Q2 2017 Earnings Call

Company Participants

- Adrian Peter Cox, Executive Director & Head-Specialty Lines
- Andrew Pryde, Chief Risk Officer
- David Andrew Horton, Chief Executive Officer & Executive Director
- Martin Lindsay Bride, Executive Director & Group Finance Director
- Unverified Participant

Other Participants

- Andreas Evert Cornelis van Embden, Analyst
- Andrew J. Ritchie, Analyst
- Barrie Cornes, Analyst
- Edward Morris, Analyst
- Joanna T. Parsons, Analyst
- Kamran Hossain, Analyst
- Nick Johnson, Analyst
- Thomas Seidl, Analyst

MANAGEMENT DISCUSSION SECTION

David Andrew Horton {BIO 5697110 <GO>}

[Abrupt Start] Presentation for the Six Months to the 30th of June 2017. If we have a quick look at the agenda, I'm going to do my usual overview of the financials and then a business update. I'm going to hand to Martin to go through the financials, a bit more depth. And this year's special guest star is Andrew Pryde who is our Chief Risk Officer. And Andrew is going to have an unusual mix. He's going to explain how we manage risk at the company, and he's also going to talk about innovation at Beazley as he is our executive sponsor for our innovation and product development initiative. And then I'm going to come back and look at the crystal ball to try to determine what on earth is going to happen from up here on in. Although, as you probably all know, I could just start recording of myself at this point in time because I'm probably going to say the same thing that I have done for the previous nine presentations about where the market is going from here forward.

So, looking at the numbers, we're really pleased with the overall picture of figures. Profit is up 6% year-on-year, and that's a good combination of a combined ratio still holding up at 90% despite rates edging down by another 2 points. The investment team have done a great job of getting investment return up to an annualized return of 1.7% compared with 1.4% in the first half of last year.

Overall, that delivers a post-tax ROE of about 18%, which is down a bit on 2016, holding a bit more capital. And our interim dividend, again, relatively consistent strategy, up 5% to 10% for many years now, and that gives a dividend of £0.037. So, overall, I think financial performance is good in an environment that's quite competitive.

What are we actually doing from the business point of view? We announced back in February that we'd acquired Creechurch in Canada and created Beazley Canada. We had no presence in Canada up until acquiring Creechurch who's an MGA we have been supporting for almost 20 years. We knew the business really well and it writes a lot of specialty lines business and a bit of property, sort of writes business lines we like, and we can now build on that group of people and add to it. And we've announced we're going to add an environmental underwriter to our Canadian operation who arrives shortly.

U.S. not growing at quite the 20% per annum. It was doing so closer to 10% in the first half of this year, very competitive market but strong growth in an economy that's not growing at anything like that rate, and we continue to invest heavily in the U.S.

Also, as we announced last year, investing heavily into Europe. So, it's great to get our Beazley Reinsurance company. dac just means designated activity company, so it's just a term, which is used in Ireland for companies. We've converted Beazley Re dac to Beazley Insurance dac. So, the Reinsurance company has now got the Insurance company licensed to actually operate through the four countries we want to operate in at the UK, Germany, France and Spain. We need to get branch licenses for those. We were in the process of applying for those branch licenses. It should take a couple of months to get those, and our aim is just to be able to start writing business, quoting for business from the end of September into October 2017.

This is all on the back of Adrian Cox's push into the international world, and the international world for Beazley is everything outside the U.S. Gerard Bloom joined us last year to write specialty lines business, which is financial institutions, management liability, E&O and cyber internationally. And Gerard is focusing on those four European countries. He's also focusing on Latin America through our Miami hub, on Canada through the Creechurch acquisition, and on Asia through our Singapore hub.

We sold the Australian accident and health renewal rights during the first half of this year. So, we only have I think, other than running off some of the claims, a couple of people left in Australia writing contingency. And on the back of that, Adrian Lewers retiring. We've reformed Political & Contingency Group and the Life, Accident & Health Group under Christian Tolle.

And the data and analytics strategic initiative is really important to us. Everybody has talked about data and analytics these days as we saw when we did a competitor analysis of everybody in the insurance sector. Everybody seems to have a data and analytics strategic initiative, so we thought we would follow suit or try and a take a lead in this. And what it's going to focus on is trying to use our internal data better, access external data, which can make our underwriting and claims decisions better. Look at Fintech. So, again, we look at Fintech and in SureTec. So, we're bringing that all under one banner and user technology. So, the buzzwords of machine learning, robotics and so on, and we're putting all under Ian Fantozzi's data and analytics strategic initiative.

I will hand over to Martin.

Martin Lindsay Bride {BIO 15458196 <GO>}

Thank you, Andrew. Good morning, everyone. I'm Martin Bride, the Group FD at Beazley. I'm going to cover the usual trio of investments, reserves and capital with a little bit on the financial KPIs just to kick off. So, premium is growing at 3%. There were one or two one-offs, and our guidance for premium growth remains mid- to high-single digit and the earned premium is tracking more towards that from the very top line.

In terms of the per-share metrics, there is an FX effect there. So, we actually have had a very positive year in that net asset value per share in dollars has grown 8% as well as £0. 23 and a bit of dividend being paid out in sterling. It's flattened a little bit by the FX rates. It's actually up 13%, but a very positive 12 months for shareholders.

