S1 2013 Earnings Call

Company Participants

- John Reizenstein, CFO
- Paul Geddes, CEO

Other Participants

- Andrew Crean, Analyst
- Andy Hughes, Analyst
- Dhruv Gahlaut, Analyst
- Gordon Aitken, Analyst
- Greig Paterson, Analyst
- Nick Danarjvic, Analyst
- Oliver Steel, Analyst
- Ravi Tanna, Analyst
- Tom Dorner, Analyst
- Unidentified Participant, Analyst

Presentation

Paul Geddes {BIO 2474781 <GO>}

Good morning. So. Good morning to everyone in the room and on the phones to our second full-year results presentation here in (local) Goldman Sachs. Good to see the sun shining after the recent weather.

I'm Paul Geddes, CEO. And I'm joined by John Reizenstein, CFO. We're going to follow the usual format today, which is I'm going to start off with some key messages. John's going to come with the numbers and I'm going to come back with an update on our transformation agenda and then some topics I'm sure high on your list of things to talk about, the UK motor market, flooding and weather. Then we're going to take some questions.

So to get started, highlights, on page four here. Ongoing operating profit was up 14%, at GBP526.5m. Profit before tax increased by 70.2% to GBP423.9m.

On the back of this, we're proposing a final dividend of 8.2p, which is 5% growth, which is in line with our aim of growing dividends annually in real terms. And we're also announcing a second special dividend of 4p funded by our better-than-expected profit from our run-off segment and proceeds from the sale of Tracker, which takes the total dividend for the year to 20.6p.

Now, those results have been achieved against a backdrop of tough markets and significant regulatory change. And our results show the benefit of our underwriting strategy of value over volume and from the major changes we've made and continue to make to transform our business.

As you can see on the charts on the right, we beat our COR target by 1.9percentage points and this led to a RoTE of 16%, ahead of our long-term target of 15%.

We improved our ongoing costs by 9.2%, hit our IPO target of GBP100 million gross cost savings. And in June extended that target. We also continued to generate significant prior year reserve releases, reflecting our conservative reserving. But also the improvements we've made to claims pricing and risk selection.

The start of 2014 has seen no let-up in the competitive nature of the markets. We will continue to pursue the same strategy, balancing underwriting margins with volumes, whilst, at the same time, building capability.

We still have a full agenda of business improvement plans going forward. And on the back of these, we are aiming for a combined ratio of between 95% and 97% for 2014.

Now, this guidance assumes a normal level of claims this year from major weather events and, clearly, the start of this year has been anything but normal. Severe flooding and storms is a timely reminder that insurance isn't just about price. And our staff are doing a great job in helping customers get back on their feet.

It's still early days. But we've published a preliminary estimate of between GBP70 million and GBP90 million for home claims from the start of the year up until February 22. And that compares with an expectation of an average full year of these sorts of claims of GBP80 million for home.

So all in all, a year of good progress, profits up, capability building. But we do face into a tough market, which means we need to redouble our efforts to deliver our self-help agenda.

I'll now hand over to John to go through the figures in more detail.

John Reizenstein {BIO 6786139 <GO>}

Thanks, Paul. Good morning, everybody. Let's start with the financial highlights on slide seven (sic; see presentation "page 6"). And I'll talk to performance against the full year 2012 to begin with.

GWP was down 4%, reflecting the impact of a competitive marketplace, particularly in UK motor, together with the Group's continued focus on managing for value. Within this, we saw growth in commercial and international, which was more than offset by reductions in UK personal lines.

As Paul said, we saw a 14% increase in operating profit, with profits rising in motor, home and commercial. We've used a COR of 96.1%, 3.1percentage points better than last year, or 2012. And better than the target we'd set with GBP110 million improvement in underwriting profit.

The actions we've taken on pricing, claims and risk mix have led to strong releases from prior years and helped us keep the current year attritional loss ratio flat.

In terms of prior year releases, these increased to GBP435m, which represents 12.4% of premiums. This was higher than expected as in previous periods we've seen releases in all segments with a major contribution from motor.

In 2013, we achieved a 2.6percentage points improvement in RoTE to 16%.

Final dividend is up 5%. And today we're declaring a second special dividend of 4p, which I'll come back to.

A couple of observations on Q4. GWP was down 3.6% in the Fourth Quarter, with motor down 9%.

Operating profit of GBP108.7 million was 4% lower than the prior year due to higher weather costs in 2013, partially offset by higher reserve releases. Other income was lower due to the banning of solicitors' referral fees.

Investment return was higher due to the effective changes in the investment portfolio. And there were very few gains in Q4.

Moving onto underwriting performance on the next slide. In a year which saw material market price deflation, holding our current year ratio flat was, we think, a pretty good result.

For the ongoing business, our current year attritional loss ratio remained stable despite competitive market conditions and high weather losses in commercial and international, which are not adjusted for in the attritional ratio on this slide.

We've seen prior year releases up substantially, which I'll come back to.

Interestingly, despite the floods and storms, home weather event costs of GBP69 million in 2013 were actually a bit lower than our budget and lower than 2012. And we think we've made a prudent assessment of those claims and how they will develop.

Both international and commercial were impacted by weather in 2013. Commercial suffered higher-than-normal claims from the very recent bad weather. And Germany from hail events in the summer. We don't adjust this table for those. But if you did, the attritional loss ratio would be around 0.5percentage point better in 2013.

Moving onto costs. You'll recall that back in June 2013 we announced further cost savings and revised our cost target to approximately GBP1 billion in 2014. This was GBP130 million better than the GBP100 million we announced prior to the IP0.

In 2013, total costs of GBP1.032 million represents a saving of GBP105m. That's 9.2% compared with 2012.

The expense ratio improved by 0.7percentage points. If you adjusted for the fall in premiums, it's 1.9percentage points better on a like-for-like basis.

You can see from the breakdown that management fees from RBS in 2012 have fallen away. We've now got control of our cost base. This makes year-on-year comparison of staff and other cost level a bit tricky. However, you can see the reduction in marketing cost in 2013 of around 9% as we have a more targeted approach to our marketing spend.

We exited the year with a run rate of around GBP250 million of costs. And we believe we're on track to achieve our target. This will require us to mitigate inflation as well as the increased amortization costs from past and planned investment spend. Overall, I'm pleased with the progress we've made on expenses in 2013. But we need to continue the momentum.

Go to the segments, starting with motor on slide 9. GWP and IFPs were down as a result of maintaining our underwriting discipline in a competitive market. Although, actually, IFPs have been fairly stable since Q2 with about a 1% reduction on -- quarter by quarter.

The current year loss ratios remained fairly stable at around 85% as our claims and pricing improvements, plus some benefits from LASPO were offset by competitive market conditions. We think that's a reasonable outcome given the competitive market and our reserving assumptions.

We saw substantial prior year releases in motor of GBP292m, which represents 20.2% of premiums. We continue to reserve on conservative assumptions. And, consequently, the benefits of the actions we've taken on claims and risk mix, plus improvements to the general claims environment, are generally recognized in the prior year.

Assuming underlying claims trends continue, a significant contribution from PY is currently expected, albeit at a lower level than in 2013.

This brings us to the overall loss ratio of 65.1%, a 9.5percentage point improvement on 2012.

The motor COR came in at 93.2% with a GBP124 million increase in underwriting profit.

As expected, installment and other income was lower, primarily due to the ending of solicitors' referral fees.

And operating profit was up 32.8% to GBP347.7m.

It's worth noting that motor includes the results of the Tracker business, which we recently sold. Tracker was a broadly breakeven business. But going forward, we'll see a reduction of around GBP18 million in revenue from vehicle recovery and repair services, which is reported within other income, offset by a reduction in expenses.

