FINAL

Bloomberg Transcript

Q1 2015 Earnings Call

Company Participants

- Christian Sagild
- Lars Thykier

Other Participants

- Christian Hede
- Gianandrea Roberti
- In-Yong Hwang
- Jakob Brink
- Jonny Urwin
- Niccolo C. Dalla Palma
- Paris Hadjiantonis
- Per Grønborg

MANAGEMENT DISCUSSION SECTION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to Topdanmark's Results for Q1 2015. I would now like to hand over to your speaker today, Mr. Christian Sagild. Please go ahead, sir.

Christian Sagild {BIO 15093649 <GO>}

Good afternoon, everybody, and good morning to the USA, and thank you for joining us in this conference call. With me are, as usual, our CFO, Lars Thykier; and Steffen Heegaard, who is Head of Investor Relations and Group Communications. And we're ready to answer your questions. Please ask them one at a time.

Operator, can we have the first question, please?

Q&A

Operator

Thank you. And your first question today comes from the line of Jakob Brink from ABG.

Q - Jakob Brink {BIO 7556154 <GO>}

I have three questions, please. The first one is regarding the guidance. You write that the - since you announced - reported the Q4 report, the interest rate level has had a negative impact on the combined ratio of 40 basis points. If I look at the FSA discounting curve since mid-February, it looks to be up. So I'm a bit surprised. If you'd just give me some details on how exactly to calculate this.

Then also, could you maybe give us a bit more wordings on the new motor tariffs? i.e. what should we expect from this? What price declines should we expect? And probably just a bit more wordings on this competitive situation.

And then the third question is regarding the new capital issuance. As far as I recall, you have DKK 250 million unutilized Tier 2 currently. Should we understand it as if you want to still have DKK 250 million in unutilized after you have done the new issue? That's it. Thank you.

A - Lars Thykier {BIO 16427122 <GO>}

The first question regarding the interest rates change. You're right that interest rates have actually increased from last guidance and until now. When we see negative impact on combined ratio, it is of course we use the quarter interest rate for the coming quarter. So we compare the year-end 2014 interest rate to the first quarter 2015 interest rate and that came very much down and that's why we have this 0.4%. That is on illness and accident and on workman's compensation and that's why the combined ratio deteriorates due to this.

A - Christian Sagild {BIO 15093649 <GO>}

Regarding the motor tariff, Jakob, we're introducing a new motor tariff where we differentiate the changes, some types of cars will have price increases and some have decreases and on average, an average is of course something that not only a few people hit on average, it will be a decline of around 5% total. So that's the competition that we are incorporating in the new tariff.

A - Lars Thykier {BIO 16427122 <GO>}

And concerning the subordinated debt, we don't have any target of DKK 250 unutilized Tier 2 capital. This is simply using the benign environment for issuing Tier 2 capital to be used after some things (3:54) comes into force next year.

Q - Jakob Brink {BIO 7556154 <GO>}

But does this mean then that we should basically take the DKK 400 million plus the currently unutilized DKK 250 million?

A - Lars Thykier {BIO 16427122 <GO>}

No. That means that we have - we repay DKK 350 million and issue DKK 750 million new Tier 2. That's DKK 400 million. And then we have DKK 400 million that we issued in 2011 that expires next year. So we'll have DKK 1,150 million, which we can utilize in the first part of 2016.

Q - Jakob Brink {BIO 7556154 <GO>}

And in your capital model as of today, it says you're only reducing the capital requirement with DKK 500 million.

A - Lars Thykier {BIO 16427122 <GO>}

Yes. That's due to the fact that in 2015 we can only use DKK 500 million.

Q - Jakob Brink {BIO 7556154 <GO>}

But, should I – next year, should I use DKK 1,150 million or DKK 900 million?

A - Lars Thykier {BIO 16427122 <GO>}

DKK 1,150 million.

Q - Jakob Brink {BIO 7556154 <GO>}

Okay. Thank you. And just to come back to the first question, so when you guide next quarter, if rates stays where they are today, you should basically have a reversal of that 40 basis points. Is that correct?

