Q2 2017 Earnings Call

Company Participants

- Christian Becker-Hussong, Head-Investor & Rating Agency Relations
- Jörg Schneider, Chief Financial Officer

Other Participants

- Andrew J. Ritchie, Analyst
- Frank Kopfinger, Analyst
- Guilhem Horvath, Equity Analyst
- Ivan Bokhmat, Analyst
- Jonny Urwin, Analyst
- Kamran Hossain, Analyst
- Michael Igor Huttner, Analyst
- Nadine van der Meulen, Analyst
- Thomas Seidl, Analyst
- Vinit Malhotra, Analyst
- William Hawkins, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good day, and welcome to the Munich Re Half-Year Financial Report 2017 Conference Call. Today's conference is being recorded.

At this time, I would like to turn the conference over to Mr. Becker-Hussong. Please go ahead, sir.

Christian Becker-Hussong {BIO 19080254 <GO>}

Thank you. Hello, everyone. Good afternoon, and a warm welcome to our Q2 2017 earnings call. Today's set-up is simple and straightforward. Jörg Schneider, our CFO, is today's speaker. And after this short introduction, we will jump right into Q&A.

The only thing left for me is to remind you, as always, to reduce the number of your questions to a maximum of two per person in order to give everybody a fair chance to actively participate in this telephone conference.

Having said that, so far so good. And we are waiting and looking forward to the first question.

Q&A

Operator

Thank you. We will take now our first question from Nadine van der Meulen from Morgan Stanley. Please go ahead.

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

Good morning. Thank you for taking my question. I suppose the first question I have was on the solvency. That improved quite a lot at 261%. That's 41% above the top end of the target range. And based on the SCR end of year, that implies around €6 billion of excess. I appreciate like you've said in the past, I think you're trying to keep optionality in case of normalization of the market. But perhaps you can comment on this to what extent or what do you think is the sustainable on the longer term solvency level that you – the extra room that you would like to keep?

The second question is on ERGO Life and Health. In one of the slides, I think slide 24, you mentioned that the strong technical result is supported by the premium adjustments in Health. Could you let us know how much of the technical result did came from these premium adjustments? Thank you very much.

A - Jörg Schneider

Thank you, Nadine. Good afternoon, everybody. This is Jörg Schneider speaking. Solvency II, our, what we call, green zone, remains between 175% and 220% economic solvency ratio. So we do not intend to change that. That means as you correctly say that we're quite a bit above that number.

We also have to have a look on our other requirements, be it rating, we want to keep the AA rating, be it the distribution capabilities of our local balance sheet. All the things you already know from us. There are some volatility in the solvency ratio, especially coming from the impact of the capital market. And therefore, if we are now again somewhat higher than originally intended, it doesn't worry us too much. It's kind of happy (03:51) problem. And you correctly mentioned that it's about optionality. When markets improve, we can grow much more intensively than we do at the moment. We can also think of acquisitions.

Currently, there are no big things in the pipeline, but perhaps especially when market somewhat normalize with regard to interest rates, volatility, or when major losses come back, then there might be opportunities. Therefore, we see it with a lot of patience, and we intend to continue with our, I think, very reliable and generous distribution policy. That means €1.3 billion in dividends plus €1 billion in share buybacks.

Second question was about the ERGO Life and Health, and here, specially a very strong technical result of Life and Health business. And you correctly quoted us that it's coming from Health. These were premium increases with a kind of catch-up effect also, because there are regulatory rules in German health business that we are not only allowed to, but we have to increase the premiums in accordance to the increased expenses, and when such a step happens, then it also has a strong impact.

So here, it stands (05:25) for something like €25 million to €30 million alone. So it's a quite substantial impact, and the good technical result in Life and Health comes from especially Health, and also there's a very good result from travel business, which is also part of that segment here.

Does it answer your question?

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

Yes. It does. Thank you.

Operator

Thank you. We will now move on to our next question from Thomas Seidl from Bernstein.

Q - Thomas Seidl {BIO 17755912 <GO>}

Yeah. Good afternoon. First question on life reinsurance. Every now and then, the recapture of old (06:14) legacy business, underperforming business resurface. So my question here would be, can you give us a sense of how much more you can store there and whether you would consider making this clean-up in, let's say, in one step rather than in a piecemeal fashion? First question.

