Company Participants

- George Quinn, Group Chief Financial Officer
- Mario Greco, Group Chief Executive Officer
- Richard Burden, Head Investor Relations & Rating Agency Management

Other Participants

- Andrew J. Ritchie, Analyst
- Dhruv Gahlaut, Analyst
- Farooq Hanif, Analyst
- James A. Shuck, Analyst
- Michael Igor Huttner, Analyst
- Nadine van der Meulen, Analyst
- Niccolo C. Dalla Palma, Analyst
- Paul De'Ath, Analyst
- Peter D. Eliot, Analyst
- Ralph Hebgen, Analyst
- Thomas Seidl, Analyst
- Vinit Malhotra, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Ladies and gentlemen, good morning or good afternoon. Welcome to the Zurich Insurance Group Q2 Results 2017 Conference Call. I'm Sarah, the Chorus Call Operator. I would like to remind you that all participants will be in listen-only mode, and the conference is being recorded. After the presentation, there will be a Q&A session. The conference must not be recorded for publication or broadcast.

At this time, it's my pleasure to hand over to Mr. Richard Burden, Head of Investor Relations and Rating Agency Management. Please go ahead, sir.

Richard Burden {BIO 1809244 <GO>}

Good morning, good afternoon, everybody, and welcome to our first half 2017 Q&A call. On the call today, we have our Group CEO, Mario Greco and our Group CFO, George Quinn.

Before we start with Q&A, can I remind you to keep questions to a maximum of two. I'll now pass it over to Mario for a few introductory remarks. Mario?

Mario Greco {BIO 1754408 <GO>}

Thank you, Richard. Good day, everybody, and thank you for joining us today.

These are good results. I'm very pleased with the first half results. They show that we're making further progress against the targets and the priorities that we indicated to you on last November. If we adjust for the impact of Ogden in the first quarter, all of our businesses have contributed positively to the first half performance.

On the expense plans, we delivered around $550 million of net savings against the 2016 basis and there is more to come over the remainder of year but this is, what I would say, it's a good progress on the expense side.

We also made some good progress against the other targets outlined last November. The return on equity, again stripping off Ogden, is at 12.5%, so above the indicated target of 12%. And cash is also are developing very nicely as expected.

Property & Casualty business, we think we stabilized the business. The top line is showing slight growth on a like-for-like basis underpinned by improved retention and by new business. The combined ratio is coming down, driven by improvement in administration expenses and the underlying accident year loss ratio. And this is in a tough market which remains quite soft in a number of locations around the world.

The Life business has continued to deliver excellent results. BOP is up 16% at the first half, and this is very much based on our strategy of focusing on protection and unit-linked products and there is a visible improvement in product mix which is triggering the higher margins that we have at the half year.

The Farmers Exchanges are also have a solid growth in their chosen areas, and the combined ratio in motor (03:29), which has been worrying many of you and ourselves for a while, has shown a sharp improvement as their reductions have taken effect. Now, these trends will continue to support growth at Farmers Management Services as well as the turnaround of Farmers Re.

Turning to balance sheet, it is very strong today. Z-ECM ratio is at 134% with strong operating capital generation of 6 percentage points complemented by a similar benefit from market movements and this is more than offsetting the call (04:09) of the dividend.

Furthermore, we continue to focus on releasing capital from non-core businesses. And that has allowed us to fully offset the acquisition of the Cover-More travel insurance business on the capital side.

Now let me pause for a second and anticipate for your questions or following up on some questions we received this morning. Let me just remind you that M&A is not a strategic priority for us. We're not focused on M&A. We don't need to do M&A. We have no gaps to fill on M&A. And we remain extremely disciplined on our capital and there we'll know that our priority is to deliver on what has been promised in November, which is to increase shareholder returns over the next years.

Overall, all these results give us confidence that we can maintain the positive momentum into the second half of year. And so we take them as an encouragement to gain even more traction in continuing on our efforts to improve the profitability and to deliver on the three-year targets that you heard us presenting in November last year.

We're now ready to take your Q&A, and so it's back to you, Sarah.

Q&A

Operator

We will now begin the question-and-answer session. The first question is from Farooq Hanif from Credit Suisse. Please go ahead.

Q - Farooq Hanif {BIO 4780978 <GO>}

Hi there. Good afternoon. Thanks for taking my questions. I'll keep myself to the two questions. So, firstly, when you talk about positive momentum continuing, given the rating environment versus inflation, are you now signaling that maybe some of the underwriting side is going to stabilize and really now it's about expenses? That's question one.

And then question two, going to Farmers, there's obviously in Farmers Management Services been this interplay between growth in numbers of policies versus pricing. So I'm just wondering at what point do you think there'll be an underlying growth in the number of policies. Are we sort of hitting an inflection point here and therefore could this be more positive for next year? Thank you.

A - Mario Greco {BIO 1754408 <GO>}

Let me start from Farmers and maybe George can help me on the rate environment, your first question. So Farmers are still passing very significant rate increases in order to bring the combined ratio below the 105% and more towards 100%. Now, optically, the next quarters will be a better benchmark because we will already compare ourselves against quarters where Farmers started – or gave customers high rate increases already. But in order to change the speed of growth of customers, definitely prices have to stabilize. As long as they continue passing high increases in model (07:56) rates, this has an impact on new business and partially on our customer retention, even that is very minimum, and you also see it in some other lines like home. But I think we all agree that profitability is the most important thing that they have to go after.

