Q2 2014 Guidance Call

Company Participants

- John D. Neal
- Patrick C. Regan

Other Participants

- Brett Le Mesurier
- Daniel P. Toohey
- James Coghill
- Kieren Chidgey
- Nigel Pittaway
- Ross N. Curran
- Ryan Fisher
- Siddharth Parameswaran

MANAGEMENT DISCUSSION SECTION

Operator

Ladies and gentlemen, thank you for standing by and welcome to the QBE Market Update. At this time, all participants are in a listen-only mode. There will be a presentation followed by a question-and-answer session. Please note that this conference is being recorded today, Tuesday, 29 July, 2014.

I would now like to hand the conference over to your host today, Mr. John Neal, CEO. Thank you, sir. Please go ahead.

John D. Neal {BIO 20988613 <GO>}

Good morning, everyone. I have our Group CFO, Pat Regan, present with me together with Tony Jackson, our Group Head of Investor Relations.

I would like to provide some color on today's market release that comes ahead of QBE's interim results, which is scheduled for 19 August. But before I do, can I be clear that as we are still completing our half-year review and closure processes, questions-and-answers today will have to be limited to matters contained in the announcement.

We are making the release today following a detailed review I instigated in Latin America that culminated in the need for an increase in reserves of around $170 million, the vast majority of which is for the workers' compensation business in Argentina.

I want to take this opportunity to give you more context for the action that we've taken and the impact it will have. The vast majority of the prior accident year claims development in Argentina relates to the workers' compensation portfolio and follows a detailed review of our claims reserves and an observed increase in litigated workers' compensation claims cost arising from legislative changes in 2012 and 2013 and partly in response to the deteriorating economic conditions in Argentina.

As a result of the review, we have also adopted new and more sophisticated actuarial models that better deal with the changing claims development patterns in Argentina. Having received the output of the review, the increase proposed is very considerably higher than we would have anticipated. However, in light of recent experiences, I considered it critical that we deal with this issue once and decisively.

Indeed, QBE's Argentine workers' compensation claims reserves are now more than 2.5 times the average that local peers hold in their statutory accounts, the litigated workers' compensation claims.

This necessary action will have an impact of reducing our 2014 insurance profit margin by 1% for the full year. There are three other items I wanted to provide further detail on before handing over to questions and answers. And these being an update on QBE's claims reserves generally and our prior-year claims development, our performance expectations for the first half of 2014, and confirmation of our further announcements scheduled for 19 August.

It is encouraging that absent Latin America, our other divisions in the aggregate will show prior-year positive claims development of approximately $14 million. We continue to see favorable prior-year development in Australia/New Zealand and our European divisions.

In North America, we have around $32 million of prior adverse development movement on our crop portfolio, which is in line with industry peers, following a tough 2013. And elsewhere in the portfolio, prior-year claims activity amounts to less than 1% on their claims line.

More broadly, and when reflecting on the group performance for the first half, whilst weather conditions in Australia had been benign, industry data puts the cost of natural disasters globally at $22 billion, notably driven by flood, hail and wind events in the US and Europe. The unusual development of flood losses in the UK over a ten-week period in the first quarter, we estimate to have cost us $85 million more than we would have anticipated.

And for this reason, our large individual risk and catastrophe claims cost will be 10% of net earned premium in the first half. Indeed, this event, when coupled with a one-off provision we've reported in Latin America today of around $170 million, contributes to the difference between our interim combined operating ratio of 96% to 97% and the market's expectation of a figure closer to 93%.

Accordingly and notwithstanding the more challenging market conditions that many have commented on in 2014, our global businesses are performing in line with expectations. On 19 August, we will provide a detailed update on performance division by division and a resume of our strategic assessment of those businesses we deem core and non-core, which, through the second half, will allow us to further improve the balance sheet.

And so, in summary, whilst it's very frustrating to be reporting a further prior accident year claims development, we do believe it was important to act decisively in Argentina and to ensure we have reserved conservatively for the long term. Our worldwide businesses are in good and increasingly better shape and we continue to expect to deliver solid levels of profitability across the group in 2014.

So thank you and we're prepared to take questions on today's market release.

Q&A

Operator

Ladies and gentlemen, we will now begin the question-and-answer session. And your first question comes from the line of Ross Curran from CBA. Please go ahead.

Q - Ross N. Curran {BIO 15090587 <GO>}

Hi, gents. I realize you said you're going to probably leave this for the full-year results, but I just noticed, conspicuous in the absence are any comments on dividend or outlook for earnings in the second half. Do you have any comments on either of them?

A - John D. Neal {BIO 20988613 <GO>}

I think as far as dividend, Ross, I think you're right in your opening remarks. We're still going through the processes of finalizing the half-year results and it'll take the board's consideration to determine any impact on dividend. I think there's no change in our dividend policy. Remains to pay 50% or up to 50% of cash profit.

Q - Ross N. Curran {BIO 15090587 <GO>}

And can we also assume then the European workers' comp we saw in Italy over last year, that's all been sorted out as well?

A - John D. Neal {BIO 20988613 <GO>}

Yeah. The reserves on the – it's, in fact, medical malpractice.

Q - Ross N. Curran {BIO 15090587 <GO>}

I'm sorry.

A - John D. Neal {BIO 20988613 <GO>}

Medical malpractice both in Italy and Spain and the reserves through the half year are stable.

Q - Ross N. Curran {BIO 15090587 <GO>}

Fantastic. Okay, thank you.

Operator

And your next question comes from the line of Nigel Pittaway from Citigroup.

