Q1 2016 Earnings Call

Company Participants

- Christian Becker-Hussong
- Jörg Schneider

Other Participants

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

MANAGEMENT DISCUSSION SECTION

Operator

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

Christian Becker-Hussong {BIO 19080254 <GO>}

Yeah, thank you. Good afternoon to everyone. Welcome to our call on Munich Re's first quarter results. Today's format is quite straightforward. After this short introduction, I'll hand it over back to you in order to kickoff the Q&A session.

Jörg Schneider, our CFO, is today's speaker. I would kindly like to ask you to limit the number of your questions to a maximum of two per person. So far from my side, we're happy to take the first question right now.

Q&A

Operator

We'll now take our first question from Xinmei Wang from Morgan Stanley. Please go ahead. Your line is open.

Q - Xinmei Wang {BIO 17860767 <GO>}

Hi, thanks. It's Xinmei Wang from Morgan Stanley. Two questions, please. First is on the outlook. At the AGM, you mentioned €2.3 billion to €2.8 billion range, which didn't include the ERGO restructuring costs. And today, we have a number €2.3 billion, which does include the ERGO restructuring costs. I'm just wondering what change in those two, if you would be able to give a more definitive number, given that we haven't had the full details of the ERGO strategy there yet, and I'm wondering where that €2.3 billion could still move.

And second question is on reserve releases, you lifted your expectations for the full year to 6% from 4%, is that something we can expect for future years as well, given the strength of the reserve buffer and I guess we're still seeing low inflation, somewhat lower large losses, and should we be using the 6% to normalize for the combined ratio? Thank you.

A - Jörg Schneider

Thank you. Hello, Xinmei. Thank you for these questions. First, on the outlook, so our original prognosis was 2.3% to 2.8% and, during the AGM, we repeated this as kind of code, but said at the same time that the first quarter has brought up probably relatively moderate to bad results, and then we decided to take into account the expenses for the ERGO strategy program. So, nothing changed between end of April and now. It was just kind of announcement that we are looking - are going to revisit that target.

The situation at ERGO, the project are underway and it has become obvious that there will be some burden on the results of ERGO and that it is no longer probable that ERGO will show a positive result and, therefore, we decided to take it unlike in March into our prognosis for the year and ended up with €2.3 billion. I think it will not move from here, provided that major losses and the development of the capital markets stays within reasonable range. So I'm confident that we can keep that €2.3 billion going forward.

With regards to our guidance on reserve releases, it has become obvious for us that, again, we show a substantial difference between actually reported losses and the expected level, and therefore, that it wouldn't have been - it would have been no longer realistic to stick with the 4% assumption for this year. Therefore, we realistically increased it to 6%. On an ongoing basis, I don't know more at the moment. If and - you would have to book it immediately, but my best guess is that the level could be higher than 4%. For our internal plans, we stick with the 4% 2017 and going forward, especially, because we do not know what inflation will do.

Q - Xinmei Wang {BIO 17860767 <GO>}

Okay. Thanks very much.

A - Jörg Schneider

Thank you.

Operator

We will now take our next question from Kamran Hossain from RBC. Please go ahead. Your line is open.

Q - Kamran Hossain {BIO 17666412 <GO>}

Hi. Afternoon, everyone. Got two questions. The first one is on the ERGO program costs. Could you maybe give us a little bit of color on whether – I know you don't want to give the actual cost number, but whether we should expect the program costs to be outweighed by, I guess, cost savings in the future? And the second question, could you just remind us what the impact of any kind of program costs might be on the German HGB earnings? Thank you.

A - Jörg Schneider

Thank you, Kamran. And with regards to the costs of the program, it is premature, because currently the talks with the representatives of the staff are ongoing and we would like to wait until they're done and there will be meeting of the supervisory board and then the publication of one-time expenses, ongoing expenses, but also of ongoing cost savings and earnings impact here. And if we were not convinced that it is worth investing here then wouldn't do it. Therefore, you can rely on the program having a very positive impact on the future on expenses and earnings and profits.

With regard to German GAAP, it's a bit too early before having talked about the numbers to make adjustment on whether ERGO will be able to finance it itself or whether it needs a contribution from the mother. And for the time being, it is our assumption that we do not have to do more depreciations on the stock price of ERGO – not stock price – on the book value of ERGO and as long as that holds true, there is no impact on the German GAAP earnings.

