Q4 2018 Earnings Call

Company Participants

- Giulio Terzariol, CFO & Member of the Board of Management
- Oliver BÃ¤te, Chairman of the Board of Management & CEO
- Oliver Schmidt, Head of IR

Other Participants

- Andrew James Ritchie, Partner, Insurance
- Farooq Hanif, Head of Insurance Research in Europe
- James Austin Shuck, Director
- Johnny Vo, MD
- Jonathan Michael Hocking, MD
- Jonathan Peter Phillip Urwin, Director and Equity Research Insurance Analyst
- Michael Hermann Haid, Analyst
- Michael Igor Huttner, Senior Analyst
- Nick Holmes, Equity Analyst
- Peter Eliot, Head of Insurance Sector Research
- Unidentified Participant, Analyst
- Vinit Malhotra, Banca di credito finanziario S.p.A., Research Division
- William Hawkins, MD, Head of European Insurance Research and Senior Analyst

Presentation

Operator

Good day, ladies and gentlemen. Welcome to the Allianz SE conference call on the financial results of 2018. For your information, this conference call is being streamed live on allianz.com and YouTube. A recording will be made available shortly after the call. 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>}

Yes. Thank you. Good afternoon, from my side as well. Welcome to our conference call. There is nothing specific to be added from my side right now. So I hand over directly to our CEO, Oliver BÃ¤te.

Oliver BÃ¤te

Good afternoon. Good morning. And maybe to some of you, good evening from Munich. We have a beautiful day, very much fitting our numbers. I'll give you a quick overview on what we have been achieving throughout '16 to '18. Then a little bit of view on the value-creation strategy that we are pursuing for the next three years and then the more concrete targets and outlook. Then Giulio is going to deep dive. And then we hope for some interesting questions after that.

So let's turn to Page A3 particularly for those that are on YouTube and other channels so you can follow. We had a very nice 2018, again, three years in a row, very good numbers. And we hit our targets on the head. Operating profit up 4%. Shareholders' net income up 10%, dividend up 13% to EUR 9, something we are very proud of. While the balance sheet is still very strong, solvency ratio stood at 229%. The return on equity is back over 13% with 13.2% and the relative total shareholder return versus the Stoxx 50 is plus 7%. So all in all, pretty nice. It is interesting to take a little bit of a step back to 2015 when we announced the first chapter of the Renewal Agenda. On Page 04, you find a reflection on what we tried to achieve over the last three years and how we positioned them. The 3-year EPS growth rate on average was supposed to be 5% ROE 13%. Businesses with the Net Promoter Score above market was targeted to be 75% coming from under 50%, which I'll explain in a second. And we had, out of our annual Allianz engagement survey, distilled an index that would indicate the leadership quality in the company and the feedback of our people thereon. And we wanted to achieve 72%.

Now we have, by and large, made all of these numbers. What I find quite interesting is to go to the right-hand side of this slide and to look at the earnings per share growth in a number of ways. The first one is the 10-year average between 2005 and '10 -- '15, excuse me, was 2.6%. Even worse, the analysts' estimates and the consensus in March of 2016 as a base was about 2.4%. So when we gave ourselves a target of 5%, a lot of people were scratching their heads and said, is this possible? We actually came out with 6.2%, 2.6x what the analyst community consensus was at the time. And we are very happy with that. Now the second argument that we had to confront. And that's focused on, on Page A5 is that we cannot achieve growth, productivity and customer satisfaction at the same time. It is not true. As you can see on this slide, we have made progress on all of these dimensions at the same time. Finally, also in '18, showing significant improvement in the P&C expense ratio, while internal growth rate was at 5.7%, very, very strong. And customer loyalty jumping to 74% of the portfolio. Something, again, that we really much like because it shows that it's not just about financial results, it's powered by underlying improvements in the business. And that is something very important. We can speak more about that. We did in the press conference this morning. And I'd like, at this point, to reiterate the point. It wouldn't have been possible without the strong contribution of our businesses, in particular, the people that live the customer service every day.

Now as we think about going forward, we always go very deep and talk to our investors that is many of you around what are you really looking for when you think about Allianz? And what are the key levers to create value? Now the underlying driver of value is really earnings growth. Once you've reached a certain level of capital strength. And that's very important, you still are giving a feedback, strong and resilient capitalization is super important, as is capital discipline. I would like to reiterate the point what we said almost four years ago now, we are managing your money very, very carefully. We are trying to make sure that it's well invested, that the return on invested capital remains high, above 13%, we'll get there. And we try to invest in the things that really grow value not just grow top line. And an additional point was, ideally a low level of earnings volatility. That is something that is important to us. But we also need to be aware as a financial institution, we are always susceptible to shocks from the outside world and we're going to discuss that today. The world after quite a few years of benign environment is getting a more rocky place as you saw in the Fourth Quarter of last year. And by the way, the First Quarter of last year was also not funny. So we need to be aware the world is

getting to be a more difficult place. And we are reflecting that in our plans, which means, is we're going to focus on managing the levers that are on our disposal, not betting on markets to be benign.

