Q2 2018 Earnings Call

Company Participants

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

Other Participants

- Andrew J. Ritchie, Analyst
- Farooq Hanif, Analyst
- James A. Shuck, Analyst
- Jonny Urwin, Analyst
- Michael Huttner, Analyst
- Niccolo C. Dalla Palma, Analyst
- Nick Holmes, Analyst
- Peter D. Eliot, Analyst
- Thomas Seidl, Analyst
- Vinit Malhotra, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Ladies and gentlemen, good afternoon. Welcome to the Zurich Insurance Group Half Year Results 2018 Conference Call. I am Irvine. I'm the Chorus Call operator. I would like to remind you that all participants will be in listen-only mode and the conference is being recorded. After the presentation, there will be a Q&A session. The conference must not be recorded for publication or broadcast.

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

Richard Burden {BIO 1809244 <GO>}

Good morning, good afternoon, everybody, welcome to Zurich Insurance Group's first half 2018 Q&A call. On the call today is our Group CEO, Mario Greco and our Group CFO, George Quinn.

Before we start, I just like to take the time to remind you that could you keep your questions to a maximum of two on the first go round and if we have time we'll open it up to further questions afterwards. But before we start the Q&A, I would just like to hand it over to Mario to make a few introductory remarks to the results.

Mario Greco {BIO 1754408 <GO>}

Thank you, Richard, and good day, ladies and gentlemen, thank you for joining us today. I'm very pleased with our first half results. They demonstrate further progress against the targets and the priorities that we outlined in November 2016. Particularly pleasing is the continued strength of the results in our Life business. Even adjusting for positive foreign exchange movements, they increased 12% year-on-year. The results also show the high quality of our Life business, 87% of revenues are coming from either technical margins or Fees and Loadings, and there is very little reliance then on investments results.

This underlines the success of our consistent strategy of focusing on protection, unit-linked and corporate products. We have continued to execute on this strategy over the first half of this year with 84% of APE from these products and 78% of new business value coming from protection business. The first half has also seen the OnePath Life business in Australia begin to contribute to our results through the planned reinsurance of a portion of their portfolio.

Our Property & Casualty business also performed well. We saw an improvement in the accident year combined ratio. This was driven by improvements in the accident year loss ratio and lower administration expenses, and our commercial business has also seen improvements. The strength of our reserves further improved, while prior year development was at a good level, positive developments in claims related to the three hurricanes, Harvey, Irma, and Maria, contributed to this development, further underlining the effectiveness of our underwriting.

Investment income in Property & Casualty has also stabilized over the first half of the year, as reinvestment is improved. Looking forward, we remain focused on further improving our underwriting performance through continued emphasis on profitability over volume, particularly in commercial insurance.

And the positive movement in pricing in the North American market that we began to see after the third quarter has continued to accelerate over the fourth quarter. The Farmers Exchanges have continued to demonstrate solid growth in their chosen areas, and in their ability to innovate with new business offerings like the commercial rideshare business with Uber.

Their customer focus strategy has also continued to drive improved customer metrics. This has been achieved with an improved underwriting performance with a combined ratio reducing 6.6 percentage points compared to the first half of 2017. This trend should continue to support growth in Farmers Management Services. Our balance sheet is very strong. Z-ECM ratio has increased further to 134%. This reflects the strong operating capital generation within our businesses.

The first half of the year has also seen us continue to deliver for customers and shareholders against our strategic priorities. We've further strengthened our leadership position in Latin America, and in the travel and assistance business through targeted acquisitions in the first half, and we continue to extract capital from non-core activities.

We also continued to invest in innovative customer solutions, including the launch of the first business of our European partnership with CoverWallet, a leading provider of direct insurance solution for SMEs. Our journey to become a more customer-focused organization also shows progress with improvements in the retail, Net Promoter Scores in our largest retail businesses.

These developments will play an increasing role as we look increasingly beyond the delivery of our 2017, 2019 targets. Overall, these results give us confidence that we can maintain the positive momentum into the second half of the year.

Thank you for listening. And now, George and I are ready to take your Q&A.

Q&A

Operator

We'll now begin the question-and-answer session The first question from the phone comes from the line of Mr. Farooq Hanif from Credit Suisse. Your line is now open. Please go ahead, sir.

Q - Farooq Hanif {BIO 4780978 <GO>}

Hi, everybody. First question is on business mix in North America. Given that the sort of top-line has dropped 4%, but pricing is accelerating, it seems to me that there's been quite a significant shift in lines. I was wondering if you can give us a guide roughly to workers' comp versus specialty versus other lines, if you could just give us a guide to mix now and your intention for taking that forward.

And then, secondly, second question is to address seasonality and combined ratio, so I think there's a kind of a 1 percentage point gap, there was a 1 percentage point gap last year between 1H and 2H, an improvement. But in the second half, it seems to me that you've got pricing coming through, obviously the early effect of cost-cutting, just wondering if you think that could be repeated or whether you're looking to be a bit more positive. Thank you.

A - George Quinn {BIO 15159240 <GO>}

So I'll start, Farooq on the second piece, and between us, I think Mario and I'll answer the first one. I mean, we had some mathematical things, which I guess pretty much everyone's aware of. So we have a crop business that has a, I think quite different structure in terms of loss ratio versus expense. And this cost a $1 billion of premium yet to come in the year and that business comes in with an expense ratio, that's more in the high single, maybe just double-digit rates. I mean, that technically will drive different answer for the expense ratio in the second half.

