S1 2019 Earnings Call

Company Participants

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

Other Participants

- Andrew Ritchie, Analyst
- Farooq Hanif, Analyst
- James Shuck, Analyst
- Johnny Vo, Analyst
- Jon Hocking, Analyst
- Kamran Hossain, Analyst
- Michael Huttner, Analyst
- Nick Holmes, Analyst
- Peter Eliot, Analyst
- Vinit Malhotra, Analyst
- William Hawkins, Analyst

Presentation

Operator

Ladies and gentlemen, welcome to the Zurich Insurance Group Half-year Results 2019 Conference Call. I am Sandra, 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. The presentation will be followed by a Q&A session. (Operator Instructions) 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, and welcome to Zurich Insurance Group's first half 2019 Q&A call. On the call today is our Group CEO, Mario Greco, and our Group CFO, George Quinn. Before we start with your Q&A, Mario will make a few introductory remarks of results, and when we come to the Q&A, as always, we just ask you to keep to two questions in the first round and if we have time, afterwards we will come back for a second pass.

Over to you, Mario.

Mario Greco {BIO 1754408 <GO>}

Thank you, Richard. Good afternoon to all of you and thank you very much for being on the call, especially, since we are in the middle of August, almost. And before we get into the Q&A, let me try to provide a few remarks about our performance and where we stand today. In '16, as you remember, we set ourselves ambitious targets and we launched a new bold strategy. The first half results show that the strategy has delivered and that we are on track to exceed all of our targets.

Our BOP has reached the highest level in the past decade, and our BOPAT ROE of 15%, shows the significant value that we're creating for our shareholders. The performance of our property and casualty business has been very strong, with the business showing growth in gross premiums and improved underwriting performance with the still very low volatility.

The strong improvement in the accident year combined ratio before natural catastrophes clearly shows that the actions that we have taken to change the mix of the business and to improve the quality of the portfolio were the right ones. This is especially the case in our commercial business, where discipline and focus has driven significant improvement in profitability, in contrast to what many have reported. Looking forward, we see further opportunities to improve the results and we see the current upturn in US pricing as supportive of the future performance of our business.

Our Life business has continued to perform well in the first half with underlying growth continuing, and with headline results held back only by the strengthening of the US dollar. The high quality of our Life portfolio and our long-term focus on protection and unit-linked savings position us as well to manage the ongoing challenge caused by the low yield environment.

About Farmers, both our own business and the policyholder owned Farmers Exchanges have continued to grow successfully in the first half of the year. Particularly the Exchanges have continued to build successfully of their presence in the Eastern United States and they also expanded Toggle, their innovative offering for millennials to over 20 new states.

Our balance sheet remains extremely strong with our solvency at both the top-end of the target range, despite the impact of falling yields in the absence of the dampening mechanisms available to peers reporting under Solvency II.

Over the first half of 2019, we continue to develop our strategy and we strengthened our business through the addition of new partnerships, and new and innovative product offerings across a wide range of our businesses. Our innovation has also gained external recognition. The Group had won a number of awards over the first half of the year, and this is, of course, quite relevant for all of us. These results and these developments give me great confidence for the future of the Group and our positioning for the next phase of our development, which I look forward to presenting to you later this year.

Thank you for listening and now we are ready to take your Q&A, and George and I will respond to all your questions. Back to you.

Questions And Answers

Operator

We will now begin the question-and-answer session. (Operator Instructions) The first question comes from Jon Hocking, Morgan Stanley. Please go ahead.

Q - Jon Hocking {BIO 2163183 <GO>}

Good afternoon, everybody. Thank you for taking my question. I've got two questions please. Could you comment on what you're seeing in terms of large loss trends? And if there's anything that is sort of anticipated [ph] underlying pattern there? That's first question. And then secondly in terms of the trends we are seeing in US pricing, are any of those sufficient yet to change your appetite for particular lines of business over and above others that you've been, maybe some of the things you've been de-emphasizing? Thank you.

A - George Quinn {BIO 15159240 <GO>}

Jon, it's George. You'll probably remember last year that we resisted the temptation to get too deep into large loss topics because often we hear that as a reason why businesses haven't achieved the targets they've been given. I mean, I think the good news for us is that we haven't had that commentary internally. I think though if we do break down the numbers. I mean, the outcomes that you see in the first half of this year aren't driven by an absence of large loss. We see more of the improvement driven at the smaller end of the spectrum, so we are still seeing large loss. In fact, if anything, slightly higher than our current expectation.

On your other question on U.S. pricing, maybe it's good to just mention where we see U.S. pricing, so that we'll all be on the same page. I mean, if you remember, the commentary from Q1, I talked about the fact that, I mean, overall, for North America, where I gave quite a bit of detail, we were slightly north of 2, slightly north of 4 rather, ex workers comp, we were right at 6, if that's a particular measure you like. Overall, things are stronger in Q2. We see things getting quite close to 7% for all lines of business, so with that change of appetite. I mean, starting for us, it's -- I mean it was actually rational about how we set targets, I mean so for the business, but they see the right levels of return. They can write the business for sure. And I'm sure that this will take some business at the margins that previously we would not have written and it would tip into places where we would write it. I think on portfolio that for me, is a different topic. So I mean, we are trying to shape the portfolio. I think that topic will continue. But certainly, the improved profitability in the market overall will increase the opportunity for us in commercial.

