S1 2020 Earnings Call

Company Participants

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

Other Participants

- Andrew Ritchie, Analyst
- Edward Morris, Analyst
- Farooq Hanif, ANalyst
- James Shuck, Analyst
- John Urwin, Analyst
- Jon Hocking, Analyst
- Michael Haid, Analyst
- Michael Huttner, Analyst
- Nick Holmes, Analyst
- Vinit Malhotra, Analyst
- William Hawkins, Analyst

Presentation

Operator

Ladies and gentlemen, welcome to the Zurich Insurance Group Half Year Results 2020 Conference Call. I'm Sandra 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. The presentation will be followed by a Q&A session (Operator Instructions) The conference must not be recorded for publication or broadcast.

At this time, it's my pleasure to hand over to Mr. Richard Burden, Head of Investor Relations 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 2020 results Q&A call. On the call today is our Group CEO, Mario Greco; and our Group CFO, George Quinn. When we come to Q&A, we kindly ask you to keep to a maximum of two questions, and if we have time, we will come back to additional questions later in the call.

But before we start with the Q&A today, Mario will just make some introductory remarks to the results. Over to you Mario.

Mario Greco {BIO 1754408 <GO>}

Thank you, Richard. Good (Technical Difficulty) the first half of 2020 has been an unprecedented period with unforeseeable events ranging from a global pandemic and recession to civil unrest and higher rates of natural catastrophes. Throughout this period, our priority has been to support our customers in local communities, while ensuring the safety and well-being of our colleagues, with this being rewarded with increased levels of customer satisfaction and employee engagement.

The pandemic will have lasting effects. And from the start of the crisis, we are focused on understanding these and adapting our thinking to ensure that we can continue to drive the business forward and deliver on the plans presented last November.

The business developed well in the first six months of the year in spite of all these uncertainties. In Property & Casualty, our commercial business reported a strong growth following the improvements made to the portfolio in recent years, with our commercial businesses seeing stronger development than similar businesses at our peers. We are in a strong position to benefit further from both the improved pricing environment and the restructuring taking place at peers.

Pricing improvements have continued to broaden out across geographies and business lines over the first half of the year, and we expect them to continue thoughout 2021. In May, we told you that we expected $750 million of Property & Casualty claims for the full year related to COVID-19, and like for many others, this number remains unchanged and has been fully reflected within our first half results.

In our Retail business, our investments in digitalization has paid off, with our business remaining very resilient. The further falls in investment yields over recent months has increased the pressure on more traditional life business models and confirms that our strategy of focusing on protection business in capital-light savings products ready for over a decade is a correct one.

Our key distribution channels have seen a steady recovery in sales activity over the most recent months and we are optimistic for an improved second half performance of our life business. Over the first half, the Farmers Exchanges continued to support their customers, refunding $300 million in respect of lower frequency observed during lockdowns. Although this came at the short-term costs to the results of Farmers management services, I am confident that by earning customers' trust Farmers will benefit in the longer term.

Our balance sheet remains very strong, providing us with significant flexibility to fully take advantage of the growth opportunities presented by improved commercial pricing and the retrenchment by some competitors, as well as growth in more digital retail business.

While the operating environment has seen changes, our goals remain unchanged, and I am confident in the strength of our business, our strategy and our ability to adapt to changing circumstances.

Thank you for listening, and now, we are ready to take your questions.

Questions And Answers

Operator

We will now begin the question-and-answer session. (Operator Instructions) The first question comes from Jon Hocking from Morgan Stanley. Please go ahead.

Q - Jon Hocking {BIO 2163183 <GO>}

Good afternoon, everybody. I've got two questions please. Firstly on the outlook for P&C revenues. For the first quarter stage you were cautioning somewhat on the outlook given the economic air pocket we hit. You're now guiding for flat in the second half. Is that an upgrade in your underlying volume assumptions or are you just reflecting what you've seen in terms of rate momentum in the first half? That's the first question. And then, second question on the rate momentum, specifically in EMEA business, can you give some color, please, in terms of which markets have seen that in the second quarter and how sustainable you think that might be for the rest of the year? Thank you.

A - George Quinn {BIO 15159240 <GO>}

Thanks, Jon. It's George. So I'll take those questions. So on the P&C top line topic, I had said at the Q1 call that, I mean despite a significant growth, we saw over up 8% in Q1, my concern is, given the way that the economic situation was developing that we would see some reversal of that in the second half and maybe would be flat to down. I think this is an upgrade compared to what we saw ourselves back in Q1. You've got a combination of actual growth on like-for-like interest rates, partly offset by the foreign exchange rate. So you got actual growth -- relatively small, but actual growth partly offset by the impact of foreign exchange headwinds that we've already partly seen in Q2. So I'd say that we are certainly from a top-line perspective slightly more optimistic than maybe I was when you heard me talk on the Q1 call.

