Q4 2014 Earnings Call - Q&A

Company Participants

- Alberto Minali, Group Chief Financial Officer
- Mario Greco, Group Chief Executive Officer & Executive Director
- Spencer Lee Horgan, Head of Investor & Rating Agency Relations

Other Participants

- Alberto Villa, Analyst
- Andrew J. Ritchie, Analyst
- Avinash Singh, Analyst
- Farooq Hanif, Analyst
- Federico Salerno, Analyst
- Gianluca Ferrari, Analyst
- Marcus P. Rivaldi, Analyst
- Matteo Ghilotti, Analyst
- Michael I. Huttner, Analyst
- Niccolo C. Dalla Palma, Analyst
- Nick Holmes, Analyst
- Peter D. Eliot, Analyst
- Ralph Hebgen, Analyst
- Robert Haim, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good day and welcome to the Generali Group 2014 Full Year Results Q&A Session. Today's conference is being recorded.

At this time, I would like to turn the conference over to Mr. Spencer Horgan, Head of Investor & Rating Agency Relations. Please go ahead, sir.

Spencer Lee Horgan {BIO 4241901 <GO>}

Hello, everybody, and welcome to our full year 2014 results conference call. We're going to have about one hour now to take your questions as usual. But before that, I'll hand it over to Mario for some opening remarks.

Mario Greco {BIO 1754408 <GO>}

Good morning, everybody, and thanks for being on the call. We're glad to report today to you that these results mark the end of our restructuring, and from that standpoint, there are three things that I want to stress in this opening for your attention later on.

One is that we took full charge for BSI in these numbers, so we also took a provision for the fine and we think that this is the final impact BSI will have on our balance sheet. We also devalued the Ingosstrakh stake to €230 million, which again, eliminates further volatility or further significant impact in next years from that stake. This means that with the changes that we made that we understand are disappointing you because there are lots of smaller changes.

But we finished at reorganizing our balance sheet and we cleaned the accounts. We gave it proper value. So we think we are at the end of it. And going forward, we think we will start with a completely different set of accounts in our balance sheet. And this is will allow us to give much more predictability and reduce the volatility of that.

We felt that it was important to do it now at the year-end just to turn the page and enter into new phases where we will manage the company with same principle of discipline, simplicity and focus, but having in mind different objectives. That is for my introduction. I'd like to stop here and open to questions.

Please, back to you.

Q&A

Operator

Thank you. We will take our first question from Peter Eliot of Berenberg. Please go ahead. Your line is open.

Q - Peter D. Eliot {BIO 7556214 <GO>}

Thank you very much. First question, perhaps, not unsurprisingly on economic solvency. You talk a lot about optimization measures that you can take. I was wondering if you could perhaps just elaborate on what those might be, and perhaps, also whether that would have an impact on the sensitivity. I know you don't show economic solvency sensitivities. But if I take the MCV as a proxy, that has expanded quite a lot, too, sort of further falls in interest rates over what it was last year.

The second question was on your investments. I see your non-investment grade, corporate bonds have increased across the year from – it looks like it's about €5 billion to €12 billion. I was wondering, if you could just give us some comfort on the risk being taken there, and I guess, I note as well that the asset duration perhaps has not quite kept pace with the increase in liability duration, so I wondered perhaps if you could comment on that and perhaps give us the Life reinvestment rate as well? Thank you.

A - Mario Greco {BIO 1754408 <GO>}

So, Peter, this is Mario. I'll start on the economic solvency and then I pass it to Alberto for the other parts of your question. So on economic solvency, one thing that I want to make clear is that besides the market trends and besides the impact from the market changes, there is one thing that you have to understand about our sense. Our economic model is two years old. This is a very short amount of time compared with all other companies.

We started at the end of 2012; actually, at the beginning of 2013 developing it. What we have today it is a model that it's not yet fully optimized as probably many of our peers have it. And we're learning it and we're doing it. So we need time. This is what makes us definitely committed and concerned about economic solvency, but not concerned about the level of the economic solvency today.

We will optimize the model. We will work on what are the ways in which we can deploy the capital in efficient ways. And we're sure that this will give us better results over time. But we're definitely late compared with the peers on this.

A - Alberto Minali {BIO 16909383 <GO>}

Thank you, Mario. To go back to your question, Peter, regarding the optimization measures, I do believe then when Solvency II comes into place next year, we will have additional levers to pull and additional operations, which we can do on the level of capital, also local level and the global level. So what we're investigating with the team at the moment is the possibility of running - of some portfolios, or making some risk (05:28) monetization, is very difficult at the moment to understand, which had implication, because the Solvency II framework is not clear on this point.

But we do believe that we will have much - a lot of room for maneuver in the Solvency II framework, looking at the liability side and also offloading pieces of risk into other balance sheet, which is not yours. So we want to work even more in the future on the liability in order to optimize the absorption of capital. The number that you've seen in terms of economic solvency is not a dangerous one. It gives us the confidence that we are well capitalized. But certainly, it signals that once we've done a lot of work on the asset side of the story, we need also to work on the liability side of the coin, which means working on how to allocate and deploy capital for our book we already have.

In terms of the investment, it's a fair comment to say that we have increased our exposure to corporate bond. And also we have increased especially in the last part of the year. I think this was a tactical move done by our investment office department that has done through private placement with an extensive work in terms of credit reserves by the internal credit team, which I think is a very good quality in an asset, honestly, in our investment department. This means that going forward this higher profile of risk will probably deliver higher returns.

To put all things in perspective, we talk about net investment of €8 billion for the Life business, which is a very small portion of the total investments we have in the corporate bonds. So it does not change the overall risk profile. It does increase a bit the risk-adjusted capital again. But it does not change the overall riskiness of our portfolio. And that I think we should keep in mind because it's a minor portion of the reinvestment.