I think it regards optimism or what our expectations are, I mean, we do plan for further expense reduction in the second half. We have an expectation of like $200 million to come. I mean, I've said in prior discussions, most of that's going to land in P&C. I mean, typically you'd see about three quarters of it. I mean, I think those are the two obvious things that will drive expense ratio in the second half.

As far as mix goes, I guess, we'll be covering this in other question, so this issue of trading commission versus loss ratio and the impact that can have on the expense ratio. I mean, we are looking to shift mixes, as far as it makes sense for us. And if I look at what we expect to see in the second half, certainly there are things that will drive commission. I think most of them are there already. I'm not necessarily convinced we're going to see another significant step up. And I think some of the trade-offs that we have for loss ratio versus commission, you've seen already in the first half, so I wouldn't expect to see that change significantly again in the second half.

On overall business mix – and if you look at the numbers for us, within the U.S. portfolio, I mean, not surprising, we prefer actually fill the retail and other business market, despite the fact that you see more rates on the commercial side. Within the commercial lines, workers' comp is down a bit, I mean not by a huge amount, down by a bit, around 1%. Commercial auto is still the strongest line in terms of rate. Inflation is running somewhere at that source (10:21) of rate. So there is still margin expansion taking place. And if we just look at the overall numbers and we take the overall portfolio, there's a bit of a proxy. I mean, we're still seeing 101 for commercial overall, 94 for retail. So even with the rates that we're seeing on the commercial side, we still have a preference to move the mix towards retail to the extent that we can.

Workers' comp has shrunk a little over the course of last few years and in fact, you'll see even more of that because of the reinsurance that we put in place at the beginning of this year. That will have a bigger impact in the second half and a much bigger impact next year. But from a mix perspective, we're pursuing the priorities that we outlined in the Investor Day.

Q - Farooq Hanif {BIO 4780978 <GO>}

Okay. Thank you very much.

Operator

The next question comes from the line of Mr. Peter Eliot with Kepler Cheuvreux. Please go ahead, sir.

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

Thank you very much. The first one was maybe just to clarify your expectations for the expense ratio going forward, so not sort of just the seasonality, but more generally year-on-year. I think I understood from your answers just then that you don't expect commission ratio to go up any further from here, but perhaps you could just confirm that and maybe give a little bit more color on where you see the expense ratio in General Insurance going in future years?

And then, the second question was, I guess, I mean things are starting to move within the Closed Book space especially in Germany. I was just wondering your take on whether there is any sort of scope, any more scope to do anything there, or your take on the environment. Thank you very much.

A - George Quinn {BIO 15159240 <GO>}

Thanks, Peter. So, on the expense ratio going forward, so again, for the OUE component, that's the one where you're seeing all the benefit of the expense reduction. Expect to see another $200 million reduction through the remainder of this year. That will bring the OUE ratio down, and that's on top of the mechanical impact of the crop business.

On the commission ratio, I don't expect to see the type of change you've seen in the first half. I mean, there are two particular blocks of business that drive that. One is actually the acquisition, well not the acquisition, but us taking over the underwriting of some parts of the travel business at Cover-More and services that attracts a fairly high commission rate. We'll have that impact in the first half. But I don't expect the impact of that to change in the second half. Having said that though, I mean, within the overall book, I mean to the extent that in the future we have opportunities to further improve what I would describe as the quality of the book and I improved the volatility characteristics, I mean, that is something we would look to do, but I think at this stage of the year for this year, I don't expect other significant shifts up in the commission ratio.

On Germany, on the (13:30) topic, I mean, I think we talked about it before. I mean, given the way that we've positioned that business, given the way it's managed by the team in Germany, we don't have quite the same pressure that maybe some of our peers have had. So there is not the same impetus, but of course we do want to make sure that the capital is managed efficiently, and as well as we possibly can. So I mean it's something we're certainly interested, we'll look at in more detail, but I think in the near-term priorities for the group, but also for Germany, I'm more about operation and operational performance, and that's certainly where the CEO and CFO and the rest of the guys in Germany are currently focused.

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

Thank you very much.

Operator

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

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

Oh hi there, I want to look at commercial versus retail non-life performance. It's very clear in retail, the trade-off between expense ratio and loss ratio, which I'm guessing reflects the business mix. But in commercial, I can see an expense ratio reduction, which is to be expected, but the implication is that the underlying loss ratio hasn't really improved in commercial and all of the underlying loss ratio improvement in the first half just reflects this trade-off issue on the retail business. Maybe if you could just clarify what is the underlying loss ratio doing in commercial lines and what's happening in some of the problem books, particularly in the second half last year, which were amongst others, financial lines pretty much everywhere and commercial auto?

The second question is PYD, I presume you still encourage us to normalize that down to 1.5, I mean, clearly there was some lumpiness in the first half to do (15:30) emergence, but maybe – but you still seem to be suggesting you're very confident in the reserve position? Thanks.

A - George Quinn {BIO 15159240 <GO>}

Thanks, Andrew. So on the first one, I think it's too negative to view commercial underlying as no improvement. I think the analysis you've done is, no, there's nothing wrong with it. I think the difference in the way that I would look at it is, certainly compared to a year ago, I think we would have worked harder to try and identify all of the one-offs and exclude them and come up with a very scientific view of where we think commercial stands. We've taken the view that the answer is simply the answer. So if it's volatility, there's volatility, it has to be paid for.