A - Lars Thykier {BIO 16427122 <GO>}

Exactly.

Q - Jakob Brink {BIO 7556154 <GO>}

Okay. Thanks a lot.

A - Lars Thykier {BIO 16427122 <GO>}

But if you take up only concerning the second...

A - Christian Sagild {BIO 15093649 <GO>}

Second half.

A - Lars Thykier {BIO 16427122 <GO>}

Half year.

Q - Jakob Brink {BIO 7556154 <GO>}

Yeah. Yeah, sure.

Operator

Thank you. The next question comes from the line of Christian Hede with Nordea.

Q - Christian Hede {BIO 18642300 <GO>}

Yes, good afternoon. I would just like to follow-up on the question on motor and the competitive situation. I think you forgot to answer how you see the competitive situation and whether it has been even more competitive in past weeks and months or if this has been underway for a long time. And also, could you give some more flavor to the outstanding FSA issues? Are we talking small details here, or is it something that could be more material?

And also, the last thing, on the 2016 buyback or the increase of the 2016 buyback, should we see it as a sign that you already now assume that you'll have to transfer money to the 2016 buyback as you have done for a couple of years or many years now, or is there another reason for why it's not included in the 2015 buyback? Thank you.

A - Christian Sagild {BIO 15093649 <GO>}

On the motor tariff, I think, yes, you're right, Christian. I forgot to mention – give us a few words on the competitive situation. The fact is that if you go back one or two quarters, I think that you will find me quoted for saying that the very good results in 2014 among most of the players in the Danish market would have to mean that competition will pick up and most likely they will pick up in the motor market. I think you can say that this is what we've seen over the last quarter or so intensified competition in the motor market where we have seen in the first quarter. Although we've grown in the private lines area as a whole, we have seen a decline in the number of cars. And that is why we are issuing this new motor tariff at the end of this month.

So we can feel – we can certainly feel that this competition has intensified. And this is basically how the competition will work. If you have a lot of companies with mid 80s% combined ratio and you think that this is not long-term sustainable, what will happen is that the same risk would have to be sold at a lower premium. And therefore, we will have these effects on top line and on profitability simply by issuing a new motor tariff. So this is how the competition works.

A - Lars Thykier {BIO 16427122 <GO>}

On concerning the discrepancies with the regulator, we had four issues or two issues and two perhaps issues last week. The two issues we had was that we want to use correlations in our internal model that was developed by expert judgment within Topdanmark. The other one was how to integrate our partial internal model with standard model. We have agreed with the regulator on both issues now. Our standing still is that we might have some minor disagreements about calculation of tax assets and how much we could count in on next year's income. But basically we are prepared to apply now, and we will send our application within three weeks or so from now.

And you asked about the DKK 400 million, this is not preliminary transfer of the 2015 buyback. This simply is that it's better possibility to use Tier 2 capital, which we will see in 2016 that is what we're waiting for and we're preparing for it. We think that no matter whether there's issues with small disagreements we might have with the regulator shows up to something in 2016. We still feel that we can exchange DKK 400 million of shareholder funds with Tier 2 in 2016. So is the pure 2016 buyback.

Q - Christian Hede {BIO 18642300 <GO>}

Okay. Thank you very much.

Operator

Thank you. The next question comes from the line of Per Grønborg, Danske Markets.

Q - Per Grønborg

Yes, good afternoon. It's Per from Danske. Two questions from my side. First of all, we touched on what are your thoughts; we touched upon the change to motor tariffs. You're lowering prices by 5%. I guess, roughly 30% of your business is motor. That'll cost you 1.5% on the top line. Does this imply that we should look for at best (9:57) growth also in 2016?

A - Lars Thykier {BIO 16427122 <GO>}

In motor or what?

Q - Per Grønborg

Overall, overall – overall for the company.

A - Lars Thykier {BIO 16427122 <GO>}

This is new tariff. This is not necessarily a one-to-one change in the premiums we charge. We have used some kind of rebating already and preparing for this changing tariff. And on top of this, when we change our prices, if we increase prices a little or if we decrease prices a little, we don't intimate this on – we don't write to all our customers and make them change their premiums right away. So this is going to take – to be gradually and some of it is already within the numbers.