Q - Nigel Pittaway {BIO 3406058 <GO>}

Good morning, guys. A few questions, if I may. First of all, can you make some comments on the source of the premium weakness because, although you're saying that FX is adverse relative to PCP, I think it's favorable relative to the time you originally guided. So can you just explain where the premium weakness has come from, please?

A - John D. Neal {BIO 20988613 <GO>}

Yeah. Nigel, it's simply a reflection of more challenging market conditions than we would have anticipated turning into 2014. Notably, that's in European market on both the international business and on the reinsurance business, particularly on the reinsurance line. So if we're not seeing the right price for the business, then we're quite rightly pulling away from business. It was particularly prevalent in the second quarter with the reinsurance renewals coming in on the Japanese book and on the US portfolio.

Q - Nigel Pittaway {BIO 3406058 <GO>}

All right. Okay. And then, secondly, just on the large losses, can you comment how the sort of new reinsurance arrangements worked and whether or not the loss was greater or less as a result of having this?

A - John D. Neal {BIO 20988613 <GO>}

Yeah. The only difference really I tried to call out in the earlier remarks is that the floods in the UK in the first quarter were quite different to a conventional loss, in that they manifested over a ten-week period. And accordingly, the losses that are reported during that period are all net. So there is no response from our reinsurance treaties to those losses where you'd normally expect a singular event to go into the reinsurance program, and that's the simple reason why, and I called the number out, the losses there are about $85 million higher or 1%, if you like, on the allowances through the half than we would have anticipated.

I think the only second thing I would say is that there has been greater loss activity outside of Australia than people have perhaps anticipated, particularly in June where we saw some pretty heavy hailstorms in Europe impacting Belgium and Germany and Central Europe.

Q - Nigel Pittaway {BIO 3406058 <GO>}

All right. And then just on the crop, you, obviously, flagged further, I think it was, $32 million adverse development. You're already reporting a combined ratio of close to 103% there. So by my estimates, that takes it up to about 106%, which I thought was impossible under the reinsurance arrangements. So can you make some comments on that? And then also, obviously, ACE and some of the others flagged this type of adverse development quite a while ago, so just why it's taken so long as well to sort of advice of that?

A - John D. Neal {BIO 20988613 <GO>}

Yeah. I think we were early than most in terms of calling the result for crop, which was what we did in December last year. Most of the development actually came through in the first quarter. And I think it's the way in which the reinsurances interrelate on a state-by-state basis with the government reinsurance operations that's really causing the difference. But you're right, the combined ratio is going to be somewhere around about 104%, 105% for 2013 in the final reckoning.

Q - Nigel Pittaway {BIO 3406058 <GO>}

All right. So I thought the cap with the reinsurance was 103%. That's, obviously, not right.

A - John D. Neal {BIO 20988613 <GO>}

It depends on how the losses fall on a particular commodity and on a state-by-state basis.

Q - Nigel Pittaway {BIO 3406058 <GO>}

All right. Okay. Yeah. And then, obviously, you were talking, obviously, about having done a detailed actuarial review in Argentina. But the impression you, obviously, gave was that there was a global actuarial review that had been pretty detailed. So, I guess, the question is why wasn't this picked up in the global review and are there any other areas where you feel that you're going to have to do these actuarial reviews which could result in further, as I called, one-off losses?

A - John D. Neal {BIO 20988613 <GO>}

Sure. I think the encouraging thing, Nigel, for us is that 90% of our businesses are contained within three major divisions: Australia/New Zealand, Europe and North America. I think as we've said before, both in Australia/New Zealand and Europe, where a substantial majority of our reserves are held, we have and continue to be happy with the reserve in position and indeed continue to see positive prior-year development. So that's encouraging for us.

North America remains a division that we clearly need to keep the closest eye on. And absent the numbers we're talking about on crop, you're talking about a comparatively small movement of somewhere around about $15 million on the other business. So that's encouraging too, but we've got hold of that position.

Latin America, in particular, through the first quarter, I think the changing dynamics in Argentina really pushed us into a very strong review of those reserves. So we just wanted to make absolutely certain that we had got a long-term line of sight on a long-term class of business.

And frankly, going into that review, I would not have anticipated a number anywhere near as large as the number we're disclosing today. But having stressed that analysis, I am satisfied that it is the right number to take. And as I think I've referred to in my opening remarks, I think it's very important that we demonstrate that we're decisive and act clearly until we have in taking the provision that we've taken.

I don't know, Pat, if you want to...

A - Patrick C. Regan {BIO 15131018 <GO>}

Yeah. Thank you, John. Hello, Nigel. I think what I'd add is, obviously, somebody joining new, there are a few things you look for when you're trying to assess for kind of risk of prior-year in terms of continuity, various things, whether that be people, processes, data, systems, books of business, kind of underlying macro inflation as well.

And I certainly sat down with the actuaries of our big business units. The data, process, systems, et cetera, et cetera, in places like Australia and Europe are pretty stable. We're not seeing any unusual trends in those and really any of the portfolios. The one that was talked about a minute ago in medical malpractice, I think, as John alluded to, is more stable now.

Clearly, the one that a lot of time and attention has been put into is North America and then that's -not a lot I can add to what's already been talked about there. We are seeing more stable developments on that in this six months. But as John said, clearly, that's the one that we'll all keep a close, thorough eye on as we go forward.