Now when you look at earnings volatility, let's take a little look at A8. And we have listed the development of the operating profits since 2008 and the business segment diversification that you can nicely see at the circles below. And there's been 2 low points. One was 2009 that, by the way, was not Dresdner bank, there was large losses in Property-Casualty, particularly in Fireman's Fund. Then '11, the sovereign debt crisis. Since then, we had a very nice and continuous growth in the operating profitability of the business and that is what we are trying to achieve to continuously build the earnings power of the group without rocking the boat along the way. And that is also reflected on Page #A9. We want to be very strong in terms of resilience whether that's equity market shock, spread sensitivity or interest rate sensitivity. We're going to talk about interest rate sensitivity going forward. One of the big downsides of the Group when that goes back even to the time when I was CFO was the very strong interest rate sensitivity that we used to have in the Life segment. And therefore, we had given ourselves a target to reduce that sensitivity to below 11%. Actually, it's 4% now. So now spread is really what moves our interest rates no more and that is what has been a decade of extreme hard work and a lot of success from the whole team.

Now capital management discipline. Page A10 gives you a very nice view from 2014 until today in terms of the ROE development. And we have said that because of the fact that shareholder equity is growing much faster and has been growing much faster than net income development that we need to work on capital and capital payouts, which Michael Diekmann and Dieter Wemmer announced at the time and we then delivered and have been delivering on. And as you can see on the right-hand side, after 2016, we've made sure that we keep on growing the net income. But do address the overcapitalization in the business to find the proper return and risk trade-off. And with what we have done in the last year, we are where we are. And we're going to continue to do what we said we would do. And you see that with the announcement of the additional share buyback that we did yesterday evening.

Now, again, that is one mechanism to keep the balance between earnings growth and capital growth in check. We obviously have other levers, in particular, to increase organic growth as we announced at the Capital Markets Day in November. Then a supplemental and bolt-on acquisitions if and when they make sense. Or that those instruments remain at this disposal. And just to be very clear, Giulio will reiterate that we keep an eye on your capital and keep it sort of very productive. But there is no automatism in doing share buybacks. We do that if and when it makes sense. Now particularly in this environment where markets are fearful of Europe and we are significantly undervalued by any stretch of the imagination, our own share remains of the most -- one of the most attractive investments for Allianz shareholders and management across the investment universe. And that's why we are investing in our own shares.

Now let's turn to strategy, Page A11. There are 3 objectives: to outperform on traditional and nontraditional competitors; to make really sure that Allianz remains at the forefront of its industry in terms of performance; to transform the business, particularly starting in retail with the Allianz Customer Model at its core and to rebalance the capital allocation towards more profitable growth supported by a number of initiatives, one of them being our direct platform. But also across the geographic channel and customer segment portfolio having very clear rules and hurdle rates. Let me remind you when I get to this section.

Let's talk a little bit about the outperform. Now Allianz has a very good record in outperforming on operating measures. On risk transformation, whether it's the investment side, ALM, on pricing and underwriting, we've always had a very strong hands. But we need to go beyond that. We need to achieve outperformance also on the customer satisfaction side. That's what we said to ourselves the targets on MTS, they are very strong. But it's not the case that we are everywhere the loyalty leader for our clients. We are in most of the places now above market average. We're not yet loyalty leaders in all our businesses and that is what we have to do. And the relative basis for decision-making is not our internal plan, it's actually benchmarking. Who is the best in the market serving clients in terms of productivity, in terms of profitable growth and those are the ones that we have to beat. We don't have to focus anymore on making our internal plans for beating them. And that is only possible if we have the right bench. We have the most motivated workforce in the industry. And there's some more work to do in terms of making sure we train our people for the future and not just motivate. But also enable them to compete in the digital world. In order to do that, we are developing the Allianz Customer Model. We spent a lot of time on that in the Capital Markets Day. So I will not repeat that here. The core idea is to make ourselves more simple than we are today, starting with the customer interfaces, products and then moving into processes and then reflecting that in internal organization, which, given our size and scope, is still quite complicated. Digitalization is a support mechanism. It's not a substitute for human beings. It is supporting simplicity and it's supporting scalability, something that we haven't been able, as an industry, to demonstrate. And Allianz has to do in order to move from a conglomerate discount to a conglomerate premium that we believe we truly deserve.

Now let's spend a few minutes on rebalancing capital allocation. So we've demonstrated and proven to you over the last few years that we are indeed very disciplined in terms of using your capital appropriately. So we started in 2015 with the commitment to move the profitability of our Life businesses, which were the ones that had the biggest challenges at the time, to above 10%. Quite a few people, some of them in the room, said that is really difficult to do. A few years later, we have done it with all but 2 OEs in the group and even those are on the way to achieve a minimum double-digit return on invested capital. On a levered basis, the segment is probably north of 12% at this point in time. We need to do this across the P&C portfolio as well. And we are going to work on making sure everybody meets minimum requirements. That is the basis for allocating capital and for allowing people to grow. We do not want top line growth for the sake of top line growth. We want to grow value. Last but not least, we are building the European Direct Platform for 2 reasons. The first one is to make sure that the direct-to-consumer interfaces are being redeveloped with our legacy. That's the real reason why we are starting there. But obviously, it will spill over and is supported by our traditional businesses. As important is the fact that we need to rebuild the operating platform bottom up and not just in a way that we improve what we have. Because we need to, on a unit cost basis, move to very different levels of productivity from where we are today.