A bit more detail on slide 10 on motor reserving. The chart on the top left shows our improvement in BI capped inflation, which we believe shows good performance relative to the market.

Up until the end of 2012 we continued to observe better-than-market inflation. We expect that the market has seen deflation since -- in 2013 as legal reforms reduced severity. But we believe we continue to outperform.

The table on the top right should be familiar, BI capped severity inflation observed on the ground versus what we've booked. I'd have to say that the 12.9% reduction in 2013 versus 2012 settled, is exaggerated. That will be because of the impact of the reduction in legal fees on small claims, which tend to settle first. There is -- as the year matures, we'd expect the deflation versus 2012 to be not as pronounced as that. However, we think that the information -- doing information on an indexed basis from 2000 and on, as you see on that chart, which shows accumulative effect over four years, shows our continued conservatism. And that pattern continues.

Obviously, this is only one peril, although it's a very important one. But it does support our current expectation of continued positive year development.

But interestingly, in 2013 we also saw significant releases from large bodily injury claims reserves. Within those reserves, from PPOs into non-PPOs, stated from PPO into non-PPO IBNR, in particular for 2012, accident years turned out to be relatively benign in terms of large claims frequency. The -- it's a bit early to call that on 2013.

The bottom chart shows the pattern of favorable releases continues. As with 2012, there is an element of conservatism in our initial (PIK) for 2013, which we expect to develop favorably, as it has in previous years.

I should also mention here that we've just renewed our motor reinsurance. We chose to increase our excess of loss cover. We've reduced our retention to GBP1 million per claim. This follows the pattern of reducing our retention from the GBP10 million level it was a few years ago.

Moving onto home on slide 11. We saw a reduction in home IFPs. And much of that is due to the removal of low premium home response products from packaged accounts. The underlying reduction is 2%. And within that, the volumes on own brands were flat.

As we said previously, we continue to have the transformation benefits in the home business to maintain performance in a competitive marketplace.

As you know, we've experienced a number of weather events in Q4. We had the St. Jude's storm in October and coastal flooding in early December followed by flooding and storms over Christmas. In total, these weather events cost GBP64 million on top of the GBP5 million in Q3.

Reserve releases of GBP43 million were broadly in line with 2012, with the current year attritional broadly flat at 51.5% despite a competitive market.

The increase in the commission ratio is from higher profitability in our partnership business. And this includes both prior year development and better weather than in 2012.

Overall, the COR improved by 2.8percentage points to 93.8% and operating profit was up GBP12.9m.

Turning to rescue and other personal lines on slide 12. The reduction in policy count was mainly due to reduced volumes in packaged bank accounts. This is partially offset by growth in Green Flag direct sales following its new marketing campaign, which we showed you. There was a small deduction in overall GWP. But rescue GWP was up 4.4% because of that campaign.

The division results have been volatile year on year, partly because of the creditor product, which is in run-off. And also the sale of the life business.

If you exclude creditor, life and other one-offs, in 2013 the division year-on-year performance is down GBP10 million in operating profit terms at GBP37m. The decline is mainly due to rescue.

Rescue made GBP38 million in 2013. That's about GBP9m, GBP10 million down on the previous year. And that reduction on rescue is due to, firstly, the higher marketing spend. And the non-repeat of some one-off noise in the previous year.

The two other main products in this division are pet and travel. Together, they would normally make between GBP5 million and GBP10 million operating profit. Pet has done okay in 2013. But travel was impacted by higher medical claims costs, particularly on packaged accounts. That will correct. And we're saying in summary, underlying operating profit is around GBP45m.

Turning over to commercial, a good performance in commercial with results demonstrating progress towards the target COR of below 100% this year.

IFPs were up 25%, GWP up 9%. On an underlying basis, excluding the transfer of the van business from motor, GWP growth was 2% largely due to growth in Direct Line for

Business. Plus, the policy count was up a lot.

The current year loss ratio shows a 2.9percentage point improvement despite high weather claims. The prior year releases are similar to what we've seen in the past and we expect this to be an ongoing feature of the commercial business.

Overall, its financial loss ratio was 62.3%, a bit lower than last year, than 2012.

There were small improvements in commission and expense ratios as a result of management action taken on cost and efficiency.

COR of 106.8% was 1.4percentage points better than 2012. If you exclude the higher claims costs from weather, the underlying COR would have been around 104%. A bit lower than 104%, which we think is a good sign to go towards 100%.

Overall operating profit increased by GBP7.3 million to GBP9.5m.

Finally, international. Overall progress. But a slightly mixed picture. IFPs up 10% and GWP up 9% or 5% in local currency terms, mainly due to growth in Germany.

Overall, the international COR was broadly flat with operating profit down GBP3m.

There was a small increase in the current year attritional loss ratio. This was due to summer hail in Germany, which cost us around GBP8 million more than normal. We have seen significant releases come through again in this division.

Profit from Germany was obviously down due to the weather I've mentioned. But on a normalized basis, showed progress. Profit initially was flat, with performance maintained despite very challenging markets and economic conditions.

We've seen competition in Italy intensify during 2013 and this will impact growth in 2014.

So let's turn to the balance sheet, starting with investments on slide 15. Investment income was GBP175.5 million with a yield of 2.1% against a yield of 2% in 2012. This pick-up in yield is mainly driven by our changes to the target asset mix.

As expected, we had lower gains mainly due to the portfolio and restructuring in 2012 which we didn't expect to repeat in 2013.

In terms of asset allocation, we continue to invest in property, which is now up to 3%, closer to our 5% target.

In Q4 we started to invest in securitized credit for the UK portfolio. It's very high quality AAA and AA mortgage bonds, auto bonds and student loans and so on. We have 3% of the portfolio invested in that asset class at the end of the year with a target of around 6%.

If you move over the page we can look at the outlook for investment yield. The table on the left shows we've maintained a short duration. And that's deliberate as we expect interest rates will increase, eventually. But who knows when. It remains an uncertain timing. In the meantime, it makes sense to stay short duration.

Once we achieved our target investments in property and securitized credit and after taking into account the current yield environment, we expect yields to increase towards 2.4% by 2015. And we continue to look for ways to increase yield within our current risk appetite and to get a closer match to our liabilities.

Next up is we're looking to invest in infrastructure bonds to match our PPO liabilities. These will be floating rate. We think that Libor basis gives us some inflation protection over the long-term. But they'd have long credit durations. Things to look forward to.

We're nearly through. I'll just take you to page 17 to look at the rest of the P&L.

Run-off profit of GBP64 million for the year was a result of positive prior year development. That's partly due to conservative reserving. But also due to good claims management. It does share some of the characteristics of the ongoing business. Obviously, the runoff has pretty much only long tail reserves now.

Going forward, we do expect run-offs to generate a profit. But not as high as 2013.

Restructuring other one-off costs came in at GBP140m, in line with the guidance we gave at Q3. The split of IT migration costs and cost reduction initiatives was also in line with guidance. Guidance restructuring costs for 2014 is unchanged at GBP80m.

The gain on the disposal of GBP12 million relates to the sale of Direct Line Life.

Finance costs increased in 2013 because we had the first full year of interest on the debt we raised in May 2012.

All of this leads to a PBT of GBP424m, up 70%. And a PAT of GBP313m, also up 70%.

The effective tax rate is 26.2%, a little bit higher than the UK standard rate. That's due to some one-offs in international and some disallowable costs. Gives us a basic EPS of 20.9p, just under 70% increase on 2012 with ongoing diluted EPS up 15% to 25p.