From a pricing perspective, I mean what we see around the various markets is mainly a commercial story and that's also true in Europe. So if you look at the rate we saw in the second quarter in Europe, we've seen the pricing environment, rate momentum has doubled, they were up from 6 to 12 on European commercial pricing. I mean as you'd expect, the major commercial markets are the main driver of that, and that will of course be the UK just given the nature of what happens there.

I think from a retail market perspective, we don't see anything like that kind of rate momentum across the other markets. And in fact, I think, we would be probably slightly more cautious for the outlook given that the -- especially around auto the market seems to become a bit more competitive. But just given the size of our book on the commercial side, we will see a much larger benefit from the commercial rate than the potential impact we'll see on the personal line side.

Q - Jon Hocking {BIO 2163183 <GO>}

And given you mentioned in the release that you're pricing ahead of claims inflation, how are you seeing claims inflation in the European business versus the US business on the commercial side?

A - George Quinn {BIO 15159240 <GO>}

Because I'm a nice guy, okay, I'll give you a third question. Like anyone else, I'd ask you, if you have a third question later in the call, please come back at the end so everyone else gets a chance to ask.

Q - Jon Hocking {BIO 2163183 <GO>}

Sorry, George.

A - George Quinn {BIO 15159240 <GO>}

No problem. So on claims inflation, claims inflation is maybe -- it's probably more in line with what we talked about in Q1. We haven't seen any significant pickup. There has been some discussion about whether the very short term trends that we saw that would actually imply a reduction and social inflation are somehow something that we'd expect to continue, if [ph] we don't. I think the only significant changes we've made in the -- the current year PIKs for the US business, in some of the lines, a good example would be excess GL, we have a substantially higher PIK in the current year than we had in prior years. But from a social -- from a claim inflation perspective, we don't see it rise significantly above the level that we saw in Q1.

Q - Jon Hocking {BIO 2163183 <GO>}

Thanks so much.

A - George Quinn {BIO 15159240 <GO>}

You're welcome.

Operator

The next question comes from Farooq Hanif from Credit Suisse. Please go ahead.

Q - Farooq Hanif {BIO 4780978 <GO>}

Hi, there. Thanks very much. First question just following up on the top line comments. So I can see where you are this year and it's a complicated year with lots of moving parts, but if you still had mid-to-high single digit pricing later in the year, it looks like that's going to continue. If you saw second wave impacts on the economy flattening out, so the retail business comes back, and obviously Cover-More falls out, I mean what do you see as an underlying growth rate here, is my ultimate question? And what does that mean for next year? Question one.

And question two on the life business, in your guidance, it's a recovery, but not that much if you add back the COVID impacts that you've talked about in 1H. So is that because you're factoring in further mortality, some more fee-based write-down? I mean just could you talk a little bit about where that $700 million comes from, what assumptions are baking in? Thanks. Yeah. Thanks Farooq. So on the top line comment, I think if we have the scenario that you suggest and we maintain rate at these levels, you can then translate rate on that part of the portfolio, which of course is not the totality of the portfolio. So you're not going to see mid to high single-digit rates everywhere that we operate. But I mean, just given the size of the commercial book, given the weight of North America and the UK in that business, if we see that economic stabilization we will start to see that feed straight back into top line in 2021. I mean if we talk about recovery scenarios, I think probably a V type recovery feels a touch optimistic for me at the moment. I don't know how things are going to progress. But certainly, if we have what you describe, you would see a more -- my outlook will be more bullish if I assumed what you've described. On the life business guidance, so the short answer to your question is, yes, we have left in an assumption about some effects continuing in the second half. So we have both an assumption that claims continue to be present in the results of some of the larger protection businesses in the second half and we also have some assumption around the impact of -- the secondary impact of markets on both fees and on DAC. So you shouldn't assume that the $700 million is a clean run rate. I mean we won't get to a clean run rate until we put all of this behind us and I think that's going to be, hopefully, as we move into 2021, but it does still include impacts from COVID in the second half. That's great. Thank you.

Operator

The next question comes from Edward Morris from JPMorgan. Please go ahead.

Q - Edward Morris {BIO 16274236 <GO>}

Hi, everyone. Thank you for taking the questions. The first one is on the frequency benefit that you saw in the P&C division. You've given us a figure of $303 million as the net benefits after your premium refunds and voluntary actions. Am I right in thinking that the difference between the gross benefits and this number is $100 million that you're talking about? And can you explain what we should expect for the second half, because obviously the claims figure that we have is a full-year figure, whereas this is really just a Q2 benefit that you've seen on frequency? So how that might play out in H2 would be helpful.

And then the second area is just on ZECM yeah. I think the benefit from markets was probably a little bit less than some of us had been expecting in Q2. And obviously, you still have reasonably high sensitivities to interest rates and credit spreads. So can you just remind us of the tools at your disposal if markets go against you in the second half and at what level you would start to put those plans into place? Thank you.