The other one that was – that fits that that, obviously, needed looking at and the review has looked at is Argentina, in particular, given the long-term nature and some of the macro and particular claims development in workers' comp there. So there aren't any other portfolios that have got those kind of characteristics to them. So this is the one that really needed that review and that review has now been done.

Q - Nigel Pittaway {BIO 3406058 <GO>}

Okay. Thank you.

Operator

Your next question comes from the line of James MacGill (sic) [James Coghill] from UBS. Please go ahead.

Q - James Coghill {BIO 14006200 <GO>}

Hi, John. I presume that's me. Apologies if this line is not clear, just getting off a plane. And also apologies if these questions have been asked already. Could you just explain why you had a net risk margin release (0:15:27-0:15:36)?

A - John D. Neal {BIO 20988613 <GO>}

I certainly didn't catch that, James. I wonder whether you could - could you just say that a little bit more loudly? You're very faint.

Q - James Coghill {BIO 14006200 <GO>}

Apologies. Can you hear me now?

A - John D. Neal {BIO 20988613 <GO>}

Yes, better.

A - Patrick C. Regan {BIO 15131018 <GO>}

Clearly. Yes.

Q - James Coghill {BIO 14006200 <GO>}

I was interested in understanding that net risk margin release of $55 million, why that's come out of the half? That's quite unusual for the PoA to drop at the half? And if you could just remind us what your targets are there for the full year.

A - John D. Neal {BIO 20988613 <GO>}

Yes. So I think the simple answer is that the PoA moves around with seasonality, notably crop. So we don't actually have any crop reserves of any substance through the half year. Obviously, they exist at some level at the year-end and they have a beneficial impact on the coefficient variant analysis that takes place on the PoA.

So we established a proportion of the difference between the PoA that we're showing and 90% - I'll come back to 90% - is really from the crop. And we believe that our target PoA on a full year basis of 90% will be met by year-end. So we just let that number flow in full anticipation that 90% will be applicable at year-end.

Q - James Coghill {BIO 14006200 <GO>}

Okay. Thanks for that. And then on the net investment yields running at 2.7%, there's, obviously, some mark-to-market benefits there relative to what you were targeting for the full year. Can you just clarify what those were?

A - John D. Neal {BIO 20988613 <GO>}

I might ask Pat to comment on that.

A - Patrick C. Regan {BIO 15131018 <GO>}

Yeah. Our running yields, to your point, would be closer to about 2.2%, I think. So the delta between that and the 2.7% is mainly made up of a combination of both mark-to-market gains – it's not completely mark-to-market gains because we've also made some actual – kind of realized gains as well. But the delta between about a 2.2% running yield and the 2.7% is a combination of mark-to-market and realized gains.

Q - James Coghill {BIO 14006200 <GO>}

Thank you.

Operator

And your next question comes from the line of Kieren Chidgey from Deutsche Bank. Please go ahead.

Q - Kieren Chidgey {BIO 7268946 <GO>}

Good morning, guys. I've got a couple of questions. I'll just step through them one by one, if that's okay. Just starting with Latin America. When I go back to your accounts over the last couple of years and have a look at the undiscounted top-ups, the number is quite substantial. You had $200 million in 2012. I think there was another $140 million last year and now we're talking another $170 million, so all up $510 million over two-and-a-half years, which, on our numbers, suggest about 80% increase in your reserves in Latin America.

I'm just surprised that things can be up that much. Obviously, inflation has, obviously, pushed up and that would have contributed to a large degree in that. But can you just go into a little bit more detail around what specifically has changed, particularly in the last six months, given a lot of these issues have clearly been around for two years and given sort of the comfort that you provided at the December results around being on top of those issues?

A - Patrick C. Regan {BIO 15131018 <GO>}

Kieren, hi. It's Pat. I'll have a crack at that. Just to your first point, just going into detail, the numbers that you referenced, as we said, undiscounted, the $200 million and $140 million are slightly apples and oranges because, obviously, the $170 million is (0:19:24).

Q - Kieren Chidgey {BIO 7268946 <GO>}

Yeah.

A - Patrick C. Regan {BIO 15131018 <GO>}

But in terms of answering your question, there's a number of things changing within Argentina. Most obviously, you've got the macro environment which has changed a lot this year, so we saw a 20% devaluation of the peso in January, the consequent impacts on inflation. And when you're dealing with a long-tail business, and our workers' comp business there is very long tail, we're kind of ten years-plus in many ways, that is kind of impactful.

Probably the more important thing, though, is there's a lot of changes to the underlying claims development. So for workers' comp claims, a number of things are happening in the industry generally there. Claims are being reported earlier. Claims are being finalized earlier. So if you look at the development quarters for accident years, you'll see a gradual kind of increase in finalization rates. The proportion of claims that are being litigated, it's changing quite a bit. That's not a brand new phenomenon, but it is a phenomenon that's certainly accelerated over the last 12 months or so. And some of that is based on these legislation changes happening (0:20:29) has broadened out the scope of claims that could be successfully litigated.

Now, the difficulty of this is - there are two impacts. One is an increased frequency, which we're seeing, and it should have a corresponding reduction in severity. And what we've been really probing in the data is actually kind of - we've taken what we think is a pretty conservative position on the severity - actually, we're not really going to assume that severity comes down, and hence we book the frequency increase, but not the severity decrease. And that really in a nutshell is why we've ended up with a big number and a number that's quite a bit bigger than the local market.

Obviously, this is something we'll continue to watch going forward in terms of whether that decrease in severity ultimately comes through, which could of possibly, logically, it would do. But they are the things that have been changing. And making the judgments of the right picks on all of that is quite complex generally, but particularly in that environment. To help us do that, we also put in a new actuarial model that we've used here in Australia and that's, I think, enhanced our ability to make some of these selections.

