Q2 2017 Earnings Call

Company Participants

- George Quinn, CFO and Regional Chairman of Europe, Middle East & Africa
- Mario Greco, CEO
- Richard Burden, Unknown

Other Participants

- Andrew James Ritchie, Partner, Insurance
- Dhruv Gahlaut, Analyst
- Farooq Hanif, Head of Insurance Research in Europe
- James Austin Shuck, Director
- Michael Igor Huttner, Senior Analyst
- Nadine Adrienne Marion van der Meulen, Equity Analyst
- Niccolo Cornelis Modesto Dalla-Palma, Research Analyst
- Paul De'Ath, Analyst
- Peter Eliot, Head of Insurance Sector Research
- Ralph Hebgen, SVP and Senior Analyst
- Thomas Seidl, Senior Analyst
- Vinit Malhotra, Banca di credito finanziario S.p.A., Research Division

Presentation

Operator

Ladies and gentlemen. Good morning or good afternoon. Welcome to Zurich Insurance Group Q2 Results 2017 Conference Call. I'm Sarah, the Chorus Call operator. (Operator Instructions) And the conference is being recorded. (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 & Rating Agency Management. Please go ahead, sir.

Richard Burden {BIO 1809244 <GO>}

Good morning. Good afternoon, everybody. 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. (Operator Instructions)

I'll now pass it over to Mario for a few introductory remarks.

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. This show that we're making further progress against the targets and the priorities that we indicated to you 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 2015 basis. And there is more to come over the remainder of the year. But this is what I would say, it's 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 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 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, 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 also have solid growth in their chosen areas and the combined ratio in motor, which has been worrying many of you and ourselves for a while, has shown a sharp improvement as day rate actions have taken effect. Now these trends will continue to support growth from a 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 6percentage points complemented by similar benefits from market movements and more than -- and this is more than offsetting accrual of the dividend. Furthermore, we continued to focus on releasing capital from noncore 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 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 we very well 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 3-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.

Questions And Answers

Operator

(Operator Instructions) The first question is from Farooq Hanif from CrÃ©dit Suisse.

Q - Farooq Hanif {BIO 4780978 <GO>}

I'll keep myself to the 2 questions. So firstly, when you talk about positive momentum continuing, given the rating environment versus inflation, are you not signaling that maybe some of the underwriting side is going to stabilize and really now it's about expenses? That's question one. And question two, going to Farmers. As obviously in Farmers Management Services, there's a bit of an interplay between growth in numbers of policies versus pricing. So I'm just wondering at what point do you think there will be an underlying growth in number of policies? Are we sort of hitting an inflection point here and therefore could this be more positive for next year?

A - Mario Greco {BIO 1754408 <GO>}

Let me start from Farmers and maybe George can help me on the rate environments, your first question. So Farmers is 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 better benchmark, because we already -- 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 seeing high increases in motor rates, this has an impact on new business and partially on our customer retention, even that is very minimal. And we also said 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. So just, I think, also on Farmers, Farooq. If you look at trends across the industry, that also looks substantially better than it has for some time. So we're seeing loss-cost trend significantly improve, both on the frequency and severity. And obviously, given that, I mean, Farmers have grew significant rate last year, they fell for more rate at the beginning of this year. If that loss-cost element stays somewhat more stable at that point, that Mario has stated that stabilization profitability will come much more quickly. I think the overall goal that Farmers have remain the same. So what they're doing on the price side is they're trying to address the issues that they have, of course, this year and reach out relatively steady state by the end of 2017. On the more general rate issue topics of the market. So let me 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 somewhat plateau and to look for improvements to come to 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's tough. I mean, there are markets that are in good condition and have different drains. But by and large, we see despite positive rate overall for the portfolio, inflation in many of the markets that's running slightly ahead. So I think as we had anticipated at the Investor Day last year, the market itself will not help us get to the overall goal. We don't have to sit with 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 look to emphasize areas, where we believe we see stronger performance and stronger potential. And we'll use that shift to also benefit the technical performance.

Operator

The next question is from Vinit Malhotra from Mediobanca.

Q - Vinit Malhotra {BIO 16184491 <GO>}

Just on the -- just moving to the noncore business campaign for the in-force management. And I was just wondering is -- I mean, given that this was such a talked about topic, is it likely to be repeated in the future? Is it -- are there plans to keep doing this? Because it does look like a noncore unit. But actually it's effectively an achievement of the company's strategy. The second question is on the one point large losses from EMEA. George, could you just update us on the man-made insurance program was tightened? And whether this is adding to those deductibles? Or what's the status in that case?