Now if we do this properly, ladies and gentlemen, we will be able to continuously grow the business as you have seen it over the last two years. I'd like to turn your attention to Page 13. The midpoint of the operating profit target for next year stands at 11.54% more than it was last year. And we're continuously growing it. On Page #14, we go back to the same type of commitment that we made three years ago, which is, we would like to grow the earnings per share more than 5%, 4% of which should be organic. Remember the long-term average was about 2%. And so we are going to drive that. The profitability is supposed to be north of 13% without compromising on capital strength. Customer centricity being north of 75% for the top (town) NPS and the IMIX score to top 73%. So we're continuously working on driving performance up across our stakeholder measures. That's what we are committing to. This is a longer-term plan. This is not about making the next quarter target. I know that some of you have different incentives. But that's what we do. And you can rely on Allianz to deliver, not just in '18. But for the years to come. Thank you very much. And with that, I hand over to Giulio.

Giulio Terzariol {BIO 17125489 <GO>}

Thank you, Oliver. Good morning and good afternoon to everybody. I will go shortly into the results for the Fourth Quarter and then speak more at length about the results of 2018. So if we move to Page 03, we see that also in the Fourth Quarter, we had good revenue growth. Especially in P&C, we see a growth in revenue of 5%. So also the Fourth Quarter, again, we had strong delivery on the Property-Casualty side. When you look at Asset Management, we see that revenue have been down in the Fourth Quarter. And this is driven by performance fees and sequentially is driven by the volatility in the market. The volatility in the market had also some impact on the operating profit development compared to the prior period for Asset Management and life science. But still the results are pretty solid considering the environment. And in Property-Casualty, we have been able to grow the operating profits significantly over the last -- over the level of the last year, also because the load from natural catastrophe was lower. And the outcome of all this movement is that the operating profit has been stable compared to the level of last year. When we look at the shareholders' net income, we see a nice increase of almost 20%. And this is mostly driven by the impact of the tax reform in the United States. That impact was negative in 2017 and it has been positive obviously in 2018.

So if we move to Page 5, here we had key KPIs for the entire year 2018. Again, very good growth in our revenue. And especially, we are very pleased with the growth in Property-Casualty, which was 5.7%. I'm going to come back later on this point. The operating profit has increased by more than EUR 400 million. This is mostly driven by the swing in Property-Casualty. We see also an improvement of the results in Asset Management. And in the case of life science, we see a reduction of the operating profit. Most of that was already anticipated in our outlook, as 2017, as you may remember, was very benign from a volatility point of view.

And now when we look at the net income, we see a nice increase of 10%. This is the consequence of the improvement in operating profit, the effect of the tax reform and also, if you remember, we bought out the minorities of Euler Hermes. So this is also contributing to the bottom line. The ROE is north of 13% and the growth in EPS is 14% plus. And as you know, we have dividend -- increasing dividend of 12.5% up. So all KPIs are showing in the right direction, which is improving. So we are very pleased with the results that we have been able to achieve in 2018.

Now moving to Page 07, here we show the solvency ratio is stable. I'm going to come back in 1 second to the different driver of the solvency ratio. Just one comment on the sensitivity. We are -- the most sensitivities are pretty much unchanged compared to the sensitivities that we saw in the previous quarter. One sensitivity, which is much improved is the sensitivity to the interest rate down 50 basis points. If you remember, just 12 months ago, that sensitivity was minus 11% and now it is minus 4%. So we don't have a significant sensitivity to interest rate. We should keep in mind this sensitivity can be a little bit volatile. We saw some volatility over the quarter. But definitely we are in a different position compared to the position we were just a few years ago.

Moving to Page 9, here you see the driver of the development of the solvency ratio. We had about 3percentage point of impact, negative impact, due to regulatory changes just to mention a couple, or three; one was the change in UFR, which is happening, by the way, every year. Then the other one was some change to the way we are including Allianz Life into the Solvency II numbers. And the third one is that we are now including also Allianz Thailand in our perimeter. And before, Thailand was not part of the Solvency II framework. What is very good is the development of the operating earnings. So the operating evolution, which is 35%, this is obviously before we take into account for taxes and for dividend. Once we adjust for taxes and dividend, we have a nice improvements to capital generation of about 15%. And this clearly is offsetting the negative impacts on the market movement. As you know, especially the last quarter has been interesting from a market movement point of view. Then on the capital management/management action, we had the impact of the dividend, the buybacks and also the transaction like Euler Hermes or Taiwan or (the OLB) transaction also impacting that driver. Then impacts that we are adjusting, impact of tax and the other restrictions. So bottom line is strong capital generation that offset, if you want the impact of the market and also has contributed to sustained buybacks and also has offset any regulatory or model change.