Moving over to dividends, on page 18, let's start with the proposed final dividend of 8.4% (sic; see presentation "8.4p"). This is line with guidance of 5% growth we gave at the half year and consistent with our dividend policy, which aims to grow the dividend in real terms. It gives us a total regular dividend of 12.6p, representing a payout ratio of 50.4% of ongoing earnings.

Now let's turn to the special. You'll recall that in November we announced the sale of the life business and we used the proceeds to pay a 4p special dividend. The rationale for that decision was that the proceeds were viewed as one-off and, consequently, it was appropriate in that instance to return it to shareholders -- return them to shareholders.

We're now applying the same logic to the better-than-expected result from runoff, post-tax. And the proceeds from the more recent sale of Tracker. And we're declaring a further special dividend of 4p per share. Taken together, the total regular and two special dividends amount to 20.6p per share and represent a total payout of just around 100% of total earnings, a bit below I believe.

Let's go to capital, on page 19, starting with the headline capital ratio. We end 2013, after adjusting for all those dividends, with a risk-based capital ratio of 148.7%, broadly in line with the position at the start of the year.

The leverage ratio remains low, at 15.7%. And for those of you that still like Solvency I, the estimated IGD coverage remains fairly stable at 272%.

So it's a relatively stable and conservative picture overall. As we look ahead to 2014 there are a number of uncertainties we need to take into account as well as factors that may be positive and also negative that impacts our capital position. And we've tried to bring these together on page 20.

You'll see the big question mark. This slide brings together the key factors.

So let's start with tailwinds. We have shown, I think, our ability to be a profitable group. And, based on our guidance on the COR, we continue to think that we will be. At the same time as we work through our transformation plan and self-help agenda we're looking to reduce operational risk in the business and that could improve our capital position. But that will take time.

Our plans in the meantime have a short-term capital cost. Reinvesting in systems. That doesn't fully qualify for capital. And restructuring costs clearly hit our earnings.

As I've mentioned before, we're also making modest changes to our investment asset mix, which also used up some capital. In the main, this is ALM driven. It's the right thing to do.

In terms of capital management more generally, we're in the process of working through the new ICAS+ process with the PRA, which includes a detailed review of our internal model and that is ongoing. This will, in part, drive our future regulatory capital requirements.

Whilst we wait to conclude those discussions and understand also more fully the transition towards Solvency II, it does create an element of uncertainty. In these circumstances we believe it's appropriate to maintain capital towards the top end of our risk appetite range for the time being. We will, of course, continue to review the capital position as these uncertainties are clarified.

Finally, on page 21, let's look at the TNAV. Headline tangible book value per share was down 7.8% to 153.2p. However, if you add back the dividends paid out during the year, underlying TNAV grew by 5%.

You can see the movements in the chart. Profit was a positive contributor. And this was partially offset by the movement in the yield curve, driving the pull to par on our bond portfolio. And also growth in intangibles from continued investment in the business.

So I'll now turn back to Paul.

Paul Geddes {BIO 2474781 <GO>}

Thank you, John. So as John has walked you through, you can clearly see the impact of the actions we've been taking across a broad range of topics. But particularly costs, claims, investments and capital. And I believe our progress here demonstrates our ability to execute against a busy agenda of initiatives and execute successfully.

And against a backdrop of a highly competitive market, we will need to keep up our momentum of delivering on a busy self-help agenda if we're going to maintain and improve our performance. And that is exactly what we intend to do. So the next six slides I'm going to walk you through the progress which we've made in 2013 and what we plan to do in 2014 and beyond.

Let's start with distribution. We continue to invest in building customer capability and propositions. Last year we set out a number of priorities, as shown here on the left.

So let me update you on our progress in 2013. We've further differentiated our propositions with offerings such as Direct Line Together and Green Flag's one-hour proposition. Our more targeted marketing campaigns was achieved with a 9.4% reduction in our marketing spend.

We launched two telematics propositions, including black box and smartphone app. And we're very pleased with the growing take-up in new business with now 30% of 17 to 20 year olds on DL taking up one of our black box offers.

In addition. And you have to believe me, the boxes are incredibly small. We have a pilot of a self-install telematics app, which we will keep you updated on and might even send you one to try out to see how you all drive.

Our planned investment in digital is now well underway with a new data center supporting our new digital platform. We exited the year having started the rollout of our new mobile-optimized smartphone and tablet-optimized website Privilege using our new digital front-end, which we've built.

So 2013 has been about building capability in the digital and telematics space. In 2014, our focus shifts to rolling these improvements out and making the most of them in the competitive marketplace.

We plan to complete the launch of our smartphone; and table-optimized websites for Direct Line and Churchill in the coming months, whilst evolving further our telematics proposition based upon customer feedback. We will also continue to differentiate the Direct Line brand as we go through the year. Watch this space.

And just to break things up a bit, in customary style, we're going to give you a quick ad break. And just remind you, not all of these adverts you are the target audience of. So if you don't like them that's my excuse. Here's some of our current advertising.

(Video playing)

Good and policies are available at the end of the meeting.

So turning onto pricing. It's been a very busy year on pricing with our pricing teams delivering a stream of initiatives to help us deliver a steady current year attritional loss ratio in a highly competitive market. The priorities we set ourselves for 2013 were about optimizing our rating engine, deploying renewal strategies and leveraging pricing sophistication to enable us, if we wanted, to target more areas of the market.

I'm pleased to say that we made good progress against all of these. We updated our technical pricing models in motor and needed to optimize our exposure in higher premium segments. We implemented enhanced renewal strategies across motor and home and, despite the market competitiveness, we managed to increase our home retention by over 2percentage points within our own brand portfolio.

But our pricing self-help agenda is still full of initiatives with clear value that we aim to deliver at pace, although we can't be too transparent of these as we're now into the area of potentially giving away trade secrets. But suffice to say, we have over 30 pricing initiatives planned across motor and home in 2014, including initiatives aimed to enhance our price comparison website capability and to fully utilize our telematics data into pricing.

So onto claims. And whilst it was a year of building capability in pricing, in claims it's been a year of maintaining our momentum. The goal we set ourselves in 2013 were about building on the claims transformation in motor and home and extending our learnings to commercial and international, whilst adapting the business to the heavy agenda of regulatory change.

So what have we achieved? We completed our claims transformation program with the full rollout of our claims center now across motor and home, supported by our new operating model. We've also reduced claims leakage through improved fraud detection techniques.

ClaimCenter has also now been rolled out into commercial and into Italy. And I'll come onto that later in those headings.

We've also leveraged our strong claims position to improve our customer propositions such as the use of our fulfillment network to offer customers a really easy and enhanced replacement car service.

And as you've seen a few weeks ago, we've received our license to set up DLG Legal Services, which builds on the foundations we laid in 2013. And that is scheduled for launch next week.

So looking ahead to 2014, following a number of successful pilots we plan to rollout our new home claims initiatives, including allowing customers to use their smartphones to report claims.

There's also more we're going to do on fraud detection and claims leakage and we have clear plans to address these opportunities.

Lastly, it's worth reminding you we actually have our own repair network. We employ 400 of our own mechanics, repairing thousands of cars every day. And through the greater use of technology, we aim to further generate -- generate further efficiencies throughout the repair network in 2014.

We'll also need to continue to engage and adapt to a changing regulatory landscape.

So next, onto costs where 2013, I think it's fair to call it a pivotal year for us on costs. Remember, at the time of the IPO we set ourselves an initial target of GBP100 million gross annual cost savings. And in 2013 we announced a further GBP130 million on top.

