# Q3 2015 Sales and Revenue Call - Interim Management Statement

## Company Participants

- Anthony Jonathan Reizenstein
- Paul Robert Geddes

## Other Participants

- Alan G. Devlin
- Andreas van Embden
- Andrew J. Crean
- Andy Hughes
- Ashik Musaddi
- Dhruv Gahlaut
- Fahad U. Changazi
- Gordon Aitken
- Greig N. Paterson
- Oliver G. Steel
- Ravi Tanna
- Sami Taipalus

## MANAGEMENT DISCUSSION SECTION

### Operator

Thank you for standing by, and welcome to Direct Line Group 2015 Third Quarter Results Conference Call. At this time, all participants are in a listen-only mode. There will be a presentation followed by a question-and-answer session. I must advise that this conference is being recorded today on Tuesday, the 3rd of November of 2015. And I would like now to hand the conference over to your speaker today, Mr. Paul Geddes. Please, go ahead.

### Paul Robert Geddes {BIO 2474781 <GO>}

Morning, everyone. Welcome to our Q3 update. As usual, I'm joined by John Reizenstein and other members of my management team. There's no formal presentation today, but I'm instead going to give you a few business highlights and then run through some of the headline financials. I will hand over to John for a few words on costs, investments, and capital. I'll then finish with the outlook before taking your questions.

In summary, it's been another busy quarter as we maintain momentum against our strategic agenda. The continued work we're doing to improve our propositions and differentiate our brands has helped us to maintain strong retention and customer advocacy scores. And this, as you can see, has led to an uptick in our own brand volumes and overall premium growth, particularly in Motor.

Before I discuss some of the figures, there are four key business highlights I'd like to put out from the quarter. First, one of our key initiatives over the last two years has been to differentiate the Direct Line brands. The highlight for this quarter was the inclusion of guaranteed hire car for all Direct Line Motor customers.

This is really exciting proposition, and together with the seven-day repair proposition and the removal of amendment fees gives our customers a unique proposition and a real reason to come direct to us.

Secondly, while we've been enhancing our product offering, we've also been improving our web presence. The launch of new Home and Green Flag quote and buy journeys in Q3 means we now have mobile and tablet-optimized websites for all of our main personal lines products.

Further, we continue to be recognized for our social media approach. And with the launch of Direct Line Magazine, we're now offering more insight to our customers as well as adding to our online – aiding our online search rankings. Combination of all these initiatives has resonated with our customers, and I'm really proud that Direct Line is now the UK's most preferred brand across both the Motor and Home.

From just being a significant quarter for personal lines, though, our Commercial division responded to customers' needs in this ever-evolving marketplace with the launch of Professional Indemnity for Direct Line for Business and Cyber through NIG. Both of these products are fully reinsured. Meanwhile, growth in eTrading and Direct has remained strong.

Finally, in the background, we're still busy working on the delivery for next generation of customer systems, and we plan to begin rolling this out initially for Motor during 2016. So, another busy quarter with lots more initiatives in the pipeline.

So, for update now on Q3 trading. We're really pleased with the progress we've made in the third quarter. Whilst our primary goal remains value, it's encouraging that all the hard work delivering our strategic initiatives has been driving forward our competitiveness across the portfolio.

Own brand policy camp (03:27) grew a little in Motor and was stable in Home, whilst GWP in Q3 was up 3% overall. Looking at the segments in more detail, starting with Motor, gross premiums were up 6.8% in the quarter, accelerating the trend we saw in the first half. Motor premiums are now up by 4.1% year-to-date. As I said, own brand policy count grew a little in Q3 with policies up now by 36,000 over the last 12 months.

In terms of pricing, our risk-adjusted prices were up 8.4% in Q3 versus last year, which is higher than the rise in Q2. This reflects the element of catch-up with the higher than expected inflation we saw in the first half of the year.

Claims trends were broadly similar to the position at the half year. There's been no change on small BI where we believe we continue to outperform the market. On large BI, the 2014 accident year has stabilized and we remain well-reserved. The 2015 accident year remains volatile, although it's still very early days and we continue to monitor this extremely closely. Finally, there has been some improvement in damage severity which is now more in line with our expectations. As we said before, we continue to trade the market as we find that will grow (04:42) when conditions allow or indeed pull back to protect value if needed.

Whilst on the subject of growth, telematics continued its momentum. At the end of September, we reached 67,000 policies, up by over 75% in 2015 to date. We continue to evolve our telematics product offering to take in a wider customer base. For example, last month, we launched a pilot where customers aged 26 and over can use their smartphones to get cash back depending on how well they drive in the quarter.

Moving now to Home. Home is currently in a different stage in the cycle to Motor, and we saw another period of new business prices deflation in Q3. Against this backdrop, we continue to maintain our competitiveness through pricing and claims projects. And together with strong retention, this led to a stable own brand policy count. Given the tough conditions, I believe this has again demonstrated the strength of our brands in this competitive market.

In terms of our pricing actions, risk-adjusted prices for own brands was down by just under 1% in Q3 versus last year. Putting all this together, our brand premiums were down 2% with good result in this market – our own brand premiums, as I should have said. We've seen in the last few quarters, partnership business has seen a great reduction in premiums and policies, given changes in distribution trends. We continue to work with partners to improve performance.

Next, Rescue and other personal lines, as we said, the half year, the rescue market has become a bit more competitive but we still manage to grow 3% in the quarter. Again, this has been mainly coming from Green Flag direct sales where our proposition is competitive. Other personal lines premiums were also up, mainly due to pricing on the travel book.

Finally, commercial traded better in Q3, with GWP up 3% versus last year. Regional business experienced a better quarter, although it's still competitive, particularly for larger accounts. Direct and eTrading continue to grow at a decent rate with policies up 7% on a year ago. This market has been a little less price-sensitive than the bigger ticket part of Commercial on our eTrading product suite and Direct offering have been helping here.