Q - Jon Hocking {BIO 2163183 <GO>}

Thanks very much.

Operator

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

Q - Peter Eliot {BIO 7556214 <GO>}

Thank you very much. The first question is, the obvious one just revisiting that accident year combined ratio ex nat cat. I appreciate, George, you don't want to sort of go too deep or over analyze the large losses. But I was wondering if you could just give us your view on sort of how much of that improvement is sustainable? And to the extent that has come from sort of pricing improvements and portfolio actions, I mean, those have been ongoing, should we expect another similar improvement over the next 12 months? Or is that certainly bullish?

Secondly, I was wondering if you could just give us a bit more clarity on -- granularity on the 8%, Z-ECM increase from business profit? Because I guess, that's what 2.5 points higher than the sum of net income contribution, so that would be great, just to understand, like the contribution from new business and many other moving parts? Thank you very much.

A - George Quinn {BIO 15159240 <GO>}

Thank you. So on the first one. So sustainability, so maybe I'll deal with high level first, and then I'll go into some of the factors that will drive what we see now or have driven what we see now, will drive what we see into the future. So the obvious thing that you can isolate in the first half results is the impact of cat. We're about 0.7 points beneath where we would expect to be, given where we price things and we don't assume that, that is a structural change. So if you adjust for that, we would see the underlying closer to 96%.

I mean, if you look at what do we expect for the future. So I mean, I'd love to be as optimistic as the second part. Your first comment implied, I think the -- I mean, clearly, there's a great environment out there, that's going to be -- that looks as though it will continue to be very constructive. I mean, I mentioned earlier in response to Jon's question that we've seen acceleration of rate into Q2. And so just to be clear, inflation, loss cost inflation, Europe and US were, I mean, definitely much, most for us in the short term. We're not seeing any significant change. It's slightly higher in the US, but I'm talking 10 basis points. So I mean, overall, that should start -- the rate net of most cost inflation should also continue to feed into the results.

But equally importantly for us, there's a whole shift taking place on terms and conditions, which I think is much harder to see. But actually, I mean, has the promise of something that will benefit us for a period that's longer than simply the -- this typical 12 months that we'll have the contractual relationship than anyone of these individual policies. So I mean, we see things like attachment points are moving up, line sizes are coming down and more business through wholesale channels where rate is probably even stronger on commercial, auto in the US, significant changes in deductibles with the continuation of the rate. I mean, I could go on and on. There's a whole series of factors and features. But I think they are very helpful from a terms and conditions perspective.

Be aware there are other things will go the other way. So I mean, we have crop in the second half. Crop is a higher loss ratio business. This will certainly not be as positive a year for crop as we had last year for the reasons, I think, you all know about from what you've seen in the first half. But I think, I mean -- yeah, I think you've had from the guidance that we've given already that -- I mean, we've guided you all to expect something around 96%, something combined for this year given the performance in the first half, given the expectations we have for the second, we expect to be a bit better than that, so something between 95% and 96%.

On the Z-ECM topic, I mean, there's always a number of moving parts. So I mean, I guess, you've seen the key features today, so we've got business profit generation of 8%. That's probably close to a couple of points higher than you would normally expect to see from us. Dividend accrual of 4%, we now call around 7% for the market movements, and that's mainly interest rate driven and then a bunch of smaller stuff explain the rest.

I mean, there are always differences between the reported IFRS profits and the impact that you see in the economic view, typically, more of those come from areas like Life, but the picture can be quite different in terms of -- I mean, the almost immediate recognition of new business value versus the spreading forwards of profit under IFRS. But I mean, equally, some of the things that we did to reduce risk around some of the legacy parts of the portfolio. I mean, that also has a positive impact. I mean, I can't give you a very scientific, very detailed explanation, but I mean, broadly, those are the main drivers.

Q - Peter Eliot {BIO 7556214 <GO>}

Thanks very much.

Operator

The next question comes from Andrew Ritchie, Autonomous. Please go ahead.

Q - Andrew Ritchie {BIO 18731996 <GO>}

I wanted to -- a simple one, I think, hopefully, to start with, the OnePath Life contribution, I think, in the notes to the financial accounts, it says $29 million pro forma for the first half. That seems quite low versus the original expectation. Maybe you could just update us on what's going on there? I guess, there's some noise in relation to OnePath. Are there any implications of some of the recent legislation that's been passed post the Royal Commission update, for example, I think, Protect Your Super legislation. Does that have any impact on the outlook for OnePath?

The second question is, sorry to return to this topic of loss trends. I guess, you are, I think, actually, the only global commercial lines insurer in the first half that's actually achieved an underlying attritional improvement year-on-year across the US and Europe. Because everyone else has reflected issues of particularly social inflation rather than classical loss cost inflation to do with legislation [ph] et cetera. What additional work have you done in the first half in the US, in particular, on looking at issues of social inflation in general liability, commercial auto, professional lines, where there's been many of your peers adjusting a real step change in claims trends? Thanks.