If you also look retrospectively, what we did we were very able in lengthening the duration in the last two years in anticipation of the yields decrease. We did a lot through private placement and then many other competitors are doing the same now, which we did in the past. So I think we need to recognize that there is a sort of ability of the company to anticipate market movements and tactical decision of corporate bond follows this road.

Q - Peter D. Eliot {BIO 7556214 <GO>}

Okay. Thank you very much. Are you able to give us a hint on the reinvestment rate at the moment?

A - Alberto Minali {BIO 16909383 <GO>}

The reinvestment rate is very high in the year, it's 3.2%. I know very well that is higher than the peers, but it depends also on the type of investment, the duration we are selecting and also the amount of investment with it. Bear in mind that roughly, we took about 10% of the portfolio that has to be reinvested year-after-year. So it's a small portion essentially. And this has been done, the 3.2% I'm referring to the Life business, while in the non-Life business, it's in the ballpark of 2%. Going forward, we do expect the reinvestment rate to decrease because of the prevailing level of interest rate in the market.

Q - Peter D. Eliot {BIO 7556214 <GO>}

Okay. Thank you very much.

Operator

We'll take our next question from Gianluca Ferrari of Mediobanca. Please go ahead. Your line is open.

Q - Gianluca Ferrari {BIO 15042989 <GO>}

Yes. Hi. Good morning. My first question is on the dividend policy. I noticed that you're distributing close to 80% of the free cash flow. I was wondering why 80% and not something more? And if this 80% or close to 80% could be taken as a guidance for 2015 as well where you have the ambition of generating €1.5 billion of free cash flows?

Second question is again on the economic solvency and the embedded value. The impact from low rate was at the end of 2014, therefore, not reflecting the QE. I was wondering if you had more updated numbers, including also the recent effects of the quantitative easing on interest rates?

And my final question is on costs. I noticed that operating holding expenses went up by roughly €70 million in 2014. During the speech, Alberto mentioned investments in the corporate center, I was wondering if you can give us more detail about this €70 million increasing costs? Thanks.

A - Mario Greco {BIO 1754408 <GO>}

So, Gianluca, this is Mario. On dividends, we did not look into dividends that way. So we know that our dividend policies haven't been rich enough in the past years. So what we wanted to set for this year was a dividend that would allow us to continue improving dividends in the next years. We want dividends to progressively grow. And we felt that distributing €0.60 this year would allow us to have a reasonable growth in dividends also next year and in the following years.

You also know that the net cash flow that we expect to generate by the end of 2015 is €1.5 billion. So really we did not think about this dividend being 80% of the net cash flow of the year, but we were rather looking at the dividend of last year and will we expect to be able to distribute this dividend next year.

Q - Gianluca Ferrari {BIO 15042989 <GO>}

Thank you.

A - Alberto Minali {BIO 16909383 <GO>}

Gianluca, hi. I pick up the second and third questions. So the sensitivity of the economic solvency ratio and the embedded value to interest rate is the following. If you look at the swap rate curve at the end of February vis-à-vis the one that we used at the end of last year, there's been a decrease. So this means that there is a negative impact on the economic solvency ratio.

On the other side, we had a narrowing of the spread of the corporate bond, and especially, of the government bonds, which has more than compensated the decrease of the swap rate. So all things being equal, we do expect the solvency at the end of February, or, let's say, today, higher than the one we had at the end of the year, because of this compensation effect of government bond and corporate bond spreads against the swap. On top of that, even if it's a minor element for us, we had also a positive contribution in terms of solvency from the equity component of our portfolio.

I'm going to the third question, costs. The total group level of cost is €6.357 million. I want to be precise on this point, because we said that we wanted to keep the cost base flat. And this is the case. We had just a minor increase less than 1%. But this is completely justified by the reinforcement of the corporate center by the fact that we have increased our regional office in some areas of the world, especially, in Asia, and also we have invested a lot of money into the global business line and especially in the restructuring process of Europ Assistance.

So what do we have in terms of a slight increase of the cost base, but again, it's less than 1%, it's totally or more than compensated by the amount of investments that we did last year. Also, looking at the picture of the cost, we have a significant decrease of the cost base in the mature markets in Italy, in Germany, in France, and in CEE. And this means that our OpEx savings programs is bringing the fruits we do expect from this program, especially, in the mature market, while in the growth area, we need to invest in order to keep our franchise and to reinforce our distribution.

Q - Gianluca Ferrari {BIO 15042989 <GO>}

Very helpful. Thanks.

Operator

We will take our next question from Farooq Hanif of Citi. Please go ahead. Your line is open.

Q - Farooq Hanif {BIO 4780978 <GO>}

Hi, everybody. I just want to return to Solvency II as well, please. So you talked about how you're optimizing and developing your model. Does that mean you're not applying for internal model approval? I mean, given that you don't feel that you've got the right model, I was just wondering whether what your approach was to internal model approval?

Secondly, could you talk also about how much your capital ratio grows because of internal capital generation? So, obviously, your dividend cost you four percentage points, but then, obviously, you create capital because of profits every year. I was just wondering if you could talk about how much you expect that – the solvency ratio to naturally grow in the year on an operating basis?

And then I just wanted to ask about the – sorry, quickly about the change to the consolidation adjustment into group investment income. Is that essentially a sort of permanent change that will be of a similar number every year? Thank you very much.

A - Alberto Minali {BIO 16909383 <GO>}

Thank you, Farooq. In terms of the economic solvency ratio, we are working very hard and we are spending a lot of time, a lot of resources in order to be ready for the pre-application process, which will start June, July of this year. It's very important for us that all the regulators in Europe define a common level playing field and that the rules of the games will be ready, clear, and applicable in all jurisdictions where we do operate.

