S1 2016 Earnings Call

Company Participants

- John Neal, CEO
- Pat Regan, CFO
- Tony Jackson, Head of Investor Relations

Other Participants

- Brad Le Mesurier, Analyst
- Daniel Toohey, Analyst
- David Spotswood, Analyst
- James Coghill, Analyst
- Kieren Chidgey, Analyst
- Nigel Pittaway, Analyst
- Ross Curran, Analyst
- Tim Lawson, Analyst
- Toby Langley, Analyst
- Unidentified Participant, Analyst

Presentation

Tony Jackson {BIO 1729093 <GO>}

We might get underway. Good morning, ladies and gentlemen, welcome to QBE's 2016 annual result briefing. My name is Tony Jackson; I'm head of investor relations at QBE. This morning's briefing, the formal side of the presentation from Pat and John will run for approximately 30 to 35 minutes, which should leave quite a lot of time, plenty of time for questions and answers afterwards.

Before I hand over to the Group CEO John Neal, if I could just ask everyone to mute their phones, please. And without any further ado, John.

John Neal {BIO 15681439 <GO>}

Thank you, Tony and morning, everyone. Pat Regan, our Group CFO and I are delighted to present QBE's 2016 full year results this morning.

There's a fair amount to review with the result. And I wanted to use this slide to pull out a few clear highlights. If we look at the slide left to right, our discount rate adjusted combined operating ratio of 93.2% is the best underwriting result we've presented for six years. And for the first time in a long while, we're showing some modest growth in the top line, 1% up for gross written premium and 2% up for net earned premium on a constant currency basis.

Significantly, our North American operations achieved underlying growth for the first time in many years and we continue to see growth from our franchise in the emerging economies of the world. Growth in our European operations division was muted as we maintained underwriting discipline in very difficult trading conditions. And of course, across the Group we continue to pursue our strategic imperative to improve business retention rates by at least 1% each and every year.

The middle bar graphs point to important components of the combined operating ratio. Despite a deterioration in the Australia and New Zealand attritional claims ratio, notably in the first half of 2016. And some FX impact in Europe, our claims ratio actually improved by 2.6% due to a very pleasing level of positive prior accident year claims development, some of which actually reflects the early benefits from our strategic claims initiatives.

On the right hand side of the slide we're pleased to be presenting an insurance profit margin of 9.7%, which is at the top end of our target range and as a result of two factors, being the improved combined operating ratio, as mentioned, coupled with a higher investment return which benefited from foreign exchange gains.

We can report that in 2016 all key performance measures improved on the prior year. Excluding the impact of discount rate movements, the combined operating ratio improved to 93.2% from 94.3% in 2015. Our insurance profit margin improved to 9.7% from 9.0% in 2015 and towards the upper end of our 8.5% to 10% target range and pleasingly, the return on equity increased to 8.1%, up from 7.5% this time last year.

We've made really solid progress on our operational areas of activity. Pat and his team have developed a comprehensive remediation plan in Australia and New Zealand where the successful execution of this is evident in the 340bps improvement in the attritional claims ratio in the second half of 2016.

So whilst insurance portfolio remediation takes time, a combination of price increases, underwriting discipline and claims focus should see the attritional claims ratio return to acceptable levels by the end of this year, being 2017.

The turnaround in performance in North America, initiated by Dave Duclos has continued under Russ Johnston's leadership, with the division's underwriting profit more than doubling in 2016. Despite underwriting losses in commercial auto, a second consecutive strong crop performance and continued profitable growth in our specialty business contributed to a very pleasing 2% improvement in the combine operating ratio.

We have completed two reinsurance transactions to sell roughly a quarter of our outstanding claims liabilities in North America at book value. And this includes our problematical program runoff reserves. This improves the quality of the balance sheet in

North America and removes substantial uncertainty from our reserve position in this division.

We met our 2016 cost savings targets of $150 million and planning is well underway to deliver a further $150 million in savings by 2018. And whilst growth is challenging in today's market conditions, we are making solid progress in each of the six strategic areas of focus we discussed with the market at our investor update in May 2016.

The profit uplift we're reporting today, coupled with strong cash flow generation, has allowed the Board to both increase the final dividend by 10% to AUD0.33 as well as announce an on-market buyback of up to AUD1 billion over a three-year period.

So this slide provides the results of the Company by operating divisions. And in summary. In a moment, Pat will provide a more detailed update on the progress we've made in North America and in Australia and New Zealand. So I will keep my comments brief in respect of these two divisions.

North America, the 2% growth in top line largely came from the development of our specialty businesses. And as I mentioned earlier, our underwriting profit nearly doubled that of 2015, which of course is evidenced in the 2% improvement in the combined operating ratio.

Our European business, under Richard Pryce's leadership, continues to present strong underwriting profits and in the most challenging of marketplaces. So once again, a 90.2% combined operating ratio is supported by a strong contribution of positive prior year claims development and equally importantly. And on a constant FX basis, our attritional claims ratio in Europe is flat at 45.4%.

Gross written premium is down by 3%, reflecting the tough pricing conditions. And you will recall we completed a further reinsurance transaction in the first half of the year to continue our move of selling claims reserves where we think it is beneficial to the shareholder and the P&L to do so.

