Q4 2016 Earnings Call

Company Participants

- Dieter Wemmer, Chief Financial Officer
- Günther Thallinger, Member-Management Board and Head-Investment Management
- Oliver Bäte, Chairman - Board of Management & Chief Executive Officer
- Oliver Schmidt, Head-Investor Relations

Other Participants

- Andrew J. Ritchie, Analyst
- Edina Rozinka, Credit Trading Strategist (Financials)
- Farooq Hanif, Analyst
- Michael Haid, Analyst
- Michael Igor Huttner, Analyst
- Nick Holmes, Analyst
- Peter D. Eliot, Analyst
- Rötger Franz, Analyst
- Vinit Malhotra, Analyst
- William Hawkins, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Ladies and gentlemen, welcome to the Allianz Conference Call on the Financial Results 2016. For your information, this conference is being recorded. At this time, I would like to turn the call over to your host today, Mr. Oliver Schmidt, Head of Investor Relations. Please go ahead, sir.

Oliver Schmidt {BIO 2473131 <GO>}

Thank you, Gail. Good afternoon from my side as well, and welcome to our conference call. As you know, we have three presenters today. Oliver will kick it off and share his views on the 2016 results and our capital management. Then Dieter will explain the numbers in detail. And finally, Günther will talk about our investments.

We have scheduled two hours for the call. In case that is enough to cover all your questions, please come and see us at our Analyst Meetings that we will host next week. And we will host one in London, one in Paris, and one in Frankfurt.

That's already all from my side. And with that, I hand over to Oliver.

Oliver Bäte

Yeah. Good afternoon, or good morning if you are in New York. Thank you very much for listening and your interest. I'm proud and happy to present very good numbers after a very challenging year for us, and good news on capital management. The headline for our presentations today is Delivery on Delivering, and that's what we have been doing for 2016.

Now, I don't need to explain to you like in the press call today what a difficult environment it has been politically and economically in 2016. And it looks like it's going to continue. Lots of unpredictabilities, and in this environment, particularly, with a very difficult interest rate environment, our company has performed really well. Thank you, in particular, to all our employees and the leaders in the company for great results.

Now, what have they been? With €10.8 billion total year results, we are near the upper-end of our target range. We have generated €6.9 billion in shareholders' net income, and we are therefore proposing to increase the dividend per share to €7.60. That's up more than 4%. Earnings per share is the same number in terms of increase. It's now at €15.1, and our Solvency stands at a very strong 218%. We assume you have some questions around that, that Dieter will address later.

The return on equity is 12%. It's somewhat down from last year. That is due to very strongly rising equity capital. There's a couple of effects related to that. We're still sticking to our target of around 13%. So, we believe it's not an issue around earnings. It's actually an issue around balance sheet strength, which we consider to be an extremely important asset in such a very difficult environment.

If we turn to A3, I'd like to highlight that all our segments are delivering. Life and Health is now with ROE about 10%; P&C, 13%; Asset Management, 15%. So, let me hit the segments one after the other.

On the P&C side, we'd like to grow 3.1% internal growth. The combined ratio, with 94.3%, is getting closer to target. The restructuring of Fireman's Fund that is still impacting the AGC&S results is on track. And we have, after installing a new leadership team in São Paulo for LatAm, are making good progress and further improving our performance across the Latin American continent.

Operating profit significantly improving, and as you will hear later, without some further clean-up in the balance sheet on an old Life portfolio that we still book under P&C, because we only otherwise have P&C and Health in Brazil would have been already significantly more positive.

The Life and Health insurance story continues to be very successful. We have told you in November of 2015 that our most important strategic priority is the transformation of our Life insurance business, moving it to new capital-light products that are both better for consumers and better for our shareholders. It is happening, and you would see that later the trend continues strongly across core markets.

The new business margin is up, despite record low interest rates and the disposal of Korea strongly benefited our Solvency II capitalization. I think some did not have that on their radar screen. And it has three positive effects. It impacts positively future profitability. It strongly helps our Solvency II capitalization. And it further reduces interest rate sensitivity, which is one thing that is of utmost importance for our risk management team, because that has been impacting us negatively as a sector and also as Allianz.

And I just wanted to say it loud and clear, we are committed to further reduce interest rate sensitivity and risk capital consumption. We have a slightly different view on credit spread, which we're going to talk about. So, operating profit here in the segment is at a record level with €4.1 billion, and it's very strong. It's also due to the fact that our U.S. Life company is doing extremely well, and congratulations to the team in Minneapolis for another successful year.

On Asset Management, we've also told you clearly what the agenda is. PIMCO, as a company, has decided to rejig its team, find a new leader, and then the investment team was able and capable to focus more strongly on investment performance and outperformance which has been very strong in 2016. Congratulations. In return, net flows have returned €11 billion in the second half, that's in euros. And also, congratulation, due to good cost management, the cost-income ratio is now again below 60%.

And not only did PIMCO performed really well, Allianz Global Investors delivered an all-time high in terms of operating profits, €543 million, despite very strong outflows of the equity sector, particularly in the United States. So overall, when you look at the portfolio, yes, times are really tough for all segments, but yes, Allianz has been performing really well.

So, we're continuing our track record. Page A4, gives you an overview of the last few years of improvement in operating profit, earnings per share and dividends per share. And as described earlier, we're again raising the proposal for increasing dividends per share to now €7.60. And that comes in addition to a share buyback of €3 billion that we have started today.

Now, talking about delivery, we are delivering at the same time on multiple cylinders. We are delivering strong results on our existing business, while in parallel, changing the company. That's a very hard thing to do. It's a particular stress for our managers, but it's working very well.

A5 gives you an overview. I don't want to go into the detail. It remains at the heart of our transformation program that we are focusing on bringing customer loyalty to top levels across our businesses. We're making progress here, as we are on digital, thanks for those that visited us in Munich, as we do on technical excellence on growth engines on culture change.

On page A6, I'd just like to highlight, people are asking and waiting for the big bangs. It's not necessary we have a track record of continuously investing. Last year, we've invested in Rogge. We have done the Zurich Maroc deal. We have created a partnership with Standard Chartered. But we're not just buying. We've also decided, and you see that it's about cleaning the portfolio wherever it's necessary. So, after disposing of the Fireman's Fund retail portfolio and AGF in the UK, we have successfully executed the exit for our Korean Life portfolio with huge benefits for Allianz.

Now, that already brings me to something that is probably very dear and important to you, the slide A7. And let me spend a little bit of time on this slide. We have debated for a number of time how do you think about the commitment that Michael Diekmann has given the few years back on the unused budget for external growth. And we've always said, if we do not find appropriate investment opportunities which we are working on, because we want to grow this company, but if it's not possible organically or externally, we are going to be disciplined and return it to our shareholders.

We're keeping our commitment. That's another form of delivery, and we are returning €3 billion to shareholders via share buyback over the next 12 months. Again, that has started today, and that is subject to a sustainable Solvency ratio above 160%. That is the exact wording, and there's no other detail to bear in mind. We will cancel the purchased shares over time.

Now, this alone will create an EPS accretion of around 4.4% if you do a full rate analysis on 2018 numbers. And also, if you think about the ROE uplift, you will obviously need to have a few assumption on how this comes, but is about 50 to 60 basis points improvement and that is important to know.

Now going forward, we have decided to simplify and flexibilize our dividend policy in order to be able to return capital to shareholders whenever that is suitable. Very important, because we don't want to run up against the three-year wall, and then being asked last year, what are you going to with the budget, what are you going to do the budget? So, we don't need to wait for the end of a three-year period. If we don't need the capital, if our Solvency remain strong, we can return capital in flexible solutions. It doesn't always have to be a buyback. It can be other ways.

