainly related to Norway. As for our operations in Sweden and the Baltics reported improved underlying frequency claims development. Our Danish operations reported a small increase in frequency claims impact compared to last year.

Higher frequency claims impacted Norway related to the extraordinary weather conditions and difficult comparables due to particularly favorable underlying frequency claims situation in Q3 last year. The weather impact was related to our property and agriculture insurance lines, estimated at NOK 130 million to NOK 160 million, above an average Q3, corresponding to 2.1 percentage points to 2.6 percentage points on the total group Gjensidige. Still adjusted for this, the underlying claims ratio deteriorated by around 4 percentage points. This can partly be explained by the strong results in Q3 2017 and partly by the underlying situation in motor insurance in Norway.

The pressure on our motor insurance line continued as expected in the quarter. As mentioned earlier, the high claims inflation for this product is related to the structural change in Norwegian vehicle fleet and related dynamics. We have put a number of measures in place and continue to do so to secure correct risk selection and risk pricing. And we're happy to see that our pricing power continues to be strong, as Helge touched upon.

In addition to the mentioned price increase in the Private segment, we also operate with significant price increases in the Corporate segment, especially for larger accounts, and for motor and property.

Let's turn to page 9 for an overview of large losses. Total large losses amounted to NOK 319 million, somewhat above our expected long-term average of NOK 295 million. The losses translate into 5.2 percentage points on the combined ratio. The large losses are primarily related to Commercial and Private property in Norway, and that's significantly influenced by the storms and heavy rainfalls in Norway during the quarter.

Moving on to page 10 to comment the run-off gains. Run-off gains for the quarter came to NOK 341 million, which is higher than our planned reserve leases of NOK 250 million. The deviation is due to random variation. The run-off had a positive impact of 5.6 percentage points on the combined ratio. We maintain our estimates of approximately NOK 250 million in run-off gains per quarter through 2022.

Let's turn to page 11. The cost ratio for the quarter was 15.6%, an increase over last year primarily related to the one-off provision of NOK 80 million in the corporate center related the restructuring measures already mentioned by Helge.

Cost development, excluding this provision, was favorable, with a cost ratio of 14.3%. This proves cost discipline, and we're particularly pleased to see continued positive effect from our restructuring efforts in Sweden and the Baltics. The cost ratio, excluding the one-offs and the Baltic segment, was 13.5%. Contingent digitalization, automation, and our timed

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effects of a new core system will enable us to remain cost efficient as (00:19:22) further in terms of our cost ratio. We'll refer to this shortly.

Page 12 illustrates highlights from the Pension and bank operation. The Pension company recorded a profit before tax expense of NOK 40 million. Assets under management in the Pension operations amounted to NOK 32 billion and 68% of the customers in our Pension business are general insurance customers as well. Annualized return on equity amounted to 14.3%.

Gross lending in the bank at the end of the quarter was NOK 49 billion. The bank reported a pre-tax profit of NOK 93 million in the third quarter, the decrease being due to higher operating expenses following growth, increased acquisition costs, and lower gains on financial instruments, as well as some one-off charge of NOK 11 million related to the termination of the agreement for distribution to the financial offices in Gjensidige's Private segment. Annualized return on equity for the bank was 11.4%.

Moving on to the investment portfolio on page 13, the investment portfolio of NOK 52.7 billion yielded a return of 0.8% in the quarter. The match portfolio yielded a return of 0.6% on a portfolio of NOK 34 billion. A large part of the match portfolio consists of bonds at amortized cost which yielded a return of 1.0%. The running yield in this portfolio was 3.8% at the end of the quarter and the average reinvestment rate year-to-date was close to 3.3%.

The unrealized excess value amounted to approximately NOK 0.8 billion. The free portfolio, which amounted to NOK 18 billion, yielded a return of 1.2% in the quarter. The positive return was primarily driven by returns on the investments in equities and property.

Looking at our capital position on page 14, our capital position is still strong. The legal perspective gives a solvency margin of 181%, while our own calibration of internal model gives a solvency margin of 197%. Note that from this quarter, our (00:21:35) are treated as eligible capital when calculated to solvency margin. This gives a better picture of the solvency margin. The principal change is made after recommendations from the Norwegian FSA. Solvency margin is somewhat lower compared to last quarter. Available capital showed a stable development and a positive contribution from retained earnings offset by among others lower market valuables, due to increased interest rates and credit spreads.

Capital requirement increased somewhat this quarter, mainly due to underlying growth within the business. Given the sale of Gjensidige Bank, the performance solvency margin as of September 30 was 262%. We'll continue to balance our capital structure in a disciplined way in order to support the targets return on equity, while at the same time allowing us some leeway for further bolt-on acquisitions and stabilization of dividend.

