Q2 2016 Earnings Call

Company Participants

- Bernhard Kaufmann
- Christian Becker-Hussong
- Jörg Schneider
- Nikolaus von Bomhard

Other Participants

- Andrew J. Ritchie
- Frank Kopfinger
- In-Yong Hwang
- James A. Shuck
- Kamran Hossain
- Michael Haid
- Michael Igor Huttner
- Olivia Brindle
- Thomas Seidl
- Vinit Malhotra
- William Hawkins
- Xinmei Wang

MANAGEMENT DISCUSSION SECTION

Operator

Good day, and welcome to the Munich Re Half Year Financial Conference Call. Today's conference is being recorded. At this time, I would like to turn the conference over to Mr. Christian Becker-Hussong. Please go ahead, sir.

Christian Becker-Hussong {BIO 19080254 <GO>}

Yeah. Thank you, Elaine. Welcome, everyone, to Munich Re's second quarter earnings call. Right next to me are Nikolaus von Bomhard and Jörg Schneider. Jörg delivered his most important messages this morning with his audiocast. So, Nikolaus will kick off this call with a few statements before we go right into Q&A, as always.

So, I now have the pleasure to hand it over to Nikolaus.

Nikolaus von Bomhard {BIO 3123407 <GO>}

Well, thank you, Christian. Good afternoon, and good morning, to all of you. And I would only like to circumphrase, to some extent, the first two slides of the slide deck. And to start it off, I think the first quarter we had what one might consider, prima vista, an unusually weak, the second quarter one might label as unusually strong. But, if you take the two, as a whole, half year result, I think it's reasonably solid, and, therefore, pleasing and largely, as Jörg worded it in his audiocast, in line with expectation. And as we always said, don't take one quarter alone too seriously, let's rather look for a couple of quarters.

Well, that being said, you know from us, of course, that we consider ourselves relatively well-positioned in what we called challenging times. Before the Brexit and the Spanish election, we did a little bit of derisking in our investment portfolio, hence we were coming out a little stronger than we ourselves thought, both on the currency side and on the investment side.

On the currency side, of course, you're, you may add unfortunately, accustomed to ups and downs all the time. In the past, mostly it was a negative. This time, it's a positive, and it has to do with two things. One is that we really have to struggle sometimes and still do with the economic position and our accounting position with the currencies and we cannot go for one only, it's a little bit of a mix, plus our conservative positioning led to quite high currency gains. We will rather have them than not have them.

Overall, we stay as we have been over the last years, in fact, cautious. Uncertainty is lingering out there all over the place, hence we still think that the solvency capital position should be strong in these days. We are cautious, specifically, on credit and even more so on bank credit these days.

The ongoing drop of the risk-free interest rates, of course, puts some dents into our net income as well. We did a little exercise over the last four years, 2012 up to 2016. And if you add that up, it's an easier exercise for reinsurance. These 80 basis points that we lost in the running yield have a price tag of about €560 million and you may add to that. And I'm only talking assets here, the ERGO, which is a much less exact exercise, let it be another €130 million roundabout, so that makes for good €700 million to just disappear by a drop – tremendous drop in the risk-free interest rate on the running yield.

In other words, 10 basis points in reinsurance normally do cost to some good €70 million. The duration, as you may have seen, is somewhere between five years and six years. Of course, the question is, how quickly do we term that over? But going forward, of course, that will keep us under some stress, of course.

The other important point is the liability side of the balance sheet. Reserving, you could see that we have released reserves north of 4% again but south of 6% overall. We feel very comfortable with our reserving position and going forward Torsten earlier today said that he expects this year, it's something around 6%. We would not put our head on the block for 6% going forward but we would for 4%. Also on the tax side, our reserving is conservative. All that including now unrealized capital gains of close to €35 billion makes us feel, as I worded it, very well-positioned and let's say in relative terms specifically for an uncertain environment.

Of course the big topic in the last quarters always has been the question of where does the reinsurance market stand. We showed you some slides on the renewal. 1 percentage point of combined ratio is €150 million roundabout in today's world of net income. If you take a normalized combined ratio of 99% and go back to 2012 with 94%, you could say 5 points are missing. The good news here is that two of those points missing, we make up by reserve releases up to 4%. If we do more, of course that closes the gap further and roundabout another 1% or 2% are just luck. Basically so far, we lost pretty much 1 percentage point of that gap, in fact, in the current year.

The recovery in the reinsurance market in terms of pricing, I think we are not yet there. The good news is that sort of loss of margin of 0.4% this renewal in July is only 20% of what we have seen as a loss a year ago. That makes us feel a little bit more comfortable, hoping that we may soon see the ground of that development.

In a nutshell, only a few more remarks and then we should go into Q&A. The innovative exercise, of course as long as it doesn't really produce big time tangible net income is by many not really looked at with sort of too much favor. Let me only say that we will continue in our efforts to produce new businesses that are not dependent on the normal cycle up and down of supply and demand. And it should have and build bigger margins because it's pilot risk.

ERGO is well underway but only two months into a five-year program with the restructuring. That will of course continue. And this, if successful – and of course we expect it to be successful – is part of the refill of those millions of net income that we lost by a lesser interest rate. The forecast, the guidance if you like, for the current year, we kept at 2.3%.