So, taking everything together, Q3 saw a combination of mixed market trends, together with the continuation of initiatives supporting our competitiveness. This has enabled us to grow in the quarter. We will continue to retain our focus on value.

I will now hand over to John for a few words on costs, investments, and capital.

## Anthony Jonathan Reizenstein

Thanks, Paul, and good morning, everyone. Let me start with costs. We continue to make progress in the third quarter, total costs including claims handling with £215 million, which is about 6% lower than Q3 last year. This means that year-to-date, our cost base is £49 million (sic) [£653.4 million] (07:28) or 7% below the same period last year. This is a good result, although as I said at the half year, maintaining [ph] this size of variance (07:36) becomes more challenging due to the progress we made at the end of 2014. While I'm on the subject of costs, restructuring and other one-off costs were £41.1 million at the end of September which, as we said at the half year, relates to a building exit and IT migration. Our expectation on restructuring cost for the year remains unchanged in the region of £50 million.

Moving to investments, we reported a total return of almost £43 million in the third quarter. Investment income was £41.5 million in Q3, bringing the year-to-date total to £124.6 million. This represents yield of 2.4%, which is up 10 basis points compared with first nine months of 2014. We also recognized a small amount of gains in the quarter, just £1 million, significantly lower than the same period last year.

Let me give a brief update on the portfolio actions in the quarter, as we continue to diversify the portfolio in a controlled way. Infrastructure's going well. We managed to increase our holdings just over 4% in the quarter. Private placements taking a little longer, and finding value in commercial property is more challenging than it was. This, together with further delays in market expectations for interest rate rises, has put some downward pressure on the 2.6% yield expectation for next year.

We thought it'd be useful to give you a brief update on capital, given Solvency II is only a couple of months away. The half year, we told you we had submitted our pre-application to the regulator. The new news is that the PRA has confirmed we have met the requirements to apply for internal model approval, which we intend to do during December.

We'll be using the standard formula for the first six months of 2016 before adopting the internal model from the middle of the year, subject, of course, to PRA approval. The risk-based capital that we've been using and the standard formula are based on different methodologies, but we expect capital coverage under the standard formula to be broadly similar to what it is under the current RBC system. And just to remind you at the half year, that was 156%.

As we said before, the board will next consider any return of capital alongside the 2015 results. At that time, the board will take into account the group's Solvency II standard formula capital requirement as well as our progress with the internal model. In line with our existing policy, we'll consider current and forecasted developments and capital requirements over a prolonged period. Furthermore, we'll also recalibrate the risk appetite range under the Solvency II internal model, and expect us to disclose that during 2016.

Now, back to Paul.

## Paul Robert Geddes {BIO 2474781 <GO>}

Thanks, John. So a brief wrap-up before questions. Our markets remain competitive. Motor's seen price rises, but this should be taken in the context of rising claims costs, which, as we said at the half year, were higher than expected inflation.

We'll continue to manage the trade-off between margin and volumes closely. Looking forward, investment in capability through new systems and improving customer experience will remain a priority as well improving efficiency and effectiveness.

In terms of 2015 performance, we reiterate our expectation of a combined operating ratio in the range of 92% to 94% this year. This is supported by the higher than expected prior year reserve releases we recognized in the first half, and assumes a normal annual level of Home weather claims of about £80 million.

As we said at the half year, the underlying trends remain broadly in line with our previous combined ratio expectation of between 94% and 96%. So another encouraging quarter. And with that, I'll hand back to the operator for questions.

# Q&A

## Operator

Thank you. You do have a few questions coming through. And the first question comes from the line of Andrew Crean from Autonomous.

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

Good morning, Andrew.

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

Hi. Good morning, Paul. Good morning, John. I just wanted to get a bit more clarity on what you're saying on Solvency II. From what I can see, you're saying that there'll be a sort of two-leg assessment of your capital needs. So at March, you will look to see whether the prospective internal model delivers you higher than sort of 125%, 150%. And then some time during the year, you'll then reassess based on your internal model, whether 125%, 150% is the right range, and that could then lead to a second return of capital. Is that a fair assessment to what you're saying?

And also, following up from that is, are you prepared to say anything on how the capital requirement under the internal model may vary from the standard formula?

## A - Anthony Jonathan Reizenstein

Thanks, Andrew. Shall I lead on that one? Just on the latter one first, I think we'll stick to the line we've said previously, which is we do think there's benefit to doing internal model, otherwise, we wouldn't do all the work. And so there is upside in terms of capital. So I think we've said that before and we still believe that to be the case, but we haven't given any numbers on it. And I won't today because we're still in – we haven't even submitted our application yet, although we're making good progress.

On the first point, just to be absolutely clear, what we're saying is at March or the year end when we report, we will make a decision about return of capital based on the standard formula which we will announce for the first time as an actual number for the year end, and that will be the base upon which we decide whether to – what dividends to pay.

And that won't take into account – or very unlikely to take into account internal model, because we'll still be in a process with the PRA at that point, and I don't think we'll have any big news to announce, although we'll give an update on progress. I expect that update will be more about words on logistics and timings than about numbers. So we're well into through the first half, we'll make that progress and we'll get to the number with the PRA.

We also have done our work on risk appetite, what should the range be, how wide should the range be off our internal model number. And that will also be done within the first few months of next year. So, it will be late but all that stuff will emerge after March. So, there won't be much of quantum in terms of the internal model, if any; probably none in March. And there won't be any indication of returns of capital based on the internal model for that same reason.

Everything we say will be based on a standard formula. Is that...

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

And so, there's potentially another look at capital, so March 2017 or August 2016?

## A - Anthony Jonathan Reizenstein

Well, no. I think the – we look at capital frequently but at least twice a year because we report it to you. And I think the second – the first half, the interim for next year, hopefully, if we make progress with the PRA and so on, will be another important milestone for us to report how we're doing on internal model. And hopefully, we'll have a number and then capture data (14:47) about what that means.