Turning to page 15, I will comment on our financial target. Our financial and solvency targets, as well as the dividend policy, have been subject to a review this quarter. Except for changing the cost ratio target from around 15% to below 15%, the targets and dividend

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policy are only adjusted to reflect, but Gjensidige Bank will be excluded from the group from early 2019.

The group's annual financial and solvency target for the period 2019 to 2022, given disposal of the bank, are combined ratio between 86% and 89%, if assuming average annual run-off gains of around NOK 1 billion through 2022. This corresponds to 90% to 93% given zero run-off gains.

Our cost ratio below 15%; our solvency margin, based on the partial internal model, between 135% and 200%; return on equity after-tax, above 20%. This corresponds to about 16% given zero run-off gains, which is comparable to the previous 15% target, including the bank. Bear in mind that these are targets and should not be regarded as guidance for any specific quarter or year.

Dividend policy stays the same, but technical adjustments reflect the bank sale. It means the minimum payout ratio moves from 70% to 80%. Our financial targets are ambitious, but achievable. We work to strike a balance between good profitability and increased investments in order to ensure strong competitiveness going forward.

Organic growth is expected to be in line in normal GDP growth in the Gjensidige's market areas in the Nordic countries and the Baltic states over time. In addition, profitable growth will be achieved by pursuing a disciplined acquisition strategy, as has been done successfully in the past. The sale of Gjensidige Bank will upon closing have a temporary negative impact on the group's return on equity and the proceeds have been reinvested in value-enhancing opportunities or returned to shareholders.

I will then hand the word back to Helge for some concluding remarks.

Helge Leiro Baastad {BIO 5865247 <GO>}

Thank you, Jostein. To sum up, on page 16, our Q3 results were significantly impacted by extraordinary weather conditions. We continue to generate improved results outside Norway, proving successful restructuring measures. Our results so far this year have been hit by the weather conditions and the pressure on the motor insurance line, challenging our ability to deliver on all our financial targets this year.

However, we have a strong focus on getting our business back on track in Norway, with price increases across several product lines. We will also continue to have a keen eye on cost control and implement efficiency measures.

We will continue our strong efforts to mitigate the claims inflation in Motor Norway and expect the turning point for profitability in this insurance line during the first quarter next year. Our capital position is strong and supports our vision to seek value-accretive M&A opportunities. And if such opportunities do not materialize, we will distribute the excess capital over time, in line with our dividend policy.

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So, with that, thank you very much. We will know open the Q&A session.

Q&A

Operator

Thank you. We can now take our first question from Jonny Urwin from UBS. Please go ahead. Your line is open.

Q - Jonny Urwin {BIO 17445508 <GO>}

Hi. Good morning. Thanks for taking my questions. And so, firstly, just on claims inflation, so in Norway, I guess, motor claims inflation is still tracking around 6%. Are you seeing any upward pressure on this at all? And just to clarify, you're expecting group loss ratio stabilization in 1Q next year, what's the confidence level in this, please?

And then, secondly, how do you think of the ordinary dividends ex the bank sales, the pro forma for the bank earnings being removed? Would you be happy running a higher payout ratio on the ordinary for a temporary period until you can potentially replace the earnings? Thank you.

[Technical Difficulty] (00:27:33-00:28:04)

Operator

Pardon, the interruption. Just to ensure that the mute function is switched off.

[Technical Difficulty] (00:28:08-00:28:34)

Please stand by while we reconnect the line. Thank you.

[Technical Difficulty] (00:28:39-00:29:28)

Dear ladies and gentlemen, please stand by while we reestablish the main speaker line. Thank you.

[Technical Difficulty] (00:29:34-00:30:10)

We are now reconnected. Please go ahead.

A - Mitra Hagen Negård

All right. We will proceed with the Q&A session. Operator, can you move on?

Operator

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Certainly. We did have a question. Did you receive that question already?

A - Mitra Hagen Negård

No, we haven't heard anything.

Operator

Okay. No problem. Just bear with me. And if I could ask the speaker to – the questioner to please repeat your question.

Q - Jonny Urwin {BIO 17445508 <GO>}

Hi, there. Can you hear me?

Operator

We can, indeed.

A - Mitra Hagen Negård

Yeah.

Q - Jonny Urwin {BIO 17445508 <GO>}

Thanks. This is Jonny Urwin here, UBS. So, I just had two questions. So, firstly, is the claims inflation environment in Norwegian motors still tracking around 6%? Are you seeing any upward pressure on this? And just to clarify that you are expecting the loss ratio to stabilize in the first quarter 2019, what's the confidence level in this, please?