So, the investment return, that's our strongest half year for quite some time. Good performance by the team, clearly assisted by particularly risk asset markets that continue to go up. So, we're very pleased to have banked that return in the first half. And Stuart, who's ever there, is fully concentrated on trying to repeat it in the second half.

So, in terms of the portfolio mix, really, just some very minor changes. The strategy remains 80% to 85% of the assets in a core portfolio of bonds and 15% to 20% in capital growth asset portfolio. There have been one or two changes in how things are allocated at the sort of very micro level, but, broadly speaking, unchanged. No plans to change that. It seems to be working well. Nevertheless, remains quite difficult environment with a lot of asset classes looking very fully valued by historic metrics. So, we hope we can continue to nevertheless make some reasonable investment return.

Moving on to reserves, it's a very important part of Beazley's results. We reserve prudently. And then, on average, therefore, you should expect to see reserve releases from the different classes at Beazley. And you can see that the overall reserve release in the first half 2017 is very much in line with our long-term averages.

It is evident and we have highlighted the rate reductions in short-tail lines of business. So, it has been a relatively benign catastrophe environment but the level of reserve release from short-tail classes has reduced, and that really reflects margins in that business.

Potentially, more importantly than reserve release is that have already been made is the future. So, the purpose of this chart is to show you how much margin we believe remains in the balance sheet reserves compared to the view of our internal actuaries. And that margin is very much in the range that we are targeting. And so, our view, all other things being equal, is the reserve releases that you've seen in the past should continue at broadly similar levels as we go forward.

Finally, capital. So, starting from last year, we've been providing to you, at this point in the year, our first view of capital support our underwriting at Lloyd's is the next business plan. So, that figure is here. We have 7% growth. That's, again, very much in line with the guidance we gave you last year, that we saw high-single-digit growth in our Lloyd's underwriting capital. We have a 31% buffer at the half year. It's above our 15% to 25% range. And so, it's a strong balance sheet that will enable us to take advantage of any growth opportunities.

Our basic approach to capital is unchanged. Dividend growth of 5% to 10%, which we've delivered, and returning excess capital beyond our needs in a disciplined fashion. So, there's no change to that view from the board.

Andrew, over to you.

Andrew Pryde {BIO 17257822 <GO>}

Thank you, Martin, and good morning. I'm Andrew Pryde, and I'm Beazley's Chief Risk Officer. I've been at Beazley for 12 years and have been CRO and part of the management team for the last six years. In this in-focus session today, I will cover two topics, as Andrew mentioned. Firstly, risk management for which I have functional responsibility, and we've been operating under a Solvency II regime now for a year and a half. And secondly, innovation and product development, as I'm the exec sponsor for this strategic initiative.

So, let me start with what the CRO does at Beazley. My risk team is responsible for risk assessment, basically working out how things might go wrong at Beazley. Within that, helping the board set risk appetite and then monitoring operation against that risk appetite are core tasks.

My capital team is then responsible for risk quantification. We find that there is benefits in having the risk and capital teams working closely together, so that these two important business processes stay in-sync. Indeed, our internal model was one of three non-life models that were approved by the Central Bank of Ireland back in December 2015.

And then the rest of my time is spent enabling opportunities by supporting and challenging my exec colleagues. I describe this as bringing together risk and capital information to provide interpretation to business challenges. Perhaps I can illustrate with two recent examples. I produced and also report recently, assessing out the risk and capital considerations to support the decision to purchase Creechurch that Andrew mentioned earlier. And my risk team produced an annual cyber risk profile, which, obviously over the last few years, is focused on quantifying the aggregation potential given the increasing importance that this cyber book is - as it continues to grow.

So, on to the design of the risk management framework, it is an intuitive cycle, which starts with identifying and assessing risk. We then set risk appetite for each risk category, which we express as the amount of risk that the board is willing to take at a 1 in 10 likelihood. Of course, we do monitor risk at other durations such as setting the natural catastrophe risk budget, the 1 in 250 points of the distribution to monitor tail risk.

Once we set risk appetite, controls are set in proportion to that risk appetite. So, for example, where we have low-risk appetite, we need more control to ensure that we stay within that risk appetite. And so, this approach helps us optimize the costs associated with the controls, with the protection that they provide.

Members and staff from across Beazley then sign in to our risk software on a monthly basis to confirm whether they're operating their controls, and my risk team then summarize that data for reporting to the board.

Finally, as we get around to the top of the cycle, we look over the horizon and consider the emerging risks that might require a change in the group's strategy. These are presented and discussed at the board strategy day in May. And so, the cycle continues.

Now, let's bring the risk management framework and the internal model, capital model together. So, I've talked about the risk assessment, and from that we're able to construct the risk register. I've also explained that we've been - this allows us to set and operate an appropriate control environment.

In addition, the risk register forms a basis of the internal model, which, along with inputs such as the business plan and risk assumptions, generates the distribution of how earnings may emerge. Therefore, we can extract the 1:10 output from the internal model for each risk category and compare that against risk appetite to assess whether the group is operating within risk appetite. For example, if a class of business would like to take on more risk, then this can be parameterized into the internal model. And once run, we extract the updated 1 in 10 earnings volatility figure. If this figure turns out to be higher than risk appetite, the board has a range of choices. It can decide to increase risk appetite or, if not, ask the team to purchase more reinsurance or simply decline the request for more risk.