Second question, reserve. Reserve is, of course, in line with your guidance. And you say you want and aim to remain at the very top end of the reserve buffer for new business. Now, when I look at your long-term liability since 2010 and this is by no means, I mean, a glee (06:51) issue. It's a sector-wide issue. I see actually the opposite that there is negative reserve development. So my question here is, what is driving the more recent negative reserve development in long-term liability and what does it mean for the outlook on reserve releases? Thank you.

A - Jörg Schneider

Thank you, Thomas. I have to look it up with the reserve buffer, because that didn't struck me when I saw the numbers that we have worse development with the long-term liabilities. It's the opposite. So most of the reserve releases are short-term reserves. So the bulk (07:31) comes from property business.

And as you know, we do not like to touch the level of and, how should I say, the very generous level of the claims reserve for long-term liabilities before positive indications show up for a couple of years to increase our confidence here, but there should be still very high buffer, especially from the long-term reserve in the liability business.

Your first question on the recapture, one step of piecemeal. I would like to clearly say it's piecemeal, because we look at the individual big contracts in a way that we compare our estimation of future premiums and future losses and sit together with the client and see whether there's a win-win situation and we look at our economic situation here. And whenever we see a window of opportunity, we want to use it and we want to use it also in cases where it comes with a very negative IFRS effect. But you can be assured that we do it in the interest of the shareholders. But we would not like to shy away from doing the right things here, but not in one major step, but rather in a very selective way. But I cannot exclude that there's more to come also in the course of this year and it can be big. Yeah.

And we will talk about it. You will see perhaps very positive impact in our economic balance sheet where we would have positive operating variances in such a case, but you would also see in many cases substantial negative hits in the IFRS result, because these, let's call it, deficient contracts, where the level of reserve is lower than the price we have to pay to the client. They would then be taking out of a portfolio, which is as such and as a whole, very profitable going forward and of which the profitability even increases as a result of such deals, transactions. Therefore, we are still very positive about these transactions and they improve the quality of the portfolio overall.

Q - Thomas Seidl {BIO 17755912 <GO>}

And maybe one follow-up if I may. Is this sort of a certain type of business require with these recaptures or is this all one-off type of transaction?

A - Jörg Schneider

It's a mixture. So we have a number of contracts which worry us, yeah (10:43). And we know them quite well and we talk to a number of clients and we hope that we find a common ground here.

And by the way, the prognosis, which we gave for our life IFRS technical result for 2017 is far away from being certain. So it can end up as being higher, but it can also end up as being lower due to the impact of these one-time transactions of these recaptures.

Q - Thomas Seidl {BIO 17755912 <GO>}

All right. Very clear. Thank you very much.

A - Jörg Schneider

Thank you, Thomas.

Operator

Thank you. We will now move on and take our next question from Guilhem Horvath from Exane BNP Paribas.

Q - Guilhem Horvath {BIO 18460437 <GO>}

Yes. Good afternoon. Thank you for taking my questions. The first one is on the mortality experience in life reinsurance and I like to understand how should we think about the (11:44) profitability guidance for the future, because you lowered (11:49) profitability guidance for 2017 this morning. Should we expect this to come back at a more higher level in the coming years or is it something which is going to be sustainably lower?

And the second question is about growth. I'd like to have a better view on what you expect in terms of top line growth for P&C reinsurance and life reinsurance for the rest of the year. Thank you.

A - Jörg Schneider

Thank you, Guilhem. Mortality life reinsurance, it's not only mortality business, which is affected here, but also disability, long term care and so on. And when you say, will the profitability of the future increase due to these one-time transactions with a negative impact on IFRS, clear answer is yes. But since these are contracts where they're sometimes multi-year and, in most cases, multi-year duration, let's say, another 10, 20 even 30 years, yeah, that means that you will only gradually see that over time.

So therefore, in my view, the impact on 2018, for example, should be minor on an ongoing basis. But the more we do in this year, the less you will see of these one-time transactions in the years to come. And by the way, if I may, from our SFCR report, you can see there expected profit from imports business in the order for the whole group of companies of €12 billion.

A very important part of that is the life reinsurance business. That means the portfolio as such overall, does imply a lot of future profits, which, in the eternity will show up in IFRS result. And I share your frustration that it's so difficult to translate one metric into other and to give more certainty with regard to the ongoing IFRS profitability. This will change with IFRS 17, which will be closer to an economic calculation than what IFRS currently is that it's a translation of U.S. GAAP rules.