A - George Quinn {BIO 15159240 <GO>}

Thanks, Vinit. So on noncore, I mean, there are 2 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 (inaudible) annuity product that we have in the legacy portfolio in North America. So you've seen that repeat in more than 1 quarter over the last probably 5 or 6. I wouldn't necessarily extrapolate that. I mean, we are looking to get rid of these things, not really intended they're continual source of profit, nor are they intended to 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 just done a study. And again, that is somewhat unpredictable in nature given the size of the business and noncore. I mean, the easiest way to think in noncore is, I mean, we would look for blank 0 from that business. I mean, anything we move there is generally on the exit ramp. And we look to do it economically. But we're looking to get rid of this stuff. So it's not going to be an outgoing source of profit. On the reinsurance topic, I mean, you mentioned, obviously, one of the reasons we pointed at half year rather than to the quarter for large losses is that, I mean, for the half year, we had relatively low; and Q1 is slightly higher; and Q2 is more balanced over the 6-month period. We do have some large loss experience in EMEA. Again, it's the nature of the business that we have. From a reinsurance perspective, it's good news and bad news. And 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, I mean, we've not only substantially reduced the absolute level you see an accident year, x cat loss ratio improvement of, I mean, nearly 3 points. If you look at the end of the quarter volatility, we're going from 6 points in 2015 to 2 points over the course of the last 6 quarters. So I mean, obviously, the reinsurance will protect us one day. But we're looking to weigh the (inaudible) rates in the way that we structure the portfolio to remove this issue. And I think maybe we'll find some success, not that we would never -- not that we would ignore the issue of large losses, I think the primary focus today is actually just outright incremental improvement, that's what we're really trying to drive in the portfolio.

Operator

The next question is from Peter Eliot from Kepler Cheuvreux.

Q - Peter Eliot {BIO 7556214 <GO>}

I'll take my questions on the Z-ECM please actually. The first one was, I'll just -- I was struggling to understand the movements precisely. I guess, the business profit development is equivalent to about USD 2 billion, which seems -- it seems more than -- a lot more than earnings. I'm just wondering whether you can sort of split that out a little bit and confirm whether you think that's sort of sustainable run rate? And also, in terms of the market sensitivities seems a little bit more than I was expecting. I mean, the equity market seems to be contributing 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 math. I just wonder if you can give us a little more guidance on how those changes have come about? And I guess, the second question is sort of inevitable given the very strong level of capital that you've got at the moment. I guess that at what point do you start to address that? And are you able to give us any hints on what's your priorities might be? I mean, you look into that share in an improving shareholders return, I just wondering if you can elaborate anymore?

A - George Quinn {BIO 15159240 <GO>}

Peter, I'll suggest -- I'll start with the walk through the Z-ECM movement. Again to avoid any unnecessary volatility, I'll focus on the first half rather than just a quarter. So if you look at where we ended the year at 125%, we've seen an improvement of around 9 points. About 6 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 and so on. There's a number of other items that drive those sort of things like foreign exchange. We benefit from some of the interest rate moves. But the favorable legacy market and credit spreads in practice between 1 and 2 points in total for both of them. From a business -- and then, of course, there's dividend accrual and there's some very small increase in insurance risk which explains the difference. The dividend accrual is 4 points. On the business profit, I mean, obviously, it reflects more than just the earnings for the quarter. And I'll emphasize maybe 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 transaction, I mean, that would be expected to boost the reported result when we translate into an economic performance. Those are really the drivers. I think the second point was about capital strength and priorities. I think -- I mean, all I would say there is that -- I mean, as you've heard from Mario already today and in the press release, the -- I mean, we have very strong capitalization. It's a fantastic foundation for what we intend to do around the dividend and earnings. So even with -- I mean, with significant volatility in the market, we would maintain our capital strength and it would pose no impediment to us whether we intend to one to drive higher earnings and to use that to drive higher returns and to shareholders through the ordinary dividend. I mean, I think mid-year 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 Eliot {BIO 7556214 <GO>}

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

A - George Quinn {BIO 15159240 <GO>}

I think it's partly dependent on -- I mean, what happens 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 bulk 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. I think that's a strong and (inaudible) for the future.