And I'd also like to highlight that we are committed to remain capital discipline, as this first share buyback in our history exemplifies, because we have very demanding earnings per share growth targets, and very demanding ROE targets. So, these are going to safeguard capital management discipline. And I'd like to mention also, that you can see from our numbers that we have extremely strong cash flows to the holding. The vast majority of our earnings are flowing up. So, we have the flexibility to continue doing what we are doing. I think we are pretty unique in that.

Now, page A8 gives you just a repetition that is often forgotten. We are committing to payout 50% in the regular dividend, with a ratchet, i.e., that we'd like to maintain the minimum level of prior year even if earnings were to be a little lower. And I think it's important to understand that next to being busy and productive, we've also obviously been fortunate.

Now, even if we're not fortunate and you have large net cap of volatility in the markets, we have another 50% of the earnings that we can use to support both growth and flexible payout of excess capital, and if needed also to support the ratchet. So, you have an insurance policy in your hand with our very reliable dividend policy.

So, let me summarize on page 8, 9, what the equity story is that we gave to our investors in November and we have repeated at the Merrill Lynch Capital Day. Allianz is an outstanding downside protection investment. We have a super-capital position. We are well-diversified, yes, sometimes one of the other segments is affected by short-term volatility.

Overall, the portfolio is extremely strong, operating profit, CAGR has been 7%. And we have a very, very high quality investment portfolio. Günther Thallinger is going to talk about that. It's not just the investment rate grading, we also are building the earnings power through our alternative investments. So, you're getting the best of both worlds, a well-diversified portfolio, and investment income above what other people can do.

Now, that would already be a rock-bottom value proposition in these very difficult times. On top of that, we have an attractive dividend policy with a 50% payout with a ratchet, and very strong capital discipline, which we are now demonstrating. We're honoring the commitment that Allianz has given, and we are buying back €3 billion.

Further to that, we have upside potential. We're absolutely committed to achieving a 5% EPS growth. And remember, in 2016, we already delivered 4% even including Korea on an organic basis. The Renewal Agenda investments are starting to pay off. They're helping us, and most importantly, over time to improve net promoter score, and have, over time, to also help us on productivity. Now, we're investing a lot at the moment, but productivity gains will have to come over the next few years. And we enjoy scale benefits on the investment side both with Allianz Investment Management and our third-party asset managers that are hard to beat on a global scale.

And while we're doing good and we are talking about it, we'd like to emphasize that this is not a company that is running for quarterly earnings. We are trying to build a franchise that delivers on a sustainable basis to society. This is not for the press. It's also important for our investors. We are really trying to deliver contribution to all elements of society, whether that is around the investment side, energy consumption, or as it is, with employee engagement, and we are very proud of that.

And with that, I'd like to hand over to Dieter with one final mentioning, that's our outlook for 2017 not to be forgotten. Now, people have said and written some comments that we have a muted outlook. I'd like to repeat then we have had a muted outlook for the last three years. What we are doing for next year is fully consistent with prior years.

As you remember, we had a mid-point for 2016 of €10.5 billion, that we've increased €300 million or 3% to €10.8 billion. So it's above significantly the last-year mid-point, and we have various numbers in the segments to get to the number with their own mid-point and variations. Obviously, not all will be top and not all will be bottom.

So we believe that even in times when the political environment looks really difficult, when economic outlook for Europe might be under stress, particularly in government markets, we remain committed to what you find on page A12, which is the same ambition we have given to you in November of 2015. Get the return on equity to 13%, grow earnings per share of 5% and also improve the health of the company to have our consumers give us 75% top marks across the business and drive up our leadership index to 72%.

Thank you for listening.

Dieter Wemmer {BIO 4755450 <GO>}

So, good morning, good afternoon. I am now going to dive in deeper into the numbers that is then section B of the overall presentation, and we start on page 3. That is the only page, which focus on Q4 standalone and then we move to the summarized annual results page.

We finished with a really strong quarter in all segments. Revenues up in total driven by our P&C segment with an internal growth of 3.6% and also internal growth in Life and Health. Of course, Asset Management still slightly negative following the larger outflows in 2015. Operating profits, €2.8 billion, almost 10% higher than a year ago and 23% up on net income with €1.7 billion.

Property and Casualty ended the year with a 94% combined ratio, I would call it a strong organic one-off of 4.9% without influencing at all the strength of our balance sheet. Life's new business margin 2.9%, with good volumes, a very strong finish of the year. I think it is one of the highest new business values in a quarter you have seen so far at Allianz. The 2.9% new business margin re-calculate with quarter-end or beginning of the year, interest rates would be 3.2%. And Asset Management also €640 million operating profit, slightly up over the quarter a year ago, that is certainly a good turning point. PIMCO cost income ratio below 60% and inflows of €6 billion, even €1 billion better ending Q3, and I am allowed to say this, January started at PIMCO very strong with above €5 billion net inflows in January.

So, now turning to the overall annual results, €10.8 billion operating profit. Strong condition from Life and Health, where P&C reduced by the falling investment income, following the natural decline of our average yield in the portfolio.

Asset Management, as I said before, still the consequence of 2015 outflows, resulting overall in a net income of almost €6.9 billion, 4% above last year and then also resulting in a 4% EPS growth. So, organically, already pretty close to our 5% target for the year.

So I focus a little bit more on the balance sheet and then go a little bit quicker through the segments because due to our ad hoc requirement, you had 12 hours more time to read all the details. So I assume you have used this, and then I would focus more on the balance sheet because I think that is of more interest.

Shareholders' equity, no surprise, slightly lower than after the nine months, falling unrealized gains on bonds, but €1 billion more in unrealized gains on equity investments. Compared to beginning of the year, our liabilities for own pension increased. However, compared to the nine months figure, we have a lower pension liability. And FX actually contributed also to a further increase of our net asset value.

The biggest jump you see in our Solvency II capitalization, and I would then move directly to the next page to have chance to discuss it in more detail. So there are two ways to look at this. I personally like the simple description first. Look at the 12 months development. Forget that there were 52 weeks, 5 days a week of daily volatility, and just look what has happened over the 12 months.

Yes, interest rates lowered over the full 12 months. Credit spread actually increased a bit. And also stock markets went up. So all these market movements, we were actually able to compensate by management action. That means refined asset liability management, as well as some equity hedging, in particular in Q4, so that was a wash. And then the 18% increase from 200% to 218% is just the earnings plus rounded 10 percentage points for the disposal of Korea that explains over the whole year the full movement of the solvency ratio.

When I go into the Q4 details then we go much more into a lot of nitty-gritty movements. For example, what you from the outside world cannot really guess and calculate is how did the swap volatility move in Q4 and a key indicator here is the 10-year interest rate volatility on the euro swap that is 19 points lower in Q4 than in the previous quarter, that it let our group solvency increase by 4 percentage points.

Then I think that you have in general calculated Korea impact a bit lower, well it's 10%, we had a better capital generations through Life profit, high new business value, and of course increase in interest rate also reduce the cost of options and guarantees a bit. And then improved and refined asset liability matching are the key driver besides the market movement what we have seen in Q4. But personally, I like more the simple full-year story because that is then giving the strategic picture and not trying to explain every movement in the financial markets.

Moving to P&C business page 13, well, roughly the same operating profits than a year ago because net earned premium, pretty flat. Yes, combined ratio, 0.3 percentage points better, but we lost €170 million on running investment income. And under other, we had 2015 a little positive impact from the disposal of the Fireman's Fund retail business, not repeated in 2016. Therefore, other is a lower number.

The combined ratio, I would say, similar; a good cat year as before, actually, Q4 almost no cat. In Q4 we have seen, in particular on the books of AGCS, some special and material large losses, but that is no concentration that is I think just our normal regular business that from to time large losses are incurring.