Q - Kieren Chidgey {BIO 7268946 <GO>}

Okay. And just to be clear around the increase in frequency you've assumed, does that allow for further uplifts in propensity to claim and litigation just given the economy is travelling pretty tough at the moment.

A - Patrick C. Regan {BIO 15131018 <GO>}

Yeah. We factored in the latest data on that. To an extent, (0:21:59) would be if you look at the charts and they can't go up that much more, simply (0:22:02) with all of the cases litigated, if they carried on at this current rate of increase. But, yeah, we have made what we think are pretty sensible assumptions around that.

A - John D. Neal {BIO 20988613 <GO>}

We've also taken the data back and drawn comparisons with other territories both in Latin America and in North America, with the frequency of claimant is six to ten times the level you're seeing elsewhere. So we've got to acknowledge that level of frequency. But as Pat suggested, it's comfortably out of step with what you would expect, but nonetheless we've accepted the numbers as presented.

Q - Kieren Chidgey {BIO 7268946 <GO>}

Okay. Presumably - whilst this has had a prior-year impact presumably, you maintain reserves at the sort of levels going forward on an accident year basis, what impact does that have on the underlying combined ratio in Latin America?

A - John D. Neal {BIO 20988613 <GO>}

So two points - yeah, two points to make on that. First point is that the model that we're looking to deploy here is really driven to look at finalization rates for claims. So assuming that there is a correlation between inflation and interest rates, then you should not see fringing (0:23:08) movements in the claims central estimate prospectively. So that's why we've taken the action we have, is the first point to make.

Second point to make is that we're actually going through the process of back allocating the changes we've made to the applicable accident years. We had a look at the performance backwards and forwards. What I can say is that the business will still have been profitable and will still be profitable going forwards. It's a very obvious thing to say because, of course, the corollary of inflation rates that are running close to 40% is interest rates are around about 25%. So you're getting a significant return on the assets that you're holding. But that's an analysis we're still completing in some detail. And again, in that respect, I think we'll update the market more fully on 19 August.

A - Patrick C. Regan {BIO 15131018 <GO>}

The only other thing I'd add to it is stating the obvious. This is very long-tailed stuff. So the reserve increase, you really do need to appoint a multiple accident years. I'm going to give you a sense of that. For our 2002 accident year, there's something close to 15% of claims still not viable. Obviously, it's very long-tailed stuff. So that the reserve increase for comp is, will be applied back over multiple accident years.

Q - Kieren Chidgey {BIO 7268946 <GO>}

Okay. Thanks. The other question, second one just on your large claims, experience in your reinsurance covers around that. John, just to be clear, are you still sort of - would you budget 8.5% of premium for the first half? Are you still running this first half, second half differential? And related to that, if you have had more large individual claims in the first half, are you approaching your deductibles on your group aggregate covers which should allow you to have a better large individual result in second half?

A - John D. Neal {BIO 20988613 <GO>}

Yeah. I think the first point I would make, Kieren, is that when we do the budgeting for large individual risk and cat claims, we tend to look at them across the full 12 months. And what we've done historically is, because of the greater propensity to weighting for cat losses in the second half, particularly in Q3 with the North American hurricane season, and that's why we said indicatively you look at a greater propensity for low decline for the second half than the first half. But, certainly, in budgeting terms, we tend not to look at it on that basis.

So I think that the short answer to that is I am satisfied that we've got adequate allowances set aside to both large individual risk and cat claims. There's nothing that's changing my mind in that respect. And equally, I'm happy that the reinsurance structures are appropriate to the portfolios that we underwrite.

On the large individual risk claims, we've just got, as I've called out, just some unusual risk claims that have presented because of flooding over an extended period of time, just meaning the way you might normally have expected a conventional risk type loss to be responding – to be asking your reinsurance treaty to respond, that's not the case in this instance.

I don't see any reason for that to put us outside of our allowances. It hasn't at the half year and it won't at the full year in terms of the allowances that we're carrying. So, no, I don't see a particular issue with the large individual risk claims being of a size that will require the aggregate covers to respond.

Q - Kieren Chidgey {BIO 7268946 <GO>}

I'm just sort of asking whether or not you've eroded enough of your, sort of, deductible on the aggregate cover, so that if you do have more in the second half, you're getting a high degree of recoveries on this?

A - John D. Neal {BIO 20988613 <GO>}

No. As at the moment, I would say it's a hard number to call. But at the moment, I would say the cost of large individual risk claims are not at a level that would require the aggregate to respond.

Q - Kieren Chidgey {BIO 7268946 <GO>}

Okay. All right. And then finally, just on the – following up on an earlier question around the premium pullback, just the particular areas you cited such as reinsurance in various classes in Europe, at a very high level, have the returns you've been making in those areas where you've significantly scaled back over 2012 and 2013 already been substantially below your underlying expectations at a group level? And therefore, as you exit those, there's sort of a positive margin mix impact for the group more broadly or is it just there's been such a significant change in rates this year that were delivering okay and now they won't going forward?

A - John D. Neal {BIO 20988613 <GO>}

Yes. I think there's three things, I would say, in this space. I think if you look in the reinsurance that – our combined operating ratios have been absolutely superb, particularly following a quite (0:28:07) year in 2013. So we certainly expected some pressure on price. I think that pricing reductions, and you see some of them here in Australia, (0:28:17) renewals, we've seen them on the Florida renewals in July are greater than we perhaps anticipated. In which case, then we'll just be a bit quieter in those books of business.