And that's a very important aspect, because while we are progressing with the modeling exercise and the modeling effort, we are not in a position to submit any at the moment, because there is still this randomness and unclear position in terms of, for example, government bond charge, volatility adjustment, correlation, and so on. So we will prepare and we are ready. We will be ready by the end of June for the pre-application process. And we do expect also to publish these numbers as soon as possible, I would say, probably during the third quarter numbers presentation, September, October, November, in that part of the year.

To go to your second question, how much capital is contributing to the solvency ratio? It depends very much on the dividend policy, on the earnings capability. But I would say that 10% of normalized embedded value earnings will contribute into the capital building-up process of the group. And then, since we want to have a dividend policy, which is progressive and sustainable over time, this might change again year-after-year.

To go back to the consolidation adjustment, we have changed a lot of things this year in terms of reporting and segment reporting, this because we wanted to give you a better and more economic representation of the group. De-consolidation (17:01) adjustment means that there are new rules for the segment reporting that you see in the slide 15 of our presentation.

This changes because we want to present also our management view. And de-consolidation (17:13) adjustment is a permanent one. And in this case, €79 million depends on the fact that we have attributed back or allocated back to the operating entity the positive interest on loans that some entity – and dividend that some entities are giving to the group. So it's a permanent change and you should expect this every single year.

Q - Farooq Hanif {BIO 4780978 <GO>}

So may I just return on the point about the capital ratio? So you are applying for internal model and the number's going to be probably different to what you're presenting today. Presumably, you're going to change your model between now and June. Is that right?

A - Alberto Minali {BIO 16909383 <GO>}

The model in terms of, let's say, sophistication and engine [and the different methodological approach are already set. So we're not going to change the methodological, architectural and framework of the model. What we are going to change is what we needed to receive from the regulator in terms of their view on how we treat some of the elements of the capital. So it's not a change in the model; it's a change in the way we treat some of the variables of the model depending upon the position of the regulator. And we do expect to have this clear off as soon as possible because essentially, we are almost ready and we needed to prepare the documentation by the end of June.

Q - Farooq Hanif {BIO 4780978 <GO>}

So that the number on a like-for-like basis could be different, but it depends on capital charges that they haven't told you about yet, basically?

A - Alberto Minali {BIO 16909383 <GO>}

Yes, yes. We need to be fully transparent in this point. Number can be different, absolutely. We don't know the numbers because still the many items that are not being defined by the regulators will impact on the capital position of the group. It can be higher, it can be lower; we will see.

Q - Farooq Hanif {BIO 4780978 <GO>}

And I...

A - Alberto Minali {BIO 16909383 <GO>}

The important thing is to understand, which levers we can pull in the future for making a more efficient use of your capital in the group.

Q - Farooq Hanif {BIO 4780978 <GO>}

And I apologize to everybody for asking one more question, but do you currently allow for cross-border government sovereign capital charge? So, for example, Spanish bonds in the Italian business, do you allow for that or not?

A - Alberto Minali {BIO 16909383 <GO>}

At the moment, yes, but remember that the cross-border exposure is less than 5%, 6% overall. So it's a minor item within our group.

Q - Farooq Hanif {BIO 4780978 <GO>}

Okay. Thank you very much. Thank you so much.

A - Alberto Minali {BIO 16909383 <GO>}

Thank you.

Operator

We will take our next question from Federico Salerno of MainFirst. Please go ahead. Your line is open.

Q - Federico Salerno {BIO 2565091 <GO>}

Good morning, everyone. A couple of questions on non-Life, please. I think there has been a small improvement in motor premiums growth in the second half, especially, in France and Italy. Do you expect this trend to go on in 2015? That's the first question.

And then the second is more specifically on Italy. What's the status of competition in here? And do you think that the recent law on motor insurance will help? And then, lastly Telco, I was wondering if you have any news on this topic? Thank you.

A - Mario Greco {BIO 1754408 <GO>}

So, Federico, this is Mario. Italy is seizing the market, which is still soft on motor rates. And also the profitability is quite stable. The rates are falling also in 2015. And we frankly do not expect this to change quickly in the next weeks or months.

About France, we expect the premiums to start turning up just because we are getting at the end of the cancellation process. And so the pruning is almost finished. And this will help the normal business to show up as a positive and growth one.

The recent low in Italy, I mean, it's fundamentally for those of you're not aware, it's promoting and incentivizing the use of the black boxes, so-called black boxes, where we're market leader. And so we're interested, we're in favor. And we count on growing our market share on this black box segment of the business.

On Telco, we have no special news. We're still awaiting the authorization to get out of Telco and break it up and receive the telecom shares. It should come, it will come, but we have not received it yet.

Q - Federico Salerno {BIO 2565091 <GO>}

Good. Thank you.

Operator

We will take our next question from Matteo Ghilotti of Equita. Please go ahead. Your line is open.

Q - Matteo Ghilotti {BIO 2333793 <GO>}

Good afternoon. One question on financial income. I've seen that in 2014 the net realized gains were stable around €3 billion. And I am focusing on 2015, when you will realize, clearly, lower cash flow from the coupons of the bond portfolio. So my question is, in order to keep the overall financial income stable, how much you should increase the net realized gains in order to offset lower bond coupons? Thank you.

A - Alberto Minali {BIO 16909383 <GO>}

Thank you, Matteo. Bear in mind that only roughly 10% of the portfolio, especially, in the Life business, is for investment purposes. And also, the vast majority of our corporate bonds and government bonds are fixed rate. And so the level of coupon will be, I would say, stable during 2015. So we don't need to increase the realization of capital gain to offset or compensate the decreasing level of the coupon because the coupon will remain flat/flattish during 2015.

We realized a lot of capital gains in 2014 for different reasons because we needed to clean up a situation. And we didn't want to impact on the policyholder participation rate. But this was a different type of reason. For 2015, I don't see there is a mechanical link between government bonds yield in the market and capital gain because our coupon remains flat over the months.

Q - Matteo Ghilotti {BIO 2333793 <GO>}

Thank you.