But I think if you look at the quality of the book, if you look at what they've done, especially around things like commercial auto which had been a perennial problem for several years now, I mean, you can see a substantial rate movement, at the same time you can see a reduction in the volume. I mean, I think the things that the commercial team are doing are improving the underlying, they're certainly improving the quality of the book. And I think we will see the benefit of it. I mean, there is no doubt it has taken it a bit longer than we anticipated, but to be honest, we have plenty of company with that issue in the commercial market.

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

And, do you think the reason maybe we're not seeing it more in the actual headline, is it sort of large loss noise or is it purely a timing thing, I mean, you're looking at it on sort of an account by account basis and underwriting your basis we're looking at on the calendar year, is that what's happening?

A - Mario Greco {BIO 1754408 <GO>}

(17:04).

A - George Quinn {BIO 15159240 <GO>}

(17:06).

A - Mario Greco {BIO 1754408 <GO>}

(17:08).

A - George Quinn {BIO 15159240 <GO>}

I mean (17:10). I mean, we've just been through reviews with the business unit and until then (17:13) come and talk to us about large losses. (17:16) if you've got initially large losses, go fix it. So I don't want to have a conversation about large losses on the call. I mean, the attritional outcome would just be attritional outcome. And I think the things we're doing will have an impact. There's no doubt it's taken longer to show up than we anticipated. But I think the things we're doing are the right things, and it will benefit commercial. So I don't have the view that, I mean, commercial is just not moving. I think they're working really hard on this.

A - Mario Greco {BIO 1754408 <GO>}

They are also working, if I may add a point, Andrew, they are working in a soft market, I mean, property has remained quite soft even after the storms last year. So, they are improving their books and they're improving their profitability in a soft environment at least for the big portion of the books, which is why (18:11). But we do see the right movements and the right traction in what we're doing and this is generating the desired results.

A - George Quinn {BIO 15159240 <GO>}

On PYD, I'm still (18:29) you can normalize it, however, I think overview today would be that we're more (18:38) to end up in the upper end of the target range than the middle of it. I think if you look at it over the course of the last couple of years, if there's been pressure on PYD, it's typically been in an upward direction, i.e., we've had more emerge from the reserving decisions that we've made than we normally would. But obviously today the numbers are a bit higher than even I would guide to, and that's partly driven by the fact that when we set the hurricane reserves last year and with the benefit of hindsight we've been a touch too prudent. So we had a better release. I mean, overall given what we've seen this year, given what we see for the remainder of the year and what we saw last year, I mean we would see PYD at the upper end of the target range.

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

Okay. Thank you.

Operator

The next question comes from the line of Mr. James Shuck with Citi. You may now go ahead, sir.

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

Good afternoon. Two questions from me. First on just actually on the retail side of things, the accident year ex-nat cat. Could you just talk a little bit about the future direction of travels there and also sort of what the development of crop was, if you could actually tell me what the combined ratio was for crop in the first half, that would be very helpful. Obviously, as we move through the rest of the year, we've seen quite a lot of drought and wildfires. I think most of your mix is in the U.S., but there has been drought around the West Coast, but also just to know whether Europe has any impact on even in the second half of the year. That's the first question.

Second question on Global Life. So I think a strong set of numbers there, I think you've raised the guidance a little bit for 2018. I just struggle a little bit to kind of get to the actual kind of genuine growth outlook for the earnings, because, I mean, new business value is slowing down 2% or so. You obviously got in the M&A that will impact about CHF 200 million next year. But when we think about the drivers of earnings growth, how is that being driven by the realization of past kind of new business value? To what extent will it continue to be driven by improvements in policyholder crediting rates and operational leverage and the like? Thank you.

A - George Quinn {BIO 15159240 <GO>}

Thanks, James. So first of all on the outlook for accident year, I think that ex-cat in retail, I want to be careful that I don't start to give very granular guidance for different parts of the portfolio. I mean, in general retail has a pretty stable book overall. Obviously it does have some exposure to more significant events because of course especially retail and other for us, and as you pointed out crop, fits within it. I think first half (21:50) I mean, that's probably not far away from where we would expect to see that business, maybe slightly lower when you allow for crop to full – and then for the full year. I mean, but it will have some volatility in it, but I mean, nothing like the scale of what we see in commercial.

On the crop side of things, our normal practice in crop is to hold crop unless there are negative issues in the first half, so either actual experience that would point to a negative outcome, we would hold it at around planned, which is what we've done in supply and obviously wouldn't be as positive as last year, but it would be a bit below the group's actual overall target for the combined ratio.

So risk factors in crop, I mean, it's a revenue protection insurance product in the end. So it's not simply things like droughts cannot be impacted by obviously the broader market for the products. I think at this stage, we don't see anything that's causing us any significant concern at this stage, not the events that we see in the U.S. in terms of weather or fire, nor necessarily some of the more geopolitical issues that can impact crop.

With that said, I mean, we're still a long way away, a long way away, we're still several months away from discovering what the actual outcome for crop will be for this year. But at this stage, we don't have a major concern that crop's going to have a bad year for some reason. So, I mean I still expect to see a positive, significant positive contribution from crop.