Expense ratio, 30 basis points up. That is not yet the reduction in expense ratio we are looking forward to in the future. We have half of it, so a bit more than 10 basis points increase in commission, the rest is also higher investment level we have done also for the change agenda. So our investments in the change are running at a fairly high level.

Run-off, 4.5 percentage point for the full year, yes, above our long-term level of 3.7% or even when you adjust for Fireman's Fund 3.9% level. So, we are slightly above. But we had very strong run-off in some markets, and it's not damaging the future balance sheet. Our accident year underwriting results or loss ratio improved slightly over the year, and will help us to achieve our 94% flat result or better in 2018.

I think I skipped the details on the individual markets as it is probably good for your reading. Also, I would not go into the details of the investment income of the segment because that is very self-explanatory, nothing special in it.

Let's move to page 19, the Life business and what we achieved there. The Q4 picture looks pretty much the same as the previous quarters. Our shift in mix with about 40% of the new business volume in our capital-efficient products. The main markets here are Germany and U.S., not only in share, but also in volume. Overall our Life new business is on a strong level.

You can see it on the right-hand side of the chart, the German Life business, 12% up in new business volume, and the U.S. also rounded 12% up in new business volume. Where in the U.S., our fixed index annuity business continues to deliver, and VA has €2 billion out of the €12 billion flat compared to previous years. So that means our focus to grow the business is clearly the fixed index annuity business.

And overall, for the year, we are still down in present value of new business. Why is it not flat or up? We have two markets, which could not repeat the sales successes on unit-linked to the same extent, that is Taiwan and Italy. I think Italy's volume in 2015 was just huge, and this year, it is still a high level, but lower.

And in Taiwan, the unit-linked market has not really recovered from the low sales following the March, April hits to the stock markets. The profitability in our Life business, page 21, on €4.1 billion for the year, as I said already in previous quarter, might be slightly above a fully sustainable level.

For example, our investment margin, which is up, includes a substantial swing also from basis risk in our U.S. VA business. We cannot expect that this gain is repeating every quarter and every year. So therefore, we are normalizing our Life results a bit lower, as you can then also see, including a growth assumption as we have done it in our outlook figure just explained by Oliver.

By countries, who produced the growth in profit? Well, that is the U.S., France, and then, of course, the non-repetition of the operating losses of Korea that is actually I think the easiest way to explain the increase. Germany produced a high, but flat operating profit in 2016.

So when we move to the page and – little bit spending time on the value of new business. As I said before, the record level 1,448 new business value. We are measuring our new business value and our new business margin following the Solvency II rules for calculating the market consistent balance sheet.

So when you are grossing up this value of new business to make it comparable to other, you would expect the risk margin, which is included in this calculation, you would move to a real growth assumption. And when you then actually gross it up from the discounting effect and ask how much operating profit will this business produce over the run of time of this tranche of new business, you end up with a number clearly north of €5 billion of operating profit.

In our 2016 numbers, the day one accounting of this new business was a loss of €400 million. So that would actually also come on top of a new business value gross up. So that means, this value is clearly sufficient to replace maturing Life business profits, as well as giving us a long-term growth perspective for our Life operating profit.

Page 25, the usual health check for the investment margin. On statutory liability basis, our yield is still 5.1% unchanged, minimum guarantee was changed, new business strategy, surely and slowly moving downwards, so that actually the gross investment margin stable to slightly up. And the profit sharing to our customers also very much unchanged compared to last year, so not only our shareholders can be very happy about the results, I think our customers should be as well.

Moving now to Asset Management business, I think I have already given the highlights that it's the flow turnaround at PIMCO. Actually our assets under management for the whole year more than €100 billion, up, €31.5 billion comes from the Rogge acquisition, similar amount comes from currency impact, and then the rest is market value gross coming also from the slightly lower interest rates, plus higher equity markets and the market movement of €47 billion. And then in total, we still had outflows because we have not fully compensated the first six months of outflows.

Allianz Global Investors so far every quarter positive, and ended the year with minus €3 billion. A simple explanation is that actually, organically, the four quarters added to a zero and the €3 billion outflow was roughly the outflows we had on the Rogge acquisition right after the acquisition and was part also in our assumption for the business plan of the acquisition.

When we move to the revenue page, yes, revenues down 7%; at – in total, PIMCO, almost minus 10%; Allianz Global Investors, small positive adjusted for currency, minus 1%. But what I think is important is that PIMCO after the little jump in fee margin beginning of the year kept it over the quarters pretty stable, which I think is important also going forward, also shows that the inflows we have achieved are also adding revenues pretty much at the average fee margin of the existing business.

So our profits, page 31, asset management ended very much at the mid-point of our outlook page we published exactly a year ago, €2.2 billion operating profit. A good last quarter with also good performance fees achieved, not the one-off performance fees, we had previous year from the distribution of the Bravo Fund returns, actually very much ongoing performance fees, also being reflective that PIMCO got a new traction on its performance. 12-month performance on the PIMCO funds was 92% at year-end. I think the three year was some 86%. So actually really getting back the traction of good customer returns what defines PIMCO's trademark for so many years.

Corporate segment, page 33, nothing really special to report. That development on the expense is a little bit less income on the banking following lower interest rate spreads in the banking industry in general and our improvement in profit, as shown under the holding and treasury segment is a lower contribution to our own pension fund. The rest stayed very much flat.

Moving to the page 35, the translation of operating profit into net income, we have indicated here what we had in total to consume or to absorb for Korea. Korea did hit our balance or did our P&L with €450 million, billion would be a lot, it's the local currency, million in the year of – that contrasts quite a bit to positive impact in our Solvency II and market value balance sheet of plus €3 billion in total when you add the impact on those capital and on fund calculation.

So that got compensated by some realized gains and losses. We had here some also blocked rates reported about earlier in the year. The impairment includes €210 million from Korea and also some – impairments for our small bank in Germany called Oldenburgische Landesbank or OLB, which we are now accounting for as held for sale in the year-end accounts.

The tax rate, yes, looks a bit lower, 1 percentage point. But I think it is, at the moment, reflecting more or less unchanged tax rates in our major markets. But we had more tax realized gains from equities that reduced the overall tax rate by 1 percentage point and helped then also us to achieve a 4% higher net income.

And with this, I would summarize 2016 as a year of – another year of strong delivery. Fifth time in a row increased net income and dividend, very much on track to achieve our 2018 ambition organically, the EPS growth target. The OE, I think what is in the way that we are, a bit rich in capital, but I would consider this as a luxury problem and a not a challenge. Combined ratio, I think, also moving in the right direction, while preserving a strong balance sheet.

Our Life OEs 75% already on an OE above 10% and the rest, we are getting there. And Life new business margin, I think the 3% target is clearly in reach.

And with this one, I would hand over to Günther to give you a much deeper insight into the investment results.

Günther Thallinger

Okay. Thank you. Good afternoon. Good morning also from my side. Now, about, let's say, the investment portfolio. We are talking about €653 billion of assets, a portfolio that is continuously growing, and I was allowed to start – to head the investment entity AIM at Allianz. The portfolio was slightly above €500 billion. This was 2012. So there, you can see it is growing strongly.

However, it is not changing in the overall structure, and that is very important. The asset allocation, as you see roughly on page C2 remains fairly constant with close to 90% of fixed income which is obviously because we are really matching our liability side. And also, the overall risk structure of the portfolio remains fairly constant which you see on the right-hand side, top right-hand side of C2 with the rating structure.

Very important for us is that, we continue to take out the interest rate risks or the risk driven by the interest rate, the interest rate sensitivity. You see this is indicated by the duration figures, again on C2, bottom right-hand side. We have achieved it now during 2016 to get, on the Life side, for instance, to 9.5% versus 9.7% which is really very, very close to and almost matching.