A - George Quinn {BIO 15159240 <GO>}

Yeah. Thanks, Andrew. So on the first one I was -- just very frankly I was actually down in Sydney last week. I met with the team to go through the completion balance sheet and also to look at the planning for next year. So maybe I'll start with the headline summary. At this stage, I mean, we anticipate an outcome for 2020, that's at or around the level that we indicated in the presentation that we published when we announced the OnePath deal back in December of 2017. And from memory, that was around $200 million. So that's still our expectation today.

And of course, where we're starting from is a bit different, certainly from a position that was the position then. Certainly, there are DI issues in the local market. I mean, we see it in our own book on the Zurich site, right. I mean, the key thing here is, I think, when we talk about the strategic reasons for the OnePath transaction, we point at a number of market features and factors that we liked. I won't get into all of them on this call, but I think we've talked about the fact, I mean, we've acted in the past in Australia to address weaknesses or shortcomings, and we continue to be confident that we can do the same in this portfolio and drive the outcome that we committed to when we announced the transaction.

I mean, there's a whole bunch of issues. I mentioned DI, you mentioned Protect Your Super, I mean Protect Your Super is absolutely a topic that will impact those that are more exposed to Group. And I think, as you probably remember, from the -- you might remember from the December conversation of 18 months ago, OnePath is a bit less exposed on the Group side of the market. I've said that Protect Your Super will also have some knock on impact on retail. We don't expect that to be so significant, but there is an impact as trustees get pushed to make sure that you don't have duplicate cover or not in a forced purchased position that were mainly in group, but it will have some impacts on retail.

So for us, overall, the first six months of this year are not representative for a whole bunch of reasons. We're still confident we can drive the level that we're committed to. The other thing to watch is, it will be a bit lumpy next year because we have to take some action around the portfolio. And of course, some of that benefit will flow once the action has taken place. So there'll be a tendency next year for that number to be a bit more back-end loaded than front end.

Loss trends; so the -- I mean, it's a -- I think I gave an answer to Peter, some of the things that we see from a market perspective, taking place. I think overview, I think without being too arrogant, is that these are not things that we started in the first six months, but we see -- maybe because of the general pressure on the market. There's more people following the changes that we've made. So I mean, we look carefully at the trends around losses. I don't see in the data that we have, some of the things that you've heard and the commentary from the others. And I guess, probably, the main driver of that is that if you look at the last three years and you look for other ways in which we don't correlate with the market, probably the presence of growth is the obvious difference.

So you've seen us act relatively early in the cycle to deal with the challenges that we have. They started with some of the large loss topics that we talked about in 2015, Mario's push to get to reinvigorate underwriting and our willingness to give up market share, where the returns just didn't justify the capital allocation. And I think one of the things that we're happiest about today is the fact that you can really see the benefits of that in the commercial performance. So I mean, I can't analyze for you in detail, again, why we're not seeing this step change in social inflation that other people point to.

A - Mario Greco {BIO 1754408 <GO>}

By the way, I think we have seen it. The point is that since we shrunk, the impact on us is reduced, and it doesn't make it as feasible as it was for the others. But we have been shrinking now since three years ago. And so it's -- everything is much more manageable for us than, probably, it is for others to grow this, because we see the same trends. But the impact is completely different.

Q - Andrew Ritchie {BIO 18731996 <GO>}

Okay. That's great. Thank you very much.

Operator

The next question comes from James Shuck, Citigroup. Please go ahead.

Q - James Shuck {BIO 3680082 <GO>}

Hi. Good afternoon everybody. So my two questions. I just wanted to return to the point around the attritional loss ratio at H1. So it's ex the PYD and ex the nat cat. If I look at kind of previous half year periods, there doesn't appear to be any seasonality around that number? I mean, I appreciate kind of second half of the year, there's more nat cat, but it doesn't seem to have been the case in the past and perhaps you've grown in crop a little bit more, so maybe that could be a little bit more of a drag this year. But I am just trying to get a feel for really the 61.8% attritional in H1, even if that goes up a little bit in H2. Am I right in kind of interpreting that the improvement in rate and what you're experiencing on the plain side?

And the point you made about terms and conditions, then that is a pretty reasonable starting point from which we should expect it to continue to improve as we look forward. I guess, there's a kind of related point around the net earned premium growth that you talk about in the presentation, because you're guiding now towards a small reduction for full year. That was obviously down 5% at H1, so small reduction that to me implies that maybe we should be up a little bit in the second half of the year. I'm not sure whether that's FX-related or not. Clearly, that might have an impact on the attritional loss ratio as it runs through as well. So any help on that would be great?

Second question was around Farmers. The sort of tone of what you're saying with Farmers, it sort of you seems to be quite pleased with it. I look at the GWP growth though, it's up 2% on a continuing basis, and that includes the Uber partnership. Policy count is actually down in H1 versus full year and largely business value, which was kind of actually

[ph] a big push around cross-sell, ATE and new business value is also down. So could you just shed a little bit of light on why you're sort of quite -- a little bit more positive than I am on Farmers performance in the period, please? Thank you.