A - George Quinn {BIO 15159240 <GO>}

Yeah. Thanks, Edward. So on the frequency benefit, so I apologize in advance that it's going to sound as though I am dodging the question. I'm not really. Just, obviously, I don't know precisely what's going to happen. I mean would I expect there is still some frequency benefit in the second half of the year? Probably, I don't expect it to continue at the same level that we've seen in the first half of the year. Your number was roughly correct. So the benefits that we've returned in a number of markets is approximately that level you've indicated, $100 million. So there should be some frequency benefit. And then the other unknown at this stage is, of course, what then happens with that. I mean is it in markets where -- just given where our customers are, it's something we feel we should return, or is it in markets where then the overall portfolio is just part of the up and down and we would retain it. So I can't give you very clear guidance other than I expect the gross number to decline significantly in the second half in terms of net benefit to the firm, I'd find that pretty hard to estimate today.

On ZECM, you are absolutely right. So the benefit from markets is certainly less than the sensitivities that we've provided would suggest. I think it's important to recognize that -- actually, we did have a very significant benefit on the available capital from the market movements. The challenge has more been the required capital. I mean that's still very high. There is a number of reasons for that, I mean partly interest rates over the period, but partly also the fact that some of the hedging that we put in place -- obviously, we didn't hedge at the bottom, but nor did we hedge at the June 30 levels either. So we're obviously far more of over the money than we were and of course, the protection that that affords us in the tail of the capital model is just less.

Now, the good news on the other side of that, of course, is if markets reverse directions, you would have a different sensitivity to the one that we've been accustomed to. So what would we do if we see further significant market movement? Really important to appreciate that ZECM at 100 is not a cliff. So we're in the green zone or amber zone would extend, but lower is for another 10 points. And also important to remember is that ZECM of course is our own methodology. We're not going to create a problem that doesn't exist for the industry at large. So I feel comfortable with the financial flexibility we have. We've got significant space beneath us if we need it. I think we're well positioned from a risk perspective. And some of the things that we've done to protect the portfolio would continue to benefit us if we see some market reversal in the remainder of the year.

Q - Edward Morris {BIO 16274236 <GO>}

Okay. That's great. Thank you.

Operator

The next question comes from John Urwin from UBS. Please go ahead.

Q - John Urwin {BIO 13389830 <GO>}

Hi. Hope everyone is well. Thanks for taking my questions, two, please. So firstly, just back to the pricing and claims inflation dynamics. So it sounds like claims inflation hasn't moved much since Q1 implying that most of the 2Q acceleration in pricing ought to be beneficial for margins, so basically. I'm just curious to understand how much of this 8% price increase booked in 1H can drop through to the bottom line net of loss cost inflation and potentially higher reinsurance costs? So any color there would be great, please.

And then, back to capital. It looks like we're going into hard market, you said ECMs are at the low end of the range. We all appreciate that it's very conservatively calibrated with your own internal metric and the like, but just please could you comment on the adequacy of the balance sheet to withstand potential volatility and to capitalize on repricing because presumably you're in that risk type on the underwriting side in this environment? Thank you.

A - George Quinn {BIO 15159240 <GO>}

Yeah. Thanks, Johny. So on the pricing topic, maybe just to give a bit more color on the claims inflation topic, so I mentioned earlier that, I think while the -- our overall view of inflation across the book hasn't really changed significantly, we did make higher initial loss ratio selections on some of the US books. So within the overall improvement that you see today, there is more than 0.5 point of deterioration in the starting point for the US book. So like-for-like, we actually have a more than 0.7 point improvement. So I think that puts us in a better place. We are clearly entering a, let's call it that, harder phase of the cycle and it's important at this point that we're actually more conservative on initial loss PIKs and be able to build up some buffers for the future. But despite that you see it come through. So if you're thinking about how much of what we're reporting should drop through, obviously, you need to analyze it and break it down a bit. So this is the commercial book, this would be the CI part of North America, rather than North America at large. It doesn't include crop for example. There's obviously a number of people who benefit from the growth improvement apart from us and that includes distribution.

I mean given the part that we retain, that would be a very significant benefit to the Group across both the US and the UK, given the scale of those two businesses. You would expect to see that partly in the second half. So we certainly anticipate that you will see further improvement in the second half of the year. And you'd expect to see that continue into the beginning of next year, even if for some completely inexplicable reason, all ran away, which is not likely of course.

From a reinsurance perspective, from what we've seen at the July 1 renewal, I would characterize the -- the cat side of the renewal has certainly been more of a terms and conditions topic for reasons that I'm going to guess everyone can completely understand. From a price perspective, not a major driver of that capacity. I think the bigger issue is simply the availability of the reinsurance or other forms of capital to allow you maybe to take more cat risk. And if I think of -- are we constrained in any significant way at the moment, actually not by capital topics, it's more about pure risk appetite. So as we look to the early phase of our planning for next year, of course, one of the things that is hard to miss is that you've got property cat market that's quite a large part of that price increase I referred to earlier, but in the end, we've concluded that we are pretty happy with the cat exposure that we've got, and we think that what we have and the approach we've taken is more consistent with the commitments we've made rather than to try and chase what in theory could be a higher ROE, but at the expense of significantly more volatility.