Now duration is only one indication clearly, and I believe it makes sense to indicate or emphasize that we are managing out a larger set of KPIs. And actually, we are not managing the duration as such, but we really manage the cash flow profile of the liability side.

The portfolio is a very diversified portfolio as you can see in the second chapter of the slides that we have provided on Investments. I will not go through these slides, but it makes sense to mention those here, because if you read those through, you will see how well diversified the portfolio is, especially if one considers the liability side in connection to the asset side, meaning that we have, of course, the various insurance portfolios in these markets that are then reflected in the asset allocation.

Now on page C3, there you see the yield that we have achieved in 2016, it's 4%. And I am just indicated that there might be a different page numbering, but I'm on the page, total IFRS yield 4%. Total IFRS yield 4% is what we have achieved. The current yield is 3.3%.

The difference there is especially realized gains and losses position of €8.4 billion. This €8.4 billion is indeed a fairly big number. That number is a result of our overall investment strategy. It is not a result of – we want to especially harvest up to a certain level. What do I mean with investment strategy that refers back to the duration management, the cash flow management that I indicated before. And in an environment where the rates are fairly low or even decreasing than any management on the fixed income side has an implication or an effect this realized gains position.

Total performance is 5.6%, which leads me already to the next page. Investment result is indeed very strong, we believe, especially if you compare it against Western European peers. The page shows the performance in the range of 2007 to 2015 and it is 50 basis points above the Western European peers.

For us, it's very important that we have a very competitive position. Although because the investment result is that strong – it's important for the group as such, but also because this drives the attractiveness of the products that we offer.

Let me go to the reinvestment yields. Reinvestment yields – economic reinvestment yields, as we show them here, reflects obviously the market environment. That means, they are lower than in 2015. They are decreasing. There's not really much that we can do. We have to work within these markets. However, they do not simply reflect the market yields there.

We are – as we will show later on very much into alternative assets because we want to boost the reinvestment yields as much as we can. And we believe with our scale, we are in a position to have underwriting capabilities and capabilities to go into alternative assets that help us to keep these yields still at an attractive level.

However, not all of the assets we can reinvest into our alternatives, and therefore you see this reflection of the market yields as they are out there. And one should remember here that, the year 2016 had a fairly strange overall pattern which is, we had decreasing yields till the beginning of the fourth quarter, and only in the fourth quarter we really had a very strong increase, and we have to work, of course, throughout the entire year.

Before I come to the alternative assets, quickly about margins in the Life/Health business. Margins in the Life/Health business are very resilient, we believe. If you especially compare the business in force figures on a reserve basis, the business in force yield versus the average minimum guarantee is really far, far higher. And that is actually a pattern that you have seen for quite some years by now. So we are actually quite happy with the achievements there and do believe that these margins are not only resilient, but they deliver quite some buffers.

Similarly, on the new business side, on the new business side, I would like to mention two things. One thing is the volume behind the average guarantee of the new business is relatively declining, as Dieter has explained, because we are working on our products portfolio such that we have an efficient capital utilization. That is one thing.

The second thing is just technicality, but important to note, the 2% economic reinvestment yield cannot directly be compared to the reimbursement yield that we showed in prior years, because the economic part is roughly 20 basis points that reflects the currency hedging costs, and that should be considered there. So, if you compare it to prior years, please reduce the prior years by 20 basis points until you get to the comparable figures.

On alternative asset, let me jump to page C10. Here, you see the development or the total volume in the various asset classes and the growth versus 2015. What you'll also see is our total and the ambition. The ambition is €140 billion in these asset classes in total of what we want to achieve. We are now at more than €100 billion. We grew in 2016 by €15 billion. That is something that you cannot directly see from comparing the figures, if you do not consider the de-consolidation of the various entities that Dieter has explained. But it's €15 billion that we are growing there, and that's why we believe €140 billion is an overall ambition that we can achieve mid-term.

The assets that we have under our alternative assets are explained in many discussions with some of you. They are very relevant for us not only because of the duration pattern, but also because the correlation, in otherwise the diversification effect is something that makes those assets also very attractive.

But I also should quickly mention, simply coming from the alternative assets, because they cover what we call sustainable assets to a certain degree, wind farms or other renewable energy, for instance – ESG for investment management. We have now rolled out our scoring. We are working now on more than €250 billion of our assets with that scoring. We do believe this is really strengthening our overall customer value proposition.

And in addition, it helps us to identify risks in the investment portfolio. We would not go that far that we would say that an asset allocation that uses also ESG scoring is going to deliver a higher investment result, but we, indeed, as mentioned, believe for risk identification, this is a very useful tool in addition to, of course, to the sustainability value proposition that we should deliver.

Well, that brings me already to the end with my summary page. I'm not going through the summary page, but I just would like to emphasize once again, the size that we have with our portfolio is not only a figure as such, it's really a driver of excellence that we can recruit and develop, and that is important especially in a low-rate environment because only with certain expertise, such a portfolio can be managed with that diversification. And we believe we have that all onboard and the figures show this quite clearly.

Thank you.

Oliver Schmidt {BIO 2473131 <GO>}

Okay. With this, we would be happy to take your questions.

Q&A

Operator

Our first question is coming from Peter Eliot from Kepler Cheuvreux. Please go ahead. Your line is open.

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

Thank you very much. I have three questions, please. The first one is on Solvency. Can I just confirm there's no change to your target range of 180% to 220%? And also, there's no change to your guidance on the underlying rate of Solvency capital generation? I mean, I guess just in context. I mean, you're probably now well-above the top of your range. I'm guessing gross of the buyback and I'm guessing the buyback drag should basically be offset by your ongoing capital generations, just the sort of context there.

Secondly on M&A, I guess – I mean, your recent deals tended to be friendly from willing sellers, et cetera. And there's been a lot of press speculation recently about potential unsolicited approaches. I just wanted to give you the opportunity to comment on that, dispelling that or disconnect if you wanted to.

And then perhaps thirdly just on the outlook, just wonder if I can understand your thinking behind the non-Life segment which obviously €0.2 billion, lower than it was last year. I'm sort of guessing you're hoping for less of a drag from Latin America and improving expense ratio and organic growth. And I know we got some investment income compression. But I'm surprised that fully offsets the positive. So just wondering if you could talk through your thinking there? Otherwise, thank you so much for an excellent set of results.

A - Dieter Wemmer {BIO 4755450 <GO>}

I think I'd start with this Solvency II question. I did win the internal bet that this would be the first question. Yeah. So, our target range is unchanged the 180% to 220%. Yes, the capital or profit generation is some 2% to 3% per quarter. But hard to be more precise, and you are fully right. When it takes 12 months to execute a share buyback, we earn it in parallel over time.

The outlook question to P&C, and I'll leave the M&A question to my boss, we have reduced the outlook €0.2 billion – I would put it this way. I think P&C has probably, of all three segments, the best chances to help with the outperformance. We have subtracted just the €200 million investment income. And if we turn around further the business, as you have mentioned, Peter, plus, we have another year where we have actually demonstrated that our net cat exposure is maybe a little bit lower than it used to be, we should be – and we're working and producing results in the right direction. But when you take our full cat load and the reduction in investments returns, then I think despite improvements, the midpoint is very much justified.

A - Oliver Bäte

Yeah. On M&A, nothing changed, actually. This is quite funny because you always need to ask yourself cui bono, Peter, this was an interest instead of tooting around. If you're not a banker and getting a fee, then it's somebody – who would benefit from being a target?