And against that, we implemented a number of efficiency improvements throughout the business resulting in over 2,000 people leaving the business in 2013 with a focus on head office.

In October 2013 we opened our new data center, the key step in our migration away from RBS's IT infrastructure. And this is at the heart of us building a low-cost, self-serve digital infrastructure for the future.

In addition, we started rolling out our new voice and desktop tools to help our people to help our customers. And the combination of these digital initiatives should enable us to drive further efficiency throughout the business in the years ahead.

So our priorities for 2014. Firstly, making substantial progress with our IT migration away from RBS, a key focus to reduce our dependency on RBS systems.

We also need to hit our cost target of approximately GBP1 billion in 2014, where, as John says, we are currently on track.

Commercial. We made good progress against our strategic plans in 2013, in line with the goals we set. 2013 saw commercial launch its full cycle eTrading platform. We've seen good growth in Direct Line for Business.

We introduced some more efficient operating models by consolidating our underwriting centers and separating them out from our trading activities. In the latter part of 2013, we exported some of our expertise in personal lines to commercial with the rollout of ClaimCenter for commercial motor claims.

So 2014 is clearly a big year for commercial as we aim to deliver the sub-100% COR target, assuming normal weather and large claims. It's a year where we embed and extract value from the investments we've already made in ClaimCenter and eTrading. We'll also continue to leverage our expertise in personal lines with new propositions, such as a telematics proposition in commercial and the launch of Churchill Van.

Finally, on international. In 2013 we continued to adapt to the different market conditions we found in the two international markets we're in. At the start of 2013 we set out our objectives to drive operational efficiency and accelerate IFP growth in Germany, whilst focusing on profitability in Italy.

So an update on progress in 2013. In Germany we grew our in-force policies to 574,000, which is a 21% increase, through a successful 2012 year end and campaigns throughout the year, importantly, without a substantial increase in central costs.

We rolled ClaimCenter out in Italy and have also delivered improved profitability with a 1.3% improvement in COR.

So looking ahead to 2014, we continue with a different focus in each market, albeit with a strong focus on operational efficiencies in both markets.

In Italy, we see the market becoming increasingly focused on price comparison websites. So we have plans to implement a new rating engine to improve our capabilities in this space.

We plan to maintain progress in Germany, albeit at a slightly slower pace, having increased IFPs by 54,000 in January after another successful year end campaign.

So I'm now going to turn to three topics close to your heart, motor pricing, home weather and regulation.

So UK motor market. In the Fourth Quarter we saw a familiar pattern in terms of our pricing and risk mix indicators. And this resulted in IFPs down around 1%. Taking the discrete quarter, we have reduced prices by 4% compared with the prior year. And risk mix was down about 3%.

As we said before, our price reductions reflect changes we've observed in our claims data arising from both the actions which we've taken in our claims transformation program as well as the benefit post the introduction of the LASPO reforms.

Our price reductions are less than the levels suggested in some recent published surveys. And against that backdrop we're satisfied with our position. And as I say every quarter, we continue to make trading choices on a daily basis to optimize between value and volume and we will continue to do so.

The chart on the top right brings to life the claims volumes pre and post LASPO and shows the reduction following the reforms in April. We've adjusted the chart this time to reflect that our IFP count has been falling. And even adjusting for that, you can see the key trends are the same as Q3. Industry claims are going down versus the prior year and we look to be modestly outperforming.

On the bottom left chart you can see our telematics penetration rates for new business in Direct Line. The overall penetration of 25s remains at one in five. But you can see there's even higher penetration in the youngest of the drivers 17 to 21 year olds. This excludes the pilot of self-install devices, which, if we included it, would take penetration towards one in four.

So taken as a whole, 2013 was a very competitive year with a number of major market changes, gender and LASPO, together with a broader acceptance of telematics.

Now, after some signs that the market may have begun to stabilize in Q4 2013, early 2014 has seen reductions in market premiums by a number of players and this has put further pressure on new business. And we're going to continue to pursue our strategy of pricing in line with claims trends. And based on our current trends, we'd expect gross written premiums for motor could be down around 10% in Q1 2014 versus the same period last year. And that 10% comes from a combination of price reductions in part flowing through from previous quarters, risk mix and volumes as a result of us not following market pricing all the way down.

This context underlines the critical importance of successful execution of our full self-help agenda.

Next, onto weather, where I'm sure you'll be interested in our take on the level of claims coming through from recent events. In the Fourth Quarter, the home weather cost was GBP64m. And that was made up of three quite different events. Firstly, St. Jude in October where some of the country suffered severe gales. The costs associated with this event were fairly low. But the volume of claims was pretty high.

In early December, parts of the UK suffered storms that led to tidal surges across the East Coast. We received over 200 flood claims. And with most of the damage caused by salt water, this increased the average claims cost. We also received claims from storm damage at a much lower average claim cost. Overall, the mix of incurred costs was skewed towards flood claims.

Finally, for those of you in the country at Christmas, you'll remember the bad weather and, again, a mixture of floods and storms. However, this time the floods were inland, which means lower severity. The mix of flood and storm claims for the event was roughly equal.

The adverse weather obviously continued into Q1 with further storm damage and further flooding. Our initial view, as at February 22, is that the costs will be in the region of GBP70 million to GBP90 million for home with a further GBP20 million in commercial.

However, all the usual caveats apply. So still very early days. We'll only start to get a more accurate assessment when the flood waters fully recede.

Compared to 2007 floods, we're not seeing claims on the same scale and, to date, flood claims volumes are less than a tenth of what we saw back in 2007. The chart on the right shows the development of claims volumes, both the Q4 and Q1 events, including both storm and flood. As you can see on the chart, notifications for St. Jude. And the tidal surge developed quite quickly whereas the events in 2014, we're seeing a slower pattern, which takes it -- makes it difficult to be totally accurate on the estimate costs at this point in time.

Over the course of the next few months we'll be back-testing our flood models to understand whether the flood defenses that were put in place post-2007 operated as we expected and to assess the impact of strategic decisions taken to tactically flood certain areas. We're going to use the insights gained from these events to further enhance our flood models and to inform our reinsurance buy.

And on reinsurance, our current claims estimates are well below the retention of reinsurance of GBP150m. And to remind people, that is a deductible on a seven days, hours clause basis for flooding.

So it continues to be a busy time for our claims departments. We've been doing everything we can to help our customers. We deployed our emergency response vehicle most recently in Staines, providing customers in the worst affected areas. Property advisors have also been out using our home estimation tool to assess and settle claims quickly. And I was out with Steve a couple of weekends ago seeing all our people on the ground helping our customers.

So regulation. Regulation remains another key areas of focus, with a number of reviews and changes proposed. I'm not going to go into all the areas and we can talk more about these in questions or over coffee. But I think our overall view remains that we're fully engaged on the agenda and our knowledge and participation in industry groups means that we're well placed to influence and understand the direction of change.

Our overall position is pretty simple. We believe that a level playing field of good conduct and prudential regulation allows the players to invest in customers and capability to be successful in this marketplace. So we are supportive of good and strong regulation.

So before I wrap up, an update on targets and guidance for the year ahead, starting with COR.

The market today remains highly competitive. But with our self-help agenda. And assuming normal weather claims of GBP80m, we would expect to achieve a COR of between GBP95 million and GBP97 million in 2014. And within this, we reiterate our commercial COR target of better than 100%, again assuming normalized weather and large loss claims.

On costs we reiterate our target of total costs of approximately GBP1b. We exit 2013 with Q4 costs running at this required rate. But as John said earlier, we are obviously subject to normal inflation and we continue to invest in the business.