On the capital adequacy topic, maybe just to add a few comments to what I said to Edward earlier. The sensitivities, we will update them in due course. They are impacted by the changes that we've made to the portfolio through the course of the year. We don't have the number for reasons that would be perfectly obvious to everyone. But just a reminder again that $100 million is not cliff. If you look at us from a comparison to industry, we've talked previously about our view of the possible delta between SST and Solvency II, and that's SST as we calibrate and we agree it with our lead regulator and based on what we see for the European businesses, a 90 point difference would give you a sense of what the gap could be. You can't apply that everywhere, but it just gives you a sense of the scale of where we would be if we report in Solvency II. So I don't want to sound relax. I don't want sound complacent. But given the flexibility that we still have on ZECM, given the position that we have from a real risk perspective, given the comparison we have on SST if you're prepared to adjust, we feel fairly comfortable with where we are on capital.

Q - John Urwin {BIO 13389830 <GO>}

Thank you.

Operator

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

Q - Andrew Ritchie {BIO 18731996 <GO>}

Hi, there. First question, COVID claims the $750 million number, I mean, since you came up with that estimate back in May, I think lockdowns probably ended up a little longer. There has been probably more proliferation of court cases, not just the FCA case, but plenty of other cases in other jurisdictions. So maybe just give us a sense as to why or what additional work you've done to audit any avenues for COVID claims, and I'm thinking particularly BI, to still be confident in reiterating that $750 million, plus I guess the $250 million from the FCA case which I'm assuming hasn't changed as well?

Second question, George, maybe this links back to, you mentioned that you've made your initial loss PIKs more conservative on US excess liability. I wonder does that affected just this current year or other years? I mean, on the topic of reserves, the PYD was quite low in the US and actually adverse in Australia. So maybe just give us a perspective on how you see reserve adequacy, what the latest spot check is, and whether some element of that was just prudence in recognition of any positive just at this juncture given all the various uncertainties on claims? Thanks.

A - George Quinn {BIO 15159240 <GO>}

Yeah. Great. Thanks, Andrew. So on the $750 million, so the number is obviously the same, the components are broadly the same. I mean, the absolute quantum of some of them has moved around a bit as you'd expect. We've run a bi-weekly process actually prior to the Q1 release, so we have a specialist team of underwriters, the claims team, the actuarial team, and as you can imagine, we've been scrubbing this stuff from very early on. I'd say that quite some time ago the numbers have become reasonably stable. So it's not that they don't move around at all, but the discovery of new issues slows down and that stops at some point. And if you look at was changed from today, so you've had state today that I think in contrast to the qualifiers or the qualifications around the $750 million in Q1, where we talked about the exclusion of various things. Now, we're saying that for the incurred events, this includes everything, including the third party component that you raised on the Q1 call, so what do we do? I mean the due diligence process is just continuing to challenge. We look at what we hear reported from the market. We have talked externally to others to get a sense of what their impressions are what's happening on D&O for example. There are parts of the portfolio where there is fairly limited experience and a slight -- zero claim notifications, but we have put reserves to it.

I think the other thing that's worth saying is that when we established the $750 million, and I think I described as a scenario in Q1, that was not the best estimate number. It was intended to be, let's call, a moderate downside scenario. So did anticipate a number of things that just hadn't emerged at that stage. So I think, we still feel pretty confident around the figure. There are risks you pointed out, some of them -- so the FCA topic is one, we've got -- we are part of the industry topic in Australia, albeit is a relatively small part of our overall portfolio. And we will see other coverage topics run through either some form of coverage process or one of these regulator sponsored processes that'd come clear in due course.

Probably also what point at this stage that IBNR is a bit less than half of the number. So this is not a case reserve in its entirety, we still have a number of areas where we're making estimates based on scenarios, based on our expectations and not based on claim notifications from clients. So I think the uncertainties are really around those coverage topics and that will remain until we get clarity from the various processes. I think the estimate around the FCA process was $200 million, I think rather than $250 million.

And your sharp eye on the loss PIK has picked out something on the PYD as well. So on the US side obviously we can have a higher loss PIK in the current year and ignore the prior years. So we have made sure that the prior years are entirely consistent with the current year's and the first half of this year. Now the reason that doesn't have a bigger negative impact is that -- and this will sound like groundhog day, I mean workers' comp continues to throw off substantial surpluses. But I think my perspective for it is, technically, if I look at the confidence interval information from the actuarial team, it hasn't moved at the end of the quarter. I think if you look at it more from a pragmatic perspective, we haven't been aggressive on workers' comp. I would suspect at the moment assuming that current trends don't completely reverse that you will see further positive development on workers' comp in due course. So overall, we feel pretty happy with where we stand from a reserving perspective, but having a higher loss PIK on the current year for casualty in the US, as I said, I mean, it feels like a good way to start the year even if it sounds like a bit of negative.