Operator

The next question is from Andrew Ritchie from Autonomous.

Q - Andrew James Ritchie {BIO 18731996 <GO>}

Two simple questions, I think. First of all, there's a lot of moving parts in the combined ratio half year, quarter, quarterly, et cetera. Maybe, George, you could just give us a view as to what you think "normalized combined ratios" running out? I'm thinking relative to sort of 99, strike a 100 it was running at last year versus the 97.5 sort of soft target for full year '17. It's very hard to know. 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 this year, you're actually running slight ahead of that I suppose at the half year. Do you think you're actually running ahead? Is that just sort of 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.

A - George Quinn {BIO 15159240 <GO>}

So first of all on the normalized numbers, there's a lot of different figures it's relatively easy to be confused and it's really relatively easy to choose the number that you prefer. I mean, I'll tell you how to look at it. I mean, I think if you took the quarter and you would do what I would normally suggest, which would be PYD and cat, I mean, 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. But are one of the reasons why I don't think that's particularly good guide in Q2. I think to make that clear that that's not cherry picking, the -- I mean, we did the same thing in Q1. So we tried to steer everyone away from doing a straight normalization in Q1, because you would have ended with the number that was too low for us. So -- and I mean, the principal driver of that was large losses where we're not far away from planned that late Q1 that we have a relatively simple reverse of that by Q2. I think if -- I mean, if you allow for the fact that large is slightly high and you allow also for the fact that the commission ratio through the first half is tilted by correction in Europe. I mean, it's -- that 0.2, 0.3. And I think on the flip side, if you also allow for the fact that we have some seasonality in expenses. And while well the cost program will continue to lead in the second (inaudible). Maybe you do have a better 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 the expense ratio, all things being equal in Q2, it's going to be a touch low. 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 x-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 which are intentionally and for you guys outside of the company having back end loaded plan wouldn't work. So we are where we wanted to be. By year-end, we would like to be above the mid-range of this target. And we think we can get there, which would give us further comfort to 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 actually just cost. Cost is about discipline and focus. And so we activated the process. We'll continue with that. You asked if we found further ways do it. And I think, yes, every day we find some more initiatives, some more chances to reduce the cost. What is important with that, again internally and for all of you guys, I think we are showing discipline and we are showing that we walk the talk. We indicated the targets and we are delivering quarter-by-quarter.

A - George Quinn {BIO 15159240 <GO>}

I want to point that how much of the P&C expense (inaudible) is I think sustainable cost reduction given the move that you can see. I mean, what you see in the expense ratio, it's a combination of lower charges from the center which are absolutely sustainable and the impacts of action that we're taking already last year and the early part of this year in P&C. So that there's no significant one-off expense (inaudible).

Operator

The next question is from Dhruv Gahlaut from HSBC.

Q - Dhruv Gahlaut {BIO 16209870 <GO>}

Two questions. First, going through the North American commercial business, could you say a few words in terms of how price is developing with respect to claim inflation on that book at this point of time? Second, you reiterated your guidance in terms of the cash flow over the next three years period. Could you say how that is looking in the 1H, I'm assuming fair amount is -- will get limited in the 1H for your guys?

A - George Quinn {BIO 15159240 <GO>}

So on the North American commercial market, fixed rate versus lost-cost inflation. I mean, you probably picked the -- one of the parts with 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. And if you look at it by line rate, it's particularly troublesome still around property and also to some degree around workers' comp. Inflation, I mean, higher generally across-the-board. But again the liability-wise, particularly the motor-related business shows, I mean, relatively healthy lost-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. And if we redrew the picture today, I'm not sure that sum total will significantly change. But you see an expectation sort of that contribution from the U.S. and maybe more from Europe. And if you look, I mean, again even more recently in Q2, we see APAC nicely contributing pretty strongly and the Australian markets are starting to turn to some degree. So I mean, overall, we're not far away from what we thought we're going to be in November, albeit the components are maybe a bit different. From a cash flow perspective, I mean, Mario commented that we are absolutely on track. We're very happy with what's happening around cash flow. We'll update you again at the year-end. 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.

Operator

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

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

Two quick questions from my side. You just talked about the expenses. 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 it still around $500 million for 2018? Then the second question is on the dividend. So the current dividend policy of 75% earnings payout ratio are maintained with 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 '17 dividend, whilst having a temporary payout ratio of about 75%?