So therefore, I have to ask for your patience for another four years (14:23) before IFRS 17 comes into play, but then you will see a recalculation of the business according to the new standards, which are also economic to some extent at least.

So far with the future results, so my best guess for 2018 would be an unchanged guidance, but that hasn't been decided yet, but with a higher certainty of achieving these results. With regard to the growth, I was quite pleased having seen the outcome of the 17 renewal, where we saw another price decline of minus 0.4%, but an increase in business volume and with a deeper look I see that at least it looks like it is good business and not that we released our profitability standards. Therefore, I would be cautiously optimistic that we at least do not lose premium income over the next two years or so.

And perhaps there's more to come and there's more profit potential, especially when times get a bit more difficult than they are at the moment with regard to major losses and so on, because that could then show the difference between Munich Re and some of the competitors.

Q - Guilhem Horvath {BIO 18460437 <GO>}

Okay. Thank you.

A - Jörg Schneider

Thank you, Guilhem.

Operator

Thank you very much. Ladies and gentlemen, we now take a question from Jonny Urwin from UBS. Please go ahead.

Q - Jonny Urwin {BIO 17445508 <GO>}

Hi, there. Thanks for taking my question. Just two from me. So firstly, just going back to that, the Life Re guidance. So are you downgrading the L&H (16:22) from €450 million to €400 million as well? I was under the impression that that's not the case, but the obvious seems to be that you're saying that you'd be happy to run with a sort of lower level with higher confidence (16:35). So just comments there will be good.

And then secondly, again, on the sort of outlook for growth in P&C. I mean, obviously, there's not much margin out there now and I know you've had some criticism of the slight change in nuance around the growth. And the reason I ask is we heard from Swiss Re last week that they were of the view they could trim the portfolio to help sort of maintain the combined ratio at current levels. But it sounds from what you were saying is you can grow and you can also maintain profitability as well. It sounds like the business you've put on in July, seems to be at similar margin to the current book. And any comments there will be much appreciated. Thank you.

A - Jörg Schneider

Yeah. An interesting remark then. First, we do not want to change the guidance for the future. The business in Life Re, the portfolio improves. And, therefore, there's no reason to lower the expectation for the technical result for IFRS.

Second, property-casualty business, I was also surprised to see the difference between Munich Re and Swiss Re. But when you have a second look on it, in the last couple of years, Swiss Re grew much more than we did. And now it's the first time in a row of renewals where Munich RE grew more than Swiss Re. I wouldn't call it a tendency. It might have been random, is perhaps the wrong word, but we saw a couple of opportunities with, especially clients from the U.S. and from other areas. And it's mostly about proportional business where we felt that this is good business. It's profitable. It will not undermine the quality of our combined ratio. And even more, it will not undermine our economic profitability.

Therefore, we are confident that these are good steps. But I wouldn't draw the conclusion that now there is the opposite direction for the renewals to come. I think Swiss Re, as we do, will decide on a case by case basis what they are doing.

Q - Jonny Urwin {BIO 17445508 <GO>}

Okay. Thanks very much.

A - Jörg Schneider

Thank you.

Operator

Thank you. We now move on to our next question from Andrew Ritchie from Autonomous. Please go ahead. An interruption. We now take a question from Peter Thomas from HSBC (19:18)

Yes. Good afternoon. Two questions. The first one would be back again on the Life Re side of things. On this recapture or on the structure of future recapture, are we talking of special vintage year, i.e. I would say business, which may have been written specific period of time, which is creating some – which are creating some concern at the present time?

Second question will be related to ERGO. So we usually see a very strong performance of ERGO in H1, but probably driven by – we've seen a couple of one-off as premium adjustments, lack of investment for the strategic program, and different things as well to fund the capital gains or fund the other reserve in H1.

So, Jörg, could you talk a bit more about the underlying performance of ERGO since the start of the year? And also, any comments you may had on the level of expense or investments you would like to, which is going to take – to be taken in the – on a full year basis seeing that in H1 you booked €70 million of investment cost, compared to a budget of €260 million. Meaning that a lot of investment are going to be booked in H2. Do you expect to book that all in H2, or any update on that will be helpful? Thank you.