And what I can also say, having seen the numbers for the first quarter, our revised prognosis for the full year, it hasn't been negatively impacted by what we show here as a lower basis for our IFRS earnings, that means the HGB German GAAP earnings seem to be in very good shape. And as you know, they are also supported by the equalization reserve, which protects us against negative surprises from the underwriting side. Therefore, I'm pretty confident that the German GAAP earnings as our basis for dividends and for future share buybacks will be in very good shape also at the end of 2016. Does this answer your question, Kamran?

Q - Kamran Hossain {BIO 17666412 <GO>}

Yeah. That certainly does (07:47).

A - Jörg Schneider

Thank you.

Operator

We will now take our next question from In-Yong Hwang from Goldman Sachs. Please go ahead. Your line is open.

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

Hello. Two questions from me as well. Firstly on the ERGO International combined ratio 93% seems significantly the way you were expecting. It seems to be some reserve releases there and kind of see an one-off, so I was just wondering what you see as a sustainable basis to start from before you do the restructuring in ERGO?

And my second question is on the big growth that we saw in April (08:28) is one very kind of large transaction, there's few kind of all the large transaction, so I'm not sure how much you can say in terms of what business lines or what geography it might be in, but just any details on where you saw the growth would be helpful. Thank you.

A - Jörg Schneider

Thank you, In-Yong. With regard to ERGO International, it's much too early to declare victory here. So one quarter with 93% combined ratio is fine, but this is not a good indicator for an ongoing combined ratio and profitability. So we rather stick to the 99% prospect, which we have given you in mid-March. But at least I'm pleased that there seems to be some stabilization.

With regard to ERGO strategy program, it's all about Germany at the moment. So we would talk a little bit about ERGO International, but that hasn't been the focus yet. This is the next step to expand the restructuring and to expand the fitness program, let me say, to the international organization.

With regard to the April renewal and the impact from the big transactions that especially one which stands out is MGA business, but we know the business quite well. This really is not exposed to the reinsurance pricing cycle. It's a mixture of various specialty - various niche business, personnel line businesses, well-diversified in itself, short scale only with a product split of property insurance 20%, a little bit of travel, miscellaneous, financial and special risk deposits, something like 70%, 75%. And due to its very low volatility, this business would usually not to be reinsured in the broad market.

For us, it's attractive; it comes with a high commission ratio that means it comes with low volatility and decent profitability. So we are very pleased with having acquired this business. There are a couple of major contracts and it's no longer the April renewal, like we show it today, has nothing to do with that of five, six, seven years ago, where it was all about Korea and Japan. It's rather a mixture with some 20% from Japan and the rest from all over the world and especially and more and more transaction of (11:25) business.

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

Okay, great. Thank you

Operator

We'll now take our next question from Frank Kopfinger from Deutsche Bank. Please go ahead. Your line is open.

Q - Frank Kopfinger {BIO 16342277 <GO>}

Yes. Good afternoon, everybody. I've two questions on the investment income. First question is on the impact on equity derivatives. Typically, I would have expected a positive contribution if you use these derivatives, equities as a hedge and we had negative equities performance in Q1. However, the performance of the equities performance – derivatives was not positive. This was negative. Can you comment this? What has changed in your derivative strategy in respect to equities?

And secondly, my question is on your regular income. When I look into the reinsurance segment, both P&C and life re, the regular income component is significantly down from the previous quarters. And even if I adjust for the Q2 effect from the previous year, it seems to be in the order of 15% to 20% below of what we saw last year. Is there anything that has changed on this end?

A - Jörg Schneider

No, Frank. Thank you. And let me start with your second question, regular income in reinsurance really substantially down. You can see that on slide 32 of the presentation. There are two reasons; one is the normal attrition of the running yield, which makes up for something up to almost – in property-casualty alone almost €50 million. So this is really substantial, because the duration has been relatively low as you can imagine in this line of business. Second, there's a special effect from the valuation of our associated company, which was very positive last year and rather negative this year.

The associated company has taken into account of our consolidated numbers here with our share in the equity and, therefore, it's different from dividend income also, and it's somewhat volatile. And basically, it comes from our infrastructure and renewable energy investments; nothing to worry about, so we are rather pleased with these investments. And it's more of a one-off effect than an ongoing decline here, which we can expect.