Q - Per Grønborg

But I assume – we must assume that for 2016 that the lion's share of the clients will be on the new tariff?

A - Lars Thykier {BIO 16427122 <GO>}

No, no.

Q - Per Grønborg

No? That's too early?

A - Lars Thykier {BIO 16427122 <GO>}

Yeah.

Q - Per Grønborg

Okay. My second question related to the new capital guidance that you - which you gave about a quarter ago that you would be able to come out with it. At that time, even the yield curve was not settled yet. My question, yes, you have addressed a couple of what seems to be smaller issues. Is there also discussions at the board? Is the full board backing up about lowering the quality of the capital in your company, or is that also a -- or is that a discussion at the board level?

A - Lars Thykier {BIO 16427122 <GO>}

I am afraid I didn't get that.

Q - Per Grønborg

The question is, I'm a bit surprised that you're not able to come out with your - with the capital plan you are very firm that you could come with when we met you last time three months ago. At that time, not even the yield curve was settled. At that time, the message was that that was no major problem. You still thought you could come out with the plan for the capital.

A - Lars Thykier {BIO 16427122 <GO>}

That's true. And when we still feel that we can't give you the final capital structure. That is not a matter of shareholders' funds. It's a matter of how big the Tier 2 loan has to be going forward. We had the concern until earlier this week that the regulator had to declare that they were not positive that we were prepared for appliance of approval of our internal model. So, we didn't really know exactly what to think about this. As it is now, we are prepared but we still have the issues about next year's profits and the issue about taxes, which might change our total need of solvency capital somewhat. But this residual, I suppose will be covered by differences in Tier 2 issuance.

Q - Per Grønborg

The deferred taxes, that's mainly the DKK 300 million from the securities parts?

A - Lars Thykier {BIO 16427122 <GO>}

No. No. That is - when we make our solvency capital required, we assume this 200 year event.

Q - Per Grønborg

Okay.

A - Lars Thykier {BIO 16427122 <GO>}

And in our view - and in our reading of the regulation, we can use the tax assets which arises due to the 200 year event and the regulator has looked at this and told us that they want to pressure test our way of looking at things, but it is not a show stopper.

Q - Per Grønborg

The second part of my question was that – is the board – is everybody on the board of the opinion that it is a good idea to reduce the equity capital of the company?

A - Christian Sagild {BIO 15093649 <GO>}

It is a unified board that decides to meet this suggestion. So, yes.

Q - Per Grønborg

Okay. Thank you.

Operator

Thank you. And the next question comes from the line of In-Yong Hwang from Goldman Sachs.

Q - In-Yong Hwang {BIO 18784369 <GO>}

Hello, hi. This is In-Yong from Goldman Sachs. Just two questions from me. So, looking at the investment income guidance, if you take out the 1Q, we're left with DKK 65 million to DKK 115 million for the next three quarters, which is around less than DKK 40 million per quarter for the remainder of 2015. Is that the right way to look at how your outlook on investment income is? And my second question is on the higher-than-expected loss of customers in SME and industrial. Could you give a bit more details around that and whether – is it just customers not willing to – accept price increases, or is it more to do with measures you're putting into lower claims trends in that segment? Thank you.

A - Christian Sagild {BIO 15093649 <GO>}

If I may remind you of how we guide our investment income. We expect that the assets that are hitching the claims reserves well, viewed exactly the same as the discounting and the price regulation of the claims reserves when interest rate changes, that is the outcome of this common portfolio of liabilities and assets will be zero.

On top of this, we had the premium reserves and part of the shareholders' funds which are invested as we please. And on this, we expect to make the FRA rate across summer, at this time of year, and plus 200 basis points. The FRA rate over summer is a little negative. So what we expect to make is DKK 100 million, which is the 200 basis points on premium reserves and shareholders' funds, the invisible part of the shareholders' funds.

And then, we have some DKK 800 million shares, which we expect to yield or to return around DKK 60 million a year. So basically, around DKK 150 million a year with current interest rate level.