Some say, well, if you have a half year result at 1.4%, why not increasing it? Well, it has to do again with the uncertainty out there and with our overall cautious stance. Of course dividend is a different subject here. I could and would and we all would put our head on the block for at least the dividend we have paid. And the share buyback will be favorably considered when time is up for doing that but also in consideration of other alternatives.

Last comment. Next year of course will keep us on our toes. It will be tough again, first, for the attrition of the interest rates, which I mentioned already, and a lot of course depending also on what goes on in the reinsurance market. The good news being that ERGO next year, of course, should start to kick back in with positive results. The question, of course, then being will we be able to go on where we are or will there be less. But this is not for today. I ask for your understanding that we can't answer these questions today because we haven't even gone through our planning process yet. And that is normally the subject of our March analyst conference.

With that, I hand it back to Christian. Thank you.

Christian Becker-Hussong {BIO 19080254 <GO>}

Thank you. We can now go right into Q&A. The usual rule applies. Please a maximum of two questions per person. Thank you. Please go ahead.

Q&A

Operator

We'll now take our first question from James Shuck at UBS. Your line is open.

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

Hi. Good afternoon, everybody. It's James Shuck from UBS. Two questions from my side, please. Firstly, could you provide - you commented in the presentation this morning that the Solvency II ratio declined to 250% to 260%. That's obviously a quite sharp decline from Q1. And you mentioned some model changes. So could you just provide a reconciliation of change from full-year or Q1 to Q2, please? And then, secondly, interested in the reinvestment yield. You mentioned 1.6% in the first half was what was achieved as reinvestment yield. What do you see that in the second half of the year, please? Thank you.

A - Jörg Schneider

Hello, James. This is Jörg here. We came from 302% at the turn of the year. We were then down to 275% roughly at the end of first quarter. And in the second quarter, we had another sharp decline in interest rates, which had a substantial impact here. And also, a model change. This model change comes from the reassessment of hidden reserves in comparison to the debt that are quite a complicated thing. And this also had a substantial impact here. I would regard both as being now kind of refinement of our internal model and there are not many more in the pipeline at the moment.

But it's unavoidable development at a time where we are still faced with changes from EIOPA, for example. Therefore, a lot has to be reworked from month to month now. But it's kind of narrowing down to a stable situation here with the models. Second question, reinvestment yield for the second half. We would guess roughly 1.6%, so slightly below the 1.5% in the first half of the year.

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

You mean the other way round. You mean, yeah, 1.5% in the second half of the year, yeah.

A - Jörg Schneider

1.5% for the second half.

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

Yes.

A - Jörg Schneider

Yeah. Sorry.

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

Okay, that's very helpful. Thank you very much.

A - Jörg Schneider

Thank you, James.

Operator

We will now take our next question from Thomas Seidl, Bernstein.

Q - Thomas Seidl {BIO 17755912 <GO>}

Yeah, thank you. Good afternoon. Two questions. First on ERGO. I think in June you told us that the €1 billion investment is self-funded. But you also called it a borderline case. And your base assumption then was flat interest rates. Now since then, the reinvestment yields have fallen another 30 basis points if one uses the (11:52) as a baseline. So have you re-run your calculations? To what extent has the risk increased that you need to put in capital in ERGO over the next five years?

And the second question is basically related to the Solvency II. You now moved closer to the 220% level where you call it the optimal level. And I think also you said this morning that only above this there was basically a strong case for buybacks. And I just wonder if you could remind us of your priorities here. So assuming that going forward, the macro risk brings down your Solvency II ratio below the 220% level. But your HTB buffer still remains high. Is that basically meaning that the buybacks will continue or is the Solvency II ratio dominating the HTB view here?

A - Nikolaus von Bomhard {BIO 3123407 <GO>}

Thank you, Thomas. This is Nikolaus. Let me answer the two questions. The first, as of today, also looking forward, we see no reason to change our statement so far. We still go by the assumption that ERGO will self-finance and that no capital is needed from the group. That can change, but it does not only have to do with interest rate level. There could be other events happening that may change that. But for the time being, we stick to that assertion, to that statement. The second question is we are still quite far away from the threshold 220% which makes us enter the green zone. The green zone actually would be the sweet spot where all the statements we made as we got dividend and share buybacks are still up and running. The only difference being that we, in view of the uncertainty, feel much more comfortable a little bit north of the 220%. But the 220% is not a threshold where our assumptions or even statements as regards dividend or share buyback would change.

Q - Thomas Seidl {BIO 17755912 <GO>}

Okay, all right. Thanks, very clear.

Operator

Our next question is from Michael Huttner, JPMorgan.

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

Thank you so much. On the business, you said you're finding these pockets of profit. I know you discussed some a little bit on your Investor Day. But can you give us some margin figures or more margin figures, say, on the €500 million innovation and maybe anything else that you see coming up? And then the other thing. If I look at the behavior of all the reinsurers, now all the reinsurers are saying pricing is tough. And I feel pity for them. I'm almost going to send you a check. And yet the behavior doesn't quite match. So if I look at the volume of your peers at July, they were all up between 8% for one, 10% another and 14% for another. Your volumes, and you're also one of those who says pricing is challenging, were flat. You're not receding from the market as it were. How do I reconcile that? My guess is that it's still a reflection of what Mr. (15:12) used to say is that you had – all the reinsurers, I don't want to single you out, had overpriced a little bit in the past. And we're still adapting to finding the right number at the moment. But can you say what you think on this pricing versus volume thing? Thank you.