And if you are one of the guys that have a strong balance sheet, then you obviously always assume to be an interested bride. Well, we're interested, but we are not obnoxious about it and, therefore, the criteria are the same. The first thing, it has to be friendly, yes. It should be friendly. It has to be EPS accretive, yes, and it needs to make sense strategically, yes. And it needs to be in a market where we have a strong management team and a strong platform, yes. And ideally, it is in P&C.

That's it.

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

Perfect. Thanks very much.

Operator

Our next question is coming from Michael Huttner from JPMorgan. Please go ahead. Your line is open.

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

Fantastic. Thank you very much. Great results, well done. 4% and with the buyback, you are well on track. Just really numbers questions. And on the turnaround potential, could you put figures to, I guess, Brazil and the Fireman's Fund?

On the Korea, sort of €454 million losses in 2016, how much can I assume this is nonrecurring or how much was offset by maybe gains which are a little bit higher than normal? Maybe you can say a word on Ocwen, I didn't see you mention of it?

And then finally on cash flow, I noticed in the Life, embedded values from the two kind of forward, the €2.4 billion capital movement, which would imply and I know it doesn't really work like that. But about 70% of your dividend is paid out of Life and I just wondered if that's the right way of looking at it? Thank you.

A - Dieter Wemmer {BIO 4755450 <GO>}

I think – first of all, we are showing under the P&C result for Latin America a loss of €75 million. The number is very much driven by really one-off reserve strengthening of our Life business which was retained after the disposal of the Brazilian Life business I think some nine years ago and that was a book which was retained and which we reviewed over the summer and then in Q3 and Q4 booked the reserve. So without this one, so when you look really at the two P&C business, that should not show up in P&C numbers but it was a composite legal entity as far as I know.

Then we would have been already at close to a zero operating profit for the year. So, I think we are turning the corner really in all three markets, Colombia, Brazil and also Argentina. Mexico is anyway on a good profitability level. So, that is not a turnaround story. That is a continued growth story at good profit margins.

So how much this is? Yeah, well, I think if you want to take for all three and the Life one-off some small triple-digit number, that is fair. Fireman's Fund continues to be – actually our accident year loss ratios are I would say very much view as market standard where we still are working on actually replacing very inefficient expensive IT systems and that has certainly taken longer than we originally thought. So it is less of – we don't know how to do the business. We know it, but it is technically less easy to get there.

Korea losses, well, that would be hard to say that we can – that it would not be – yes, it will not be repeated in 2017. However, I think also some of the realized gains, I cannot promise that it will be repeated at this level. So, therefore I see this not as a big positive for 2017. And, yes, I did not mention Ocwen, but we have taken already some reserves in our UK book for a move in the discount rate in the Ocwen tables.

And your last question on the capital movement in Life, no, it's not correct that Life is paying all of our dividend. The highest payout ratio is still coming from our Asset Management business. Actually, I think they paid in 2016 105% of the earnings that are the numbers I like. And P&C has also a strong dividend distribution. So, it's not that Life is the only one, but Life is also returning on a very good level.

I cannot tell you exactly by heart how Korea did influence the overall movement of this individual number, but I think that is as I just said.

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

And on the – just the P&C payout is it, in the past I remember was it 70%? Is that the figure we had this year?

A - Dieter Wemmer {BIO 4755450 <GO>}

Yes. That is certainly on the run rate. And I think on the – on our cash flows from subsidiaries to holding company, I think we are in a very good shape. Our treasury overachieved its annual target, and that is a good way to handle it.

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

Thank you.

Operator

Our next question is coming from Vinit Malhotra from Mediobanca. Please go ahead.

Q - Vinit Malhotra {BIO 16184491 <GO>}

Yes. Good afternoon, Dieter. Dieter, can I just ask a bit about the interest rate gearing from an earnings perspective, because I think it was a few years ago that there was a presentation you made in London or Allianz made in London, which suggested that it takes several years for the earnings to start really materially coming in. Is there any change to that or should we assume that – I know duration is now longer, but is there any intention to change that? Is that a way to put the – maybe that's a better to ask this question.

Second question, obviously, you have commented on P&C. But I'm just wondering whether it was too cautious target, simply because probably this is the first time that in several years that the outlook year-on-year is lower than the previous outlook.

And in this context, I've noticed that you said [AYLR] is flat. But wasn't it true that in the last quarterly results we were hearing that the claims inflation with being beaten by the price increases a bit more. If you could just comment on that also please. Thank you.

A - Dieter Wemmer {BIO 4755450 <GO>}

Okay. Vinit, the interest rate gearing on our earnings, well I think that is very much part of the business model. That is not something we can influence as we like. When interest rates go up – look, in P&C, we are turning around. maybe 20% of the portfolio every year? So that means you have the chance to reinvest 20% of the portfolio and the speed of this – yes, we can certainly look to speed it up where bonds are already shortly before maturity and reinvestment opportunities here. Our teams will for sure, do this and – are doing this already and now quite a bit. But by and large, it is driven just by maturities in business model.

And in Life, the same. We can invest new money and we can invest in matured businesses or where the steepness of the interest rate curve allows a good trade between turning a short maturity into a longer maturity because interest rate got even steeper in the long ended rates. That type of optimization, we will always do.

And in Asset Management, it is obvious what is happening. First on a fixed income fund, the market value goes down. That means even if the average fee is the same, that means on a lower AUM, you are earning in the first moment less on a fund which has a smaller market value, that is just the physics of the setup, there is no chance to influence this.

But in the mid-term, it clearly moves up, and still our Solvency II balance sheet has an interest rate sensitivity towards rising interest rates, so we have a better capital position. We will be easier able to sell new products in Life, also new products in Asset Management. So overall economics, I would see very positive to interest rates, but P&L will – little bit slower follow.

In P&C, I don't think that inflation is already our enemy. I think the claims inflation is not really changing at the moment. Yet now everybody says, in Europe, our inflation rate is up, but when you dig little deeper, the negative inflation rates in Europe were driven by lower oil prices. Now, you have a higher dollar and slightly higher oil prices. As the cost of energy driving up inflation rates, that is pretty much delinked from what we pay for our claims.

So – and we have seen in 2016 there is the latest analysis. We have still overall seen a favorable reduction in inflation compared to original reserving assumptions, and that allowed us, and continues to allow us to recognize reserve strengths as we show it.

Q - Vinit Malhotra {BIO 16184491 <GO>}

Sure. Thank you, Dieter.

Operator

Our next question is coming from Farooq Hanif from Credit Suisse. Please go ahead.

Q - Farooq Hanif {BIO 4780978 <GO>}

Hi there. Firstly, on the Solvency II owned funds and SCR movement, I can roughly calculate the operating capital generations roughly €5 billion to €6 billion, something like that post-tax. Is that right? And how does that compare with the holding company cash flow that you refer to earlier? And are there any operating variances in Life that we should take out going forward?

And a second question again on Life. In the investment margin breakdown that you calculated, there's clearly a big increase in harvesting. And I know that that's an output, not an input in the way you run your business. But, what risk do you see of that declining quite sharply in the next couple of years or is it something that will possibly increase with movements in the yield curve and change in your portfolio? If you could comment on that, it would be really, really helpful. Thank you.

A - Dieter Wemmer {BIO 4755450 <GO>}

I will pass on the Life realized gain question to Günther. Let me start with Solvency II. We have a before tax and dividend and operating capital generation Solvency II of 30 points. Is this fully matched by cash flows? No, because I think the Life new business value is obviously a non-cash item that you have to realize over time. Actually on day one, Life new business cost you cash and is not creating cash in most circumstances So that part is certainly not cash.

But as I said before, we have a strong cash flow when you calculate it the relative to our IFRS net income. And in the end, we are paying out – the dividend out of our IFRS net income. And as you all remember, Farooq, we have done quite a lot of excess capital return activities over the last years and continued in 2016. So I think we are in a very good cash position as I indicated before. But I think to say that we could really cash out every quarter Solvency II earnings, that would go a little bit too far.

