CEO's review

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Jon Greenwood
Acting Chief Executive Officer

Looking ahead to 2023

2022 was a difficult year for the Group. Our performance in Motor fell well below our expectations and did not reflect our previous track record of delivering strong returns for shareholders. Rising claims inflation and new regulatory changes, along with severe weather events, resulted in a material fall in the Group operating profit and solvency ratio, and the Board's decision not to recommend a final dividend.

This is deeply disappointing and we have already taken and continue to take actions designed to strengthen our solvency position and improve our Motor pricing in this difficult trading environment. Enhancing how we price in the motor market will be a key focus for the Group throughout 2023.

All of our other businesses performed broadly in line with our expectations when normalised for weather.

Despite the setbacks in Motor in 2022, the long-term earnings potential of the Group remains robust. Our diversified business model and fundamental strengths remain a significant asset in the highly competitive UK insurance market. We have a strong franchise, some of the most recognisable insurance brands in the UK and strong customer service delivered by a high-quality workforce.

With a determination to enhance our pricing capability and better leverage the benefits of our integrated business model, I firmly believe that we can restore our performance in Motor, enabling the Group to get back to delivering attractive returns for shareholders.

Improving performance in Motor

Our main operational focus during 2023 will be on restoring performance in Motor, in order to drive profitability and build capital resilience, and we are pushing ahead in four main areas.

First, we have already taken pricing action to restore written margins based on our rebased inflation assumptions, and we will continue to prioritise maintaining margins over volume as we progress through 2023.

Secondly, we will focus on utilising our new pricing tools to their full potential and enhancing the sophistication of our risk pricing models. This will include deployment of substantial additional resource to ensure that Motor has the capability and capacity it needs to price with greater precision.

Thirdly, we will better leverage the wealth of claims insight that we have available through our vertically-integrated model. We want to move from being an efficient claims processor and repairer, into a data-driven claims operation, utilising all our data to enhance our pricing capability.

Finally, we will align our model more closely to the price comparison website ("**PCW**") channel, which accounts for around 90% of new business motor sales in the market. We will do this through new propositions, such as our new Churchill Essentials product, which has demonstrated how we can expand our PCW channel footprint and offer value to our customers.

Restoring the resilience of our balance sheet

In addition to the capital benefits from improving our Motor performance, we have a range of levers aimed at helping us build back our capital strength.

Reinsurance

We have always used reinsurance through our motor excess of loss reinsurance and our property catastrophe programmes to manage our risk profile.

We have now built on this with a new 10% quota share reinsurance arrangement effective from 1 January 2023. This not only strengthened our solvency position as at year end 2022 by six percentage points, but it is also the foundation for an efficient long-term source of capital for the Group. We continue to explore further strategic reinsurance options.

Portfolio actions

At the 2022 half-year results we flagged our review of where we deploy our capital in order to deliver the highest returns. As a result we have decided to exit certain partnerships, reducing our exposure to low margin insurance within packaged bank accounts. In the second half of 2023 we plan to begin our new 10-year partnership with Motability Operations, which brings 600,000 new customers. We believe these changes to our portfolio will be positive from both a financial and strategic perspective.

Investment portfolio

With investment yields having increased substantially over the last 12 months, we are rebalancing our target asset allocations in order to deliver the correct balance between return and capital allocation. This should release further capital over time.

In addition to management actions, we expect the unrealised loss position on our investment-grade debt security portfolio to unwind due to the pull to par effect as bonds mature.

Organic capital generation

We believe the Group will be capital generative in 2023 supported by Home, Commercial and Rescue and other personal lines, although it will take some time to restore earnings in Motor.

Continuing to deliver for customers

Excluding Motor and elevated weather claims, all other business traded broadly in line with expectations.

Commercial delivered another strong performance, with the benefits of the technology transformation enhancing Commercial's already strong product and service offering and sophisticated pricing. In 2022, Commercial delivered double-digit growth across both its main businesses, NIG and Commercial direct own brands. Over the past 10 years this business has doubled in size and improved its combined operating ratio to 94.2% from over 100%.

Home successfully navigated the implementation of the FCA's Pricing Practices Review ("**PPR**") regulations and elevated inflation by focusing on maintaining margins and leveraging its diversified business model. Home also made progress with its new technology platform, which remains on track for roll out in 2023.

Green Flag successfully diversified its product portfolio, providing further value for customers by offering accessories via the Green Flag shop. This gives customers the convenience of booking maintenance and repair services, or providing a competitive price to check a vehicle's history before they decide to make a purchase. In January 2023, Green Flag patrol was launched, with its own network of recovery vehicles, in order to enhance network efficiency, improve customer experience and increase sales.