And now let's go to Page 11, where we show the growth for the Property-Casualty segment. Again, as I said before, it is a very strong growth, 5.7%. If you look at the growth rate we have been able to achieve in the past in Property-Casualty, you see a growth rate of between 2% and 3%. So what has changed? Just to mention the first 3 companies in Germany, we have been growing 4% in 2018. If you look at 2017, the growth rate was 2%. In Italy was -- we had a growth rate of 1%. In 2017, was a negative growth rate of minus 1.3%. And even in France, for example, the growth rate has gone up from 1.4% in '17 to 2.2% in '18. And that can go down all the list. And I would say, there are almost no exceptions to the fact that we are being --growing faster compared to what we did in 2017 or also 2016. When we look at the renewal season, overall, you see a stable or positive environment. So I wouldn't say that there is a hardening, still hardening in the market. But there is also not a softening. And considering that we have a strong position to start with, overall, we see this as a benign environment. Moving to Page 13. So we see the development to the operating profit for Property-Casualty which went up about EUR 700 million. There are 2 drivers. One is the improvement to the combined ratio and one is the improvement in the investment results. Just to speak now about the combined ratio, the combined ratio improved by 120 basis points compared to the time period. And this time is very easy to understand the drivers. If you see 50 basis point improvement is coming from a lower impact from national catastrophe. Then we have. And that's very good news, 70 basis point improvement from the expense ratio. You remember the beginning of last year. Last year, we said, we want to get to 28.4%. And we are taking productivity very seriously. We have been able even to achieve a 28% and that's a combination of the productivity actions that we have put in place and also is a consequence of having a stronger growth rate compared to what we had anticipated. Also, I just tell you the improvement combined in the expense ratio is more or less wide spread across all entities. So it's not just 1 or 2 entities driving this. But there was a big push in all organization within the Allianz Group.

At Page 15, you can see the combined ratio and operating profit for the selected entities. I will not go into the details now, you can ask me later. But as you see, most entities have been able to improve the combined ratio compared to the '17 level.

Now we come to Page 17, where we show the investment results. As you see, the investment result has gone up by about EUR 100 million compared to 2017. This might not look intuitive, indeed, there is a one-off, which is an accounting consequence of a change in how we participate a policyholder to the different property sources in our accident business in Germany. It is also a component of giving back the premium. So there is a stock of policyholder participation. We have changed the way we participate the policyholder to the different sources and that has an accounting consequence, which has led to, in this line item, to an impact of EUR 100 million positive. There is also, not necessarily related to this thing, a EUR 50 million negative impact on the underwriting result. So the net is about EUR 50 million. But that is important for you to understand that you need to normalize the EUR 3 billion to EUR 2.9 billion. Now EUR 2.9 billion is a good number because that's pretty much stable over the level of 2017. And also, where we are focusing on the development of the interest income coming from our bonds, we see that it's going down. But it's not going down as we thought. So we see some more stability compared to what we had thought in the past.

And with that, we come to Page 19. That's about the Life business. We have been able to grow production by more than 4 -- 5%. And the main driver for the increase in production are Germany and then also the United States. Still a comment we give ourselves the goal three years ago that 80% of our production should be in capital-light or preferred products. And now, we are at 82%. But the good news is not only that we are at 82%. But also that we are able to grow our business having a different products range compared to what we had just 3 or 4, five years ago. So that's the very good news.

Now, we come to Page 21. You can see here that the operating profit for the Life business has gone down compared to the level of 2017. Again, '17 was very benign. On the opposite, '18 was a little bit more challenging. Reality is that we are being able, more or less, to achieve our target of EUR 4.2 billion. So we have been very close. And this despite a higher volatility that we have experienced, not only in Q4. But also, remember, Q1 was also a quarter with a lot of volatility. There are different moving pieces as used in the numbers but the main driver for the reduction of operating profit is the investment margin. Again, the majority of that was already expecting our -- in our outlook for 2018.

And now at Page 23, we show the operating profit and the value of new business for the selected entities. Let's focus on the value of new business for one second. It is growing double-digit. And this is driven by 2 things. First of all, as I said before, we are growing our premium or (low) production by more than 5% and the second one is we have an increase in the new business margin of 20 basis points. So the combination of higher new business margin and also higher production is leading to double-digit growth in value of new business.

When we look at the operating profit, we see that the operating profit for the German entity was relatively stable, which is also what we would expect in such an environment. In the United States, we see a drop of the operating profit. This is, again, the consequence of the low volatility in 2017 and higher volatility, if you want, in 2018. I would even say that the level of performance in '18 is more representative. If you want on the underlying performance, slightly below what we would expect. But not significantly below. Then we had a few headwinds in France. On the other side, the development in Asia-Pacific has been very good with a growth rate of 30%, which is a consequence of the growth of the business. But also, it is a consequence of the fact that we have sold our legacy block in Taiwan. And so the drag from the legacy block in Taiwan has now vanished from our numbers at least for half of the year.