A - Jörg Schneider

Thank you, Thomas (21:11). First, on Life Re, the recaptures, when you asked about the vintages, it's more or less the known problem of the industry that is pre-2009 contracts, and it's a mixture of various coverages, mortality in some cases, in some cases living benefit. But it's a limited number of contracts so it's not that we have rubbish portfolio (21:42) here that we are confronted with general tendency. It's very isolated situation, and we think we have the power, and should also have a kind of resilience to a forward negative P&L hit as long as we can demonstrate by the development of the economic balance sheet that this is rather value creating than destructing. And therefore, we would dare to show more of that, but it's a known problem, it's like you know them also from some competitors here.

Second question about ERGO, it's too early to declare victory, but the development of ERGO is very pleasing overall, so the ERGO strategy program has been delivering the restructuring of the sales forces has been done, it has been put in practice it will take a while to stabilize. The first move on the IT side are overall encouraging albeit with problems here and there that had to be expected.

With regard to the underlying performance, there are a couple of one-off items you are aware of with ERGO in the first half. The first is that (23:13) our financing in life, we tend to have very high capital gains at the beginning of the year, which will not repeat in the second half. Second is we had relatively benign losses. We had one-off tax effect, one refers to the year 2001. So, it's that old.

And in the second half, they are also typically, the testings of the deferred acquisition costs and the liability adequacy testing, which could also translate into some expenses here. And what you correctly mentioned is that we are behind schedule with the investment expenses for the ERGO strategy program. So, we only booked a net impact of €70 million of the total estimated for this year of close to €260 million.

In the second quarter, we expect – in the second half, we expect a catch-up effect here. So, internally, we think that it could be more than double the size of the first half. And we hope that we end up with expenses, which are somewhat lower than we had originally expected, but we can't promise that.

But, clearly, there are a couple of more negative impact or, let's say, less positive impacts in the second half. If we adjust for everything, then the performance of ERGO in the first half would have been something like €100 million per quarter, and this is a quite normal performance.

And, therefore, I can summarize, adjusted for all the noise and all the special impacts from the strategy, ERGO is performing according to expectations.

Q - Operator

Thank you, Jörg.

A - Jörg Schneider

Thank you, Thomas (25:24)

Operator

Thank you. And we will now take a question from Andrew Ritchie from Autonomous.

Please go ahead.

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

Hi, there. I just wanted a bit more color on the Life Re business, sorry to return to that. I guess where I'm coming from is, you encouraged us to get more optimistic about this back in March, (25:44) some of the actions on recaptures were known about in March. So, is it just the opportunities for recapture increased significantly or you significantly changed your view on the risk of some of these contracts?

And also on the call, on your videocast this morning, you mentioned adverse experience in Asia, is that Asia or Australia? And what is that exactly? Obviously, it's been a big area of growth. Also, overall I'm just surprised it's only couple of months since you gave the last guidance that you're changing it so quickly?

And the second question is on FX. If euro continues to be strong versus dollar which it has been since the half year, will we still see a similar degree of FX effect through the P&L or have you reduced your long dollar position? Thanks.

A - Jörg Schneider

Thank you, Andrew. Life Re, you're right. These deals – these transactions – the recaptures don't come after a one-week negotiation. So, they had been in the pipeline, but with a high uncertainty whether they come or not, and we did not anticipate that, yeah. So perhaps the probability has somewhat increased. Please allow me to not be more specific with regards to what is coming because we just don't know and we are in negotiations. We did not anticipate the one which happened in the second quarter, but we saw it coming. What we overestimated somewhat was the kind of tailwind we've been enjoying in the first quarter because in the first quarter, we had an above expectation result. And all the other impact like increased mortality in U.S., also some deterioration in Asia, some worries in Australia also that came afterwards, yeah. That means we would have hoped to be able to digest the impact of the recapture due to the over-performance of the remaining book and this did not materialize. Therefore, your remark is valid.

In Asia, I'm not so worried. So, the business is in very good shape. But we had, for example here, one major loss. So, therefore, that happens. That is a business and that has somewhat diminished the result coming from there.

Overall, and really critical here internally. Perhaps, you could imagine that after you've known me for such a long while, I still believe that this is a good business, and that the colleagues are in command of what they are doing there, and that they are deciding with a very long term view, very long term view of what they do. And we must sometimes live with the negative consequences with regard to the short-term impact on the P&L.