Also for investment life, we should mention that the income from deposit account went down due to the decline of the major quota share treaties. This was the driver for the decline in regular income reinsurance life. On your first question, I was also surprised to see that our equity derivatives were negative. The reason is simple. We do not only use puts but also forwards to take long positions in equities and these positions went into a loss and this overcompensated the positive impact from the put option. That's it.

Q - Frank Kopfinger {BIO 16342277 <GO>}

Okay. Thank you very much.

A - Jörg Schneider

Thank you, Frank.

Operator

We'll now take our next question from Michael Huttner from JPMorgan. Please go ahead. Your line is open.

Q - Michael I. Huttner {BIO 21417183 <GO>}

Fantastic. I had – I suppose one simple question is when you're going to stop adjusting your guidance and it's not – I suppose it must be complicated that originally started the year with a range of €2.5 billion to €3 billion, then at the AGM we had €2.3 billion to €2.8 billion, now we have a spot estimate of €2.3 billion. And in terms of combined ratio, I see so many figures I'm not really sure which one I should use. We have 99%, 98%, 95%, and then we have somewhere in the reconciliation today, 100%. So, I just wonder, which is the right figure. What is it all – it gives the impression that's Munich Re is a bit unsteady is I suppose how I put it. But that would be really the main question.

The other is again on investment income; did you have a big hedge fund position? That's the only way I can explain this big impairment relative to your normal run rate or gains. If I back somebody and they make a mistake and these things can happen. Anyway, those are my two questions. Thank you. Did I lose them? I lost them. There's nothing.

Operator

Ladies and gentlemen, please standby, as we're experiencing a momentary interruption in today's conference. Thank you for your patience. Please continue to hold.

Please go ahead. And caller, if you could please, Michael Huttner from JPMorgan, if you can repeat your question. Thank you very much.

Q - Michael I. Huttner {BIO 21417183 <GO>}

Yeah, so my two questions. First one is when can we expect the earnings guidance for the year to stabilize, as we had three different numbers so far this year or three different names ranges, I don't know how to look at it. And also, on the combined ratio, which are the numbers I see and which are cited in various parts of the reporting is a reliable kind of base number I can use going forward? I can see 99% from the start of the year, 98% the corrected, I suppose AGM figure, 95% which is the figure kind of as guidance today and the 100%, which is the underlying today and, of course, the wonderful 88%. Thank you.

A - Jörg Schneider

Yeah. Thank you, Mike. First of all, I want to apologize to all our listeners. Suddenly the line broke down while Michael asked the question, so we weren't – not shocked about the question, but there seems to have been a technical problem.

Q - Michael I. Huttner {BIO 21417183 <GO>}

Just so you know I hear lots of comments from my competitors saying my questions are too tough. But any way, thank you.

A - Jörg Schneider

Exactly.

Q - Michael I. Huttner {BIO 21417183 <GO>}

Sorry about that.

A - Jörg Schneider

Okay. First, you're absolutely right. Originally, we came from 2.5% to 3% (20:16), then we were a bit more cautious during the analyst conference mid-March, having seen the decline of the equity markets especially and having been worried also about the interest rate level.

Now, we again go down from the range to the lower point, and I'm pretty confident that we can stay there, because also we have a lot of room to also influence our earnings and we wouldn't let it fall endlessly. And by the way, also from an economic point of view, we do not fall so dramatically. There are a couple of one-offs which made the Q1 results decline to the extended date.

And second question on the combined ratio, we started from 99%. In March, we gave 98% because we already knew that major losses were low in January and February and our philosophy is, let's put it this way, the second quarter doesn't know whether there were many losses in the first quarter, so we immediately translate the experience of the past month into our prognosis for the full year. And therefore, we went down to 98% and now we take another point off to 97% for the reason that also from mid-March to end of April, there were very low major losses, seems to change in May, by the way. Plus, second effect is that we are confident that we can release more reserves at the end of the year and that 6% is more realistic than 4% that makes up for the other 2 percentage points.