And now at Page 25, we show the investment margin. As you can see, the investment margin has declined by 10 basis point compared to the 2017 level. As you might remember, our range was of a new business margin for 2018 of 90 to 95 basis points. So we are little bit below the range that we gave you. And that's because of the volatility that we saw in the capital market. For 2019, we expect anywhere the range to be between 80 to 85 basis points. I would say that if we have a normal volatility level, we should be at the 85 basis point, close to the upper end of the range. Then if we see more volatility, we are going to grow most likely towards more the lower end of the range. Then clearly, there is always a possibility to end up outside the range in one way or the other. But our best guidance at this point in time is of an investment margin between 80 to 85 basis points.

Now we come to Asset Management. In Asset Management, you can see that the third-party assets under management have been broadly stable. When you look at that, at the net inflows, you can see that on a net basis, between AGI and PIMCO, we had, for the year, the net outflows of about EUR 3.5 billion. Now if you look at AGI. And the allocated number is positive and that's a very positive news considering the environment. When you look at PIMCO, we had about EUR 8 billion of outflows. If you look at the quarterly development, you can see that we had quarters with positive inflows and quarters with negative inflows, especially in the last quarter, we had inflows in the amount of about EUR

29 billion (sic) (negative EUR 29 billion) So that was a difficult quarter. But we also see that as we come into 2019, we had in the month of January, EUR 5 million of positive inflows. So there is some volatility around inflows. But I would say that there is nothing which is fundamentally structural. And especially in the case of PIMCO, considering the excellent level of performance of the funds, we think the franchise of the business is extremely strong. And indeed, we can see this at Page 29. When you look at the revenue development, you can see that the revenue on a fixed adjusted basis went up 6%. If I remove then the performance fees that have some kind of volatility and I just look at the, if you want, the assets under management driven fees, the increase adjusted for FX was 9%, about 9%. So we had a very strong increase in the revenue basis. There are 2 reasons for that. First of all, the average asset bases during the year was higher compared to the level of 2017. But the other point, which is critical is that fee margin is going up. And we saw the fee margin not only being stable. But we already are going up over the last quarters. And this, for me, speaks about the quality of the business.

And with that, we can move to Page 31. Clearly, when the revenue are growing, one would expect to also the operating profit to grow at least to the level of the revenue. If we adjust for fixed effect, the growth in our operating profit in the Asset Management segment was about 7%. One comment on the cost income ratio, as you see, is going up. But here, we need to take into account that we had a consolidation, if you want to call it that way, of ACP, Allianz Capital Partners. If we remove from the numbers the consolidation of Allianz Capital Partners. The cost income ratio improved by about 20 basis point. And this despite the fact that we are investing our business both at AGI and especially at PIMCO.

And with that, on the corporate line, I would just say that the drop in investment in the operating profit of corporate line is explained by the consolidation of OLB. And so we can move directly to Page 35, where we show the nonoperating items. As you see, the nonoperating items went a little bit more negative compared to 2017. Here, clearly, we had a little bit less realized gains. We had a little bit more impairment than we had the impact on the transaction in Taiwan. On the other side, restructuring charges have been lower compared to the level of 2017. What has definitely also impacted positively our results is the tax reform in the U.S.A. As you see, last year, our tax rate was 29%. And this year, it's 26%, which is at the lower end of the range we gave to you of 26% to 28%. And as we move forward, we expect this to be more or less at midpoint of the tax rate we are going to see in the future years.

So Page 37, that's just a famous or a regular scorecard that we show to you. And now, we are at the end of 2018. So we can look backwards. But I believe Oliver has already talked about the very good journey over the last three years. So I don't have anything else to add. It's now that I also want to thank our employees for the great effort and for making these results across the board.

And with that, we come to Page 38. That's some more detail about the outlook for 2019. As Oliver has pointed out before, that's an increase of 4% compared to the midpoint of last year. And that's flat to the level of 2018. That's also tradition that we have here at Allianz as you all saw in the slides of Oliver, usually we set the outlook at the level of the prior period or lower. This tradition has been serving us pretty well in the last year. So we'd like to keep a good tradition. And on top of that, I would also say that there is some volatility anywhere that we saw in the last -- not necessarily in the last weeks. But at least at the end of 2018. And we are very cautious about this volatility. And this is clearly impacting a little bit our view on Asset Management. Maybe in January, the performance has been very good. So this number might be conservative. We take what's happened in January. But we shouldn't forget adjusting it, saying that things might have looks a little bit different. On the Life side, we have a outlook of EUR 4.2 billion, which is consistent with the level of profit of 2018. Here, we need to consider that we are anticipating that the consolidation of a joint venture in Spain. And so from that point of view, if you put back the profit that we are now going to get, the number will be EUR 100 million higher. Then in Property-Casualty, beside the fact that you need to normalize a little bit profit for Property-Casualty and for the one-off I was explaining before, the point is, we expect to have an improvement in the underwriting results as we go into 2019. On the other side, we still take a very cautious view on the development of the income or the investment income. Up to now, usually, our estimates have been always on the conservative side. So our investment income has been higher compared to what we have assumed. But we continue to take a conservative view and then we see what happens in 2019.

And with that, I would like to open up to the questions you might have on our numbers or strategy.

Questions And Answers

Operator

(Operator Instructions) And we'll take our first question from Michael Huttner with JPMorgan.