In Australia and New Zealand, gross written premium is up by 5% and whilst a combined operating ratio of 92.4% is 1.3% worse than the prior year, we are pleased to present a significant improvement in the second half attritional claims ratio, with a much improved performance from our trade credit and surety business. And the New South Wales compulsory third party portfolio following rate in increases in-year of around 18%.

David Fried and the emerging markets team provided growth of 10% on a constant currency basis in 2016. And all this was achieved with a stable combined operating ratio. The division retains a strong focus on profitable growth across specialty, commercial, SME and personal lines via strategic partners and all this is supported by a single strategy across the division to drive and improve productivity, efficiency with some cost reduction initiatives.

Whilst we have more work to do to improve performance, most notably in Latin America, we're well positioned to benefit as the favorable long-term economic outlook for emerging markets leads to additional trade and investment in infrastructure.

Equator RE plays a critical role in assisting all of our operating divisions to manage their balance sheets and capital requirements through the provision of excess of loss reinsurance and some proportional covers. 2016 was another successful year for Equator, with an improved combined operating ratio of 78.9% and where positive prior accident year claims development was a significant contributor to the result.

There are a number of important features in our 2016 result that for us point to our ability to continue to provide predictable and improving returns into 2017 and beyond. We are presenting a fifth consecutive period of positive prior year accident year claims development and we believe this pattern can continue into 2017. This result has been achieved while simultaneously strengthening our balance sheet. And in a period where we've seen our probability of adequacy increase by 0.5% to 89.5%.

We are maintaining or improving our underwriting performance in each division, even in the most challenging of market conditions. And most notably in North America where the division continues its trajectory to a mid-90%s combined operating ratio by 2018.

Equally importantly, we continue to position all components of our balance sheet conservatively and this includes the manner in which we elect to buy reinsurance. And notably, to protect ourselves against the frequency of large individual risk and catastrophe claims. We have consciously sought to eliminate unpredictability for this category of claim. And the evidence of this action can be seen notably where the gross cost of large individual risk and catastrophe claims actually increased appreciably in 2016 but the net cost is essentially unchanged from 2015.

Similar protections are already in place, not only for 2017 but also for 2018 and will ensure that the cost of such claims is locked in at around 9.5% of net earned premium.

We are encouraged by our expense and cost reduction initiatives in 2016 and can confirm that plans and activities are already in place to generate a further $150 million reduction in costs across 2017 and 2018 as previously communicated to the market.

Now I'd like to hand over to Pat to discuss our results in further detail and in particular, to add some progress and some color to the story in Australia and New Zealand and North America. Pat.

Pat Regan {BIO 15131018 <GO>}

Thanks' John. Good morning everybody. As John said, in addition to my usual run through the Group results, I'm going to give you a little bit more detail in what we've been up to in Australia.

Starting with the Group results first of all, the Group reported a net profit after tax of $844 million for the year, up some 5% versus our adjusted net profit after tax for 2015. On a constant currency basis, that was a 16% increase versus 2015. That improvement was due to higher investment income and improved underwriting result offset by a discount rate movement and a lower tax rate in 2016 as well.

Cash profit after tax was $898 million which was up some 12% on a constant currency basis. GWP on a constant currency basis was up 1%. Emerging markets grew by 10%, largely driven by Brazil and Argentina. Australia and New Zealand grew by some 5% through a combination of both starting writing South Australian CTP and by our rate increases in the second half of the year. And that offset the small decline in our European operations as we focused very much on margin versus volumes there.

Excluding discount rate impacts, the combined was 93.2% and interestingly, we said to you a few times before that we expect the second half combined to be lower than our first half combined. In fact we'd expect that again in 2017 and our second half combined for 2016 was 92.5%, reflecting another half year of positive prior year development, a good crop result and a decently improved attritional claims ratio in Australia. Also worth noting in the second half we increased the POA from 89% at the half year to 89.5% at the full year.

The significantly adverse discount rate movements for the half year largely but not completely reversed in the second half and we recorded an $80 million pre-tax negative impact for the full year. Notwithstanding some pretty volatile investment markets in 2016, our investment return overall came out at 2.4%. And all of that meant our insurance margin, even after the adverse discount rate movement, came in at 9.7% towards the upper end of our 8.5% to 10% range.

The volatility of FX rates particularly around the Brexit vote combined with our usual hedging programs gave us a larger than usual FX gain in the second half and finally, our full year tax rate at 21% was lower than 2015, primarily now because we're generating profits in the US, we're using tax losses there.

I'm now going to give you a little bit more detail on what we've been up to in Australia and New Zealand and where I spent most of my time since we got together at the half year. What we've been doing is designing and implementing a remediation plan. Overall, I've been really pleased with the progress we've made so far.

To give you a little bit of color about how we've gone about that, we've subdivided the business into just under 50 sub-business units, or as we call them, cells. To give you an example of that -- direct motor would be a cell, direct household would be a cell, travel would be a cell, commercial packages would be a cell, et cetera. Each of the cells has a clear business owner and each of the cells now has a customized remediation plan.