A - George Quinn {BIO 15159240 <GO>}

Can I add one thing? I think also in Farmers, Farooq, if you look at trend across the industry, I mean, that also looks substantially better than it has for some time. So we're seeing loss cost trends significantly improve, both on frequency and severity. And obviously, given that – I mean, Farmers had put through significant rate last year, they fell for more rate at the beginning of this year. If that loss cost element stays somewhat more stable, that point that Mario has made about stabilization and profitability will come much more quickly.

I think the overall goal that Farmers has remains the same. So what they're doing on the price side is designed to try and address the issues that they've had over the course of this year and reach a relatively steady state by the end of 2017.

Q - Farooq Hanif {BIO 4780978 <GO>}

Thanks.

A - George Quinn {BIO 15159240 <GO>}

On the more general rates issue topics in our market, so let me just to restate the question again to make sure I got it correct. So, I mean, are we signaling that given the market conditions that we now expect somehow the technical performance to somehow plateau and to look for improvements to come, say, exclusively from expense topics? I think the answer to that is no. I think you're absolutely right about the market conditions. I mean, it is tough. There are markets that are in good condition and have different trends but, by and large, we see, despite positive rate overall for the portfolio, inflation in many of the markets, that it's running slightly ahead. So I think as we'd anticipated at the Investor Day last year, the market itself will not help us get to the overall goal.

But we don't have to sit with the just the portfolio that we have. I mean, we are looking to rebalance the portfolio. We are looking to change the shape. Over time we'll want to emphasize areas where we believe we see stronger performance or stronger potential and we'll use that shift to also benefit the technical performance.

Q - Farooq Hanif {BIO 4780978 <GO>}

Okay. Thank you very much.

Operator

The next question is from Vinit Malhotra from Mediobanca. Please go ahead.

Q - Vinit Malhotra {BIO 16184491 <GO>}

Yes. Good afternoon. Thank you very much. Just moving to the non-core business, the campaign for this in-force management. And I was just wondering if, I mean, given that this was such a talked about topic, is it likely to be repeated in the future? Are there plans to keep doing this? Because it does look like a non-core unit but actually it's effectively an achievement of the company's strategy.

The second question is on the 1 point of large losses from EMEA. George, could you just update us on whether the man-made insurance program was tightened and whether this is adding to those deductibles or what's the status there, please? Thank you very much.

A - George Quinn {BIO 15159240 <GO>}

Thanks, Vinit. So on non-core, there are two things in the quarter that drive the performance. So one of them is something that you've seen several times before, which is around the steps that we're taking to reduce our exposure to some of the variable annuity product that we have in the legacy portfolio in North America. You've seen that repeat, I mean, on more than one quarter over the last probably five or six. I wouldn't necessarily extrapolate that. I mean, we are looking to get out of these things. They're not really intended to be a continual source of profit nor are they intended to be any source of loss.

The other thing we had in the quarter, we had a very small reserve adjustment on one of the portfolios. We've just done a study. And again, that is somewhat unpredictable in nature given the size of the business that non-core has. I think probably, Vinit, the easiest way to think of non-core is, I mean, we would look for a black zero from that business. I mean, anything we move there is generally on the exit ramp. We would look to do it economically but we're looking to get rid of this stuff. So it's not going to be an ongoing source of profit.

On the reinsurance topic, so, I mean, you mentioned a bit - obviously, one of the reasons we point to the half year rather than to the quarter for large losses is that - well, I mean, through the half year we had relatively low, in Q1 slightly higher, in Q2 is more balanced over the six-month period. We do have some large loss experience in EMEA. I guess it's the nature of the business that we have.

From a reinsurance perspective, I mean, it's good news and bad news. The bad news is that I don't believe we'll attach the reinsurance this year. I mean, it obviously depends on what happens in the second half. But the good news is I don't expect our large losses to reach that type of level. And I think if you look at the experience since 2015 when we clearly had a major issue, we've not only substantially reduced the absolute level you see in an accident year ex-cat loss ratio improvement of nearly 3 points, if you look at the inter-quarter volatility, we're going from 6 points in 2015 to about 2 points over the course of the last six quarters. Obviously the reinsurance will protect us one day but we're looking to the way we underwrite and the way that we structure the portfolio to remove this issue. And I think we've had some success. Not that we would ignore the issue of large losses. I think the primary focus today is actually just outright technical improvement. That's what we're really trying to drive in the portfolio.

Q - Vinit Malhotra {BIO 16184491 <GO>}

Thank you very much.

Operator

The next question is from Peter Eliot from Kepler Cheuvreux. Please go ahead.

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

Thank you. I might update my questions on the Z-ECM please, actually. The first one was I was struggling to understand the movements precisely. I guess that the business profit development is equivalent to about $2 billion, which seems - I don't know, it seems a lot more than earnings. So, I'm just wondering whether you can sort of split that out a little bit and confirm whether you think that's a sustainable run rate. And also in terms of the market sensitivities, it seemed a little bit more than I was expecting. I mean, the equity markets you seem to be attributing to about 2 points of the gain, which, according to your sensitivities, would have required a rise of about 20%. Maybe I'm just going very wrong on my maths but just wondering if you could give us a bit more guidance on how those changes have come about.