On Global Life, you're absolutely right, so I mean, we gave guidance at the beginning of the year. Given the very strong performance in the first half, we've raised that today just for everyone's benefit. We've indicated low-double digit growth rates, which essentially would annualize the relatively strong underlying performance that we see for Life in the first half.

The drivers of earnings growth, I mean, apart from the things that you've referenced, it varies quite a bit by the different businesses we have. So I mean, obviously, new business value and the more mature markets, particularly in Europe are typically very important to what the earnings outlook is going to be and very predictive of a relatively long-term view of what you can expect from that business. Our faster growing businesses, though, I mean, many of them are more – they're more like P&C than Life in many ways and it's almost like a combined ratio basis, so if you look at the business in LatAm and some of the business in Europe, not so much, I mean, they tend to have shorter term drivers.

If you look at what's driving the outcome in the first half of this year, obviously a bit of FX. If you ignore that, you still got significant growth. Some of the macroeconomic environment is helping us, but we're seeing good growth in the business in Spain, our businesses in Asia-Pacific still contribute well. I see no reason why the current trend that we see currently would slow down significantly in the short-term. We are looking for the Life to increase its contribution as a proportion of the goods overall earnings and improve the predictability.

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

That's great. Thank you very much.

Operator

The next question comes from Thomas Seidl with Bernstein. Please go ahead, sir.

Q - Thomas Seidl {BIO 17755912 <GO>}

Yeah, thank you. First question is on commissions again. Sorry about this, but I just want to double check. Yeah, I get, of course, that the bigger step is done now, but with the high commission businesses in Asia, like Cover-More, but also Latin America growing faster than the average group, shouldn't we see further incremental increase of the commission rates? That's the first question.

And this goes on for years, I guess, depending on how you see growth prospectively. Secondly, more from a top-down perspective, but related to that, you grow now much faster in APAC and Latin America in P&C, whereas you are (26:30) North America and stagnating in Europe, the higher margin area. So to what extent, does this mean you are structurally moving into a weaker combined ratio mix in a way a headwind to your aim to get to the 95, 96 combined ratio level?

A - George Quinn {BIO 15159240 <GO>}

Thanks, Thomas. So, on the first one, I think you would be right. If we saw a continuation of what we've seen, I mean absolutely, I mean, this is higher commission business. I think the reason why I gave the answer to Peter Eliot, the two things, one on Cover-More, I mean, we didn't necessarily buy Cover-More for the underwriting side of what Cover-

More does. We saw a much more as something that had a really interesting proposition around assistance, some of the services around travel.

We've given the businesses around the world where Cover-More is operating, I mean, the choice, they can make the decision if they want to compete and offer their underwriting capacity to Cover-More, but that wasn't the key driver. So far for various reasons, Australia is the most significant place where we underwrite travel. And I don't expect to see a major shift or major – a very significant growth rate that would disturb the group's numbers in the second half. So for that component, I think what we've seen it won't get better, it won't get worse. So it will be what it has been in the second half of the year.

In LatAm, it has had an impact, but I think if you look over the last, say two, three years, we see most of the growth on the mass consumer side. It's a lot more gradual than we've seen either from the travel businesses, first half or even from the F&I business in North America, which actually is the other big driver of the commission shift.

So from a preference perspective, we're happy to continue to see that shift, provided we see the overall profitability that we want. I think my comment to Peter was really, if I look at towards the end of the year, I mean, do I expect another significant shift in this year? I don't. Is this a trend that might continue over time? It may well do.

I think your second question was about, are we structurally moving into a weaker combined ratio, because of the higher growth rates in LatAm and Asia-Pacific. So first, let's take LatAm, I'm not sure I would call them weaker. I mean, obviously interest rates are a bit higher in Latin America, so combined ratios tend to be a bit higher.

I think as we look at the pricing hurdles that we set in LatAm and again going back to the Investor Day presentation that was back last November, I mean, we do think about the trade-off of volatility and the duration, the impact on investment income and just outright return on capital as we try and set the target portfolio mix. I think provided we can achieve, I mean, what we want to achieve from a return on capital perspective, I mean, we're happy to see the growth rates that we see in LatAm.

Again, I think given where we're coming from, I don't see that disturbing the group's overall expectations for combined ratio for next year. I mean, similarly for APAC, I think the issues in APAC are really quite different. We've had a challenge in the commercial market in Australia. The underlying performance is better in the first half of this year, quite a bit less PYD, though, so the overall result was maybe not quite as strong. I mean, I would characterize that as a completely different issue from a growth preference for a business that is producing an attractive return on capital, albeit potentially slightly higher combined ratio.

Q - Thomas Seidl {BIO 17755912 <GO>}

If I may follow-up on Cover-More given the high commission you're paying there, overall is the combined ratio running above the APAC level or below?

A - George Quinn {BIO 15159240 <GO>}

Right. So in the first half it's above, and there are some initial, I call it, transition impacts that are special for the first half. We expect it to be at target levels for us in the second half of the year, and the targets are based on return on capital.

Q - Thomas Seidl {BIO 17755912 <GO>}

All right. Thank you very much, George.

Operator

The next question comes from the line of Mr. Michael Huttner with JPMorgan. You may now go ahead, sir.