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

Okay. Great. Listen, thanks.

## Operator

Your next question comes from the line of Oliver Steel from Deutsche Bank.

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

Morning, Oliver.

## Q - Oliver G. Steel {BIO 6068696 <GO>}

Hi. Morning, Paul; Morning, John. A couple of questions. First, I'm a little unclear on what you're saying about Motor claims trends, because in one paragraph, you talk about Motor and Home claims trends, underlying claims trends being in line with the first half. And then the second – another paragraph talks about sort of price acceleration reflecting claims inflation trends or something like that. So, I wonder if you could just give us a little bit more clarity around how claims trends relate to that 8.4% increase in pricing that you'd seen year-on-year.

And then secondly, thinking about the 94% to 96% sort of underlying everything type of guidance, is – I mean, implicitly, you're telling us there what you think the excess reserve releases are for this year. So, I was wondering if we can then take that as being a sort of underlying type of guidance and looking through into 2016 as well on how we should be thinking about sort of reserve release going forward?



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

Sure, I'll let John do the second. I think on the first, the math, it was pretty similar to what we said last time, which is claims inflation has turned out to be more than we thought it was, and in hindsight, we haven't fully priced it in 2014. So, we've got a bit of catching up from that, as well as claims inflation from this year. And you put both of those together and that you see why we need 8% to hit the sort of loss ratios we want to target. So, that's what we mean by catch up. And I think we (16:51) today on some of those claims trends, but it's still probably not a million miles away from where we thought it was three months ago, just some slightly more encouraging news on a couple of them.

Did that answer it, Oliver?

## Q - Oliver G. Steel {BIO 6068696 <GO>}

Well, I guess, I'm still – I mean, are current prices ahead of current claims inflation?

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

Well, we're trying to price to a loss ratio that we want to achieve, and so the percentage is bigger. We're off a base that wasn't fully priced the loss ratio we wanted to start out a year ago.

## Q - Oliver G. Steel {BIO 6068696 <GO>}

Okay.

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

So, we've got to do a bit more than claims inflation to get back to that.

## Q - Oliver G. Steel {BIO 6068696 <GO>}

Got it. Okay. Thank you.

## A - Anthony Jonathan Reizenstein

On the second, Oliver, the 94% to 96% obviously is underlying COR for this year. And you're right, it does reflect the higher than expected prior-year releases we had in the first half of the year; so that's correct. We haven't given any guidance for future years. I think it's likely, because we got into a bit of a habit on this, that we will give COR guidance at the year-end for 2016. But we haven't given any yet, and we're not going to do it 'til then, when we have the full year under our belt and we've seen what's happened with reserving and the Q4 answer to the pricing question you just asked Paul.

So, in terms of looking-forward, I think all we've really got that's on the table that we can talk about is the 15% long-term COR ROTE target. And the sense that we've given that over the medium term, the prior-year releases will reduce as an input to our P&L, as the current year in the expense ratio, as we invest in those things and intend to improve – and seek to improve them.

So, I think you'll have to wait, unfortunately, for an update at year-end to that last question.

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

And, Oliver, just to get back to the major one. Just (18:40) obviously, as we're now playing catch-up, there'll be some quarters (18:45) obviously have a little bit of a drag as we catch that up, as we've said at the half year (18:55) Okay. Thanks a lot.



## Operator

Thank you. Your next question comes from the line of Gordon Aitken from RBC.

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

Hi, Gordon.

## Q - Gordon Aitken {BIO 3846728 <GO>}

Morning. A couple of questions, please. First, you've been able to push prices up. So, you've talked (19:12) about this north of 8% and ahead of the market, and retain the number of policies. I mean, are you sensing a reduction in competition here, or is this a strengthening of the customers' perception of your own quality, such as brand and service, or is this a case of both? That's the first question.

And the second question is, one of your competitors is pushing cross-selling Motor and Home into their substantial pension's book. Is this a concern for you? And if you could just update us on how many products do your customers have currently on average and what you would hope that to get to.



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

Good. Thanks, Gordon. I mean, I think versus a couple years ago, I probably would observe some of the kind of no-name players maybe out of Gibraltar, feature less on some of our comparison tables than they did. But there's still very active competition in the market and you'd recognize many of the names. And, as we said before, (20:06) in terms of kind of who's competitive at any one stage.

I would play a bit of credit for the stuff we've done in terms of self-help. We're working very hard on lots of pricing initiatives, lots of claims initiatives, and I think we're talking a bit more actively about brand and customer service and customer proposition. We've seen really good improvements in Net Promoter Score. I think our marketing is working well. Our propositions, I think, they're really strong in the market. Direct Line is going well as is Churchill going well, which is also very helpful from us because those are our real value-added brands. So, I think the market is part of it, but I also think self-help is part of it.

I think on cross-selling, a couple things. We're not bad at cross-selling. We're pretty good. It was something which we talked about at the IPO, if you remember. Some are stats (21:00) if you want them, 40% of our Home new business comes from people on Direct Line that already had a Motor policy; about 40% – just under 40% of Direct Line new business gets the multi-car discount. So, that says we've already got one car. And 20% of our Motor policies, we sell Rescue to. Now, those aren't bad. Obviously, the Motor sales into the Home book would be lower, because one (21:30) typically grow the Home book out of a Motor book. And with those percentages, we see opportunity.

So, we – all my experience at cross-selling over the years says if you can make products easier and better value, if people buy them from you and there's a brand logic to you doing it, then customers will do so. So, we see a lot of opportunity in selling more multiple products, more multi-car, more Home into Motor, Motor into Home, travel, pet, et cetera. So, those are logical products when you talk to the customer.

Now, I think in terms of one of our competitors talking about pensions, I think there are two things in that. One is a, I think, an observation that if you understand somebody's psychology and if someone pays well (22:27) for their pension that probably tells you something about them being a good risk. Now, that is data we're able to access, we think, in other ways to get at the underlying what sort of person is the customer.