Then towards the bottom of the slide, the consolidated assurance report brings it all together, highlighting any changes to the risk landscape, explaining whether the group is operating within risk appetite, and reporting whether - and describing the status of the control environment and reporting whether there have been any risk incidents that we can learn from. In summary, we use a practical yet comprehensive approach to identifying and managing risk, which aims to lower earnings volatility and support capital efficiency.

Let me move on to my second topic, innovation and product development. This has been a strategic initiative here at Beazley since 2010. Given that we're a specialist insurer, it is important that we continue to innovate and develop new products. This keeps us relevant to brokers and our clients, and allows us to continue to attract talent.

Since taking over the exec sponsorship of this initiative, I focus on simplifying and communicating the process we follow to get products to market. We use four steps. Step one, idea identification. We use an Internet collaboration forum called the BHive. Step two, developing a viable product, developing wordings, pricing, marketing, distribution. Step three is all about product delivery, updating all of our systems and downstream processes. And finally, step four, provides post-launch support to fine-tune the products based on market feedback.

The executive are currently monitoring the progress of 15 new products, which are at various stages of development with six now in the product delivery stage as one of these launched recently namely Virtual Care. You may have seen the press release last week about this pioneering product, which provides an integrated insurance policy for healthcare providers and technology companies active in the growing telemedicine industry. It took just under a year for this product to go through this process, from that initial spark of an idea through to the fully launched product in the U.S.

Finally, I wanted to touch on the BHive Internet collaboration site, which actually includes a mobile app, so all of our staff can contribute wherever they are. We have about 20% of staff actively participating on the site proposing and improving new product ideas or process efficiency. We also have a relatively high success rate of converting the ideas into something tangible with about a third delivered so far in 2017.

I'm pleased to report that this focus on innovation is recognized in feedback from our stakeholders and has led to Beazley winning awards for innovation. Most recently, in 2016, we won two Lloyd's awards including the most innovative firm amongst Lloyd's managing agencies as voted for by brokers. I think Beazley's future is bright with this innovation.

And with that, I'll hand back to Andrew to conclude this morning's presentation.

David Andrew Horton {BIO 5697110 <GO>}

Thanks, Andrew. That's great. Our future is even brighter. This rating chart was the other way up actually, so we need to invert it. The challenge with rates, I'm looking at the outlook. Our aim, and we've done a pretty good job I think over the past few years, to keep the dotted line, which is the overall portfolio, as close to 100% as possible. So, despite the rating environment going down over many years now, several years now, if you look at the dotted line from 2008, we're only at about 96% or 97% of where we were back in 2008.

And that is the process we go through, and Neil has just kicked off this morning. He's taking a break from his business planning meetings, looking at the business plan for 2018 and trying to rebalance the business as far as possible, looking for the ones, which have the most margin at this point in time, staying in the ones where the margins are under most pressure and trying to keep that dotted line as close to 100% or even above it. I'm not sure you're going to achieve that for 2018 but, going forward, as far as we possibly can.

Why is it only just under the 100%? You can see the red line, which is specialty lines, Adrian Cox's business. That's been ticking up post the financial crisis. There's claims going through and investment yields are lower and has stayed relatively flat in 2017, and it's close to half of our business now. So, half of our business has been ticking up or flat.

The other line that's a positive thing, I guess, is the rate of decline is slowing down. So, in the reinsurance one, the marine one, the property one, you can see how they're kinking and they're flapping out a bit. We had hoped I think in 2017 some of those would have been flat rather than flattening out. And we're planning, in some cases, in 2018, they will actually flatten out. Overall, ratings are up, trying to hold that dotted line as flat and close to 100% as possible.

It is very difficult to get through any presentation these days when it's interactive without questions on cyber coming up. So, we've managed to get through almost to the penultimate slide without talking at any length about cyber. So, we'll just try to put a few bullet points to how we're thinking about and where we are at this point in time. It is our largest product. It's around 15% of what we do including the E&O part of the tech business. It's very U.S.-centric, as you all know, so we haven't really grown much outside the U.S. We have got this data regulation coming in next year, spring of next year within the EU, and we're ready to launch – launching the BBR product, the flagship BBR product into the UK, France, Spain, Italy and Germany, which should be exciting for us.

Just touching on the two events that have taken place so far this year, primarily against non-U.S. entities, primarily low loss events, so likely not to be picked up that much by insurance policies.

And the final comment, we're doing – we do mainly – our book on cyber is mainly a mid-market and small book, but we are writing the larger cyber in partnership through with Munich Re, which we now named the Vector product and partnership as we are covering very large businesses, cyber, and also mid and small businesses.

A crystal ball on the outlook. It's very difficult to actually write a different outlook slide in six months. So, we continue to see a low catastrophe claims environment. We do believe growing is going to be quite tough going forward, continue to focus on this mid-digit growth if we can by rebalancing the book as much as we can. That seems to have worked well over the past few years trying to protect margins as far as we can. So, aiming for this mid-digit growth, as Martin said, and then continuing with the same rate of growth ideally into 2018 subject to all the business plans we're now reviewing.

What do we focus on the growth areas for us? The U.S. is still a large growth area, and we wrote $750 million last year. It's still possible to continue to increase that, and we continue to invest people into that. Cyber, obviously, more growth in the U.S.. Not everybody is buying it yet and then internationally. And then, the specialty lines, the international project including the insurance company will continue to grow into 2018, which started in a relatively low base in SL International. So, that should be a growth possibility for us going forward, but growth is going to be quite tough. Margins are continuing to be under pressure.