And I guess the second question, the sort of inevitable - given the very, very strong level of capital that you've got at the moment, I guess at what point do you start to address that, and are you able to give us any sense on what your priorities might be? You hinted at improving shareholder returns et cetera but I'm just wondering if you can elaborate any more. Thank you.

A - George Quinn {BIO 15159240 <GO>}

Peter, so I suggest I'll start with the walk through the Z-ECM movement. And again, to avoid any unnecessary volatility, I'll focus on the first half rather than just the quarter. So, if you look at where we ended the year at 125%, we've seen an improvement of around 9 points. About 6 points of that comes from business profit. So, I mean, that's close to the level that you quoted. If you look at market changes, they drive about 6 points. I think the 2 points that you referred to is equity and credit rather than just equity on its own. There's a number of other items that drive it, sort of things like foreign exchange, we benefit from some of the interest rate move. But the favorable equity market and credit spreads impact is between 1 point and 2 points in total for both of them. And then, of course, there's dividend accrual and there's a very small increase in insurance risk which explains the difference. Dividend accrual is 4 points.

On the business profit, I mean, obviously it reflects more than just the earnings for the quarter and it will emphasize a bit more from the Life performance. And, for example, given the relatively strong new business value performance you see in the second half, particularly from the bancassurance transactions, I mean, that would be expected to boost the reported result when you translate it into an economic performance. So those are really the drivers.

I think your second point was about capital strength and priorities. So I think all I would say there is that - I mean, as you've heard from Mario already today and in the press release, the very strong capital position, it's a fantastic foundation for what we intend to do around the dividend and earnings. So, I mean, even with really significant volatility in the market, we would maintain our capital strength and it would pose no impediment to us to do what we intend to do; one, to drive higher earnings and to use that to drive higher returns then to shareholders through the ordinary dividend.

I mean, I think midyear is an unusual time to discuss capital topics for me. So, I mean, it's a topic we'll come back to at the end of the year.

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

Thank you. Could I just maybe follow up very quickly? The 6 percentage points of business profit, you'd say that's a pretty good sustainable underlying figure?

A - George Quinn {BIO 15159240 <GO>}

I think it's – obviously, it's partly dependent on what happened in the Life business because, of course, there's a capitalized element there. So, it can be a touch volatile. But I think if you look at Life in particular, both on a BOP and an economic basis in Q2, I mean, very strong performance, not dependent on one-offs. We're very happy with what we see there, and I think that's a strong and confident sign for the future.

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

Thanks very much.

Operator

The next question is from Andrew Ritchie from Autonomous. Please go ahead.

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

Hi there. Two simple questions, I think. First of all, there's lots of moving parts in the combined ratio, half year, quarterly, et cetera. Maybe, George, you could just give us a view as to what you think the "normalized combined ratio" is running at. I'm thinking relative to the sort of 99%/100% it was running at last year versus the 97.5% soft target for full year 2017. It's very hard to know what – I mean, given all the moving parts. So just what's your view? What is the current run rate of normalized combined?

Secondly, on cost saves, I think the plan was to achieve an additional $400 million this year. You're actually running slightly ahead of that, I suppose, at the half year. Do you think you're actually running ahead? Is that just a timing issue? And maybe qualitatively, the achievement of the cost saves, is it easier or harder than you thought? Are you discovering any more things that are interesting in terms of potential?

And just to clarify, if I look at the absolute admin expenses in non-life, all the movement there is cost saves, there's nothing else going on? Obviously, they came down quite a lot quarter-on-quarter. Thanks.

A - George Quinn {BIO 15159240 <GO>}

So, first of all, on the normalized numbers, yeah, I mean, there are lots of different figures, it's relatively easy to be confused and it's relatively easy to choose, let's say, a number that you prefer. But, I mean, I'll tell you how I look at it.

I think if you took the quarter and you would do what I would normally suggest, which would be PYD and cat, I think you'd get a much higher number than the one that we believe we're currently running at. There are a number of smaller items, I'll touch on them in a second, that are one of the reasons why I don't think that's a particularly good guide in Q2.

I think to make that clear there, that's not cherry-picking. I mean, we did the same thing at Q1. So we tried to steer everyone away from doing a straight normalization at Q1 because you'd have ended with a number that was too low for us. And the principal driver of that was in large losses where – I mean, not far away from plan, but a bit light at Q1 and we have a relatively simple reverse of that at Q2. I think if you allow for the fact that large is slightly high, you allow also for the fact that the commission ratio through the first half is distorted by a correction in Europe, I mean, it's about 2/10, 3/10 of a point.

I think, on the flipside, if you also allow for the fact that we had some seasonality in expenses, so while the cost program will continue you'll hear in a second from Mario, we do have a bit of seasonal pattern that you've seen before and you will see to some degree continue into the second half of this year. That would mean that expense ratio, all things being equal, in Q2 is maybe a touch low.

So I think if you allow for all of them, we would see an underlying combined ratio that's around that 98% level. I mean, not far away from the half year combined ex-Ogden. So that's roughly where we think we are at the moment.

A - Mario Greco {BIO 1754408 <GO>}

So, Andrew, on the cost side, so first of all, we wanted to have an accelerated development of the benefits because both with intentionally (22:37) and for you guys outside of the company, having a backend loaded plan wouldn't work. So we are where we wanted to be. By yearend, we would like to be above the midrange of this target, and we think we can get there which would give us the further comfort that a big chunk of the program has been done in the initial two years.