A - George Quinn {BIO 15159240 <GO>}

Thanks, James. So first of all, on the attritional, and so no seasonality. And I think that's true in terms of outcomes. I think there are some prices that I think as you think about from a planning perspective or a headcounting [ph] perspective that you would expect some -- and the two most obvious sources of it. You mentioned crop. So certainly in the last couple of years, the second half of the year has been a major beneficiary of -- in fact, I think, the last three years, has been a major beneficiary of significantly bad crop performance than planned. And I think I talked about that earlier in the year, and I mentioned the fact that as we planned for this year, you were going to see about a 7 point change as we moved back to a more normal crop outcome. I think crop will be slightly worse than that, given the challenges in the first half and the issues around planting. I don't think it will be a big issue, but the benefit we had from crop that one -- that doesn't noteworthy [ph] to emerge in the second half.

I think the other thing is the presence of the -- probably the peak nat cat scenarios in the second half. They do cause seasonality, but maybe not the reason you'd expect. I mean, obviously, we have a lot of reinsurance that's running through to cat protection. I mean, the nature of that stuff is that if we have significant event, and these very significant events, we get coverage and if we have a more normal year, we don't get any. So I mean, the reinsurance approach would tend to slightly penalize the second half in most years. So I think, you need to offset those two things against the other things that you mentioned on the positive side of the spectrum. So the improvement in rate, the terms and conditions. And I guess, you called that a reasonable starting point, I would be far more bullish than reasonable.

On the premium side of things, that's mainly FX that you're picking up, so it's been the headline number that is our underlying view. Of course, the actual outcome will be determined by -- I mean, how the market develops, so though at this stage might even is falling as what to shift in the second half. You're not going to see a big impact on the ends anyway.

Q - James Shuck {BIO 3680082 <GO>}

Farmers?

A - George Quinn {BIO 15159240 <GO>}

Farmers, so why are we pleased with it. So I think the -- so from a management company first. So the fee-based part of the business. I think they still continue to do exactly what we expected them to do. And exactly, I think we've generally guided all of you guys to expect. So we did expect to see a bit more rates run through this year. We've had a bit more cat on the exchange side, so we don't see a significant shift again on the combined. But I mean, if you compare the Farmers' technical profitability today to, I mean, just 18 months, two years ago, it's completely different.

We do wanted to see them grow the policy count. We do wanted to see them expand more. It's a topic of discussion between us and them and how we can support them to achieve that. Let me -- I mean, everyone on this call appreciates the value of Farmers and between us and the exchange, we're trying to manage this for the best outcome for both of us. If there's any hint of something we would like to see improved, it would have been the thing that you commented on last. So on the Life side, there's evidently more work to be done there. The things that you pointed to, that are strategic priorities for us around cross-sell and the growth. We haven't seen it, we're not giving up on it. We expect the team to deliver it, but we haven't seen it yet.

A - Mario Greco {BIO 1754408 <GO>}

But let me add something on this. We started a while ago discussing with Farmers and Farmers management, all these issues that you raised, plus some others. Things have started to change. Management has been reinforced. Actions have been changed and taken actions on the agency structure on the project investments on the cost basis. They're launching new products. We see these things. And so we're confident that by doing the right things, then the numbers will come through. I understand that you haven't seen yet the numbers as they should be, but we're confident that they will come, and we see the actions before they track the numbers, right? It takes always a bit of luck to get that, especially when you have an agency model and you have a routed business.

Q - James Shuck {BIO 3680082 <GO>}

Okay. That's very helpful. Thank you very much.

A - George Quinn {BIO 15159240 <GO>}

Thanks, James.

Operator

The next question comes from Kamran Hossain, RBC. Please go ahead.

Q - Kamran Hossain {BIO 17666412 <GO>}

Hi. Just one question from me. Basically, if price momentum continues in the US, how does that make you think about reinsurance purchasing and the kind of the actions you've taken over the last few years? Will you still seek to kind of manage volatility or if pricing improved considerably, will you then begin to kind of risk taking a little bit more of that business on your own balance sheet? Thank you.

A - George Quinn {BIO 15159240 <GO>}

Yeah. Thanks, Kamran. So, I am going to be very careful what I say though. So I mean, obviously, we expect to see the price momentum continue. And if I -- I mean, we saw the price momentum start before the beginning of this year, and we made some changes already to the reinsurance program at the very start of the year, especially around the property side of things. If you look at the major programs we have in place, I mean, we have a cat program, but we have no intention to change that. So I don't think that's a price-driven topic. That's a risk appetite issue. And even if we saw the stuff becomes fantastically profitable, it's not the kind of risk that we necessarily think we are the best carrier of.

The other two things, which are part of the -- the most significant is we have a very large question on property. I mean, we've been clear with the market when we placed that. That was a risk that we seemed to like less than the market did at large. And on the day that things changed, we would definitely retain more of it. So we certainly have an option around that topic coming to retain more.

And then there's another large contract, which again is relatively recent. I think probably, most of you are aware, we have a very large liability core share. That's more like the cat cover. So that was intended to be a long-term commitment. It's about the shape of the portfolio that we have. There's a capital allocation topic in the end, but more from a longer-term perspective than a short one. And certainly, I mean, if the market continues to support us in the way it has, I mean, we would not intend to make significant shifts there. But the property topic is certainly one that every -- I know that every time we come through the planning process and we start to approach the renewal, we have pretty intense internal conversations about what should be in that core share and this year will be no different.