A - Nikolaus von Bomhard {BIO 3123407 <GO>}

Well, Michael, Nikolaus again. As regards the first question, we have put out so far on the revenues and not margins yet. But the assumption – and I don't have a specific number here to what extent to take as a proxy combined ratio. This new business has a different combined ratio because we mix up here primary insurance's life and reinsurance non-life. So a combined ratio wouldn't even be a real proxy. And I don't have an absolute number to put against the premium. That's why I have to unfortunately admit I can't give you a straightforward answer. I would dare to say, however, that on the average those businesses that can be compared with existing businesses have a better margin. We know that the loss ratio in cyber risk so far is below 20%.

It comes in at a higher cost because you need to offer a lot of service. But this is a typical pilot risk that can change overnight with one serious damage of course. But so far, so good. And it is not unusual for pilot risks. So the margin is for sure better. It's not a specific answer but an answer. The second one, I consider it almost a philosophical question. It is astonishing indeed that at the time the pricing gets worse by the quarter, people still are able to grow their businesses. Of course you would have to ask those competitors who show bigger growth rates where exactly it comes from. We had quarters too where we did show growth. In almost all of these cases, this was triggered by transactions.

So the good news is the top line looks as if it doesn't shrink much. The bad news is what we consider traditional bread-and-butter business many times is replaced by single transactions that normally have an expiry date and are of a lesser margin. So that's why it's very difficult for an outsider to look through these numbers and truly understand what's going on. Those businesses that we do not accept and almost 25% of the business that had to be renewed in July 1, we did not renew. Now the question is where did it go.

Some of that business certainly stays with the client and just disappears. And then maybe at their retention, other businesses may go to companies who for diversification reasons can accept it at a different price. I don't want to bad-mouth anyone here. And some others may indeed have different return targets. So the fact of the matter is that the business we take in is clearly above our cost of opportunity threshold. But it certainly is not where it used to be some four years back and the combined ratio is a proxy. Then I talked about 2012, 94% pretty much normalized today, 99%. And there you see where the margin went. Even though I repeat it, we come up with a better combined ratio right now for the reasons I mentioned.

And, overall, I don't see yet that the thing has stopped. The fact that the revenues are not shrinking is mostly in our case for sure dependent on either new businesses that just didn't exist, innovative businesses didn't exist or transactional business. For the rest of the market, unfortunately, thanks to our franchise, it's very difficult for us to find businesses that just has not been seen so far. Jörg, anything you would like to add? No.

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

Okay. Thank you very much.

Operator

Our next question is from Kamran Hossain, RBC.

Q - Kamran Hossain {BIO 17666412 <GO>}

Hi, afternoon. I got three questions. The first one is - I guess this is coming back to normalized combined ratio and I guess large and catastrophe loss expectations within that. It seems like almost everyone has characterized the second quarter as a particularly high loss quarter except for yourselves. And this quarter is kind of bang in line with your 12% guidance for that part of the combined ratio. Can I just ask, do you think this number is still right? Just wondering if you could give any thoughts on that. And second question just on German GAAP earnings. Would it be possible just to give a comment on how those are developing this year just in kind of view of the buyback that many of us probably have in our numbers? Thanks.

A - Jörg Schneider

Yeah, Kamran, normalized combined ratio for Q2, the 12.3% was pretty high. So you're absolutely right and we expect more major losses in the second half and especially here in the third quarter. We do not want to bring that aspect too much on the table because during the last couple of years, especially the manmade losses had a major impact and also the earthquakes don't know anything about the season. So it's not reliable enough to make it a benchmark. But in tendency everything has been taken into account when setting our 95% target for the year. But we must be prepared for major losses, major natural catastrophe losses. And what you should have in mind also is that we had substantial losses below the €10 million threshold which divides attritional losses from major losses for us, especially in our primary insurance business which is written out of reinsurance.

For German GAAP, the situation is in very good shape. Couple of reasons. One is that we made some internal rearrangements of our shareholdings, which produced some additional German GAAP earnings only which do not show up in IFRS. And apart from it, we also had a very strong year because with the strong investment result, you see it one-to-one in our German GAAP calculation. And I would also like to remind you that the resilience of the German GAAP calculation vis-à-vis natural catastrophe losses is extremely high because it's protected by the equalization reserve which is close to its border. So it's a very stable basis for future distributions.

Q - Kamran Hossain {BIO 17666412 <GO>}

Thanks very much. Really appreciate the color. Thank you.

A - Jörg Schneider

Thanks, Kamran.

Operator

Our next question will be from Xinmei Wang from Morgan Stanley. Your line is now open.

Q - Xinmei Wang {BIO 17860767 <GO>}

Hi, thanks. I have two questions please. The first is a follow-up from the previous question on the Solvency II number. Could you give us the amount of the decline from 1Q to 2Q due to the model change and the amount due to interest rates? And then my second question is again on the innovative products across the Group. So on the growth of that, which has sort of grown about threefold in just two years. Realistically, how many years do you think it would be for it to be a material portion of the Group? And do you think there needs to be any catalyst to happen to boost that growth, for example, regulation or legislation changes that require more of these products to be bought? Thank you.