And then, secondly, how do you think about the ordinary dividend ex-bank sales, the performance of the bank earnings? Would you be happy to run a higher payout ratio from the ordinary dividend for exemplary period until you can potentially return the earnings? Thank you.

A - Jostein Amdal {BIO 19939645 <GO>}

Yes. It's yes on the first question. The motor inflation level is expected to be around 6%, the combination of 5% underlying claims cost inflation and a 1% effect from increased frequency due to the changes in the bonus system. We still think that we'll reach the turning point in the first half of 2019, as we have previously communicated. So, that means that's unchanged.

The last question on the dividend, we are comfortable running with a high payout ratio in 2018. The dividend policy stays the same. It's high and stable nominal dividends, meaning that the starting point for looking at the dividend for 2018 is last year's dividend of NOK 0.70 (00:32:12) per share.

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If we go above 100% of this year's result, we will need to apply to the Financial Services Authority if we get approved. But we have a very high solvency margin even before the sale of the bank. We do expect that to be okay.

Q - Jonny Urwin {BIO 17445508 <GO>}

Thank you.

A - Mitra Hagen Negård

Next question, please.

Operator

We can now take our next question from Sami Taipalus from Goldman Sachs. Please go ahead. Your line is open.

Q - Sami Taipalus {BIO 17452234 <GO>}

Hi. Morning, everyone. Thanks for taking my question. Look, my first question is just on the repricing in Norway. You've got the slide there on the high customer retention. I guess, usually when companies do these sorts of efforts, retention goes down a bit. So, I'm wondering if there's room for you to push a little bit harder on the rights here (00:33:18) to make sure that you definitely get on top of claims inflation. So, that's question number one.

And question number two is, you've got – you've disclosed a pro forma solvency ratio of the bank or a solvency ratio pro forma of the bank sale. Am I right in thinking that that's on the legal basis? Could you just tell us what that ratio is also on the (00:33:43) basis, which is what I think your forward-looking solvency ratio target is based on? Thank you.

A - Jostein Amdal {BIO 19939645 <GO>}

Effects on the retention, yes, it has been – yes, actually seen Norway increasing in churn based on the pricing measures we have put through so far. We are, of course, profit maximizing. We'll try to do what we think is the best at all times in terms of hitting the gas pedal there, accelerating the pedal.

So, if we take up what we think is doable here and look at the situation weekly really to what we can take out, still, remember it is dynamic and very differentiated approach where the good customers get best increase and the bad or more riskier customers get a higher increase in the rates. And we'll monitor it. If it's possible to take up more, we will take up more.

A - Helge Leiro Baastad {BIO 5865247 <GO>}

I think it's important also to mention that the frequent development is a Norwegian overall problem. So, it's not only Gjensidige meeting this. And you have seen communication and also reports from other competitors. So, the climate is absolutely much better this

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year compared to previous years when it comes to price increases. That's actually both for Private lines and Commercial lines.

Q - Sami Taipalus {BIO 17452234 <GO>}

Sorry. Can I just interject there? So, if you look at where you are now versus where you were maybe six months ago, do you feel that there's room for more price increases than what you've may perhaps initially anticipated?

A - Helge Leiro Baastad {BIO 5865247 <GO>}

I think I can start, maybe. And compared to six months ago, we have a more holistic view looking at products, terms, and, of course, maybe a more offensive view when it comes to price increases overall. And you also heard what I said regarding freeze (00:35:59) expected frequency development going forward for property lines due to more volatile weather. So, instead of meeting the building index which we have done for a period, we have to increase prices of both the building index to meet more volatile weather also for the property lines in Norway. So, the climate is better, and we are slightly more offensive today compared to six months ago, I would say.

Q - Sami Taipalus {BIO 17452234 <GO>}

Okay.

A - Jostein Amdal {BIO 19939645 <GO>}

In terms of the solvency margin, our target solvency margins are based on the legally approved partial internal model to stock debt. These are not that different necessarily, and the change in the effects from the sale of the bank will have a, incentive wise, more or less the same effect on the legal approved partial internal as our own partial internal model, yeah.

Q - Sami Taipalus {BIO 17452234 <GO>}

Okay.

A - Jostein Amdal {BIO 19939645 <GO>}

That's your question, I guess.

Q - Sami Taipalus {BIO 17452234 <GO>}

Yeah. Okay. Good. Thank you.

Operator

Thank you. We can now take our next question from Blair Stewart of Bank of America. Please go ahead.