Q - Kamran Hossain {BIO 17666412 <GO>}

That's very clear. Thanks, George.

Operator

The next question comes from Michael Huttner, JP Morgan. Please go ahead.

Q - Michael Huttner {BIO 1556863 <GO>}

Thank you very much. I had -- So on cash flow -- and by the way, well done, really well done, that's amazing what you achieved. And on cash flow, so for the first time in a while, you've given us a figure at the half year. So it implies that there was $1.7 billion in the first half. Can you just explain which of your large entities have still to pay or have paid to give us a feeling for any kind of seasonality here?

And the second question, which is really a bit lightweight and apologies for that. Given where markets are today, so interest rates have dropped a little bit more and you seem to -- sorry, I changed my question. You kind of indicated that the business operating profit delivery in terms of solvency is about 2 points ahead where you would normally expect it. And you alluded a little bit, where it came from. Can you say what it looks like for the second half? In other words, are there any changes in that -- in those kind of numbers we've seen, all those trends we've seen in the first half? Thank you.

A - George Quinn {BIO 15159240 <GO>}

Thanks, Michael. Maybe I do the first one first, because that's the easiest one. Not anticipating any significant shifts, and I apologize, I think I said 1 to 2 or 2 to 1. It's about 1%

above what you would normally see us. So there's no major model shift taking place currently. I don't see one planned, so no reason to expect that anything other than the operating profit and the ability of the life business to generate new business value will be the drivers of capital generation in the second half.

On the cash flow, so I can say, which -- I will resist the temptation to start this one, I think the people who will be helping us in the second half of the year, they already know who we are. I mean, we've talked in the past about the fact that if you look at last year, I mean, you see this unusual picture between the life side and the P&C side, where P&C was a bit weaker, Life a little bit stronger. I expect Life to continue to be strong this year, not only will we see the operating cash generation, but we're still continuing some of those balance sheet optimization topics that we covered back in February. And you'll see more of those in the second half very likely. I mean, the reason for giving a number today, which is unusual for us. It was simply to underline how close we are to the overall goal, given that probably the conversation switches fairly soon to what does the next three years look like.

Q - Michael Huttner {BIO 1556863 <GO>}

Before that, you have to decide on the dividend. The cash is the dividend, for me, that was the underlying question, I beg your pardon, I interrupted you.

A - Mario Greco {BIO 1754408 <GO>}

Yes. How they progress on. So the only thing to be careful is that the cash flow is extremely important, but cash has never been a constraint nor honestly a driver of the dividend here. It should be about earnings, because that's what defines sustainability for us. But I mean, we have a whole system of the Group, which is designed to make sure that we convert earnings into cash in a disciplined and ideally rapid manner, but that's not the key factor when it comes to that dividend decision. They'll get made in February of next year.

Q - Michael Huttner {BIO 1556863 <GO>}

Absolutely. Super. Thank you so much and well done, again.

Operator

The next question comes from Nick Holmes so Societe Generale. Please go ahead, sir.

Q - Farooq Hanif {BIO 4780978 <GO>}

Hi there. Thank you very much. Just a couple of questions. First one is does the fall in bond yields make you more optimistic about P&C pricing? And I was already surprised nobody has mentioned it, to be honest, because surely that could be an important contributor to getting to a properly hard market?

And then the second question is just coming to the expense ratio, it's still a bit high. Wondered if you could take us through your plans or remind us where you want to go on that? Thank you very much.

A - George Quinn {BIO 15159240 <GO>}

So thanks, Nick.

A - Mario Greco {BIO 1754408 <GO>}

Yeah. It's an important question. I mean, if you look at the movement in the markets, even very recently. We're seeing levels that we haven't seen for some time. Although, interesting, if you compare them to the levels that we based the current share targets on. I think what you would have seen is just a reminder, the current share targets were struck based on yields around the middle of 2016. Europe is definitely lower for sure. It's a bit less relevant for us in Europe, given the portfolio is typically about shorter duration in Europe. At US, actually, still a touch higher, not sure that can be true by the end of the week, but it's somewhat true very recently. But of course, we have had a benefit in the intervening period from the fact that interest rates have risen.

I think the point you make is important. I think it could well be true that this helps sustain the price trend that we see for longer. I think the only caution I would signal is that one of them has given today. The other one we've yet to see. But I think it's certainly helpful and encouraging the market to underrate in a very disciplined fashion.

Q - Farooq Hanif {BIO 4780978 <GO>}

Thank you. Yeah. Sorry, and expenses?

A - George Quinn {BIO 15159240 <GO>}

Expenses, so -- and I mean, you'll hear a bit what you've probably heard from me before. You need to break apart the expense ratio. We've tried to do in the investor presentation. I think you see the continuation of the fall. And the -- what we refer to as the OUE, the other underwriting expense or overhead component, so that's dropped, 13.7% down from 14.1%. That's partly offset by two factors. One is premium taxes, which, of course, we don't entirely control, but that impact is quite small. And then on the commission topic, I think the interesting thing you see on commission, it's slightly higher and I think you've heard today, and you may have read in the press release that we have some new relationships. We have access to another significant group of clients, this time in Europe actually as opposed to elsewhere.