And I'd just like to touch on Martin's point again on the special dividend front because that always seems to come up at this point in time. Our view of special dividends is we are going to be consistent with capital management. We assess it when we get through the windstorm season and have our defined plan set for 2018 with the absolute capital. Martin gave an indication of where we think the capital will be at the end of this year for next year's underwriting, but we don't know that until we've gone through the formal business plan process.

We are now open for questions.

Q&A

Q - Kamran Hossain {BIO 17666412 <GO>}

Good morning. It's Kamran Hossain from RBC. The first question, I don't know if I should let let someone like (22:55) Adrian on this. But it's nice to see that you released reserves from cyber and you talked about the 2014 year accounts and potentially being off kind of risk at this point. Do you have an idea of where or how profitable cyber is relative to the total group? So, that's the first question.

And then the second question, just following up on, I guess, the section on risk. What is the risk appetite on cyber or how do you express that internally? Thanks. Sorry, Adrian.

A - Adrian Peter Cox {BIO 16257010 <GO>}

On the – am I on? Perhaps, on the first point, we believe there's potential for systemic events in the cyber insurance. Those haven't really happened yet. So, we do price for them in the products. So, yeah, over the last couple of years therefore, cyber results have been quite good rather like kind of catastrophe insurance when there's no wind. So, we believe the products are adequately priced.

But in terms of saying over a long-term period, is it a high-margin product to mid-margin product? We're not really able to say yet because we don't really have sufficient line of sight on systemic events, how much they cost, how often they occur. But certainly in terms of current P&L, that the product is starting to contribute strongly to the bottom line of specialty lines.

A - David Andrew Horton {BIO 5697110 <GO>}

On the risk appetite, we have some similarities there. Till we look at the risk appetite on a similar basis to the net cap appetite, the main problem with the – not problem. We've spent a lot of time thinking about some scenarios that can actually happen. The main problem with the risk appetite on the cyber is we haven't had seen any of the scenarios we thought of happening while, on natural catastrophe, we planned for hurricane and it actually happens.

So, we do think of it in the similar sort of way. We haven't published a number yet because we just want to put more thought into it. But we are buying reinsurance around it, and you will have seen some seed (24:52), some cyber into 6107, which is our sidecar syndicate on the back of, if we think we got too much and taking out too much risk appetite, we will seed some away (25:00) and we do buy a reasonable amount of reinsurance both the credit share and surplus and through clash program to get an aggregated event.

A - Andrew Pryde {BIO 17257822 <GO>}

We spent a lot of time with external third parties to understand, from a technical perspective, how things may happen. It's an area that evolves. And so, that's why we're in this period of the risk team producing an annual review. If you take some of our other insurances, the way that things happen don't really change that off into the way a building is built, doesn't evolve every two weeks or so. And so, that's why there's that focus on understanding both the risk pricing but also the aggregation potential.

Q - Thomas Seidl {BIO 17755912 <GO>}

Thanks. Thomas Seidl from Bernstein. My first question is on people management. So, you hired around 100 underwriters over the last one-and-a-half years, which is a substantial inflow of talents. So, how do you manage this inflow? How do you make sure that these adhere to the underwriting standards and so on? So, just quite a big inflow of talent, I would say.

Secondly, on the top line and maybe related to this question, with this inflow of 60 underwriters last year, 30 this year plus cyber, 2% top line growth, it seems a touch low. So, the question is, what are the one-offs? Even an underwriter normally produces like say 5 million premiums or where is this business flowing out in a way?

And the third question is political risk accident, it seems to be in a tough place, the combined ratio, weak pricing down, expense ratio very high. So, is there a chance that this – is a segment, which becomes unsustainable at a point?

A - David Andrew Horton {BIO 5697110 <GO>}

Okay. Let me start and hopefully my colleagues can pick up some of those because, you see, there's three questions in that. So, from people management point of view, I think we spend a lot of time ensuring we're recruiting the right people in the first place. So, the effort goes into recruiting the right people who are going to fit in well to the company, culture of the company. The quality of our people is really important to us, It's probably first and foremost because we believe if we get that bit right, everything else will follow. So, we have a very good talent management function that ensures we bring in the right people.

As far as when we bring them in, they have to live with the underwriting controls and standards we have. And that is made very, very clear for the underwriters very early on through their induction process. So, there is no choice in which underwriting standards and controls and, Neil, our Chief Underwriting Officer, ensures that is well communicated and ensures it's applied consistently and continually. So, we have no problem with that.

So, I think we're quite good at recruiting. I mean, we've gone from two people to 1,200 people mainly organically. So, I think that is something we're very good at.

It's interesting your comment about the 2% growth with the number of people we've actually brought in because, of course, we're focusing most of the recruiting in the areas, which are growing most. And I suppose one of the challenges we have is why have we not reduced the number of people in the areas that have shrunk. So, the energy team is a good one. The energy premium is now a third of what they are but the team is the same size. And our view is that if we invest in the talent and we believe long term in the product, we don't stop taking people out. So, that's going to be – we're all going to have this investment issue and it possibly impacts our expense ratio to some extent as well. We're going to have this issue at this point in time. We're holding on to people who we spent a lot of time bringing in and are aligned to us, and therefore, we have not cut back the people in the areas that have shrunk while we have invested in the areas which are growing.