With regard to the foreign currency, most of the negative FX result comes from the over-coverage in U.S. dollar that means that we have more U.S. dollar assets than liabilities. So we took a willing bet here and reduced that bet (29:38). That means, with the remaining effect, which are incoming now, the intensity to our P&L should be somewhat lower.

So, you correctly assume that we reduced over coverage and that is due to our skepticism with regard to the political conditions with regard to the United States. Because from an economic perspective, we are very bullish about the U.S. but short-term we see a lot of negative impact from what see currently on the political scene. Thank you. Andrew.

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

Thanks. [Technical Difficulty] (30:18)

Operator

Thank you. We now take a question from Kamran Hossain from RBC Capital Markets.

Q - Kamran Hossain {BIO 17666412 <GO>}

Hi. Three questions. The first one is on performance of risk solutions. Obviously we saw some problems that Swiss Re's primary insurance unit last week. Just any comments on performance there will be helpful.

And the second question, just thinking about the normalized combined ratio, clearly within that calculation, you target 4% of reserve releases, but I guess based on past experience we know that your reserve is set pretty conservatively the last time you tried to set it at 4%, ended up paying 6%. So the 4% in your normalized combined ratio calculation, is this a realistic number or conservative one, so, i.e. we should 4% be less than 4% (31:14). Any color on that would be most helpful. Thank you.

A - Jörg Schneider

Thank you, Kamran. First, what we call risk solution that is not totally similar to corporate solution within Swiss Re because, as far as I understand, corporate solution with Swiss Re is more the heavy primary insurance business, industry business. Whereas in our case, it's also part of that, it's the same business, that is a corporate insurance partnered broker business with the Fortune 500 companies of the world.

But there's also quite a big chunk of business, which we call specialty and which is really very special from our subsidiary, American Modern, from Hartford Steam Boiler and from other entities, and this is not subject to the same market dynamics. Therefore, the most recent experience is not bad. We are faced with problems here and there, but of a minor character and they are not so much correlated to the overall market situation.

Second question is about normalized combined ratio. We normalized for 4% reserve releases. We still expect for this year 6%. I personally don't know why it should be less next year. But if inflation increases somewhat, it would have an impact. We were very pleased that we did not see any impact from the Ogden rates change, for example, that to me was a very good sign for the conservatism in the reserve.

So, perhaps, this answers your question. To normalize for 4% is, for the time being, really, very conservative. In the long run, it's the right number. And we feel comfortable with saying that we reserve new business with bias to the upside of the reasonable range of best estimate, setting the claims reserves, and that is 4% there. Perhaps, I leave it to you to judge.

Q - Kamran Hossain {BIO 17666412 <GO>}

Okay. Yeah. (33:44) Thank you.

A - Jörg Schneider

Thank you. Thank you, Kamran.

Operator

Thank you. We now move on and take our next question from Ivan Bokhmat from Barclays.

Q - Ivan Bokhmat {BIO 15378004 <GO>}

Hi. Good afternoon. I've got two questions. The first one is on the investment result. I've noticed the reduction in reinvestment yield while a lot of your peers this quarter actually saw the opposite and the gap between your running yield and reinvestment have actually increased. The question that would be related to that is you've had 3.5% return on investments in the first half, why is the full-year guidance is still being kept at 3%? Perhaps it's linked to some extent with the FX position that you've just mentioned?

And the second question, probably more broader on the guidance for this year. It seems like you have a very good headroom to at the very least narrow it, maybe towards the upper end of the guidance or even increase. Can you elaborate on why you haven't taken that step? Thank you.

A - Jörg Schneider

Thank you, Ivan. With regard to the investment yield, yeah, we are still faced with the fact that our reinvestment yield is substantially lower than the current yield. And you are correct. It increased somewhat between the first and the second quarter. The reason is that we invested in a little bit lower duration, and that the spreads for the corporate bonds tightened. So, the two make up for this difference between 1.8% in Q2 and 1. – 2 % in Q1. Why do we stick to our 3% guidance for 2017 because we expect lower gains from disposal in the second half. The FX effect is unimportant. So, we calculated it was a couple of basis points not more. Then the guidance for the full year, I already mentioned the effect for ERGO. So ERGO showed €100 million per quarter in the first half and for the second half, we do not expect a lot additional profits here.