So the commission ratio or the commission ratio component that's driven actually by changes in Europe in the first six months, whereas in the markets that have generally been driving it up in more recent times, typically, LatAm and Asia Pacific, their contribution is actually smaller but there is a net increase, and that's driven by more of that mass consumer business that is slightly more expensive to acquire, but is typically less volatile, more predictable. And certainly just helps the overall quality of our portfolio. So as you've heard before, it's a trade-off we're happy to make. And the focus of the expenses has to be in the OUE ratio, and we expect to continue that focus in the second half of this year.

Q - Nick Holmes {BIO 3387435 <GO>}

And thank you, George. Can you give us any sort of quantification of those numbers? I think OUE is meant to be around about 13% is your sort of unofficial target. Is that still correct and moving the overall expense ratio down to sort of 31% over a period of time?

A - George Quinn {BIO 15159240 <GO>}

So on the two things. So we're looking to bring it down towards 13%. That is if you look at where the peer group is, we think that's roughly where they are. I think if you look at what we still to bring in the second half, I am not -- as you get all the way from where we are to 13% in one step. But you'll certainly see a further move in the second half of the year.

On the commission ratio, for the reasons I gave earlier it's a bit tricky to be really hard and fast on the commission ratio. I mean, all things being equal, if we had done none of the portfolio change that you've seen from us over the course of the last couple of years, we would have an overall expense ratio that would be in the high 20s. But we wouldn't have the outcomes that you squeeze from an underwriting perspective. So the overall expense ratio, we're probably standing by, whether we get the opportunity to do more of this. And if we see it at the right levels of return, we would do more. But our focus is mainly OUE. And we are expected to bring that down further, but probably not all the way to 13% by the end of the year.

Q - Nick Holmes {BIO 3387435 <GO>}

Okay. Thank you very much, very clear.

Operator

The next question comes from Vinit Malhotra, Mediobanca. Please go ahead.

Q - Vinit Malhotra {BIO 16184491 <GO>}

Yes. Good afternoon. Thank you. So George, one question on P&C, one on Life, please. On P&C, at the Investor Day last year, we talked about the Life -- the commercial business in North America targeting, I think, it was 3 percentage of improvement from HY to 2021, but that was before this whole momentum or tailwind from the pricing and claims attrition came in. Would you say that they are likely to change something there? Are they trying -- will they have a higher, better target? Or does that number already getting somewhere close given that we've seen a big change in commercial. If you could just comment on the commercial US, anything you can comment on?

And second question on the Life side. So there's about, give or take $100 million lower guidance effect to be for '19 now versus previously guided. Is that -- and I understand from speaking to the IR team, that's mostly FX related. But I mean, if I -- very statistically, the dollar was also, I mean, all over the place last year, for example, is there anything else on Life that we should note regarding this guidance and any commentary there?

Thank you very much.

A - George Quinn {BIO 15159240 <GO>}

Thanks Vinit. So it's a good point on the first one. So Kathleen and the team have slightly overachieved versus the target we set at the Investor Day. Remember, there's cat in that, so there's a -- I mean, there is some benefit there, although most of the cat benefits, so to speak, actually comes in Europe. I won't get into what we did at Investor Day in November. We need to have a look again, how we performed in the first half of the year. We're in that process currently of preparing the plans and the targets for the next three years. And we'll come forward with another set of ambitious goals for the Group when we get to November.

On the Life side, so you're right, I mean we -- I think the -- it is really important to appreciate that we're happy with what we see in Life. We think the constant FX performance is pretty much where we fixated to be. So the headline guidance topic is entirely driven by foreign exchange. There's also a tough comparison to the prior year. And almost half of the one-off that we saw last year, are cut in the first half of the year. If you remember, the FX topic around Argentina. There are always positives and moving parts -- positive and negative moving parts on the business that overall we're happy with what we're seeing in Life. There are always opportunities to improve, and the team are focused on those, but the overall outcome is pretty much in line with plan.

Q - Vinit Malhotra {BIO 16184491 <GO>}

All right. Thank you very much.

Operator

The next question comes from Johnny Vo, Goldman Sachs. Please go ahead.

Q - Johnny Vo {BIO 5509843 <GO>}

Yeah. Thank you very much. I guess, I guess, it's good that the shape of the business has changed and it's been typified by the fact that 50% of your net earned premiums are now in specialty and property. I guess, does this trend continue to happen? Or do you see other opportunities in potentially merchant, casualty and shifting the business back potentially?

The second question just relates to your sensitivity to rates. I've noticed that the sensitivity to a drop in 100 bps interest rate is very sensitive now as it was compared to the end of last year, where I think end of last year was about 3 percentage points, and now it's about 14 percentage points. Is it because you're opening up the duration? Or what's going on with the sensitivity there? Thank you.

A - George Quinn {BIO 15159240 <GO>}

So on the first one, the -- I think it was in response to the question earlier around rates. Apologies, I forget who asked it. I made the comment that the -- that some of the things we're doing are really about strategic view of the portfolio. I think portfolio mix is one of those things, so that's something, a bit like almost of the asset allocation, you should expect to see that change relatively slowly in any given direction over time. I mean, we have priorities that we haven't yet achieved around some of the specialty lines, but I mean, our view is that the current market conditions are really quite difficult to support those. So if we see further price move, maybe you'll see a bit more specialty move into the portfolio. I mean, specialty for us also includes credit. And this doesn't feel at the right point in the cycle to really push credit. So I mean, think of this more of as a strategic view, there'll be some tactical movements, but the overall goals for the portfolio remain the ones that we laid at, I think at least a couple of years ago.

