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Bloomberg Transcript

Q3 2018 Earnings Call

Company Participants

- Roland Helmut Vogel, CFO & Member of the Executive Board
- Ulrich Wallin, Chairman of the Executive Board & CEO

Other Participants

- Andreas SchÃ¤fer, Analyst
- Andrew James Ritchie, Partner, Insurance
- Frank Kopfinger, Research Analyst
- Jonathan Peter Phillip Urwin, Director and Equity Research Insurance Analyst
- Kamran Hossain, Analyst
- Sami Taipalus, Research Analyst
- Thomas Fossard, Co
- Vikram Gandhi, Equity Analyst
- Vinit Malhotra, Banca di credito finanziario S.p.A., Research Division
- William Hawkins, MD, Head of European Insurance Research and Senior Analyst

Presentation

Ulrich Wallin {BIO 4863401 <GO>}

Good morning, ladies and gentlemen. I'd like to welcome you to our conference call presenting our results for the first nine months of 2018. As always, I'm joined by our CFO, Roland Vogel.

The most significant event that had an influence on our results of the Third Quarter were the recapture charges from our U.S. legacy mortality business, which was a result of our in-force management actions. This resulted in a one-off pretax IFRS loss of USD 260 million, equal to EUR 218 million. This is very much in line with our reporting that we issued on the occasion of our half yearly results. After tax, this negative effect is around EUR 170 million. Considering that despite that, we generated a group net income of EUR 725 million. This tells you that the performance of our business otherwise was rather satisfactory. In particular, this relates to our Life & Health business, though the international business outside North America as well as the U.S. financial solutions business performed fully in line or even better than our expectations with the Third Quarter performance here, very much in line with a favorable performance that we have seen in the first half year of 2018.

Our property and casualty business, on the other hand, felt an increase of frequency of sizable losses below the threshold of our large loss reporting. And thus, the combined ratio for the first nine months of 96.8% was slightly above our target.

The return on investment from assets under own management again developed very favorable with 3.2%, well above our benchmark for 2018 of 2.7%. The top line grew considerably, with the gross written premium increasing by 16.5%, then adjusted for foreign exchange rate movements, which reflects the increased demand from our clients for our reinsurance solutions. The bottom line rose sharply compared to 2017, mainly due to the fact that in 2017, we had suffered the well-known cat losses. However, the EBIT of EUR 1.15 billion after nine months as well as the group net income of EUR 725 million came in at a quite acceptable level. This is underlined by the fact that the annualized return on equity with 11.5% continues to be well above our minimum target of 900 basis points excess of risk-free rate.

Despite the fact that the book value per share reduced slightly as a result of dividend payments and interest rates and spread movements, the solvency ratio remained comfortably above EUR 252 million (sic) (252%) at the end of the half year. And we expect to be well above our threshold despite the growth of our business also for the 9-month period.

The large loss burden of our P&C business absorbed almost the entire large loss budget during the Third Quarter. However, if you look at the 9-month period, we are still well below the budget. Therefore, it can be said that the increased large loss activity during the Third Quarter was well absorbed within our expected values for large losses.

The premium growth of our Life & Health business of 4.8% adjusted for foreign exchange rate movement is well in line with our target of growth of 3% to 5%. Also the third -- in the Third Quarter, our business continued to generate a very positive operating cash flow, which was the basis for the growth of the assets under own management as well as the gratifying increase of our ordinary investment income.

On this note, I would hand over to Roland, our CFO, who will explain these numbers in more detail.

Roland Helmut Vogel {BIO 16342285 <GO>}

Good morning. And thank you, Uli.

As the nine months result does not include so many one-off effects other than the recaptures in our Life & Health segment, I will try to keep my comments as brief as possible.

On the Page #2, we see that the remarkable top line growth of 16.5% adjusted for currency effect in the first nine months of 2018 is largely driven by our P&C business as we continue to see ongoing high demand from all clients, especially for structured products.

Net premium earned developed overall in line with the gross premium. The group EBIT improved significantly, although the individual parts showed a quite mixed picture. P&C improved remarkably on the basis of a previous year, which was hit hard by the Hurricanes Harvey, Irma and Maria. On the other hand, L&H is -- or the Life business is impacted by charges from the recaptures impacting the current year's result negatively to quite some extent.

Finally, even though the year-to-date 2018 development was very satisfactory, investment income is down because we could not sell our equity portfolio another time, which had boosted last year's results by more than EUR 220 million pre; as well as after-tax.

On the -- other income and expenses improved mainly due to positive currency effects and the increase in net income was less pronounced compared to the rise in EBIT, reflecting a higher tax rate. This is mainly a reflection of the extraordinary tax burden in connection with the U.S. tax reform in the First Quarter of 2018 and the nearly tax-free profits from the liquidation of our equity portfolio in the previous year, as already mentioned.

Operating cash flow here on the next page continued to be very positive in the first nine months, increasing by more than 15% compared to the previous years. And for those who have been following our Investors Days, I would like to remind you of the impact of the operating cash flow on the assets under own management as well as the investment income going forward, which I was trying to make transparent at that occasion.