Second is that we are somewhat skeptical about our Life Re results, and you see it's signaled by the lowering of the technical result expectation. Then we will have lower disposal gains most probably also in reinsurance. The reason is that we are now somewhat standing on the brake here. So, we want to protect our unrealized gains which make up for €25 billion for the whole group in order to postpone the lowering of the running yields as good as we can.

If all other areas are performing well, why should we continue with very high disposal gains? Also, taxes, we had positive tax effect not only with ERGO, but also for the other parts of the group. So, all that leads us to the expectation. And this is not just conservative and you can take it. It's just the number we show you internally that we do not expect the same amount of profits for the second half as we do in the first. So we are confident that we will end within the range €2.0 billion to €2.4 billion. But where it is, I cannot predict. And especially, in this is what I forget, what is the most obvious, we are now entering into the hurricane phase. So our expectation for major losses in the second half are much higher than those for the first half of the year. And therefore, I think for the time being, it's realistic to expect a lower second half result.

Q - Ivan Bokhmat {BIO 15378004 <GO>}

Thanks.

A - Jörg Schneider

Thank you, Ivan.

Operator

Thank you, ladies and gentlemen. Now we move on to our next question from Vinit Malhotra from Mediobanca.

Q - Vinit Malhotra {BIO 16184491 <GO>}

Yes. Good afternoon. Thank you for the opportunity. Just to check again, if you don't mind, the P&C Re growth outlook is a bit more optimistic on your commentary, Jörg, but when I look at the organic change trend, between nine months, full-year, 1Q, suddenly 2Q seems to have fallen off a cliff, if you like. And there is a comment in the slideshow which says that disposal includes a liability calculation. And I just thought that if I could just reconfirm that are you really saying we're now, we are at the bottom of where the volume cut has been. And just linked to this question, I also noticed a rather sharp fall in the asset level of the P&C Re. Is that mostly FX, you think, or is that because of this volume cut? If you don't mind that, one question on growth in asset.

And second question, if I could ask is the Solvency was obviously a big surprise. And one of the comment was economic capital generation was stronger, but also the market move, which market move do you think was most surprising to you? Was it is the spread or was it just the interest rate gearing balance sheet? Thank you.

A - Jörg Schneider

Vinit, hello. I'll try the first. I'm not so sure whether I can give you a satisfying answer. Did you talk about the growth in assets?

Q - Vinit Malhotra {BIO 16184491 <GO>}

Sorry. Apologies. I combined P&C Re, very sharp fall in 2Q organic top-line. And also, that the P&C Re asset base has fallen from 65 (40:43)...

A - Jörg Schneider

Yeah. Okay. Yeah, yeah. Now, I understand. Thank you. Yeah. Thank you. That helped. The top-line is due to the renewal. 1st of January, where we showed a substantial decline and this has now translated into the growth premiums. You will see some reversal trend in the third quarter and the fourth quarter, due to the very positive outcome of the July renewal. And, let me say, we are hopeful and confident that we can develop more growth potential going forward.

You might have heard from Joachim Wenning in the analyst conference that he encourages the teams not to stupidly take down the profitability requirements, but to more selectively and more aggressively go for risks where we had an increased confidence in our data over time. And that we should translate this increased confidence into more business. So you could see here and there perhaps some growth initiatives not in a way that it's a totally different general underwriting approach, but perhaps more confidence in our abilities which we build up during the last couple of years.

With regard to the asset level decline that is due to currency effect, so I have the number in my head with regard to the whole group, they declined by €6 billion and €3 billion of that is due to just currency effect, another good €1 billion is due to interest rate movements mostly and another €2 billion is due to just sales which we needed to finance our high distributions and the redemption of the subordinated loan, because as you know, we had very high share buyback dividend plus loan repayment in the first half.

And all of that is financed by reinsurance by the parent company of the group and therefore, we have this very strong impact, though there is only a minor correlation to the level of reinsurance business. It's, I would call it, a one-time development which we see here. Your question about the Solvency II ratio, let me briefly summarize where the increase of the ratio comes from. Foreign exchange was neutral. Because it decreased our own funds and it decreased our capital requirements SCR. So it affected both sides of the calculation, both down. Then we had higher euro risk-free rates that was beneficial and beneficial for both, for the eligible own funds and for the SCR.

