Q2 2018 Earnings Call

Company Participants

- Paul Robert Geddes, Chief Executive Officer & Executive Director
- Penelope Jane James, Chief Financial Officer & Executive Director

Other Participants

- Andrew J. Crean, Analyst
- Dhruv Gahlaut, Analyst
- Dominic O'Mahony, Analyst
- Edward Morris, Analyst
- Greig Paterson, Analyst
- James A. Shuck, Analyst
- Jonathan Denham, Analyst
- Thomas Seidl, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Hello and welcome to the Direct Line Half-Year 2018 Results Call. My name is Molly, and I'll be your coordinator for today's event. Please note for the duration of the call, your lines will be on listen-only; however, you will have the opportunity to ask questions later in the call.

I now would like to hand over to your host, Paul Geddes, CEO, to begin today's conference. The line will now go quiet until we're about to start. Thank you.

Paul Robert Geddes {BIO 2474781 <GO>}

(00:00:45) by saying that as you all have seen, this morning, we announced that I will step down as CEO next summer. As I approach my 10th anniversary, I think it's right to put a successor in place to lead the company in the exciting years ahead. Announcing it today well ahead of time will help us achieve an orderly transition. In the meantime, I'm fully focused on working with my fantastic management team to deliver the initiatives which I'm going to be outlining later in the presentation. But turning to the pressing matter of the day, our half-year results, and I'm joined by our CFO, Penny James, and members of the management team.

And without further ado, let's kick off with the highlights. 2018 has started well with a good financial performance and good progress on our strategic priorities. After normalizing for the first quarter weather losses, our operating profit was up compared to a very strong comparative in 2017. And even including that weather, we delivered a good combined ratio. We continue to grow our direct own brands and we're able to continue to reduce our expense and commission ratios. And Penny and I see further opportunity here. And this was supported by our strong balance sheet with solvency of 169% after growing our interim dividend to £0.07.

As we've shown, our model has given us resilience against market pressure on individual lines. The inherent diversification in terms of product, brand, and channel gives us options in different market conditions. And of course, there has been plenty of commentary on pricing in the Motor market in recent months, which Penny will address.

The observed behavior of the past few years gives me optimism that the market will continue to remain rational, but we are well prepared for a scenario where it doesn't (00:02:29). Indeed, the reiteration of our targets today shows our confidence in the strength of our diversified business model, our pricing discipline, and the good progress our talented team are making on the many initiatives we currently have in train. I'm going to come back later and talk you through those initiatives.

But first, I'll hand it over to Penny to run through the financial performance of the first half.

Penelope Jane James {BIO 15157212 <GO>}

Thanks, Paul, and good morning, everyone. Turning first to slide 6, I'm going to give you an overview of the main features of the results with more detail in the preliminary statements and the appendices for the pack. This is good results, particularly in light of the weather losses this year and the Ogden release last year.

Now, turning to the specifics. Operating profit was £57 million lower than a very strong first half 2017. Normalized for weather, operating profit was up slightly. Freezing weather in the first quarter costs us £75 million compared with just £9 million in the first half last year. Last year also benefited from a £49 million release in relation to the Ogden discount rate, while this year, we made a £10 million gain on the sale of our Bristol office and had higher investment gains.

So, when you look past all the one-offs, how's the business actually performing? Well, prior-year development continues to be favorable compared to our reserving assumptions, further demonstrating our prudent approach and resulting in a release of £30 million higher than last year, largely from the Home and Commercial book. In terms of current year profitability, we continue to make good progress. So, overall, I'm very happy with how the businesses performed in the first half.

On slide 7, we summarized some of our key financial priorities, and I'm pleased to say we've made progress against each of these this half. We've said 12 months ago that we have three priorities: one, to grow our revenues across the cycle; two, to improve our efficiency; and three, to continue to deliver underwriting and technical excellence.

Looking at each of these, on the top left, you can see we grew our own direct own brand premiums 3.3% with Motor continuing to drive performance. On the top right, you can see our expense and commission ratios are both down year-on-year. The bottom left chart shows that the combined ratio was 93% or approximately 91% on normalized weather, demonstrating our strong technical performance. And the result is a return on tangible equity of 21.8%, showing we continue to deliver excellent returns for our shareholders.

Turning to premiums on slide 8. On the left here, you can see the group's premiums. And on the right, the table shows the growth in our direct own brands. Direct own brand premiums grew 3.3% compared to last year, whilst overall premiums were down 5% due to the exit from Nationwide as expected.

Motors growth of 1.9% was slower than in recent years with lower prices and less shopping around. The exit from Nationwide drives the headline Home figure, although own brands grew 0.6%. Green Flag, our direct Rescue brand, continued its strong growth trend, up 13.3%, largely offsetting lower partner volume. And Direct Line for Business grew premiums 6.5%.

Turning to the loss ratio on slide 9. The headline loss ratio increased by 7.3 points to 62.1%. And the difference splits into the following three areas. The first is weather, which increased 4.2 points relating to the freeze claims in the first quarter. Our view of this loss (06:17) has remained quite stable from our initial estimate in the first quarter, so nothing new to report here.

Second, the current year attritional loss ratio increased 1.7 points, which is primarily a consequence of a change in product and channel mix as we exit from the Nationwide partnership. This is offset by improved commission ratio. So, we'll come to that on the next slide. At a segmental level, Motor delivered a 3-point improvement in current year loss ratio as it continued to earn through the strong pricing from 2017.

With higher reinsurance costs and lower price increases in the first half of this year, profitability of the business written this year is more characteristic of 2016 than 2017 and will start earning through more substantially in the second half. The strong Motor results was offset by higher ratios across the other divisions, which we'll come to shortly.

Third and finally, prior-year releases reduced 1.4 points, although releases remain significant at £207 million or 13% of earned premium. As normal, we conducted our large bodily injury reserve review in the first half. This is our biggest risk pool and has historically resulted in the first half prior year releases being higher than those in the second half.