Q - In-Yong Hwang {BIO 18784369 <GO>}

So, is that the interest rate level as of in the 1Q 2015. So...?

A - Christian Sagild {BIO 15093649 <GO>}

No, that is the fixed rate under the FRA, forward rate agreement over summer.

Q - In-Yong Hwang {BIO 18784369 <GO>}

Okay.

A - Christian Sagild {BIO 15093649 <GO>}

And just to give you few, I mean what you say is that the guidance for the investment return is between DKK 220 million to DKK 270 million, which is between DKK 65 million and DKK 150 million more than we produced in Q1. And if you'll spread that out over to three quarters, of course you get less, but that is because the performance in Q2 up until the day when we closed the books of the 8 of May has been affected by the negative development due to rate increases.

A - Lars Thykier {BIO 16427122 <GO>}

It is – sorry, it is not really the rate increases that is the problem. But the market on Danish mortgage funds has very very difficult in the first half of Q2. We have seen the spreads on mortgage bonds increase substantially compared to spreads on the yield curve we used to discount the liabilities and on mortgage bonds. It has been very unusual – we have the highest spread since the crisis in 2008 now.

A - Christian Sagild {BIO 15093649 <GO>}

Regarding your questions – your question regarding the loss of customers in the SME market, we would like to follow a policy where we don't make general price increase. Therefore, we constantly address customers where there is a gap between the claims they produce and the premium they pay. And we addressed them in different ways either to change the terms or to increase prices or increase retention or whatever in different ways. And some of these customers, they feel sort of invited to ask someone else for a quote on their insurance and some of these customers they move. Others, they say, yes, we can understand your position and we accept the increased prices. So, a majority of the customers that we lose are customers that we wouldn't make money on if they stayed at the premiums they were at, but it would be unfair to say that it was only those types of customers. We also lose customers that simply are trying to test the market and get a better offer than the one they have with us, so we see both.

Q - In-Yong Hwang {BIO 18784369 <GO>}

Great. Thank you.

Operator

Thank you. Your next question comes from the line of Niccolo Dalla Palma, BNP.

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

Hi, good afternoon everyone. Just a follow-up on the price change for motor 5%. You clarified very well that on new business only. So it will take more than just one year to come through the numbers. Can you please put it in perspective compared to changes to tariffs in the past? I mean, is 5% a significantly bigger move to tariffs than you made in the past, or how long didn't you see such a big move, just to put it a bit on – in a historic perspective as well?

And secondly, on capital, in the Q4 call, you gave us a couple of numbers just to give an idea about the ballpark available capital of around DKK 6 billion and the underlying capital requirement of around DKK 3.4 billion. Are these numbers still valid, of course, with the pending discussions with the regulator? And last question, you actually said that any residual capital needs can be covered with tier two issuances and in case of disagreement with the regulator. Does it actually mean that there -- it's unlikely that there's an outcome where, beyond optimizing the capital structure, you can actually further use the absolute level of capital that you hold within the company? Thank you.

A - Lars Thykier {BIO 16427122 <GO>}

Your first question. We made a change of tariff in late 2012, around the 1 of September, which was around the same size as the change in tariff we're having now. And the second question was...

A - Christian Sagild {BIO 15093649 <GO>}

Regarding the capital structure...

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

DKK 6 billion, the DKK 3.4 billion.

A - Lars Thykier {BIO 16427122 <GO>}

I don't recognize the DKK 3.4 billion.

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

You mentioned, I mean, you said the sum of the – in the capital – individual capital requirements was DKK 3.8 billion...

A - Lars Thykier {BIO 16427122 <GO>}

Okay, okay, yeah. I get it, I get it, sorry, sorry. What we did was, actually, there wasn't a group solvency capital required in 2014, so it's just a calculation we made.

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

Okay.

A - Lars Thykier {BIO 16427122 <GO>}

But, if we made the calculation as we think it is going to be made in the future, then we will reach at DKK 3.4 billion. But that was due to the interpretation we did have at this point of time.

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

Okay.