And I think equally, as we note, pricings in the London market seem pretty competitive for a period of time. And you would be hoping at this stage in the cycle, you'd see prices moving up. That's not the case. I metaphorically shrug my shoulders at that. That's our job. We're meant to cope with market conditions and I think we are coping with market conditions, frankly, with the results that we're putting out.

Two other areas I'd reference, one will be closer to home. I think in the Australian market, we saw pretty hectic competition around the July renewals, to be honest with you. So if you look at our premium throughputs in July 2014 versus July 2013 for the industry, it's down, showing you that price competition there is pushed quite hard. But, again, I think we're happy with the performance of the portfolio.

And then the third one I'd call out is really in North America as we said, we grapple with right-sizing the lender-placed insurer and particularly the lender-placed components of QBE FPS. We have seen some falling volume there as the US economy recovers. And you just see default rates falling, and therefore, less business coming from the lender-placed space. So that's been a factor as well. So those are the three callouts, I would say, that are having an impact on top line.

Q - Kieren Chidgey {BIO 7268946 <GO>}

All right. Thank you.

Operator

And your next question comes from the line of Ryan Fisher from Goldman Sachs. Please go ahead.

Q - Ryan Fisher {BIO 3487027 <GO>}

Thanks, guys. Obviously, a lot of questions and there's a lot of answers of what I was going to ask. But on the GWP, I just wanted to check, given that I gather some of the reinsurance is sort of 1H biased with GWP, should we just annualize - roughly annualized the shortfall from the first half? Or are there any half-on-half issues we need to take into account?

A - Patrick C. Regan {BIO 15131018 <GO>}

I don't think there's any dramatic seasonality that is worth - it's more the underlying business points that John referenced. The only one actually that we did try and highlight in the back of the release was there was an FX impact on both GWP and earned premium in the first half, so that contributed. So you can make your own conclusions about FX rates in the second half. But other than that, I don't think there was anything particular seasonal. It was just general business trading.

Q - Ryan Fisher {BIO 3487027 <GO>}

Okay. Thank you. And just a final question. Just picking of the big picture thing, so you've commented that, and correct me if I'm misinterpreting any of these things, but you've commented that you're still fairly happy with the 10.5% large loss budget. You've indicated in the release that your expenses are trending at least on track for what you're hoping. I think, John, you indicated that, and I think, Pat, you as well, indicated that you're pretty happy with reserves post Latin America for the final - please, you confirm those three things.

But also on capital, that's sort of the final leg, how are you feeling about the capital position and the gearing at this point?

A - John D. Neal {BIO 20988613 <GO>}

So I'll deal with all four and Pat might want to jump in. I'd say the first one, yes, I'm very happy that the allowance is at 10.5% of net earned premium, the large individual risks, that are appropriate. I see no reason to change that. And I think when you do get chance, if you could detail on 19 August division by division, our underlying performance is indicating an improvement in performance which I think would support that those allowances are right and appropriate.

Those are the cost-out programs. I think as I've said before and I'll continue to say, those are exceeding expectations. So we're very happy that they will deliver at least in lines with the market expectations.

I think on the reserve point, yes, we do believe that we've covered the reserves now, disappointing that is and frankly frustrating as it is, to be dealing with the Argentine issue today. I think that's evidenced by the stability we're seeing elsewhere in the book.

On the fourth issue, of course, as you can sort of see with a simple hinge of metrics, our capital position will inevitably improve during the half year, not least because we're still talking about making a profit of around $390 million. So capital is actually improving and gearing is going down. But it is our intention to give a very full update on our capital plans and indeed our reference core and non-core businesses at the half year and it's probably best to leave any further discussion on that until 19 August.

Q - Ryan Fisher {BIO 3487027 <GO>}

Okay. Thank you. But nothing dramatic on the capital front at this point?

A - John D. Neal {BIO 20988613 <GO>}

No, nothing today.

Q - Ryan Fisher {BIO 3487027 <GO>}

Yeah. Thanks, John.

A - Patrick C. Regan {BIO 15131018 <GO>}

Yeah. The other thing I'd add to that, John, as we alluded to there on the capitals, gearing has got better in the six months as we've made money. So that's what helped. I think we're fairly comfortable we want that to continue to trend down over time. And we think there's some intelligent things we can do in the core and non-core review that will very specifically help that.

Q - Ryan Fisher {BIO 3487027 <GO>}

Great. And very finally, just clarifying that there's no update or clarification on full year guidance at this point, is that correct?

A - John D. Neal {BIO 20988613 <GO>}

No, there isn't today. I think what' I'd like to do is to see that sort of final consolidation at the half year and then be very explicit in that respect on 19 August.

Q - Ryan Fisher {BIO 3487027 <GO>}

Okay. Thank you, guys.

A - John D. Neal {BIO 20988613 <GO>}

Thank you.

Operator

And your next question comes from the line of Daniel Toohey from Morgan Stanley. Please go ahead.

Q - Daniel P. Toohey {BIO 16751863 <GO>}

Good morning, guys. Just a few questions. Firstly, on Argentina, with the recent - sort of the recent top-ups, I thought we already had a buffer that we've put in there over and above what was necessary just to insulate against any adverse development. So can you confirm sort of what that buffer was, and so it's clearly that would - obviously move through that buffer and exhausted that on top of the $170 million?