There, I think, as a cross-sell, they obviously believe that's an opportunity, and good luck to them. But I think we have quite nearer-term opportunities, I'd say, and just making a better job of cross-selling within our kind of suite of products, as well as getting this particular insight, I think, they're on to in terms of people that save, that does say something about their likelihood to claim, which is why credit score has been something that insurers have been interested in for years.

## Q - Gordon Aitken {BIO 3846728 <GO>}

Thank you.

## Operator

Thank you. Your next question comes from the line of Ashik Musaddi from JPMorgan.

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

Morning.

## Q - Ashik Musaddi {BIO 15847584 <GO>}

Hi. Good morning. Just two questions. So, first of all, you mentioned that your 2015 business has been a bit volatile. Can you give a bit more color what you are trying to say here? Is it something we need to think about when we come to the reserve releases or reserve additions? That's the first one.

Also, you mentioned somewhere that the Motor volumes were particularly strong in Churchill as compared to your other business, which is online Direct. So, what's going there? Why is that a difference? And at any sense on profitability, how we should think about that? Yeah. That would be great. Thank you.

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

Yeah. Thank you. I'll let John talk about the 2015, I think, the large BI trend you're referring to. Just on our brands, we've slightly changed the relative positioning of Churchill versus Privilege, and we've been really pleased by the results. We've got slightly rejuvenated marketing on it. People love the Churchill brand. We can get Churchill just a little – people (24:15) a little bit of a premium upfront. And if people can get a brand as good as Churchill for not a lot more than our basic brands, they – it turns out they will do. And then we like that customer if they tend to have then some other attractive things like great retention. So, we're really pleased with how we've played that.

I think the other dynamics we talked about before is that I think we're pleased with how Direct is working, particularly on – well, Motor and in Home. So, that's a trend which has been more positive than in previous years, and I think that's partly because the job that we're doing in terms of giving people good reasons to come to Direct Line. John?

## A - Anthony Jonathan Reizenstein

Yes. Let's talk about 2015 large BI. But just to give it some context, I think we've said that 2014, which had been elevated, still elevated but it's looking a bit more stable than it was last time we spoke; still, the year with highest BI - burn cost for large BI.

At 2015, it isn't this high and haven't been as high as that at the same stage of developments. But whilst the 2014 for the monthly data looks to have stabilized, the one data for 2015 evidently hasn't. So, we've had some better months of data and some worse months of data. And it is a very immature year, clearly.

But I think in terms of your question about future prior year releases, it probably means that we're more likely to get releases from 2014 now than from 2015. Now, the timing of those releases is also uncertain because these being long-tail liabilities and all our - we'll have seen very, very few settled yet (26:03) incurred. They may not be particularly quick, those releases, but I think on the (26:08) on today's date, you'd say 2014 which we certainly reserved (26:21) very conservatively is more likely to release in 2015.

Yeah. I think we've said before we do believe there have been some changes - well, there have been some changes in claims processes that make it likely that we're getting some earlier reporting. However, we are not yet in a position to confirm that we can all breathe a huge sigh of relief and say these are not really inflated at all or elevated at all. We're not saying that yet. If we can, in the future, we'd love to be able to do that, but we're still waiting for more data and still investigating.

## Q - Ashik Musaddi {BIO 15847584 <GO>}

Yeah. That's great. Thanks a lot, fellas.

## Operator

Thank you. Your next question comes from the line of Ravi Tanna from Goldman Sachs.

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

Hi, Ravi.

## Q - Ravi Tanna {BIO 16926941 <GO>}

Hi. Good morning, Paul. Good morning, John. Just - a couple of my questions have already been answered actually, but maybe a couple more. The first one was just with regards to your inclusion of guaranteed hire car within your comprehensive Motor policies. So, I was just wondering if you could provide us with any sorts of details whether it'd be financial for yourselves or in terms of the headline price impact for the customer and how this impacts whether ancillaries versus your core insurance premiums?

And then the second question was just going back onto the 2014 accident year stabilization in large BI claims frequency. Just to push you on that maybe slightly, in light of that, how should we think about your guidance around reserve releases for 2015 being at lower levels than 2014?

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

Okay. Thanks, Ravi. So, yeah, listen, we've invested a bit in the proposition. So, we've given some for free that we used to charge for the premium line. Why do we do that? Because, these are very valuable customers and we want to make sure they have a very good proposition and the monetization of that is more people will come, more people will stay. So, I think it's a really good investment.

And yeah, there's accumulating effect of all the stuff which we're doing in Direct Line, which is starting to kind of make this brand feel like it's really relevant. And, as I said to you before, it's – (28:24) held its own in the market, driven by the stuff that Direct Line and probably Aviva is doing in the direct space. John?

## A - Anthony Jonathan Reizenstein

Yeah. Ravi, thanks, I think the answer is we're still sticking by that guidance which is our expectation is that our prior year reserve releases for this calendar year will be lower than last year.

## Q - Ravi Tanna {BIO 16926941 <GO>}

Okay. Thank you very much.

## Operator

Your next question comes from the line of Dhruv Gahlaut from HSBC.

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

Hi, Dhruv.

## Q - Dhruv Gahlaut {BIO 16209870 <GO>}

Hi. Good morning, guys. Just a couple of questions. Firstly, just going back to the amendment fees on the Direct Line brand, could you say what is the financial impact of this? And also, would you be looking at doing something similar for the Churchill brand as well? That's one.

Secondly, just going back to the question about the large BI claims. Could you say as in how that's impacting the booking of reserving as in last year – as in 2014 accident year, you've taken a reserve strengthening last year. If I was to compare the 2015 booking, how should I be looking versus that number; is it higher or lower than that? (29:35) Where exactly are you booking the 2015 number?

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

Okay. So, on...

## Q - Dhruv Gahlaut {BIO 16209870 <GO>}

And also, sorry. Just Nationwide as well, as in when do we have more on Nationwide?