A - Lars Thykier {BIO 16427122 <GO>}

There has been a couple of changes since then. One is that interest rates have come pretty much down. The lower interest rates are, the higher the solvency capital required in that company. The other change we have seen is that the prices of equities have increased and when price of equities increase, we have that possibility that our portfolios increase and on top of this the (22:44) on the equity – the solvency capital required on equities increases as well. There is increase from about 2% at yearend to close to 7% now. So that increase is solvency capital required.

And then we have the discussions we have had with the regulator. One of them was, as I said before, the integration between the individual or our internal model and the standard model, where we have changed the way we do things, which has increased our solvency capital required as well. So, there are a couple of things that has increased the solvency capital required from the DKK 3.4 billion until now. The major part of this is delivered. We can choose whether we want a solvency capital required to equity exposure to increase or not. We can choose to bring down interest rate exposure. We cannot choose to change the integration technique that we have agreed with the regulator, but that's a smaller part. If we look at the DKK 4.7 billion that we have claimed on to now is the necessary capital. There is no change to this.

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

Okay.

A - Lars Thykier {BIO 16427122 <GO>}

There was a third question concerning subordinated debt which was....

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

Yeah. I mean, it was actually just related to the answer you gave in a sense that if you said – so the question was if the regulator is fully happy with your interpretation of deferred tax assets and inclusion of next year's income, is there any chance that you can further lower your view of capital needs i.e. freeing up extra money for buybacks other than (24:40)?

A - Lars Thykier {BIO 16427122 <GO>}

On top of this, I remind you that we're freeing up DKK 250 million this year and we intend to free up DKK 400 million next year as well.

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

Yes. Yeah.

A - Lars Thykier {BIO 16427122 <GO>}

And I can't rule it out absolutely, but I'll say that we are on a reasonable level when we have reduced the shareholders fund with this DKK 650 million compared to where we were before.

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

That's very, very clear. Thank you very much.

Operator

Thank you. Your next question comes from the line of Gianandrea Roberti from Carnegie.

Q - Gianandrea Roberti {BIO 6786731 <GO>}

Yes, good afternoon from me as well. I just got back again to the motor statement and the 5% cut on the new tariff. Christian, if I look at the combined ratio on motor as a whole at Topdanmark, it has been 82%, 81%, 81%, rounding in the last three years, 2012, 2013, 2014. And, Lars, you just said that around the September 2012, you cut prices 5%. It's almost three years from that now. It doesn't really show up in the profitability here. In this time, the top line in motor insurance has actually gone up a little bit, not much, but a little bit during the last three years.

Now, I'm just trying to make sense of all this. My impression is that, yes, prices may go down a bit. It remains to be seen to the claims line, considering that while we have new cars with much more safety equipment in there compared to the old fleet, but overall, basically, I don't see any problem for you to keep on having your guidance at 91 long term, which allowing for runoff remains for a combined ratio between 88% and 89%. It seems to me that the issue, it's mostly that we should probably expect a lower top line compared to previous assumption. And I'm not even sure about that considering what has happened three years ago that you mentioned now that you cut prices 5%. Can you just elaborate a little bit more on how you see this?

A - Christian Sagild {BIO 15093649 <GO>}

I don't think that the change in motor tariff will change our long-term goal of remaining at 91% pre run-off either Gianandrea. So we agree on that. When you implement a new tariff in motor, it happens gradually and if you look at the portfolio that you have, the price that customers pay for their motor insurance in the portfolio today does not necessarily reflect the tariff for new customers today, because it will be over time affected by the knowledge that we have of these customers, for instance, better than average claims experience or worse than average claims experience and these things will be incorporated in the total premium package for individual customers.

So we don't necessarily see a one-to-one correlation between the actual tariff that we have today, and the prices in the portfolio. Therefore you will have a lot of people who pay less, because they are profitable, and therefore will not benefit from it, actually turning to a new tariff. Furthermore with the new tariff we will probably also see that in some cases even the new tariff would because of nice claims experience allow us to give a discount on that towards certain customers.