And of course, our 15% ROE target remains ongoing.

So to sum up, a good financial performance. We've rewarded shareholders with total dividends, including specials, of 20.6p and we've continued to make good progress against our strategic agenda in highly competitive markets.

And with that, I will open up to questions. We'll just pause and allow the telephone operator to say what she needs to say and then we'll --.

Questions And Answers

Operator

(Operator Instructions)

A - Paul Geddes {BIO 2474781 <GO>}

Okay. So if we can follow our normal guidance of starting with two questions, not naming any names. So -- and then we'll return if we've got time for any more. We'll start -- Greig.

Q - Greig Paterson

Two questions. One -- just one point. My wife pointed out that in your adverts your line is not direct, it's squiggles. So you should actually, potentially, tell your advertising agencies to produce a direct line, yes.

A - Paul Geddes {BIO 2474781 <GO>}

And your second question?

Q - Greig Paterson

That was a statement. I need a fee for that.

So house. Can you just give me the Fourth Quarter year-on-year pricing that you achieved in house?

And I wonder if you can give us an update or a steer? I remember when you IPO'd you said there was 7% of reserve redundancy. And I know you said that number would come down over time. I wonder where we are at the end of 2013 so we can get an idea of modeling going forward.

A - Paul Geddes {BIO 2474781 <GO>}

Okay. So let me give you a year's view on the home market pricing and what we've done, if that's helpful and then John can talk about reserving.

So we saw -- we think the market has seen price reductions, according to surveys, about 8% to 10%. We reduced our new business pricing between 5% and 7%. On the total book, taking into account renewals, total premium reduction was down about 2% to 3%.

And despite that, as you saw, we retained our loss ratios. So that's showing our reinvestment of our self-help agenda to keep us really competitive. And we're really pleased, particularly with our own brands business in home. As we said, we've done everything we said we'd do.

Self-help gives us all a pot to be very competitive in a increasingly-competitive -- and with the growing rise of PCWs. But we are very -- a very strong player in home and we've maintained our position.

John, do you want to talk about 7%?

A - John Reizenstein {BIO 6786139 <GO>}

Sure. The 7%, thinking back to those days, it seems like such a long time ago. Anyway, that was the margin we published at the time of the IPO. And I think we also said then. And we've said it ad nauseam probably from your perspective, that our actuarial best estimate is also conservative. And it's actually the actuarial best estimate conservatism that is driving the reserve releases. It is nothing to do with the margin.

The margin remains as strong or stronger. I'm not going to give a number as it was then.

Q - Andy Hughes {BIO 15036395 <GO>}

Hi. Andy Hughes, Exane BNP Paribas. The first question is on costs, I guess. So the first question on the cost target. Presumably, we knock off the Tracker costs from that to get to the actual target for the year end. So it should be GBP980m-something? That's a statement, not a question. So please take that one off.

So in terms of the IT spend, I think you mentioned in the capital section that you're going to be increasing intangibles on the balance sheet. Does this mean there's a bunch of costs in terms of IT development that's not coming through the P&L or restructuring charges? And roughly how much would that be?

And I guess the second question is related to the motor market and whether you think it's going to turn any time. A few people have been making predictions about late 2014. So I'm just interested in your take on this. Thank you.

A - Paul Geddes {BIO 2474781 <GO>}

Okay. I'll handle the last one, happily. John, do you want to take the --?

A - John Reizenstein {BIO 6786139 <GO>}

Sure. Heard what you say about Tracker. We'd love to do what you said. I just hope we can.

On costs, on IT costs, they're of two types. We do have some restructuring costs that hit the P&L straightaway and we've said it's likely to be GBP40 million next year and there is GBP40 million of other one-off costs next year making GBP80 million in total.

The others get capitalized and -- primarily. And come through the P&L as amortization cost, which is why we say if you look at any bit of our cost base, we hope to drive most bits down. But that bit is the bit that we will increase within. It's roughly running around GBP60 million at the moment. It will go up.

A - Paul Geddes {BIO 2474781 <GO>}

Okay. So I'll do my motor speech once and then I'm sure we'll get other questions on it.

So I think the first thing to say is I think predicting the future is a bit of a mug's game in terms of accuracy and it's led -- there are all sorts of legal issues with making any forward-looking statements even if I thought I had some stage knowledge, which I don't. So I'm not going to make any future looking comments.

But I can be quite accurate about what we're seeing today. And I know we've obviously, I think, with our news today probably has run somewhat counter to some of the hopes people had based on the Q4 results.

So let me just wrap up some of those factors. So there are three surveys out there that are public domain and one which we get to see. The one we get to see has got 2,000 risks in it. So it has some limitations. But, the other surveys also have limitations.

But if you look across the four, I guess you would see a range running around double digit or up to double digit. We think that's a little bit high. So, we think it's 5% to 10%. We can be a bit more specific about that and we've clearly been running at about minus 3%. So we think we have been pricing less aggressively down than the rest of the market. Our pricing follows absolutely our observed trends. And we think those observed trends are quite impressive versus the market from all the comparisons which we can make.

So that's the choices that we have made. Other people clearly, it looks like, have priced some more than that and I don't think that's driven by them having superior claims inflation to us. So I guess there are implications of that in terms of potential impacts on market profitability.

We saw in Q4 some easing of the rate reductions and some signs of stability. It's not -- we didn't make any forward-looking statements or big conclusions from what we saw in Q4 because it's a seasonal market and Q4 has some eccentricities to it normally. So we didn't read too much into Q4.

But we have certainly seen a resumption of market competitiveness in Q1. Versus Q1, we've seen some players take prices down quite a bit.

We've sharpened our own prices a couple of % going into the quarter, again justified by our own claims trends. And we have, as a result, seen -- we will expect to see policies fall about another percentage point in Q1.

Just to be really clear, we still have about five weeks to go. And we trade -- Gus at the back there trades every day. So I'm not giving up on Q1. But we expect, from the trends which we see today, to -- our prices to be down another couple of percentage points from where we left the year. And policy count, because that's less than we're seeing in the market, reduce about 1%. Risk mix is probably swinging around at the moment. It may come in our favor. So that's quarter-on-quarter.

Year-on-year what that's likely to look like is prices down about 4% year-on-year. ISPs cumulatively now to about minus 4% year-on-year. And risk mix may be swinging around too. And hence, that's the 10% which we come to.

Risk mix is probably the most volatile of those and things may change. So when we come back and report on Q1, those numbers might be a bit different.

So that's what we see. We are happy with the decisions which we take. We can't talk about what our competitors' decisions they take. I'm not using any words like irrational because they may well have their own good reasons for what they're doing.

But we are well practiced to what to do in these sorts of markets. We had a soft market plan. We're executing against that. We continue to pull all of our self-help levers as hard as we can.

Andrew.

Q - Andrew Crean {BIO 16513202 <GO>}

Morning. It's Andrew Crean at Autonomous. Two questions. Can we -- can you give us the numerator and denominator in the economic capital model? We do want to have a look at what your capital requirement is relative to premiums.

Secondly, you had reserve releases in the home business which were quite substantial last year. What -- I mean, normally you've said that you would not expect releases out of home. Is that still the case, or are things changing?

A - Paul Geddes {BIO 2474781 <GO>}

Just taking the second one first, because I can remember the second one. Home releases, yes, we had said they would be likely random. And I think what -- the new point is that as we invest in new claims techniques and pricing techniques, for example, activities on fraud, for example, we -- that will tend to be recognized a bit more slowly. And therefore, some of that can come through prior year. So that would give rise to that and, obviously, we are investing in those sorts of things. So at the moment, while we invest, we could see some prior year.