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

And I had 2 very geeky questions. So I apologize if that's a bit boring. The first one is on Slide B41. And there you -- where you've served the MCEV, the Life embedded value. And there is the item, which shows, what I think of, cash flow to the impairment is just EUR 190 million. Last year, it was EUR 2.6 billion. And I was hoping that Life generates more cash for the group. So I just wondered maybe you can speak a little bit about that. Then on the share buyback, maybe you can expand a bit because there seems to be lots of interesting angles saying, well, it's good to maintain the ROE. But it's not automatic and you only spoke about bolt-on not large deals that you may have done in the past. And also maybe a little bit on the timing. Was it something you wanted by the AGM? And still on the buyback, my favorite topic, what -- on Slide, I think, A10, it says, over EUR 5 billion capital management. And I just wonder if it opens a door to do a little bit more in the rest of the year?

A - Giulio Terzariol {BIO 17125489 <GO>}

Okay. Maybe I'll start with the question on Page 41, where you see a EUR 200 million negative impact on the market consistent embedded value, which is, at the end of the day, if you want that impact coming from dividend that have been distributive from our Life OEs outside of the segment. Now you need to adjust this number also for management action so which have nothing to do with the dividend. So we have management action that improved the MCEV. So you should adjust for that, which is about EUR 300 million. Then we have 3 things that have impacted the position compared to 2017. One is Taiwan, where we had -- as a consequence of the transaction, we had to send money to Taiwan. So that's -- and also a substantial amount of money -- so that's a negative impact there. You can look at this almost like in M&A. Then we had lower dividend or no dividend in 2018 from Allianz Life in U.S.A. as a consequence of the tax reform and also as a consequence of growth. And in the U.S.A., when you grow premium, you have a big charge on premium. The beauty is that when you just go down on premium this comes back right away. Then we had also less upstreaming from Italy compared to what we had in 2017. So if you just adjust for the what is not really a dividend issue and what are the impact from these 3 countries, you go back to a number which is closer to the 2017 number. So that's on this one. On the share buybacks. So the question is what is going to happen by the AGM. I don't think we are going to complete a EUR 1.5 billion program by the AGM. But I would expect that 1/2, or I would say, 2/3 of the program is going to be completed by that date. So that's what will be my guidance. It doesn't make a lot of difference whether we are going to be done by the AGM or 1 or two months later, if you think about the number. But if you are interested in the payout ratio, I will say that the payout ratio should be slightly above 50%. So we'll say something between 50% and 51%. In the sense of the logic of buybacks. And if we are going to do future buybacks, my response to it -- to this question will be, we are just doing a buyback right now. And we are going to think later about potential buybacks. I think we have been very clear in explaining our philosophy. At the end of the day, we are looking for opportunity to create value. And maybe I'll give you also a point of reference. We did significant buyback in the past and also, we have a buyback right now. On the other side, we're also doing M&A. So we -- it's a combination. So if you ask me the best way to create value is some amount where the combination between the 2. Then now, we are doing buybacks. So maybe this might also mean that we might do some bolt-on acquisition. It's also -- but if we don't find any opportunity, we are more than happy to do buyback. Again, we don't have a schedule. It's not that we say every x months, we are going to do a buyback. We look at the opportunity, we look at the numbers and then we decide based on capital discipline, financial discipline. That's how we decide when to do a buyback and also how much of a buyback we want to do.

Operator

And we'll take our next question from Andrew Ritchie with Autonomous.

Q - Andrew James Ritchie {BIO 18731996 <GO>}

So I had 2 quite big-picture questions. Oliver, you talked in the beginning about how we're in a more difficult place with respect to asset markets, capital markets, obviously, we saw that in Q4. I just want to clarify, what is the Group doing in terms of its asset allocation? We got the annual update this time. When I look at it, it doesn't seem there's been any derisking of positions in credit. It looks like you are willing to take up real assets -- real asset exposure higher even though I'm not sure returns are higher. So maybe just clarify what is the Group doing with respect to its own asset allocation in light of tougher markets, potentially more credit volatility? And second question is just a clarification. The ROE target on the going-forward basis, just to clarify, is it formally upgraded from 13% to 13% plus? That being the case, what are the other levers besides earnings growth and capital management? What about internal capital allocation, is there much scope there left still in terms of to deliver the ROE plus target, if that is the new target?

A - Oliver BÃ¤te

Yes. I'll answer the first one and Giulio can do further one. So on the asset allocation, Giulio can give you some more of the details. Indeed, it's watching very carefully the credit quality that we do. And including government debt exposures because they are also relevant for us and we have been very careful. When we talk about real asset exposure, we typically like infrastructure and less liquid assets that are less exposed to mark-to-market volatility day-to-day. Remember, the original target for the so-called alternatives -- and when we talk alternatives, we don't mean low-credit quality, we mean real estate, we mean infrastructure, the original target was EUR 110 billion. We have achieved EUR 140 billion at the end of '18, just to give you the comparison. So this is what we are talking about in order to make sure our results are less volatile than they would otherwise be. And we are very careful in terms of diversification. The other one is, in terms of where is upside on the ROE side. Indeed, we would like to maintain an ROE higher than 13%, not just get to 13% and there is various levers. The number one is what we've just said and the people still apparently not fully believe is that we keep our investors' money very carefully where we need it to have it. But if we don't need it, we'll bring it back. Now the reason why we are on this one in an environment that we are in where you have lots of volatility, you need to find the balance, not just the disciplines, between having a very strong balance sheet and not having capital sitting idle. We have quite a few investors said, don't go too aggressive on buybacks and on solvency because you want to make sure that under all circumstances, Allianz will be standing. And that is a very clear prerequisite for anything that we do on capital management. We draw the house, err a little more on the conservative side just to be very clear. Now we still believe in the portfolio. I can take P&C as an example. We have improvements in terms of capital efficiency. Some of our wholesale businesses that are operationally very good, Euler, AGCS are still extremely capital intensive. So there are various levers that we can pull to improve capital efficiency further.