Operator

We will take our next question from Michael Huttner of JPMorgan. Please go ahead. Your line is open.

Q - Michael I. Huttner {BIO 1556863 <GO>}

Thank you. And I'm sorry if you don't hear me very well. I'm on a mobile and I'm in the airport, so sorry. But thank you very much. And my first question was on German Life and I just wondered if you could give a fuller picture, if you can, in terms of – sorry, here we go, in terms of buses, and so the buses in Germany are the RfB, the ZZR and the unrealized gains. I think at previous year-end, you were roughly 12% ratio of total buses to total liabilities.

I think Allianz is at 20%, Zurich's around 15%. Then maybe you can give us an idea of what's happening to the ZZR? My impression I have from meeting with Munich and other German insurers that it's accelerating. So it's not going 1%, 1.1%, 1.2%, it's like 1%, 2%, 4% (25:03) and I just wondered what this could do to your earnings going forward?

And then, very briefly, you mentioned non-Life sounding stable in Italy and France. I don't know if that was right, but can you just give an overall picture, the combined ratio of 93.8% is fantastic. Is that a figure I can just put in my models for this year?

And then very light question, I'm sure you've already answered it, future one-offs, is it right to say they will be zero? Thank you.

A - Alberto Minali {BIO 16909383 <GO>}

Thank you, Michael, for the question. Let's start from the German one. The buffer at the end of 2014 for the RfB is in the ballpark of €2 billion and the stock of the ZZR is more or less equivalent. The projection of our ZZR going forward is not a geometric progression. I would say, it's more an arithmetic one, if you allow the expression. There is no 1, 2, 4, 8, it's 1, 1, 2 (26:01). So the riskiness of our book is lower probably than the one that is prevailing in the industry.

In terms of the Italian and the French combined ratio, we usually do not provide indication of the future combined ratio because this depends on many, many variables. I don't know if you referred to the overall portfolio or just the Motor one, but for the Italian Motor business, we are around 91%, 90.8%, which is stable. A very important element here is that the claims costs in Italy are stable and also, the average number of contract is stable. So there is not anymore any losing customer situation that we experienced in the past because of the competition in Italy.

The combined ratio in France is very high, indeed. It's 104.9%. It will go down during 2015 because of the pruning of the portfolio and the exiting from Motor business and garage-related business, which we are going to complete in the next months. So I do expect the French combined ratio to improve progressively during 2015 because of the activity the new management team has brought about.

Then the one-off in the future should be zero. I will be in Stockholm to pick up the Nobel Prize winner if I would be able to answer this question. I'll leave it to Mario.

A - Mario Greco {BIO 1754408 <GO>}

Yeah. But, Michael, I think what I intended to say, we cannot say they're going to be zero, but they're going to be zero for the extraordinary reasons that we had in the past two years or three years in our balance sheet. From now on, we're going to drive a balance sheet, which is clean off legacies from the past and which is just dependent on the normal market conditions that everybody else will see in the market, which is much better for us, I understand for you, but also for all of us, than it was in the past.

And, again, if you go back and think about all the transactions we made, all the things that we cleaned off, it is a relieving situation, the one that we have today where we have moved on and we have eliminated all these things.

Q - Michael I. Huttner {BIO 1556863 <GO>}

Thanks. That's brilliant. On the last buffer for German Life, which was the unrealized gains, is it best for me to ask your IR team later? That's probably the best thing.

A - Mario Greco {BIO 1754408 <GO>}

Yeah. We'll come back to you later on that one, Michael.

Q - Michael I. Huttner {BIO 1556863 <GO>}

Lovely. Super. Thank you so much. Thank you. Bye-bye.

Operator

We will take our next question from Niccolo Dalla Palma of Exane BNP Paribas. Please go ahead. Your line is open.

Q - Niccolo C. Dalla Palma {BIO 16052945 <GO>}

Hi. Good afternoon, everyone. My question is to follow up on Germany, you actually mentioned an interesting point that the low interest rates are not only a problem for traditional savings business, but also for clients and potential clients. Could you expand a bit on this point? Are you pointing to some difficulties in replicating current pricing structures of the products or client appetite for products? Maybe you can say something more on this specific point?

And then, back to economic solvency. You clearly gave a strong message about being comfortable with the current number. Can you express in some way what a comfortable range would be? And I know there's many moving parts here, but I guess, the aim is to understand how fast the dividend can grow rather than assessing the riskiness of the current levels?

So is there any range you would have in mind and that you can share today? Or is it something you would rather share maybe after the summer when your model is fully approved by the regulator? And are maybe – are you worried at all about the volatility of the ratio that you're seeing currently? Thank you.

A - Alberto Minali {BIO 16909383 <GO>}

Thank you, Niccolo. I will take the first question then the second I'll leave it to Mario. The Germany – the German situation, it's fair to say that the very low level of interest rate is creating a bit of a tension in the industry in every single Life portfolio. So this does not create problems for our clients or for potential clients. What we want to do in Germany and we already started this process is to expand the production – protection on unit linked business.

And if you look at the number of the Life net inflows this year, we have a negative €800 million from in the savings and Pension business. So we are, in a way, re-tilting the portfolio, re-changing the portfolio and serving the clients in a different way with protection and unit linked business. So no problem in terms of future sustainability of our liability, but the idea is to move the clients toward the business, which is not the typical savings one with a very long duration especially in this market context where it's probably not very smart to sell or to carry on selling this type of products.

A - Mario Greco {BIO 1754408 <GO>}

On the economic solvency target, which is what you're asking for, so first of all, we're not prepared today to express any target also because we would like to talk about our next plans in what we maximize and what we target when we have our presentation in May, on May 27 about the future of us.

Second, I think if you look back at what we went through, we had – and we still remember that we had Solvency I 120% (32:08) at the time when rates were 4% and even 4.5%. And we managed through and we took actions and we brought it up even against some consensus. So we brought it up to 160% ahead of time. So we know how to deal with these things. We know what to do. And we will manage, but we feel today in a much better position.