A - Nikolaus von Bomhard {BIO 3123407 <GO>}

Thank you, Xinmei. On the first question, it's two-third capital market impact especially decline in interest rates and one-third model change. And the second question, Xinmei, is very difficult to answer. It's not exact science because it's a basket of different initiatives. And of course there may be businesses where a regulatory change may play a role. There's other businesses where it will certainly not as it's rather about technological changes. And I would also not be ready to extrapolate the growth of the last two or three years into eternity here. It may go in sort of loops or it may go like leapfrogging a year where we don't see much change and in another year, we see a lot of it because it also all depends how long we leave business in that book labeled innovation. I always tend to say that after three years, a business cannot be labeled innovative anymore. It should be taken out. And depending on how big it was when it came in of course, then you have to first of all earn back that level or that portion to even make it up to the €500 million.

So I'd be rather be cautious here in coming up with what we truly expect. If cyber risk, to take one very concrete example, takes up the way we think it will take up; we now stand on a worldwide scale probably somewhere between €2 billion and €3 billion of revenues in cyber risk space that is expected to be three times to four times as much by the end of 2020. If you assume that we probably have $200 million in that book, then you could use the same growth rate and go along with it. So that is one of those businesses that might grow fast and I would still label them innovative. In other businesses, I would be way more cautious. Digitalization, different from cyber now, may also create new businesses. But some of those will be fee businesses rather than risk premium. That's why I used to call it a real big basket with many things to it.

Jörg.

A - Jörg Schneider

Yes. With regard to cyber, cyber is also a good example how non-financial regulation can play a role with regard to demand for these products because at the moment, most of the demand is coming from the U.S. and the pure reason is that we have very high regulatory standards for the treatment of cyber attacks and similar IT-related problems for the corporations. And the same kind of regulation is currently spreading all over the world. And therefore, that could have an impact. So it's not only about financial regulation for our clients, the primary insurers, but also about a growing level of regulation for the non-financial primary insurance clients, which can drive the demand for insurance products.

A - Nikolaus von Bomhard {BIO 3123407 <GO>}

Let me give you one further tangible example. If in China, for example, coverage for natural catastrophes really takes off because this is a tremendous book of business, of course first of all, for the primary insurers, but a lot will have to be reinsured as well. And I think we are just at the starting point of that business to develop. So if that goes fast, you will certainly see the consequences in our book as well. But this is not in our hands. We try to do what we can also together with the government to promote the development of that business. But this is – for the sheer size of the market and the country, one, if we do succeed, you will immediately see it at both balance sheet and P&L.

Q - Xinmei Wang {BIO 17860767 <GO>}

Okay, brilliant. Thanks very much.

Operator

Our next question is from Vinit Malhotra from Mediobanca.

Q - Vinit Malhotra {BIO 16184491 <GO>}

Well, hey. Good afternoon. So just on the normalized combined ratio of 100.3% at 1H. Is it safe to assume that the difference between 99% which is the guidance and this 100.3% is all because of below-the-radar losses, maybe some business mix? Or another way to phrase this question, what do you think gets us to 99% from this 100%? And it might be semantics, I apologize. But just this has been a focus in this morning for me, so I just wanted to know that.

Second question, just on the way you perceive reserve releases. Obviously, we have seen that as per IR team, there's the low triple digit million euro reserve release on the nat cat side sitting over and above the basic losses of releases of 5.1% in 2Q. How should we think about this? When you think about the reserve release guidance, is that only for basic losses or do you also believe that the nat cat 4% should be in that? And I'm just quoting from the report here where you've stated that continue to put new business at the very top end of the estimate range, so that to have a further release later on as well. But how do you think between nat cat and basic losses for the reserve release, please? That's all for me. Thank you.

A - Jörg Schneider

Hi, Vinit. Normalized combined ratio, what brings us down from 100%-something to 99%, there's always a lot of fluctuation here or some fluctuation. It can also come from currency effects, for example, yeah, that losses appear at another time as the premium comes in and we track that. It is not possible to precisely define it or even to normalize for that. That would be overdone. But please rely on us.

It's two factors. This random fluctuation plus this roughly 1 percentage point, which is major losses below the €10 million threshold. Second, reserve release. When we talk about 4%, 5% or 6% reserve release, we are talking about basic losses only and not natural catastrophe or major losses. And what showed up in the second quarter, that was the more and more obvious maturing of the claims from some major natural catastrophe events where we couldn't postpone any longer to set the reserves free. And it was a number above €200 million and it's mitigated the effect from the very high loss burden from the quarter itself.

Q - Vinit Malhotra {BIO 16184491 <GO>}

All right. Thank you for the clarity.

A - Jörg Schneider

Thank you, Vinit.

Operator

Our next question is from Olivia Brindle, Bank of America. Your line is open.

Q - Olivia Brindle {BIO 17273762 <GO>}

Hi there. My first question is just around your comments on growth in the renewals, your comment that you're continuing the shift to casualty lines. I was just wondering if you could give a little bit of color on exactly what you're growing within that and also tying that into the comments around large transactions. I think, historically, you've said you're a little cautious of sort of big tailored casualty deals. And if you could give some color on how that looks now, that would be great.

The second question is just on your Canadian loss. €400 million sounds like quite a high number compared to the market loss and also to your other peers who have given us numbers. So just wondering if you could comment on whether that's above what you expected or how we should think about that €400 million? Thank you.

A - Nikolaus von Bomhard {BIO 3123407 <GO>}

Well, thank you for your questions, Olivia. The first one, again, a quarter should not be overstated. But what we have seen indeed is that for pricing reasons, the property lines have been under much more pressure than casualty. This is the starter. Two, we have had some new businesses including transactions here combining your two points. And some of them have been just motor business. So this looks like heavy casualty, but it's relatively homogeneous and shorter tail business and doesn't really bring all what casualty could bring to the balance sheet in terms of uncertainty depending on the line.