Looking at the development of our investments and (net) effect from currency translation and the change in valuation reserve was minus EUR 200 million. Here, the currency adjustments -- the positive currency adjustments of EUR 500 million were more than offset by the decrease in valuation reserves due to the rising interest rates and spread increases, which produced a negative effect of around EUR 700 million. In spite of this and driven by the positive cash flow, assets under own management increased by 3.5%.

The capital position on the next slide is impacted by the same effects. The dividend payout is fully covered by the profits from the first nine months of 2018 or the potential dividend or payout. Rising interest rate in the U.S. and spread increases resulted in a decrease in unrealized gains, which was only partially offset by positive currency effects, as already mentioned. Therefore, the overall negative development of the OCI led to a decrease in shareholders' equity of 2.1%. And here on the left-hand side of the slide, the picture is nearly unchanged. But let me remind you of the remaining high degree of flexibility in the Tier 2 bucket, which potentially could be utilized whenever necessary.

P&C gross premium increased by a remarkable 24% on an FX-adjusted basis. The main driver of this organic growth continues to be new business written by our structured reinsurance team. Additionally, a few larger transactions in our traditional business lines contributed to the development, especially in Australia and China.

Net premium developed in line with gross premium. Again, this gross pattern demonstrates that we do not have a volume problem at all. And this is the basis to stick to our purely result-driven underwriting approach and that we should only assume business which lives up to our profitability targets.

Following a very benign first half year, we have seen a significant increase in large loss activity in the Third Quarter, exhausting the budget on a stand-alone basis. However, we still carry forward the unused budget from the first half as part of our IBNR reserves.

The combined ratio of 96.8% is slightly above the full year maximum target of 96%. This can be partly explained by the strong increase in our structured reinsurance business, which naturally comes with a higher combined -- or comes with higher combined ratios of around 98%, 99% due to the lower risk transfer. As part of the structure of those deals, the commission is also often slightly higher than the rest of the business. Additionally, we saw an increased frequency of small and midsized losses in the Third Quarter, which explains the 98.7% in the stand-alone quarter as such. Overall, the underwriting result is still rather positive in light of the competitive environment. The runoff of loss reserves in the first nine months was in line with our expectations overall.

Ordinary investment income increased slightly. And other income expenses also improved mainly because of positive currency effects. The operating profit increased by 67% due to the high level of cat losses in the previous year.

As mentioned earlier, the increase in the tax ratio is mainly due to the fact that last year's result benefited from the tax or nearly tax-free disposal of gains and dividends. The relatively low tax ratio in the Third Quarter is due to a few smaller items adding up to this positive effect. You might remember that it was exactly the other way around in the Second Quarter. And therefore, overall, the tax ratio is now in line with expectations year-to-date.

Major losses, on the next slide, were below the expected level and entirely driven by the very benign first six months of the year. This leaves us with comfortable cushion to absorb large losses in the Fourth Quarter, including the unused budget carried forward and our retrocession, which are also nearly fully intact. The large (loss list) is predominantly driven by the strong storm activity in the Third Quarter both in the Atlantic and the Pacific regions and particularly in Japan, where a series of typhoons led to widespread destruction and flooding. The difference between the gross and the net loss illustrates how well our protection is working. Although, of course, it should be noted that it also includes our activity in the ILS markets where we are one of the larger players in the collateralized fronting business. And that also leads to a higher difference in gross and net.

You might ask what we expect from Hurricane Michael. Early in the Fourth Quarter, we have no concrete calculations available yet. But we would expect Michael to be in the ballpark of the Florence losses based on the information we have available today.

The next slide shows a little bit of a mixed picture of underwriting profitability by line of business. Facultative business is affected by large losses. So for instance, also the Ituango dam in Colombia. Within the U.K. business, we expanded our nonproportional mortal portfolio, which comes with high initial loss ratio assumptions, well above the 100%. And marine -- on the other hand, marine aviation credit and surety are significantly below the MtCR. Most other lines of the portfolio as a whole are close to our target combined ratio. And on this basis, we would expect to meet our 96% target by the end of this year.

On the Life & Health side, here on Life & Health, the gross written premium increased by 4.8%, adjusted for currency effects, which is exactly in line with our expectations for the entire year. The main driver for this development was gross from U.K. longevity business and the expansion in China.

Uli has already commented on the development in U.S. mortality. And he will most likely come back to that as part of the outlook. The very favorable development of our mortality business outside the U.S. and our financial solutions business in the U.S. as well as around the world continued in the Third Quarter. Our worldwide morbidity business performed particularly well with significantly improved profitability. And also, the well-discussed U.S. mortality business came in better, or to be correct, less negative than expected. Nevertheless, these positive developments were overshadowed by the recapture effect we had to reflect in Q3 with an amount of EUR 218 million. Ordinary investment income increased realized gains. And losses were significantly lower compared to last year's, partly driven by the increase in interest rates in the U.S. Consequently, net investment income from assets under own management came down to EUR 232 million. As already mentioned, we had a one-off effect of about EUR 22 million from the tax reform in Q1 2018. Apart from this, the tax ratio is also somewhat distorted by the quarterly loss in Q3.

Looking at the investments. The development in the first nine months of 2018 was very satisfactory, with the investment income remarkably above our return expectations for the full year. The contribution from private equity and in real estate continued to be quite attractive. But we've also seen an increase in ordinary income on our fixed income portfolio.