So you should not regard the 5% as something that will materialize very quickly compared to where we are today because, first of all, what we see is this slower implementation of the new tariff and furthermore; what we saw on the back of the last time we changed tariffs, we actually saw a very nice development in the underlying claims ratios which meant that even though we lowered the tariff, we still had nice profitabilities in motor. So the market is moving, and the competition is moving, and we are moving within the portfolio depending on the claims ratios with the individual customers. So a lot of things are moving and therefore it's very, very difficult just to say, when and with how much this change of tariff will actually affect our numbers.

Q - Gianandrea Roberti {BIO 6786731 <GO>}

Right. Thanks for that. I have a couple of more things that I would like to ask. First of all, one of the two areas of discussion with the FSA was the treatment of future profit. Am I right in assuming that a rough calculation should actually take your long-term combined ratio guidance, or 91%, so a 9% profit margin times the around DKK 2.7 billion of premium reserve that you have and tax that amount? So, basically, you may have around DKK 200 million more from this item, again, after tax in the capital structure. I just want to check if the math is correct. And also, what is it that you're discussing with the FSA? If there is a disagreement somewhere, what is that?

A - Lars Thykier {BIO 16427122 <GO>}

I do not agree with the principles in your suggestion. We do not have disagreements with the regulators. The regulator just tells us that they are not confident yet that the way we do things is the right way to do it. The 91% in combined ratio, that leaves us a margin of 9%. And during the next year, we'll have DKK 9 billion in premiums. That is DKK 800 million – around DKK 800 million income minus tax. That is what we expect to count in. And there might be some slight differences because the way you count the next year's expected profits when you're using the Solvency II principles, it is a little different from IFRS, but that is where the problem is or the question is.

Q - Gianandrea Roberti {BIO 6786731 <GO>}

Sorry, Lars. I thought that that was calculated on the unearned premium reserve. But, now, you mention the premium, so the top line. It is a very different number here. So...

A - Lars Thykier {BIO 16427122 <GO>}

Yeah, but it should be the top line. When we make an internal model or when we make a model, you have to estimate what is the average income. The average income is zero in any modeling. And then you can go up or down, depending on whether you are lucky or unlucky this year. You should not go away from the expected value. Now, expected combined ratio is as it is now 91%, then we'll have some distribution about this 91%. We may have 89% one year, 93% in another year, but the mean is 91% and that means that we count in nine points on the premiums.

Q - Gianandrea Roberti {BIO 6786731 <GO>}

And just to clarify, this is in top of every – this item of around DKK 800 million or slightly less than that, is in top of any other discussion we've had here today, right, like the sub debt and hybrids and everything else. This has not been included anywhere at this point in your calculations. Is that correct?

A - Lars Thykier {BIO 16427122 <GO>}

The purpose of the internal model is to make a distribution of outcomes from year-to-year. And this distribution is distribution around the mean, and the mean is 91%.

A - Christian Sagild {BIO 15093649 <GO>}

(32:35)

A - Lars Thykier {BIO 16427122 <GO>}

It is a part of the solvency capital required. When I mentioned the DKK 4.7 billion, that is sufficient. I have counted in that I can use this expected income.

Q - Gianandrea Roberti {BIO 6786731 <GO>}

Super. Thanks. The last question is on life. I noticed that your guidance is around DKK 20 million higher after Q1 compared to the full year. And I'm just trying to understand what is driving that.

A - Lars Thykier {BIO 16427122 <GO>}

We have had a one-off in Q1 that's been some reservation for premium extensions, where we changed the principle on that cost in DKK 15 million. I think that explains the difference. Doesn't it? And then we had a better investment income than we expected at our full-year accounts.

Q - Gianandrea Roberti {BIO 6786731 <GO>}

Super. Thank you.

Operator

Thank you. Your next question comes from the line of Jonny Urwin from UBS.

Q - Jonny Urwin {BIO 17445508 <GO>}

Just most of my questions have been asked actually, but just a quick one on the investment portfolio. I was just wondering if you could please give us some detail into the latest reinvestment yields that you're seeing right now on the fixed income portfolio and across the wider portfolio as well.