A - Mario Greco {BIO 1754408 <GO>}

No. 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 said 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 has 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 year-end. 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.

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

No. This is already quite helpful.

A - George Quinn {BIO 15159240 <GO>}

Nothing on the first part of your question around expense and particularly the restructuring topic. So I mean, 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 said it 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 the restructuring (inaudible) go through BOP in the second half. So you may see up to 150 run through BOP. But we still expect the total economic restructuring to be within the $500 million guidance.

Operator

The next question is from James Shuck from Citigroup.

Q - James Austin Shuck {BIO 3680082 <GO>}

Two questions from my side. I'm kind of going to give up trying to get answers to the question about returning capital and what your plans are around the dividend. But I would like to just ask kind of theoretical view of what is actually possible. Because you've got 134% Z-ECM. You actually run -- 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 agencies? Is it SST? Is it central liquidity? If you could just update on that, that would be great.

Secondly, on the U.S. commercial. There's been a bunch of repositioning of the portfolio in that territory, particularly kind of 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, the competition's got much stronger in the larger ends. I'm interested in 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. So I don't think you have so far. So just an update on what's happening on U.S. commercial would be helpful.

A - Mario Greco {BIO 1754408 <GO>}

So a good try. And if I can't 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 year-end over the last four years, we've been almost in a very narrow range between $120 million, $122 million in each single year. Today, it's $134 million. Part of it is due to market movements that can change. And part of it is due to our actions into the business profitability. I don't think that we're focused -- that we have focused ourselves on capital returning or 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>}

I would like to add one comment. So James, I think there was a -- part of your question, which was asking about whether there was a hidden constraint that we haven't disclosed. So I mean, the -- as you'd 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, though, if you look at the overall -- I mean, 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 wouldn't materially change the picture.

Q - James Austin Shuck {BIO 3680082 <GO>}

I guess, if I can just very quickly -- 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. So 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 promise, 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, by maintaining positive momentum to have a more rewarding dividend policy. That is our priority #1.

On U.S. retention and customers. I mean, I think if there is one thing which is undisputed at ZÃ¼rich's strength is that -- 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 and 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, 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 things 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 skills to broaden the services.

Operator

The next question is from Thomas Seidl from Bernstein.

Q - Thomas Seidl {BIO 17755912 <GO>}

I come back to this combined ratio point because it's so important for ZÃ¼rich, obviously. So at half year, you had 97.8. George, as you said, compared to last year half year, you have a similar period. You had 0.9 higher reserve, 0.5 lower cap, a few one-offs. But it seems that the combined ratio, that is stable, if not slightly. And notching upwards. And you want to get to 95 to 96. This is what the market also has started to expect from you. I wonder how you get for the next two years to the 95%, 96% level. Question 1.

Question 2 is on reserves. You have this Ogden hit, $289 million. You did a lot higher reserve leases in this quarter, the highest since 2014. And still you say that the reserve adequacy is unchanged to the date. I mean, (inaudible) has this morning basically reported a similar number for Ogden but has clearly said that this -- their reserves trends negatively as one would expect. So I wonder why this is not the case at ZÃ¼rich.

A - George Quinn {BIO 15159240 <GO>}

So on the first one, Thomas, on the combined ratio. I mean, I think I said in response to Andrew's question earlier that -- I mean, 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 x Ogden. 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. 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 bear guide. So again, I mean, 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 2percentage point to improve over the next year as a minimum. So how do you get there?

A - George Quinn {BIO 15159240 <GO>}

So -- I mean, as Mario said earlier, we make good progress on the expense program. But we're by no means done. So I mean, we still have the second of $1 billion to deliver. And you know the proposals 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 to some of the market softness, I mean, that expense ratio on its own is a very significant state. And taking the combined ratio, that's exactly in the range that you just quoted.

On the reserving topic, as you saw from us, we took the full charge, I mean, back in Q1. Well we took the -- part of the charge based on the same announcement from the government in the U.K. 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 prior quarters -- and the growth reserve releases have run slightly higher than the ones that we've typically released over time. I mean, we have a bit of that again in Q2. So while I had expected that it would take us probably more of a 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 2 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 is you did a higher reserve and still you said -- to offset Ogden, obviously, to get to the 1percentage point net and still you say the reserve adequacy stays unchanged. How...