The capital point on the first part, which is can we give you all sight of everything, can I go away and think about that rather than just quote them, even if I knew them?

On the second half of that point, I can't remember what that point -- the second half of it was. But I could answer that one as I recall. If you remind me I'll give you the answer.

Q - Andrew Crean {BIO 16513202 <GO>}

With the first part you went away and thought about it at the half year, as well. So you've had quite a lot of time to think about it.

The second part will give way the first part because what I wanted to know is what the capital requirement as a percentage of premiums is.

A - Paul Geddes {BIO 2474781 <GO>}

Ah, well, that, well, there you've got to be a little bit careful because we've actually published some data in the back of this pack to show how we allocate our capital, where our capital requirement arises from. And, nearly half of it arises from reserving risk. So obviously, premiums are not a good measure of that. Historic premiums might be. But current premiums aren't. So you might want to look at the (multiple speakers) many, many years.

Q - Andrew Crean {BIO 16513202 <GO>}

I just want the totality of the number.

A - Paul Geddes {BIO 2474781 <GO>}

Sorry?

Q - Andrew Crean {BIO 16513202 <GO>}

I just want the totality of the number, not the (multiple speakers).

A - Paul Geddes {BIO 2474781 <GO>}

The number? Well we -- at the moment we think we've given quite a good level of disclosure. If we find a way to give any more we'll do that.

Q - Andrew Crean {BIO 16513202 <GO>}

That's strange.

A - Paul Geddes {BIO 2474781 <GO>}

Okay. Yes, front row.

Q - Dhruv Gahlaut {BIO 16209870 <GO>}

Thanks. Dhruv Gahlaut from HSBC. Two questions. One, if you guys could give us the capital employed in the run-off business at this stage and the results what are of -- what -- as in how much relates to the run-off business?

And I think, going forward, as in you've had a decent amount of reserve releases coming in that run-off line, if this was to reoccur in 2014 or 2015, should we expect further special dividends on this line?

A - Paul Geddes {BIO 2474781 <GO>}

Okay. Thanks. The capital remains at around GBP300m. And the reserves are around GBP800m-and-something. GBP850m, something like that. I can't remember offhand. In that order of magnitude.

I think on -- in terms of would there be any future special dividends, I think we -- what we've shown is that if we get windfalls. And depending on our overall capital position, then that's certainly a possibility. And we've seen it twice. I don't think we could commit that every time we saw a windfall we would automatically do it. It might be a matter of scale and it might also be a matter of the total capital position.

I think looking at the whole thing today, if we had another windfall today, yes, we would have done it today.

A - John Reizenstein {BIO 6786139 <GO>}

I think there's a materiality point, as well.

A - Paul Geddes {BIO 2474781 <GO>}

Okay, yes.

Q - Unidentified Participant

Thanks. Just as a quick follow-up to that one, I'm not sure if that counts as a question. Of the GBP300m, how is that expected to develop over the next couple of years?

Then my two questions. How much is the increased risk in investment? How many percentage points on the RBC is that meant -- expected to eat up over the next year?

And also, on your investment yield charts it looks like you've increased the guidance. Is there anything within there that takes account of duration being more matched, or is that something on top of that, potentially?

A - Paul Geddes {BIO 2474781 <GO>}

I'll try my best. Development of the capital in run-off will be very, very slow because, increasingly, it is going to just be PPOs, I'm afraid and so that will be stuck for a long time. Potentially decades.

On the capital utilization by investment, I mean it's not a number we've given out. It's not huge. I mean, we're not putting masses of extra capital in. It depends which measure you use. It's somewhat more consumptive on an S&P basis than on a risk-based capital basis. And we manage to both. It's not having a big impact on our RoTE as we publish it.

On the yield, we don't assume we suddenly go long when rates have spiked. So if there is some potential --. We're buying increasingly floating rate instruments and holding them floating like the securitized and also the infrastructure and we do that. We have the option at some point if we get confident about the market and make the right decisions to call it and go a bit longer. So there is potentially some upside. But I'm not sure we'll take that because there'll be risk involved, potentially even capital involved and on the -- on some of these assets where we're holding them for PPO, we actually think going floating is the right thing to do from an ALM perspective.

Q - Unidentified Participant

So to be clear on that 2.4% guidance, that assumes you remain at the current duration?

A - Paul Geddes {BIO 2474781 <GO>}

Yes. We'll keep working our way back.

Q - Tom Dorner {BIO 15847486 <GO>}

Hi. It's Tom Dorner at Citi. My first question is on your expectations for the outlook for the home insurance market. You'll get lots of questions on motor. But do you think that your portfolio is more resilient because of the distribution agreements you have? And do you think competition there will increase during the course of this year?

The second question is on your cost savings target. Given that you're already pretty close to the GBP1 billion at the start of the year, I can imagine what the answer will be. But how realistic is it that that guidance will improve and what would be your next steps to further lowering the cost base?

A - Paul Geddes {BIO 2474781 <GO>}

Okay. So we simultaneously think we're well placed in the home market and it will get more competitive.

I think actually the current floods and storms remind people that this is a product to be purchased seriously from credible brands that will be there on the scene to sort you out. Not nickel and dime you. Look after you. And I think, therefore, it is what we do. And we do that well.

That said, we don't have our head in the sand. This is a market which is going to get more competitive. Price comparison websites will be -- will grow albeit we still believe that not to end up at the destination where motor is because of the reasons I said about the -- it's harder to compare. People care more about brands than about quality.

But we have, as we said, a very active self-help agenda which we plan to churn back into keeping ourselves very competitive in that market place. And I think our performance of our own brands in home, I think, we feel very pleased with their performance in terms of both loss ratio and in terms of ISPs in that increasingly challenging environment. So I think we're up to the -- up for a very competitive marketplace.

On costs, there's a few things. So first of all, our -- the ink's only just dry really on our GBP1 billion cost target. So we just need to make sure we get on and deliver that. And as we said, an additional observation on it, we've got to offset inflation. We are continuing to invest in the business.

But let me tell you about why we're investing in the business. We're investing in the business because we believe that in a medium; to long-term sense there is a more efficient operating model if we do invest in digital and self-service and allowing customers to do the things they want to do and that for me is the next frontier of costs. And we'll start talking to you about it as we go forwards.

But I think in terms of managing expectations, GBP1 billion is our focus for 2014. Clearly, we'll look at opportunities to do more. I think we've got a good track record now of finding our own cost opportunities and pursuing it. We're getting a good cost culture going and we'll do everything that we can. Obviously, being disciplined on costs will help us deliver the GBP95m, GBP97 million in a very competitive market place.

The final thing I'd say on costs is one can be quite macho on costs and really try and force them through. We're also trying to run an organization here where people on the phones are motivated and we get the best people in each of our functions to do all the brain work that we do and, therefore, I think what I'm really proud of it is I think we've kept our people with us through the last year. And I think we have a pretty engaged and motivated workforce. And I think keeping that, I think, is really important as well to balance against just the pure cost number.

Q - Unidentified Participant

Coming back to motor, two questions. One, on the risk mix. Could you maybe explain exactly what's going on there particularly when you refer to moving to the higher premium level part of the market? I assume you're targeting the younger driver, riskier segment of the market. But still your average premium per policy would be moving up in that case. I just wonder why the risk mix continues to be negative also into Q1.

And the second question, again on motor, if I may? On your retention on renewals, what was it in 2013 versus 2012 please? Thank you.