A - Lars Thykier {BIO 16427122 <GO>}

The reinvestment income, we expect that is the market rates, and the market rates in Denmark for the time being is around 0.5% of government bonds. Then we have somewhat higher expectance on what we make on mortgage bonds, but that is due to risk, that is due to optionality and that is due to credit risk. So the basic risk free interest rate is around 0.5% on senior government bonds.

Q - Jonny Urwin {BIO 17445508 <GO>}

Can you also give us a bit more color into the Danish mortgage spread business? That seems to have been quite choppy in Q1. Has that continued into Q2? And also, how should we – I believe that has continued into Q2 actually. But how should we think about that going forward? And I suspect from your commentary around investment return that you're quite cautious on that.

A - Lars Thykier {BIO 16427122 <GO>}

Sorry, I didn't get that one?

Q - Jonny Urwin {BIO 17445508 <GO>}

Yes. So my second question is just around the Danish mortgage spread business. It seems that it's been quite choppy in Q1. And also, that may have continued into Q2. How should we think about that going forward? I suspect from your investment return guidance that you're thinking quite cautiously around that.

A - Lars Thykier {BIO 16427122 <GO>}

We do not include expected (35:16) normal returns except for the 200 basis points on our premium reserves and the investible part of the shareholders' funds, which adds up to around DKK 100 million. Except for that, we do not expect any of a normal return. But you're perfectly right, when you're talking in Danish mortgage bond that it has been very choppy during especially Q2. As I said before, we have the highest option-adjusted spreads on Danish mortgage bonds since 2008. That means that the option-adjusted spreads now they are higher than they were during the two euro crises we had. So it is very unusual where we're at for the time being. It is my expectation that this spread will come down, which will yield some profits to us, but we don't guide for that.

Q - Jonny Urwin {BIO 17445508 <GO>}

Okay, great. Thanks.

Operator

Thank you. The next question comes from the line of Paris Hadjiantonis with KBW.

Q - Paris Hadjiantonis {BIO 19703051 <GO>}

Yes, good afternoon. Just one question from my side. I was wondering if you can comment a bit on your runoff for the quarter and the reserve adequacy. I assume that there is a negative impact from lower interest rates and how much you can actually release from a long-tail line, such as workers' comp. I was just wondering if you can give us an idea about a normalized trend and whether or not with interest rates going a bit up, whether we should be expecting that runoff to increase a bit. Thank you.

A - Lars Thykier {BIO 16427122 <GO>}

We do hedge the interest risk – rate risk we have, which means that changes in interest rates have no impact on the runoff size. We guide runoff size going forward on extra reservation each year of between 1.5% and 2% a year. It might be different or it is different when we look at what we'd realize going forward. But our intention is to make reservations between 1.5% and 2% higher than necessary.

There is some impact from inflation, though, and that is due to the fact that we hedge the inflation risk on working compensation and illness and accident with inflation swaps, but only to some extent. When we have losses on increases in inflation on the liability side, we get gains on our inflation swaps, but inflation swaps are smaller than liabilities. Some part of the liabilities are hit by index-linked bonds and by property and the gains on index-linked bonds and property goes to as capital gains. So there is a mismatch here, but that is on the inflation, not on interest rates.

Q - Paris Hadjiantonis {BIO 19703051 <GO>}

Okay. Thanks for the answer.

Operator

Thank you. And at the moment this is your final question. Next question comes from Per Grønborg from Danske Markets.

Q - Per Grønborg

Hello. It's Per again. I have a couple of additional questions. You write that you basically have been understaffed on the sale side. What will the – how much money are we talking about cost wise that you need to bring in additional to get up to a fully staffed sales force?

A - Christian Sagild {BIO 15093649 <GO>}

If you compare our expenses in Q1, 2015 to our expenses in Q1 2014, you will see that it is somewhat lower and that is among other things due to the fact that sales have been lower. We are increasing expenses over the rest of the year, but we are still seeing an expense ratio in spite of the double premium income and expense ratio below 60%.

Q - Per Grønborg

But, they could be marginally up versus 2014.

A - Christian Sagild {BIO 15093649 <GO>}

It will be - yes, it could, it could. I mean, the change in premiums, it has been impacted on the expense ratio, which is somewhat substantial. And on top of this, we have the levy on salaries that increases as well.