Having economic solvency around 160% doesn't look at all as something as scary as what we saw in the past. This is a more solid company today. We have better ammunitions. We will continue producing actions on profits and on capital in the next months. And we feel much better prepared than we were years ago when we anyway tackled the issue.

Q - Niccolo C. Dalla Palma {BIO 16052945 <GO>}

Thank you, Mario.

Operator

Thank you. We will take our next question from Nick Holmes of Société Générale. Please go ahead. Your line is open.

Q - Nick Holmes {BIO 3387435 <GO>}

Hi, there. Thank you very much. I had two questions. The first is actually on the expense side. Wondered if you could explain why the P&C expense ratio has stayed the same at 27.1% although you saved €500 million of costs? And related to that, looking forward, is there any sort of feel for where the expense ratio might go in particular when you save – when you achieve your €1 billion of cost reductions?

And then, the second question is - apologies about this coming back yet again to Solvency II. I know you're getting sick of these questions. But with the big two variables, the volatility adjustment and sovereign risk, I wondered if you could outline what it is you're actually doing at the moment, particularly - I mean, with sovereign risk, is it correct that you're not taking any charges apart from cross-border? And with the volatility adjustment, are you taking sort of 60%, I think, it is of the notional basket that EIOPA has guided?

And I wondered, if you could elaborate on where you think Solvency II is going to end up on those two questions? Thank you very much.

A - Alberto Minali {BIO 16909383 <GO>}

Thank you, Nick, for the question. Going to your first one, the expenses, the property and casualty expenses ratio is not immediately linked to the €500 million of OpEx savings, because then you have to consider also the inflation and you have also to consider the investments. So it is stable, not because we have not saved enough, but also what we have saved, we have reinvested.

And the proof of the pudding is in the fact that the overall cost base of the group is flat. We do expect it to have - and improving the efficiency in which we run the business. But it's very difficult for me at the moment to make a forecast of the expense ratio going forward. We know that by the end of 2015, we will save additional €250 million and we know that we are going to run the same amount of business with equivalent to the same level of the cost base. Then it means that the efficiency ratio because of the investment we did has increased, but I don't know how to forecast the future level of the expense ratio in the P&C business.

In terms of the Solvency II, I think your questions are very precise and very technical one. So in terms of the volatility adjustment, there are a lot of discussions between the different teams of the risk management of the different companies in Europe with their respective regulator. And the position is not clear at the moment whether there could be a sort of a volatility anchoring allowing us in order - the possibility - the technical possibility to reduce the dispersion of the scenarios that we generate in our engine in order to monitor and to calculate the risk capital.

It is not clear whether the volatility adjustment will be given even if in some cases and I've seen the disclosure of one of our competitor, they have put the government bond charge into the system, but they also benefited a lot from the volatility adjustment.

Our position on this point is very clear. We will do what the regulation and the regulator will require us to do. So in terms of the sovereign bond, we do have a charge in our current old model for the cross-border exposure. And we will be ready to apply also to the domestic portfolio if this is required. So difficult to say whether Solvency II will be higher or lower, the ratio vis-à-vis the current one if we take into consideration volatility and sovereign risk.

My understanding is that these are two important points that need to be sorted out sooner than later because they will determine the overall allocation of capital for the group. But I'm not in a position, unfortunately to tell you which is the impact.

Q - Nick Holmes {BIO 3387435 <GO>}

Okay. Thank you very much for that. Very useful. Just one follow-up question which is, are there any areas where you feel that you're perhaps more conservative than peers? I mean, any areas where you think you might have hidden reserves, if you like, in your current approach?

A - Alberto Minali {BIO 16909383 <GO>}

Yes. Thank you very much for this question, because I want also to give a positive sign on the Solvency II. We certainly are more conservative than the rest of the market in the way we treated the operational risk. The operational risk project has just started. And we at the moment put down a very important chunk of capital for the operational risk, which honestly, is a multiple of what it should be. So we have a very high absorption of operational risk, which should disappear, and will disappear, going forward once the risk team has completed the analysis of the operational risk capital.

The other one is the correlation. I think because of the nature of the business, we do not have the correct level of diversification that we should have if you take into account how diversified we are, how much retail business we write, and not how much concentration risk we have in the books. So all things being equal, I do expect to have less operational risk capital and so to have a benefit from the modeling from this source, and to have a better diversification benefit if the model considers the inherent dispersion of risk that we have on the books because of our positioning.

And these are two important elements that really are on the negative side at the moment, if you compare us with the peers. We do not have enough diversification and we should have it more, because of the book and the business we have written.

Q - Nick Holmes {BIO 3387435 <GO>}

That's great. Thank you very much indeed.

Operator

We will take our next question from Alberto Villa of Intermonte. Please go ahead. Your line is open.

Q - Alberto Villa {BIO 16005221 <GO>}

Hi. Good afternoon. Thanks for taking my question. Just a brief one on the outlook. Are you expecting a strengthening of the operating performance? I guess, you will expand at the Investor Day. Just wondering what you're seeing as the contribution to this improvement, if it's more Life that has been very resilient, that it will continue to do very well. And if you expect the P&C maybe to be stable or a little bit under pressure due to the softening of the market and the low contribution from investment income?

And finally, if you can give us an idea of what are your expectations in terms of Life net inflows, if we should expect another very strong year in 2015 given the very low interest rate environment, especially, in Italy? We have some indications coming from the industry that the first months of 2015 are doing very well in terms of net inflows. Wondering if you can add something on that? Thanks.

A - Mario Greco {BIO 1754408 <GO>}

So, Alberto, this is Mario. First of all, on the Life net inflow, the only thing that we can say is that the first months of this year started off very, very strongly. But it's very difficult to make a forecast and I wouldn't make a forecast at March of the year. But the early numbers make us quite optimistic.