On how tough or difficult it is, look, it is definitely much more challenging and much more complex to reduce the combined ratio than to reduce the cost. Cost is about discipline and focus. And so we activated the process, we'll continue with that. You ask if we found further ways to do it. I think, yeah, every day we find some more initiatives, some more chances to reduce the cost. What is important is that, again, internally and for all of you guys, I think we're showing discipline and we're showing that we walk the talk. We indicated the targets and we are delivering quarter by quarter.

A - George Quinn {BIO 15159240 <GO>}

On the point about how much of the P&C expense ratio in fact is – I mean, sustainable cost reduction, given the move that you can see, what you see in the expense ratio is a combination of lower charges from the center which are absolutely sustainable and the impacts of action that we've taken already last year and the early part of this year in P&C. So there's no significant one-off from an expense perspective.

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

Okay. Thank you.

Operator

The next question is from Dhruv Gahlaut from HSBC. Please go ahead.

Q - Dhruv Gahlaut {BIO 16209870 <GO>}

Good afternoon now, guys. Thanks for taking my question. Two questions. First, going to the North American commercial business, could you say a few words in terms of how price is developing with respect to the claim inflation on that book at this point of time?

Second, you restated your guidance in terms of the cash flow over the next three years period. Could you say as in how that is looking in the 1H? I'm assuming a fair amount will get limited in the 1H for you guys. Thanks.

A - George Quinn {BIO 15159240 <GO>}

So on the North American commercial market expense rate versus loss cost inflation, I mean, you've picked out one of the parts of the portfolio that has some of the bigger challenges also from a market perspective. So I think if we look at the overall today and, again, compare it to the assumptions that we would have had when we put together the targets that we discussed at the

Investor Day last year, I think we would have anticipated slightly more rate and slightly less inflation in North America, and we see a bit less rate and a bit more inflation.

Q - Dhruv Gahlaut {BIO 16209870 <GO>}

All right.

A - George Quinn {BIO 15159240 <GO>}

If you look at it by line, rate is particularly troublesome still around property and also some degree around workers' comp. Inflation, higher generally across the board but, again, the liability lines, particularly the motor-related business shows I think relatively healthy loss cost inflation.

Having said that, not to leave it just on an absolute negative, I mean, that is offset by what we see elsewhere in the portfolio. If we redrew the picture today, I'm not sure the sum total would significantly change, but you see an expectation of some of this contribution from the U.S. and maybe more from Europe. And if you look even more recently in Q2, we see APAC actually contributing pretty strongly. The Australian market has started to turn to some degree. And so overall, we're not far away from what we thought we were going to be in November, albeit the components are maybe a bit different.

Q - Dhruv Gahlaut {BIO 16209870 <GO>}

All right. Thanks.

A - George Quinn {BIO 15159240 <GO>}

From a cash flow perspective, Mario commented that we're absolutely on track. We're very happy with what's happening around cash flow. We'll update you again at the yearend but we are very confident that we will deliver more than the $9.5 billion that we have committed at the Investor Day last year.

Q - Dhruv Gahlaut {BIO 16209870 <GO>}

Great.

Operator

The next question is from Nadine van der Meulen from Morgan Stanley. Please go ahead.

Q - Nadine van der Meulen {BIO 15200446 <GO>}

Good afternoon and thank you for taking my questions. Two quick questions from my side. You just talked about the expense saves. On the restructuring costs or restructuring provisions, they were down quite a bit in the second quarter. Do you still guide – or maybe you can remind us again on the guidance you gave for that. Is that still around $500 million for 2018?

And then the second question is on the dividend. So the current dividend policy of 75% earnings payout ratio or maintaining the CHF 17, whichever is the higher, you emphasized or you mentioned in the past that the dividend is based on forward-looking earnings or could be based on forward-looking earnings. I was wondering, given the sort of strong capital of the group and the earnings growth that you are continuing to show, do you see the possibility to increase the current 2017 dividend whilst having a temporary payout ratio of about 75%? Thank you.

A - George Quinn {BIO 15159240 <GO>}

Thanks, Nadine.

A - Mario Greco {BIO 1754408 <GO>}

So we're looking in the eyes, George and I, on who should tackle this question. Okay, I think it is my turn. So, look, it's clearly early to talk about dividends. So George say that before, I mean, we can't talk in August about the dividends for the year.

Definitely, the year has been progressing well. So what we see is that we have significant performance improvement. If this momentum is continued through the year and if this performance improvement make us confident that we can keep running the business with this higher level of profitability or even better, and considering the capital situation, we will carefully look at the dividends by yearend. But it's really too early to say.

In the horizon of the plan, there is no doubt that the plan brings us to reward shareholders in a better way. And so it's more a question on execution and speed of execution of the plan than about what will get done by us over the time. Sorry that I cannot add more to that but (29:52).

Q - Nadine van der Meulen {BIO 15200446 <GO>}

No. This is already quite helpful. Thank you.

A - George Quinn {BIO 15159240 <GO>}

Nadine, on the first part of your question around expense and particularly the restructuring topic, it has been a slightly quieter quarter from a restructuring perspective in Q2 than the linear run rate would suggest. We're not changing guidance. We certainly won't be more than $500 million. I don't expect to be very substantially less than $500 million. So we'll be within that $500 million level.