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

So, no news on Nationwide. We'll let you know if we hear (29:48) On the amendment fees, we're trying to, as we said before, offer different propositions to different sorts of customers. So, not to say we would never do on Churchill, but this is a differentiating thing for Direct Line. Direct Line customers really like it. They've repaid us the investments that we've made. We've seen a benefit in retention because customers are more likely to stay with us when they amend their policy.

So, we will feel good about that, but slightly different sort of customer buying a slightly different sort of proposition, more on price comparison websites. So, it's slightly (30:20) but not to say we would never do it, but we're not automatically going to do it. We want our brand to be more different than they were.

John?

## A - Anthony Jonathan Reizenstein

Yeah. Just on the booking. We booked 2015 large BI lower than 2014. As we said, 2014 was the highest year we've had for many years. 2015 is somewhat lower. Obviously, I've said that we're feeling a little bit more optimistic about 2014. So, I guess, 2014 could come down in the future although I can't give you a number or timing. But, yeah, at the moment, 2015 is booked lower than 2014.

## Q - Dhruv Gahlaut {BIO 16209870 <GO>}

And just one follow-up on the retention, as in, could you say what is – how much is the difference in the retention between the Direct Line brand and the Churchill on the Motor side?

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

It's – I'm looking at the numbers, but I think it's probably commercially sensitive for us to kind of share that with you, but it's higher – meaningfully higher. But that's to say Churchill has a pretty good number as well, and Churchill is higher than Privilege. So, that's just the nature of the customers in the markets we serve, and Privilege (31:25) other things as well.

## Q - Dhruv Gahlaut {BIO 16209870 <GO>}

All right. Thanks.

## Operator

Your next question comes from the line of Sami Taipalus from Berenberg.

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

Hi, Sami.

## Q - Sami Taipalus {BIO 17452234 <GO>}

Morning, everyone. Sorry. Just two questions, please. First of all, on rate increases. Do you think there's a risk at all that once you kind of stop putting to (31:50) rate increases in the direct space, that's going to lead to some increased churn or increased shopping realm which might push more customers into the aggregate space? And the reason I'm asking that is just because the rate increases in direct space seem to be higher than in the aggregate space and the premiums in the direct space still seem quite a bit higher, about 50% or so, than in the aggregate space.

Then the second question that I have is on capital returns. You mentioned that you might do – change of risk appetite once you get internal model approval. And I'm just wondering whether that's just related to the capital requirement falling, whether you might do other things, like maybe reduce the coverage or change your capital structure. Thank you.

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

Thanks, Sami. So, we know the survey, I think you're referring to on the different rating between direct (32:51) We're not particularly compelled by the data. Our own retention rates have actually notched up a little bit Q3 on the year are pretty much in line with where it's been for the first half. So, retention I'll say it's pretty stable.

Obviously, we've got IPT to happen, which, everything else being equal, if it is passed on, I'm not saying – I can't say anything about pricing, but if it would be passed on obviously that's price increases which one might think could cause maybe more people to (33:24) So, we'll wait and see with that. What we're saying is that we're definitely collecting the tax from the Chancellor, but in terms of how we price it, that's obviously commercially sensitive and you wouldn't expect me to comment on that.

## A - Anthony Jonathan Reizenstein

Yeah. The question over the risk appetite question, Sami, I think what we're saying is we just want 125% to 150% risk appetite range for the last few years based on the old system. We got this transition period for first six months of next year where we're into a temporary new system, a standard formula, but it's not that different than the old one. So, the risk appetite recalibration work we're doing is based on the internal model, which of course is yet to be approved. So, it's going to take a little while, a few months.

And so, it's a completely different model, the Solvency II model. It is different on the resources definition. It's different on the requirements. It's more volatile. And we get to go through discussions with the PRA, which aren't just about the calculation of the model, but they're also about stresses and scenarios and all the testing we have to do on a regular basis.

So, all of that to be gone through and will input our risk appetite range, which we'll talk about during next year, but no, we won't be ready with (34:43) in March. So, that's still to come and I couldn't give you a range or anything like that now.

## Q - Sami Taipalus {BIO 17452234 <GO>}

Yeah. I wasn't really looking for a range. I was just kind of trying to gauge what sort of changes it might include with the...

## A - Anthony Jonathan Reizenstein

Yeah. So, the only thing that strikes me is that it could be a wider range because it's – so there's more volatility in the calculation. But that's a very high – it's very kind of seat-of-the-pants comment and I think it's much better for us to give you the full lowdown on it when we get there.

On cap structures, I think, what I'd say on that is we have a tool that's proving reasonably useful and resilient, which is if we have more capital than we need, we've got special dividends. Simple. Everyone understands it. I don't think – since we go that tool and it works, I'm not promising we'll use it. (35:33) but this is a tool that works. I don't think we'll be looking at our capital structure because we got that tool if we need it.

## Q - Sami Taipalus {BIO 17452234 <GO>}

Yeah. Thank you.

## Operator

And your next question comes from the line of Andy Hughes from Macquarie.

## Q - Andy Hughes {BIO 15036395 <GO>}

Hi, guys. A couple of questions, if I could. The first one is on the 8% price change for Motor. How should we think about it from a like-for-like basis had you've not made the change on Churchill to reduce the price in line with Privilege or given away free car hire to Direct Line customers? I mean, does that mean, if you hadn't done those two things, the price rises would have been substantially higher or is that included in the index? And if so, how?

Second question was on reserve releases. So, 2014 is going to be strongly reserved, but I'm a bit confused with squaring that with the idea that claims inflation is a lot higher than you expected. I mean, are you saying that 2014 is strongly reserved but less strongly reserved than 2013, was it the same points? And could you just talk a bit about that as well. Thank you.

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

Yeah. Okay. So, it's a comparison of kind of the base price to the base price rather than about amendment fees and guaranteed hire cars. So, that's going - excluded from that.