Yeah. You would think...

We've done a small amount of movement. We went after a small amount of movement of moving an underwriter from one area to another area but that's not that easy to do. (28:43).

A - Martin Lindsay Bride {BIO 15458196 <GO>}

Yeah. (28:44). I mean, our guidance for the full-year growth remains mid-single digits.

A - David Andrew Horton {BIO 5697110 <GO>}

Yeah.

A - Martin Lindsay Bride {BIO 15458196 <GO>}

So, our company is going to get one-offs. So, I think growth is higher than the 2%. And say, growth is 5%, there's actually two things going on. There's parts of the company growing at 15% and there's parts of the company, in terms of premium income, shrinking at 10%. And so, I think it was a great question. I post the same question to my executive colleagues on vacations.

A - David Andrew Horton {BIO 5697110 <GO>}

Right. Right. Yeah. So, we're on top of it.

A - Martin Lindsay Bride {BIO 15458196 <GO>}

But I think with those – the underwriters (29:14) and are supporting the growth in the businesses we're currently investing in. Our business model is – not all businesses will be growing at the same time. And I think we've got a platform that's capable of supporting future growth in the growth areas without adding underwriters necessarily at the same rate, albeit that we're always prepared to invest if we can find high-quality people who want to joins the company in areas where we still think there's sort of room for more underwriters, if I could put it like that.

As far as a PIC (29:50) division is concerned - well, I should say, part of our business model is to have a broad range of products driven by different cycles and somewhere in profitable phases at different points in time. That business - we've exited Australia. That didn't work as we would've liked. Our U.S. business is still in start-up mode. New leader for that business joined in the first half of the year. And so, currently there we have a cost base and not much premium income. And over the next two to three years, we're hoping to redress that.

But they are classes of business that fit the specialty basis that we had targeted on, and we believe they will have their moment again. If you look at the political team, in particular, it's delivered very significant profits over the years, albeit, terrorism in particular is one of the classes of business at the heart of price competition currently.

A - Andrew Pryde {BIO 17257822 <GO>}

And then, Martin, (30:57) just add back on the first point, obviously, the people side is quite important from my perspective. And so, that's why it's important to travel quite a bit and meet with the underwriters once they've joined to reiterate exactly the level of expectation. And Andrew encourage us all, all members of the exec, to get out and meet people, and I think that helps with the on-boarding.

Q - Nick Johnson {BIO 1774629 <GO>}

Morning, all. Morning. Nick Johnson from Numis. Three questions, please. Firstly, premium income growth in the marine and property segment is actually really strong given what's happening to rates. Just wondering if you could just remind us what the drivers of that have been. And secondly, acquisition cost ratio is up a little bit. Just wondering whether that is internal acquisition cost or external. Could you sort of give us a feel for what's moved there?

And then, finally, deferred acquisition cost on the balance sheet, they're also up really quite significantly, much more than premium income growth. Just wondering if you could talk to the reasons. Has there been any change in your cost deferral policy? Thank you.

A - David Andrew Horton {BIO 5697110 <GO>}

Yeah. Why don't I - no one else is going to grab the dac question, I imagine.

(32:13-32:17)

A - Martin Lindsay Bride {BIO 15458196 <GO>}

So, yeah, acquisition costs are up a little bit. Yes, there's a little bit more internal underwriting cost, Nick, and then there will be subtle mix of business changes, and not all businesses have the same commission rates. So, I think both internal and external drivers (32:37) of that.

dac growth is driven by two things. It's driven by premium growth, but it's also driven by acquisition cost rate. So, the reason dac is growing at roughly 10% is because we think our underlying growth rate in premiums is 4% to 5%. And then as you've identified, the acquisition cost ratio is up one point. And so, that has a sort of leveraged effect when you look at the dac.

There's no change in – absolutely no change in policy, and we tend to seek to defer as little as possible. In particular, we don't defer the variable compensation of underwriters in our dac, and we take all of that through P&L and the – are you going to have a go at...

A - David Andrew Horton {BIO 5697110 <GO>}

Just a bit to the marine is slightly unusual in that they found an area where rates are actually going up, which is transportation liability in the U.S., and it's an MGA we've been supporting since the beginning of last year and continues to grow, and the rate increase is positive. So, Clive has just the hand (33:48). The small niches are actually working well. It's core book of how almost everything else has flatted out. So, almost everything else is down.

The property one is interesting because Mark has done a good job, I think, of trying to get each of the areas using their risk appetite well and ensuring that we can get a reasonable share of the business. So, we've always struggled to get our U.S. onshore business running in line with budget, and this year it is doing well. We open market book in the UK, similarly is Lloyd's is doing well. So, I think that's an aggregation of relatively small bits rather than anything major that's going on in the property book. And he's also hedging a reasonable amount of it out because we're buying a reasonable amount of reinsurance against them.

Q - Andreas Evert Cornelis van Embden {BIO 1795530 <GO>}

Andreas van Embden, Peel Hunt. Just on the reserve releases and the reserve margin, if I look at the 2016 underwriting year, you don't seem to have released much from your cat margin. Is that because there's no more margin there or is it because you're holding it back for the second half of the year to release it against any losses?

A - Adrian Peter Cox {BIO 16257010 <GO>}

If you look at – yeah. So, the most common point of time at which reserves are released from last year's cat book is in the second half of the year.