And now, I hand it over to Günther.

A - Günther Thallinger

Yeah. Regarding the gains realization, you do know about the total figures that we have here is €8.4 billion now. We had €7.9 billion in 2015 and we had €4.3 billion in the three years before that. So that is more the normal level in terms of total investment picture.

On the Life side, one should actually expect indicative rates increase that this realized gains position goes down, of course, pretty considerably. That's simply following the approach that we have. Is that a risk? No, this is not a risk because, as I said before, it is more a result of implementing our investment approach rather than a form of generating the IFRS result.

As perhaps a final remark to this, one should see that these gains realization not necessarily is always fully into the operating profit because it is, of course, is shared with the policyholder, and in that respect, let's say, even a big figure should not be seen as a major operating profit contributor.

Q - Farooq Hanif {BIO 4780978 <GO>}

Quickly on – if I may return on the capital generation, Dieter, would you be willing to give us a potential conversion ratio, roughly, of earnings to HoldCo cash?

A - Dieter Wemmer {BIO 4755450 <GO>}

I must say then that that is really a creative new question, so I like it. But before I now start a back-of-the-envelope calculation on it, I think we will try to figure out whether we can really find any logical combination between the two that we can give a rule of the thumb for the future. But I would stay away from an answer here on an ongoing basis.

I would only like to add on the Life realized gains. You should not forget the situation in our German Life business which is a major part of our traditional Life liabilities and also assets. Under the local statutory reserves, there is a transition which is so-called ZZR, actually to build up additional statutory reserves, which is I would describe it's technically nothing else than moving unrealized gains from the asset side to the liability side.

That has certainly driven an increased level of realized gains in our overall portfolio. You have to remember that the German number makes almost one-third of our overall traditional Life portfolio and that sets that our contribution, I think, are going to peak in 2016 and 2017. And that is something which is certainly part also of our investment management.

Q - Farooq Hanif {BIO 4780978 <GO>}

Thank you very much. Thanks for humoring me on the cash. Thank you.

Operator

Our next question is coming from William Hawkins from KBW. Please go ahead. Your line is open.

Q - William Hawkins {BIO 1822411 <GO>}

Hi, guys. Thank you. On your change of definition for operating profit, I am now ignoring restructuring charges, just a numbers question, should we still be penciling in as the normal expectation a couple hundred million a year we've seen in the past?

And then more strategically, I guess you're deliberately sending maybe the positive message to your colleagues that they shouldn't be scared to invest in growth or removing that from a performance metric. I mean, is there any material way that might manifest itself in terms of company behavior?

And then secondly, could you just highlight for us this year the Life market that you think you're going to be getting particular attention around your 10% ROE target? They could already be above it. Clearly, the ones that are below it, where you expect that to be the most kind of attention for either earnings or capital relief? Thank you.

A - Dieter Wemmer {BIO 4755450 <GO>}

William, I somewhat missed your first question on the operating outlook. What was your link between the restructuring expense and behavior?

A - Oliver Bäte

Oliver here. I think the question was given the signal on the change in definition, is that also signaling a change in strategy in terms of restructuring our business?

A - Dieter Wemmer {BIO 4755450 <GO>}

Then, I got it right. Thank you. I think, indeed, we remove it from the operating profit because the operating profit is used internally also for our target setting process. As you know, it is part of the management target setting system, and we want to encourage people to constantly think about changing the business, and the target setting system should not be in the way that people are stopped doing what is right to drive the future. That is really to get more speed into the organization and get the people also more looking at opportunities where change could help to a positive future.

The 10% ROE target, well, we haven't not given a list there, that would be actually also a bit unfair to my colleagues in the countries who at the moment, not yet on the 10% level because they are all working hard and has given us a lot of high hope that they are getting there. Therefore, we should wait with until we have 2018 and the .

Q - William Hawkins {BIO 1822411 <GO>}

Okay. Thanks. And sorry, just to come back, in terms of the numbers on the restructuring charge, should we inevitably assume that that line item could be increasing because you said it was fine to be investing or should we...

A - Dieter Wemmer {BIO 4755450 <GO>}

Yes. That line item should be increased, but I'm not expecting jumps to huge numbers. But certainly, a growing – I think we had some €100 million in last year. And currently, we see the same level, but I think we have now the change, and that could be a bit more coming towards the next quarters.

Q - William Hawkins {BIO 1822411 <GO>}

Okay. Thanks very much. See you next week.

A - Oliver Bäte

See you next week.

Operator

Our next question is coming from Nick Holmes from Société Générale. Please go ahead.

Q - Nick Holmes {BIO 3387435 <GO>}

Hi there. Thank you. Two questions. The first is, I wondered how concerned are you by the EIOPA requirement to disclose Solvency II without the long-term guarantee package. I'm sure you can't give us any sort of ratio on what it would be like, but can you give us any idea of what the ratio sort of range might be?

And then secondly, Oliver, just wanted to come back on acquisitions. I know you said nothing has changed, but correct me if I'm wrong, but I think you have indicated in recent interviews that you are looking at large acquisitions, and I think that is a change, is it not? I wondered if you could give us a bit more color on that. Thank you very much.

A - Oliver Bäte

Nick, thank you. Oliver here. It came also up this morning. That is actually a misunderstanding based on an interview earlier where the question was, are you not investing or trying to invest and buy something in the U.S.? And then we basically said, well, that is very challenging because in the U.S., the valuations are very high for the market relative to Europe. And if you want to do something in P&C, you would need to go very large, and then I said – and that's why it's very unlikely.

Now that was turned around and to say, ah, so since you need to be large, then they're going to do large. So that is a little bit like the deck of buy and sell, the chart that you know, and you say buy and then sell is coming out at the end.

Cut the long story short, we remain disciplined the way we are, and our balance sheet allows us to do both large and smaller. But what we are needing to do is to have transactions that make economic sense and that we can handle. And these criteria have not changed. And...

Q - Nick Holmes {BIO 3387435 <GO>}

Sorry.

A - Oliver Bäte

And the other comment, as I said earlier, there's lots of speculation driven by people that have low share prices and we always come up as the guy that might be interested, but we'd like to have a nice bride. Okay. So, Dieter will talk about long-term guarantee.

A - Dieter Wemmer {BIO 4755450 <GO>}

Yeah. I think actually our balance sheet is the best long-term guarantee. I think the EIOPA requirement that I think it's somewhere mid-May that all legal entities in the eurozone have to give their full details on their Solvency II balance sheet and assumption setting is a good step in transparency. I'm really looking forward that there is more transparency in the Solvency II regime as we currently have.

Am I concerned about it? No, because we are not using a balance sheet transitional. And the VA, yes, that was part of the long-term guarantee package. But I think it got diminished by EIOPA redrafting of it in a way, I think, the industry should have got a much better way to handle it because the credit spreads we can use under the VA is substantially lower than the current spreads we are experiencing every quarter in our results. So it is really a small recognition of what we achieve and what any insurance company achieves. And the U.S. insurance industry is clearly benefiting from recognizing 100% of their credit spreads and Europe has to live with a small portion of it. So I think any transparency will help also to drive a fair competition between Europe and the U.S. and I think also a fair transparency between Allianz and its peers.

Q - Nick Holmes {BIO 3387435 <GO>}

Thank you very much for that. Can I just follow-up very, very quickly. First, Dieter, on the long-term guarantee package, are you – I mean is there any concern that the transparency will work against both, perhaps yourselves, but also the industry in lowering ratios to levels where people might get concerned?

And the second question, Oliver, sorry to pester on this, but just very, very quickly, are you saying that you rule out large acquisitions or do you not rule out large acquisitions?