Just one point I want to flag ahead of time. Given the definitional requirements for restructuring from an accounting perspective, we may see some of a "restructuring" go through BOP in the second half. So you may see up to $150 million run through BOP but we still expect the total economic restructuring to be within the $500 million guidance.

Q - Nadine van der Meulen {BIO 15200446 <GO>}

Thank you.

Operator

The next question is from James Shuck from Citigroup. Please go ahead.

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

Hi. Thanks for taking my questions. Two questions from my side. I'm kind of going to give up trying to get an answer to the question about returning capital and what your plans are around the dividend. But I would like to just ask a kind of theoretical view of what is actually possible, because you've got 134% Z-ECM. You obviously run for – 100% to 120% is the target. If you just take the kind of midpoint of that level, you get many billions of theoretically usable surplus. And I guess I'd just like to get your thoughts on what are the binding constraints when it comes to actually distributing or the potential to distribute or deploy that capital. Is it rating agency, is it SST, is it central liquidity? If you could just update on that, that would be great.

Secondly, on the U.S. commercial line, there's been a bunch of repositioning of the portfolio in that territory, particularly around deepening customer relationships and moving into new areas and trying to take some of the volatility out of it. If you could just update on where you are with that. Obviously, you'd be – the competition has got much stronger in the larger ends. I'm interested to know what you're doing at the micro end. You've seen a number of your competitors make acquisitions and start to move into that segment. I don't think you have so far. So just an update on what's happening on U.S. commercial will be helpful. Thank you.

A - Mario Greco {BIO 1754408 <GO>}

So good try, and if I can satisfy you with the answer but it's a good try on capital and dividends.

I guess what I would first like to remind you is that there is volatility in this capital ratios. At yearend over the last four years, we've been almost in a very narrow range between 120%-122% in each single year. Today, it's 134%. Part of it is due to the market movements that can change and part of it is due to our actions into the business profitability.

I don't think that we have focused ourselves on returning excess capital when we presented the strategy. We focused on dividends. And we committed to have a clear payout ratio policy and we spoke about achieving the capacity to improve on the dividends. And this is still where we are. I mean, we're glad that the capital is moving this way. We're glad that we're finding ways to protect and improve our capital position. But our commitment, the first commitment we have is to show that we can establish a positive dividend growth after so many years.

A - George Quinn {BIO 15159240 <GO>}

Can I make just one comment? (34:00) there was a part of your question which was asking about whether there was a hidden constraint that we haven't disclosed. So as you would expect, ordinarily, rating agencies tend to be a more significant constraint than some of the internal models. Liquidity is no constraint for us. I think that if you look at the overall, we certainly have more balance between all the measures than I've seen for some time. So there's nothing that we're not showing you that would materially change the picture.

A - Mario Greco {BIO 1754408 <GO>}

Yeah.

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

I guess if I can just very quickly, I mean, you have a target range of 100% to 120%; that's meant to allow for the volatility as is. So at some stage you've got to manage yourself to the midpoint of that range, I would guess, or you need to revisit the capital management framework.

A - Mario Greco {BIO 1754408 <GO>}

And we will at some stage as you said. But in the meantime, let us deliver on what we promised, which is based on dividends. And this is what we owe you all and this is our first priority, to show that profitability can allow us, by gaining momentum, or by maintaining positive momentum, to have a more rewarding dividend policy. And that is our priority number one.

On U.S. retention in customers, I think there is one thing which is undisputed that's Zurich's strength is the customer management system and the customer services. We are still enhancing it. And the good thing is that we see retention moving up in U.S. and in Europe on our midsize companies in our commercial companies. We see lots of opportunities for further cross-selling. We're carefully exploring, client by client, account by account. You know that we have 1,000 clients which are managed individually by account managers. And for each one of them, on a name basis, they will look at how many products that we have sold them, what are we missing, what else can we sell them. And that I think is much more effective than going through acquisitions. We don't need acquisitions for that. Not at all. We need to work ordinarily day by day and with methodical pressure on knowing our portfolios and bringing the offers to the customers. And that is working well. This is one of the thing where the traction is visible internally and I'm quite pleased with what the underwriters have been doing around the world and the way they have been using their schemes to broaden the services.

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

That's great. Thank you very much.

A - Mario Greco {BIO 1754408 <GO>}

Thank you.

Operator

The next question is from Thomas Seidl from Bernstein. Please go ahead.

Q - Thomas Seidl {BIO 17755912 <GO>}

Yeah. Thank you. Good afternoon. I come back to this combined ratio point because it's so important for Zurich, obviously. So at half year, you had 97.8%, George, as you said. Compared to last year half year, you have similar period. You had 0.9% higher reserve releases, 0.5% lower cat, a few one-offs. But it seems that the combined ratio, that is stable, if not slightly nudging upwards. And you want to get to 95% to 96%. This is what the market also has started to expect from you. So I wonder how you get for the next two years to the 95%, 96% level. Question one.

Question two is on reserves. You have this Ogden hit, $289 million. You did a lot higher reserve releases in this quarter, the highest since 2014. And still you say that the reserve adequacy is unchanged year-to-date. I mean, another Re (38:12) has this morning basically reported a similar number for Ogden but have clearly said that this hit their reserves to range negatively, as one would expect. So I wonder why it is not the case at Zurich.