A key pillar of our strategy is reducing our carbon footprint and helping our customers make the green transition. Alongside expanding our electric vehicle propositions, in 2022 the Group became one of the first personal lines general insurers in the UK to have its Science-Based Targets approved by the Science Based Targets initiative.

Business performance

In 2022, there is a clear distinction between the results of Motor and those of the Group's other business lines.

	Gross written premium £m	Gross written premium %	Normalised combined operating ratio %
Motor	1,432.7	48.2	114.7
Home, Commercial, Rescue and other personal lines – ongoing operations	1,537.1	51.8	92.2
Total ongoing operations	**2,969.8**	**100.0**	**103.3**

Motor delivered a poor result, with a combined operating ratio of 114.7%. Claims inflation over the course of the year was greater than we expected, and not reflected in our pricing. This was compounded by higher claims frequency in the fourth quarter. This coincided with the introduction of the FCA's PPR regulations which reduced new business growth opportunities. Retention remained strong at 81.6%.

Our normalised combined operating ratio for ongoing operations across our Home, Commercial and Rescue and other personal lines was 92.2%. In Commercial, we combined strong growth with an improved current-year loss ratio following several years of pricing ahead of estimated claims inflation. We also priced ahead of claims inflation in Home, which saw a challenging new business market following the implementation of the FCA's PPR regulations. Rescue did not see the same growth as previous years but its margins remained strong.

Weather

During 2022, we experienced our highest level of weather-related claims since before our IPO in 2012, including our highest individual event from the freeze in December. Overall claims from weather-related events were £149 million, more than double our 2022 annual assumption of £73 million. This was made up of three events – storms in February, extremely dry weather over the summer which resulted in subsidence and the freeze in December. The freeze event was the most significant, with £95 million of claims costs across Home and Commercial following prolonged sub-zero temperatures, especially across Scotland and North West England. With relatively large shares of Home and Commercial insurance in Scotland, we experienced a significant number of large claims.

Implementation of IFRS 17 'Insurance Contracts' and IFRS 9 'Financial Instruments'

IFRS 17 and IFRS 9 are effective from 1 January 2023. These new accounting standards will improve alignment between IFRS earnings and capital generation under Solvency II and will not affect the economics of our business or its dividend paying capacity. Overall, we believe the new standards should improve comparability between companies.

We will change our headline key performance measure from combined operating ratio to net insurance margin ("**NIM**") under IFRS 17, which we believe is a better measure of how we run our business.

The key reconciling items when moving from a combined operating ratio to a NIM are the inclusion of instalment and other income within revenue, alongside the additional benefit from discounting more of our insurance liabilities. As a result, the NIM is expected to be around six percentage points better than the margin implied by the equivalent combined operating ratio. For example, a 100% combined operating ratio, implying a 0% margin, under the previous accounting standard would translate into around a 6% NIM under IFRS 17.

Capital management

The Group's capital position was affected by the combination of significantly weaker levels of Motor profitability, adverse investment experience and well above average claims from major weather events. These factors reduced the Group's own funds during the year, whilst the weaker Motor outlook and higher inflation also contributed to an increased capital requirement, which was only partly offset by higher than expected investment income.

During H2 and into 2023, the Group took several actions which increased the Group's solvency capital ratio by 14 percentage points, including reducing the risk in the investment portfolio and agreeing a 10% whole account quota share reinsurance arrangement. As at the end of 2022, the Group's estimated solvency capital ratio was 147% which is within the Group's risk appetite range, albeit towards the bottom end of that range.

At the end of February 2023, the Group's solvency capital ratio has increased by approximately five percentage points due to the positive movements on the bond portfolio as well as a reduction in ineligible capital. We are pursuing a range of actions designed to bring the Group's solvency position back towards the middle of the range. The Group expects positive organic capital generation in 2023.

The Group paid an interim dividend of 7.6 pence per share in 2022; however, given the year-end solvency ratio, as indicated at the January trading update, the Board is not recommending a final dividend. The Board understands the importance of dividends to shareholders and will update the dividend outlook at the half-year results.

Outlook

Higher than expected claims inflation on business written during 2022 and in early 2023 will continue to affect Motor earnings during 2023. Furthermore, the outlook for claims inflation remains uncertain given, for example, capacity constraints in the repair industry, continued settlement delays in third party claims and potential care cost inflation.

In our other businesses, trading conditions in Commercial have remained favourable with continued growth in 2023 to date. In Home, market conditions in early 2023 have improved and Green Flag direct has continued to perform well.

The Group believes it continues to have a fundamentally strong business and has an ambition over time to generate a NIM of above 10%, normalised for weather.

Jon Greenwood
Acting Chief Executive Officer