In the early days, we spent all of our time really making sure we understand any root causes or deterioration in performance on a cell by cell basis and then making sure we constructed the right plan to make it better again. As you'd expect, the actions do vary on a cell by cell basis. But to give you a sense of the main actions we've put in place, obviously premium rate increase. I'll come back to that in a minute. Revised and tightened underwriting selection -- so for example the type of property risks we're writing or the type of trade credit business we're underwriting.

Tight in delegated authorities for our teams, our underwriters in the field. Change in terms and conditions -- so that might be deductible levels. Particularly tighter practices and governance around our claims processes. So that could be better use of our approved suppliers, enhanced recovery processes or better fraud prevention techniques. Then we've monitored all of those actions on an actual versus expected basis each month for each of our 44 cells.

I'm pleased to say after all of that, that we actually did see some improvements in the second half of 2016 when the claims ratio improved -- or attritional claims ratio improved from 62% in the first half to 58.6% for the second half standalone and that improvement as you would expect was particularly evident in the Fourth Quarter.

By picking out a couple of the cells, New South Wales CTP -- over the last 12 months of so, we've increased rates by some 18% and that flowed through to an improved attritional ratio in the second half.

On trade credit, we really focused on different risk selection and underwriting practices. So the type of business, the industry types that we were providing trade credit to and that really paid dividends with a much improved attritional claims ratio in the second half. As well as CTP and trade credit, we also made good progress in things like commercial packages, public liability, household and travel.

On the premium rate increases as you can see on this slide, we ended 2015 down some 2% or 3%, started this year with a negative and I'm pleased to say we that to 4.5% increases in the Fourth Quarter.

In January we managed a 5.5% increase for the month of January. Despite this, we were pleased to see the retention held pretty stable, above 80% for most of the year and even in the Fourth Quarter still roughly at an 80% -- at a policy level. We also saw continued positive prior year development with $64 million of positive prior year development in the second half and given our long track record of positive claims developments in ANZO, I'm confident that we're reserving our current accident year picks [ph] conservatively.

Overall, while we've put together a good set of plans and our remediation activities to date are encouraging, there remains quite a bit of work still to do. We need to continue to improve the ANZO results into 2017. But I'm confident that we'll do so.

I just wanted to talk for a couple of minutes on LMI. Broadly what I'm going to say is that the trends we're seeing are much in line with what we discussed with you at investor day. So on the top line as you recall, we expected a decline in premium primarily due to tighter lending conditions and we've seen a 22% drop in GWP but just a 5% drop in NEP, partly due to the long earning patterns in LMI, partly due to reinsurance savings.

On our claims -- worth remembering that 85% of the portfolio is owner occupied, just under 15% is investors, just 3% is low doc [ph] loans and just 1% of the portfolio is in mining areas. That said, broadly as we expected, we did see an uptick in the trip arrears levels as we went through the year, primarily in Western Australia. But overall, claims levels were actually flat in 2016 versus 2015.

Notwithstanding that, we did take the opportunity to book our loss ratio and combined ratio a bit more cautiously at the end of 2016, more into line with our long term average there and we've actually assumed a further slight increase in the claims ratio in our plan for 2017.

Turning to North America. And the team there delivered a further improvement in 2016, doubling the underwriting profit from 2015. That was despite significantly higher both CAT [ph] and large risk loss but also a problematic commercial auto book. Profitability improved on the back of a lower expense ratio a market leading crop result and strong growth in our specialty franchise.

The crop business had another excellent year and while it was a good year for the crop industry overall, the benefits from our data analytics driven farm by farm selection was evident in the standout loss ratio and the market leading combined ratio. Expenses North America down $127 million from 2015 due to both the continued expense reduction efforts there and the sale of the expense heavy mortgage and lender services business. That gave an expense ratio decrease of some 190 basis points. As John mentioned, we would expect further expense savings in both dollars and expense ratio into 2017 in North America.

Perhaps most importantly they also did two significant pieces of risk reduction or portfolio change. Firstly, we terminated a number of loss making commercial auto programs, including one major standalone program, all of which together lost us about $100 million in North America in 2016. By the way, the outstanding claims reserves for those commercial auto programs to tidy things up, we reinsured those into Equita.

Secondly we also successfully reinsured all of that old program runoff book to a third party at book value, thereby eliminating the risk of any adverse development and what's a potentially volatile set of liabilities there. Those two transactions gave a onetime reduction in NEP in North America of about $600 million.

On investment performance -- and it was certainly an interesting year to be managing investments, with the geopolitical events, Brexit, US election, yield moves, FX rates. We took the decision early in the year to stay defensively positioned and our growth assets stayed less -- decently less than 10% for most of the year and we decided only to extend our duration as and when yields increased. In this context, our annualized investment return of 2.4% was a sound outcome.

Our blended asset -- blended growth asset return was just under 5% for the year and we did increase our growth assets to 10% at year end and a little more than that since year end. Similarly, when yields increased, we did extend duration up to 1.5 years at year end and again, we've extended that a bit further since year end. We think that what this means now is we can reasonably comfortable generate investment income for 2017 in excess of 2.75%.

Notwithstanding those volatile markets and economics, we enhanced our already strong capital position in 2016. We now have capital equivalent to more than 1.3 times the capital needed for an S&P A rating and our PCA multiple at 1.79 times is right at the top of our 1.6 to 1.8 range.