Q - Andreas Evert Cornelis van Embden {BIO 1795530 <GO>}

And so, the decline in the reserve margin from 8% two years ago to around 6%, is that driven by your short-tail book? The margin there is sort of decreasing or what's driving that?

A - Martin Lindsay Bride {BIO 15458196 <GO>}

I'm going to give you the same answer to that question. 1% to 2% on that graph is just noise. So, really our message is the reserve margin is at broadly the same level, Andreas, and there's certainly no mix issue driving a change. The actual – our view is that the reserve margin is broadly the same level. It's potentially located in different places. Because, as I've said, there's less margin on the cat businesses, so, mechanically, they'll be carrying a lower percentage of the total dollar margin.

Q - Edward Morris {BIO 16274236 <GO>}

Ed Morris at JPMorgan. Two questions, please. The first is on specialty lines and the pricing outlook for that division. Can you give us an idea if there's any major difference between cyber and the non-cyber part of that business? And particularly, in cyber, it seems more and more companies are talking about doing this. What form is the competition coming? Is it purely on price or people starting to launch products that look a bit more like BBR?

And then the second question is coming back to risk, if that's okay. You talked about measuring risk on a 1-in-10 and 1-in-250 basis. Could you give us an idea of how cyber risk compares to other big (36:40) risks in the business and maybe how that looks today versus, say, three years ago? Thank you.

A - David Andrew Horton {BIO 5697110 <GO>}

I'll start and then Adrian will correct me after we've done the presentation. And so, on the specialized – I mean, specialized book is a relatively diverse book in itself. And so, it's going to have a mixture of pricing going up and down. So, I'm not sure I think of the – we think of the cyber as having a dramatically different rate increase or decrease but may do at this point in time and definitely the rates in cyber are coming off as they have been made three years ago when we saw rates in cyber, for larger cyber, doubling, tripling, quadrupling because there have been major claims. And not surprising when you go to a new line like that and no one really knows where it should settle out yet because we haven't released either claims, enough claims to check whether the pricing is right. That's on the larger side. But the smaller side, that tends to be less volatile. Never (37:30) pricing moves within narrow events. But Adrian, in his book, you're seeing some ups and some downs depending on the claims environment overall.

Was there another question (37:41)?

(37:42)

A - Andrew Pryde {BIO 17257822 <GO>}

I'll pick up the second question. So, this is sort of relative contribution of risk. So, follow it back at sort of Beazley from three or four years ago, we probably had two key risks. One was the natural catastrophe risk and then the other emerged from the casualty business, and that is having systematically mispriced the businesses. We know within specialty lines, they can take a number of years to understand the true claims costs. And so, those were sort of relatively equal a few years ago.

What's happened since, the rates of natural catastrophe have reduced. And so, the board has reduced the risk budget in proportion to that. And at the same time, there's been more opportunity within specialty lines. So, over time, those two risks have moved with specialty lines actually being the higher risk as natural catastrophe has reduced.

As we've grown the cyber book, what we've found is that that is emerging as the third risk. And so, if you're sort of wanting a risk ranking, I put it in those orders at the moment with the pricing of specialty lines followed by natural catastrophe, followed by cyber. And that may well continue to evolve as we enhance the portfolio and respond to market conditions going forward.

Q - Joanna T. Parsons {BIO 1558226 <GO>}

Joanna Parsons from Stockdale. Three questions, please. Firstly, could we get a bit of color on the projected speed of growth for the international business and Europe and trying not to mention the word cyber, but is cyber going to be one of the first classes that you see the growth or is it financial institutions? I mean, how do you see that portfolio panning out and if you give us some idea of when we might be starting to see a clear profitability from that book coming into the bottom line?

In the U.S., there have been a number of surveys, which seemed to suggest that commercial lines in the U.S. seemed to stabilizing a bit more. I wonder if you're seeing any of that. And at the full year, you talked about looking into more partnerships similar to what you've been doing with Munich Re. Is there anything in that arena that you can give us some insight on what's happening there?

A - David Andrew Horton {BIO 5697110 <GO>}

Okay. I mean, the growth in SL International, this is great. I love these questions because I can set targets for my executive colleagues who always want to come to the presentation. So, the growth in SL International starting from small – is starting from a relatively low base. So, in percentage terms, Jo, it's going to be quite high. The issue is how large can the book become. So, how large can the book become?

And Gerard came from running a book of €0.5 billion of international business. So, ideally, we want to get to this sort of number. It's unlikely to happen from what we write at the moment, which is about $100 million of European business to €0.5 billion within one year, I would have thought. So, we're going to be building on that. So, we're going to be building on that .

So, you could expect, in 2017, to add tens of millions of dollars of business on the back of the – in 2018, tens of millions of dollars of business on the back of it, and it's going to be a balanced book of looking at FI, which is Gerard' expertise, financial institutions, and MSI by the E&O and the management liability. So, it's going to be a balanced book.

But we've only just started, so we need to get – we haven't written anything on the European insurance company yet, so we'll need to see how that goes when we actually have the licenses in the four countries and we start marketing in the fourth quarter.

Q - Joanna T. Parsons {BIO 1558226 <GO>}

But presumably on that GDPR coming through May 2018...

A - David Andrew Horton {BIO 5697110 <GO>}

Yeah. Sure. That's Right. So...