We had tightening spreads which were also very helpful for both numerator and denominator and we had very strong economic earnings for our eligible owned funds. According to our expectations, plus positive variances and these positive variances come, for example, from the low level of major losses. And there's also a small impact from catch-up effects with regards to previous year quarters where some things where we calculated at the end of last year were not brought to the model earlier than in the second quarter of 2017.

Therefore it's a mixture of effects. Some of you were disappointed after the first quarter. And now we are all a little bit positively surprised. There's a little bit of volatility in these numbers, but most of this volatility fits perfectly to the sensitivities which we gave you in the analyst conference.

Q - Vinit Malhotra {BIO 16184491 <GO>}

Thank you.

A - Jörg Schneider

Thank you, Vinit.

Operator

Thank you. We now move on to our next question from Frank Kopfinger from Deutsche Bank. Please go ahead.

Q - Frank Kopfinger {BIO 16342277 <GO>}

Yes. Good afternoon, everybody. I have two questions. My first question is on your regular investment income, especially in reinsurance and given that Q2 is typically a dividend season and given that I would assume that you hold the majority of your equity's exposure in the reinsurance, I did not really see the typical Q2 pick up there in the regular investment income?

And maybe the other question goes into the same direction of 46:05) Vinit's. So what happened there in the reinsurance regular investment income and what are the movements, especially as I would have expected there for the dividend pickup?

Then secondly, on ERGO International, there, you again had a negative impact from Belgium in this segment for Belgium Life, was this the same issue then we had already in 2016? Can you quantify the impact there?

And also, I think in 2016, you had to increase the capital base for your entity (46:45) this further deterioration has any impact on the capital base?

A - Jörg Schneider

Thank you, Frank. First, regular income, yeah, so there is a dividend impact, that is clear. Most equities we hold in reinsurance in both segments, but more in P&C than in Life, because the Life entities allocated sometimes in other areas where it's not so favorable for holding equities. Adjusted for it, there's a small decline, not a major decline. It's still holding up quite well. So I'm not concerned. It fits somewhat. Yeah.

And also, I do not expect since there is a high impact from the U.S. dollar, by the way, with the negative currency change here, but we invest in U.S. dollars, which means that even for treasuries at 10 years, we get some 2.3%. But our investment duration is lower than 10 years. That means one should get something like 2% without substantial risk in U.S. dollar. Therefore, it will not drastically go down further.

Second question, negative impact from Belgium, yes, more or less the same sources as last year. There's a recalculation of all these very complex balance sheet positions due to the fact that the business went in a rundown situation. The effects for this quarter is roughly €20 million gross. The capital base is still okay.

Q - Frank Kopfinger {BIO 16342277 <GO>}

Okay. Thanks.

A - Jörg Schneider

Thank you, Frank.

Operator

Thank you, ladies and gentlemen. We will now take a question from Michael Huttner from JPMorgan. Please go ahead, sir.

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

Thank you. Thanks very much. Most of my questions have been asked. The question standard (49:04) is amazing. And also, the standard of the (49:10) replies. One general question, it feels very much like 2017 is a year of clean-up where the CFO is just tightening (49:21) everything up in all the corners and sweeping them up and there's a bit of Life recapture, there's a bit of Belgium, there's all the kind of sweeping up the negative. Does that mean that you can then – when we come to 2018, it could be much more positive on the outlook (49:41) would be my first question.

And then, on the renewals, I was astounded (49:46) figure, given the worries (49:49) that we had from (49:52) maximum price pressures, can you give a little bit more feel – a bit of a feeling of how you see now the cycle developing? My guess is, it looks as if we've almost reached the bottom of the cycle, but you're obviously at much better place. Thank you.

A - Jörg Schneider

Thank you, Michael. Yeah. Clean-up, no, not really. Unfortunately, that is part of my professional deformation. New problems will come around the corner, I'm sure about it. And this is not the major clean-up. So also, it doesn't have anything to do with the change in the CEO role. (50:36) is trying to stimulate a lot of motivation with regards to look for business, look for growth, be more selective and so on, but I didn't get any order to do a major clean-up exercise. It would also be difficult without exchanging (50:55) somewhat.