We are not of course shying away from heavier casualty lines. So we have also bigger businesses coming in here or there, but that is normal. So provided that the pricing environment doesn't change much, I would assume that we probably see more casualty business coming in rather than property. But this is not a given. It really depends on what markets will do. And the casualty book, as I said, it's a very diverse book. This time there was a lot of motor coming in with bigger transaction and not so much of the more serious liability lines. And as you do know, when it comes to workers comp which we consider casualty, we are extremely cautious do we in fact have hardly anything left on that side.

When it comes to the Canadian cat loss in McMurray in the province of Alberta, that has to do with – call it unfortunate, but I think it is rather good. If you are a market leader like we are in the non-life business in Canada, we would expect to have the largest loss in the first place. If you're then a little unlucky in the sense that the loss is very confined and a couple of primary insurers have most of the – such a relatively high share in that very city and you are then the one who has the bulk of the reinsurance of that very insurer, you end up with a loss that we have now booked and it is as I would consider it rather a – what do we call it, not coincidence, but it's (33:39) it's really incident. Random, that's the word. Thank you, gentleman.

It's just random. So it doesn't worry us at all. We looked also of course into underwriting and what have you. This is what you sometimes get in other losses. Then you are the lucky one because you have all those already insured who have not too much of market share. So that's why our relative share is higher here in comparison to others in whatever measure you take be it relative or be it absolute.

Q - Olivia Brindle {BIO 17273762 <GO>}

Great. Thank you for the color.

Operator

We will now have our next question from Frank Kopfinger, Deutsche Bank.

Q - Frank Kopfinger {BIO 16342277 <GO>}

Yes. Good afternoon, everybody. I have two questions. And my first question is on your regular investment income. On a Group level and it's similar for the segments, the regular investment income is down 11% year-on-year on a quarter. But also on the half year in life where it's even down by 23%. Is this the normal impact from lower yields or are there any other developments including like specials within this development? And my second question is again on this underlying impact from reserve releases within the nat cat segment. You quantified it. This is highly appreciated. But can you be a little bit clearer, was this just one event or did it affect several events, which you just had to release now, and what was the trigger for the timing now in Q2?

A - Nikolaus von Bomhard {BIO 3123407 <GO>}

Well, let me start with the second question. Of course, you should not put too much into your spreadsheet as regard to reserve releases on the major loss side. We try to pick loss ratios right from the start cautiously. We don't like to come up with reserve increases. Over time, you may remember the kind of unfavorable increases on the New Zealand earthquake at the time, this is something we don't like to do.

On the other hand, with other losses, we were either right on the spot or we were a little bit too cautious and then we have these releases, but this is nothing that we, in the sense, even plan going forward of releasing over time, so rather don't expect anything here. Every now and then, there may be an amount. Why did we release it now? Well, very easy, because, as you have said, they were very old, and, of course, we don't mind doing it now with a relatively heavy cap burden anyway. But this is not a cushion that we move forward and waiting for the next loss to release it, so don't expect much from that side. It's very, very different from the reserve releases from the basic loss side.

A - Jörg Schneider

Frank, this is Jörg. On your first question, regular investment income slightly down in the first half. In the second quarter by the way on a standalone basis, it went up. But in the first half, it's not only driven by the lower reinvestment yield and how it eats into our current income, but also due to the termination of large contracts, a very substantial impact here. And with a triple-digit number going down, just from one contract, this contract come in very big numbers with a very small margin, and therefore, you see a little bit of a, how should I say, of some artifacts here that here the running income goes down the current income and you would see the compensation on the net expenses for claims and benefits, but we cannot isolate it. On balance, it's more or less, it's very small, a very minor loss of profitability here.

Q - Frank Kopfinger {BIO 16342277 <GO>}

Okay. Thanks.

Operator

Our next question is from In-Yong Hwang from Goldman Sachs.

Q - In-Yong Hwang {BIO 18784369 <GO>}

Good afternoon. Thank you for taking my question. Two questions for me. Firstly, Nikolaus, you refrain from talking about outlook for next year. But when we look at the normalized combined ratio, you're still growing into casualty, which presumably would have some business kind of mix effect into the combined ratio. So the way we should think about normalized combined ratio, should we expect it to pick up or do you think some of these are kind of resolutions or innovative businesses enough to kind of offset a, I guess, deteriorating impact on the normalized combined ratio? That's my first one.

And second is hopefully a very quick on clarification and the comments around keeping a special dividend. I'm just wondering if that's on a per share basis or total dividends paid. Thank you.

A - Nikolaus von Bomhard {BIO 3123407 <GO>}

Well, In-Yong, let me start with the combined ratio. Actually, we are not entirely sure yet, because one big renewal is coming up that will be crucial for 2017, that's the January renewal and the other renewals as well. You're right, however, the more we go into causality, the likelihood of that pushing the combined ratio up is there. We will also have a spillover still from the lesser margin in the current year and the years before to the extent the business is for longer and that will spill over into 2017 as well. So that, in other words, is the best estimate I can give you right now. We will move from €99 million closer to the €100 million. Will we pass it? I'm not sure yet, I would hope we will not. I can't exclude it as of today.