A - Paul Geddes {BIO 2474781 <GO>}

Sure. So on the risk mix we've got an appetite. We think we're competent to be pricing right across the risk mix spectrum and that's something which we updated on last year, which is now we think that we're good at doing the claims and the pricing of those higher risk and now with telematics. So, we're fully equipped to compete in it. But it has been the area of the market that's probably had the most price deflation in it and, therefore, our algorithms have led us to the risk mix which we've got now.

So whilst we could write more risk mix business, our algorithms are saying the value is in writing the level of business that we have chosen to write here. So we could come back and say the market pricing has changed and our risk mix has gone positive and we'd be happy with that, as well.

So we're not constraining it. It finds its rightful level given the profitability we see in our portfolio.

The second thing was on retention and our retention was down a smidge. It's still just under 80% or 79% on motor. And as I said, homes increased. So motor is off a point or two but still at 79%, which we think is pretty good in the market place.

Direct Line, that's the own brands, I think.

A - John Reizenstein {BIO 6786139 <GO>}

Yes.

A - Paul Geddes {BIO 2474781 <GO>}

Okay. Sorry. We need to make a decision. Oh, sorry, he's on second. So we'll -- anyone on first.

Q - Unidentified Participant

Just a quick question on the RBC ratio, please. I mean, you've obviously given guidance that you've got ongoing discussions with the regulator over the course of the year. Is it calibrated at the moment to think about the worst case scenarios of those conversations?

So with Solvency II you've got PPOs as a big discussion point. If it goes for you, does that mean that your risk-based ratio looks inflated, or if it goes against you, will it go a lot lower?

A - John Reizenstein {BIO 6786139 <GO>}

I don't think we can comment on the discussions with regulator and those sorts of things.

Solvency II is interesting. Obviously, there's lots of people doing lots of work on actually operationally delivering it as something we can comply with.

From a -- still feels a bit distant in terms of what's the effect going to be on capital. There could be opportunities out of Solvency II. There are things like the matching adjustment and so on. But we're not clear yet how they're going to be enabled or enacted. In the UK it's not been published yet. And I don't think we should assume that it's going to be a bonanza, a win for all the companies in the industry as a result of Solvency II. We're continuing to manage towards the current environment, which is pretty close to our own way of looking at capital.

Q - Unidentified Participant

Can I just come back on that? Are you therefore -- in your modelling, are you thinking about matching adjustment treatment for PPOs in your current RBC ratio?

A - John Reizenstein {BIO 6786139 <GO>}

No.

A - Paul Geddes {BIO 2474781 <GO>}

Has everyone had a first go? Then we'll go onto second.

Q - Gordon Aitken {BIO 3846728 <GO>}

Thanks. Gordon Aitken from RBC. A couple of questions. So first on telematics customers. Now that that's gaining a little bit more traction, what's the profitability versus non-telematics customers? Presumably there's higher -- or lower losses and higher costs.

And the second question is what sort of pressure are you getting from the government in both home and motor at the moment? Home presumably the government doesn't want further pain for customers who've seen storm losses. And on motor is it less pressure given that prices have come down such a lot over the last year?

A - Paul Geddes {BIO 2474781 <GO>}

So do the second one first. No direct pressure from government. But I think it's seen as a very competitive market place and it is.

I think the other thing is the government did invest political capital in all the changes that we've had to date on motor. And it's investing political capital on Flood Re. And I think, therefore, to see the fact that the last stuff seems to have worked and contributed to lower prices is a good thing. And I think that we need to get behind the government and get Flood Re over the line.

I think there's been a lot of talk potentially thinking about where the line is drawn and where the cross-subsidy is set. I think it's clearly a matter of public policy to try and keep the cross-subsidy minimized and therefore beneficial. The scheme has a line round it. That has been set and agreed and I think we just need to work within that now to really focus on execution to get this over the line for 2015.

There's 350,000 homes that need the protection of Flood Re and we are very, very focused on taking our market-leading position at that particular table.

So I'd say the government is not especially a factor other than competitive markets obviously pass on claims trends. The government helps claims trends and I think, therefore, we'd expect to see those things following through, which they are and probably more than on motor, as we've described.

In terms of telematics, it's early days. Just to remind people of what the nature of the benefit is. There is a self-selection benefit, which is better drivers, we think, tend to want a telematics box. When they have the box in their car they tend to drive better because they know they're being watched and their behavior will be priced in some way and we also give them live feedback on how well they're driving. And that improves behavior. Then, of course, we get the data and can do something with it. And at the moment, we're just trying to pull apart all the effects.

But our early signs are that those are positive effects. And over the next year we're really going to start using the granularity of the data into pricing.

I wouldn't underestimate. For me the most-exciting thing, which we're working on in telematics I do -- I like the black boxes, I think they're working well for young drivers is self-installed because it fundamentally changes the economics of black boxes.

I think clearly you can see what Progress have done in the States. But the fact that you can have a box that really removes the installation cost, that you can mail out to customers, they can potentially mail you back, I think potentially changes the price point to which telematics starts to work. So we are very excited about our pilot and we'll update you on that. And as I said, we should probably get you some boxes.

Okay. Thanks Gordon. Do --? We probably need to go to the phones in a second. Who else hasn't asked a question first time? Can we go here?

Q - Oliver Steel {BIO 6068696 <GO>}

Oliver Steel, Deutsche Bank. Just one quick technical question on the commission ratio. How much of the increases that we've seen over the last year is actually down to better underlying -- is basically profit commission and how much is underlying?

And I think in the past you've not wanted to give any sensitivity. But if reserve releases do come down a bit next year, can you give us some sensitivity now?

A - John Reizenstein {BIO 6786139 <GO>}

Yes. I mean it's -- the partnerships account for about half our home business. So if we have benign weather or bad weather, they're going to get -- I mean, they're obviously -- they're dependent on the precise deals and there is profit shares and this that and the other. But they're going to get part of it. And so this time they've got -- I mean, our commission ratio will go up if we have good weather, which is what we've had, strangely enough, this year. And -- but this year has obviously started the other way. I don't know if that helps you.

So there's no real underlying change. It's mainly about what's happening on the weather.

A - Paul Geddes {BIO 2474781 <GO>}

The weather. Okay, can we just --? Sorry, one final first timer and then we'll go to the phones. Then we'll --.

Q - Ravi Tanna {BIO 16926941 <GO>}

Thanks. So Ravi Tanna from Goldman. It's just two quick questions, please. The first one is on UK motor and claims frequency. How much of an impact are you seeing in terms of the pick-up in the UK economy and generally trends in claims frequency and also relative to the offsetting reduction in frequency from LASPO?

And linked to that, to what extent do you feel that the LASPO impacts are fully reflected in frequency or not?

Then secondly, just to follow-up on Flood Re and the extent to which you feel that's likely to impact pricing, albeit that it's early days yet in terms of 2015 implementation.

A - Paul Geddes {BIO 2474781 <GO>}

Okay. John, are you happy to do the motoring one and I'll do the flood one?

A - John Reizenstein {BIO 6786139 <GO>}

Yes. I mean, the -- there are some signs of driver miles rising and so that's clearly got to be watched.

And in terms of LASPO frequency, I think we'll -- it will all merge together in numbers and we'll just have to see that and react to it as it happens.

I think, as ever, I don't want to repeat the story about how we price and how we look at the market that Paul said. But yes, you're right. And we will have to reflect what we see.

A - Paul Geddes {BIO 2474781 <GO>}

So on Flood Re, it's basically an extra level of reinsurance. So had Flood Re been in place, we'd had got some costs back and if there had been no floods, it would have cost us some premiums.