Q - Andrew Ritchie {BIO 18731996 <GO>}

Okay. Great. Thank you.

Operator

Next question comes from James Shuck from Citi. Please go ahead.

Q - James Shuck {BIO 3680082 <GO>}

Hi. Good morning. So two questions from me. Firstly, on combined ratio. So it looks like H1 normalizing about 95.2%. We've talked about the rate being up pretty significantly and some of the volume impact. So I guess I'm looking for a bit more guidance about how that rate will feed through into next year? You might as well see some negative mix effects from travel and warranty, et cetera, and you talked about setting the loss PIKs being more conservative, but equally, you've got investment income coming down, and that will earn through. So just trying to get a bit more of a feel for the extent of that improvement. And also if you expect the expense ratio is still to come down as well.

Second question you talked through the presentation about strong central liquidity. I couldn't see a number anywhere. Quite keen to understand what that level of central liquidity is? To the extent that you won't answer that question, perhaps you could instead answer, why the commission ratio in H1 didn't get better, because obviously we've seen that commission ratio come off as you grow in the travel book and it could be the extended warranty business, all of that pulled back and yet the commission ratio hasn't come down? Thank you.

A - George Quinn {BIO 15159240 <GO>}

Yeah. Thanks, James. And so on the combined ratio, I think if you think of it in terms of what's on the investment income side. I mean you can see that the interest rate effect is already evident in the first half of the year. We've talked about it already back-end of last year. We've given sensitivities in Q1, that the 100 basis points is about $100 million per year for five years. I mean well, it seems clear to me that the combined ratio is going to more than compensate for that. And if we had a couple of points of improvement in this combined ratio over where we started, that would leave you roughly in the same territory. I expect that -- the current outlook around pricing, my guess is, that continues well into next year. I don't think it will start to slow down rapidly just given that there is a number of the factors that I think drive this will continue. Now, precisely how that feeds into the results given the mix, I think you'll see it continue to improve.

Now, whether I would -- I don't want to give a short-term prediction around the combined ratio because of course, there can be some volatility from claims, but certainly the trends that you've seen over the last 18 months, I don't see any reason why they go away from a longer-term perspective, and in fact if anything, for the reasons that you gave, why wouldn't that improve at slightly faster rate. Apologies, that's a slightly coy way of putting it, but it gives you a reference point to go back to and maybe make your own estimates.

So you're absolutely right, I'm not going to put a number on what strong central liquidity means. I think the thing I have said already this year is that, early in the year there was a lot of discussion around the stance of regulators both for the topco level and the payment of dividends and also at the Group Company levels, at the Intragroup payment of dividends. And they are concerned that would weaken the system in some way. I did make the point to investors and to you guys back at Q1 that in the very unlikely scenario that we would have a complete halts on dividend flows, we still have sufficient central liquidity to address liquidity needs that allow you to fall due at the end of the year, assuming that the Board makes a decision that would be in line with past experience. So I think liquidity I don't see is an issue for us. Also for the fact that a complete halt to liquidity is so unlikely given that we've got a huge chunk of it coming from fees that aren't subject to that issue we talked about earlier. So I just don't see liquidity being a significant issue for us.

On the commission ratio, why they are not getting better given that we've seen a drop off from volumes, I think you should see it improve a bit as we move into the second half of the year. And we need to go a wee bit careful because some of what we've -- we've a lot of maybe around some of the mass consumer business for example in the Brazil market, the German team have done reasonably well on holding up their end, but the earning effects of these things, I think, you'll see a bit more in the future come through rather than you see in this first half because obviously it's very hard to go back to people, to agents and distribution and in every case, get the commission back. So I think it's more the earnings effect that you're seeing on the commissions ratio for the time being.

Q - James Shuck {BIO 3680082 <GO>}

Okay. Thanks, George.

Operator

The next question comes from Nick Holmes from Societe Generale. Please go ahead.

Q - Nick Holmes {BIO 3387435 <GO>}

Hi, there. Thank you very much. Just a couple of quick follow-ups. Coming back on ZECM, could you remind us, if the ratio goes below 100%, at what level is the dividend threatened do you feel? And then, secondly, coming back on P&C pricing, where do you think we are in the hard market at the moment, have we kind of reached the peak? I mean sorry, it's a very difficult question to answer, and obviously, it depends on different products. And also, low bond yields, will they make this hard market different this time around, or will they make it last longer do you think? Thank you.

A - George Quinn {BIO 15159240 <GO>}

Yeah. Thanks, Nick. So on the first point, so just to remind you how the system works, so we have a target range of 100 to 120. We have a 20 point range above 120 to 140, which is I guess officially seen as amber, i.e., leading to plan to address that excess level of capitalization. And we have a 10 point level 90 to 100 beneath it, where there is an expectation that we'll do the same, but in the opposite direction. So plan, take into account the direction of markets, the trends that we have in our businesses and come to decisions on what we would recommend to do to restore capitalization back into the target range. So the short answer to your question is that, dividends are threatened at level that's way below the current level of equity.