A - John D. Neal {BIO 20988613 <GO>}

Yeah. I think, Daniel, what that might be is - and we've done some cross referencing as part of the process here of looking at how the local market behaves and how they reserve, we've always reserved on a significantly more conservative level on a per case basis for these litigated claims than the local market has.

So the decisions that we've taken today have further - if you like, further widened the gap between the reserve position that they would hold and we would hold. I hasten to add in saying that, I think we've taken the right and appropriate steps. It's not a reflection of that being any more or any less than that.

Q - Daniel P. Toohey {BIO 16751863 <GO>}

Okay. And on the core and non-core components, is the long-tail volatile business in emerging markets, is that core or non-core?

A - John D. Neal {BIO 20988613 <GO>}

I think if you turn to this - let's deal specifically with the workers' compensation book in Argentina. It's a book of business that we've underwritten since 2001. We do think our approach is different for the local market in terms of the way in which we select risk, price for risk and reserve. And as I hinted earlier on, whilst there's clearly some further improvements we can make at the front end of the business, it is profitable and has been profitable for us.

Q - Daniel P. Toohey {BIO 16751863 <GO>}

Okay. The high individual risk losses, it seems to be - there's a recurring theme with respect to that. There always seems to be some unusual risk claim and at a frequency which is probably higher than expected and it's been, I guess, that for a little while. How are you going about fixing the underwriting position on some of these broker facilities or areas where you might be - have historically been exposed to some weakness?

A - John D. Neal {BIO 20988613 <GO>}

Yeah. It's a good question. Perhaps the one thing I should've been clear on and haven't been clear on so far is that the frequency of large individual risk losses is down. And that's the point that's encouraging me that, whether it be the underwriting decisions that we've taken in Europe - and as you know, we've withdrawn from some lines of business. All the decisions we've made as we look to reset North American business into the commercial specialty space, I think on the underlying performance, are telling me that we've made the right decisions.

In terms of where the market's expectations were or consensus expectations on our large individual risk and cat costs through the first half, I think there were just a couple of features that are probably - make consensus come to a different conclusion than us, one of which was the sort of unusual nature of the way in which loss is presented through in an extended period of flooding in the UK through January and February. I think the second of which is probably not having the broadest line of sight over the loss activity in the US and notably in Europe in June. I think the losses are perhaps bigger than the market expects.

Q - Daniel P. Toohey {BIO 16751863 <GO>}

Okay. Can you comment on the risk margins or the adequacy thereof of risk margins in Europe?

A - John D. Neal {BIO 20988613 <GO>}

Yeah. I think in - risk margins generally, it's a good point really because I think we need to remind ourselves that we're always talking about the claims central estimate here and we're still talking about risk margins of around about $1.5 million is about the central estimate that we're talking about. And as I referred to earlier, we've not changed our sort of average target from one year to the next of a probability of adequacy of through 90%.

On the European business, I might ask Pat to comment specifically on that.

A - Patrick C. Regan {BIO 15131018 <GO>}

We'll give the group number today and we'll give you more specifics, obviously, as we get together on August 19. I'd refer back to is generally what we're seeing outside of

Argentina, specifically, is pretty stable claims development across our major portfolios. And that certainly includes Europe. And I think we said in the release today, we actually saw positive prior-year development coming out of Europe. And actually, it wasn't - that wasn't the negative loss of ups and downs. It was pretty stable across all of the major portfolios.

Q - Daniel P. Toohey {BIO 16751863 <GO>}

Okay. Okay. And just a final question then on the cost-out story. Obviously, it looks to be running ahead of expectation. Clearly, your expense ratio is better than budget, but your top line is down. As we look ahead, is there a risk - are we really, sort of draw a line in the sand on the benefits, given if we are moving into a tougher market, are we more likely to see some of those savings traded away to preserve or retain sort of business?

A - John D. Neal {BIO 20988613 <GO>}

No. You won't see the savings traded away. I think, yes, there is a risk if your top line falls that the ratios will go up in percentage terms. I think what I'd say in addition, though, is that the business is now pretty well versed in terms of managing costs and taking cost out. And there's no reason why we can't continue to take costs out of the business if income falls. And that's exactly what we will do.

So, I think the biggest impact for 2014 on cost-out will actually come through - sorry, they're starting to see the benefit of the cost-out program come through in 2014 on a net basis. The actual benefits would exceed the investment in costs. In 2015, the important point to remember is there's no further cost or investment in the program. It's then all benefit. But as we're saying earlier on, I think if we do see pressure on top line, then there's no reason why we can't correspondingly take cost out.

Q - Daniel P. Toohey {BIO 16751863 <GO>}

Okay. Thank you very much.

Operator

And your next question comes from Siddharth Parameswaran from JPMorgan. Please go ahead.

Q - Siddharth Parameswaran {BIO 15037291 <GO>}

Hi, John. It's Siddharth from JPMorgan. A couple of questions, if I can. Just one on reserves. I'd like to just clarify, the $170 million in Argentina, is that a number net of the discount rate change as well? So, presumably, that would have gone up?

A - Patrick C. Regan {BIO 15131018 <GO>}

Hi, Siddharth. It's Pat here. The $170 million is actually Latin America, the vast majority of which is Argentina. It is net of the discount rate, yes. So we've made a little footnote in the release. What we've moved to now is an explicit linkage of both discount rate moves and claims inflation moves in Argentina specifically.

Those two numbers are always close to 30%. So you end up with some crazy math unless you look at them on a net basis. So the $170 million is after capturing both the discount rate and the claims inflation.