A - George Quinn {BIO 15159240 <GO>}

So on the first one, Thomas, on the combined issue, I think I said in response to Andrew's question earlier that there are – there's a lot of numbers around the combined ratio. I mean, you can choose how you prefer to assemble them. I think the way I see it and the way I would suggest that others look at it, is that if you look at the performance for the half, I think that's a better starting point ex-Ogden. And if you prefer to start from the quarterly combined ratio and normalize it, I think you also need to allow for some of the – I mean, not one-off, but some of the more unusual elements that are in the result.

So in the same way that I discounted the positive large loss experience in Q1, I slightly discount the negative large loss experience in Q2. The half is just a better guide. So again, if we allow for that, we allow for the commission one-off, we would see ourselves around the 98% level.

Q - Thomas Seidl {BIO 17755912 <GO>}

Which basically leaves you 2 percentage point to improve over the next two year as a minimum. So how do we get there?

A - George Quinn {BIO 15159240 <GO>}

So, as Mario said earlier, we've made good progress on the expense program, but we're by no means done. So we still have the thick end of $1 billion to deliver. You know the proportions of the group and you know how much of that will benefit the P&C business. So even if you discount the comment I made earlier about portfolio management being used to more than offset the impact of some of the market softness, that expense ratio on its own is a very significant step in taking us to a combined ratio that's exactly in the range that you just quoted.

On the reserving topic, so as you from us, we took the full charge back in Q1 – or we took the part of the charge based on the same announcement from the government in the UK and that clearly had an impact on our reserving position because we simply let it flow through. We had indicated earlier that through the course of this year, we expected that we could absorb it within a normal 1% to 2% PYD. What that means is achieve 1% to 2% after the absorption of Ogden. As you've seen from us in several prior quarters – and the gross reserve releases have run slightly higher than the ones that we've typically released over time, and we have a bit of that again in Q2.

So while I had expected that it would take us probably more of the year to absorb the full impact of Ogden, I mean, here we are at the end of Q2 and we have absorbed it and we are back at our targeted PYD range with no adverse impact on the group's reserve strength. I would not expect that PYD would run at that same 3% level for the next two quarters. You should expect to see something back more consistent with what you've seen from us before.

Q - Thomas Seidl {BIO 17755912 <GO>}

I think what's slightly confusing here is you did a higher reserve release and still you – to offset Ogden obviously, to get to the 1 percentage point of net, and still you say the reserve adequacy stays unchanged.

A - George Quinn {BIO 15159240 <GO>}

Yes. But it's important to remember that a number of different things drive reserve strength. So of course there's the reserve strength that you start with and there's the reserve strength that's changed by facts and information that comes to your attention during the course of the quarter. And I think you can see within the PYD that we have some notable one-offs, for example, in New Zealand and the change that was made there. So at the beginning of the quarter that would not have formed part of reserve strength. But if we had less there at the end of the quarter, it would have. And that partly explains why you see this significant PYD but with no impact on reserve strength.

Q - Thomas Seidl {BIO 17755912 <GO>}

All right. Thanks, George.

Operator

The next question is from Ralph Hebgen from KBW. Please go ahead.

Q - Ralph Hebgen {BIO 6297020 <GO>}

Yeah. Hi, guys. Thanks for taking my question. It's actually only one question. I'm going back to the combined relation, specifically the component which is the accident year loss ratio before nat cat.

Now, I appreciate all your comments, and I understand that it will be to some point even arbitrary or discretionary to pick the combined ratio apart. And yet it is quite optical the increase in the accident year loss ratio from 64.5% in 2Q 2016 to 66.3%. So, any comment there would help.

And perhaps what I have in mind is perhaps something like the normalized expectation of large losses where, following the implementation of the various management initiatives, you would not expect sort of large losses to run. And then perhaps you could indicate where 2Q 2017 runs against that benchmark compared to where 1Q 2017 ran and where 2Q 2016 was, if that bit makes sense. I mean, I'm just groping around a little bit trying to get a benchmark against which I can measure or gauge where the dynamics, the underlying dynamic of loss cost and the loss ratios are.

A - George Quinn {BIO 15159240 <GO>}

So I think the first point, Ralph, is that, I mean, you point to the answer in the question. I mean, the comparison of Q2 this year to Q2 last year is heavily impacted by the point that you make. I mean, we had a very, very benign quarter Q2 of 2016 and we've had a very slightly heavy quarter in Q2 of 2017. Again, I think I also mentioned in response to an earlier question that despite that, we've been in a relatively tight band. So if you look at us over the course of the – I think the last six quarters, since we've started making changes both to the way we underwrite, to the risk selection and to the reinsurance, you've seen the accident year loss ratio ex-cat move in a band that's around 2 points.

If you look at it Q2 2016, that's probably the low point. If you look at it again today, I think we are at or around the high point. I think that type of variation, if you take high to low of a year and a half, it's not impossible we'll see that type of move given the kind of business that we have.

As far as benchmark goes, I'd point you back to what I said both in response to Andrew and just a second ago to Thomas. If you allow for what we see as slightly larger than expected large losses – I don't want to make a huge deal of it, but if you compare that to what you would see as the normal normalization, if that's not too much of a twist, I mean, we see ourselves around 98% and that would give you an immediate sense of what we would believe the excess large loss on the quarter to be. But that comparison year-over-year is driven by one very benign quarter versus a slightly heavier quarter.

Q - Ralph Hebgen {BIO 6297020 <GO>}

Okay. That's fair enough. Thank you.