Q - Andrew James Ritchie {BIO 18731996 <GO>}

And just to clarify, are there any areas of credit risk where you have actively derisked over the year?

A - Oliver BÃ¤te

I am not aware of that in any large scale. We do this on a continuous basis.

A - Giulio Terzariol {BIO 17125489 <GO>}

Italy. Italy.

A - Oliver BÃ¤te

Yes. The one thing we can -- could talk about is that we, as we have outlined three years ago, have a consistent strategy to reduce sovereign debt exposure in sovereign Europe. Italy has been example, where we have a long-scale schedule. But we try not to sort of panic just because some spread widening happens. We have an optimization program that balances returns with risk reduction. And Italy would be a notable case. We have been reducing our exposure. But that is according to plan, not because of the elections or anything else.

Operator

And we'll take our next question from James Shuck with Citi.

Q - James Austin Shuck {BIO 3680082 <GO>}

First question was -- I just want to return to the dividend and the buyback. So the payout ratio is -- I think, Giulio, you said, it was 50% to 51%. I kind of get 51.6%. So a little bit above that. Your kind of guidance on the dividends had been pretty clear. It's 50% on payout. So I'm just wondering whether that's just a nice rounding to get to EUR 9.00 on the dividend. Or are you starting to creep up a little bit on the ordinary dividend payouts? Then within that, also on buybacks, I heard your answer from earlier. I'm just interested to know, are you moving more towards an annual cycle for buybacks? Or is it something that you'll just revisit at relevant reporting periods? Second question on the Allianz Customer Model. So the digitalization and products simplification, obviously, you're seeing good benefits from that taking market share in some markets and good margins. I'm just wondering, is there a trade-off with that model? So for example, is it affecting your product delivery? And is it affecting the actual customer segment that you're going after? So for example, is it mass-market customers more than the higher affluent who might want a more tailored solution? Then finally, just on U.S. Life. So I think the fixed index annuity book was up 20% or so across the year. Do you think that business is really starting to get to reliant on 1 product? If you can get me a split of the sales by type of product that would be helpful. Just focusing really -- I imagine that kind of 70%, 80% of sales were FIAs. But some -- obviously, there's some quite attractive valuations out there at the moment for U.S. Life company. So if you did want to diversify, would M&A be something you consider in that space?

A - Oliver BÃ¤te

Well then, Giulio will tell you all of the big ones. I'll start with a funny answer. We really liked that EUR 9. So we -- generally the policy is 50% payout plus obviously the effects of the share buybacks that come on top. But just as a more facetious answer. Giulio gives you the details. The other one on the ACM, I think there is a misunderstanding. When we talk about harmonization of what we do, for example, the Allianz product library that has more than 200 modules, then this has nothing to do with standardization in the bad sense. You think about it as your playlist on Spotify. Now you have billions of combination opportunities. But it's always the same songs that you are combining. It's just no more printed -- pressed on to a record. So what we're trying to say is we are creating modularity that we can replicate across markets. And by the way, we are underpinning it with IT capability so that we can sell, for example, a German life insurance product into Italy or into Belgium in the future. That is really what behind -- it's behind and that will give us, for the first time in our history, true scale. It doesn't mean that an affluent client is going to get the boring standardized offer that doesn't meet their needs. Giulio?

A - Giulio Terzariol {BIO 17125489 <GO>}

Yes. So maybe starting from the question about Allianz Life. So the production is pretty much everything either in FIA or in a so-called hybrid VA. And hybrid VA, at the end of the day, from an economic point of view, is the same like fixed index annuities. So the distinction is a poor -- pure technical distinction of the way you submit a product. But I will say that 99% of the production is fixing this annuity or fixing this annuity life production. So that's also business we are extremely comfortable with, with a new business margin, which is north of the 3.7%. So that's also the bread and butter of the company. And there is pretty much no traditional VA left, I will say. It's totally negligible. Then I think you had question on the buybacks whether we are on a annual cycle. No. We are not on any kind of cycle, again. We're definitely not on a quarterly cycle, let's put it this way. But I wouldn't say, now we are on a annual, biannual cycle.