A - Jörg Schneider

With regards to your second question, special dividend, as Nikolaus said at the beginning, our distribution cover is still intact. And we would very much like to gradually increase the dividend over time, the regular dividend. And what we distribute in addition, we do as you know typically by share buybacks, we do not see a special advantage of a special dividend in comparison to share buybacks, share buybacks are a little bit more flexible and that is for us of a certain attraction that we can easier spread than over the year that we could in very extreme situations also stop them for a while like we did in 2011 for some months. So, therefore, we do not see enough of an advantage of a special dividend.

Q - In-Yong Hwang {BIO 18784369 <GO>}

Sorry, Jörg, my question is more around not necessarily a special dividend, but because your share count is going down because of the buyback, I was wondering whether commitment to keeping stable dividend was related to the dividend per share or (40:42) dividend?

A - Jörg Schneider

Okay. Sorry. No firm commitment I would say, but according to experience, I wouldn't say you can rely on it, but my boss always wanted to have it like that.

A - Nikolaus von Bomhard {BIO 3123407 <GO>}

It's true.

Q - In-Yong Hwang {BIO 18784369 <GO>}

Sure. Okay. Thank you.

Operator

Our next question is from Andrew Ritchie from Autonomous.

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

Hi, there. First question, the flip side of the low rate environment is that it's very cheap to issue debt, and a number of your competitors or all of your competitors have been issuing debt in various innovative forms this year. Your gearing is very low, nobody needs debt, but what are your thoughts on potentially opportunistic issuance or even some - use of some potential facilities, given how low the gearing is and how potentially cheap the debt would be?

Second question, I'm just trying to working out the decline in running yield, you realized a lot of fixed income gains in Q2, and you appear to have derisked the gain, both on the fixed income side, on the equity side. Is there going to be an acceleration of yields compression, therefore, from this point? I know you've sort of lengthened duration a bit as well, but on the other hand, you seemed to have locked in quite a lot of lower rates very quickly. Just some color on the speed of yield decline from here would be useful? Thanks.

A - Jörg Schneider

Andrew, first on the issue of debt, we looked at it, we could issue up to at least five years for zero, if it's a normal debt without subordination. But what we do with the money then? Yeah. When we look how we have to invest if we want to make, let's say, yield of just 1%, we would have to take substantial risk and increase our risk capital requirement, our solvency capital requirement. Therefore, the attraction from our side is pretty low and the same applies for subordinated debt, because we couldn't easily replace equity for debt, which means our equity distributions are dominated by German GAAP considerations. We are in very good shape, so there is no bottleneck at the moment. But it wouldn't make a lot of sense if we increase our leverage. Yeah, at least that is my conviction.

Second decline in the running yields, yeah, there is always a response to the high disposal gains that it's speeding up a bit, but we still work on the assumption of a decline between 20 basis points and 30 basis points per yield. So it could be rather 30 basis points than 20 basis points, and that is our expectation at the moment.

A - Nikolaus von Bomhard {BIO 3123407 <GO>}

Let me only add one thing to the first. We are, and, of course, it's a harsh statement maybe to make, that financial engineering is not very high on our priority list. And if we issue debt of whatever format, we want to have a real, real relevant reason for it. So in the case of an M&A or something like that, I could imagine doing that, but we'd rather keep our powder dry and do not issue debt right now for the reasons, that Jörg mentioned.

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

Okay. Thanks.

Operator

Our next question is from Michael Haid, Commerzbank.

Q - Michael Haid {BIO 1971310 <GO>}

Good afternoon. Thank you for taking my questions. I have two questions. First of all, when I think about it, I was a little bit surprised by the €340 million FX gain, it is rather huge. And I wanted to know what was your motivation for taking this exposure, I mean, when an exposure works out well, then one probably should not ask any questions, but nevertheless, Munich Re is not known for taking these kind of bets and in the end, the Brexit would have not caused a loss for you. So, did you consider this as an investment opportunity, which, in this case, I missed or did you – and also I want to know whether you closed this FX exposure?

Second question on the normalized combined ratio, maybe it's a philosophical question. But, do you think of this at a normalized combined ratio of 99%, you are still value creating? In the end, the combined ratio is an IFRS figure, which mixes up discounting and various underwriting yields. So it may be meaningless. At what level, if one can say, at what level of combined ratio, you would no longer be value creating?

A - Jörg Schneider

First, these are not very high bets. Let me give you an example, in U.S. dollar, for example, we have more assets than liabilities in the order between $2 billion to $2.5 billion, yeah. So compared to an investment portfolio of $238 billion, this is not a huge bet, but we had enormous developments, enormous changes in exchange rates at the end of the second quarter. So, in a way, it's an outlier, but it is an absolutely – it's a willing position, deliberate decision of the board of management to have this over-coverage in U.S. dollar at times where we see a lot of uncertainties around us.

What's more, there's also some accounting distortion here. You know that we take the asset liability matching according to economic principles very serious. And the IFRS developments for the currency gains and losses are somewhat overstated here in comparison to the economic situation.

On your second question, at 99%, we are still value-creating according to our value-based management system. I can't give you the exact number, because it also has to do with portfolio shifts, with interest rates and so on. And also, I do not want to give somebody the opportunity to arbitrage ourselves, especially our clients, how far can he go in a way.

So, therefore, at the current level, we can still work with it. And for the IFRS accounting, we also have the additional earnings from the very strong balance sheet.