When we normalize the number for the first quarter then, we come to 100% and the simple reason is that we do not adjust for seasonal effects. That means we always expect 12% loss ratio points, major losses in each quarter, although, in the first quarter, we wouldn't expect so many. So on a realistic basis of normalization, the number would be below 100% and 99% would be more realistic. But, we do not want to make it so complicated after I had listened to the Swiss Re conference call. They did the right thing to give the seasonal breakup, but it was so difficult to understand and to explain that we decided to stick with our simple version.

Q - Michael I. Huttner {BIO 21417183 <GO>}

Thank you.

A - Jörg Schneider

Thank you, Michael.

Operator

We will now take our next question from James Shuck from UBS. Please go ahead, your line is open.

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

Hi, Jörg. Good afternoon, everybody. I had three questions from my side, please. Firstly, just on the outlook around for the growth in P&C re. 60% volume growth at the April renewals and you've explained that there's a couple of large treaties in particular that had driven that growth. I just want to understand your kind of outlook for growth in P&C re, because relative to some of your peers, you've taken a much more measured approach to growing in certain lines and certain territories. And it seems to me as if there might be a subtle kind of shift in what you're indicating about the future growth outlook in P&C re. That's my first question.

Secondly, the reserve releases point, so 6 points of releases in the current year is what you're expecting. If I look at the last kind of three or four years, you seem to be running consistently above the 4 points that you guide to. I think I'm correct in saying that you haven't relaxed the reserving conservatism and, therefore, my question is really shouldn't you start doing that, because you're still releasing above that guided level and it seems as if you're baking in more conservatism than you really need to, so when will we see that conservatism be taken down?

And then, finally, just a quick one on ERGO International. It's an interesting businesses and interesting kind of niche positions, if you like. But I guess my question is why you're really bothering with it? Are any of the territories that really you're operating in, do they really have the potential to become a meaningful earnings engine for the group as a whole or is this something really that is just distracting from management focus? Thank you.

A - Jörg Schneider

Yeah. Thank you, James. Let's start with the April renewals and the growth we show here, the impressive growth compared to the more measured approach, which we typically use when talking about markets and growth opportunities at the moment. It had just to do with the transaction type of that business. So, we still stick with our general impression that it wouldn't be wise to aggressively grow on a broad basis here in business and this does not only refer to Property XL business in exposed areas with sharp decline of terms, but also for causality business, where we have a more tempered approach here. We are active in the market. We have always been active in the market, but not growth at any price.

When there are good opportunities coming more from our good client (26:22) and from the consultancy intensive, know-how intensive transaction business, then we happily take it up and this was the case on April 1 for the business I described before. We could see more of that. I'm quite confident that we will, because we are putting a lot of effort here. We are investing very much in that kind of business, but it's not a given. It can come or it will not come. And therefore, our outlook for growth is somewhat difficult, because it's somewhat volatile here.

Second, on the reverse releases, 6% more realistic than full, yes, and even with 6%, I assume that we still stick to our reverse conservatism. But we shy away from aggressively taking it down, because it's so much driven by the low inflation. And therefore, perhaps it has also to do with my personal history and that of this board of management, because we experienced years with very adverse developments with our claims reserves.

And therefore, we decided never again and perhaps, this message was somewhat over interpreted within the company that conservatism is a value as such. I'm always concerned that we leave business on the table from overestimating the losses here, the future losses. But, to some extent, this concern is moderated by the fact that our pricing assumptions are somewhat distracted from the reserving assumptions, which tend to be more conservative here.

And so, from my point of view, no major change foreseeable. What I would like to subscribe is that, we can avoid negative surprises on the investment side on the basis of our very strong basis here. Your third question was about ERGO International, is it worth bothering with that type of niche business, which is too small in many areas. To some extent, I agree, but we have very promising market positions, which shouldn't be underestimated.

Take Poland for example where we are one of the biggest companies of the country, of a country with still low insurance penetration and with very strong economic growth potential. Then there is promising initiatives in Asia, joint ventures in India for example. So, there's a long list of interesting businesses. And overall, I think it is worth following that route also taking into account that the growth potential in the German market seems to have been moderate, perhaps it's improving due also to the immigration in the long run, but who knows. At least it's an additional option for the Munich Re Group. Thank you, James. Bye.

Operator

We will now take our next question from Thomas Fossard from HSBC. Please go ahead. Your line is open.