Q - Siddharth Parameswaran {BIO 15037291 <GO>}

Yeah. Okay. That makes sense. Can I just ask, Pat, about your comments about the US reserves. It seemed that that was the one market where you still had some residual concerns. You said you were quite cautious still on how the experience was emerging. I was wondering if you could just give some comments on what you're seeing in terms of how the latest accident years, in particular, are trending.

I think from previous comments, I think those are meant to have been reserved more conservatively than they had in the past. I was just wondering if you'd give some comments on particular lines that might still be causing some concerns and how the latest years are trending.

A - Patrick C. Regan {BIO 15131018 <GO>}

(0:42:50) comments, I think, particular set of genius that they're a little bit a statement of the obvious. The development patterns on the business we're writing now is pretty good. We're seeing business come through broadly, as you would expect us to see.

I think the kind of the data and the information the team's got around that now is better than they've had historically, both in terms of business that we kind of are directing through brokers and are the ones that come through MGA. So I think that's all kind of good.

But, inevitably – I'm not suggesting we've seen negative development, but, inevitably, just are a little bit more uncertain on things like the things like the program (0:43:30) just by the nature of that type of business. That's true of every book run of book of business of that type. So that's naturally something we'll keep a close watch on. There's nothing new on flagging in terms of the development patterns around that. But there's much higher level of complexity in that kind of book.

A - John D. Neal {BIO 20988613 <GO>}

I think, in reverse, if you turn the positive on that, I think whilst there's lots of movement in crop, I think that's been pretty well flagged across the industry. Absent the crop movement, the numbers we're talking about in North America in prior are really comparatively small compared to their income to almost be incidental.

Q - Siddharth Parameswaran {BIO 15037291 <GO>}

Yeah. Okay. Fair enough. Could I just ask a question on rates as well? It seems like a lot of the rate pressures you're flagging, John, seem to be – seemed to have occurred in the latter period in the half. So would it be imprudent to assume that some of those pressures would manifest themselves in the second half in a greater way than they manifested themselves in the first half?

A - John D. Neal {BIO 20988613 <GO>}

I think the - I'll take the longer-term view of that. I think it's more prevalent for 2015 than it is for 2014 in many respects. In Europe, I think a significant proportion of the business is written. So, in terms of the drop in income, I think much was anticipated. It's also important to remember in Europe that Richard Pryce and the team have taken a pretty tough line in determining what they think is core to their business. And they have actively discontinued some lines of business. That work is now complete. So I think that's the activity that you're seeing. So in the first half of 2014, you've seen the remediation activities really drive the impact on income and some FX. I think the pricing pressures, which you're seeing in the marketplace, which would be the hope that you'd see price move in Europe, but looks like being delayed, and clearly you're seeing price increases getting close to zero, marginally above zero in Australia, I think, will have an impact on the thinking that we might have for premium expectation for 2015.

Q - Siddharth Parameswaran {BIO 15037291 <GO>}

Yeah. Okay. Okay. And one last question. Just on what the implications, if there is a credit rating downgrade at all, are there any lines of business you may not be able to write business in or that you may face some GWP pressures?

A - John D. Neal {BIO 20988613 <GO>}

I think on the basis of what we're discussing today, again, it's important to remember, we're dealing with an issue which frustrates us, but impacts our profit, reduces our profit at the half year. We don't see that impacting our financial strength ratings with any of the major rating agencies, so we just don't see that as an issue.

Q - Siddharth Parameswaran {BIO 15037291 <GO>}

Yeah. But if at some stage, there was an issue, are there any class of business where the credit rating is particularly important to write the business that you currently write?

A - John D. Neal {BIO 20988613 <GO>}

I think it's - it's rated independently. Obviously, the LMI business has its own independent rating, which as you know is AA minus. So it's above the rating that applies for the group. Their rating was just recently affirmed two weeks ago. But that rating is quite sensitive, but we don't see any issues there.

I would say, generally, if you took an abstract view, then you could write a predominantly commercial portfolio with an A Standard & Poor's rating, but that's not what we're setting out to do. We're looking to maintain an A+ rating and an A rating where they invest. But as I said, I don't see any issues that we're discussing today that should impair those rating.

A - Patrick C. Regan {BIO 15131018 <GO>}

I'll just refer you back to the comments John and I made earlier on, as well as the increase of - improvement, I should say, in gearing for the first half. We are going to talk you through the core, non-core and how we see that kind of improving capital ratios going forward. So that's much more, the kind of the intention and direction we have (0:47:47).

Q - Siddharth Parameswaran {BIO 15037291 <GO>}

Okay. Thanks very much.

Operator

Your next question comes from the line of Hugh Dive from Filo Capital (0:47:58). Please go ahead.

Good morning, guys. Following on from an earlier question, can you give me some indication of the historic profitability since 2001 of the Argentinean workers' comp business? So, obviously, tomorrow morning, the bears and the (0:48:10) investors are going to be asking me why QBE is involved in this business, which should appear to be sort of quite far away from your sort of core geographic markets?

A - Patrick C. Regan {BIO 15131018 <GO>}

It's quite a complex exercise. I wish didn't sound like I'm avoiding your question.

Q - Operator

No.

A - Patrick C. Regan {BIO 15131018 <GO>}

I think – the first couple of things I'd say is, you need to apply the, albeit sizeable reserve strengthening clearly, back over a number of accident years. So the amount you're adding into it any individual accident year comes more in the kind of 15%, 20% increase in the loss ratio.