As presented at our Investor Days, some 3 weeks ago, the reinvestment yields for the U.S. dollar is currently higher than the maturing yields by quite a margin. And we are therefore starting to see slightly the benefits of the rising U.S. interest rates in our numbers and especially the ordinary income.

Realized gains and losses decreased compared to last year, particularly to the sale of our equity portfolio in 2017. Impairments, depreciations still consist mainly of regular depreciation for real estate.

Overall, the ROI of 3.3%, if we exclude the effect from our ModCo derivative, which was minus EUR 4 million after the nine months, the 3.3% is clearly above the full year target. That means that we will probably see an ROI figure potentially with a 3% also by the end of the year. But 6 weeks before the end of the year, it didn't make sense to change our guidance here.

As a result of increased interest rates and widened spreads evaluation, reserves decreased compared to the year-end 2017. As mentioned at previous occasions, we do appreciate the slowly growing reinvestment yields and their impact on the ordinary income. But we also have to get used to a smaller contribution from realized gains.

The next slide shows the usual overview of how the different asset classes contributed to the ordinary investment income compared to where we are invested. In the course of our portfolio reshuffling, we have reduced our share of high-risk corporates and now -- and are now investing on a more diversified basis across the rating spectrum again. And we are also expanding into emerging markets a little bit. Additionally, we have modified the nature of our government bond holdings and expanded our portfolio instruments with inflation that coupons and redemption amounts to counteract potentially rising inflation risks, especially for our P&C reserves.

The left-hand side illustrates the favorable performance of our private equity and the real estate portfolio. The contribution from the govies is increasing compared to previous periods, driven by a mix of higher volumes and increasing interest rates, especially in the U.S., as already mentioned more than once.

I think this concludes my remarks. And as usual, I leave the target matrix and the outlook to you, Uli.

Ulrich Wallin {BIO 4863401 <GO>}

Thank you, Roland.

Well the target matrix shows most of the targets actually ticked, which demonstrates that the business performed largely in line with our target. It's fair to say that the earnings growth is, of course, inflated due to the underperformance of, at the same time in 2017 due to the well-known hurricane losses of last year. But we didn't have to tick it on the combined ratio, which shows actually what's already mentioned, quite a higher frequency of losses outside the large losses. But as Roland said, we expect that to come back into the target level by year-end. Also, I mean, of course, the EBIT growth on Life & Health would have been there without the recapture. But having the recapture, of course, it's not there.

That leaves me -- this comes -- we now come to the guidance for the current year, which we left unchanged from our previous reporting. And I would like to confirm, in particular, our net income guidance of more than EUR 1 billion, which we expect to achieve, including the burdens that we have seen from the Third Quarter and expecting for the first -- Fourth Quarter from our U.S. mortality business due to the already-mentioned recapture. We have much better clarity of the position on this topic now. And we are expecting a further negative one-off effect in the Fourth Quarter in the region of EUR 100 million. This burden should be absorbed by the underlying profitability of the rest of our Life & Health business so that we do not expect any significant negative result from our Life & Health business during the Fourth Quarter. As always, our net income guidance is subject to no major distortions in the capital markets and on the basis that the major losses remains in the large loss budget. And as the same conditions, we would expect that the dividend payout should be at least at the level of the previous year of EUR 5 per share.

This then brings me to the development of our P&C business this year. Overall, we expecting good growth of the premium. That continues on from the first nine months. And on the profitability, we expect that, overall, we will earn the cost of capital margin. Of course, here, the very-well diversified portfolio helps to absorb underperforming lines of business, like for example U.K. and Ireland and facultative business this year with other lines of business that are in line or outperforming the business, such as for example credit, surety and marine. So despite the continued very competitive market in the P&C side, we still feel that we are in the position to deliver profitability in line with our target.

Coming to the Life & Health business. We will continue to see, as we have seen in the first nine months, excellent profitability from our financial solutions business. This is for the most part a U.S. business. But also our non-U. S. financial solutions business is very profitable.

Longevity, we see a rather stable development, both bottom and top line. This business is largely centered on the U.K. business for the time being. But we are working on a number of very promising opportunities outside the U.K., particularly in countries like Australia, Canada and -- but also Asia. However, the premium income and profits from those initiatives would probably only come to fruition in the year 2019 and onwards.

Mortality is negative due to the already many times mentioned recaptured-only U.S. mortality business. It's quite interesting to note that our mortality business outside North America actually have shown -- I mean, an EBIT margin north of 7%. That has been for quite some while. And it's also been true for the first nine months. And we also expect that for the entire year.

On the morbidity business, we have seen clear improvements, both bottom and top line. So we expect that business will at least earn the cost of capital. However, overall, due to the loss on -- expected loss on the mortality business, the profitability on our Life & Health business will be somewhat short of the necessary margin to serve as the cost of capital.

This brings me to the guidance for next year. The guidance for next year, we expect further growth of our premium income, even though not quite at the same range as in 2018. But well in line with our targets from the target matrix.

Return on investment has been calculated on a bottom-up basis of 2.8%. This was a bit more than our targets that we had for 2018 and as a result, that just under 50% of our assets under management are denominated in US dollars. So the ordinary income should benefit from the significant rise in the interest rates for U.S. dollar investment.