A - Nikolaus von Bomhard {BIO 3123407 <GO>}

And don't forget one thing, Michael, that the (47:59) for us and the steering of our non-life reinsurance is a proxy only. So, the steering starts from the different system and outfolds by the end combined ratio. So, it's kind of a backwards calculation. That is also why we are hesitant to be too specific. But one thing is for clear, what Jörg said, at 99%, we are clearly making, creating value.

Q - Michael Haid {BIO 1971310 <GO>}

So, the FX exposure was more for the reason of asset liability matching than any backdraw or anything like that?

A - Jörg Schneider

Mostly, yes.

Q - Michael Haid {BIO 1971310 <GO>}

Okay. Thank you very much.

A - Jörg Schneider

Thank you, Michael.

Operator

Our next question is from Michael Hawkins (sic) [Will Hawkins], KBW.

Q - William Hawkins {BIO 1822411 <GO>}

Hello. Thank you. It's still William, I think. Sorry, just I have one question, but just a follow-up on your answer to Michael, first. I don't understand, if you made a 1% profit on premiums on new business and you're telling us you're reinvesting at 1.5%, how on earth that could be value-creating. I just don't get the math.

But my question was, can you just remind again, I'm confused on your Solvency II ratio sensitivity to yield. You've talked about this before, but I'm still confused. You're acknowledging a very high sensitivity to yield movement, that's crystallized in the second quarter. The whole point about the UFR is to protect companies that have guarantee or long duration risk from that headline sensitivity, and the thing that I still find strange about your business is you show almost no sensitivity to the UFR, but a massive sensitivity to yields. So, can you just conceptually help me understand that?

And then finally, I'm sure this is a small number because it was at the full year, but you showed at the full year a sensitivity to a 100 basis point cut in the UFR of only 4 percentage points. What would that be today, please? Thank you.

A - Jörg Schneider

William, Jörg here. I hand over this question to Bernhard Kaufmann, our Chief Risk Officer, but first remark from my side is that the UFR kicks in dramatic only at the very long end and we have a lot of liabilities between 10 years and 30 years where the UFR doesn't play a major role, but Bernhard more specific.

A - Bernhard Kaufmann {BIO 18347993 <GO>}

Yes. Hi, Will. You have pointed already to the major issue, it's really about the duration and in our portfolio the music plays between 10 years, 20 years and 30 years and their view of our impact is rather low. And then also you have to consider that it's about the interest rate and development in different jurisdictions and in different currencies. So, it's also UK or U.S. where we saw a major declines in interest rate that also impacts the risk capital and it's mainly the increase in risk capital that drove our solvency ratio down. Owned funds were rather stable.

A - Nikolaus von Bomhard {BIO 3123407 <GO>}

And let me add one thing to your short comment on the 1% combined ratio, this is a little bit in Warren Buffet's language about the free float. If we get the premium upfront and we take a loss ratio pick and keep that money for a long time until the loss is finally paid out. We sit on that money and that produces return. So, it very much depends on the kind of business you write, the longer the tail and the much further out the point in time where you pay, a 1% combined ratio can be great. As a margin take the business which we don't write any more, but workers' comp, you could work with 140 combined and still make profit. So, it really, really depends on the very business.

Q - William Hawkins {BIO 1822411 <GO>}

Thanks, guys. Any sensitivity to the UFR, is it still very, very low?

A - Bernhard Kaufmann {BIO 18347993 <GO>}

Yes, that is still that the UFR sensitivity for our portfolio is relatively low.

Q - William Hawkins {BIO 1822411 <GO>}

Thank you.

Operator

Our next question is from Michael Siddall (sic) [Thomas Seidl], Bernstein.

Q - Thomas Seidl {BIO 17755912 <GO>}

Thanks. It's Thomas Seidl again. A follow-up question. So, two things on the growth side apart from last inflection, in the past you mentioned risk solutions being one of the alternative areas. So I wonder what organic growth, but even more importantly, what are you seeing in terms of inorganic growth you see in terms of risk solutions? Have you stepped up your activity given past success stories and doing some M&A in the risk solutions space?

And the second follow-up question, one of the extraordinary sources over the last years of income has been also deferred tax. I noted you had changed the accounting a little bit here. Can you give us an update how you see the risk that, for example, this year or next year, you enjoy similar benefits like over the last two years, three years on the deferred tax side? Thank you.

A - Nikolaus von Bomhard {BIO 3123407 <GO>}

Well, Thomas, we are incessantly working on our second HSB acquisition, so (53:15) the right target. But, you're right, in assuming if there was excellent growth, the likelihood of seeing it in the risk solution camp is by far the highest right now. So we would be ready if we run into the right target at the right price, we would not hesitate a second to execute.

So far ever since, we didn't run into any of those targets yet, which brought organic growth and you're also right in assuming that part of our business is the one that relatively steadily has been growing over the last years, mostly in the highest single-digit range. And of course, we will do everything to make sure that continues, so the relative share risk solutions (54:00) should most likely go up. With that, I hand it to Jörg.

A - Jörg Schneider

Yes. With regard to extra tax gains for the second half of the year, like that showed up in the last two years and there will be some, but far less than in the past. It's very simple reason. As Nikolaus said, we tend to set our tax reserves with the conservative bias to have there. So, where we are now, we set up the reserve and that translates then into later additional earnings.