We still expect the level of prior-year releases to reduce over time, as lower reinsurance retentions that we've been vying in the past few years reduce the opportunity for reserve releases or strengthening.

Turning to expense and commission ratio on slide 10, this is an area I've been very focused on with the ExCo since my arrival. And Paul's is going to talk, give a few more details on this later.

Starting with the expense ratio though in the first half shown here in the dark blue, we were able to absorb inflationary cost and achieved higher earned premiums which has provided us with the leverage to improve the underlying expense ratio 50 basis points to 24.4% in the first half of 2018.

The commission ratios, shown in the light blue, was 6.5% in the first half, 2.4 points better than last year. There's two parts to this improvement. About half of the improvement reflects changes to business mix and new partnership arrangements, which offset the loss ratio movements we've just described on the previous slide. The other half of the improvement relates primarily to the impact of our partners sharing weather, current-year and prior-year experience.

Now onto the Motor business on Slide 11, I'll describe some market perspective in more detail in a moment. But on this first slide, the facts (00:09:10) of our portfolio. In the first half, our average premiums were up 0.7%, but you can see from the table on the top left that pricing in Q2 became more challenging, amplified year-on-year by the rate rises seen in the second quarter last year after the Ogden announcement.

However, we have achieved our target loss ratios in the half and with claims experienced returning to our long-term claims inflation expectations of 3% to 5%. So, you can see our more modest premium growth reflects our discipline to prioritize our target loss ratio over volume.

Also, as many of you would've read (00:09:51), the Ministry of Justice has recently announced it's now targeting implementation of the whiplash reforms for April 2020, some 12 months later than originally planned. All these lead to a less benign claims outlook in our view than we've seen over the past year or so. I'll come back to this in a moment.

Turning to the good profitability actually achieved in the first half, Motor profit was flat at £238 million. The first half last year benefited from a onetime release of £49 million relating to a new Ogden discount rate, which was not repeated this year. And after taking this into account, prior releases were flat. As mentioned earlier, the current year loss ratio was strong.

Finally, at the end of December, we renewed our excess of loss reinsurance and 16% higher costs, reflecting the change to the Ogden discount rate, (00:10:44) through this year and next. We're pleased with the overall outcome and continue to look for ways to ensure that we're using our reinsurers as optimally as we can.

Now, slide 12 shows what the market has been doing. Here you see the ABI Motor premium data index at the start of 2014. The Ogden announcement in February last year triggered a sharp rise in premiums, which you can see in the chart.

In September 2017, the government confirmed that they intended to revise the Ogden process and indicated that the discount rate might rise between 0% and 1%. As a result, premiums started to come down, and this continued into the second quarter of this year.

So what's really going on through these tariffs? Starting on the left of slide 13, this time last year, we saw significant increases in claims costs from the Ogden announcement on top of normal claims inflation expectations. And insurers responded by increasing premiums. Through the latter part of 2017, claims experience was favorable and claims expectations were falling as Ogden was revised. Premiums follow suit.

During these two periods, the market responded quite rationally, we think, to current and anticipated changes to claims cost and showed healthy competitive dynamics. But where are we today? Well, moving to the right, I think the Ogden position is relatively stable, albeit the legislative process is yet to complete.

Underlying claims inflation has returned to long-term trends, and the implementation of the whiplash reform looks set to wait until April 2020. Based on the evidence to-date, we're optimistic the market remains rational. And, of course, you know what we will do, which is prioritize our target loss ratios over volume, focus on cost management whilst remaining committed to disciplined and targeted investments to improve our costs, pricing and claims effectiveness across the cycle and strengthen our competitiveness. I hope this gives a very clear picture of our priority.

Moving to Home on slide 14 where underlying performance has improved with a combined ratio normalized for weather a little over 2 points better. Starting with pricing where we were able to achieve price increases in the half both in direct and the PCW channels, our average premiums remained flat as we particularly grew in PCW business which has typically lower premium. New business volumes grew year-on-year while retention levels remained strong.

Turning to operating profit which is £47 million lower at £21 million, weather losses were £65 million before sharing some with our partners through profit commission arrangements. Normalizing for weather, our combined ratio improved by about 2 points.

We've been able to absorb the loss of Nationwide and expect to continue to do so as the loss of the book runs off over the course of this year. Prior-year releases returned to more normal levels in the first half having dropped last year due to high escape of water claims. We're pleased with how the team has been able to absorb the exit of Nationwide and continue to make current operating profit levels when normalized for weather.

Now, I'll talk to other businesses on slide 15. Commercial delivered a good result having incurred approximately £10 million of weather losses in the first half compared to none in the first half of 2017. The Commercial current year loss ratio was up 2.2 points, reflecting slightly higher claims inflation in its Motor book but broadly in line with the full-year 2017. Higher releases on the other hand was strong at £38 million compared with £27 million in the first half of 2017 as we continue to see good development on the property and liability books.

But overall, the market remains competitive, but we've been able to get enough straight away (00:14:54) across the portfolio to broadly maintain profitability level. Strategically, we've taken another significant step forward with Direct Line for Business, which Paul will update you on in a moment. Finally, Rescue and other personal lines profit was £8 million lower.

Within this, Rescue was £2.5 million lower as headwinds on that part of the business and some weather costs were partially offset by the strong Green Flag performance underpinned by new strategic plan which is now underway. And we look forward to telling you more about this in the future. Other personal lines was impacted by weather and some timing issues on our reserve and recognition which should even out over the course of the year.

Looking at the investment return on slide 16, total investment return was ahead of the run rate for the year, largely as a result of realizing in the first half most of the gains we expect for the year. Net investment income was £7.1 million lower primarily as a result of lower assets under management. As the construct of our balance sheet stabilizes for our current reinsurance program, we expect the trend for modestly lower assets under management to continue for the next couple of years.

As you can see, the continued divergence between U.S. and UK interest rates led hedging cost to remain high as we convert back to sterling floating rates. Available-for-sale reserve of £7.7 million was £72.5 million lower than at the end of last year, reflecting credit and interest rate movements and the realizing of gains in the half. Given the expected gains profile for the year, we continue to expect to achieve approximately £150 million of total investment return in 2018.