Secondly, historically, this business has been viewed as very profitable. Clearly, it's a bit less profitable. But, previously, you'd have been thinking of combined ratios in the probably 80s.

Q - Operator

Right.

A - Patrick C. Regan {BIO 15131018 <GO>}

Thirdly, as John referenced, it's not a particularly satisfactory or completely satisfactory answer. You've got elevated – with a higher claims inflation, you have higher investment income. So the effect of that does mitigate to an extent the higher combined ratio. So you've still got a business, albeit double-digit ROEs, albeit no way near as profitable as either we'd like or historically we have thought of it as.

Q - Operator

Okay. And so, going forward, what are your plans for this particular business given the environment is quite unfriendly?

A - John D. Neal {BIO 20988613 <GO>}

Yeah. I think in terms of reserve position, we do think we've dealt with that absolutely in the positions that we've taken.

In terms of our pricing of the products, we are already the most expensive in the marketplace locally. Our risk selection criteria are very different, very individual, so we do risk survey every risk on the new (0:50:05) inflection. And we've had a good look at those processes just to make sure they're as tight as they need to be.

We'll have a second look at pricing just to make sure that we're getting the right levels of return. Pat's referred to the business will be achieving attractive return on equity. We just need to make sure those returns on equity are appropriate in a high inflation environment. So we'll have a look through on pricing in that respect.

The thing I would say is, with the action that we've taken indeed over the past two years, our market share has fallen by that 30%, 35%. So, we have already acted in advance with the conditions that we're looking at today in Argentina.

Q - Operator

That's it. Thank you.

And your next question comes from the line of Brett Le Mesurier from BBY. Please go ahead.

Q - Brett Le Mesurier {BIO 5909278 <GO>}

Thank you. A few questions. Is the Australia/New Zealand division the only one to make the 10% insurance margin target in the first half 2014?

A - Patrick C. Regan {BIO 15131018 <GO>}

Well, I don't think we've given - we haven't given out the specific combined and insurance margin today, Brett. Obviously, we'll get into that on August 19. But I think we - basically, as we said in the result, we talked about a couple of specific items, really most of which relates to Latin America. Europe, Australia, and North America are pretty - and Asia, I should say, are performing pretty much in line with our expectations.

Q - Brett Le Mesurier {BIO 5909278 <GO>}

Right. And in the announcement, it said that the European business was doing the same as it was last year, I think it said, which was an insurance margin of about 5%. Is that the correct interpretation of your words?

A - Patrick C. Regan {BIO 15131018 <GO>}

We were talking specifically that the combined ratio is broadly in line with last year. Again, we'll give you the insurance margin when we get to the - when we get to the half year. I'd imagine it to be a little bit more than 5%, but we'll give you that number.

Q - Brett Le Mesurier {BIO 5909278 <GO>}

Now, given that you're confident that you've got the right reserves in all your geographies and given the central catastrophe claims, large and catastrophe claims number that you use, I don't really understand why you're not confident about giving an insurance margin number for the second half of 2014. Is there something else that's going on?

A - John D. Neal {BIO 20988613 <GO>}

No, there's nothing else that's going on. We're literally updating the market today as we're going through the processes to consolidate our half-year result. And as part of that process, we'll always get through in detail division by division with their updated forecast for the full year. So it's just not appropriate today to be giving the sort of – detail that information when the work is not yet completed. So it's as simple as that.

Q - Brett Le Mesurier {BIO 5909278 <GO>}

When did the actuarial review in Argentina start?

A - John D. Neal {BIO 20988613 <GO>}

The actuarial review really flagged late Q1. We'd involved our group actuarial team and the local actuarial team. So the group actuarial team has actually been down there four times. Literally, the information, as presented today, was consolidating both with internal and external actuarial review yesterday in terms of the final number it will come to.

And there's a number of options there, Brett, particularly if you're changing from one model to another. Do you take the new model in its entirety? Do you blend the two models? Do you favor (0:53:47) taking the reserving? So there's quite a lot to consider in the final reckoning. And frankly, I think because of issues that we've been discussing particularly over the past 12 months, I thought the only thing and right thing to do, take the action, take it up and take it today.

Q - Brett Le Mesurier {BIO 5909278 <GO>}

So that review started a couple of months after the last result – the last result announcement, I should say.

A - John D. Neal {BIO 20988613 <GO>}

Late Q1, early Q2, yes. So your into March.

Q - Brett Le Mesurier {BIO 5909278 <GO>}

Okay. Has the result or this announcement that you've had – that you made today been discussed with the rating agencies?

A - John D. Neal {BIO 20988613 <GO>}

We've had very early and preliminary conversations with the rating agencies, yes.

Q - Brett Le Mesurier {BIO 5909278 <GO>}

And their reaction is consistent with what you said earlier?

A - John D. Neal {BIO 20988613 <GO>}

It is.

Q - Brett Le Mesurier {BIO 5909278 <GO>}

Okay, good. Thanks so much.

Operator

Ladies and gentlemen, we will now close the question-and-answer session. And I would now like to hand the conference back to today's presenters. Please continue, gentlemen.

A - John D. Neal {BIO 20988613 <GO>}

Okay. Thank you, everybody. Thanks for taking the time to dial in. And I think, as we've said, we will be providing a very detailed update on 19 August including a division-by-division analysis as well as answering in detail the plans that we have on core and non-core businesses and the capital updates that Pat's referred to.

So thanks for dialing in today. I'll close the call on that basis. Thank you.

Operator

Ladies and gentlemen, that does conclude our conference for today. We thank you for participating. You may now all disconnect.