On the outlook for the year, we're going to have the cost reductions kicking in, because many of them were backend loaded. And so we still have to see the benefits of some of them. The improvements in France are quite significant for us. France has been underperforming over the past two years. And so we are looking forward to see France coming back as a strong contributor and all the data that we receive from France confirm it.

We're also launching a restructuring in Germany, which is going to be quite important. I'm not sure how much it will contribute in this year, but it will definitely contribute in a significant way to the next years. And we will talk about that on May 27. We expect Italy to be quite stable, and this is what we've seen so far in Q1. We expect CEE to be able to do better than they did last year, when they were hit also by Polish new laws that were issued by the government on Life by year-end. So it's a tough market out there, but we still have margins to improve our results and we're confident that we will expect this value in the next months.

Q - Alberto Villa {BIO 16005221 <GO>}

Thank you very much.

Operator

We will take our next question from Ralph Hebgen of KBW. Please go ahead. Your line is open.

Q - Ralph Hebgen {BIO 6297020 <GO>}

Hi, guys. Thank you very much. Ralph Hebgen from KBW. I would like to go back to the economic solvency ratio, apologies. Just one element there. I saw in the waterfall chart that by far the most important impact downwards was generated by the increase of required capital. If I now look at the required capital breakdown, which you kindly gave on slide 54 of the presentation, it appears that credit risk is the most important element, which went up by about 50% over 2013.

So my first question relates to that. It would be interesting to hear your thoughts on the dynamics behind that. Something tells me this may not actually relate so much to the increase in corporate bonds in your bond portfolio, but more to interest rates and that's really what I would like to explore.

Second thing is in Life. This is a question of detail. I noticed the policyholder share is down again. And I discern a trend over the last year although over the long run, it is actually pretty much the same as it's always been. So my question here is really is this something which you observe? Is this something, which just happens and driven by portfolio structure? Or is this something that you actually are managing to come down?

And finally, just in confirmation, you had some exceptional items as we know. Did any of these exceptional items come through in cash? So in other words, did any of these have an impact on the cash which you disclosed? Thank you very much.

A - Alberto Minali {BIO 16909383 <GO>}

Thank you, Ralph, for the questions and let's make some numbers. So I hope with this answer to close the questions on the Solvency II because it seems to me that is the focus of this investor call. So Solvency II, the RAC increase has been in the ballpark of €3.5 billion, the risk adjusted capital. And if you look at the breakdown, we have an increase of the financial risk roughly 6%, credit risk, roughly 53% and the Life underwriting risk and the rest is 13%. But it's correct to say that most of the increase of the risk-adjusted capital at the end of last year comes from the credit risk.

But which is the source of this credit risk increase? The source is the level of interest rate. If you then go down to the country, you see that most of the increase of the credit risk is in countries where we experience a very low dramatic level of interest rate, especially Germany, which is bringing roughly 50% at the moment, and France, which is bringing roughly 20% at the moment. So it's a consequence of the fact that the asset allocation has moved progressively towards corporate bond, but it's not the quality of the assets. It's the impact of the interest rate level structure on the asset that has determined the dynamic of the credit risk charge.

Then on the other side, we had a negative impact on the available capital because of the reduction of the value in force, roughly for €1.4 billion. And also in this case, there might be elements coming from – there are elements coming from the level of interest rate. So interest rates are really creating an impact on the available capital to roughly €1.5 million (47:04) in terms of less value force, and €3.5 billion more in terms of RAC. And of this one, the predominant part is attached to the credit risk not because of the quality of the assets, but the exposure of the assets to the interest rate level.

So I don't know if I'm being clear on this point, but it's a combination of two effects that have the same source of randomness, which is the level of interest rate.

Then to go back to your second question, the policyholder participation is not something that we actually manage. We manage in the way that when we set up the new products we also define the policyholder participation, but that's not the case in Germany. It's a dynamic of the portfolio more than a management decision.

Then going to your third question, the cash impact of these one-off items is zero. The BSI has been reserved for the full amount of the fine. And we're going to pay the fine in due course when the Department of Justice will quantify it. And so far there is no cash element. The impairment of INGO (48:13) does not have any cash implication. So the cash earnings of the group are untouched by the one-off items that we recorded last year.

Q - Ralph Hebgen {BIO 6297020 <GO>}

Thank you very much. Very clear.

Operator

Thank you. We'll take our next question from Avinash Singh of Nomura. Please go ahead. Your line is open.

Q - Avinash Singh {BIO 20134511 <GO>}

Yeah. Hi. Just one question. If I look at your P&C performance as given very clearly on slide 30, I was just wondering what should be the best case guidance for 2015, given that one would expect the investment result to come down slightly given the interest rate environment.

There could be slight improvement in the others. But at the same time, in terms of your technical results, there – I mean, you had a very good low (49:07) this year and also a high level of reserve release. So what kind of improvement do you expect over this €1.8 billion operating result for this year? Thank you.

A - Mario Greco {BIO 1754408 <GO>}

Hi. This is Mario. Let me just disagree with you on one thing. We did not release reserves this year. If you look at our reserve ratio, it went up by four percentage points with respect to premiums. So we're better reserved today and we have a more ample buffer of reserves this year than we had in previous years. It is very difficult then to give guidance on combined ratio. You know the combined ratio is quite volatile. And fundamentally, we expect so far the combined ratio will remain at the same level of this year plus improvements in France where France will converge this year, next year towards 100% combined ratio.

And this will, of course, help us in reporting much better group results overall. But I cannot give you any guidance on (50:30) on other items, beside the fact that so far Q1 has been fairly stable one.

Q - Avinash Singh {BIO 20134511 <GO>}

Okay. Thank you.

Operator

We will take our next question from Robert Haim of JPMorgan. Please go ahead. Your line is open.