## Q - Andy Hughes {BIO 15036395 <GO>}

So, the actual price rise is probably lower than the 8%, if you allow for the free Churchill at best? (37:01)



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

Not free Churchill. Free Churchill?

## Q - Andy Hughes {BIO 15036395 <GO>}

No. I mean, in terms of the price of Privilege. So, if you'd sold (37:11) the Privilege policy, it would have been 8%. But now you've sold a Churchill policy which you would have charged 5% more for the last year, presumably, so the price rise on a Churchill like-for-like is only 3%.

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

Well, it is in totality. This is a simple average of all that stuff. So, that's included within it the amendment fees and the free guaranteed hire car (37:31) John, (37:32)

## A - Anthony Jonathan Reizenstein

Yeah. I think, this may answer the question, Andy. When we talk about claims inflation, obviously, that includes a number of perils in there - all the perils in there, the element that is Motor bodily injury excess, we will - we think - when we talk about claims inflation, we talk about a long term claims inflation trend not short-term volatility around those trends.

But obviously, we do get short term volatility around those trends. And what we previously said is that 2014, as we look back at it, look like it was above the trend, so we had to book for that. And whereas, 2013 and 2012 and some of the early years, were lower than the trend, so we got releases from those. So, we thought that 2014 was above the trend. It still looks like it's above the trend, but we've reserve conservative approach, (38:32) so I'm sort of feeling more confident about it. Don't think it's going to get worse, could get a bit better; but it's still above the trend. But that's how - why there's a slightly different assumption we come to obviously booking versus our view on claims inflation, which we build in the long term trend on large BI.



## Q - Andy Hughes {BIO 15036395 <GO>}

Does that kind of mean that 2012 and 2013 had exceptionally high reserve releases, because it was much lower than the trend you expected?

## A - Anthony Jonathan Reizenstein

Yes. Yes.

## Q - Andy Hughes {BIO 15036395 <GO>}

Okay. All right. So, we shouldn't expect the same sort of reserve releases from 2014 as you got from 2012 or 2013.

## A - Anthony Jonathan Reizenstein

Well, in general - yes, in general that will be true (39:11) if they're on trend...

## Q - Andy Hughes {BIO 15036395 <GO>}

Yeah.

## A - Anthony Jonathan Reizenstein

...won't give us as much as the ones which we know were better.

## Q - Andy Hughes {BIO 15036395 <GO>}

Yeah. No, no, it makes sense. Thank you.

## Operator

Next question comes from the line of Fahad Changazi from Nomura.

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

Morning.

## Q - Fahad U. Changazi {BIO 15216120 <GO>}

Good morning. Just a very quick follow-up on claims inflation. So, the market is – looks like it's also running at 8% according to Towers Watson. So, are you seeing the market, the claims inflation around 8%, which is probably sort of backed up by Aviva as well, and you're doing better than that. And could you please tell us what the number is for your current claims inflation? And if we could just harken back to your previous comments of a normal claims inflation being around 3% to 5%. I mean, are you still sort of expecting that longer term, or has your view sort of changed now? Thanks.

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

Thanks, Fahad. Claims inflation, yes, longer term, we're still holding by the 3% to 5% longer term trend for claims inflation for Motor. At the moment, we're probably at the top end of that, maybe a little above it. But we're not at 8%. The 8%, as reported earlier, which is our pricing, reflects a view on catching up.

## Q - Fahad U. Changazi {BIO 15216120 <GO>}

That's clear. Thank you.

## Operator

And your next question comes from the line of Greig Paterson from KBW.

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

Hi, Greig.

## Q - Greig N. Paterson {BIO 6587493 <GO>}

Morning, gentlemen. How are you doing? Good, good, I hope. Three questions. One is, I noted you said in terms of whether you'd pass on a new premium tax in the fourth quarter to a client that you weren't going to tell us what you were going to do and it's commercially sensitive. If my memory serves me right, at the half year, you said that you would pass on the cost to consumer. So, is there a change in approach now?

Second point is, just on the first question that we had on the call, in terms of the return on capital or potential return on capital in March. If I'm reading what you've written here, you said that you would consider the standard formula and progress with the internal model approval. In other words, in your release, you've explicitly linked the potential for a special dividend to (41:31) internal model story is going. So, I wonder if you can just clear up that confusion.

And the third question in terms of UK Home, on your partnerships, I wonder if you could just inform us what the year-on-year rate was there, A; and B, what's your general claims inflation is in Home year-on-year?

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

Thanks, Greig. I didn't say that on IPT. I said that we would collect the tax. So I didn't say how we'd price it. I never talk about future pricing. On cap percent (42:05)?

### A - Anthony Jonathan Reizenstein

Yeah. Yes, we will reflect both the standard formula actual number and how we're doing on the internal model. And I suppose there's a sort of careful wording there, I suppose. We don't know today what the PRA's going to tell us, and we may get some bad news. So, I'm sort of slightly protecting myself there in case there's some bad news, but I'm not expecting any bad news.

### Q - Greig N. Paterson {BIO 6587493 <GO>}

But if there is good news, would that influence a maybe higher (42:36)

### A - Anthony Jonathan Reizenstein

No, because good news will be no news at that point

### Q - Greig N. Paterson {BIO 6587493 <GO>}

All right. So, just covering yourself for (42:39) bad news.

### A - Anthony Jonathan Reizenstein

(42:39) will be, that you'll probably get the bad news early if it's bad news. But the good news, they'll keep you waiting till last minute. (42:48)

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

Yeah. Just on claims inflations, pretty low, actually. And I would also spec (42:58) the market but we always think we're doing slightly better than that. We have a lot of claims initiatives in here. So, we think we can afford the slight (43:09) investment in price that we've taken.

### Q - Greig N. Paterson {BIO 6587493 <GO>}

It's a positive claims inflation.

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

Yeah. And I think it's certainly pretty low. I think for our case in the market. For our case, we think it's slightly – probably slightly negative which is why we'd be able to do (43:26) pricing. And I think on partnerships, I'm sure you'd expect, I can't kind of split that out separately.