Now, whether the market will price those premiums in net extra or whether the market will absorb them is a -- really a factor of the markets. And so that's, I think, to be determined and we'll have to wait and see. It's about 2.2% or GBP10.50. So we will wait to see how the market deals with that.

But if you just view it as a reinsurance layer, obviously, there are years when that will benefit your P&L and years when it will hurt it, just like all other reinsurance arrangements. But we think it's a good thing. I may have not said that enough.

Has everyone -- all first time questioners --? Can we just go to the phones to be fair to everybody and then we'll see how much time we've got left.

Can I send it to you, the operator?

Operator

Thank you. (Nick Danarjvic), Brewin Dolphin.

Q - Nick Danarjvic

Hello. I was just wondering -- so you said that cost cutting needs to offset inflation. Could you help us think about what kind of inflation index is appropriate? Obviously, CPI is well above PPI. And what is the -- what was the impact of inflation on 2013 costs?

Then secondly, just on the combined operation ratio guidance. This assumes -- obviously assumes normal weather. Are we already above a normal weather year and what would the guidance be assuming the expected losses so far?

A - Paul Geddes {BIO 2474781 <GO>}

So let me deal with the second. John can do the first.

So we've said GBP70 million to GBP90m. Normal year is GBP80m. So if we have a miracle of nine months of weather that's good. And it does happen -- the first nine months of weather in 2012 cost us GBP5m. So it could be that we come in within our weather load. If normal business resumes for the other three quarters, it's about 1.5 points of hit to the COR. You can do the maths. GBP80 million weather load. So we attributed slightly more so the quarter is one in four.

Q - Nick Danarjvic

Should I be excluding that GBP20 million from -- sorry, should I be excluding the GBP20 million from the commercial? You said the next will come at GBP20 million in commercial.

A - Paul Geddes {BIO 2474781 <GO>}

It's been a long commercial story, really which is --.

Q - Nick Danarjvic

Okay, yes.

A - John Reizenstein {BIO 6786139 <GO>}

And inflation we're thinking along the lines of about 2%.

Q - Nick Danarjvic

And what was the impact on 2013 with inflation?

A - John Reizenstein {BIO 6786139 <GO>}

We don't do that number broken out of everything else. Probably similar. A bit lower.

Q - Nick Danarjvic

Okay. Thank you.

Operator

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

A - Paul Geddes {BIO 2474781 <GO>}

Okay. We'll do two here and then we can do any others over coffee, if that's all right. Can we just try and do one further from three of you and then we can --?

Q - Unidentified Participant

Okay. One. Well actually I'll do a quick -- two quick ones, if that's all right?

So I guess there's been quite a few questions about the run-off business. And I'm struggling with the size of the reserves you've got for the run-off, especially when I look at some of your peer group. I think -- I thought you only had GBP260 million as PPOs. So I wasn't sure how you got to that GBP800 million of reserves.

Is that including IBNR? So if some of these settle as non-PPOs, there will be quite a big reserve release and capital release? And are there options to release capital from this book through either insuring some of these in payment PPOs or even changing the asset mix around a bit because obviously it's quite a big number relative to the market cap of the Group?

And I guess the second question was more on prices and premium rates. Since the IPO, as far as I understand it, you've reduced premiums across most lines. But significantly less than the competition. And it's been a number of -- two years presumably now that you've done that. And the retention still remains at 80%. So is what's happening we're seeing a very low level of new business coming into the Group because the prices are significantly different to the market? And does that mean that even if the market did recover, you'd continue to see declines in prices and outflows in terms of ISPs during the year? Thank you.

A - Paul Geddes {BIO 2474781 <GO>}

Sure. Given that they were both quick questions I'll do your second.

I mean, on the second one, look, we have spent a lot of time thinking about working on our retention strategies. And I think we are pleased with the retention levels we're seeing given the pricing.

Now, to be fair, we are giving pricing benefits. The price reductions I talked about was on the total book. And we're giving those to new business and to retention customers because we think it's a pretty good bet to retain a customer. There is lots of benefits to doing that. So it's not that we haven't passed on any of these price decreases to our back book.

I didn't quite get your point, maybe pick that up over coffee, about if the market turns what that then does. But I think the market turning -- I can't see it being anything other than potentially good news. But you can enlighten me on that.

Do you want to --?

A - John Reizenstein {BIO 6786139 <GO>}

PPOs, I mean the -- you'll see when the annual report comes out that the net PPO booking is GBP630m. I can't split it in my mind between run-off and non-run-off or motor. But a lot -- a big chunk of it will be in run-off.

I think in terms of -- so it will represent a big chunk of the roughly GBP800 million of reserves we've got in our own book.

In terms of what could we do with it, I mean that's a very interesting topic. We spend a lot of time thinking about it. We're very open to any brilliant ideas about that and it's certainly something that gets attention.

A - Paul Geddes {BIO 2474781 <GO>}

Good. Right, two more quick ones because we are running out of time. Greig, do you want to go?

Q - Greig Paterson

Yes. Mine is just you've sold Tracker and you've sold the protection business. Are there any further sales of small subsidiaries in the pipeline? I wonder if you could quantify the pipeline now?

A - Paul Geddes {BIO 2474781 <GO>}

We haven't got -- I don't think we've got any left, actually. We're running out of --.

A - John Reizenstein {BIO 6786139 <GO>}

We keep looking.

Q - Greig Paterson

(Multiple speakers).

A - Paul Geddes {BIO 2474781 <GO>}

But --. Right, okay. Any -- a final question to end the whole day on?

Q - Unidentified Participant

Just on the expenses I wanted to ask if you fully load for commission and claims handling, your expense ratio is still 40%. You're cutting the costs. But your premiums are coming down. So, the efficiency isn't actually improving, particularly. How do you respond to the question that you're still a long way from being a low-cost operator in personal lines?

A - Paul Geddes {BIO 2474781 <GO>}

Well I think we've slightly answered the point on commissions and how they ebb and flow depending on good and bad weather.

Listen, am I happy with where we are on costs? No. We continue to need to go at the right pace towards a lower-cost operating model. Some of that will require us to invest in our systems and infrastructures and that's exactly what we're doing right now. So I think in the medium; to long-term I aspire to keep improving the efficiency of our business.

As I said, the pace of that needs to be set around certain constraints. And we move within those constraints as fast as we can.

I think the other point is to say we're not a pure low-cost operator. We do think investments in our brands continue to be beneficial. We do believe that for some of our brands really differentiating with customer service is also money that we'll get repaid for by customers. So we have within our portfolio, for example, the Privilege brand where it does need to be absolutely a real low-cost operator to compete with the low-cost operators in the market place.

Direct Line we need to be a very high-performance brand. Churchill a very dependable brand. Green Flag.

So I think the goal seek isn't that all of our brands will be -- look like the lowest-cost operators. But we need, within that, to make sure that the brands that are going for those customers that just care about price, we need to make sure they're very competitive.

So -- but don't mistake what I've said for any lack of ambition or energy about costs. It's a fixation of ours.

A - John Reizenstein {BIO 6786139 <GO>}

And just to add one thing. If you take the home business, the home business is a very-profitable business and it will always have high commissions because of the way we distribute. Sure, we'd like to get them down if we can agree that with our partners.

And our costs, yes, we'll try and do our best on cost as well. But I think obviously we're going to have to look -- you have to look at each town differently.

A - Paul Geddes {BIO 2474781 <GO>}

Very good. Listen, thank you very much for your engagement questions. And I think we have coffee after if anyone wants to stay. Otherwise, thank you very much for coming.

Operator

Thank you. That does conclude our conference for today. Thanks for participating. You may disconnect.