Q - Michael Huttner {BIO 1556863 <GO>}

Fantastic. Thank you so much. Two questions. The first one is on Farmers, and the second one is on the benefits of the M&A yet to come. On Farmers, you characterized the half year's solid growth. I just wondered if you can explain that a bit more, because as far as I can see, the fee contribution is growing at 2% which is inflation and that's fine, but I wouldn't exactly say that's – doesn't stand out and it's quite different from the impression that I had gained from the Investor Day in November when there was so much talk about the various initiatives and stuff. So I'm disappointed and I can't quite reconcile it with your statement, so I must be wrong, but I just wondered if you could help out on this a little bit, maybe you can share your view of where we are in the growth cycle of Farmers. And then on the M&A, so I think I remember the two deals which I'm not sure have closed, or are closing, can you just remind us or remind me of the benefits yet to come in addition to what we've seen in the first half from the ANZ deal and the QBE deal relative to the second half and also in 2019? Thank you.

A - George Quinn {BIO 15159240 <GO>}

Thank you, Michael. So sorry if we disappointed you on Farmers, I mean, I think if we could split it into two parts, I think a lot of the conversation we've had about Farmers, and I can remember, I think you asking a question of Jeff or Mike at the event back in November, which I think you said was a question that perennially comes up around Farmers, which was about sustainability and whether the things that were happening and happening around profitability would really have an impact on the business overall.

So I think on the exchange side, I mean, what you see in particular and the overall result today is a technical performance that I think most people would recognize as – I mean, more consistent with a sustainable business model. So the benefits of the – I mean, really the market-driven changes around rate have helped Farmers achieve a combined ratio that's consistent with the targets that the exchanges have set. I think within that, there's still work to do around auto, so I think it will improve further. But certainly the basic profitability of the business is good.

Now, on the growth and the fee growth which of course is the part where we're all interested in. We said already in Q1 that given the move into commercial rate share where the cost of acquisition of a very large book of business is clearly much less than sourcing the individual policies, which has been the traditional business with Farmers. We have agreed a lower fee level for that business. I think that's probably one of the reasons why there's a disconnect between the – maybe the fee growth that you were hoping for versus the premium growth that we've seen in the past.

I think the – for us, I mean we focus on the overall fee growth for the organization. I mean, over time, we'd like to see that grow at around that same level as GWP, but the commercial ride share business will now introduce an element of, I don't see unpredictability, because it doesn't make Farmers unpredictable, but it will mean that the trends, I mean that, that very predictable trend between GWP and fee that we've had in the past is a tiny bit broken. And from a group perspective, Zurich group perspective, I mean we focus on the absolute fee growth more now than the margin and what things like the commercial rate share do for us. So you're absolutely right to be disappointed if you were hoping to see the same rate of fee growth. I'm not sure that you should assume that you will not see fee growth at similar levels to GWP growth in the future. But we have a special impact in this first half.

M&A, on the two deals, as a matter of fact, all of the benefits are yet to come. So QBE, we have closed Argentina and Brazil just after the quarter end. So we'll see the impact of that in the second half of this year. ANZ, given ANZ commentary around the complexity of dealing with the restructure to affect the IOOF transfer, that looks as it will slip until probably somewhere around the end of Q1 beginning of Q2 next year. So, Argentina and Brazil from the very beginning in the first half, the remainder of QBE probably around the middle of the half and ANZ somewhere around the middle of the first half of next year.

Q - Michael Huttner {BIO 1556863 <GO>}

And can you just remind us of the numbers you'd cited before? The reason I asked in particular is, I understood from the comment, the opening comments of some of the ANZ benefit is already coming through. So I'm trying to reconcile bits (36:43) which, I've forgotten which bits (36:44) was high in the numbers and I don't know about?

A - George Quinn {BIO 15159240 <GO>}

Sorry, Michael, so on the ANZ topic, I think someone referenced earlier we talked about $200 million per annum. So you should expect that to come, but with a lag. The reinsurance is now in place for a piece of ANZ and the proportion of earnings, I think we've had about two months of it in the course of this year, so at least had a relatively material impact this year so far. Maybe when we get to the end of the second half, I cannot tell you more clearly on what we've had in the second half of this year, and therefore what you should model for next year in terms of the delta.

Q - Michael Huttner {BIO 1556863 <GO>}

On QBE?

A - George Quinn {BIO 15159240 <GO>}

You need to forgive me because I don't have – I won't break down the individual parts of QBE, but I think you've seen from a disclosure that I mean we've invested between $300 million and $400 million in that transaction and we guided that the return on equity or the return on investment rather is significantly above the target that we would normally set, which is 10%. And Argentina was the most important part of that transaction.

Q - Michael Huttner {BIO 1556863 <GO>}

Brilliant. Thank you so much. Thank you very much.

Operator

The next question from the phone comes from the line of Mr. Nick Holmes from Société Générale. Please go ahead, sir.

Q - Nick Holmes {BIO 3387435 <GO>}

Hi, there. Thank you very much. Two questions. With the $900 million of expense savings, can you explain why we can't see these more clearly in the results? I mean, we can see them to some extent clearly in the P&C admin or (38:30) ratio? And also to some extent, it's nice, but I would have expected them to have a much bigger impact.

And second question is on Life and the high level of realized gains. I wondered can you tell us was that a bit of a one-off? I think you said most of it related to or a lot of it related to ZZR? Thank you.