Q - Joanna T. Parsons {BIO 1558226 <GO>}

...that it could mean that that...

A - David Andrew Horton {BIO 5697110 <GO>}

...should take up. But I think the comment we've made several times is there are more people in the starting line for Europe because we've all been revving our engines for a long period of time. The U.S., we got in very early, greenfield, launched a great product. Nobody seemed to want to compete for several years, and now the competition is coming in.

So, the guys in the U.S. are feeling more competition this year than ever before. In Europe, they're getting more people ready to jump in having seen what's going on in the U.S. So, I think we're more competitive from minute one.

Q - Joanna T. Parsons {BIO 1558226 <GO>}

Thank you.

A - David Andrew Horton {BIO 5697110 <GO>}

(41:58) U.S. commercial lines and then more partnerships.

U.S. commercial lines, I suppose, yeah, there is always talk about the U.S. seems to be flattening out a bit. And I suppose it's flattish, I mean, on the SL book in total, but it's still, as I was mentioning Ed, it's ups and downs in a variety of lines.

And the final one is partnerships. Partnerships, yeah, the Munich Re partnership is working well. We're still looking for partnerships. We have looked at a partnership and working with a company, an insurance company in Mexico to write more cyber into Mexico. And I think the one in Brazil is also a cyber initiative into Brazil. So, we have got two other partnerships. We are looking at cyber where it's hard for us to access. But we can access it on – through a partner. So, we do continue to do that, but we don't talk specifically about it and they're relatively small to start with.

Q - Andrew J. Ritchie {BIO 18731996 <GO>}

It's Andrew Ritchie from Autonomous. Sorry. A couple of sort of follow-up questions. First of all, just looking at specialty lines division, there was sort of an 8-point improvement in the loss ratio, half of that is PYD, half of it is current year. I'm a bit surprised the current year loss peak (43:13) has fallen. I mean, is that a mix effect? I guess, I'm surprised because the average rate is down a bit and the loss environment I don't think is any more benign in that division. So, maybe just a bit of color as to so why the current (43:26) fell so much?

The second question, you talked a lot about your 1-in-10 volatility appetite. But what is that appetite? Is it to lose all your profit in one year or to lose the quarter of the book? What is it? Just the actual number or some indication will be useful.

The third question, there was – Thomas actually asked the question about the political risk or the new division, the merged division and what we should think of as the sort of ongoing combined ratio there is obviously high in the first half. But maybe just give us a bit of guidance on that, it will be useful.

And finally, just on cyber, it's more a qualitative question. All the commentary we see and there was a big update from RMS a month or so ago about the amount of – the types of cover being offered in the market is widening dramatically, weekly, daily. Is that a concern? Are you having to offer – obviously, the breach product is the core product, but there's a lot of other things being added in now by competitors. Is that something that's concerning you? Are you having to take on more things like contingent, business interruption, et cetera, that you're not as comfortable with? Thanks.

A - Martin Lindsay Bride {BIO 15458196 <GO>}

Shall I start by tackling the specialty lines combined ratio? So, yeah, as you've identified, the biggest effect is reserve releases between 4 or 5 points. The two other things that are going on there are both mix related. That is the percentage of the cyber business within the whole portfolio because we opened that at a lower loss ratio than, what I'm going to call, traditional specialty lines business. So, as that grows, that has an effect.

The other effect is the split between U.S. underwritten business and London underwritten business in the portfolio because the U.S. business is – the premium is grossed up all the way to the original brokerage of the paid to the retail and the wholesale distribution in the U.S. And so, the opening loss pick in IFRS GAAP is lower on the U.S. business. So, you'll also get a slight trend of downward combined ratio as U.S. originated specialty lines business is a bigger percentage of the total.

Q - Andrew J. Ritchie {BIO 18731996 <GO>}

Will the expense ratio be higher or not than...

A - Martin Lindsay Bride {BIO 15458196 <GO>}

Yes. Yeah. Yeah. And you can see a mine (45:46) of it. As far as PAC guidance is concerned, the rating environment for terrorists and businesses is challenging. The life business does have an expense paid in the U.S., which it is going to take a couple of years to cover premium-wise. So, I think breakeven is the sort of level at which I would give guidance. Our contingency business has got some growth opportunities, but I think it'll be difficult for the contingency business, on its own, to turn the combined ratio around without some help from the U.S. Life, Accident & Health business getting back on track premium-wise. So, we probably got a couple of years to – of relatively breakeven performance I would have thought.

A - David Andrew Horton {BIO 5697110 <GO>}

And I don't disagree with my CFO, but as Christian Tolle sitting in the audience, I think it can be lower than that, it can be lower than 100% over the next two years because the political risk and the terrorism should be well under that. So, he has combination. He has many tools in his toolbox, so you can look at political risk and terrorism and contingency. So, breakeven would be disappointing because the PCG division was obviously profitable before it merged with LA&H and hoping it's not going to become unprofitable going forward. It's not trying to aspire to the LA&H profitability. It's the other way around, I think.

A - Adrian Peter Cox {BIO 16257010 <GO>}

But Christian, I'm certainly not going to disagree with the CEO.