Q - Robert Haim {BIO 20636816 <GO>}

Hi, guys. Just a couple of questions. The first one is, can you please explain to me – I think it's somewhere in the slides, but the actual difference on the €4.125 billion (51:02) of investment management is on 21 for the group and the €1.9 billion for the Life side? You're saying it's mainly interest rates driven and I can't quite explain that one.

And the second question is in your modeling, do you build in for negative interest rates all in your stochastic modeling? Or do you still use – do you use zero in? And the last question is how's the relationship with Discovery going?

A - Mario Greco {BIO 1754408 <GO>}

Give us a second because we're still trying to understand what answers that you deserve for your questions. They're quite complicated. Give us a second please. We're coming.

A - Alberto Minali {BIO 16909383 <GO>}

Yes. So if I understand correctly your question, Robert, you are referring to the negative variances of the embedded value...

Q - Robert Haim {BIO 20636816 <GO>}

Yeah. Page 21 and 49. On 21, it's €4.1 billion and on 49, it's €1.9 billion, so I'm just wondering what the difference on that is?

A - Alberto Minali {BIO 16909383 <GO>}

Yeah. We have a negative difference of €1.1 billion coming from the equity volatility.

Q - Robert Haim {BIO 20636816 <GO>}

Well, isn't that already in the Life one?

A - Alberto Minali {BIO 16909383 <GO>}

In the Life one, yeah.

Q - Robert Haim {BIO 20636816 <GO>}

But then, that's the point. I don't actually understand why €4.1 billion in the group one and only €1.9 billion in the Life one.

A - Alberto Minali {BIO 16909383 <GO>}

Yeah. We have a negative or positive variances on the debts and also the variation of the surplus of the property and casualty negative in the Life.

Q - Robert Haim {BIO 20636816 <GO>}

Could you provide the walk-through on those two exactly?

A - Alberto Minali {BIO 16909383 <GO>}

Yes. We will. We will. But it's also interesting to know that someone reads with a lot of detail our slides. So it's very reassuring, Robert.

Q - Robert Haim {BIO 20636816 <GO>}

Okay. I thought it was a big number and I just thought the rate of interest effect to me is mainly to the Life side, so I can't quite see...

A - Alberto Minali {BIO 16909383 <GO>}

No, no, because there's (53:07) Robert, but we'll send you the numbers afterwards.

Q - Robert Haim {BIO 20636816 <GO>}

Okay.

A - Alberto Minali {BIO 16909383 <GO>}

In terms of the second question in the modeling, we certainly generate scenarios with a negative interest rate. And that's part of the problem because when you generate scenarios with negative interest rate, you absorb linearly the whole capital that is included in the scenario. At the moment, the discussion, which is in the industry, it's out to limit in a way these negative scenarios and out to limit the impact of those on the capital. This goes under the name of volatility adjustment. But at the moment, yes, we do consider this.

Q - Robert Haim {BIO 20636816 <GO>}

And Discovery?

A - Alberto Minali {BIO 16909383 <GO>}

Discovery, we have set up a team together with them. We are working hard in order to create the infrastructure between their database and our local teams and local entities. It's very early days, to be honest with you. We just started to work with them and we will see some fruits probably next year.

Q - Robert Haim {BIO 20636816 <GO>}

Okay. Thank you very much.

Operator

We will take our next question from Andrew Ritchie of Autonomous. Please go ahead. Your line is open.

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

Hi, there. First of all, a technical question. When I look at your EV supplement and the sensitivity analysis, I'm a little struck by the interest rate sensitivity of new business, because obviously, I know the aim has been to reduce the interest rate sensitivity of new business, particularly, in Italy, where there's a very high sensitivity of your new business profit to a decline in interest rates. Why is that? Is that because you're still selling implicitly some guarantees? I know they're not very high guarantees. But maybe just explain why unfortunately your new business interest rate sensitivity appears to be higher than your in-force?

And the other two questions are very quick ones. I think on the HoldCo expenses, I appreciate there is some inflation because you're investing to improve systems. So should we take the HoldCo level of expenses as the run rate from here? And the final question, Latin America, clearly loss-making in Q4. I mean, do we expect that to get to breakeven in 2015? Or this is kind of multi-year improvement in that area, Latin America P&C, sorry? Thanks.

A - Alberto Minali {BIO 16909383 <GO>}

Thanks for the questions. Sensitivity analysis on new business, bear in mind that when we project the new business value, we don't use future forecasts of capital gains. So it's just the technical performance and the stream of flows coming from the product. So it's very highly sensitive to interest rates, because when we modify the interest rate, we can erode the level of the fee that we get from the business. So it's very sensitive because the level of the fee is at the margin of the interest rate that we assume in our calculations. So it's just a mechanical element. But when that product goes into the portfolio, it would benefit from a different level of financial performance. So the sensitivity of the product will decline if it is in the portfolio.

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

Does this mean – sorry. Go on. Sorry.

A - Alberto Minali {BIO 16909383 <GO>}

No, no. It's the difference between the valuation at the point of sale when you sell a business and the valuation of the same product when it's in the portfolio.

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

But this is – because this is unit linked product, so if there's no market return, this would be the sensitivity? Is that a simple way of putting it?

A - Alberto Minali {BIO 16909383 <GO>}

Say it again, sorry?

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

These are products that are sort of unit linked with a capital guarantee, so this sensitivity kind of basically builds in...

A - Alberto Minali {BIO 16909383 <GO>}

No, no. These are products. These are savings and savings business with minimum guarantee rates. And that's why also we decreased the minimum guarantee rates, because there is a very high level of sensitivity to interest rates. So we needed to decrease the level of minimum guarantee rates. But these are not unit linked. Unit linked do not have a very high sensitivity to interest rates, because essentially you don't erode the fee because of the interest rate.

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

Okay. And then what you're saying, I think, is that that sensitivity maybe overstated because there are things you can do with respect to fees?