The other key metric for a global business like us is the cash remittances you get from the business units to the center and that was up some 55% to $1.1 billion. Obviously that's an important measure of coverage of our external dividend and we had cash coverage there of just under two times.

All of this gave the Board confidence to both increase our final dividend by 10% to AUD0.33 per share, representing an 8% increase in our full year dividend and to establish a three year on market share buyback facility of up to AUD1 billion. Back to John.

John Neal {BIO 15681439 <GO>}

Thanks Pat. So turning to our outlook, QBE's built on the strength of our underwriting performance. And this will always remain our overarching focus. And we are far from complacent. We've more work to do execute on the remediation plans in Australia and New Zealand, as Pat's discussed, we have more work to do to continue the improvement in our North American property and casualty lines. We need to be robust in the actions we take in developing our emerging markets business, particularly in Latin America.

So whilst the competitive environment did not support significant growth in 2016, our cross cycle of gross written premium target remains unchanged at 3%. In renegotiating our reinsurance treaties for 2017, savings of more than $350 million were achieved. Those savings are split roughly equally between the excess of loss reinsurance contracts and the proportional treaties. But let's be very clear that in so doing we have not added more risk to the portfolio.

So our 2016 expense savings target of $150 million was met. And as I mentioned earlier, our planning is well advanced to deliver a further $150 million of expense savings by the end of 2018. Some of these further savings will be reinvested in technology. So this should result in a further 1% reduction in our expense ratio by 2018. We anticipate that half of our 2018 target of $200 million in claims savings will be achieved by the end of this year in 2017.

Initiatives to combat claims fraud, being smarter in the way in which we achieve claims recoveries and in our optimization of the claims supply chain are all giving encouraging early results. At the same time we're looking at our IT strategy and technology to ensure that the Company is set for the long term. And after establishing our data and analytics capability as a global function in 2016 -- including the development of our offshore support in India, our focus I'm 2017 will be directed towards projects that support portfolio remediation, claims initiatives and customer analysis.

For the first time in 2017 we will be investing a minimum of $50 million in partnering with insurtech companies. But those that have a particular focus in the data and analytics field.

The Group shared service centers in the Philippines continue to give us significant flexibility in the way in which we manage and balance onshore and offshore operational support in a cost effective and efficient manner.

Our dividend policy is designed to ensure that we reward shareholders relative to cash profit as well as maintain efficient capital for further investment and growth in our business. Our 2016 performance has supported a further increase in all of our key capital metrics. In recognizing both the quality of our balance sheet. And importantly the confidence of our forward plans, the Board has not only looked to increase dividend payments. But also to establish a three year cumulative AUD1 billion on market share buyback facility.

So we anticipate that the market backdrop will remain challenging in 2017, although there are indications of some modest improvement, particularly where the rate of decline in global insurance premium pricing is easing. There will always be variations market by market. And whilst we believe price increases in Australia will be maintained, elsewhere we expect pricing to be broadly flat.

In light of this competitive backdrop and some exchange rate volatility, we're anticipating gross written premium will similarly be broadly flat in 2017. Albeit the reinsurance savings achieved should support a modest uptick in net earned premium.

So whilst our base case combined operating ratio expectation for 2017 allows for only a modest level of prior accident year claims development, a higher level of positive development could contribute towards a combined operating ratio at the better end of our target range.

Some of you may have seen our UK and global peers make reference to Ogden table changes in the UK in their results in the past fortnight. The timing is unfortunate but we expect the UK Ministry of Justice will announce a downward revision in discount rates for UK personal injury claims tonight our time in Sydney. Sadly any change has zero benefit for claimants. But necessarily will require an increase in claims reserves and therefore a hike in price to the detriment of the UK customer.

While we've allowed for a 1% reduction in the discount rate -- or roughly a $33 million impact in our risk margins as at December 31, 2016, should the UK Ministry of Justice announce a bigger reduction in the discount rate then the impact on QBE will obviously be greater. If you have a look on page 24 of the Annual Report, we've provided sensitivities for potential outcomes. Depending on where the discount rate lands, we would be inclined to take the whole impact through the P&L at the 2017 half year result and maintain our probability of adequacy at 89.5%. Please note that the P&L impact related to this regulatory issue is not currently allowed for in our 2017 target combined operating ratio range.

So looking at the investment markets, we're targeting an investment yield of between 2.5% and 3% for 2017. So please bear in mind the numbers on the slide are of the investment yield, not the contribution to margin. So if you multiple that number by 1.35, roughly you get the contribution to the margin. But based on our early year performance we are actually hopeful of getting closer to the upper end of this range.

So this slide actually repeats the investor thesis we presented in May last year. And remains as valid today as it was then. Our targets out to 2018, including an ability to exceed a return on equity of 10%, are unchanged. Through the second half of 2014 into 2015. And now in 2016, we have executed effectively to our targets and plans. And are confident in our ability to meet the performance targets we've set out in the market today for 2017. And importantly our ability to continue to improve our business through the medium term.

2016 represents our best underwriting performance in a long time. And our balance sheet stands comparison to any of our global peers. We continue to buy reinsurance protections with the downside risk of running an insurance company in mind. Our claims provisions have shown consistent improvement for five consecutive reporting periods. The Board's confidence in our plans is reflected in both a healthy increase in dividend payments and the announcement of an on market share buyback facility.