Q - Thomas Fossard {BIO 1941215 <GO>}

Yes. Good afternoon. I've got two questions. The first one would be related to the life reinsurance portfolio. Obviously, it's now a couple of quarters we've got, I would say, a pretty significant volatility on the net income contribution of the division. Would you be able to help us to understand what could be a normalized quarterly run rate in terms of life reinsurance contribution to the group earnings providing that the experience is in line with expectations and, obviously, you don't have any negative on the investment side?

And also the other question, the second question will be, could you update us on the status of the underwriting profitability of the book both P&C and life re in Q2. So, life re will be any big – additional single cases to be expected again in Q2? And on the P&C side, could you update us on the May big losses just to have a feel on where you stand currently? Thank you.

A - Jörg Schneider

Thank you, Thomas. Significant volatility in life; let me start with your second question on that. We do not see anything for the second quarter at the moment. So, no spectacular single losses (31:47) at the moment. This volatility in second half of last year and in the first quarter really comes from a random accumulation of major losses. We have been in these single risks already for seven or eight years without having seen this outlier losses and now random accumulation, nothing more. Therefore, we stick to our guidance that a normalized run rate would be an underwriting result of €100 million per quarter.

It's ambitious, also taking into account unavoidable volatility from the investment side, which is indirect here because investments can have an impact on the valuation of the reserve. But, overall, we are confident that we can run that business within that range. Second, your question on the Q2 performance of property-casualty, now the phase of a lack of major losses seems to be over. We saw the Ecuador earthquake, in spite of the human tragedy, it shouldn't be a major insurance event here because the region is not highly industrialized.

We had the Japanese earthquake. Here, unlike in Ecuador, production facilities are affected. There will be business interruption losses. We expect mid-double-digit loss with high uncertainty, because business interruption is still ongoing. The same number could show up for the Alberta wildfires. Then we had Texas floods. So, it's quite substantial number of midsize major losses which happened, if I may add perhaps, this is also somewhat healthy for the industry in order not to become too much accustomed to this close to zero major loss appearance. Thank you, Thomas.

Operator

We will take now our next question from Andrew Ritchie from Autonomous. Please go ahead. Your line is open.

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

Hello. Hi, there. Just wanted to follow-up on the recurring income in reinsurance, both life and non-life. I was a bit confused by your earlier comment saying – you were saying there was sort of effectively, other than mark-to-market of alternatives, in that regular income, could you tell us what effect that was and what is the actual underlying running yield currently in P&C and life? How quickly is it declining? Because I'm guessing also, I think, you were suggesting the underlying running yield is also falling a bit quicker than maybe you would have expected.

Linked to that, the asset base in life reinsurance is falling quite a lot. You say that's because of some large contracts running off. Are we now in a point where the portfolio of life re is shrinking or you expect it (35:15) to grow again? And then the final question is, I'm not sure, maybe I missed it earlier in the call. Did you provide any details as to exactly what went on in ERGO Germany P&C in the first quarter? I wasn't quite sure why there was such a big miss versus what you're targeting?

A - Jörg Schneider

Thank you, Andrew. First, on the investment income in reinsurance life and property-casualty, the mark-to-market, you called it alternative investments, this is at equity valuation, which means these are not quoted instruments, but typically it's participations of between 20% and 50% in the respective companies, special purpose vehicles, who run windmills, motorways, airports, it's a broad mixture of investments and the diversity as such is a big plus. And therefore...

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

Sorry. Is that coming through the regular income line? So if I look at P&C, it was €388 million, what was the effect of that?

A - Jörg Schneider

The revaluation of investments – I can give you the number without indicating that this is an ongoing number here. Last year, in 2015, it was a plus €29 million and this year it was a minus €5 million, but it is random fluctuations. So, I frankly admit it's also new territory to us; nothing to worry. So the investments are running pretty well.

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

So what you think the running yield is in P&C re?

A - Jörg Schneider

The running yield decline in P&C re makes up for close to €80 million minus in P&C re.

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

Okay.

A - Jörg Schneider

And of which these alternative investments had an impact of close to €35 million.

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

€35 million.

A - Jörg Schneider

So substantial, yeah. And the attrition of the regular income was close to €50 million. Then second question, life re - yeah, the major contract running, yes. Life re always promised or promise is the wrong word here. We always made it clear that these major contracts had duration of typically somewhat like five years or so. And then, there is a recapture option of the client, which is sometimes used, sometimes not used. At least there's typically a renegotiation which happens and here it ended up in the continuation of some of these contracts, but with lower volumes. That is the reason.