The net income guidance of -- in the region of EUR 1.1 billion is supposed to signal that the profitability in 2019 will increase as compared to 2018. Because in 2018, of course, the net income guidance is centering at around a number of EUR 1 billion. Of course, EUR 1.1 billion is not a point estimate here. It leaves room more ups and down, I would say, from the EUR 1.1 billion. It takes into account that our Life & Health business is expected to be significantly more profitable in 2019 than it has been in 2018. For our P&C business, the combined ratio target that we have of 96% or better (would) still hold true for our expectations and is still the basis for our guidance of 2019. And therefore we feel quite comfortable with the 1.1 -- with the around EUR 1.1 billion guidance.

Dividend payout ratio is unchanged here. However, this -- the growing net income, we most likely will be in the position to consider an increase in the ordinary dividend which then most likely will, circumstances allowing, again be boosted by a special dividend. However, the component of the ordinary dividend should actually increase for 2019. So to caution you that this is of course all under the same providers that you see in the footnote of this slide. And of course, I mean, it's relatively (easy) to talk about dividends there for 2019. But the general policy here remains unchanged.

Then this slide that you see here is actually the same I was showing to you on our recent Investors Day. It should tell you that also in the medium term, we are expecting that our business model should be capable to grow our profitability of our business based on outperforming the market on the P&C reinsurance, growing EBIT, EBIT contribution from our Life & Health business in 2019. But also beyond. And the investment income, of course, a little bit held back by the reduced valuation reserves as the result of the increased interest rates and spreads. But these expectations of growing assets under management gradually would also see increasing bottom line numbers here.

That would end our presentation. And we would be more than happy to answer your questions. Thank you very much.

Questions And Answers

Operator

(Operator Instructions) And our first question comes from the line of William Hawkins from KBW.

Q - William Hawkins {BIO 1822411 <GO>}

Uli, in your closing remarks, you just slightly touched on this. But could you be little bit clearer about how you view the walk from 2018 to 2019 guidance? I mean, it strikes me that the non-recurrence of the U.S. mortality charges alone should be adding something like EUR 250 million to next year's performance. Then you've got business growth and high yields and hopefully an unchanged combined ratio, all of which to me should be pointing to momentum allowing for a correction of something like EUR 400 million or so. So I appreciate what you say about conservatism and the rest of it. But could you just be a little bit clearer? Because to me, EUR 1.1 billion does not seem ambitious if you're going to achieve EUR 1 billion this year. There must be some negatives I'm missing. So that's question #1. Then I suppose question #2 is very brief again. You did allude to this. But just in terms of your commitment to the 96% or better combined ratio, the Slide 17 that you've repeated from the Investor Day has kind of dropped that number out. And so I'm just wondering, again, given that you're growing in structured products and the rest of us -- and the rest of it, do you want to be pulling back a bit from that 96% or is that still a key target for you?

A - Ulrich Wallin {BIO 4863401 <GO>}

William, well, I mean, the EUR 250 million improvement you are expecting from the Life & Health is, of course, a pretax number.

Q - William Hawkins {BIO 1822411 <GO>}

No. It wasn't, sorry. Sorry, Uli, it wasn't. Because your figure originally is EUR 300 million to EUR 350 million. And so I tried to take some tax off.

A - Ulrich Wallin {BIO 4863401 <GO>}

Well I mean, we have EUR 155 million EBIT now. We are expecting at least 0 for the Fourth Quarter on the Life & Health. So if I add EUR 250 million to that, I arrive at EUR 400 million. That's probably a fair guess, I would say. Then on the 96% combined here, that is still the target for 2019, which we expect to reach. We think that the quality of our P&C business would support that. That is also based on our assumptions that the pricing quality of our business in 2018 would be at least as good as in -- in 2019 would be at least as good (at if in) 2018. And well, I mean, if the pricing quality is the same as that, considering that the large losses remained in the somewhat increased large loss budget to EUR 875 million, we should reach the 96% or better. So that's all there. Of course, I mean, it's early days for next year. So we, as we did in previous years, are reasonably cautious. This is our guidance. You should also take into account that this year. So far, we have a significant outperformance of our benchmark for our investment income, which will probably remain until -- for the entire year as well. So that would of course signal a drop in investment income for next year because the target is 2.8%, which is a bottom-up target. So from that point of view, I would say we feel comfortable with the -- I mean in the region of EUR 1.1 million (sic) (EUR 1.1 billion). As I said, it's not a point estimate.

A - Roland Helmut Vogel {BIO 16342285 <GO>}

Well if I may add one component, Will. I think one of the differences in assumption is here that you just take out the recaptured charges. We did mention that the mortality business has been performing better, or I did mention less negative than in the previous years. We did not assume that for next year already. So we are a little bit more conservative on that side, which is then -- may also be an explanation for the difference in assumptions.

Q - William Hawkins {BIO 1822411 <GO>}

Just on that final point, Roland. Is there anything for this year in Life & Health that you would like to highlight that is explicitly one-off in nature beyond that point you just mentioned? One-off positive in nature?

A - Roland Helmut Vogel {BIO 16342285 <GO>}

Not really. It was -- we had negative surprises in the past. We had a -- which we were always wondering should we really write that forward and prolong into the future or is it a -- statistically a one-off this year. It came in better. Just the mortality came in better. We didn't have so many large losses with higher sums insured. So we appreciate that this was the case. But we did not assume this to continue next year and the years going forward to the full extent.