### Q - Greig N. Paterson {BIO 6587493 <GO>}

But does that mean – is the rate on partnerships flat dramatically, whereas – I'm just trying to get a feel and order of magnitude versus...

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

(43:42) on pricing or claims, Greig?

### Q - Greig N. Paterson {BIO 6587493 <GO>}

On pricing. Because you talk about own brands and it's half and then you've got the other half is partnerships and we basically got no clue, (43:54) year-on-year.

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

Yeah. There are different trends within that. There are some different propositions we've just launched with RBS a proposition where your price will stay stable for three years. So it's slightly higher initial price but it will stay stable for three years and as you make a claim. So, I guess its people trying slightly different things.

I think the key art with partnerships is propositions which meet the partners' kind of brand proposition. So, that's why we've been working on this new proposition with RBS. But yeah, a mixed picture, I'd say, depending on their propositions.

### Q - Greig N. Paterson {BIO 6587493 <GO>}

So, it's not bad for us to just assume that your own brands (44:29).

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

I wouldn't trend dramatically – (44:32) on average, dramatically different (44:34) trends on partnerships in terms of kind of pricing and profitability.

### Q - Greig N. Paterson {BIO 6587493 <GO>}

Perfect. Thank you.

### Operator

Next question comes from the line of Andreas van Embden from Peel Hunt.

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

Andreas, hi.

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

Hello. Good morning. Just really a question about expenses. This continued to decline in the third quarter. And just looking forward to 2016, are there any new initiatives that are in the pipeline that would sort of allow you to continue to reduce your expenses next year?

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

I mean – I'll hand it to John for specifics. I mean, basically, we just keep on it on expenses. And I think exactly what's driving it was kind of very quarter-on-quarter and year-on-year, but there's a lot of programs in the tank. We've just launched a employee scheme where we give people up to £50,000 is an (45:29) amazing idea, 1% of the savings. We had so much as (45:32) 1,000 ideas already. So, those will go into future years.

Investments we're making toward the future to give us much more self-service capability is a kind of, again, a medium to long-term opportunity. So, there's short, medium and long-term initiatives and we are absolutely on it. And I think we've hopefully rewarded the trust that people have given us, not to live off a – have a explicit cost target. We think the freedom of action that gives us is business-helpful; helps morale, it helps us spend good money on good costs.

I think we know we need to repay that by not disappointing on progress on costs because it's clearly an opportunity. And if we don't continue to focus on it, it could be a liability for us. So, we are all over it.

### A - Anthony Jonathan Reizenstein

I mean, there's some schemes (46:27) in terms of new (46:29) initiatives which I think we'll repeat now because we found there's ongoing activity you can do on things like property, on procurement, on automation, self-serve, offshoring, software rationalization. All these things are – they're not one-off things. I mean, we'll gradually inch our way hopefully down on using all these tools.

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

Of course, we have to offset – we'll continue to invest in next-generation IT. We need to, as everyone knows, continue to invest in, as every other company does, with cyber and all these other things. So, it's not like we're not having a cost base which also means we can reinvest in propositions in the future in technology.

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

Yeah. But in terms of the absolute number, it's been coming down year-on-year, Q-on-Q. Is that sort of absolute decline still possible?

### A - Anthony Jonathan Reizenstein

I think – yeah, like-for-like, it is possible. And I guess the way we look at it, we want to get our people and that's why Paul mentioned this new thing we got with our people. The way we're liking is, (47:34) is for the same amount of output, we'd like our cost to go down every year.

Now, we might want a bit more output. We might want some more value added in certain areas or some more risk to be more closely managed in a lower risk appetite, or we might want some more propositions, or we might want a marketing campaign or something. But on a like-for-like basis, and obviously these aren't numbers we can easily demonstrate with the right mix (48:02) but that's – the philosophy is for the same amount of output, we should get our costs down every year, which should be more productive.

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

So, no change in cost ambition. We've got loads of cost initiatives. We're all over it. I guess what we're flagging is we still don't want to be constrained by targets, but once we deliver this sort of cost performance, hopefully, you don't need to ask for them.

### A - Anthony Jonathan Reizenstein

(48:21) positive thing now, sort of behaviorally is that obviously, we've in a sense, we've got our costs down and at the same time for a number of quarters had declining revenue. We managed to just about beat the declining revenue with declining costs, so a bit more or just about (48:38) which is good. But just because we're now seeing a bit more positive revenue, doesn't mean we're going to take the foot (48:46) off the costs.

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

Clearly. (48:47)

### A - Anthony Jonathan Reizenstein

So, now that's kind of in-built (48:48).

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

And we'd like to – that gives us an opportunity to open up some jewels (48:51) here...

### A - Anthony Jonathan Reizenstein

Yeah.

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

Which really can (48:52) help us offset some of this decline in prior year which we've got ahead of us.

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

All right. Okay. Thank you very much.

## Operator

Next question comes from the line of Alan Devlin from Barclays.

## Q - Alan G. Devlin {BIO 5936254 <GO>}

Hi, guys. Just a couple of follow-ups. First, just on the last question on the expenses. First of all, did you take any cost out this year or was it all initiatives in Q4? So, it shouldn't be that much of a change going into kind of into next year?

And then just to confirm that if you do start to see top line growth and actually there should be some offering there (49:28) which comes through next year whether expenses are flat or down? Whatever (49:33) next year it should at least lag the top line if the trends continue?

And then just to follow up on Home insurance from Greig's question, and you mentioned that the – it was a different part (49:442) of cycle for Home insurance. It doesn't sound like from your comments to Greig that there's not much (49:48) pressure. (49:49) pressure on Home pricing given claims inflation is quite benign (49:51) and you have a slightly negative claims inflation. But can you just give us a comment on where you think the Home cycle is and does it need to turn and then what would happen if you did have a more severe winter weather? Thanks.