On the other hand, there are areas with strong growth potential like our business in Asia, like our business with asset protection, like major capital relief contracts for Solvency II affected companies. So, it could well be that we can replace part of these major contracts going forward and we should rather talk about profit potential than volume, because volume can be very high with low profitability and vice versa. But, overall life, re is a promising area for us, especially in a world with ever increasing regulatory requirements, which are always good for the life reinsurer.

Lastly, in ERGO property-causality Germany, it is really a miss of our target of 95%, we achieved 98.6%. It has to do with some random losses, especially liability losses from prior years. Part of this losses are reinsured with the mother. That means for IFRS consolidated account, they stick with ERGO. In reality, they are absorbed by the reinsurer because ERGO has been running only very limited self retention. So, therefore, on the single company accounts, they have lower impact here. Hence, going forward, we do not expect them to be an ongoing phenomenon. So, we still stick to our target of 95%.

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

So ex the liability reserve change, it would have been 95%, is it?

A - Jörg Schneider

Not really. They make up for 1.5 points or so something like that here. We also have a negative impact from what is called title insurance, which is written through our UK branch and booked under P-C Germany. A small business with very high expense ratio, you may know it from your home country. And this is something which, I would call at the moment, accounting noise. So it should flatten over time.

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

Okay. Great. Thank you very much.

A - Jörg Schneider

Thank you, Andrew.

Operator

We will now take our next question from Thomas Seidl from Bernstein. Please go ahead your line is open.

Q - Thomas Seidl {BIO 17755912 <GO>}

Hello. This is Thomas Seidl from Bernstein. Three questions, two on life re again. Number one, I'm not sure I see how we get to a sustainable margin of 100%. When I look at the income statement, you see basically that the benefit ratio is better than last year at 103%, so the two claims have not really impacted or resulted in a higher benefit ratio. The main impact is, what you call, technical interest which is the risk-free yield. So in order to get to 100%, you need to get back to €160 million technical interest, how realistic is that is my first question.

Secondly, you say life re is a promising segment, but in different and contrasting your peers, you're shrinking organically, so if that's due to enormous competition for the few large transactions around or why do we see here less growth compared to the rest of the market?

And thirdly, I go back to your video message this morning. You basically say that the HGB balance sheet continues to provide headroom to pay out the dividend and the buyback even if you would hit the €2.3 billion net income. But I also remember that at the analyst conference, you mentioned that the investment income headwind is the major risk here on this headroom. And so I wonder what you reported today, has that already started to eat into this headroom?

A - Jörg Schneider

Thank you, Thomas. On your first question, the benefit ratio is effective from the large transactions. So you can't take it as a very good measure at the moment here. And also with the technical interest, we're still confident that this 100% is realistic. It's a stretch, but it is realistic.

A promising segment, it is a promising segment. Perhaps one reason why we grow less than some competitors is that we have a different view on specific risks here. For example, the recapture risk, the less risk from major contract. You can take a more aggressive or less aggressive stance. I don't know anything about our competitors, but very often when we talked about business opportunities, I heard from our colleagues that they do a very complex calculation, valuing in these optionalities very high, which is not a given, but which is kind of conservative approach here. But there are really many areas of potential growth, especially, from this transaction business, which we foresee will have a strong focus on Asia. But, also, United States and Canada are still promising markets, and Europe.

On dividend and buyback finance by the local GAAP balance sheet, the investment income is still in good shape. Our prognosis for the full year does not show a decline here. The equalization reserve protects our underwriting result. So, therefore, that seems to be in quite safe territory with the typical (44:57) that impairments can happen, impairments on subsidiary like ERGO can happen, and see the probability at the moment is relatively low, plus a potential positive impact as of 2017 for our equalization reserve.

Q - Thomas Seidl {BIO 17755912 <GO>}

Maybe one follow up on the life re side if I may. Can you talk about let's say the pipeline? I'm hearing also a lot about there's only two transactions coming up more, is that all that visible in move over coming quarters?

A - Jörg Schneider

Yeah, there is some transactions in the pipeline, but sometimes you work three to five months on the transaction and the outcome is zero. That happens. But we are confident that a lot will be put in place in the end.