A - George Quinn {BIO 15159240 <GO>}

So, on the first question of – so I apologize that you can't see it. So we need to try and change the disclosure, so we can help you find it, because I can see it quite clearly. I mean, I think we've talked about and the fact that even if you look at the face of the income statement and you compare the 2015 level, you have to annualize this year to get a clean comparison you need to adjust a bit for foreign exchange, which has been a bit volatile over the period, adjust a bit for M&A and but you do see a very substantial reduction in expenses. You might not get precisely 900s but I mean I think even with a very simple calculation, you see a very substantial reduction.

On the second question on realized gains in Life, obviously, there's a practice in Germany of how ZZR impacts and managed part of that is by realizing gains. I think from an economic perspective, it changes nothing, I think from an overall viewpoint. Given the likelihood I think at this stage that we'll see a change in the status of that, in ZZR in the second half, I mean, that may impact whether you see as many realized gains or not, but from a shareholder perspective it really has almost no impact.

Q - Nick Holmes {BIO 3387435 <GO>}

Okay. But, sorry, just to follow up very quickly. So the realized gains is more sustainable than it might appear for the second half at high level, you mean to say?

A - George Quinn {BIO 15159240 <GO>}

So what I was trying to say, Nick, was that within the Life portfolio, I mean there can be realized gains from time-to-time. It certainly is one of the techniques that's used in Germany to manage the impact of ZZR on the statutory financials, but I mean it can be a bit volatile. For example, ZZR requirements changed, I mean, that might change the way we manage the issue. So I don't want to paint it as sustainable, but from an overall perspective, I think we've talked here before about what the overall ZZR impact would be for us. And I guess if you're looking at it incrementally, the change that BaFin seemed to be contemplating, could be nothing other than good news for us, that might impact the realized gains position in Life, both from a shareholder perspective, and more important that driver would simply be less onerous ZZR requirement, that would have an impact on the reported operating profit in Life.

Q - Nick Holmes {BIO 3387435 <GO>}

Understood. And just a very quick follow-up on the P&C expenses, would it be right to assume that the OUE ratio is going to fall down to 13%, something like that?

A - George Quinn {BIO 15159240 <GO>}

So I think if you look at where we are now and again going back to, I think, again, maybe in the answer I gave Peter, we've got about $600 million to go, I'd expect, over the course of the next 18 months about $400 million-ish of that fall into P&C, it's a bit more than a point. And all of that will be in OUE.

Q - Nick Holmes {BIO 3387435 <GO>}

Okay. Great. Thank you very much.

A - George Quinn {BIO 15159240 <GO>}

Thank you.

Operator

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

Q - Vinit Malhotra {BIO 16184491 <GO>}

Yes. Good afternoon, George and Mario. Just one follow-up, sorry, on the Life side, so if I'm on slide 19 of the presentation today, I see that the investment margin is up 35% in Life in local currency terms and there's some FX and some one-off, but still a big jump. Is that part of the reason for this change in more confident guidance, remember we were discussing this topic even in the full year call and I'm just curious as to how to project Life going forward?

And second, again, just a clarification these reinvestment yield being cited now, it's 2.6% at the end of 1H, whereas in the call in the 1Q you had said 2.9%, was it a different metric of some sort because if anything probably went up, at least from many of the peer group, so I'm just curious on this topic. Thank you very much.

A - George Quinn {BIO 15159240 <GO>}

Yeah. Thanks, Vinit. Thank you for paying extra attention to particularly to my comments about running Q1. So I guess on the running yield topic, so I mentioned the fact that we had 2.9% I think if I had given a fuller answer, which I should have done, (43:58) that there were FX impacts in there that may have made that less sustainable than maybe I had thought when I gave the answer. Certainly, that's why you see a slightly different picture today.

Ultimately though, I mean, this will be the transition year for investment income for P&C. It will be at least based on what we expect today at the same level as last year, and of course, if interest rates are as stable they are will start to edge back up. But you're absolutely, right, I did guide 2.9%, 2.9% had a better foreign exchange impact and it did not repeat in Q2.

On the Life topic, I think, the confidence again, and it's not driven by the investment margin topic, and in fact, I think as you know from previous disclosure sorts of earnings, I mean, well, it's not unimportant, it's not typically the biggest driver of income for us and in fact it's probably one of the more volatile components.

I mean, for us, I mean, loadings and the technical margin are typically much more important. I think the confidence that you see today, simply comes from probably the same thing that you guys all reacted and that is that the Life business has continually produced stronger performance than we planned for. There is some one-off that (45:21) the number. So we have some foreign exchange in LatAm today, which again is not, I mean, it's not something that it's not management driven. We've got active policy of how we do ALA (45:37) in Latin America to avoid some of the devaluation or inflation risks. And that's what drives a chunk of this one-off (45:45) in the first half, but even when you peel that back, I mean all the businesses are performing strongly.

Some of them did so well, for example, around Germany, but the contribution is strong across the entire book. I think, we're happy with the way we have the capital allocated. We're not looking to make major shifts in the short-term. We expect to see more of what we've seen. There's no reason to expect something else. I think that's what drives the confidence.

Q - Vinit Malhotra {BIO 16184491 <GO>}

Okay. Thank you very much, George.

Operator

The next question comes from Jonny Urwin from UBS. You may now proceed, sir.