So thank you very much. And now Pat and I will be very happy to take questions.

Questions And Answers

Q - Nigel Pittaway {BIO 3406058 <GO>}

Hi John and Pat. It's Nigel Pittaway here from Citi. First question, just in the pack in terms of guidance, you have sort of reiterated the 93% combined target for FY2018. Previously though you said that was pre-reserve releases, whereas this time there's no mention of prior year releases. So can you just clarify what you're exactly saying in respect of that?

A - John Neal {BIO 15681439 <GO>}

Yes, I think as I said in my closing remarks, it includes an anticipation of a modest level of prior accident release in 2017 and 2018.

Q - Nigel Pittaway {BIO 3406058 <GO>}

Okay. Thank you. Okay, next question on crop. Although the result was obviously very good, one noticeable thing was that the premium split was 57% first half, 43% second half, which is quite a reversal from what it's been in prior years. Can you sort of explain whether or not that's an ongoing feature, or is it particular due to factors that existed this year?

A - John Neal {BIO 15681439 <GO>}

Good spot, Nigel. It was an unusual feature for this year because the combined was very good, you actually end up ceding part of the premium back to the government. That happens right at the top end of the range and right at the bottom. So it meant that, actually slightly unexpectedly, we ceded premium -- net earned premium to the US federal government. And that reduced earned premium in the second half. But you wouldn't expect that to happen each year.

Q - Nigel Pittaway {BIO 3406058 <GO>}

Okay. Then maybe just one on LMI. I think obviously you had a figure combined of 34.9% for the full year, that was already sort of high 20%s in the first half. So it obviously deteriorated quite a bit in the second half. If you do look at the sort of claims ratio picture you had on the strategy day it does suggest that the claims ratios run a bit higher than that. So is all that are you saying conservative booking, or have you really seen a deterioration in those trends where WA was in fact worse --

A - John Neal {BIO 15681439 <GO>}

Yes, I mean it's an increasing question. We have seen higher arrears in WA. But not really a lot more than we were expecting -- a little bit more. Whether you look at house prices, whether you look at unemployment rates, whether you look at the individual arrears in individually affected areas, none of it is kind of wildly different from what we expected. So we just booked it a little bit more conservatively at the year end.

Q - Nigel Pittaway {BIO 3406058 <GO>}

Okay. Thank you.

Q - Daniel Toohey {BIO 16751863 <GO>}

Thanks, Daniel Toohey from Morgan Stanley, just a few questions. The first one is just a follow-up from Nigel's. I think in FY2016 you talked about modest reserve releases at a magnitude of around 1% to 2%. Clearly you've come in well above that. We don't have the hang-over from the US commercial auto in the outlook. So does modest imply 1% to 2%, or is it?

A - John Neal {BIO 15681439 <GO>}

Modest implies less than 1%.

Q - Daniel Toohey {BIO 16751863 <GO>}

Less than 1%, thank you. Second question just on the New South Wales CTP, you've had obviously some pricing benefit come through helping on the attritional line. Can you comment whether you would expect to be a beneficiary under the proposed Risk Equalization Scheme reform, or a payer?

A - John Neal {BIO 15681439 <GO>}

I think we'll be broadly neutral. So I think we were following the spirit of what was intended out of the way CTP pricing work. So I don't expect it to be greatly altering how we do things either way.

Q - Daniel Toohey {BIO 16751863 <GO>}

Just finally, on the cash remittances to Group, how much of that is coming through from the LMI business?

A - John Neal {BIO 15681439 <GO>}

So I think we mentioned before, I think we mentioned it at investor day, that we're still a little bit lumpy with it; we'd like to be a little bit more even. So we're still slightly over reliant on Australia and Equator. And within the two of those you captured the LMI element of it. North America is coming back on stream now. And we're still a little bit underrepresented in Europe. So we'd have benefited by a couple of hundred from LMI in 2016. Equally as I say, we're kind of underweight in what we would consider our normal dividend from Europe at this stage.

Q - Daniel Toohey {BIO 16751863 <GO>}

All right. Thank you.

Q - Kieren Chidgey {BIO 7268946 <GO>}

Kieren Chidgey UBS. Just a question on the impact of the reinsurance savings coming through this year, you've called out $350 million-plus. I think you said half is in the excess of loss. So if we called that $175 million. I also note on slide 33, your retention is up around $100 million on the aggregate next year. So should we view the net benefit that drop through to the P&L as about $75 million around that excess. Is that the way to think about it?

A - John Neal {BIO 15681439 <GO>}

I mean sadly it's a big more complicated than that. You're right. So half's excess a loss. So the actual P&L benefit that will come through from that, we would estimate at about $20 million to $25 million. The balance is really through a restructuring of the crop quota share contracts predominately. So that's the second part of the saving.

When you get to the slide that's on -- the final slide in the deck slide 33, yes you're seeing some increase in the risk retention and some increase in the first retention for CAT significantly reduced the second. But all of that is captured in the aggregate. So any increase in retentions falls to that aggregate treaty at the back end. So if you follow the math’s through of increased retention and capturing the aggregate the net position for us is broadly unchanged at around 9.5% of net owned premium for large risk and CAT claims. So a little bit of P&L benefit, $20 million to $25 million. But actually the restructure gives us net/net no increase in exposure.