A - Ulrich Wallin {BIO 4863401 <GO>}

Yes. It's just one of those years where, in Life & Health, nothing went wrong really outside the recapture. I mean non-U. S., very strong result. I mean financial solutions (U. S.), very much in line with expectations. That will continue to grow on bottom line next year. And mortality solutions, I mean, on the old books that we bought from Scottish Re, the mortality experience was actually quite a bit better than expected and significantly better than in 2017. We did not assume that, that will also be the same in 2019. So there's quite a little bit of caution, even though the portfolio has shrunk a lot now there because, I mean, all the recaptures. And we are currently in the process of evaluating the loss expectations for the coming years based on this significantly smaller book of business. And -- but that hasn't been finalized as yet.

Operator

Our next question comes from the line of Kamran Hossain from RBC.

Q - Kamran Hossain {BIO 17666412 <GO>}

Two questions. First one is just on, I guess, P&C combined ratio and loss experienced. Could you -- I mean, a couple of your peers have talked about higher attritional losses in the quarter. Could you give any comments on that and kind of whether you see this as a costly blip or something that is around longer term? And the second question, just coming back to Life. I guess if we net out your (2018) of your EBIT loss, we get to a number which suggests a higher EBIT than the EUR 400 million, EUR 450 million. Could you talk about one-offs in this quarter and why we shouldn't take this quarter underlying and then extrapolate that times 4 for the next few years?

A - Ulrich Wallin {BIO 4863401 <GO>}

Well I wouldn't say that there are positive one-offs in this quarter. Just nothing went wrong. I mean that's also a one-off, I would say. And it is obvious something is happening, in that the EUR 20 million retention per Life, of course, I mean that could also generate some volatility. No. I mean, it's no positive one-off. I mean it's just, as I said, nothing went wrong. Of course, if that would be true throughout the entire -- and almost be the truth throughout the entire 2018 year. But of course, we would think it's rather optimistic to hope for the same in 2019. So from that point of view, we're obviously a bit cautious there. I mean losses, losses on the -- underlying losses on the P&C side, particularly in the Third Quarter, of course, a lot of industry of higher losses. I mean, we had a refinery in Bavaria. I mean, there was another refinery loss in the Middle East. There was the bridge in Genoa. Quite a lot of losses. I mean, marine wasn't pristine either. But -- therefore, I mean, we clearly saw increasing losses. And you can see it in, I mean, in portfolios of large commercial business with many of our clients. I mean, they have significant losses as well. And some of them ended up in our books. I mean, I would still say that it's a quarterly volatility. I wouldn't think that it's a general trend that we can, I mean, assume forward also in 2019 and to come. But it also reminds us very sharply that there is no room for rate decreases at the coming renewals.

Operator

Our next question comes from the line of Vinit Malhotra from Mediobanca.

Q - Vinit Malhotra {BIO 16184491 <GO>}

So my questions are, sorry, in the same lines of thought. The -- just moving step-by-step. So the combined ratio at the 98.6% -- or rather, even if it's to nine months, it's 96.8%. To move towards the fourth -- I know 4Q stand to be sort of in the (90th) range. But just could you help us understand, I mean, say, either 3Q or nine months, how much is the effect of the structured solutions or even the large treaties and then this frequency topic you just mentioned? Just so that -- trying to understand how this can go back to 96% next year, please. But that's probably my main question.

A - Ulrich Wallin {BIO 4863401 <GO>}

Thank you, Vinit. Well the financial solutions here, I would say, probably just under one combined ratio, loss point, percentage point. Why should they move back? I mean, on the -- we have seen quite a lot of business growth also outside the structured reinsurance. And I mean, therefore, our rather conservative -- I mean, reserving in the initial underwriting years plays a major role here. I mean, we have, I mean, combined ratios in the newest underwriting years valid by the 100 just based on our general conservatism when we set up our loss reserves. And I mean, we're not expecting to grow to the same magnitude next year. So the latest underwriting (years) that was subject to that rather significant growth. Certainly on the shorter to midterm lines, we are expecting to show some positive development on the loss ratios. That's the main reason why we expect that to come back. I mean, we still -- of course, we try to keep our buffers on the loss reserves, which we just had shown you at the occasion of our Investors Day to the extent possible. I mean, you can see that we didn't have to show a spectacular good combined ratio on the Third Quarter in order to make up for the recapture. So on the U.S. Life & Health business, which also shows you that the remaining life business and the investment income, both actually quite favorable.

Q - Vinit Malhotra {BIO 16184491 <GO>}

And just for a second follow up on just the Slide 14 please, from today's presentation, the one which shows the cost of capital by line. And just by virtue of comparison compared to last quarter, I mean, there's 2 areas which are changing. North America seems to have gone down in profitability a bit, one notch. And marine seems to have improved. Could there be a comment from your side on this? Just if I can help link with what we're talking about anyways?

A - Ulrich Wallin {BIO 4863401 <GO>}

Well North America is higher than we would like to see it. That is mainly due to property losses from the hurricanes. And I mean, marine is -- I mean, on the marine side, we are actually rather conservatively reserved on the old losses, on -- I mean, on additional claims reserves. And therefore, we have those coming out at times. And that then makes this spectacular combined ratio. But the volume is not all that large either. I mean, that is probably be expected for the entire year, even despite the fact that we have losses like that German shipyard loss, which is also reasonably sizable despite the fact that we are -- our retrocession on (sales works) actually particularly good.