Turning to slide 17 on capital generation, going from left to right, you can see there hasn't been too much movement to report. We started the year with a surplus above requirement of £910 million. Solvency capital requirements remain broadly flat. Rising interest rates and modest credit spread widening all contributed to a negative impact from the value of our investments, as you will have seen by the reduction in our AFS reserve under IFRS.

However, this is partially offset by a reduction in our technical provisions which is included in our capital generation column. This totaled £310 million of capital generated in the half, a strong performance. Capital expenditure of approximately £60 million is in line with our expectations. And finally, the dividend of £0.07 for the interim is just over £95 million taking off surplus at the end of the half just shy of £1 billion.

Now, on slide 18, there's not much news to report on dividends. In line with our policy, we've increased our interim regular dividend to £0.07. As you know, it's our normal policy to aim to be around the middle of our risk appetite range of 140% to 180%. And as usual, the board will consider the appropriate of any additional capital return against this criteria and in light of the business plans and results at year-end.

Finally, our solvency ratio on slide 19. After all this, the group's Solvency II position remains strong at 169% after paying the regular dividend and comfortably within the risk appetite range.

Before I hand back to Paul, I'd like to close with the outlook and target from slide 20. I've now been in the business for nine months, and I can see that we can further strengthen our business by improving our execution and efficiency and have a few specific topics in my slide.

I'm confident that due to the investments we are making and by adopting a more disciplined and focused approach, we have a real opportunity to materially improve our efficiency. And this is key to achieving our 93% to 95% core target. As our investments in the business yield benefit, we expect to see a further rebalancing of our profitability from prior year to current year. Having re-based the regular dividend by 40% in 2017, we now stick to grow the dividend in line with the growth of the business.

And finally, on capital, we normally expect to be around the middle of 140% to 180% Solvency II target range. Of course, we maintain our long-term ambition to achieve at least a 15% return on equity.

And with that, I will hand over to Paul who will give you an update on what we're actually doing to achieve it.

Paul Robert Geddes {BIO 2474781 <GO>}

Thank you, Penny. As I said at the start of the presentation, reiterating our targets today shows our confidence in our business model, our pricing discipline, and the good progress we're making on our strategic initiatives.

So, here's the chart I put out last time with our channel strategies and over the next few minutes, I'm going to update you on our progress here. I'm then going to take you through the initiatives that we'll continue to improve the efficiency of the business and drive down our expense ratio.

Combined, they will show that we can continue to make our own luck. So, let's kick off with our biggest and most advantaged channel, Direct. And we've got a lot going on to drive this channel. The growth we've achieved across Direct Line, Direct Lines for Business and Green Flag demonstrates that if you give customers a reason to come to Direct, then they will. In Direct Line, we had a busy first half launching two new unique propositions on Home and Motor.

And the new Motor proposition was our biggest yet. We've removed one of customer's greatest frustrations and protected their no claims discount on non-fault claims. These two new launches takes us to a total of nine propositions customers can't get anywhere else. We've given them to all our customers new and old, helping deliver our strong retention levels, and continuing our virtuous circle.

Moving to Direct Line of Business, which has continued its profitable growth, this time last year, we said we launched a new platform to deliver bespoke insurance policies to small and micro segments. We started, as you'll recall, with the power of hair and beauty, and last time we spoke, we'd follow this up with bed and breakfast. I'm delighted to say that we've just released over 500 new trades, taking us to 75% of our target trades on the new platform.

And we said that once we have that scale, we'd ramp-up our marketing. So, last week, we launched a national campaign showcasing the flexibility our product gives these small businesses as they evolve and grow. I'm going to show you that ad in just a moment, too.

The success of the DL4B team is in part due to working in new ways and demonstrate that we have the capability and agility to quickly launch new innovative products to meet the ever-changing needs of our customers.

Then we come to Green Flag. We believe our challenger brand has great growth potential and demonstrated this again by having achieved another period of double-digit growth in policy count and premiums. Our marketing is focused on showing customers they can get a better deal by coming to us.

We'll play you our latest ads in a moment. They target the two-thirds of AA and RAC customers who renew without much thought. We aim to wake them up by dramatizing that we match the best things about their service and we can do that at half of their premium.

Service matters a lot in this market. Customers won't sacrifice it for price. That's why we give it so much focus. Now, as you'll recall, we've just brought in new leadership and brought the business together, not only in reporting lines but physically too, to create a rescue center of excellence to deliver this great service.

And we've just approved the new team's plan to help realize Green Flag's full profit potential. We're going to be using many of the same agile techniques that proved successful in delivering fast and affordable change for Direct Line for Business. We look forward to sharing more of that with you at a later date. Finally, Process Automation/straight-through processing, I'm going to cover later as it will benefit all of our channels.

So before we turn to PCW, let's look at those ads. Apologizing for those on the phone, you can only hear them.

[Video Presentation] (00:23:11-00:24:46)

Good. Three more sales (00:24:51). At the full year, I shared our plans next on PCW to move towards best-in-class. We actually start from a pretty good position here, and it was encouraging to see our Churchill brand start the year well, again proving that strong brands and propositions are also relevant to customers in this channel. But we recognize that great prices are critical in this channel, and that's why we're putting so many efforts into getting to be the best-in-class in fraud and pricing.

We've delivered some good practical initiatives, and our pricing team continue to make refinements to our pricing every day. But most of our work has been going on behind the scenes as we continue to build our latest generation IT capabilities. We're on track with the bills (25:33), which is going well. And we're going to testing late this year to begin rollout next. These systems are designed to step change our ability to use internal and external data in a split second to return a quote, allowing us to improve our loss ratios or write more business.

Our new pricing engine will make it much easier and quicker to develop, test and deploy new models, all with greater accuracy. This allows to better tailor our models to the PCW channel and also helps to step change our capabilities in market pricing. The same systems will also allow us much more product and underwriting agility, which is particularly important in the PCW channel.