Q - Daniel Toohey {BIO 16751863 <GO>}

Maybe just tying that back to the investor day I've thought you were talking a number in the order of $50 million to $100 million P&L benefit.

A - John Neal {BIO 15681439 <GO>}

Yes I think the second component really depends on crop. If the crop business continues to perform as we would expect it to in 2017 then yes you'd see a further benefit come through from that crop quota share. So in effect we've retained $200 million more of net earned premium in crop in 2017. So if that performs in line with expectations that's the balance of the number you're looking for.

Q - Daniel Toohey {BIO 16751863 <GO>}

Are you still seeing 92% as the target combined ratio for crop or has that come down?

A - John Neal {BIO 15681439 <GO>}

It's the number we've reflected in our plans. We think it's a little too early to assume that it could be better. But the indications of the use of data analytics and the selection criteria that Pat spoke about gently tends us to assume that it's a better business than that.

Q - Daniel Toohey {BIO 16751863 <GO>}

Thanks.

Q - James Coghill {BIO 14006200 <GO>}

James Coghill, UBS. Just a couple of questions on the underlying trends in the business for the attritional loss ratio. So the first one is on Europe. You have called out that there was a 90 basis point drag from the mismatch between the earned premium coming through and any claims costs from the Sterling's devaluation. So I guess there are two parts to this questions. Perhaps you can just explain why that mismatch is there and why underlying claims don't also change.

Secondly just comment on the trajectory for that drag into next year. Is there still something we have to think about for the first half? Because I think it is.

A - Pat Regan {BIO 15131018 <GO>}

Yes there will be a little bit more of that come through into the first half of 2017 but less than we saw in the back half of 2016. It's to do with the rate that the unearned premium earns through versus the claims earns through. Again it's a feature of the Lloyd's business where you're writing so many different types of business in different currencies. Without making it sound more complicated than that -- that's basically the explanation. So there is as you would imagine a little bit more flow through of that into the first half of 2017 but to a lesser extent.

Q - James Coghill {BIO 14006200 <GO>}

Okay the second one just turning closer to home Pat. And probably one of the most remarkable and speedy turnarounds in the insurance business that I've ever witnessed given that you didn't even know that it had blown up in May last year. But perhaps more seriously could you just take us through your thinking around how much of that attritional loss ratio reduction in the first half you think will ultimately reverse into financial 2017?

I'm referring to the 6.6% reduction in the first half. I think you mentioned a 1% drag so that was -- call it 8% of which 340 [ph] -- 3.4% that's turned in the second half. How should we be thinking about that turn into financial 2017?

A - Pat Regan {BIO 15131018 <GO>}

Yes, good question James. I don't think I'd want you to draw a straight line from picking a point in the first half, picking a point in the second half and through. You remember we defined attritional as $2.5 million. So a little bit more in Aussie dollars. You get -- some of it will depend on the amount of claims you get of that, just under that kind of size.

But if your question is, are we made some sustainable changes then it feels like it yes. Then obviously rates a big indicator of that. We'll get more of that earning through in 2017. We've only picked up really the early parts of that in 2016 whether it be CTP, commercial motor, trade credit.

The British election is definitely a factor in it. I mean that's -- obviously in something like Trade Credit that's been a big -- we saw a big improvement in the attritional in the second half there. Claims is the other big one where -- that just to your average claims payment does tend to jump around a little bit more albeit we've seen lower levels clearly in the second half of 2016 than we saw in the first half of 2016.

So John said we'd expect to see more improvement in 2017 partly because we're just earning through the rates increases. We're still carrying a little bit more rate in the early part of 2017 than we did in the latter part of 2016.

A - John Neal {BIO 15681439 <GO>}

Without wanting to make it more complicated. And you've heard me say this before -- an actual year lives for two years so at the half year you're a quarter of the way through the life of the year. So I think when we spoke here in August we felt very confident in our ability to be able to recapture that attritional claims ratio movement. I think the team have done a nice job in promoting change in price, change in deductibles. Some portfolios you can fix quite quickly, which is what's happened with Trade Credit maturity.

The rates increases that Pat and the team have put through on the balance of the portfolio, we need to see how that performs through this year. But it encourages us.

The other factor I'd say is that -- don't underestimate the value of those re-insurance treaties. So in November we get a very difficult earthquake in New Zealand. The net impact on our P&L is nil. This is the way in which we've elected to buy our insurances. So that helps as well when you're looking through the performance in Australia and New Zealand.

Q - Toby Langley {BIO 15924432 <GO>}

Hi, it's Toby Langley from Bank of America Merrill Lynch. On your capital position you're knocking on the top end of your range. You've taken a lot of actions to restructure the business, de-risk, sold stuff, et cetera, et cetera. How do you feel about the interplay and where that capital position is now sitting in your PCA target range?

A - Pat Regan {BIO 15131018 <GO>}

I mean we've talked about before a lot of the things that we've done worked better on the more risk adjusted measures whether that be our own internal capital model or S&P. So it was actually nice to see the PCA also respond and grow in the period.