Operator

The next question is from Paul De'Ath, RBC. Please go ahead.

Q - Paul De'Ath

Yeah. Hi, guys. Another question, sorry, on the combined ratio and more specifically looking at the commission ratio. So I think George mentioned that part of the increase in the commission ratio was a correction this time around, and then there's obviously an element of it that is due to mix. And I guess going back to this point of how do you see that in relation to then the loss ratio, so if you say 0.7 possibly points of movement are down to mix on the commission ratio, should we expect a kind of reciprocal movement on the loss ratio? That's kind of the first point.

And then the second one was just going back to Ogden. Obviously there's potential that we get further move in the Ogden rate later in the year. Obviously, any comment on that would be gratefully received. But assuming it moves in the right direction, is that just an additional bonus in terms of the numbers for you guys in the second half or whenever it comes? Thanks.

A - George Quinn {BIO 15159240 <GO>}

Thanks, Paul. So the only thing I will say is that you are completely tenacious around this commission topic. I mean, you checked this with me the last time we had this conversation. But I mean, you make a very good point. We have talked about mix of business driving this. We do expect to see improvements in performance.

Again, if I point to the things that are – maybe start with the numbers first. So commission ratio is up by about 1.5 points. Bulk of that – I mean the vast bulk of that is business mix, and there's a small piece of it which is that commission adjustment that I referred to earlier. It's about 2/10, 3/10 of a point in the quarter. And that's a one-off. We do not expect that to recur.

Within the business mix, a number of different drivers. So, I think we've been successful in Latin America at driving growth in the mass consumer business. If that opportunity continues to present itself to us in a way that would drive profitability, we would continue to take it. But the characteristics of the business is that it has higher commission levels with typically lower and typically far more stable loss ratios.

I mean, I can't scientifically point to you today that this drives that, so I'm sure there's a piece of what we see in the commission which is showing up in the loss ratio improvement. I think, Paul, just as importantly, probably stability that I've referred to earlier, I mean, while I think we'd all like it to be more, one of the benefits of that business mix shift is more stability in the group's performance, and that's something we would continue to pursue in future, but assuming that that opportunity was profitable.

The other big driver of it is actually in the U.S. As you know, the more competitive end of the market is the large commercial. It typically comes at a much lower cost of acquisition. We've continued to prune that book at the edges. That's been offset by growth in the direct markets book which for us is the F&I business and the surety book. And I mean, they both carry much heavier commission rates than the commercial book.

One additional comment on that, and that's that ordinarily we'd expect those businesses to be, again, have characteristics closer to the, let's say, the mass consumer than the large corporate commercial which would be more exposed to some peak (50:10) risks. I mean, it was a relatively difficult quarter for some of the direct markets business because they were more impacted by the cat experience that we've seen in Q2. So that somewhat dampens the ability to bring down the overall combined ratio for the quarter. But that's something we are driving towards, and I would hope that we could demonstrate that more clearly as we move through the year and we have a bit more experience behind us.

On your second point on Ogden, I mean, really difficult to say anything on that today. From an information flow perspective, I think – I mean, you guys probably know at least as much as I do at this stage. There was an expectation of an announcement last week which has been postponed. And as far as I'm aware, no subsequent date has been established. Obviously Ogden as a topic is a major event for the UK market. It's a relatively substantial (51:12) on rights. As to how much, when, even if, the UK government would come forward with a different proposal, I mean, my guess today is as good as yours.

Q - Paul De'Ath

Okay, great. Thanks.

Operator

The next question is from Niccolo Dalla Palma from Exane BNP Paribas. Please go ahead.

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

Good afternoon, everyone. My first question is on top line. Clearly, good news to see that the like-for-like top line has been stabilizing in P&C both in Q1 and in Q2, actually slightly up you mention. I just wondered if you could tell us, is it still requiring above normal effort to keep it stable especially on the commercial side I guess from the management, because my understanding was that your efforts to show you're there to write business were more important than in a business-as-usual situation. Just wondered where we are on that.

And the second question, if you could run us through the impact on earnings specifically from the Banco Sabadell deal. What impact should we expect from here? But also Cover-More group, if could run us through today, given your expectations of the increased reinsurance on that book, what should the broadly impact be of these two transactions for the remainder of the year and going forward. Thank you.

A - Mario Greco {BIO 1754408 <GO>}

So, Niccolo, I start – this is Mario. Start with the sales and commercial question you raise and then I leave it to George on the Sabadell impact. On sales in commercial, so it's not really an extraordinary effort that was needed, but definitely we have been in change and transition also for the organization. We unified the organization of commercial and corporate almost a year ago, or some quarters ago, and we unified also the management in each country. That initially created some distress in the people and in the sales organization which is now over. So the better situation we have now is that while we're settling down with the long-term organization that we want to have and people have their roles, people feel good about their roles and that is naturally facilitating then going back to customers and markets and growth initiatives. And I think that this will continue. I'm quite positive that this will give us a further boost later on.

We're still extremely careful. We know that the markets are quite soft. And so, we're doing only the things that we want to do with the customers. But the power of the engine is back in place.