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

Yeah. Good. Alan, I think on costs, there are many, many lines to it. And some of them using (50:08) some of them the last year's saying (50:10) we've got new ones starting up now. So, we're not kind of facing a cliff of anniversarying kind of maturing cost things. It's many more smaller moving parts. So, I think we can reassure you on that.

On Home, I've been really, I think, quite disciplined (50:28) a couple years now, which is, again, the dynamics of this market are fit for (50:31) competitiveness. The softer insurance market, the appeal of this sort of Motor players – to Motor players now – or the Motor market, a bit better, maybe, there will be a little bit of that bit (50:43), but we're not kind of banking on it.

The advance price comparison sites, the panels. So, I think all of those competitive dynamics kind of are here with us. So I'm not going to comment on future products, and which I don't, but I think in terms of the market dynamics, I think those remain kind of where they are, and we're certainly planning on continuing to need to have a self-help plan, which we have, to continue to do it. And so far, that' been working. I think we should be really proud of this performance, to be maintaining our market position, our policy count in a market under this much competitive intensity and have the impressive loss ratios which we write at is testament to many initiatives working. And just as I said on Motor and on costs, we keep going with a lot more still to do on Home.

## Q - Alan G. Devlin {BIO 5936254 <GO>}

Thanks for your answers. Thanks, guys.

## Operator

And you have another question from Grieg Paterson.

## Q - Greig N. Paterson {BIO 6587493 <GO>}

Sorry, gentlemen. Apologies drawing it out (51:47). Commercial rate increases versus inflation. I know there's three or four different lines today, but I wonder if you can give us just a general (51:57) on where the write (51:58) is, positive, neutral, negative and how inflation stacks up against it.

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

Yeah. So we've got various fits (52:06) of our business. We deal with the (52:08) biggest stuff in our more traditional, around the country, much more manual, slightly more often (52:18) science albeit underpinned by science, and in that bit, we have insight into slightly bigger market which we feel is a pretty – very competitive, actually, that we think there's a lot of competition for the better risks in that.

Now, the good news of our business mix is was that (52:33) important part of it, we have other strings to our bow, which we think are intrinsically a little bit less susceptible to that level of competition, albeit sort of restive (52:43). So the direct – as you get slower tickets and as you get more direct we then get – (52:47) it's less intense than we're seeing in the bigger ticket stuff.

## Q - Greig N. Paterson {BIO 6587493 <GO>}

So, does that imply that the rates are negative?

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

No. I mean (53:00). I mean I think – I don't think there's a lot of rate that hasn't shown (53:04). Again, historic, there hasn't been a lot of rate increases, I'd say, in the bigger stuff that we've seen.

## Q - Greig N. Paterson {BIO 6587493 <GO>}

And what's claims inflation look like?

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

Yeah. I mean I think probably not dissimilar to probably what we'd only say long-term Motor the trend is, I'd say, in that sort of region.

## Q - Greig N. Paterson {BIO 6587493 <GO>}

So 3% to 5% if we pencil in our modeling is fine?

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

Yeah, I'd say close (53:23).

## Q - Greig N. Paterson {BIO 6587493 <GO>}

All right. Cool. Thank you very much.

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

Super. Right. Unless anyone's got – we haven't heard from anybody. I think we should probably close it there just for people's diaries and I've got... (53:36)

## Operator

You have another last question. Would you like to take that one?

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

Yeah. Depends who it's from. Yeah. Of course, we'll take it. Yeah.

## Operator

It's from Andy Hughes from Macquarie.

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

For Andy, of course.

## Operator

Okay.

## Q - Andy Hughes {BIO 15036395 <GO>}

Thanks, guys. I thought you were going now (53:53). So, quick question on the Churchill price reductions. How does that filter through the book? Does that mean that if I have a Churchill policy last year where I paid 5% more than Privilege, is my renewal quote 8% higher than what I paid a year ago, or do I get the now Churchill discounted rate, and so I get less? And how does that work, does that impact – does that reduce the average rate reduction – rate increases across the book?

And I guess, a second short question on the standard formula. Are you expecting a capital add-on to the standard formula, and does that create uncertainty regarding capital, et cetera? Because we didn't really expect the internal model to be less than the standard model. But is there a chance you might have an add-on on the standard model if? (54:37) Thank you.

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

Yeah. So I think – sorry, we didn't want to overstate what we've got (54:42) on Churchill. What we're saying is just in our relative rankings on new business on price comparison sites, we've marginally tightened the price difference between Privilege and Churchill. As a percentage of our total book, when you work it through, it's not the most substantial thing really. (54:59) I don't think you need to worry about it, but we think we found a good balance now of the initial price premiums to be charging, which is slightly less than it was. But, again, that's on a general level. It's very – it's much more fine grain than that in its execution. But I don't think it's things you should worry about. It's obviously fully in the numbers which you're seeing here.

## Q - Andy Hughes {BIO 15036395 <GO>}

Okay.

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

There's not an anniversary to come or anything to worry about in that point of view.

## Q - Andy Hughes {BIO 15036395 <GO>}

Okay.

## A - Anthony Jonathan Reizenstein

Yeah. Andy, on the last question. For the transitional period of six months, which is the period on which we're expecting to be on the standard formula, there won't be an add-on. That's the answer. That's the precise answer.

### Q - Andy Hughes {BIO 15036395 <GO>}

Okay. Even with the PPOs, there's no add-on?

### A - Anthony Jonathan Reizenstein

For the transitional period of six months on which we're expecting to be on it, there will be no add-on.

### Q - Andy Hughes {BIO 15036395 <GO>}

Okay. Thank you.

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

Very good. All right. Gloria, any more?

### Operator

No, there are no more questions at the moment.

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

Okay. Thanks, everyone. Speak to you soon.

### Operator

Thank you very much. That does conclude our conference for today. Thank you, all, for participating. You may now all disconnect. Speakers, please stay on the line.

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