Q - Vinit Malhotra {BIO 16184491 <GO>}

And on these buffers, could you just update us, Uli or Roland, on what is the normalized sort of normal loss reserve release run rate per annum or per quarter? And is this changing next year probably? It used to be EUR 50 million a quarter, long ago. But you updated to EUR 100 million already, I think. And I'm just wondering if it's changing again next year?

A - Roland Helmut Vogel {BIO 16342285 <GO>}

Well this is of course difficult to foresee, what's going to happen next year. If we have business growth and the redundant reserves grow, then of course also the, what we call the regular runoff should be growing. We haven't been growing the redundancies over the last years dramatically. So in that regard -- and I think we updated that when we discussed the extraordinary EUR 800 million last year, that a regular accepted or expected number should be around EUR 400 million for the year. But also this is, of course, then -- and not a certain number because it can be impacted, especially also by a large contract where you sometimes have movements from commissions into losses and vice versa. But the EUR 400 million would be the ballpark number per year, which we are expecting, which we also have been seeing in previous years.

Operator

Our next question comes from the line of Jonny Urwin from UBS.

Q - Jonathan Peter Phillip Urwin {BIO 6126952 <GO>}

Just two -- two for me, please. So firstly, could you talk us through your thinking behind increasing the cat budget? Is it just that you've grown a lot for this year? I guess I always thought your cat budget was always quite plentiful. So no great need to increase it. And secondly, how do you expect percentage of capital to react to the losses through the Third Quarter and Fourth Quarter so far, if at all?

A - Ulrich Wallin {BIO 4863401 <GO>}

Well the increase in the cat budget is just a factor of the actuaries because you calculate the expected losses on the natural catastrophe side on an annual basis and with an increase to -- I mean, to increase underlying exposures, which always happen inflationary-driven and also, I mean, some slightly increased aggregates that we have written on the cat business that just came out with a high expected loss. We also have more premium as a result of that. That's the reason -- I mean it hasn't grown significantly. And we kept it stable for number of years. I mean if you just look at the actual experience, you might say, well, I mean, EUR 825 million is plenty because in most years, we are not hitting that. But this is just an actuarially calculated number, which we also use for our planning purposes. That's on the large loss budget, why we increase it, to reflects just increased exposures and increased premiums as well. The other question, the losses in the Third Quarter and the Fourth Quarter. What was that due to the market? I think it should allow us to, I mean, not give away any of the, I mean, rate increases, not large enough but the rate increases as we got in 2017. And on the contracts that have suffered losses and our negative territory as a result, I mean, we would expect further rate increases.

Alternative capital, while this is a difficult one to predict, I would say -- I mean the results of the alternative capital facilities this year have not been brilliant. Of course, it's a mixed picture. I mean the variety of outcomes from various funds is quite different. But I mean I would expect that the investors might be a little bit more cautious for 2019 than they have been for 2018 because some of the expectations on significant rate movements have not been fulfilled. And I mean, if the investors look at the Guy Carpenter Rate On Line Index, they would have a very good proxy to -- what to expect.

Operator

And our next question comes from the line of Sami Taipalus from Goldman Sachs.

Q - Sami Taipalus {BIO 17452234 <GO>}

Just to ask a question on pricing, actually. I understand your comments regarding the loss experience this year and obviously why that should (help) support the pricing in the following year. But if we just look to one-one purely, which I guess is more Europe-focused and casualty-focused, could you just provide a more specific outlook for just one-one, what you expect to see there? And also maybe comment a little bit about what you're seeing in terms of demand for large P&C transactions. Then my second question is on investment income. It's just not quite clear to me how much of the ordinary investment income in this year, year-to-date is extraordinary and how much is -- you consider to be fully ongoing. So it'd be great to have some more detail there, please.

A - Ulrich Wallin {BIO 4863401 <GO>}

Well I mean on the pricing, in Europe in particular, I mean, we expect that to be rather stable because there have been quite a lot of losses in the market. And if you look at the reportings of the larger reinsurers so far. And look at the combined ratios and compare that, say, with these reporting sets at the same time in 2016 and in 2015, for argument's sake, you would see that the combined ratios are remarkably higher now. So that shows you that there is no room for rate reduction. And also, such as that there are more programs that are actually in the loss position this year than there have been in previous years. And that will have an effect on the pricing, I'm pretty sure. Demand for reinsurance is still, I would say, rising. Particular -- I mean some of the -- of our clients have experienced significant volatility in their own results. And of course -- particularly on the commercial lines. And as a result, are quite interested in getting reinsurances in place that uses that volatility. And as a result, both large and small; to medium-sized transaction, we would expect to see more demand in the market for that into 2019. On the investment, ordinary investment, I would, of course, hand over to Roland.

A - Roland Helmut Vogel {BIO 16342285 <GO>}

Thank you. Sami, we had, especially in the last years, some extraordinary distributions from larger funds, PE funds as well as high-yield funds. There was, I think, one also this year. But I would not really see that as an extraordinary ordinary income contribution. So in that regard, I -- again, there was one. But there could be another one also next year again. So we should really see that as driven by ordinary, ordinary income and nothing special. No one-offs included in there.