Q - Jonny Urwin {BIO 17445508 <GO>}

Thank you. Just one question from me, please, on German insurance. How much of the book is still falling short of hurdle rates? And so I appreciate you still got some work to do in terms of repositioning the book by shortening the tail, but I wanted just in rough percentage terms how much of the book do you view as unsatisfactory, just trying to gauge how much more re-underwriting you think needs to be done? Thanks.

A - George Quinn {BIO 15159240 <GO>}

Thanks, Jonny. As someone who typically sees the world through half empty perspective, I think that I'm challenged by that question a bit – I think for us the – I mean, I think to take a realistic view of it, I mean, we look at several dimensions as we try and decide what the portfolio we're looking for from the businesses going forward would be. I think it's not only where we stand today. It's what we expect of through the cycle for the business and it's also where the market is currently.

I mean, I think from the very high level as Mario mentioned earlier, I mean, the commercial market is a bit challenged by the market conditions. I mean, that's clearly the area that needs the most attention from us. I mean, within that are businesses that do very well. There are other businesses that remains very challenged, but I mean it's mainly a commercial team. And again, I think, as I also said I think it's not just us. I don't just want to point the finger at our commercial teams at the global level or even the countries, where there's clearly work to do. They're working hard against a difficult market backdrop.

On the flip side, I mean, you can also see that on the retail and other businesses, where I mean we found some – I mean, they're not all niches, but I mean we found some very attractive pockets in the market, where the businesses are doing exactly what the clients want them to do and they benefit significantly from doing that. So I mean, overall P&C can certainly do more, but I think we're happy with the changes that we see. We think we know what the issues are and we see those issues being addressed. We hope to see further improvements in the coming halves.

Q - Jonny Urwin {BIO 17445508 <GO>}

Thanks.

Operator

Our next question is a follow-up question from Mr. Eliot from Kepler Cheuvreux. Please go ahead, sir.

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

Thank you very much. Yeah. Maybe just a couple of thoughts, on the PYD, I was wondering if you could quantify how much of that came from Harvey, Irma and Maria? And then secondly, I mean we touched on forest fires and some sort of impact on the crop business, is there likely to be any effect from sort of H2 events to date on your business at all? Thanks very much.

A - George Quinn {BIO 15159240 <GO>}

Thanks, Peter. So, I mean, I resisted the temptation to quantify in the disclosure. I mean, you can assume that, if you adjust for it, I would see it as (48:20) in our target range, I mean, again maybe just worth reiterating that when we think about PYD, we're guiding to the top end of our target range and that's taken into account all of the factors that are impacting our reserving position currently.

On the second question of the second half, there's probably not much I can add to the answer I gave to James earlier, we were not aware of anything at this stage that causes immediate challenges for crop. And I don't have a negative outlook for crop for the year, but the year is by far not over yet.

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

Yeah. Sorry, it wasn't – I mean, I was just looking to expand it beyond crop, actually versus the rest of your...

A - George Quinn {BIO 15159240 <GO>}

So again, obviously, if I was aware of something that was particularly significant I would disclose it out, either as part of the material, or in the call. I mean, I would characterize our view of the business through the first half is on track and we have no reason to expect something definite in the second half of the year.

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

Okay. Thanks very much.

Operator

Your next question comes from the line of Mr. Niccolo Dalla Palma from Exane BNP Paribas. Please go ahead, sir.

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

Hi. Good afternoon, everyone. First question is on the reinsurance structure you've put in place to drive further shift of mix on net premiums. You mentioned this earlier in the year and also today on the call. Just wondered if you could remind us if these is quota shares that kick in over time and that's the reason why we'll see a more important impact of this in H2 and further impact next year. So just what are the mechanic, why it's taking some time to show up?

And the second question is on the other operating results. Could you tell us first what the FX gains were in H1, so we can clean up for that going forward even if you give a guidance. And secondly, on the lower recharges to the business units, are you now, let's say, at the normal level, is there further change to come in terms of recharges between Unit and Central? Thank you.

A - George Quinn {BIO 15159240 <GO>}

Thanks, Niccolo. So on the first one, so the issue simply is that we entered into a reinsurance agreement on a liability book, which excludes workers' comp in this case as of January 1. We haven't disclosed externally, I mean, the precise scale of it is a quota share, it's a very large quota share and that's probably I mean at the kind of level that they – the maximum level the market would accept. The mechanics are that this is a risk attaching contract. So new business attaches to it rather than the end premium coming in from prior years. And just given the nature of the business that means it will take up to two years to see the full impact and through on the policy – the portfolio mix measured by earned premium.

On the foreign exchange gains, there's nothing unusual, I mean, the foreign gains can be a bit volatile quarter-to-quarter. I think they're – I mean we have good guidance in the past around the non-technical part of the performance. I don't think there's nothing that would cause me to change that currently. And then on recharges, the – I mean, the way we've worked over the course of the last two years is that all of the reductions in the corporate center are passed on to the businesses. We've had a further reduction in the corporate center, in the first half of this year, I think our plan for the next year hasn't actually yet been through Mario, so I should be careful what I say.

A - Mario Greco {BIO 1754408 <GO>}

(53:32).

A - George Quinn {BIO 15159240 <GO>}

It doesn't here anticipate the same level of reduction, but it hasn't been approved yet. But I guess the way to think of this is that we have an overall target of $600 million still to come. Some of that will definitely come from the corporate center. But all of it will flow to the businesses, so we will hold the net position and group functions and operations around those level you've seen for the last couple of years of somewhere in the $750 million, $800 million range and all of the benefits of the production should show up mainly in P&C.