Separately, we continue to make good progress on our alternative pricing project, which will give us leading-edge capability by applying new data science methods and machine learning. We believe this approach will complement our existing model and will increase our competitive quote footprint at similar or better loss ratios to our main model. We are progressing well with bills, again using agile methodology.

And finally onto partnerships. And again here, we are leveraging our digital capabilities. In the first half, we continue to grow our RBS home policy count and have a pipeline of new initiatives to embed home insurance within the bank's core channels even further. And the digital capabilities we've demonstrated through the RBS partnership is also giving us a great opportunity to talk to potential new partners.

Moving across to Rescue and Travel, here we're building a new travel system that's designed to enable customers to self serve and interact with us day or night, offering greater support when they need it most. Again, this digital-first platform gives us a great opportunity to talk to potential new partners.

And finally, on Motor where at the full year I told you about our new Motor partnership with VW Insurance Services, and six months on, I'm pleased to say it's going well. We've started by offering five-day driveway cover to customers buying new cars from Volkswagen's SEAT, Audi, and ŠKODA dealers, and we're pleased with the conversion rates we're seeing. It's very early days, but we're excited about the future with these leading Motor brands.

Finally, on to costs, and as Penny said, reducing our expense ratio is a key target, and we are acting on it with a disciplined and focused approach. As we've shown before, we can deliver cost improvements in tough markets, and the good news is that we can see a lot of opportunity. Here, you can see the six key levers we're working on, focusing on our largest areas of cost. Those on the left, the mature and have already delivered significant benefits. And as we go further to the right, the future opportunity increases.

Let's talk about marketing efficiency. Since listing, we've reduced marketing spend by over 40% in five years, and at the same time returned our own brand to growth. It's not an accident this happened. It is testament to the science behind our marketing, which means that the effectiveness of our brand is up there with the best in any sector. This team will optimize our spend by channel and will play their part in delivering the next wave of efficiency improvements.

Next, moving to more efficient UK sites. Over the past five years, we virtually halved the number of sites and reduced our annual rent cost by about 40%. A good example of this is our Bristol office where we used to have about 1,200 colleagues and a warren of offices within a dilapidated building. We now have a new building that's half the price of the old building.

So, offshoring and automation, we reduced head count 20% to around 950 people and coupled with hot desk and home working, our run costs in the new building are 55% lower. We also realized the £10 million profit on the sale of the old office, which you saw in the results today. Our bright new Bristol office, there's a real buzz about the place, and we're really looking forward to taking some of you there later in the year.

Next, automation and offshoring, where we've now automated over 35 processes representing tens of thousands of transactions every month. But we believe there are more opportunities here. Where we can't robotize, we'll look for opportunities offshore. We now have over 1,500 people in three locations largely providing back-office services but also some head office functions. Our benchmarking indicator, offshore penetration is ahead of the market but we still look of it as a source of opportunity.

These are all good examples of how we've already achieved extensive cost reduction in a targeted way that enhances the business for the future and we do see further opportunity across these. However, the final three initiatives could unlock the greatest potential opportunity starting with cost culture and agility.

Since becoming an independent company, we've made great progress in getting our people to care about costs and to remove wastes. Over 10,000 of our staff now own shares in the company, which is a great motivator and thousands have participated in our Idea Lab initiative where they share in their cost saving ideas. I recently gave a check for £50,000 to a frontline colleague for a simple idea that save the business over £1 million a year.

But there's much more to go after here. We've strengthened our central procurement team to work closely with the business to get better deals on third-party spend which makes up that much of our cost base. And as I said, we're increasingly using agile methodology to deliver change quicker and cheaper. But we still have much to go after as we roll out this more broadly into the business.

Next is IT run costs where we've recently signed a contract with a leading third party, which delivers significant cost savings from our new hosting and network strategy. Over the next few years, we plan to wind down and remove our mainframe whilst growing the use of the cloud. This is planned to give us flexibility in the future to deal with changing business requirements and changes in technology.

Finally, our latest generation of systems is designed to enable much more customer self-service and straight-through processing, giving our customers easier and quicker service at a lower cost. The new systems are also expected to make some critical head office teams much more efficient. But, overall, I'm pleased with the progress we're making on these new systems and lots of material progress on all our initiatives and a great focus on costs.

Before we move to your questions, a quick summary. We've delivered another period of good financial performance and continue to fuel growth across our own brand portfolio. As you've just heard, we've made excellent progress against our strategic initiatives with an emphasis on cost and efficiency.

And against that backdrop, we're confident that we're going to continue to deliver against our financial targets. There is a lot to do over the next 12 months, and I'm fully committed to ensuring that the initiatives we currently have in train will further improve our efficiency, technical capabilities, and customer reach.

Thank you, ladies and gentlemen. And I will now open it up for questions. Right. Where should we start? Let's start – yeah, start online.

Q&A

Q - Operator

Okay. Thanks. Just some company updates. First one is on whiplash (00:32:43) reforms. Do you think that the market anticipates the claim savings from these reforms and prices in advance? And is there a risk from that that vendor reforms are actually implemented that government wants more evidence of this discounting passed on? So, is there any risk of double discounting?

And the second one would be on this proposal from ABI and BIBA about reducing the difference in renewal and new business pricing. So, firstly, what is the percentage point difference between your renewal and new pricing? And can you give us a bit more color on how do you expect it to feed through your book?

A - Paul Robert Geddes {BIO 2474781 <GO>}

Sure. So, I think whiplash and Ogden are quite different in terms of prospects and timings, and I think Ogden is well expected to go through claims settling at zero to 1% level. Obviously, the impact this year is minor because it's basically baked into our reinsurance process. You saw it coming at 16%. I think the future whiplash reforms, we have pledged that it will be passed on to consumer and we just need to make sure we do that in a transparent and fair way, and you start point at the right stage and you measure it in the right way and we, as you would expect, given our industry position are closely involved in those talks.