Operator

Our next question comes from the line of Frank Kopfinger from Deutsche Bank.

Q - Frank Kopfinger {BIO 16342277 <GO>}

Actually, I have a follow-up question on Sami's question because I still don't understand how you get to this 2.8% guidance return on investment for next year. And as after the first 3 quarters, you had already an ordinary investment yield of 3.3%. And you just said that this is already the ordinary level. So I still don't see the gap to the 2.8%, which you have within your guidance. Then secondly, how should we think about the unused major loss budgets for 2018? Obviously, as of now you have still EUR 460 million unused. There will be some effects obviously in Q4 and probably to come. But how should we think about the residual? Are you going to put it into the reserves or are you able to release it into the result?

A - Ulrich Wallin {BIO 4863401 <GO>}

Well on the (lay down), I mean I would say this gives us good confidence that the loss ratio for the entire year will drop below 96% because that is still there. It's -- also at least, on the cat side, it's highly unlikely this year that the cat losses will be able to exhaust our budget because of our retrocessional structure. So I think it's quite, quite likely that we will end up with unused large loss budget also at the end of the year. But just due to the structure of our retrocessions. And on the 2.8%, that's far too complicated for me. Roland?

A - Roland Helmut Vogel {BIO 16342285 <GO>}

You're right. We had mentioned the 3.3% as ordinary investment income. But that is, of course, before any depreciation and any expenses. So in that regard, we have to deduct already this year, if you look at the publication, some 40 basis points. And that would then result at 2.8% to 2.9%. And we cannot expect really contributions from disposals going forward. Yes. We -- our evaluation reserves came back from EUR 1.7 billion to EUR 900 billion by the end of the quarter based on what was happening since then. You can imagine that this number is lower rather than higher today. And the remaining contributions to the valuation reserves do come from the more illiquid classes like real estate and private equity and high-yield funds. So in that regard, we just have to expect that there will be -- and this is the basis of our planning, that there will be no contribution from realized gains and losses. We might also have to see that disposals and sales of securities will be still associated with the realization of negative reserves. And from the bottom-up calculation we did, maturing yields, new investments, the 2.8% is what we achieve. Could that also be 2.9%? Yes. But again, the contribution from realized gains is not expected to be as high as in the past. And I think if you look at the publications of also the industry this year, we've already seen also, not only for us. But also for the industry that these contributions cannot be taken into account as much any longer. Still, we appreciate that ordinary investment or reinvestment yields are rising again.

A - Ulrich Wallin {BIO 4863401 <GO>}

I have to say that, at least, in previous years, we normally somewhat outperformed our ROI guidance.

Operator

Our next question comes from the line of Andrew Ritchie from Autonomous Research.

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

I think, Uli, you suggested there was continued appetite out there for more demand for structured solutions in the P&C Re business. Is there any sort of natural limit to how much of this business you want to write? Presumably, more -- there will be a greater earned effect on the combined ratio in '19 than what we've seen this year in terms of inflating the combined ratio, I think. Just clarify that's the case. And related to these large deals, what is the group's current appetite on U.S. casualty? I think it's not for some of the wider nationwide deals. But maybe just clarify that.

A - Ulrich Wallin {BIO 4863401 <GO>}

Yes. I mean, of course -- I mean, from principal point of view, we write the business that fulfills our margin requirements based on our assessment. From that point of view, of course, there is no limitation for our colleagues that do these deals. Of course, I mean, we are looking a little bit more for structures that have a higher, say, EBIT margin based on the premium. And of course, I mean, it's also a question on the margins which should depend on the type of deal. But we still have -- continue to have an appetite for this deals as long as we have a very good return on them on the capital (applied). So you would see -- probably, growth of that is always a little bit difficult to predict because many of these are written for 100%. And yes, I mean, we have already month for margin. And if somebody else is prepared to calculate with a sharper pencil, they will get the business. If we have a sharper pencil, we get it. So you can see, it's quite price-sensitive business. But I think that you would see further growth in it. At least, that's set in the business plan for next year. U.S. casualty, still, we are (enervate), I would say, on the large excess and umbrella business, where we have hardly any on the books now, particularly U.S. We continue to do that. I mean, where we write our U.S. casualty, which was just still a sizable book, is more -- this is more to a medium-sized clients in the U.S. And it's more the many and more specific contracts than writing single, large contracts on U.S. casualty. That, for the time being, remains our strategy. We see positive movements in the U.S. casualty pricing, which we, of course, observe, which slightly increases our appetite. But certainly not for unsupported large excess and umbrella accounts.

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

And just to be clear on the -- there is more inflation in the combined ratio from the structured solutions next year, isn't there? In calendar year -- we haven't -- it hasn't fully (run) through yet?

A - Ulrich Wallin {BIO 4863401 <GO>}

Yes. I mean, the returns on the structured solution business next year should increase actually remarkably. And the reason for that is that we realized a profitability backloaded on that. And particular the newer, larger transactions will contribute to the 2019 EBIT, more -- significantly more favorable or more significant than we have seen in 2018.

Operator

Our next question comes from the line of Andreas SchÃ¤fer from Bankhaus Lampe.