Now on the sensitivities, I mean, I need to go back and look, because I don't recall a change of that magnitude. I mean, there's a lack of linearity for obvious reasons. So as interest rates get compressed, you have a risk of developing higher sensitivities, but that scale of change, which surprised me. So we need to have a look and come back to you. Sorry, Johnny.

Q - Johnny Vo {BIO 5509843 <GO>}

Okay. No, worries. Thank you.

Operator

The next question comes from Farooq Hanif, Credit Suisse. Please go ahead.

Q - Farooq Hanif {BIO 4780978 <GO>}

Hi, everybody. Good afternoon. Just want just to ask one of Vinit's question in a slightly different way. So going back to the Investor Day, you talked about a potential convergence of your commercial combined ratio. I think you commented at on 99.5% commercial combined ratio in the US, with big peers. Can you talk about the relative -- how you see your relative positioning in profitability in the US versus those peers and whether that closed gap is now sustainable, and where it needs to be?

And then secondly, just a very quick question on CoverWallet. I see that you're very happy with it. And you're going -- you're expanding into Switzerland. Can you just briefly tell us what the learning has been? I mean, has it given you access to new premium growth? Or has it been an expense ratio reduction in SME? What is the learning? And how far could this go throughout your business? Thanks.

A - George Quinn {BIO 15159240 <GO>}

Thanks, Farooq. So on the convergence with peers in the US. I think you need to give it a bit more time to absorb what we've seen of the peer groups. Of course, one of them only reported last night. I mean, we did a lot of work ahead of Investor Day. So we want that exercise to get a sense of where we see ourselves relative to others. I mean, for obvious reasons, we're really happy with the progress, which driven by commercial, driven by the US, is a great combination. But I think we need a bit more time with the peer information before I can really draw any conclusion or depth from it. On the...

Q - Farooq Hanif {BIO 4780978 <GO>}

Could you have a -- sorry, could you have a combined ratio for the commercial as opposed to alternative markets for 1H '19?

A - George Quinn {BIO 15159240 <GO>}

For the US?

Q - Farooq Hanif {BIO 4780978 <GO>}

Yes.

A - George Quinn {BIO 15159240 <GO>}

We'll get one for you. We have it. It's not a state secret. We just -- I just have them.

,

A - Mario Greco {BIO 1754408 <GO>}

We definitely have it.

Q - Farooq Hanif {BIO 4780978 <GO>}

Of course.

A - Mario Greco {BIO 1754408 <GO>}

So they did...

A - George Quinn {BIO 15159240 <GO>}

Yeah. I've seen bullets, will come back to you. We'll come back to you. On CoverWallet; that the CoverWallet is pretty new in Switzerland. I can't say much there. It has been running in Spain for a bit longer. There's still a level where it's not so material to the Group. I think most of us have seen what CoverWallet does, works. I mean, for me, having looked at it, what's impressive is the ability to package something for a buyer in a way that helps them make sure they protect themselves across all the different risks that they may have without them having to stitch that coverage together for themselves or to find an agent to do it for them. It's a fairly inexpensive system, as you can imagine, ease-of-use to is really very high. And we have high hopes for it in Switzerland, where we are a bit under-penetrated on the SME side, and we think we have a very significant opportunity here, a bit too early really to draw too many conclusions.

A - Mario Greco {BIO 1754408 <GO>}

Yeah. Look, and in general, the SME opportunity is so big that you can pursue it only with the one solution. So CoverWallet is very interesting, because it allows us to contact the customers among the SMEs, who are already connected online, and they can be reached out of the web. But that's a portion of the huge, huge ocean of SME customers in Europe or in other continents. And so we're also using every other possible distribution mean to reach out to the SMEs. Switzerland has an SME program, which has been developing very nicely in H1. And CoverWallet is a part of it, but it's not the program altogether.

Q - Farooq Hanif {BIO 4780978 <GO>}

Thank you very much.

A - Mario Greco {BIO 1754408 <GO>}

Welcome.

Operator

The next question comes from William Hawkins, KBW. Please go ahead.

Q - William Hawkins {BIO 1822411 <GO>}

Hi. Thank you very much. And back on those Z-ECM sensitivities, please, George. Is there any way that you can give us a hint -- an idea of what the absolute interest rate is that you're plugging in around which the sensitivities are being shown? I appreciate that it's going to be fiendishly complicated and based on curves and that kind of thing, but in the back of my mind, there's going to come a point when showing a 100 basis point reduction is implying that you've got significantly negative inputs across the curve, which, at some point, is going to sort of mean that your calculation is technically correct, but possibly economically kind of meaningless. So I'm just trying to get a sense about what the absolute rate is, so what you would be at, if you took it down 100 basis points?

And then secondly, could you give us any kind of qualitative or quantitative update on where your Solvency II ratio equivalent could have moved? Because again, the difficulty with both Z-ECM and the SST is that potentially exaggerating an awful lot of these market movements, so the divergence with the hints you've given us in the past could have moved on? Thank you.