Q - Blair Stewart {BIO 4191309 <GO>}

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Thank you. Good morning, everyone. I've got three questions. One of them is actually just a clarification. Helge, you mentioned in your opening remarks a total of NOK 530 million to NOK 560 million of additional claims year-to-date. I'm just checking, is that purely frequency-related or have you also included the deviations in large claims within that as well? That's just a clarification.

My second question just relates to the last question that you answered. Could you give us an indication as to what the excess capital above 200% – above your 200% threshold, what level of excess capital does that imply that you have at this time?

And my third question is really just on M&A and the potential deployment of that excess capital. You've sold the banking business which has led to a reduction in profits. And I'm just interested in what type of M&A you would be considering, what sort of timeframe we'd be talking about in terms of either potentially replacing those lost earnings with an acquisition or the decision to give that money back? Thank you.

A - Helge Leiro Baastad {BIO 5865247 <GO>}

Thank you, Blair. The spend was NOK 530 million to NOK 660 million actually.

Q - Blair Stewart {BIO 4191309 <GO>}

Okay. Thank you.

A - Helge Leiro Baastad {BIO 5865247 <GO>}

And it's purely frequency. So, that's your first question. Your last one – and Jostein can prepare the question regarding the excess capital and solvency ratios. M&A, as we have commented before, we want to grow outside Norway, preferably Sweden, because we have the weakest position in Sweden, and it's a more fragmented market in Denmark. It's dynamic in Denmark also. So, both Sweden and Denmark, if it arise opportunities, we will look into that.

I think I also commented last quarter that it should be somewhat sizable because it's hard work every time we take onboard new companies. And then, you're asking me when – if it doesn't arise, M&A opportunities, when do we want to pay back to shareholders. I can't be exactly regarding that timing. I guess, we will use next year at least. And then, if nothing arise, I guess, we have a discussion again when it come into early 2020.

A - Jostein Amdal {BIO 19939645 <GO>}

And on the second question, the excess capital, I mean, I think you referred to 135% to 200% new solvency margin range and then...

Q - Blair Stewart {BIO 4191309 <GO>}

Yes.

A - Jostein Amdal {BIO 19939645 <GO>}

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...when we're above that, kind of, how much is that. I didn't quite catch it. Do you ask more than nominal amount of how much...

Q - Blair Stewart {BIO 4191309 <GO>}

Yes, please.

A - Jostein Amdal {BIO 19939645 <GO>}

...is above...

Q - Blair Stewart {BIO 4191309 <GO>}

If possible, just an indication of what it would be above 200%.

A - Jostein Amdal {BIO 19939645 <GO>}

Yeah. Excluding the bank and very round numbers, NOK 10 billion capital requirements. It's about NOK 13.8 billion legal capital requirements as of now according to the partial internal model. And then, the bank consumes approximately NOK 4 billion. Is that okay?

Q - Blair Stewart {BIO 4191309 <GO>}

Yeah. Okay. Thank you very much.

A - Jostein Amdal {BIO 19939645 <GO>}

Yeah.

Operator

Thank you. We can now take our next question from Vinit Malhotra from Mediobanca. Please go ahead.

Q - Vinit Malhotra {BIO 16184491 <GO>}

Yes. Good morning. Thank you very much for the opportunity. So, my question was around the – this property and frequency claims or the frequency claims in property, have you conducted some internal studies which would make you change some underwriting criterion or would you attribute this to purely bad luck? And do you also have plans to put in place some frequency covers for reinsurance or some such measures do you think are necessary for this problem? Thank you very much.

A - Jostein Amdal {BIO 19939645 <GO>}

In terms of underwriting criteria or terms and conditions for our products, it's obvious that after this quarter, we'll look into the terms and conditions of the agricultural product to see if we have the right price for this type of damages in crops or whether we should do something about the terms of it.

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But remember, it's just been really very few claims on this – of this type. And if I'm really, I mean, it's the first time about this type of damage, so it is natural. Sooner or later, we'll actually get claim on such a cover.

Other criteria, please bear in mind that if you have a natural perils type, a storm or a flood or something, that is actually covered via the Norwegian Natural Perils Pool, which has its kind of own criteria and we can't really change those criteria. It's a common criteria for the whole Norwegian market.

Otherwise, in terms of reinsurance, it is always constantly evaluated, whether it's actually would pay off to buy kind of lower level reinsurance to protect this, I guess, this type of short-term volatility. Usually, it doesn't pay off and we have a really solid capital position which makes us confident (00:43:07) short-term volatility.

Q - Vinit Malhotra {BIO 16184491 <GO>}

Okay.