So they're both sort of right at the top end of our range and hence really the Board's decision to both grow the dividend and take the opportunity to announce the buyback. So I think it was good to see them both respond. They're both right at the top end of where we want them.

Q - Toby Langley {BIO 15924432 <GO>}

But that's probably not going to be corrected if you limit yourself to $333 million and the dividend you've got today, that PCA is still going to be knocking at that level?

A - Pat Regan {BIO 15131018 <GO>}

Yes. We're still going to be capital strong as we go forward. I think that -- you know, it's good to be capital strong.

Q - Toby Langley {BIO 15924432 <GO>}

With regard to your actions in Australia Pat, is that project just about restoring businesses that you have or are you leaving other options on the table, i.e., would you consider disposing sales or injecting to beef up parts of the business that maybe could do with being bigger?

A - Pat Regan {BIO 15131018 <GO>}

No it's much the former. It is about improving what we've got. Actually it's an interesting -- the business has got great market positions in most of what it does. I've been lucky to inherit those. So you know, a lot of what we're going we've got very good strong distribution partnerships. We've got a very strong position in the market. Therefore that's allowed us to make some of the changes maybe a little bit quicker than I thought we could do.

So no, it's very much more about making a change as you said. And actually growing where we can. Some of the portfolios are performing well and where we can growing as well.

Q - Toby Langley {BIO 15924432 <GO>}

Thank you.

Q - Ross Curran {BIO 17605313 <GO>}

Hi gents. It's Ross Curran from Deutsche Bank. Two quick questions. Circling back to James' question on attritional losses in Australia. Pat you mentioned that much of the remediation happened later in the half. Is there much difference on a quarterly basis? Is the Fourth Quarter attritional performance dramatically different from the second half attritional performance as well?

A - Pat Regan {BIO 15131018 <GO>}

It's better. Yes. So now I'll refrain from giving you attritionals on a quarter by quarter or month by month basis because it does jump around a little bit. But yes, the Fourth Quarter is better than the Third Quarter or the second half alone each year.

Q - Ross Curran {BIO 17605313 <GO>}

Can I get a comment on the exit rate, on attritional losses into the year?

A - Pat Regan {BIO 15131018 <GO>}

I'll repeat my earlier one -- I'll refrain from giving you month by month or quarter by quarter.

Q - Ross Curran {BIO 17605313 <GO>}

Sure. Then can we get a comment on the amount of capital in the Australian LMI business and how much the capital lift from that over the next three to four years helps underwrite that buyback?

A - Pat Regan {BIO 15131018 <GO>}

Oh I mean --we've talked a bit about having just over AUD1 billion in the LMI business. But actually as Toby said we're very capital strong anyway. The two things -- what our overall group capital looks like. Is it fungible enough? Are we getting good capital flows? Actually in both -- we're strong on both sides. Any capital release in LMI is sort of icing on the cake in that sense.

Q - Ross Curran {BIO 17605313 <GO>}

So you're not dependent on capital coming out of LMI to fund the buyback?

A - Pat Regan {BIO 15131018 <GO>}

No.

Q - Brad Le Mesurier

Pat, Brad Le Mesurier from Velocity Trade. A question on your deferred reinsurance costs. They fell from about $1 billion at the end of 2015 to about $600 million end of 2016. Do you recall the reason for that?

A - John Neal {BIO 15681439 <GO>}

Because we buy our aggregate reinsurance treaties on a two year basis. You book the cost of the two years up front and earn it over the two year period. So that's the reason for fall.

A - Pat Regan {BIO 15131018 <GO>}

So last year was unusual rather than this year being unusual based on that sense.

Q - Brad Le Mesurier

So there's not much in that deferred reinsurance costs for business not yet written I presume.

A - Pat Regan {BIO 15131018 <GO>}

No, as John said -- so last year we would have actually -- essentially written if you like two years' worth of the deferred reinsurance costs. So you end up with -- I think it's $1 billion versus $600 million or $500 million, something like that the delta is in that.

Q - Brad Le Mesurier

Yes. But in the half -- last year you had, I think it was $200 million relating to business not yet written.

A - John Neal {BIO 15681439 <GO>}

If you book it up from -- so if we buy a treaty for two years the accounting standard requires us to book the premium in full up front, even though in the year in question we will only write half of the business we would expect to. So that's why you end up with deferred cost. Then obviously in year 2 you earn that cost through against the business that you're writing. It's as simple as that.

Q - Brad Le Mesurier

So that would have reduced that figure?

A - John Neal {BIO 15681439 <GO>}

Correct. You'll see the same again in 2017 because in effect we bought the same treaty for two years. You'll see the same pattern of earnings.

Q - Unidentified Participant

John and Pat this is (inaudible) from JP Morgan. A couple of questions if I can. Firstly just on the premium rates environment. Can you just comment on how premium rates are tracking in your various regions against inflation? Is there any pressure in any region of the combined ratios?

A - John Neal {BIO 15681439 <GO>}

Yes good question against inflation. If I turn the question around, if there's one thing that we're keeping a close eye on it is just that. It is inflation. We saw it as you know in Australia for the first time in a long while through the early part of last year. We're alert to it in the UK. An output of Brexit you would think would result in inflation coming through the claims line.