I think the initiative the ABI took to be proactive on this issue of the discrepancy, new business discounting, I think is a positive step. I think it'd be more warmly welcomed. We, for a number of years, have been paying attention to this topic and work within a framework that we're happy with and we think it's really good that it needs an industry-wide approach to make sure it's a level-playing field as the industry moves forward on it.

Q - Operator

Thanks.

A - Paul Robert Geddes {BIO 2474781 <GO>}

Yeah.

Q - Edward Morris {BIO 16274236 <GO>}

Edward Morris, JPMorgan. Two questions, please. First is on the commission ratio. You had quite a big benefit this year both on the Nationwide transaction and also perhaps from lower weather claims. I wonder if you could just isolate the impact of weather on the commission ratio, give us an indication of what you think a normal commission ratio is going forward.

And the second question is on reserve releases. You've been guiding to these coming down over time for quite some time. How far are we in this process? Can you give us an idea of what we ultimately are trending towards in terms of reserve releases, so in three or four years' time, what do you see as a normal run rate?

A - Penelope Jane James {BIO 15157212 <GO>}

Commission ratios first. I think come down by, on Home, 7 points or 8 points over the course of the year. And I think it's about half and half kind of price commission factors so including weather, not only weather but including weather, and half sort of the MBS side. The weather side, you're right, should all things being equal, reverse off a little bit, equally, the MBS stuff is just probably over halfway through. So, I think with there or thereabout, make it a little further but not materially so.

And reserve releases coming down, and we haven't specified exactly when we've been flat, if you like, but the underlying performance keeps being better than our assumptions, which is a good thing and a strong thing. So, we're pretty comfortable that'll still strengthen those reserves in that some time to come. I guess the point I'd make is the 93% to 95% call reflects us being able to make that switch between prior year and current year, and the initiatives that you here and that Paul talked about all drive towards achieving that. So, that's the way we think about it.

A - Paul Robert Geddes {BIO 2474781 <GO>}

Andrew.

Q - Andrew J. Crean {BIO 16513202 <GO>}

Hello. It's Andrew Crean, Autonomous. Couple of questions. Firstly, I mean, you're clearly putting your foot down on costs more than perhaps in the recent past. Are you prepared to give any targets around – or improved targets around cost? And secondly, escape of water, could you give us numbers what the impact in first half 2018 versus 2017? And a general sort of update as to whether this is an issue which is being solved?

A - Penelope Jane James {BIO 15157212 <GO>}

Okay. Cost first, putting our foot down. Let's go to working harder as an ExCo. So, it's definitely in our focus putting this turnaround there. And the business has made a lot of progress to-date, but I think that further, it can – more it can do. And in this kind of environment and this kind of inventory, we really need to keep doing that.

We are not at the moment putting numbers on that view. Again, it's within the 93% to 95% trajectory. You've got the expense ratio passed, so a downward trend on the expense ratio that's all feeding into that. So, at this stage, I don't want to put further numbers on it.

Escape of water. I think the key is we're back on long-term 3% to 5% trends in Home. So, the actions that have been taken, both in claims and in underwriting, have kind of addressed the increased inflationary trend and it's now operating back on long-term track. So, back in shape.

Q - James A. Shuck {BIO 3680082 <GO>}

Thank you. It's James Shuck from Citi. I had three questions from my side. Firstly is just on the Solvency II development. So, as we roll forward to year-end and you think about how you've modeled and captured some of the risk in there, obviously, you've got the Ogden, which is reserved at minus 0.75%, it's obviously going to be – giving you a raise later in the year. So, for the full-year solvency, will you actually switch that to 0 to 1%? There's difference about how that goes through the IFRS accounts, but I'm interested to know what the actual solvency impact would be when you recognize that at full year.

And linked to that, we've seen a big decline in the PPO propensity as opposed to taking the lump sums. What would be the impacts on your Solvency II ratio at year-end on that basis, please?

Second question, the Motor...

A - Paul Robert Geddes {BIO 2474781 <GO>}

Oh, that's both one, is it?

Q - James A. Shuck {BIO 3680082 <GO>}

Yeah, that's one. I've become Greig. (00:38:53)

A - Paul Robert Geddes {BIO 2474781 <GO>}

Very good, 1a and b, okay?

Q - James A. Shuck {BIO 3680082 <GO>}

On the Motor attritional loss ratio, so 320-basis-point improvement in the attritional loss ratio at H1. You do mention the reinsurance impact on that. I'm just keen to get a feel for the actual underlying development of that attritional loss ratio, because pricing is up 1.1%, claims inflation return is in normal levels. It seems that attritional is going to get worse going forward at least on that basis. And final question is my favorite topic is the policy administration systems. Could you shed some light on how the pilot testing has been going so far? Perhaps give us some data around customer experience and retention rates? And just outline what phased roll-out would be in 2019 when that does go live, please?

A - Paul Robert Geddes {BIO 2474781 <GO>}

Yes. Well, I'll start with your fourth question or three. So, our policy system and builds are going well, going to testing later this year, rather next year, taking a phased roll-out. Probably for commercial sensitivity reasons, we only give our competitors a sense of – in fact, how we're going to roll it out. But we'll roll it out to bring it onstream in the way that minimizes risk and maximizes benefit. So, you're going to have to leave that down to us, I think. But please, where we're at is going well. You can pin Steve down later at the coffee break, look into his eyes. But, no, we're pleased how it's going.

Q - James A. Shuck {BIO 3680082 <GO>}

(00:40:24)

A - Paul Robert Geddes {BIO 2474781 <GO>}

Well, I said last time, we'd be really surprised and that's not the way the program is developing. We did what we needed to do. I think some of you and in the light of experience of other people, the right time to pull and get things right before you launch systems. But we think we're on the right track. Penny?