A - Helge Leiro Baastad {BIO 5865247 <GO>}

Just to add to the overall comment on the property situation, just to remind you of past, present, and the future perspective on that. If you look back, we have had very benign winters and actually very benign situation for many, many years. We could say that the situation in 2018 is bad luck, but we do not want to take that bet going forward. So, the weather-related climate changes is a long, long-term trends, but we have to take into consideration that we may see maybe more volatile weather also for short-, medium-term.

Therefore, I commented that price increases have to be above the building index to take into – to prepare for more volatile weather going forward. But, of course, we could meet the 2019 and year 2021 like 2014, 2015, 2016, but we do not want to take that bet.

Q - Vinit Malhotra {BIO 16184491 <GO>}

Okay. And can I just summarize the motor situation from what I've understood, please, just to follow-up? That that – from back in August to now, things are going as per your expectations in the direction of claims or pricing and there's nothing to – there's no change on that. That's a good summary of the motor situation?

A - Jostein Amdal {BIO 19939645 <GO>}

That's correct.

Q - Vinit Malhotra {BIO 16184491 <GO>}

All right. Thank you very much.

Operator

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Thank you. We can now take our next question from Kevin Ryan from Bloomberg Intelligence. Please go ahead. Your line is open.

Q - Kevin Ryan {BIO 1814771 <GO>}

Thank you for taking my question. It's just a point of clarification. The solvency margin target you've given is quite a big range. Can I press you to come up with a solvency margin that you would really like to base yourself around, because it has a huge impact on your dividend paying capacity? That's the angle I'm looking at here. So, any additional help you could give us on what the ideal solvency margin for the companies would be gratefully received. Thank you.

A - Jostein Amdal {BIO 19939645 <GO>}

I think the only indication I think we've given and I can give you is that we try to be in the upper half of that range to be consistent with long-term A rating. But this really this – the rating agencies and the regulators look at capital very differently and capital requirements very differently. So, that's not necessarily a stable relationship over a long time. But given where we are at the moment, I would say, upper half of that range.

Q - Kevin Ryan {BIO 1814771 <GO>}

Thank you.

Operator

Thank you. We can now take our next question from Youdish Chicooree from Autonomous Research. Please go ahead.

Q - Youdish Chicooree {BIO 17430923 <GO>}

Good morning, everyone. I've got three questions, please. The first one is really on your combined ratio target. You've improved your – you've lowered your expense ratio target, but kept the combined ratio target unchanged. So, if you could just comment on which areas you expect the loss ratio to be weaker going forward?

And then, secondly, on your comment around more volatile weather and property claims going forward, could you just remind us what level of inflation you're seeing at the moment and confirm whether so far you've been – I think you said in the past you've been pricing around 4% increases. So, if you could just give us an idea of what you're expecting going forward, that would be very helpful.

And then, finally, on – again, coming back on the ordinary dividend, I mean, you raised your payout ratio range, but already with the earnings this year it looks like keeping the dividend flat will require the challenge. So, how confident are you that the FSA will give you the approval to pay in excess of earnings this year? Thank you very much.

A - Jostein Amdal {BIO 19939645 <GO>}

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On the first question, we have raised our ambition, expressed ambition at least, in terms of cost ratio. We still have, as you know, an interval (00:47:39) in terms of the combined ratio. We will be within that interval (00:47:42). It's up several percentage points change in the cost ratio, so we'll still keep the same ratio in terms of combined ratio. It doesn't necessarily mean a significant decline in the loss ratio.

Q - Youdish Chicooree {BIO 17430923 <GO>}

Okay. All right.

A - Jostein Amdal {BIO 19939645 <GO>}

Yeah. Second question is inflation in property, as I understood, your question was mainly related to property?

Q - Youdish Chicooree {BIO 17430923 <GO>}

Yeah.

A - Jostein Amdal {BIO 19939645 <GO>}

I think Helge already has commented. Over time, the building index is volatile, but over time, we expect something like 4%. But then, we also need to price to meet the increased frequency due from what we think is – might be a change in the pattern of the kind of weather-related claims and so on. So, we will aim or are aiming higher now in terms of price increases than the building cost index, and that is the same from if you look one or two years back.

Q - Youdish Chicooree {BIO 17430923 <GO>}

Okay.

A - Jostein Amdal {BIO 19939645 <GO>}

Third question was on the ordinary dividends. We – when we or if we apply for the – to the FSA for an ordinary dividend above this year's profits, then they will look at the solvency situation both at the moment and forward looking. We have a very strong solvency position both now and after the sale of bank, even stronger last year as you know.

Q - Youdish Chicooree {BIO 17430923 <GO>}

Okay. And in terms of the sale of the bank, what approval is pending so far?