A - Alberto Minali {BIO 16909383 <GO>}

It's overstated, because it's in the way we calculate new business value. Imagine that you sell a product with a minimum guarantee rate today. And at a point of sale, you do the calculation. So if that product is not put into a portfolio with other assets, that product shows a very high level of sensitivity to interest rate. The moment after, when you put that product into the portfolio, you will have a different level of financial performance...

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

Okay, okay. I understand. Standalone, that is the sensitivity, but when you consolidate it with the overall fund – okay, fair enough. I guess, the point is that there are actually still some element – a fairly high element of embedded interest rate risk in the new business then.

A - Alberto Minali {BIO 16909383 <GO>}

Yes and no. Yes, because we do have minimum guarantee rates. No, because we have reduced it progressively (58:45).

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

Sure. Okay.

A - Alberto Minali {BIO 16909383 <GO>}

Are you (58:46) clear on this point?

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

Yeah. That's very helpful. And the two other questions, quickly HoldCo and LatAm?

A - Alberto Minali {BIO 16909383 <GO>}

Yes, yes, I will come to – yeah, give me a moment. On the HoldCo expenses, we have at the moment a level of in excess of €400 million at the holding level in terms of total expenses, and it's because of the reinforcement of corporate center and different functions that in the meantime we have built up. I would assume that we do not increase it dramatically, the level of these holding expenses going forward. So you could consider this a sort of – in general terms a sort of a level that you can project in your model.

The loss in the 4Q of Latin America comes from two sources. One is the inflation dynamic in Argentina, but that's not the most important one. The most important one is in Brazil where we had a poor performance of our operation for different reasons, which then led us to change the management to inject a new management team, to completely change the underwriting policy. And we have asked also our colleagues, our Brazilian colleagues, to resubmit a new business plan for the entire operation.

I do expect to have a minor loss again in 2015 coming from the Brazilian operation. Bear in mind that we have also made a capital increase at the end of the year to reinforce the position of the company in Brazil, but I do expect it to have a roughly €10 million, €15 million loss again in 2015 according to the plan that I'm seeing going through at the moment.

But we need to monitor very closely this situation because that market is particularly sophisticated and we had a very poor performance. So I think now the operation is in order, but I want to monitor the next Qs how they evolve.

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

Okay, very helpful. Thanks very much.

Operator

We will take our final question from Marcus Rivaldi of Morgan Stanley. Please go ahead. Your line is open.

Q - Marcus P. Rivaldi {BIO 5739374 <GO>}

Good afternoon. I've just got actually one question, please. Just looking again through the embedded value disclosure, maybe I shouldn't have been, but I was quite surprised by the sensitivity to rates of your French business. So, obviously, during the course of the year, embedded value showed the greatest decline over any of your geographies. And looking at future sensitivities to further fall in rates, it's again even more sensitive than Germany. And I was wondering if you could maybe give a bit of background about that, please, and if there's anything you're trying to do there to reduce that sensitivity in what is a large chunk of your embedded value. Thank you.

A - Alberto Minali {BIO 16909383 <GO>}

Yeah. If we look at the sensitivity, you are focusing on the sensitivity, 35.5% for the French business to the yield curve, minus 1%. This depends very much on the type of underlying business. You know that in France we have an enormous portfolio of pension business. I don't remember the name in French, but you will - Retraite, yes, you will forgive me. And this pension business has a very long liability profile. And so this sensitivity of the interest rate is a function of the duration of the liability.

And then also, this type of portfolio will attract annual premium because of the pension nature of this portfolio and so then will probably jeopardize even more the sensitivity and the disability of the cash flow profile. So it depends on the level of interest rate in France, certainly, but also depends on the nature of the underlying business, which is predominantly pension one.

Q - Marcus P. Rivaldi {BIO 5739374 <GO>}

Okay. Is there anything you can do to manage that? I mean, again - there's been so much attention clearly on the issues in Germany, but is there anything you can do here in France as well?

A - Alberto Minali {BIO 16909383 <GO>}

Yeah. In France, this business attracts a lot of capital, as you can imagine. And there is also a possibility, a legal possibility to isolate this business and to put into a different capital framework, which is the one governing the pension business in Europe. And we are working hard with our colleagues in France to see whether we can make it more efficient. But that's, I would say, more a legal solution than a business one.

Q - Marcus P. Rivaldi {BIO 5739374 <GO>}

And does that have any implications for your goal to see France making a cash contribution to group center (01:03:21) this year?

A - Alberto Minali {BIO 16909383 <GO>}

No, no, because the inability of France to pay the dividend this year was entirely driven or predominantly driven by the poor performance in the P&C business. So it's important that France will converge quickly to 100% combined ratio and even lower, if it is possible. And this will generate operating performance, and from the investment, also cash to be remitted back. So the French pension business does not have anything to do with our ability to get dividends from France.

Q - Marcus P. Rivaldi {BIO 5739374 <GO>}

Thank you very much.

A - Alberto Minali {BIO 16909383 <GO>}

Thank you.

Operator

We have no further questions in the queue. I would like to turn the call back to the speakers for any additional or closing remarks.

A - Mario Greco {BIO 1754408 <GO>}

So thank you very much for having been on the calls and for all these questions. Let me close by saying that in 2015, we're going to see hopefully all of you on May 27 to discuss our future priorities and the strategy that we will follow in the next years. Our most important priority for this year, for 2015 is to improve significantly on the net profits, which suffered this year and last year for the adjustments and to continue growing the operating profit by taking advantage of the technical actions and the cost reductions.

We're committed to do so, we are confident that we have the right actions in mind. And over the next three weeks, Alberto and I will be on the road to meet hopefully many of you and to discuss our 2014 results and our 2015 prospectives. Many thanks again and hope to see you soon at the latest in London on May 27. Goodbye.

Operator

Thank you. That will conclude today's conference call. Thank you for your participation, ladies and gentlemen. You may now disconnect.