A - David Andrew Horton {BIO 5697110 <GO>}

That's right. On the coverage one was an interesting one, isn't it, because the coverage is – the broadening coverage is on things without really thinking about them is a very dangerous thing for insurance companies to do. I think the excitement to the cyber policy is that coverage doesn't need to broaden out and cover other things that happen in a cyber event. So, we see that is a positive thing to do. We have seen people broadening coverage in 2017, and I think we've responded to it by actually thinking through what can we add, at what price, which makes sense and is still competitive. So, Adrian, Neil, and the team spend a lot of time thinking through this before we add, just throwing coverages into a policy at no extra price.

So, we all thought about it. We appreciate it's going to continue to develop. People were keen to compete against this, not surprisingly because we have a good position in it. But I think we've come up with a good solution, launching new products with further coverages that make sense, and we've understood the downside risk of doing it.

A - Andrew Pryde {BIO 17257822 <GO>}

And then on the risk appetite, the board doesn't declare what the risk appetite is. But if I give you a sort of an indicative view to help you understand the concept, for example, if it's graduated by risk category and is sort of set as a percentage of earnings. So, given that we're an insurance company and therefore taking insurance risk, unsurprisingly, the sort of percentage of earnings that we put at risk for insurance risk is at the highest. So, for example, if we're to put 100% of earnings at risk, when we then look at asset risk, then we don't want to put as much risk from assets and maybe take half of that. And then, if you take operational risk, then clearly the board doesn't want operational risk to happen. But that might be, say, 10% of earnings or something like that (49:07) to be able to rank the risk.

And then, I think for people to care about risk appetite, it needs to be measurable. And so, therefore, I can then report, as I mentioned in my presentation, the output from the internal model, linked in the internal model with the risk management framework to give the board an indication as to how close to those sort of earnings volatility potentials. We find that it gives rise to interesting conversation. So, when you're thinking about asset liability matching, so as profits were to go down given the cycle, it creates an interesting conversation about what to do with asset risk if you were to maintain the same sort of asset volatility.

And so, I think the most important thing for risk appetite is, A, making sure the board knows where they are against that line in the sand and also to create conversations, so that decisions can be made and knowingly rather than inadvertently finding that we're putting the same amount of risk to – earnings volatility risk from asset with insurance.

Q - Andrew J. Ritchie {BIO 18731996 <GO>}

So, after, say, 1 in 10, you'd still want to be within, let's pick a number, the 15% to 25% surplus target, for example, after that or does the 15% and 25% target surplus you're happy to go outside of that after 1 in 10? What I mean...

A - David Andrew Horton {BIO 5697110 <GO>}

I mean , that 15% to 25% is the surplus we're trying to run to of all points in time. So, yes, (50:33)...

Q - Andrew J. Ritchie {BIO 18731996 <GO>}

At all points in time, right.

A - David Andrew Horton {BIO 5697110 <GO>}

The aim is to stay within it. Now, if we had a catastrophic event, which meant we dropped beneath it for a period of time, then we'll be fine until we refinance up to it. So, we're not seeing it as a buffer. We would like to maintain the 15% to 25% pickup some sort of short-term volatility. I suppose we could go below it if we get to have a massive event and then we'd refinance back to up to the 15%, 25%, but I'm not sure they are necessarily linked.

Q - Andrew J. Ritchie {BIO 18731996 <GO>}

Okay.

Q - Barrie Cornes {BIO 2389115 <GO>}

Thanks. Morning. It's Barrie Cornes from Panmure Gordon.

I've got a couple of questions. First of all, on Canada, I'm wondering if you could tell me how Creechurch underwriters is settling in and whether or not there's any losses in the first half, towards the end of the first half in Canada that I've heard about.

And the second question, I know we've almost done cyber to death, but I might as well throw over the last one in on it. Just want to get a few of your net retention either on each every basis or in aggregate basis and how does it compare – I know it may be sensitive, but maybe you could compare it to windstorm losses or any other way, which we could get a feel for how big a risk you're running on an individual event.

A - David Andrew Horton {BIO 5697110 <GO>}

So, the Creechurch guys, in my view, are betting (51:45) in really well. (51:47) in a long time, so that we knew them all. They knew us really well and therefore it should be a relatively easy integration. As you all know, we're not really keen on M&A because of the cultural difficulties. But the company we've been supporting for 20 years, we've known the people a long time, it makes it a bit easier and that's working well. I'm not aware of any losses in Canada in the second half. Look at my group actually who's nodding their head or shaking head, shaking head (52:11). So, therefore, we're not aware of any losses. We haven't picked up anything specific in Canada in the first half.

So, what was the second...

Q - Barrie Cornes {BIO 2389115 <GO>}

Cyber network retention.

A - David Andrew Horton {BIO 5697110 <GO>}

Cyber network retention. Similar to other SL business where we will retain maybe up to $10 million or $11 million on any one risks, so the retention on cyber is no different from any other large risk E&O or management liability alike. We buy reinsurance about that and put out lines greater than that, but it goes into a surplus.

A - Adrian Peter Cox {BIO 16257010 <GO>}

The specialty lines clash reinsurance program has a retention of $30 million, Barrie. So, if events appear where we get claims from several specialty lines clients, that could be aggregated and protected by that cover, which has currently, I think, a $30 million attachment point.

Q - Barrie Cornes {BIO 2389115 <GO>}

Great. Thank you.

A - David Andrew Horton {BIO 5697110 <GO>}

Anything else? Great. Thank you for joining us this morning. Good to see you as always.

A - Unverified Participant

Thank you so much.