A - Jostein Amdal {BIO 19939645 <GO>}

The competition authorities have given their approval and we're waiting for the Financial Services Authority.

Q - Youdish Chicooree {BIO 17430923 <GO>}

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Okay. So, they could take a decision while it's in their hands to decide whether the sales was ahead, and then at the same time, they can make a judgment on whether it will have the necessary capital after that approval, basically?

A - Jostein Amdal {BIO 19939645 <GO>}

I didn't quite catch what you're asking. Are you asking about the timing of the different decisions or...

Q - Youdish Chicooree {BIO 17430923 <GO>}

Yeah. I'm saying that, well, at the end of the day, it all depends on the FSA then, whether you can pay in excess of 100% and whether the bank sales goes ahead.

A - Jostein Amdal {BIO 19939645 <GO>}

Of course. That is how the legal requirements are. They need to approve both the bank transaction and any dividend about 100%.

Q - Youdish Chicooree {BIO 17430923 <GO>}

All right. Thank you. Thank you very much.

Operator

Thank you. We can now take our next question from Steven Haywood from HSBC.

Q - Steven Haywood {BIO 15743259 <GO>}

Good morning. Thank you very much. Just a quick clarification. You say your solvency ratio will be reducing by 10 percentage points by the end of this year. Is that both Solvency II ratios that you provide?

A - Jostein Amdal {BIO 19939645 <GO>}

Well, that is the legally approved partial internal model only.

Q - Steven Haywood {BIO 15743259 <GO>}

Okay. And so, your own partial internal view won't reduce by 10 percentage points?

A - Jostein Amdal {BIO 19939645 <GO>}

It might change. But then, this is what we are referring to, some specific requirements from the FSA to change to legally approve the model. And I think it's the same. We actually communicated externally and at the same time as we've got the model approved early this year.

Q - Steven Haywood {BIO 15743259 <GO>}

Okay, okay. So...

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A - Jostein Amdal {BIO 19939645 <GO>}

There's nothing new, it's been trend all the time.

Q - Steven Haywood {BIO 15743259 <GO>}

Okay, okay. So, pro forma for the bank sale and looking at your excess capital position here, if you were to use the bottom of your new target range, you may have over NOK 12 billion of excess capital, or if you will use the middle of the range, you say you want to be in the middle or the upper half, you may have NOK 10 billion or more excess capital to use for M&A opportunities. Is this the right sort of size that you would use or would you not be willing to go down to the 135%? And then also, can I ask, what's the willingness of your foundation to partake in a capital raise?

A - Jostein Amdal {BIO 19939645 <GO>}

Not commenting on number, but the target is obviously – range is there for a reason. That's kind of where we are – use that as guiding post to where our capitalization should be. Our foundation needs to speak for itself, but it has ownership policy that states that kind of in terms of kind of value-creating transactions, they will be participating if that means new money or if it means settling done and reducing their ownership stake in Gjensidige. That is kind of something they are willing to consider if they deem the case to be right.

Q - Steven Haywood {BIO 15743259 <GO>}

Okay. Thanks. And I think just a final question on your claims inflation. You say 6% is for 2018. Can you give us a figure for 2019 expected claims inflation on your motor book? And also, if you're having a buildings index at 4% currently, what is your claims inflation levels that you're expecting here?

A - Jostein Amdal {BIO 19939645 <GO>}

The 6% is the forward-looking estimate on the motor. It is not the last 12 months or 2018. It's what we expect going forward. And in terms of the building property index, we are not precise on kind of our expected inflation going forward. We are saying that – or posted earlier, we said it is probably more than the building cost index of 4%.

Q - Steven Haywood {BIO 15743259 <GO>}

Okay. That's good. Thank you very much.

Operator

Thank you. We can now take our next question from Niccolo Dalla Palma from Exane. Please go ahead.

Q - Niccolo C. Dalla Palma {BIO 16052945 <GO>}

Good morning. My first question is on the frequency-related weather losses. If you – can you give us some indication of what indication was in Q4 last year so that we can take that

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into account when we do our estimate for Q4 this year?

And the second question is on your hurdle for M&A. How do you think about your own cost of equity in terms of relative point for value creation? And you just increased your ROE target, are you then ready to decrease it again in case you have to pay a price for an asset that requires that? How should we think about again the hurdle rates for M&A given what your cost of equity and given there are retargets?

And the third question is on the bank disposal, could you just clarify, is there any other impacts on your shareholders' equity other than the gain of NOK 1.9 billion that you disclosed? I mean, is there any tax implications there? Thanks.