But, some 10 years ago, we had a backlog in the tax inspections, we are having here on-site by the authorities of over 10 years. Meanwhile, we are close to being up to date. That means for the last couple of years, there was always the finalization of specific years more than one in one calendar year. So I hope that I could express it in an understandable way. That means in each of these years, two to three earlier years were closed years and produced their additional tax reserve releases. The same will not apply as of now because we are close to being update here – up-to-date. And therefore, I would give you the guidance, there could be some but not major amount at least as I know today.

Q - Thomas Seidl {BIO 17755912 <GO>}

Excellent. And maybe a follow-up on the risk solutions, would you say that the M&A pipeline is rather dry compared to last year in this area or is it the same as last year?

A - Nikolaus von Bomhard {BIO 3123407 <GO>}

It has been full all through the last years and it is full as of today as well. So we have enough out there that could be of interest, but as you also know not much did realize over the last years. I can't even give you kind of a sense for probability of execution on this one, it really depends and sometimes things then move very fast. One thing is for sure, the type of the situation out there for whoever owns those companies, the better for us.

A - Jörg Schneider

But, up to now, it's too expensive.

Q - Thomas Seidl {BIO 17755912 <GO>}

Okay. Thanks very much. Very clear. Thanks.

A - Jörg Schneider

Thanks, Thomas.

Operator

Our next question is from James Shuck, UBS.

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

Hi, there. Thanks for taking my follow-up questions. I just had a couple to circle back on. One is, just the looking at the level of realized gains in recent years, I mean, it's obviously led to a certain degree of volatility in your earnings in a way you saw that with your Q1 share price reduction and the Q2 share price reduction today. We're at a very elevated level though and going forward, I mean, presumably you derisk the portfolio as much as you're going to, certain things you can't predict such as derivative gains and loss and foreign exchange, et cetera. But, would you be expecting the level of realized gains before materially going into 2016 and beyond, that any guidance you're able to give around that would be helpful?

And then secondly, I just like to return to the point around the accumulation of losses around the $10 million and below level, could you just elaborate a little bit on that? What are the trends driving that? Is this just purely a Q2 thing or is this – is there a bigger pattern that play here? Thank you.

A - Nikolaus von Bomhard {BIO 3123407 <GO>}

Well, the question of the realized gains, I would not – I mean actually when we do the planning, let me start there, we normally do plan for very low level of realized gains. And then in the course of the year, things may change for different reasons, one thing is for sure in the ERGO life side we have to realize gains to fill the drawers of the interest rate sort of reserve as you know the German book that has and does, in fact, go through the P&L and that pushes up and you see that clearly in the second quarter, the realized gains.

From the reinsurance side where we don't have that kind of "an obligation," we have a freer hand, but it depends also on the repositioning sometimes of either our benchmark portfolio or our technical allocation which is done by (58:30). We have, in fact, asked all those involved to not do too much also because the bid and ask spreads are what they are, so every movement of an asset these days comes at a much higher cost than it used to.

Therefore, I would say as little as possible, but we cannot avoid with the interest rate level we have whatever we touch, I think we said it on the last two quarters also, whatever we touch in our asset book once we sell it, it creates a gain, that's a happy problem, but of course it creates volatility in the quarterly results. But going forward, we do not plan for that specifically and we try to keep it as low as possible. Yeah, Jörg.

A - Jörg Schneider

Let me make – one addition is that we hope and believe that the volatility of the derivative result will somewhat reduce going forward. So we have a little bit redirected our positioning here. And for example, we have lower amount of inflation derivatives onboard at the moment. So here you could see perhaps a little bit more of stability going forward. Back to Nikolaus.

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

May I just have a request actually? It would be helpful if you – on the realized gains, it would be helpful if you just spilt out the shareholders share as a realized gains, because it just takes a little bit of time to get there immediately because it's diluted obviously with the policyholders share in ERGO?

A - Jörg Schneider

James, we have split of the investment income in the Annex of the presentation. I think it provides you with not everything but with a lot of information on that.

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

Thank you.

A - Jörg Schneider

Nikolaus?

A - Nikolaus von Bomhard {BIO 3123407 <GO>}

Yeah. The second question that was the question on the $10 million losses either beyond that or below that level, that level of course has something artificial to it. By coincidence, the second quarter did show a couple of those losses just below that limit so that did not make it into the major losses and stayed with the basic losses, which was the reason why we think that normalized combined ratio is rather than 99% instead of the calculated 100%, at least one of the reasons.

We don't see a trend there. We follow up on these single losses. We did that recently on the life reinsurance side. We, of course, do that also with the manmade losses in general, but also for the risk solutions businesses. And whenever we think there is a pattern behind it, then, of course, we would react either with the models or with the limits that we set, or with the budgets we put up. So far, we cannot see any pattern with that, it's just random. And of course, in the book with the ticket sizes that we have, this happens and the €10 million, as I said, the €10 million, $50 million limit is chosen by us, but there is no let's say signs behind that.

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

That's very helpful. Thank you.

Operator

We will now have Michael Huttner from JPMorgan. Mr. Huttner, your line is open. Mr. Huttner, if you could just make sure that your line is open, and that it's not muted.

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

Okay. I think Michael is not on the call any longer I'm afraid. So thanks to everyone for joining us. Thanks for spending your time with us this afternoon. I hope all your questions have been answered. And we are happy to follow up on any further questions with the IR team if you just give us a call. Thank you very much, and hope to you see soon. Thank you.

Operator

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