And I think I'm going to repeat something I said at Q1, I think, there is a forward-looking element, that's what we do here, we've talked in the past about how do we think about dividends. And as part of it, which is a about what we've earned, the underlying performance, but there is a more important part of it, which is, what do we see in the future. And I think if we get to the end of the year, if the outlook that we have today holds up and we see that significant strength and we don't have wave two, wave three, wave four, I don't think we'll be troubled if the capitalization level was lower than it is today, I think, we would still do what you would expect us to do in those circumstances. But conversely, if we get to the end of the year and capitalization is high, the whole industry is on the edge of something that's far more darker than what we're currently seeing, I mean you may expect us to be more conservative. But I mean hopefully you can judge from the tone of the communication today that that's not what we expect. I mean there is still significant uncertainty through the second half of the year, but I mean we feel we're well positioned to manage that. And more importantly, from an outlook perspective, the things we've discussed around the pricing trends, I mean that's a more significant positive factor than we would have allowed for when we set the targets last year.

On the hard market topic, have we reached the peak. So recognizing the I'm the guy that thought the peak was about 18 months ago, you're probably asking the wrong person. If you look at the points you raised, is interest rates going to be a significant factor here, I am pretty sure it is. If you're not pricing this thing from a technical perspective, how as an insurance company are you going to make any money for the next several years. So this is a significant disciplining factor. And in fact, of course, in this market where we operate, I would argue that it's generally pretty disciplined around that topic anyway. So the cause and effect has been well demonstrated in the past and I would expect that to have a significant sustaining effect on the current market price trends as I mentioned earlier.

Q - Nick Holmes {BIO 3387435 <GO>}

Thank you very much. And sorry, just very, very quick follow-up with an impossible question to answer, but if bond yields don't move higher, would you expect the hard markets to last? I mean it will come down from a peak level, but to last full well into 2021?

A - George Quinn {BIO 15159240 <GO>}

So today, just given what -- that the market is still going up. I mean if we look at the July price levels, it hasn't doubled on what we've seen today, but you still see another step in the right direction. It's hard for me to imagine at the moment, but that's certainly going to turn and reverse. Would it be reasonable to assume that it slows down in terms of the rate of entries? Absolutely. But I expect it to remain at a pretty high level through the end of the year. And of course, that will benefit all of 2021's earning.

Q - Nick Holmes {BIO 3387435 <GO>}

Great. Thank you very much.

Operator

The next question comes from William Hawkins from KBW. Please go ahead, sir.

Q - William Hawkins {BIO 1822411 <GO>}

All right. Thank you. George, can you just clarify, first of all, you made reference in answer to an earlier question about the 90 percentage point uplift for your European operations to Solvency II from SST. I thought you might have made a point on the first quarter of saying that it was no longer that high but still material. And so I just wanted to check, if you're saying that now, is that because of the way the markets have bounced in the past quarter? Or did I misunderstand what you said at the first quarter, please? And then related to that, and again, I think that number you're referring to and the last time you did that math it was quite a while ago, can you remind us what does that actually mean for the Group? Will we dilute that number massively, or will we take it a lot higher? Because again the European business is pretty small for you.

And then, secondly, please, can you just remind me when you calculate your payout ratio, how would you intend to treat the COVID losses? Would you normalize them out to get to what you call sustainable earnings or would you be keeping them in?

A - George Quinn {BIO 15159240 <GO>}

Thanks, William. So on the first one, sign of my advanced age, I can't remember some of that from Q1. So if I go back to Q1, and I'll tell you where we stood in Q1, I think, if we had strictly applied the same mathematics, you would have got much higher number. But there are reasons for that, including the fact that some of our businesses have transitionals in them and that's not a reasonable way of trying to judge the real gap between Solvency II and SST. So I eliminated that and it left us roughly -- and I think more by coincidence than anything else, at the same level, the 90 points. So if you're going to take that and apply it to the Group, what do you have to do with that? So complicated, I guess, is the short explanation, which is a way of saying, I don't really know the answer precisely. But obviously, you couldn't apply it to the entire Group. You'll have to think more carefully about where the US business is, which set, but again there, if we took the approach that some of our European peers do, you set target capital level and everything excess of that would be surplus, you came to the calculation and for us, of course, the largest external business is the North American one, and we have a very substantial surplus over I think what would typically be a target capital level from a European perspective.

So I mean long story short, my guess is, it's not 90 points. I'd be surprised if it's really that level, but equally, I would be surprised if it wasn't at least say, for example, half of that number just looking at what we've seen elsewhere in the Swiss market from people who have actually done the thing bottom up. But it's a gut feel and intuition rather than something I can mathematically prove to you.