A - George Quinn {BIO 15159240 <GO>}

Yes. It's important to remember that a number of different things drive reserve strength. So of course, there are -- there's a reserve strength that you start with and there's the reserve -- 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 -- I mean, 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 have left it, at the end of the quarter, it would have. So that partly explains why you see the significant PYD. But with no impact on reserve strength.

Operator

The next question is from Ralph Hebgen from KBW.

Q - Ralph Hebgen {BIO 6297020 <GO>}

It's actually only one question, I'm going back to the combined ratio. And specifically the component, which is the accident year loss ratio before net cuts. I appreciate all your comments. And I understand that it will be just some point, even arbitrary or discretionary to take the combined ratio apart. And yet it is cut off thicker, the increase in the accident year loss ratio from 64.5% in 2Q; '16, 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. We're following the implementation of the various management initiatives. You would not expect some of the large losses to run. Then perhaps you could indicate where 2Q '17 runs against the benchmark compared to where 1Q '17 ran and where 2Q '16 was, if that 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 dynamic, the underlying dynamic of the loss cost and the loss ratios are.

A - George Quinn {BIO 15159240 <GO>}

So I think the first point, Ralph, is that you point to the answer in the question. 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 in Q2 of 2016. And we've had a very slightly heavy quarter in Q2 of '17. I mean, again, I think I also mentioned in response to an earlier question that -- I mean, 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 6 quarters, I mean, since we've started making changes both to the way we underwrite to the risk selection and to the reinsurance. I mean, you've seen the accident year loss ratio x cat move in a band. It's around 2 points. I mean, if you look at 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 mean, I think that type of variation -- if you take high to low over I mean 1.5 years, it's not impossible to 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. I mean, 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. If you compare that to what you see as a normal normalization -- if that's not too much of a twist. I mean, we would 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 can pass. And year-over-year is driven by one very benign quarter versus a slightly heavier quarter.

Operator

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

Q - Paul De'Ath

And another question, sorry, on the combined ratio. More specifically, looking at the commission ratio. So I think, George, you mentioned that part of the increase in the commission ratio was a correction and -- this time around. But then there's obviously an element of it, sorry, 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 your 0.7 possibly points of movement down to mix on the commission ratio, should we expect a kind of reciprocal movement on the loss ratio? And that's kind of the first point.

Then the second one was just going back to Ogden. And obviously, there's potential that we get further moves in the Ogden rate later in the year. And 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 numbers for you guys in the second half or whenever it comes?

A - George Quinn {BIO 15159240 <GO>}

The only thing I will say that it you are completely tenacious around this commission topic. You checked this with me the last time we had this conversation. I mean, you make a very good point. I mean, we have talked about the mix of business driving this. I mean, we do expect to see improvements in performance. I mean, if I -- again, if I point to the things that -- maybe start with the numbers first. So I mean, we're -- 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's -- I referred to earlier, about 2/10, 3/10 of a point in the quarter. Within -- and that's a one-off. We do not expect that to recur. Within the business mix, a number of different drivers. So I mean, we've been successful in Latin America. It's driving growth in the mass consumer business. If that opportunity continues to present itself to us in a way that we drive profitability, we would continue to take it. The characteristics over the businesses that it has higher commission levels was typically lower and typically far more stable loss ratios. I mean, I can't scientifically point 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 ration improvement. I think just as importantly, probably the stability that I've referred to earlier -- I mean, I think we'd all like it to be more. I mean, one of the benefits of that business mix shift is more stability in the group's performance. And that's something we will continue to pursue in the future, assuming that, that opportunity was profitable.

The other big driver of it is actually in the U.S. I mean, as you know, the more competitive end of the market is the large commercial. Typically, it comes at much lower cost of acquisition. I mean, we've continued to prune that book, at the edges. That's been offset by growth in the Direct Markets book, which for us the F&I business and the Surety book. I mean, they both carry much heavier commission rates than the commercial book. I mean, one additional comment on that -- and that's -- I mean, ordinarily, we'd expect those businesses to be again of characteristics closer to the, I'm going to say the mass consumer than the large corporate commercial, which would be more exposed on peak 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's somewhat dampened the ability to bring down the overall combined ratio for the quarter. But I mean, 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. I mean, from an information flow perspective, I think -- I mean, you guys point to it at least as much as I do at this stage. There was an expectation of an announcement last week, which has been postponed. As far as I'm aware, no subsequent date has been established. Obviously, Ogden as a topic is a major event for the U.K. market. It's a relatively substantial (inaudible) -- it's on rates. As to how much, when, even if the U.K. government would come forward with a different proposal, I mean, my guess today is as good as yours.