A - Penelope Jane James {BIO 15157212 <GO>}

Ogden. So, yes, it was running at 0.75% at the moment. Will it move at the year-end? Probably depends where the legislation gets to. I think, we'll take a few ones, what stage we are legislatively and may take a view on where to move in the range and so on at that point. Will it knock through to Solvency II? There will be an impact. Solvency II kind of reflects the range of possible outcomes a little more. There are other lows in Solvency II that's linked to that Ogden rate. But you should see some flow through from that.

PPO propensities. We don't automatically shift in line, you're right, at the very low rates. But we don't automatically think the two. It's such a long-term assumption, but we wouldn't automatically shift it and the sensitivities that we give around Ogden are pure, if you like, they don't have a knock-on effect of the PPO propensity and so it should be positive, but they're as the same degree as IFRS.

Motor. Yes, motor attritionals. So, you're right. You're seeing a strong uptick in the first half from the premium growth from last year kind of earn through. As you roll that forward into the second half, you've got two effects. One is at the growth level (42:03), the premium starting to come down again as the rates drops off into this year (42:08). So, you'll get more of that earning through.

And then the reinsurance cost that's up 16% from 1/1 (00:42:15). And it's risk attaching basis, so that's going to earn every two years (42:18). So, you're right. The second half, just mathematically before you get to any claims, particular claims trends in any direction and so on and so forth, mathematically, the second half should be lower just because of the earning profile, which is why we steered back in towards the 2016 levels to try and give people a sense that – even of the level of we'd expect it to write at (00:42:39).

A - Paul Robert Geddes {BIO 2474781 <GO>}

Right. Yes.

Q - Dominic O'Mahony

Thank you. Dominic O'Mahony from Exane BNP Paribas. So, just the first question back on Motor attritionals expectation. You said in the statement the business you're writing in 2018, you're expecting to be at roughly 2016 level attritional loss ratios. Could you just confirm whether that's written in 2016 or earned in 2016? And if you wouldn't mind reminding us what that number might have been, that would also be very helpful.

The second question is just on the trends in PYD (00:43:13) which as you said, you expect to come down. The way you described the driver, it sounds like a purely motor issue. Can you just confirm if that is true that there's no particularly structural reason to expect PYD (00:43:25) in the other lines to decline or whether actually there is a reason behind that?

And then the last one on the investment return, some bumper items in half year, guidance for the full year are unchanged. I'm just trying to understand whether actually that's an implied reduction guidance (43:41) for the full year, because when you strip out the bumper items, it's a lower number or whether actually the bumper items are just a sort of an acceleration of what you would have expected anyway for the full year? I'm really trying to think about more 2019, I suppose.

A - Penelope Jane James {BIO 15157212 <GO>}

Okay. Right. Okay. So, no particular order. Trends on PYD (00:44:00), yes, the most structural point is Motor points rather than a wider book point. Investments, it's an acceleration. It's really an acceleration of gains point (44:12). The only ongoing trend point that I've pointed out is one that I've made about – because of our reinsurance profile again, the assets should see a tweak down on AUM. So, that bit is a longer-term structural the gains point is facing.

Although I would just point out that given where property is in the cycle and so on and so forth, the opportunity for unrealized gains and so on and that has to be reducing every time, I think, from this point. But fundamentally, that's the investment story.

What was 2016 – yes, pointing back to 2016, we're running in at 78% at the moment. 2016 would have been in low-80s.

A - Paul Robert Geddes {BIO 2474781 <GO>}

(44:56)

A - Penelope Jane James {BIO 15157212 <GO>}

And so, I don't know what claims would do in the second half. So, I can't – I refuse to be held guaranteed for that, but (45:00)...

Q - Dhruv Gahlaut {BIO 16209870 <GO>}

Dhruv Gahlaut, HSBC. A couple of questions. Firstly, just going back to the question around the current year, given you expect Motor to deteriorate the current-year attritional. What are the areas where you'd see an improvement coming through from here on?

And maybe linking to that question, you haven't really said much about NIG this morning as in, how did NIG do within that 90-ish combined ratio, and what's the trend there? As in, how do you expect that business to move from here? Lastly, also on the Home business, would you update – actually, Home and Motor both, the retention rate, how that has done half year versus last year or last few quarters?

A - Paul Robert Geddes {BIO 2474781 <GO>}

Go ahead (00:45:40), Penny.

A - Penelope Jane James {BIO 15157212 <GO>}

I'm not sure I've got all of that. But I'll attempt and I'm sure you'll tell me when I get it wrong. Retention on Home, that's the last thing I wrote, yeah, retention holding up really just micro movements rather than anything else. So, really positive about that and I think Home, generally, we've been positive (46:01) that we've maintained growth in (00:46:02) in what's been a pretty competitive market overall, but retention, good.

NIG continue to make progress, so continue to move in the right direction. Our premiums were slightly off but profitability overall, a couple of points up this time, but actually overall, we're comfortable with the plans and the direction they're going in. So, we see that as a positive future.

And the last one was – I can't remember, (46:34). I can't remember. It's my writing if I'm completely honest.

Q - Dhruv Gahlaut {BIO 16209870 <GO>}

So, the attritional loss ratio, what could improve it from here given Motor is going the wrong way?

A - Penelope Jane James {BIO 15157212 <GO>}

And I think the way to – we're writing at a core (46:46), normalized weather, is 91%. I think we've – 2017 rolled into (46:57) this level of sort of super-charged numbers. So, I think overall, we're comfortable with that underlying run rate. There is a point at which you would trade the excess into growth at that strength.

So, the way you articulate it implies it's a problem, and I look at it and say that core is fantastic and I'm very happy with the attritional. So, we'll be very happy if we hold the Home book profitability at the levels we have with the exit of Nationwide and the competitive market space. And we're very clear that's what we mean to do. We think the future growth potentials are in the Green Flag and the DL4Bs and some of the other investments areas.

Q - Dhruv Gahlaut {BIO 16209870 <GO>}

(00:47:45)

A - Paul Robert Geddes {BIO 2474781 <GO>}

(00:47:45) What we have seen historically is, (47:51-48:00)...there'll be growth from above that. And we're doing a lot of heavy lifting on NIG to improve its pricing efficiency. And we've got more rate away (48:07) than claims inflation. I wouldn't always recognize that that quickly because we're pretty conservative. Initial reserve is on Commercial, so not all the heavy lifting is evident yet in the results. But we're encouraged by progress right now.