A - George Quinn {BIO 15159240 <GO>}

Thanks, Will. So on the first one, I think maybe a topic that the IR team could cover in more detail with you after the call. On the issue having significantly negative rates. I mean, obviously have the asset side of things, we will have significantly negative inputs in some parts of the model already, especially if you look at Europe, but I appreciate there are other aspects of the model where you may well floor things because in the real world, you're not going to get maybe the same thing you see on the borrowing side, on the asset side. I mean, please speak to Rich and the team afterwards, and they can walk you through that in more depth. I don't have an update at the half year around Solvency II or the potential difference between -- I mean, where we are now from a Z-ECM or SST perspective and what you would have seen versus the peer group.

I mean, If you look at us, I think I mentioned in the early part of the call, there's about certain points of market movement, we see that mainly as the longer interest rate in Europe, and the impact that that has on some of the very long liabilities we have on the

Life side. Again, I don't know to what extent we've seen that quite so much in the peer group. There would be some impact from the ultimate forward rates in the Solvency II system that would certainly dampen that more than you would see for us. I think probably that delta and so on, maybe it's a few points, it's not so significant, I think, in the half year comparison. I think it's the starting point of the basic SST versus Solvency II framework. And I did talk about the delta, I think, back in the February call, maybe the May call, in the past and we've highlighted, I mean, deficit of up to 50 points or more between SST and Solvency II, and we think they're still valid. And in fact, one of the most recent day we've seen, it would be higher today.

Q - William Hawkins {BIO 1822411 <GO>}

That's great. Thank you.

Operator

We have a follow-up question from Peter Eliot, Kepler Cheuvreux. Please go ahead.

Q - Peter Eliot {BIO 7556214 <GO>}

Thank you very much first for taking another one. Two more from me. First of all, maybe just to carry on the life topic. I mean, if I just look a big picture down, then one thing I noticed was that the costs sort of seems to be increasing a bit on a like-for-like basis. And that was despite new business being down, so it can't sort of really be attributed to the acquisition. So I was just wondering if you could sort of comment on that dynamic? And if we might see any improvement going forward?

And the second thing was, I was interested, you flagged IFRS 17 costs of $50 million to $100 million in H2. I am just wondering if you could comment any further out or in terms of total costs? Or if you've done the sort of the analysis and anything you might expect in the future? Thank you.

A - George Quinn {BIO 15159240 <GO>}

Yeah. Thanks, Peter. So on the cost side of it, I mean, you've seen most of the benefit flow through the P&C side, I mean, there is some benefit that is partly obscured because some of it gets shared with the policyholders and some of it falls to the shareholder. In the second half, I mean, I think if you look at it, certainly from a operating profit perspective, you will see the impact, for example, some of the integration what we're doing in Australia. We do have a synergy goal there, and that will show up on a like-for-like basis with the Australian business and the starting point. I mean, otherwise, the main focus for us, it's really been on the P&C side and trying to drive most of the expense improvement through there. Although you have seen Life improve, certainly earlier on the time series.

IFRS 17, yes, I'm glad we're only talking about costs and now the project itself. I think -- I mean, having said that, this probably works giving you a sense of where we are. So, in fact, today is the first delivery day for our Tier 1 entities and our first practice run of IFRS 17. So we are actually having the Company's report up today as we speak. I don't know that the numbers will make too much sense in the first go round for -- we have plenty of time to perfect them over the course of the next year or two. We haven't given a total cost number, but I mean, we're running, I mean, between $50 million to $100 million, I mean, pretty much every year, this project runs currently, which is one of the reasons why we're keen to see the whole conversation come to an end and for the thing to get adopted, so that we can start -- or start to understand it together and move on. It's extremely expensive and unfortunately, well, it does have benefits. I am not sure they will outweigh the costs.

Q - Peter Eliot {BIO 7556214 <GO>}

Okay. Thanks a lot.

Operator

We have another follow-up question from Michael Huttner, JP Morgan. Please go ahead.

Q - Michael Huttner {BIO 1556863 <GO>}

Fantastic. Thank you so much. On the -- in Farmers, you have a surplus ratio, which I think is better than your target of 41%, an improvement of $200 million of the event to $5.7 billion. And what can you do with that money? How does it benefit you given that the growth is still relatively modest? Thank you.

A - George Quinn {BIO 15159240 <GO>}

Unfortunately, Michael, that's not our money. That belongs to the exchange, so that's their surplus ratio. And that's the -- the one thing I would point out is the exchange has been a big buyer of reinsurance. I mean, the capital strength means that they can retain more of it. But in essence, any benefits that flow from the management surplus really will accrue to the exchange and not really to Zurich.

Q - Michael Huttner {BIO 1556863 <GO>}

Yeah. That's one simply put. Thank you so much.

A - George Quinn {BIO 15159240 <GO>}

Thank you.

A - Richard Burden {BIO 1809244 <GO>}

Okay. Thank you very much everybody for dialing in. If you do have any further questions, please don't hesitate to call the Investor Relations team. We'd be happy to take any other questions you might have. Thank you very much, and goodbye.

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.