Q - Per Grønborg

Okay. That gave an impression of that one. My second question, I just want to clarify. You addressed life that one driver of the guidance upgrade was a higher-than-expected investment income allocated to equity. Was that right? I'm just wondering. It's only DKK 4 million for the quarter.

A - Christian Sagild {BIO 15093649 <GO>}

Yeah. But that is - we changed the way we divide the income between different lines in the presentation as you can see.

Q - Per Grønborg

I see that, yes.

A - Christian Sagild {BIO 15093649 <GO>}

The DKK 4 million you see is the sum of what we make as direct investment income and the income we make on the products portfolio that is outside contribution. And the change in principle, I mentioned before on premium extension, that is on - that is the part of - or that hits this line. So, that's why it looks so low. The direct industrial income of the shareholders' investment income and portfolio is positive in Q1.

Q - Per Grønborg

What did you say did hit this line? What was the (41:01)? Didn't get that one.

A - Christian Sagild {BIO 15093649 <GO>}

Sorry, I'll try again...

A - Lars Thykier {BIO 16427122 <GO>}

(41:08)

A - Christian Sagild {BIO 15093649 <GO>}

If you compare to what we used to do then we have a line which says investment income and we have a line saying other.

Q - Per Grønborg

Yeah.

A - Christian Sagild {BIO 15093649 <GO>}

And I think it was you who told us last time that this order was too big that we should change our distribution of income, which we did.

Q - Per Grønborg

Okay.

A - Christian Sagild {BIO 15093649 <GO>}

And that means that the first line in our presentation, that is the return on the shareholders' investment in the coming portfolio plus the income from our fixed rate annuities, plus income from group life plus a couple of other things that goes directly to the bottom line that is risk for the shareholder's account. And that includes the reservation for premium exception and that is where we changed our principles from last year to this year and that cost us to sit around DKK 14 million which hits this line.

Q - Per Grønborg

The sales and admin, that's basically still the short-term costs over one down in the new unit-linked sales?

A - Lars Thykier {BIO 16427122 <GO>}

Sorry?

Q - Per Grønborg

Sales and admin, the minus 15.

A - Christian Sagild {BIO 15093649 <GO>}

Yes, that is the cost. What the customers pay for administration and sales is less than we charge.

Q - Per Grønborg

Okay.

A - Christian Sagild {BIO 15093649 <GO>}

Sorry, sorry. We spend more on expenses for sales and administration than we charge the customers. That is one of the screws we have, so to speak, where we can change our income going forward if we so please. The intention has been to grow the life company fast and I think that we are succeeding quite well.

Q - Per Grønborg

Okay. Thank you.

Operator

Thank you. We have one final question and it's from the line of Gianandrea Roberti.

Q - Gianandrea Roberti {BIO 6786731 <GO>}

Sorry, just to come back on the internal model discussion, is it still the case, like you were writing in the full – in the annual report that, if the internal model for any reason is not approved, then the standard model would sort of cost you DKK 800 million, but you're confident that you could cover this DKK 800 million by additional sub debt, and you were mentioning also by reducing asset risk. And would it be possible to have an idea of, what would your contingency plan mean, meaning, I mean, how much would your residual asset risk and how much you would issue more debt if this DKK 800 million materialize? Thanks a lot.

A - Lars Thykier {BIO 16427122 <GO>}

It is still the case. But I think the game looks different now. When the regulator has declared us prepared for clients, that means that nobody expect us not to get our model approved.

Q - Gianandrea Roberti {BIO 6786731 <GO>}

Very clear. Thanks a lot, Lars.

Operator

Thank you. There are no final questions, sir. I'll hand back to you for any closing comments.

A - Christian Sagild {BIO 15093649 <GO>}

Well, thank you for taking the time to attending our conference. And as you know, you're always welcome to call one of us if you have any further questions. We'll be happy to answer them. Thank you and good bye.

Operator

Thank you. Ladies and gentlemen, that does conclude your conference for today. Thank you all for participating. And you may now disconnect.