Operator

The next question is from Niccolo Dalla-Palma from Exane BNP Paribas.

Q - Niccolo Cornelis Modesto Dalla-Palma

My first question is on top line. Clearly, good news to see that the like-for-like top line has been stabilizing and P&C both in Q1 -- I mean, Q2 actually slightly up, you mentioned. I just wondered if you could tell us, is this 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 -- you're there to write business where more important than in the business-as-usual situation. Just wondered if that -- where we are in that.

Then the second question is: If you could run on -- as for the impact on earnings from -- specifically, from the Banco Sabadell deal, what impact should we expect from here? But also cover more group, if you could run us through today. Given your expectations of the increase of insurance on that book, what should probably impact of these 2 transactions for the remainder of the year and going forward?

A - Mario Greco {BIO 1754408 <GO>}

So Niccolo, I start. This is Mario. I start with the sales in 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 changing 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 we're settling down with the long-term organization that we want to have. People have the roles, people feel good about the roles. And that is naturally facilitating them going back to customers' 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. But 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 2 transactions. So Sabadell will have, I mean, 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. Of course, there's some initial upfront cost that we'll incur. So expectations this year are relatively low. I mean, we price these transactions. But we don't price individual transactions. But we set huddle rates for the transactions that we'd be expecting to achieve ROIs, a minimum level of 10 and perhaps higher, depending on the risk profile of the transaction. I mean, you can apply that same growth to cover more.

Q - Niccolo Cornelis Modesto Dalla-Palma

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 -- I mean, 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.

Operator

The next question is from Michael Huttner from JPMorgan.

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

On the organic capital generation, could you just say -- give a little bit more granularity. Looking at the BOPAT report, it was $1.66 billion taxed. And you said the profit figure, which was mentioned, the organic capital generation, is just under $2 billion. So there's a gap of about $200 million. And you said that's capitalized less the cost. And I just wondered if you can say a bit more about that?

Then the second. You talked about mix of businesses and you gave some examples. Is there any way that -- for us to follow it? I mean, the examples you talk about are fantastic and it's lovely granularity. But is there anything that we can see in the slides or the supplemental information where we can say, aha, here's -- 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, it's a bit difficult to give you much more than I gave an 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 I mean, the key difference between the reporting earnings that you can see and the impact that we have in that Z-ECM ratio essentially is the new business value in life. That's the main explanation of the difference.

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

And the Ogden is deducted from both?

A - George Quinn {BIO 15159240 <GO>}

Ogden. So Ogden, it's a wee bit complicated. So Ogden was out at the starting point.

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

Okay, okay. So we can all (inaudible) both.

A - George Quinn {BIO 15159240 <GO>}

Correct. So and the 125 starting point we 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 1,662,000,000 -- no, sorry. Ignore that. Sorry carry on. I'm wasting your time.

A - George Quinn {BIO 15159240 <GO>}

On the second topic, I suspect that we'll have to have a look. It would 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, we -- you have a commercial segment where you can see the change in volume and the impact on the expense ratio there. Brazil, it's not solely mass consumer. But it certainly dominates the overall portfolio. I think Richard and I will have to have a look and see if there's something we can do that's more helpful around that mix topic. So I mean, yes, I think you couldn't bridge it from what we gave you today other than my comments.

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

Okay. And if I think about the bigger picture about the mix shift, you say at the -- when (inaudible) arrived, your portfolio was in 30-70 for 2010, stuff you don't like and stuff you do like, 2018. Where are you now?

A - George Quinn {BIO 15159240 <GO>}

We've certainly improved (inaudible) where we are in that continuum. I'm not sure it ever rains is 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 never a landing point in, at least in...

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 the effects from the Third Quarter, we will move to reporting the full financial disclosure at 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 2 questions that were still waiting to be answered. But I'll see in the interest of the time, given it's a busy day with other results. And we'll close it there. And the IR team stands ready for any questions that you might still have.

So thanks 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. Thank you for participating in the conference. You may now disconnect your lines. Goodbye.