A - Jostein Amdal {BIO 19939645 <GO>}

We do not have a number, sorry, for that Q4 2017 extraordinary weather effects. I think we didn't disclose that at that time. Obviously, in the winter in 2017, the last quarter was more than 2016 and the average of the last years because this year, kind of extraordinary winter situation in last quarter of 2017. So, there was something there. I'm sorry, we might look at that before the Q4, but we don't have the number now, and we didn't disclose it at that time.

And in terms of hurdles for M&A, when we look at a target, the first and foremost is, of course, the industrial logic, and as Helge mentioned, it needs to be some size because there are integration costs and take some focus away from running that business.

Our cost of capital, as we see it, cost of equity capital is 7.5% after-tax. That is what we use for our calculations. And, of course, there needs to be value creation above that cost of capital for us to be willing to enter into a transaction. If we did something of a meaningful size, it will, of course, have a negative effect on the ROE in the short-term that, of course, really is mathematically.

Please remember that 20% return on equity is based on two assumptions. First, 1 percentage point is just due to the sale of the bank and based on that assumption. And the other part, the 4 percentage points increase is based on including the expected run-off gains through 2022 and that's consistent with 86% to 89% combined ratio target. Just to clarify that, it is not directly related to your question, but just to avoid any misunderstandings. The sale of the bank does not give us any tax implications. It's tax exempted.

Q - Niccolo C. Dalla Palma {BIO 16052945 <GO>}

Thanks for clarifying that. So, the ROE targets that you did is actually – that's therefore a target of average ROE on 2022, and therefore it benefits from 2019 when you have a big gain. Is that right?

A - Jostein Amdal {BIO 19939645 <GO>}

No, no, no, It's not related to the gain of the bank. It's just related without the bank in that book. Their return on equity higher.

Q - Niccolo C. Dalla Palma {BIO 16052945 <GO>}

But as you said, that's 1 point. And then, sorry, I didn't then get the other 4 points?

A - Jostein Amdal {BIO 19939645 <GO>}

It's the run-off gains that we're planning...

Q - Niccolo C. Dalla Palma {BIO 16052945 <GO>}

Okay.

A - Jostein Amdal {BIO 19939645 <GO>}

...through...

Q - Niccolo C. Dalla Palma {BIO 16052945 <GO>}

Okay.

A - Jostein Amdal {BIO 19939645 <GO>}

Yeah.

Q - Niccolo C. Dalla Palma {BIO 16052945 <GO>}

Okay. Sorry. That's clear now. And one more question, please. On the large losses, slide 23 specifically, if you look at the long run, the left-hand side chart, it seems that with a few exceptions, you typically are at expected level or below with very few exceptions. How should we think about the large loss budget? Is it still the right number? Should we assume that it's always a bit less than this? How do you set this large loss budget? Thanks.

A - Jostein Amdal {BIO 19939645 <GO>}

The large losses is based on the partial internal model, and use the same data and the same type of modeling. And large losses, the typical large loss here will be below the expected level. But every now and then, we will have average that's much worse. So, the average will be as we expect, the expected level, but the median for the typical year will be lower. That makes sense?

Q - Niccolo C. Dalla Palma {BIO 16052945 <GO>}

Yeah. Thanks very much. Thank you.

Operator

Thank you. We can now take our next question from Wajahat Rizvi from Deutsche Bank. Please go ahead.

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Q - Wajahat Rizvi {BIO 19928187 <GO>}

Hi. Good morning. Waj Rizvi from Deutsche Bank. Three questions for me, please. The first one on the weather losses, which you said NOK 530 million to NOK 660 million for first three quarters. Firstly, are you able to break that between your motor book property agriculture and other books, please? I'm guessing that most of it is in property and agriculture book. And secondly, given the visibility you have, how are you driving comfort that all of these extraordinary weather losses are definitely weather-related and there isn't any accretional impacted in (00:59:03) behind these losses? That will be the first question.

And second is a bit of a clarification. So, you alluded to pricing for extra volatility in the property book. So, the current 6% sort of price increase level you guided for, does that already include the price increase you need to put for, for this volatility, or is that something you need to take account into your future pricing and you haven't done that yet?

And the final question would be on IT system update. I think Helge talked about it in his remarks. So, will that be included within your expense ratio guidance which you have given, or will you capitalize it on your balance sheet? Thank you very much.

A - Jostein Amdal {BIO 19939645 <GO>}

Hi. The first one, the split between different lines, let's start with the last – the new – this quarter's claims. That's divided only between property and agriculture, 80 (01:00:02) in agriculture and the rest in property, more or less. No more during the third quarter estimate.

The previous quarter estimates, I need some help to remind – remember it. But in Q1, there was more or less an even split between motor and property. In Q2, it's mainly related to property. But if you add that up, someone needs to add that up, but (01:00:29) numbers, that's kind of, first quarter, evenly split between motor and property; second quarter, property; third quarter, agriculture and property.