A - Dieter Wemmer {BIO 4755450 <GO>}

Yeah. I'm not concerned about our solvency ratio and the transparency. I'm looking forward that this is a positive. And in particular, when I consider this a very unfortunate debate about the German life insurance industry, and I think I'm really looking forward to the transparency, and maybe some of you have to address their comments.

A - Oliver Bäte

Talking about [adjusting] comments. So let me repeat. We have no predefined size that we are looking at. We're looking at strategic fit.

Q - Nick Holmes {BIO 3387435 <GO>}

Okay. Thank you very much indeed.

Operator

Our next question is coming from Michael Haid from Commerzbank. Please go ahead. Your line is open.

Q - Michael Haid {BIO 1971310 <GO>}

Thank you very much. Good afternoon. Three questions, and first on the expense ratio in P&C, which was again very high. And you mentioned that it includes some investments. Can you talk a little bit about these investments, and can you also give us kind of a number, which may or may not in the future reduce the – by which the expense ratio may be reduced in the future?

Second question, new business generation in Life in Germany was very strong in the fourth quarter. Can you tell us where it comes from? Is it more single premiums or more recurring premiums business and is it more new or actually does it include traditional product? And also regarding German Life, you mentioned that there was a burden from the policyholder crediting in Germany in the fourth quarter. Can you talk a little bit about that?

And last question regarding the ZZR, you just mentioned that this you expect to peak in 2016 and 2017. Do you say that because you assume that the regulation or the legislation is going to change or do you – or can you say that without a change in the legislation regarding ZZR requirements?

A - Dieter Wemmer {BIO 4755450 <GO>}

That was – was this along question two or already including question three?

Q - Michael Haid {BIO 1971310 <GO>}

It was already question three.

A - Dieter Wemmer {BIO 4755450 <GO>}

Okay. Yeah. Okay. Michael, thank you. Expense ratio P&C, well, over the whole year, our admin cost ratio moved 10 basis points up. So that is a [per mill] of €50 billion. Yes, that is still a large number, but it is actually quite a number of projects, we are doing for the Renewal Agenda, and it is, whether it is the customer centricity, to move up net promoter score, whether it is our digital agenda, there is quite some change or implementing technical excellence.

To give you a precise number, I have then really to add up quite a number of details, but it is roughly explaining the 10 basis points up in total. The new business in Life, and in particular in Germany, we are in 4Q – it's roughly half-half between recurring – well, it's difficult to say, because under the German measurement, it is half-half between recurrent premium and single premium in recognizing the revenues of gross single premium as very much the dominating part.

It is very strongly driven by our new products, otherwise we would never get for the whole portfolio the 40% out of capital efficient product and I think our page 19 indicates this. We have in Germany a higher share in the capital efficient product than overall, that is 42%, and only below 20% are actually still traditional products.

Yes, you are right with your observation. We have allocated a higher share of the profits in Q4 to the policyholder. Q4 is always a bit of catch-up quarter to average out the whole year and align it also with the statutory result and the pay – the real payout to the customers. So therefore, there is always a little bit of catch-up. Therefore, the numbers are not stable over the quarter.

Now, my assumption about ZZR peaking is actually more the assumption how the roll forward of this average interest rate is moving. So it is not assuming any change by law or formula or whatsoever. It is more, I would say, a rough guessing how this impacts are moving forward, and that is just a slowing in decline of the interest rate growth, so nothing else.

Q - Michael Haid {BIO 1971310 <GO>}

Okay. Thank you. Regarding the expense ratio in P&C, the 28.7% for 2016, I think it includes more than just the 10 basis points investments into the Renewal Agenda, right?

A - Dieter Wemmer {BIO 4755450 <GO>}

The rest is commission increase. I said this before. Sorry that I did not repeat myself.

Q - Michael Haid {BIO 1971310 <GO>}

Oh, okay. Thank you very much.

A - Oliver Bäte

Michael, Oliver here. Just – because the underlying question is are we remaining committed despite the surge to drive down the traditional business, I just wanted to be very clear, there is just an acceleration, not just a commitment. There's an acceleration of an increase of risk protection, unit-linked, and in particular capital efficient.

And when you – I think your question reflected the fact that, in the past, we were very strong in the change in Germany around the retail portfolio, and in the corporate portfolio, we were a little slower. That was not because we don't want to, but the issue is you have ongoing client relationships and contracts with corporations that take a while to change.

But the direction is everywhere the same. We go into more capitalization products because it's actually better for consumers. It's not just better for shareholders. It's better for consumers, gives them more choice; it gives them more yield. So the – it's actually unabated, and our German colleagues are doing an outstanding job to drive further in the right direction.

And that is what we want to see overall-wise. So the revenue are still slightly down. As we are moving from the old world to the new world, you already can see in Germany how big the success is once you have the right platform of products and services. We will accelerate in the future into the new direction.

Q - Michael Haid {BIO 1971310 <GO>}

Thank you very much.

Operator

Our next question is coming from Andrew Ritchie from Autonomous. Please go ahead. Your line is open.

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

Hello. Hi there. Some very quick questions. What funds are driving the inflows at PIMCO? Is it still mostly the – it was the income fund that was the particular flagship success most of last year.

And in relation to PIMCO and Asset Management division, what are your sort of base case assumptions for 2017 behind the forecast? I mean last year, you were willing to give us – I think that you said you'd get to breakeven or positive flows by the second half, which you did, also kind of working assumption for 2017 both in terms of flows and performance fees.

One other quick question. I just want to understand too, the balance sheet is very strong from the Solvency II perspective. Your debt capacity on a Solvency II basis is obviously very, very large. But I suppose, I'm just trying to – what's the binding constraint on your debt capacity? Is it the IFRS gearing, which is kind of flat year-on-year? And maybe if you give us a number to what you think your debt capacity is.

And the final question is you look like you've hedged equities more in Q4. Will that have a P&L impact, increase in volatility from associated derivative noise? Thanks.

A - Dieter Wemmer {BIO 4755450 <GO>}

Andrew, I start with PIMCO fund inflows.

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

Yeah.

A - Dieter Wemmer {BIO 4755450 <GO>}

Well, you can look at it from various angles. I think what is good in Q4 is that we have actually seen good net inflows in the U.S. And it is still, the old funds therefore I think somebody asked me early this morning that Total Return Fund continues to see outflows, yes, correct. But it is clearly outrun by the newer product categories. And it is also when you look at customer groups, we see the stronger inflows in separate accounts. So that is a bit how I would characterize it in total, so various things.

To give an outlook for the year, well, certainly we assume that the current situation continues. Active credit, I believe, has really a good outlook, volatility in the market, yes, slightly raising underlying rates, more steepness in the interest rate curve. I think that are all good points for an active credit manager, so I think PIMCO is well-positioned for the current environment.

Your question on what is really limiting our leverage. In general, we are still fairly conservatively leveraged. We are not going to the maximum. With our current rating, the bottleneck is Moody's calculation and requirement for our current rating under Solvency II. Indeed, we have substantially more room to go forward. It's interesting, yes, we will, which really allow us to leverage up a bit. Under S&P, I think our capital position, I did not mention this earlier, is very strong, and also the financial leverage would be less binding than Moody's. You had another question, Andrew?

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

Did you hedge equities in Q4. The equities activity was down, and is there an earnings impact from that going forward?

A - Dieter Wemmer {BIO 4755450 <GO>}

I'm glad to pass this on to my new colleague.

A - Günther Thallinger

Yes. It is indeed the case that we manage our equity exposure, of course, to also optimize our overall capitalization under Solvency II and you see this in the sensitivities, and we believe we can do this very well with the know-how that we have internally with AGI, but also with companies like AIG Life in the U.S. And yeah, I believe this is basically the answer to whether we hedge or we don't. Yes, we do.