A - George Quinn {BIO 15159240 <GO>}

On the impact of the two transactions, so Sabadell will have an immaterial negative impact on Life earnings. Obviously part of the transaction is to capitalize a future earnings stream and dispose of it, but I don't expect that to be significant in the context of reported earnings. Cover-More, this year, I mean, it will have some impact but of course there's some initial upfront cost that we'll incur, so expectations this year are relatively low. We priced these transactions at – well, we don't price individual transactions, but we set hurdle rates for the transactions that would be expecting to achieve ROIs at a minimum level of 10% and perhaps higher, depending on the risk profile of the transaction. I mean, you can apply that same rule of thumb to Cover-More.

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

And sorry for a small follow-up. On Banco Sabadell, do you expect that capital to be released up to group or is that, first, not in your hands and, secondly, not in today's plan also for cash remittance?

A - George Quinn {BIO 15159240 <GO>}

That's a really good question. I mean, as you heard earlier, there's no significant capital benefit to us from the transaction because of the different treatment between Solvency II and SST. It would therefore be – even though we're not in control of it and it's subject to regulatory approval, I mean, the benefit to us would be the cash flow, assuming that the business was to receive approval to make that additional payment to us. Given the uncertainty of something like that type of transaction, that would not have been in our initial plan.

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

Thank you.

Operator

The next question is from Michael Huttner from JPMorgan. Please go ahead.

Q - Michael Igor Huttner {BIO 1556863 <GO>}

Thanks very much and well done, sir. These are really good results. We're very impressed. But on the organic capital generation, could you just give us a little bit more granularity? So, looking at the BOPAT report, it was $1.66 billion taxed (56:49). And you said the profit figure which was mentioned, the organic capital generation was just under $2 billion. So there's a gap of about $200 million. And you said that's capitalized less (57:03) costs and I just wondered if you can say a bit more about that.

And then the second, you talked about mix of business shifts and you gave some examples. Is there any way for us to follow it? I mean, the examples you talked about are fantastic and it's lovely granularity but is there anything that we can see in the slides or the supplementary information where we can say, a-ha, I can track it myself, here's a mix shift that I can see and it's really lovely?

A - George Quinn {BIO 15159240 <GO>}

Thank you, Michael. So, on the first question, I mean, but it doesn't give you much more than I gave in answer to the earlier question. So, I mean, I don't have a bridge in front of me that I could give you it point by point. But the key difference between the reported earnings that you can see and the impact that we have in the Z-ECM ratio essentially is the new business value in Life. That's the main explanation, I would say, the difference.

Q - Michael Igor Huttner {BIO 1556863 <GO>}

And the Ogden is deducted from both?

A - George Quinn {BIO 15159240 <GO>}

Ogden, well, so Ogden is really complicated. So, Ogden was out of the starting point.

Q - Michael Igor Huttner {BIO 1556863 <GO>}

Okay. So, (58:20). Okay.

A - George Quinn {BIO 15159240 <GO>}

Too right. So in the 125% starting point I talked about earlier, Ogden was already accounted for in that number.

Q - Michael Igor Huttner {BIO 1556863 <GO>}

So, the bridge is actually quite small, because the $1,662 million – no. No, sorry. Ignore that. Sorry. Carry on. I'm wasting your time.

A - George Quinn {BIO 15159240 <GO>}

No problem, Michael. On the second topic, I suspect Richard and I will have to have a look but it'd be relatively difficult to substantiate my comments from the disclosure that we make. I think you can use some proxies but they won't – I mean, you have a commercial segment where you can see the change in volume and the impacts on the expense ratio there. Brazil, it's not solely mass consumer, but it certainly dominates the overall portfolio. But I think Richard and I will have to have a look and see if there is something we can do that's more helpful around that mix topic. So, I mean, yeah, I think you couldn't bridge it from what we gave you today other than my comments.

Q - Michael Igor Huttner {BIO 1556863 <GO>}

And if I think about the bigger picture about the mix shift, if say when Mario Greco arrived, your portfolio was, I don't know, 30/70 or 20/80 stuff you don't like and stuff you do like, where are you now?

A - George Quinn {BIO 15159240 <GO>}

We've certainly improved to safely (59:42) where we are on that continuum. I'm not sure it ever ends. It's the problem, isn't it? So, you're always looking at the portfolio again and thinking that there's further steps I could take to improve it. So, I don't think there's ever a landing point in these things.

Q - Michael Igor Huttner {BIO 1556863 <GO>}

Okay. Lovely. Super. Thank you so much.

A - George Quinn {BIO 15159240 <GO>}

That's the last question we have on the call. So, thank you all very much for joining us today.

Just before we close the call, I want to point out something that's in the press release about our financial reporting going forward. In line with our peers and with effect from the third quarter, we will move to reporting the full financial disclosure for the half year and full year only. That means that for the first and third quarter reporting, we'll continue to have an analyst call with management and we'll have a statement that provides the highlights for the quarter that will focus more on top line development. We'll have qualitative information on the most important market trends. We'll also cover development of the group's capital position and any other notable significant or exceptional items.

With that, I'll hand over to Richard.

A - Richard Burden {BIO 1809244 <GO>}

Okay. Well, thank you very much, everybody, for dialing in today. I think there may have been one or two questions that were still waiting to be answered. But obviously, in the interests of time, given it's a busy day with other results, we'll close it there, and the IR team stands ready for any questions that you might still have. So thank you very much.

A - Mario Greco {BIO 1754408 <GO>}

Thank you.

Operator

Ladies and gentlemen, the conference is now over. Thank you for choosing Chorus Call and thank you for participating in the conference. You may now disconnect your lines. Goodbye.