And second is, therefore, I do not expect major changes for 2018, except for the fact that some of that stimulus could perhaps find a way into the business and into the number spend. And second, with regard to the cycle, when we look at where we grew, it was more or less all proportionate business and this proportionate business is to a lesser extent exposed to the cycle than the XL business.

And we still had pressure, especially in property XL business in the most exposed areas which caused us not to increase our exposure here. So it was proportionate casualty and proportionate property business which made up for this increase in premium income. Our view of the cycle – my personal view is also after having talked to my colleagues here, all the time is it only needs normalization of major losses. It doesn't need the big one to make the market really bottom out where it is.

But, as long as too many people are making too much money on the basis of the current level of pricing, I'm not too optimistic that there will be a change. Another driver for change could be an increase in interest rates because that would decrease capacity if measured according to U.S. GAAP or IFRS standards, because the shareholders' equities would come down somewhat.

And by the way, the most recent minus 0.4% in pricing of the latest renewal when you see the difference in interest rates between 2016 and 2017, especially in the U.S. dollars figure, then this is not a decline for the business, but rather an increase in profitability and that is what we clearly see in our internal numbers with regard (53:15) or to, what we call, contribution margins, yeah. They are slightly increasing and not decreasing under these circumstances. Therefore, the cycle is what it is. We do not expect a major change, but we can live with the current level quite well.

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

Just on the profitability, can you give a feel for the magnitude of the increased contribution or better rollback (53:39) or something? Are we talking about 1 basis point or 1,000 basis points for the (53:48) basis points or is it more like 0.5% to 1% or maybe 2%?

A - Jörg Schneider

It goes as high as 1%. At times, it personally, a little bit exaggerated when I see this calculation. But just as a rule of thumb, it's somewhere between 0.5% and 1%. That means that instead of a minus 0.4%, we would have a plus little bit. At least the bottoming of the profitability, yeah, and slight increase in internal returns on risk adjusted capital.

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

Okay. Thank you very much.

A - Jörg Schneider

Thank you, Michael.

Operator

Thank you, ladies and gentlemen. And we now move on and take our last question from William Hawkins from KBW.

Q - William Hawkins {BIO 1822411 <GO>}

Thanks for squeezing me in. Hi, Jörg. Could you be a little bit more precise, please, on the helpful color you've given about the Solvency II ratio? I'm seeing as its bounced around a lot. So for example, can you just tell us what's the numerator and the denominator as of the end of June? And given all that you said about market sensitivity, I think I'm right that in the first half of this year, you'd normally have about €1.25 billion of capital generation, being just $0.05 billion of €2.5 billion (55:05), which would only be about 4 points a quarter. Could you maybe just give us an indication of how much of the big move in the second quarter came with capital generation rather than other stuff? Thank you.

A - Jörg Schneider

Thank you, William. I'm not allowed to tell these numbers, because my colleagues say that they are still subject to changes. So it's still in the stabilizing phase, but nevertheless, I shared.

So eligible owned funds went up by roughly €1 billion in the second quarter from €37 billion to €38 billion. And Solvency capital requirement went down by some €0.7 billion from €15.3 billion to €14.6 billion. And when I look at the economic earnings, the economic earnings were in the order of €0.7 billion, which is quite strong. It includes the effect from the low level of major losses. And we have the change in capital requirements, as I said before of €0.7 billion. So overall, that would be a capital generation of €1.3 billion.

But I must say that with a little bit of reservation, because still we are confident that 97% of the models are in a very mature stage. But still, it's difficult on a quarterly basis. So I have to back – for your understanding, if in this next quarter, there are still another change, a slight change, but it's a very pleasing picture overall.

Q - William Hawkins {BIO 1822411 <GO>}

That's very helpful. I hope you're not in trouble with your colleagues. I won't tell them.

A - Jörg Schneider

Thank you, William. And thank you to all of you.

Operator

Thank you very much, ladies and gentlemen. That will conclude today's Q&A session. And I will now hand back to Mr. Becker-Hussong for any additional or closing remarks. Thank you.

A - Christian Becker-Hussong {BIO 19080254 <GO>}

Yeah. Thank you. There's nothing really to add from my side. Thanks to all of you for joining us this afternoon. And please don't hesitate to call for any further questions. Thanks again and bye-bye for now.

Operator

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