A - Penelope Jane James {BIO 15157212 <GO>}

(48:27) cost of capital; plus, it doesn't yet clear the target returns. So that's the (48:30).

A - Paul Robert Geddes {BIO 2474781 <GO>}

Good. Who's next? Right, yes.

Q - Thomas Seidl {BIO 17755912 <GO>}

Thomas Seidl from Bernstein. Three questions. Firstly is on claims inflation, you said it's going back to normal levels, that includes small bodily injury (48:43) or is it continuing to improve (48:47)? Secondly, the strong improvement on small bodily injury (48:51), how much impact is left on the whiplash reform, right? I mean, we had 8%, 9% I think (49:01). How much is really left after those strong improvements over the last two, three years? And thirdly on the Home, how do you describe the pricing environment in Home. You seem to have achieved good pricing. At the same time, you also reduced the risk mix. So, what does it tell you, or rather tell us about the price environment in Home, please.

A - Paul Robert Geddes {BIO 2474781 <GO>}

So, let me have a go at Motor claims inflation. So, I think we roll out the sleeves (00:49:23). So, just at frequency and severity, the frequency story is a really interesting one which is 2017 was an amazing year for frequency. And we said at the time, we're not going to trend it and I think we were right not that trend it. It looks like it was just one of those one-offs that may have been a bit of weather which is perfect weather last year. 2018 has reverted, and it actually might be in a little bit above trend. We think that's because it was the cold weather at the start and then hot weather and therefore it causes everyone to drive lots. And therefore frequency probably will go slightly above trend at the start of 2018. So, that's the frequency story. So, kind of generally flat but a bit down and then maybe a little bit up.

Severity, we think, is kind of probably the bottom end of the 3% to 5% range. And as you rightly highlighted, a game of two halves, accidental damage is above trend, probably above the top of the 3% to 5%, bodily injuries probably negative, I guess. And the bodily injury – and what's driving that is probably lots of things. It could be everything from car technology to the previous Jackson reforms to MedCo (00:50:34) now.

So, that's a different thing to whiplash. The only symmetry might be is obviously Lloyds is may be preempting future changes in their business model, but the only kind of – that's the only kind of thing you might already have a little bit from whiplash, because whiplash benefits are quite different to the things we should – have driven it.

So, the only kind of linkage between the two might be Lloyds business model planning. Between the two, I think I might be saying gas up here as a safe bet. So, I think if you multiply the two together, you can kind of see we had a better than trend year last year. This year is probably like to be more – kind of a more on trend year.

Now, if you then say that the pricing versus us in the market is kind of requirements to observe. So, you take a two-year trend, if you take the ABI data and strip out IPT, within the market's price, it's kind of 6% to 7% on that two-year period. Maybe half of that, you can say, is the real Ogden cost. So, it leaves about half of it left for covering claims inflation.

Therefore, what I'm saying is actually against that backdrop given the positive claims experience in 2017, it's not – it would take a two-year view. That's why we're saying the market is rational, because probably it's pretty close, we think, depending on how the market's done it. So, it's surprising that the real claims inflation observed in that period given that's not a great experience in 2017 (52:00) Have we nailed the Motor answer now? That's good for everybody. Right, shall we move on?

A - Penelope Jane James {BIO 15157212 <GO>}

(52:08)

A - Paul Robert Geddes {BIO 2474781 <GO>}

I'm sorry. So, there was one on Home. Sorry, Penny. Yeah.

A - Penelope Jane James {BIO 15157212 <GO>}

Home, I think, overall market is flat. Within that, we think a lot of the market is getting rates away. So, I think we are with – we're ahead also or thereabouts of the claims inflation.

What we're finding is there's one or two players. They're probably moving around a little bit who are pricing lower and bringing that down. So, overall, market is flat. But within that, there's quite a lot of divergence between the players.

I think we're pleased. We've managed to get rates away in both the main channels, and we're growing in both of those channels. You're right. There's been some reduction in risk mix and 00:52:52 and so on. But, overall, we're positive on that direction given that competitive market.

A - Paul Robert Geddes {BIO 2474781 <GO>}

Any more questions in the (00:53:00)? We're going to go to the phones in a second. Wow, quick one.

Operator

We do have a question on the phone line calling from the line of Greig Paterson from KBW. Please go ahead.

A - Paul Robert Geddes {BIO 2474781 <GO>}

Greig, (00:53:11).

A - Penelope Jane James {BIO 15157212 <GO>}

Greig.

A - Paul Robert Geddes {BIO 2474781 <GO>}

Hi, Greig.

Q - Greig Paterson

Could you just repeat when you talk about bodily injury, the severity points, I didn't actually get exactly what you were saying.

A - Paul Robert Geddes {BIO 2474781 <GO>}

I'm saying, Greig, that the – probably an average between accidental damage and BI perils. You get probably towards the bottom of 3% to 5% range, which is AD running well above 5% probably, and BI probably running negative.

Q - Greig Paterson

And you said something within the BI, you said...

A - Paul Robert Geddes {BIO 2474781 <GO>}

All I'm saying that the question was about linking have we had all the benefits of whiplash already, and I guess I'm saying not really because the plausible explanations of why BI is coming down are things that previously happened and whiplash is a different thing. And my only connection between the two is Lloyds is preempting whiplash reform to change their business models, might be giving us some benefit today from that. That's what I mean.

Q - Greig Paterson

I'm just trying to understand. So, in terms of BI severity small and large, what – can you just take those two and just tell me what you're thinking about...

A - Paul Robert Geddes {BIO 2474781 <GO>}

I think negative is what we'll say between the two. I mean, I think – actually both encouraging, right? Yeah.

Q - Greig Paterson

So, both small and large are negative.