Let's say, if – yeah, I'm just getting – cost was also a question there. Look, if we now are going to really illustrate what kind of fee load we have on these structures, we really start to make those very transparent. We actually believe that we have a little bit of a competitive edge on that side and therefore, we are not going to explain that. Sorry.

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

Okay. Thanks.

Operator

The next question is coming from Rötger Franz from Société Générale. Please go ahead.

Q - Rötger Franz

Yes. Hello. Thanks for taking my question. I have two little questions. First of all, last year, you disclosed the risk capture breakdown by risk category in your presentation, and that we no longer see that in this year's presentation. So, my question is how actually – has this changed in 2016, especially in the context of the Korean – sale of the Korean Life business? So, can you give us a bit of more detail how this profile has changed over the last year?

And second, it's a bit of a follow-up to Andrew's question in terms of leverage. I understand that Moody's is binding constraint for your leverage. I also see that you increased your sub-debt over the last two years or three years quite significantly. Also, when you take into account that you called €1.4 billion of sub-debt today, which is already refinanced, issued €1 billion in January, do you have a kind of a specific target range that you aim for? Thank you.

A - Dieter Wemmer {BIO 4755450 <GO>}

Yeah. I think, overall, the target range, as I said, is driven by the Moody's constraint. Otherwise, we don't have a specific target range. But when we can use this in a different form, we would also do. At the moment, we have the feeling that buying something more at this favorable market conditions is a great long-term deal. So therefore, we did this very opportunistically. The risk capital breakdown will be, for sure, published in our annual report every year. So, that document is being published soon, and I would ask you for the patience, to do the specific reading there, or when you need to do it faster, call our Investor Relations team and you'll get it earlier.

Q - Rötger Franz

Okay. I will. Thanks.

Operator

Our next question is coming from Edina Rozinka from Deutsche Bank. Please go ahead. Your line is open.

Q - Edina Rozinka {BIO 16575765 <GO>}

Hi there. Two questions, please. Going back to the M&A topic. You highlighted that you are looking at opportunities in P&C. Would you consider a composite business? And the second question is, when you are considering the size, how important for you to maintain your current rating and stable outlook? Thank you.

A - Oliver Bäte

Dieter has given you so many good answers so...

A - Dieter Wemmer {BIO 4755450 <GO>}

I think it's certainly – the rating, we clearly want to maintain. We are selling a AA security to our customers. It is important for our large industrial customers on the P&C side. But personally, it should be much more important for the retail customers who trust us our money for their pension years because there you need to be sure that you get your money back risk – return 50 years from now and that people should be really focused that they have a high quality and highly rated balance sheet, which helps in their – for their old-age provisioning.

So, yes, the composite M&A question is a very obvious one. Sure, when you find something interesting in P&C and Europe there are most likely a Life balance sheet coming along with it. Yes, from our strategy and business interest, we have enough Life balance sheet in Europe. We can cover every part of Europe with all Life products, and we don't need more Life balance sheets. But if the overall deal is attractive, then you have to take it or you will not get the P&C part.

So it has to be taken into the overall calculation, and then you'll decide whether the mix enterprise makes it or doesn't make it. It is a rational commercial decision that is less than a strategic decision.

Q - Edina Rozinka {BIO 16575765 <GO>}

Very good. Thank you. So you are basically saying whatever M&A opportunities you are going for, you want to maintain your rating with a stable outlook, just to confirm. With stable outlook, it...

A - Dieter Wemmer {BIO 4755450 <GO>}

Yes. I think an acquisition, which destroys our rating – the question is about, well, you are creating with this, I wouldn't see this as compelling.

Q - Edina Rozinka {BIO 16575765 <GO>}

Perfect. Thank you so much. Thank you.

Operator

The next question is coming from Michael Huttner from JPMorgan. Please go ahead.

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

Oh, my lucky day. Thank you so much. I was still practicing my question. So, one was just these little points again. You said [U.S. basis] you made some money, and I just wondered how much? And on the assets, I see you said the item, which is across this year and might not be going forward is the IT, and I just wanted a figure for that.

And then in terms of general philosophy on capital management, this kind of more flexible 50 bp envelope, which you can review every year and not every three years, can you give me a idea that you would like, let me put in extreme, compete with Munich Re in terms of being a big cash return company with kind of €1 billion annual buyback and a huge dividend or is your idea instead that you would have the nice dividend that we see at the moment backed by high ROEs, in other words high ROEs meaning more earnings growth? So is capital management designed to return cash, or is it designed to increase your ROE? And linked to that, I still don't understand why the ROE actually went down from last year to this year when everything else seemed good? Thank you.

A - Dieter Wemmer {BIO 4755450 <GO>}

Well, Michael, the swing in the U.S. basis risk is some €155 million, and it is roughly also the profit from the basis – no, the swing, it was a – it's still – it was a year ago a small loss, and this year it is a profit. So why is the ROE down? Well, our net income is 4% up, and very simple, our average equity is more than 4% up, driven also by changes in FX.

And for example, the boost in the equity markets at year-end, which is a nice problem to have, created €1 billion more after-tax after policyholder share in unrealized gains in equity. And as we are calculating our ROE, excluding unrealized gains in bond, so the bond movement doesn't play a role for our disclosed ROE. But obviously the unrealized gains in the other investment classes, also the unrealized gains in our real estate portfolio went slightly up with further increase in real estate pricing. So actually, it all went up for good reasons. As I said before, I really see this as a luxury problem and not as a drama, which we cannot manage.

A - Oliver Bäte

And Michael, the answer on capital management is a cyclical one, not a fundamental. So if you are implying that we want to put ourselves in runoff, yes, but it's not. We would like to grow the business organically and unorganically, but since we do not want to capital sitting idle and accumulating it over three years, so that over time ROE and capital returns deteriorate, we want to give ourselves more flexibility.

Other one is the signaling function because quite a few investors were getting itchy at the end and said, is the share buyback coming, is it not coming. So we want to remove the uncertainty around it. Having few handcuffs and straightjacket is helping our ability to manage. The discipline will come from the targets, let me repeat that, we have given ourselves in November, the ROE targets and EPS targets, and they'll make sure that management is incentivized to keep capital efficiency very high.

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

On the ROE target, I mean the EPS you're there or it's a calculated guessing there, that was all my little questions and stuff. The ROE target, as you say it's a luxury problem, but it seems to be drifting further away. Anyway, it's just a remark. I'm sure it's a luxury problem and you're enjoying it.

A - Oliver Bäte

But Michael, we have given you some sensitivity initially that the share buyback already is adding a significant boost to...

A - Dieter Wemmer {BIO 4755450 <GO>}

50 bps yeah, of course.

A - Oliver Bäte

...EPS growth, all right, and then, tomorrow as well.

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

Yes. Of course.

A - Dieter Wemmer {BIO 4755450 <GO>}

Now, we have to always say when are the shares really bought, when are they really...

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

No, no.

A - Dieter Wemmer {BIO 4755450 <GO>}

But we'll get a double bang for the buck on that.

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

Fantastic. Thank you so much. Thank you.

A - Oliver Schmidt {BIO 2473131 <GO>}

All right. After we have now made it to the second round of questions, I think for the sake of everybody this should come to an end and close this conference call for now. Again, let me remind you, there will be more opportunities to ask questions next week at our analyst meetings.

So with this, we say goodbye to everybody and thank you for having joined our call, and we wish you a very nice weekend. Thank you.

A - Oliver Bäte

Thank you for your support, guys. Keep on buying our shares.

A - Dieter Wemmer {BIO 4755450 <GO>}

Thank you. Bye.

Operator

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