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

Thank you.

Operator

We have a follow up question from Mr. Michael Huttner from JPMorgan. Please go ahead, sir.

Q - Michael Huttner {BIO 1556863 <GO>}

Thank you very much. I actually I had three, but the first one, do you remember, I think it was the full year, we said, oh, you're going to achieve your targets easily, why did you raise the hurdle rates on what you get paid, et cetera. This is I think on the ROE waterfall, I just wondered if the optimism which I sense on the – on your P&C business would mean that if you were to look at that waterfall chart today, you'd nudge it up a little bit more even than we've had in the past.

The second is on deals, so you very kindly explained the past deals. And I just wondered what's left in the kitty for deals yet to come. And the third one, and I'm really sorry, Peter, cut me off, on the ZZR benefit, I wonder if you could give a figure? I think you are one of the few groups where in the past you've said that it does affect operating profits. So if the (55:18) does change the rules, what's the variance? Thank you.

A - George Quinn {BIO 15159240 <GO>}

Thank you, Michael. Thank you in particular for trying to tempt me to change the target. (55:30-55:36) we showed people what the impact of the acquisitions and the impact of the tax reform in the U.S. would be. I mean, as you can see today, I think if you look at the results on the same basis, we've got an ROE somewhere in the mid-12s about 12.6% or thereabouts, that would leave some room still to go to achieve the level that we said last year.

But I mean, I think from a portfolio perspective to maximize the economics, to grow the returns to shareholders, there's a point at which if you push that number too far you end up going backwards. I think the targets or rather the picture that we laid out last year, I hope would be an attractive one for shareholders, and that's what we're aiming to try and deliver.

Deals, I think the question was what's left in the kitty. I mean, we're in the fortunate position that we are well-capitalized. It's a feature of the way that the group operates that it prioritizes balance sheet strength and we have, I mean, fairly exceptional balance sheet strength currently. I mean, for us in terms of how we use that balance sheet strength, I mean, I think actually past behavior is a good guide to what you will see in the future from a – I mean, our priorities haven't changed. It's all about the operational topic. If opportunities arise to invest that at attractive rates of return, we would certainly consider it, but it's not required to achieve the goals that we've laid out. And we are in the position that if we choose to we could fund more growth, it just has to produce the right return.

On ZZR, we have given guidance around the negative impact of ZZR on the current basis, I mean, ahead of – I mean any potential formal change, I don't like to try and guess what the impact would be. I mean, my sense is that it cannot be negative, it can only be positive. I mean, I don't really want to share information that could easily be misleading if outcomes are different from the ones that we anticipate. But I mean, it offers the potential of some upside depending on exactly where the (57:54).

Q - Michael Huttner {BIO 1556863 <GO>}

And what was the guidance in the past on the negative?

A - George Quinn {BIO 15159240 <GO>}

So, I think the guidance on the negative side was – so this goes back already to 2016. We said we would be flat into 2017 and we weren't even flat, because we didn't have the full negative impact of ZZR. Can I leave it that we come back to you on that?

Q - Michael Huttner {BIO 1556863 <GO>}

Of course, and of course, and it was my third question. So I appreciate it. Thank you.

Operator

The next question is another follow-up question from Mr. Farooq Hanif from Credit Suisse. Please go ahead, sir.

Q - Farooq Hanif {BIO 4780978 <GO>}

Hi, there. Thank you again. On the capital position, you've been well above target for quite a long time and that's in spite of having deployed quite a significant amount of capital. So I'm just kind of wondering about the time line on what and when you will address this or do you still believe that it's good to be, to have an elevated position because of your market risk, for example, if you just comment on sort of timeline?

And then, secondly, going back to your sort of guidance on Life, double-digit growth, I mean, obviously that will happen this year hopefully because of the first half trend, next year, you've got M&A, But just sort of thinking longer term, do you think high single-digit is doable given the growth that you're seeing in various areas and the business mix shift? Thanks.

A - George Quinn {BIO 15159240 <GO>}

So on the first one, I think at this point nothing I could say that would be any different from everything we've said before on the capital topic. I mean, there is no change in how we operate. There are – there is no hidden set of rules that we operate to. We haven't disclosed. I think as you point out through we have not only invested, we've returned capital already this year. I think the other thing I'd add to what we said before is, I think we always try to be pretty measured on anything we do, whether it's an investment or whether it's capital return. But what we've done before and the policies that we've had they're unchanged, you see we'll approach in the same way in the future.

On the guidance on Life, I think again, I resist the temptation to give the financial guidance ahead of the strategic direction of the firm. We have an Investor Day coming up in December, maybe we can talk about it there in a certainly broader context.

Q - Farooq Hanif {BIO 4780978 <GO>}

That's worth a try. Thank you very much.

A - Mario Greco {BIO 1754408 <GO>}

Thank you very much everybody for dialing in. And we are aware that there's one or two more questions still pending, unfortunately we don't have any more time to take them now. However, the Investor Relations team will get back to you later on this afternoon. Thank you.

A - Richard Burden {BIO 1809244 <GO>}

Thank you.

A - George Quinn {BIO 15159240 <GO>}

Bye.

Operator

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