Q - Thomas Seidl {BIO 17755912 <GO>}

Okay. Thank you.

A - Jörg Schneider

Thank you, Thomas.

Operator

We will now take our next question from William Hawkins from KB&W. Please go ahead. Your line is open.

Q - William Hawkins {BIO 1822411 <GO>}

Hey, Jörg. Thanks very much. I missed the very beginning of the call, so just tell me if you've already answered this, but back on the derivatives question, this is another quarter when you've had difficulty presenting numbers because of what could just be accounting mark-to-market noise and it clearly hurts your cost of capital. First off all, is there any way you can demonstrate simply that your investment policy that seems to differ from everybody else's is actually producing a good cost benefit? And then, related to that point, given that you continue to have these difficult presentational issues, are you thinking about changing what you're doing economically or finding a better way of accounting for this noise? Thank you.

A - Jörg Schneider

Difficult questions, William. Thank you. Yeah. I can assure you that CFO is not happy seeing this volatility. And we've had numerous discussions here about whether we should change it, whether we should use less derivatives, but typically, they come along with a higher volatility of our economic situation. And for us, as you know, we are ayatollahs of economic steering. And we rather like to have an accounting volatility than a major economic mismatch.

And for us, the usage of derivative is a very effective way of dealing with our asset liability management. The account – and what you can also see as an outcome is a relatively high stability of our economic solvency number, which went down by 20 percentage points to 30 percentage points. Sounds high, but is driven by dividend and share buybacks, which are fully taking into account into the first quarter.

Therefore, the numbers are pretty stable on the economic side. And also sitting on €32 billion of unrealized gains on the investment side should provide us with plenty of opportunities to deal with serious accounting problems. Serious would mean those which jeopardize our dividend or share buyback capability. Therefore, I understand your concern and I understand also the criticism and I take it – I take the blame to some extent. On the other hand, I think our shareholders are well off with us, because we provide them with a very stable payout here, and that we cannot legally guarantee, but at least, as long as I can foresee it, that should be in very safe territory.

Q - William Hawkins {BIO 1822411 <GO>}

Okay. Thanks. And I suppose...

A - Jörg Schneider

Thank you, William.

Operator

We will now take our next question from Michael Haid from Commonwealth Bank (sic) [Commerzbank] (49:28). Please go ahead. Your line is open.

Q - Michael Haid {BIO 1971310 <GO>}

Thank you very much, sir. Good afternoon. I just have to come back to the normalization of the combined ratio. If I understand correctly, you expect 6% reserve releases in this year instead of 4%, but how sustainable is the 6% going beyond 2016 in the current low inflation environment? There is also – one can also make a mistake being too conservative and if you normalize the combined ratio at 6%, then your normalized combined ratio would rather be 98% than 100%, and is the 98% rather the right figure at the moment?

A - Jörg Schneider

Michael, it depends on the question how much conservatism there is in the current reserve setting. If there were 6% included in each reserve setting for new claims, then you were right. Then it would really be 98% on a normalized basis. But, for that, we do not have enough evidence. Also, what I want to add here is, the reserving is based on very conservative approach, but a stable approach, so we are not piling up from one quarter to the next.

The ratio between actually reported losses for early accident years and the expected level is stable, so it's not increasing. That means we do not release the existing conservatism, but it's on a stable basis and it's not accumulated more and more. We don't know how inflation would work. So, for example, let's assume that a loss inflation, especially, medical inflation would substantially go up, we would still be on the safe side. But I think that redundancy would be reduced to a large extent in such a situation. Therefore, I can only offer and propose to our investors to take this as a very strong basis, which we do not intentionally exaggerate, but which gives you sleep-easy cover on that front.

Q - Michael Haid {BIO 1971310 <GO>}

But, sorry, I'm still a little confused. Is it the right assumption then for us, as outsiders, you reserve the initial business with basically broad-based 4% and the outgoing reserve releases is then 6% or is it now 6%, 6% or what is it economically?

A - Jörg Schneider

Yeah. I can't give you a reliable number, Michael, because we can't measure what is conservatism in the current losses. We reserve them on the high-end of the best estimate range. There is a lot of room for estimation and we use it perhaps in a little bit of a careful way.