A - Paul Robert Geddes {BIO 2474781 <GO>}

Yes.

Q - Greig Paterson

All right.

A - Paul Robert Geddes {BIO 2474781 <GO>}

Yes.

Q - Greig Paterson

Two other questions. One is if you just talk about the current year-on-year rate you think the industry or you're seeing, i.e., in August on Motor. And the second thing, I saw the advert that you had about guaranteeing on landlord insurance to meet any competitive price for the same policy. I was wondering how much is the cost? Is there a gain? I mean, what's the story with that? I'm just trying to figure out.

A - Paul Robert Geddes {BIO 2474781 <GO>}

Yeah. I mean, (00:55:09) we run fairly regularly. It's a sign of confidence in our pricing and yet, people do sometimes claim on it. But we got good experience in what that costs us, and we price it into the cost of the proposition. So, we've been running that since I've been here, which is a long time. That's really established. Penny – sorry, this was the...

A - Penelope Jane James {BIO 15157212 <GO>}

Year-on-year average rate.

A - Paul Robert Geddes {BIO 2474781 <GO>}

Yeah. I mean, basically, I mean, this is the...

Q - Greig Paterson

(00:55:35).

A - Paul Robert Geddes {BIO 2474781 <GO>}

I'm not going to give you an August update. I mean, I think what we're saying is the market is – well, Q2 and Q1 maybe our point of view is a little bit less deep in terms of reduction. We're still 1.1% on a kind of risk adjusted, mix adjusted basis. Listen, we're optimistic about the market. The market has turned left and right to claims trends pretty well. Competitively, we're optimistic it'll do it again. Obviously, we don't know what's going to happen in the future.

Q - Greig Paterson

Yeah. And the reason I'm asking the question is about two weeks ago or three weeks ago. Two weeks when they announced the deferral of one year in the whiplash, and the market had started in the second quarter factoring in.

A - Paul Robert Geddes {BIO 2474781 <GO>}

Yeah. I mean...

Q - Greig Paterson

I was just wondering whether there was a jerk back (56:22) given the lengthening (00:56:25) of the cycle.

A - Paul Robert Geddes {BIO 2474781 <GO>}

I'd say no jerk (56:26) but – and I think the other point is to think about how you'd stop dripping that into your pricing, probably people would have risk adjusted the likelihood of that anyway because there's narrative about that probably in Q2. And then it would only have been a twelfth and then a sixth (00:56:44) of renewal prices even if you did. So, I wouldn't expect.

Q - Greig Paterson

So, you didn't absorb any shock in the (00:56:50)

A - Paul Robert Geddes {BIO 2474781 <GO>}

No, no shocks.

Q - Greig Paterson

Right. Thank you.

A - Paul Robert Geddes {BIO 2474781 <GO>}

Yes.

Q - James A. Shuck {BIO 3680082 <GO>}

It's James Shuck form Citi again. Couple of follow-ups. Penny, just interested about your comment around the Motor normalized combined ratio being, well, ex-weather, I think you said 91%. Obviously, with the high level of releases in that currently, is that the view of where the underlying combined ratio is? So, if I was to look through that reserve releases and then where the attritional work eventually trend to so, i.e., is mostly really running 91% kind of normalized level?

And then second question is on Commercial. I'm just interested – obviously, you've got big plans to grow Commercial in the micro segment. You've got smaller areas that you're focusing on to begin with. But what was the size of that addressable market and what's your current footprint within that market size?

A - Paul Robert Geddes {BIO 2474781 <GO>}

Yeah. I mean, basically, as we said before, our Direct Line for Business, which is a big business, 450,000-plus policies. It's largely two businesses, which is a van business which is like kind of Motor and a landlord business which is really like Home. And actually SME is a relatively small part of it. We think that's £3 billion addressable market which is us working trade-by-trade within that 500 and going, okay, this is likely to stay a broker because the characteristics they've got, that sort of business, it's – their main task is very professional and they want a broker and here's a business we think largely can go direct. So, that's putting all those little slices together to get to the £3 billion.

Q - James A. Shuck {BIO 3680082 <GO>}

(00:58:29).

A - Paul Robert Geddes {BIO 2474781 <GO>}

No, that's the addressable market in the SME bit. So, we have – in our plans, we've got ambitious growth from that working out. It's going to take us probably a little bit of – trying out to get absolutely on the gas because we're requiring some behavioral change but we're helped in that by other insurers actually going direct. And as we said before, actually back in the 1980s and early 1990s, what made Direct Line grow was other people getting with the pricing cycle and more than one person trying to do direct. So, actually, our competitors are starting to do direct and SME, but we think it will be helpful to reassure small businesses, that it's an okay way to find things (00:59:09).

(00:59:11), do you want to clarify on (00:59:12)?

A - Penelope Jane James {BIO 15157212 <GO>}

Yeah, yeah. (00:59:14) Motor is, by way, the biggest book. I'd point back to the 93% to 95%, I think. 91% permanently would be kind of pretty rich, and we'd be well under I think that 93% to 95% target range if we're running at that level permanently. So, that's the place to look.

A - Paul Robert Geddes {BIO 2474781 <GO>}

Yes. (00:59:35)

Q - Jonathan Denham {BIO 19972914 <GO>}

Jon Denham, Morgan Stanley. Penny, would you just, I would say, quantify the net impact from Nationwide, the deterioration loss ratio and improving commission ratio?

A - Penelope Jane James {BIO 15157212 <GO>}

It's not huge overall. It's more of a rotation between lines. So, I don't want to give an exact number for commercial reasons, but it's not a huge impact on the operating profit. Hence, the fact with bit of work, we can absorb that and give some profitability then.

A - Paul Robert Geddes {BIO 2474781 <GO>}

Good. Last calls were within an hour, which is excellent. Any more on the phone? Excellent. No one's asked a question about me, which is excellent. So, I think that was an intuitive (01:00:20) confidence.

Thank you very much, everybody. It's been great. I will be here next time. Nothing changes. And we'll see you then. Thanks very much.