We are actually only seeing it on motor at the moment. We're not seeing it more broadly. Claims inflation on motor is running about 8% to 9%. So you won't be surprised to hear that the level of rate increase is in excess of that.

I think when the Ogden changes go through goodness knows what the level of rate increase will be on motor in the UK. Not seeing any unexpected inflation in the US actually as yet. But again we're looking for it. Natural output of the new administration's policy is positive in the main but you would think inflationary. So that's the view on inflation.

In terms of rates obviously as Pat referred to here, a nice level of rate increase knocking through the 5%s [ph] in the early part of the year.

As we came through our one/one [ph] renewals in Europe, I actually am reasonably encouraged, it was a relative comment, reinsurance pricing was off by less than 1%, property and casualty pricing was literally flat. The same was true in the US macro, albeit our rates in the US were up by just over 1% on one/one [ph] renewals. So hence our assessment is broadly flat pricing ex-Australia and on the inflation point, we're keeping a weathered eye on inflation.

Q - Unidentified Participant

So basically no margin pressures and arguably some benefits coming from Australia.

A - John Neal {BIO 15681439 <GO>}

No, correct.

Q - Unidentified Participant

Great, thank you. Then maybe it ties into my second question which is just around your guidance which you've given on the combined ratio. When I look at your attritional ratio, it seems to deteriorate at about 2.5 points ex-crop in the preceding year. But your guidance is actually improved on the combined ratio versus what you gave for 2016.

So maybe it is that you're seeing a better environment. But I'm just trying to marry up those two trends. Should we take it that you're more conservative last year?

A - John Neal {BIO 15681439 <GO>}

I think yes, if you look at it this year, because I said in closing remarks, we're very confident in our ability to execute on plan. The only watch I've got on the combined ratio is the prior question, what's actually happening with market conditions, does that put us under a bit of undue pressure.

At the better end, we've got two or three areas of the business we have to improve still. I'm very happy with the trajectory in Australia, very happy with the degree of improvement in North America. So those are all positive factors in terms of performance.

Per Nigel's earlier question, it's right for us to assume some prior accident year development positively. But I think again we've been reasonably cautious in what that might be. So there is a challenge, market conditions aren't great, we're not seeing price increases everywhere. But there is some opportunity for upside.

Q - Tim Lawson {BIO 3280691 <GO>}

Tim Lawson, Macquarie Securities. Just in terms of the buyback, just in any internal and external considerations around a three year timeframe into long period?

A - John Neal {BIO 15681439 <GO>}

Sorry, I missed that.

Q - Tim Lawson {BIO 3280691 <GO>}

So the timeframe to put out a three year buyback announcement over that period? So why not just do a one year and follow it up? What are you thinking about for a three year period in terms of the business operating conditions and what the external environment might look like over that period?

A - John Neal {BIO 15681439 <GO>}

We're just trying to balance the best means of returning capital for shareholders. The reality is that as our business performs in line with expectations across the geographies, our franking credits in Australia reduce. So historically we've had franking credits of around 50%, they will naturally fall to 30%. So just simply increasing dividend is not necessarily the best answer for the shareholder, hence the ability to buy back shares.

Our view on that is that in almost all circumstances, any form of buyback is ROE accretive. But clearly we're going to be sensitive to the share price and ensure that we get the balance between buyback and dividend right for the shareholder. So there's no absolute view on how much buyback we conduct in any one year. But I think if you were to assume it evenly over the three years, that's probably appropriate.

Q - Tim Lawson {BIO 3280691 <GO>}

And an overall payout ratio, is that including dividends and buyback?

A - John Neal {BIO 15681439 <GO>}

So the payout ratio is purely for dividend at 65%, up to.

A - Pat Regan {BIO 15131018 <GO>}

I think we have a question on the telephone, David Spotswood.

Q - David Spotswood {BIO 17576616 <GO>}

Thanks for that, just a couple of quick questions. The interest cost of $294 million, that's a bit of a jump from last year, is the $294 million a reasonable number to assume going forward? The tax rate you called out was 21%, will that revert to something higher, 24% or should we assume 21% going forward? Just a comment on the interest rate sensitivity, if interest rates -- discount rates go up 1% across the board, the flow through to the P&L on that. Thanks.

A - Pat Regan {BIO 15131018 <GO>}

Thanks David. On the first one, the $294 million was a little bit higher. I think I mentioned we exited a number of our commercial auto programs in the US and we had a one-off payment to exit those. So our run rate of interest costs is closer to around $250 million which is a bit more similar to what it was in 2015.

The tax rate, because we've got profits coming through in the US and we're using the tax losses, you would expect the 2016 rate to be more for the long term go forward, if anything it might even be slightly lower than that.

Then the impact of discount rates movements, well 1% movement in discount rate has an impact on liability of what, about $350 million pre-tax. I guess the new news is, because we now have a longer duration of our assets, that would be largely but not completely offset on the asset side. So we're closer to that being offset. There would still be a mismatch. But to a much lower extend than we've had in the past.

Q - David Spotswood {BIO 17576616 <GO>}

Thank you.

A - John Neal {BIO 15681439 <GO>}

Okay, if there are no further questions, thanks everyone, we'll close there. Thanks for joining us.