And on payouts, so it's a good question. In fact, your back to 2017. And while I don't think it's quite the same circumstance when we had the hurricanes at the end of the year, we did a look through them, I think we would do the same with any event that's clearly temporary. And I think when it comes to COVID, depending on what we foresee at the end of the year, but let's assume that everyone starts to get on top of this, and to get it under control or to find a way that we can live with it, I think if you look at the components today, you'd have to make an assessment of what's temporary, which certainly feels like the absolute vast bulk of it, and what may have some residual impact into 2021 and then maybe some elements that continue to have some impact next year. So for example, I mean we take a brave prediction to assume that the Latin American economies would recover maybe quite as quickly as we might see elsewhere. So I think I may not just pick up the entire COVID number and carry it across, maybe I would look at it a bit more carefully before to say I think how I would allocate. Although maybe just to point out, of course, the 686 COVID number we've given across the entire Group doesn't include the FX topic and LatAm. Hope that helps.

Q - William Hawkins {BIO 1822411 <GO>}

So you've mostly added it back, but not all of it?

A - George Quinn {BIO 15159240 <GO>}

Correct.

Operator

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

Q - Vinit Malhotra {BIO 16184491 <GO>}

Yes. Good afternoon. Thank you. So my two questions please. First one is the Slide 20, George, has the newly named retail and SME segment, combined ratio being sort of flattish. And I'm just a bit curious, we talked about $300 million plus -- say $350 million of frequency gains. And I'm just surprised why it hasn't yet shown to this AY or -- well maybe because you've excluded the cats here, but is there any comment on this number being sort of flattish? I know in the commentary there is something about Asia-Pac. But if you could just comment a bit about that retail and SME segment, that will be great.

The other one is, the EU price acceleration comment, which I found interesting as well, because -- I mean -- which areas are or what reason is there for this acceleration in EU, is it business interruption because of COVID because social inflation wasn't really the topic in the EU, right? So if you can just comment on why European prices are going up? Thank you.

A - George Quinn {BIO 15159240 <GO>}

Yeah. Good. So I think on the first question. I think your assumption about the possible answer is correct. So that excludes the cat and the frequency impact. So as you look at that, you can't frame the frequency benefits because we've tried to normalize that to show you more like-for-like, so apologies for that if that wasn't clear.

On the second point, again, I think you're right. You don't see some of the same drivers. So if you look at price trends in Europe over a longer period, you haven't seen it react in quite the same way that the US had reacted already well more than a year ago, because again, you don't see quite those same social inflation issues. But other things that drive availability. So the claims topic that you point to, so the BI experience, the capital impacts, the challenges that a number of markets have suffered, and you've seen them adjust their approach, so capacity has fallen for a whole range of reasons. So while I wouldn't necessarily predict, you'll see the European commercial market reach the same heights as the US market, obviously, the change that we have seen over the course of the first and second quarter is driven by some similar themes, just not all are present as you pointed today.

Again, for the same reason that I expect the price movement in the US to be about -- I hate to use sustainable, that's not sustainable, but I expect it to continue through the end of the year. I think the same is true for Europe on the commercial markets. So we are pretty bullish on the outlook for commercial pricing US, -- some US and Europe or North America and Europe. LatAm has been a bit more variable, but it hasn't been impacted really by the same topics. And Asia-Pac, which for us given that our largest exposure is really in Australia, that is moving, but I mean in general for other reasons. And so I think we're confident you'll see this price trend continue for some time.

Q - Vinit Malhotra {BIO 16184491 <GO>}

Thank you.

Operator

The next question comes from Michael Huttner from Berenberg. Please go ahead.

Q - Michael Huttner {BIO 21454754 <GO>}

Thank you very much. Yes. Hi, George.

A - George Quinn {BIO 15159240 <GO>}

Hey, Michael. Good to hear you.

Q - Michael Huttner {BIO 21454754 <GO>}

Yes. Sorry, George, exactly.Thank you very much. And I think I'm the one who is not here. Just two very quick questions on (inaudible) sadly, anyway. On the cash flow. I know you never provide guidance, but I think if I frame the question in terms of the experience of 2015 or maybe 2017, you might be able to kind of address it. So last year, $3.4 billion, previously I think $3.9 billion, guidance somewhere around between $3.5 billion and $4 billion or target for next 2020 to 2022. When you have big claims in events like COVID, do they affect the cash flows this year, for now? Or do they affect the cash flow next year? In other words, where will I look at the sensitivity to this?

And then the other question is incredibly lightweight, but you know last year you did this incredibly opportunistic deal where you bought QBE for, I'm not saying a song, but it wasn't a very high price, under the nose of -- there were two of them -- under the nose of your two big competitors when they were looking elsewhere. Are you looking at deals as well at the moment because you are the one which can afford to be a bit opportunistic at the moment? Thank you.