Up to now, we think that is a good judgment that there might be conservatism for loss ratio points involved, whether it's higher or not, we don't know. If we release 6% for 2016 and include 4% in our new losses, then the level of conservatism would go down. I can't give you a precise answer. With the 6% for 2016, we just respond to indications we get very clearly from the observation of our losses, but please have in mind how low inflation is at the moment.

Q - Michael Haid {BIO 1971310 <GO>}

And have you (53:34) incoming business reserving for the low inflation that we currently see or is it still – is your – the reserving of the incoming business still based on that expectations of inflation, like 2% or whatever?

A - Jörg Schneider

In theory, they always include the best judgment also on claims inflation. In reality, there's always a bias, I would say. But even our reserving actuaries noticed how low inflation is, so I assume and I know that they take into account the current very low level of inflation, but they don't take it as being there forever.

Q - Michael Haid {BIO 1971310 <GO>}

Perfect. Thank you very much.

A - Jörg Schneider

Thank you, Michael.

Operator

We will now take our next question from Vinit Malhotra from Mediobanca. Please go ahead. Your line is open.

Q - Vinit Malhotra {BIO 16184491 <GO>}

Yes. Good afternoon. Thank you. Two questions from my side. First is just on this April renewals, this very large PT which Jörg, you've mentioned very rarely this kind of portfolio comes to the market. And it seems like, it's like the risk solutions business that usually gets you a 90% combined, if I remember right, from previous guidance. Is this a similar 90% kind of profitability? And is this why you probably offered some incentives to this client to bring this business to the market? So that's really the question on the profitability of this new very rare block that you managed to acquire.

And second thing is just on a normalized net income thinking, I can imagine that if it was just below €600 million for the quarter and that ties in with the €2.3 billion next year if we think the reserve releases are 2% and not – sorry, if you think reserve releases are 6% and not 4%, then we can sort of see what the market is thinking. But how would you like us to think about it? Particularly, if ERGO does take a lot of restructuring charge now or this year, would you expect improvement next year itself or would you think it takes longer? What are you thinking on that? Thank you.

A - Jörg Schneider

Yeah. Fair questions. Hello, Vinit, Thank you.

Q - Vinit Malhotra {BIO 16184491 <GO>}

Okay.

A - Jörg Schneider

April, this big business here is – it doesn't come at a 90% combined ratio. It's a big block of business, which will typically perform around 100%, because it's shorter business, and it doesn't have a lot of investment income involved. And as I said before, commissions are structured in a way that there is relatively low volatility. The risk solution business, which you correctly quoted as being very low combined ratio business, that is that what we produce ourselves with Hartford Steam Boiler, AMIC and in other areas, so this one is rather reinsurance transaction business in the MGA form.

Then your second question on profit going forward, about the reserves, I can't say more than that we expect for the time being, the 6% reserve release. I'm very grateful that we do not have to worry about reserves and that we do not have to show nasty volatility from quarter-to-quarter here, but I can promise the 6% for 2016.

For ERGO, I dare to promise an improvement for 2017, but it will be a slow improvement. Typically, in these kind of restructuring situations, you have a phase of transition before profits really go up sustainably. And therefore, overall, yes, I expect an improvement; I expect a stabilization of our earnings and also, please do not forget the various innovation initiatives and the enormous amount of under-insured business, where we do the utmost, where we really fight for expanding the barriers of insurability, some things will fail here.

Our basis for calculating the expected losses and for the premiums is not similar to that of the well-established natural catastrophe business. But, on the other hand, margins are quite high here. So, therefore, I'm really confident that innovation will bring us very good additional profits going forward, which can more than compensate for the loss in profitability, which we see due to current market structures. So, overall, from my side, a lot of optimism if I may call it when I talk optimism, at least relative to how I saw the future already from the past. I'm very confident that we will have our fair share to increase profits over time again. Thank you.

Q - Vinit Malhotra {BIO 16184491 <GO>}

Thank you.

Operator

That would conclude today's question-and-answer session. I would like now to turn the call back to our host for any additional or closing remarks.

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

Yeah. Thank you very much to everyone. Thanks for joining us this afternoon. Further questions, please don't hesitate to get in touch with the IR team and we very much hope to see all of you soon again. Thanks for now and good-bye.

Operator

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