Q - Wajahat Rizvi {BIO 19928187 <GO>}

Okay. Yeah.

A - Jostein Amdal {BIO 19939645 <GO>}

Yeah. Are we sure that this is weather-related and not some other reason? It is based on looking back at the average of these types of claims. They go down to each type of claims and you get what this average was of the years before. These are typically types of claims that are related to weather losses, either that heavy snow which makes roofs falling, and it's based on the water forcing the rain to houses and so on. So, it's typical weather-related losses.

And kind of for indications, you often see these weather statistics that we've given you in terms of snow depth, the precipitation, and changes of weather during these first two

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quarters, and then the heat and the dryness in the third quarter. So, I think it's – we can't be 100% sure, and we try to give a range just to indicate that. But it's fairly sure that this is weather-related.

Big question is, of course, what's going to be going forward, is this a pattern that is going to repeat itself or was it a one-off in 2018? And we don't want to take the fact that this is all returning back to a benign situation in 2019. So, we'll take that into account in pricing. This applies mostly to property. I think from our motor estimate, we think that currently weather-related effects will be handled within this 6% expected going forward. But, of course, these are our estimates based on certainly around those estimates. So, things might happen.

Q - Wajahat Rizvi {BIO 19928187 <GO>}

Okay.

A - Jostein Amdal {BIO 19939645 <GO>}

IT system, when we invest in a new core system, the investments will be capitalized and depreciated over approximately 10 years. That is – these depreciations are handled within our 15%, below 15% cost ratio target.

Q - Wajahat Rizvi {BIO 19928187 <GO>}

Okay.

Operator

Thank you. We can now take our next question from Blair Stewart from Bank of America.

Q - Blair Stewart {BIO 4191309 <GO>}

Hi. This is Blair again, and apologies, just another clarification. Just on the question I asked on excess capital, I think you mentioned the NOK 10 billion number, I just wanted to check what that was. I think that was – you said the – I think that was an implication that the capital requirement was NOK 10 billion because you said it was NOK 13.8 billion on a legal basis today and you take off around NOK 4 billion from the bank. Is that correct?

A - Jostein Amdal {BIO 19939645 <GO>}

Yeah. That's on my – that's was my...

Q - Blair Stewart {BIO 4191309 <GO>}

Yeah, yeah. Just – yeah. Just a rough number. So, NOK 10 billion of capital requirements. So, at 200% at the top-end of your range, that would be NOK 20 billion of capital requirements. I think we can work out a pro forma end-of-the-year ratio of about 250%, which is the 262% less 10 points, so 250%. So, it would imply that you've got available capital of about NOK 25 billion against a capital requirement at 200% of NOK 20 billion.

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So, there'll be about NOK 5 billion of excess capital at the upper end of your ratio. Is that – just want to check my calculations are correct there.

A - Jostein Amdal {BIO 19939645 <GO>}

(01:03:59) calculations. But – and then, the reasoning is correct, I think. It's (01:04:06) the solvency margin actually moves from quarter to quarter by any other reason. So, it might not necessarily be the numbers that you...

Q - Blair Stewart {BIO 4191309 <GO>}

Yes.

A - Jostein Amdal {BIO 19939645 <GO>}

...referred to. But I think your reasoning is valid.

Q - Blair Stewart {BIO 4191309 <GO>}

Okay. I just wanted to check that. Thank you very much.

Operator

Thank you.

A - Jostein Amdal {BIO 19939645 <GO>}

Blair, just a clarification and just a reminder, in terms of when we 100%, the solvency margin every quarter, bear in mind that we assume a 70% pro forma dividend ratio, which is kind of our stated dividend policy. So, if the – when it came to the fourth quarter and the actual dividend payout ratio is higher than 70%, that means kind of a drop in the solvency margin as of year-end.

Q - Blair Stewart {BIO 4191309 <GO>}

Yes. Okay. Yeah. Thank you for that.

Operator

We have no further questions in the queue at this time. I'd like to turn the call back over to you for any additional or closing remarks.

A - Mitra Hagen Negård

Thank you, operator. We will be meeting with investors over the next couple of days. We will be meeting investors in Oslo today, and Frankfurt and Copenhagen tomorrow. I would like to remind all of you of our Capital Markets Day in London, which we will be holding on Tuesday, the 27th of November. Looking forward to seeing you there. Thank you for your attention, and goodbye.

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Operator

Thank you. That will conclude today's conference call. Thank you for your participation, ladies and gentlemen. You may now disconnect.

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