A - George Quinn {BIO 15159240 <GO>}

Thanks, Michael. So on the cash flow topic -- so thank you for pointing back to the '17 year. I think that's a good way to illustrate what happens. So if you think of the effects, our cash flows typically come in two more significant chunks. So we get some cash flow at the beginning of the year, and we take a typically larger cash flow towards the end of the year. And what that means for me is that, you'll see an impact on this year's cash flows, and unless something extraordinary happens, you'll probably also see some impact on next year's cash flows and the early part of next year as people declare the year-end dividends. From a quantum perspective, you're absolutely right. I'm going to avoid making short-term predictions and I could probably only reiterate what I said earlier that, on the one hand, we're not dependent on it, on the other hand, the system as it's currently structured, obviously, has quite a bit of resilience baked into it, but we won't be immune, that's for sure. So we'll certainly see businesses that will produce less profit and therefore, they will dividend less cash to us as we come up to either the end of this year or beginning of next year and then there is, of course, some regulatory risk. I think as we look across our book, I don't see that that has really shifted, but I mean we won't really know where that stands until we get to the end of this year and regulators take a view on the trajectory of the market and the risks. But I think from a cash flow perspective, for all the reasons I've just given and given earlier, I think we are in a good place.

From a deal perspective, I think as you point the case, I think it's a bit quiet at the moment. There is not an awful lot going on. I think people are maybe focused on other topics. I think there's some expectation that maybe this will drive some people to look at portfolios and maybe address some of the things that they were prepared to tolerate, because they could and maybe they are reevaluating now. I mean if things do come up with a strategic and financial goals, we would certainly take a look, but I don't want to give anyone the impression that there is something imminent. The market is reasonably quite at the moment.

Q - Michael Huttner {BIO 21454754 <GO>}

Thank you very much.

Operator

The last question comes from Michael Haid from Commerzbank. Please go ahead.

Q - Michael Haid {BIO 1971310 <GO>}

Thank you very much. Good afternoon. Two questions I'm afraid on the ECM ratio. You are at the lower end of your target range. I understand the 10% range on the lower end and the 20% range on the upper end, which you mentioned. But my question is, did you take any management action in the second quarter to stabilize this ZECM ratio? Or do you plan also some actions in the second half maybe on German life business for instance, policyholder participation whatever, duration lengthening, whatever? And the second question, how did the higher pricing in P&C effect that ZECM ratio, is it possible to isolate this effect from operating capital generation? May be it is not possible.

A - George Quinn {BIO 15159240 <GO>}

Are those the two questions, Michael? Or is that question one?

Q - Michael Huttner {BIO 21454754 <GO>}

These were my two questions.

A - George Quinn {BIO 15159240 <GO>}

Excellent. All right. I don't want to start in case you're going to ask me a third question-- maybe another question of a different kind. So on the ZECM topic, I think, I mentioned earlier on one of the questions and apologies that I forgot who it was, we had already talked about things that we were doing at Q1. Some of those we've continued. I think as we look at the portfolio, ZECM tends to be more of a challenge when it comes to the longer end of the curve, especially in Europe. It doesn't have the benefit of any ultimate forward rate that the other systems have. And of course, what that really means is that, if you have an ultimate forward rate and you have a gap, essentially you are going to pay that over a very long period. We have taken actions. Staffing in Q1 continued through Q2 to reduce that sensitivity. That's a topic we will reevaluate as the year goes on, but we have tried to reduce that particular challenge in our model. I think in the end, as a real risk, it does exist.

On the equity and credit side of things, again, it was more of a Q1 topic. We had talked about the fact that we had put some hedging in place. And I think I mentioned earlier that good news on the market recovery, bad news, if you want to look at it this way, the protection that we have is all the money, but of course, if markets reversed, we will get closer to the money again, and the impact of it would be more substantial. So I'd hesitate to say that you can stabilize one of these completely economic capital models, but we do look at the risks we run and we try and make conscious decisions on the ones that we like and the ones we don't like.

On the pricing component and the impact that that has on the ZECM ratio, I couldn't give you a number today. The impact of course is that we've generated higher profitability in the P&C segment, albeit, something that for the time being only partially offsets the negative impact of the immediate costs of pandemic. So I find it pretty hard to annualize that both for you today and of course, the one thing that model doesn't have is, it doesn't add up, say, two or three years of price increase and anticipate that. So I suspect that the impact -- it won't be immaterial just given the scale of the change. So if you take the 70 basis points that we've had in the half year, apply it to the premium volume and tax it, I mean that'll give you a good sense because there's not a lot difference, it's a short-tail business.

Q - Michael Haid {BIO 1971310 <GO>}

Perfect. Thank you very much.

A - George Quinn {BIO 15159240 <GO>}

Thank you very much for the questions, Michael. And I will give it back to Richard and I'll give Richard the microphone.

A - Richard Burden {BIO 1809244 <GO>}

Thank you very much everybody for dialing in. If you do have any further questions, obviously, please do not hesitate to reach out to the Investor Relations team. Have a safe afternoon. Thank you and goodbye.

Operator

Ladies and gentlemen, this concludes today's Q&A session. Thank you for participating. And I wish you a pleasant rest of today. Goodbye.