Q - Andreas SchÃ¤fer

I just want to come back to the issue of Life & Health Re insurance. I mean, you mentioned that this underlying EBIT of roughly EUR 150 million in Q3 was not really affected by huge (exceptionals). But looking at your ordinary investment income or looking at your investment income from own sums, it's almost EUR 100 million and EUR 20 million above the run rate (of the first) quarters. Is there any part of big realized capital gains in the earned EBIT of more than EUR 150 million? Or is that really a normal run rate in terms of investment result?

A - Ulrich Wallin {BIO 4863401 <GO>}

I think, Roland, that's one for you.

A - Roland Helmut Vogel {BIO 16342285 <GO>}

We have not seen large realized gains or any extraordinary gains on the Life & Health side. So in that respect, I'm not aware of any one-off here. So we should assume it is a regular result here. So I think we will have to dig into that a little bit more. But again, overall, there have not been any extraordinary investment gains on the Life side.

Q - Andreas SchÃ¤fer

I was just pointing to the fact that the, overall, your realized capital gains were, again, pretty high at almost EUR 50 million. So it's just P&C? Or...

A - Roland Helmut Vogel {BIO 16342285 <GO>}

Again, as we mentioned before, of course, the contribution from the realized gains, it didn't -- that also had to do with the restructuring on the Life side. Early this year, we had to move some investment portfolios from one jurisdiction to the other based on the tax reform. That came with some realized gains already. And as I mentioned before, we will not see these realized gains into the future. Still, as the reinvestment deals are rising. And we see the still positive cash flow increasing the assets under own management, we do assume that the contribution on the net investment income side should be stable.

A - Ulrich Wallin {BIO 4863401 <GO>}

But we also see, I mean, good growth of the profitability, for example, of our Chinese business. And that refers to both financial solutions as a lot of very traditional business. So I mean, this kind of growth that we have seen on the Asian business, for example, or the Australian business, is actually contributing very positively.

Operator

Our next question comes from the line of Thomas Fossard from HSBC.

Q - Thomas Fossard {BIO 1941215 <GO>}

Two questions. One, remaining on the story on the investment income. Because looking at Slide 10, Q3 stand-alone, ordinary investment income is at EUR 360 million. And this compared to EUR 317 million Q1, EUR 317 million Q2. So still, there seems to be a pretty significant pickup in the Q3 stand-alone. That would be the first question. Second question would be relative to the Life business and the -- I mean, the financial solutions business, which I think a significant part of it is coming in the order income and expenses line. So actually, you're seeing a deposit accounting treatise generated an EBIT of EUR 144 million year-to-date. This compared to EUR 139 million last year. So after a significant -- a couple of years of significant increase, it seems to be that we are more, I will say, reaching now a kind of plateau, flat EBIT growth on that side of the business. Could you comment a bit more on what we should expect going into 2019?

A - Ulrich Wallin {BIO 4863401 <GO>}

Well of course, I mean, we had a significant increase in the deposit accounted income, I think in 2017, which was related to a few large transactions. I mean, we still expect this line to grow further. But of course not at the same pace as we have seen, unless we get a similarly large transaction, which could be -- it's not that likely because, I mean, a lot of that, the larger transactions revolves around XXX and AXXX reserving. And of course, this principle-based reserving is the only older existing blocks of business. And so there's only opportunities as they get, I mean, reshuffled. And I mean, it has changed in the way, say, as the collateral debt finance. So I would expect that the deposit accounted income, we are not dropping the coming years. But the growth of that will not be as pronounced.

A - Roland Helmut Vogel {BIO 16342285 <GO>}

Let's go back to the ordinary investment income. I think there was not a real structural change in our portfolio, which would be a reason that we have a remarkable shift here. And if stand-alone quarters deviate from each other, that might also really be an issue of when funds or investment managers report what. Still, of course, as reinvestment yields are rising and the cash flow was positive, one should assume that, over the course of the year, the contribution to ordinary should be increasing over time just based on higher reinvestment yields and that -- and the volumes which are accumulated. But that was not driven by some structural changes in the portfolio. I hope that explains what's going on here. So again, what you mentioned, this EUR 360 million here being higher than the previous year and also being higher than the average of the previous stand-alone quarters, I would not really see that going forward. But again, that this is rising over time, that is explainable by, again, accumulated volumes and a little bit higher reinvestment yields over the course of the year. But this is not -- it could also be really that some of the investment income is accrued in the one month rather than the other month.

Operator

Our next question comes from the line of Vikram Gandhi from Societe Generale.

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Q - Vikram Gandhi {BIO 18019785 <GO>}

I've got just one really simple question. Can you share the year-to-date EBIT contribution from the financial solutions business on the Life & Health umbrella?

A - Ulrich Wallin {BIO 4863401 <GO>}

We should have that number somewhere. I think it's around EUR 180 million. Got it there, correct?

Q - Vikram Gandhi {BIO 18019785 <GO>}

Can I just check how does that compare with the 9 month over 2017?

A - Ulrich Wallin {BIO 4863401 <GO>}

It has increased, actually. I would say about 10% increase.

Operator

Thank you. And as there are currently no more questions registered, I now hand back to our speakers for any closing comments.

A - Ulrich Wallin {BIO 4863401 <GO>}

Okay. Thank you very much for calling into this conference call of ours. And I wish you all a very pleasant day.

Whatever you want to do, all the best. And goodbye.