A - Oliver BÃ¤te

Let me just add, James, because I think actually it's a very good question in the following sense. Giulio has explained on the capital generation side that we typically have an idea of what the underlying capital generation of the group is, it's about 10% of the solvency. Now last year, it was 15%. It was very strong. The cylinders kept on pumping. And when we find out that the capital generation is stronger, I just would like to reiterate that we are then disciplined to say whatever we don't need for the growth of the business, we'll give back as it emerges. So we have no incentives in the board to have your money sitting here idle. But we also have, in light of this markets, no hurry in order to make sure that we stay protected with a strong balance sheet. That is the balance that we are trying to strike.

Q - James Austin Shuck {BIO 3680082 <GO>}

That's helpful. Just coming back on the U.S. Life. My question was also around, do you think that business is overly reliant on 1 business line? And shouldn't you look to be diversifying into new areas? We've all seen what happened with or nearly happened with (inaudible) annuities, for example?

A - Giulio Terzariol {BIO 17125489 <GO>}

Okay. That's a good question. So personally speaking, I can speak as the former CFO of Allianz Life. I wouldn't say that it's critical to diversify into different lines of business. I would say think about that, we are speaking of the huge market, the annuity market in the United States. And also, I will say, it's more about diversification within different distribution channel. So that's the diversification we should be looking at. But it's a huge market. So we think is a niche. We are speaking of markets of billions, billions of U.S. dollars. So my view. I might be wrong. But my view has always been that there is enough diversification revenue that you can get by diversifying distribution. And I think that being very focused on doing something very well can pay off also pretty well.

Q - James Austin Shuck {BIO 3680082 <GO>}

And by implication, I presume you've ruled out any acquisitions in the U.S. Life space, does it?

A - Giulio Terzariol {BIO 17125489 <GO>}

I never rule out anything. But I will say, there will be something that is not necessarily -- yes, I wouldn't say this is something very likely. But completely ruling out something, we'll never do this, yes.

Operator

We'll take our next question from Jon Hocking with Morgan Stanley.

Q - Jonathan Michael Hocking

Three questions, please. Firstly, over the beginning, you were talking about earnings volatility, reducing it as a value lever. I just wonder whether you can talk a little bit about which lines of business or maybe geographies you see as being particularly volatile? Or whether you're just talking about lines of business or potentially managing the vol through the mix. Is there anything left here that you want to -- you've taken obviously some of the lifelines, a lot of capital intensity. Was that something that's backward-looking, or was that a forward-looking statement? Secondly, on AGCS, the revenues are up a lot even though the rate achieved is relatively modest. I just wonder, are you actually calling the cycle a little bit there? And how did you sort of square the circle in terms of growing that business so much when it's still running at above 100% combined? Then just final question on the capital sensitivities. Maybe a little unfairly given what you've done on the interest rate risk. But given the interest rate sensitivity, now it's so modest, the softening spread is looking at one of your biggest sensitivities on the downside. I just wondered, firstly, how much of that is Italy? Then whether there's anything you can sort of usually do to reduce that volatility?

A - Oliver BÃ¤te

I'm going to talk about the earnings volatility and then can hand it over to Giulio, can say a little bit about the AGCS strategically. Now there was more a backward-looking statement in terms of what is meant and it was more solvency at the moment and then volatility out of risk that we don't get paid for. So people will sometimes internally say, Mr. BÃ¤te doesn't like volatility from NatCat. No. That's not true. I just don't like volatility that's not paid for. So we need to make sure that we actually get paid for taking risk. And we have a very robust proactive framework that you know, that Dieter introduced on the top of what we've done in prior years. I'm just reflecting on what investor feedback is. They search for us. I just like to always mention, we have volatility and solvency out of credit spread that we believe we actually economically don't have, it's one of the failures in the Solvency II model because it reflects run risk that we don't really see. And I would like to reiterate that and hope that, that Solvency II flaw gets eventually fixed one day. But the interest rate sensitivity was really one of the things that are really bad because you don't get paid for it neither by the market nor by that. So I'm very proud of the team in terms of having brought this one down and that is a big achievement. AGCS, when you look at the numbers of AGCS, never forget they still chew on the Fireman's Fund portfolio in the U.S. They're still in the process of restructuring. We said, until 2021, they have to change their underlying operating platform and system. So they're running on both the old and building the new. And that creates a drag on -- gives them the very high expense ratio. And in terms of the growth, we're obviously looking at it and we need to look at it very carefully. But Giulio can give you some more details.

A - Giulio Terzariol {BIO 17125489 <GO>}

Yes. So and as you said. So we know the history. We are three years of combined ratio of over 100%. But we know for sure that there was also a lot of volatility going against us. So we're not at a 100% combined ratio as the underlying performance of AGCS, that's very important. This -- we don't want to be complacent. Me understand that there is some work we need to do. And on the pricing side, I would tell you that we see some stronger pricing, especially in the area that have been either affected by natural catastrophe in the past year. So also in the areas where the combined ratio, the underlying combined ratio is higher. You can also see that a lot of competitors are suffering on the industrial line. So there is definitely a trend, which is in the right direction. And now we need to see how strong this trend is going to be. But I sat down with the management team of AGCS just a few days ago. And we can really see some rate improvement, underwriting action that we can now get through. That wasn't necessarily the case a few months ago. So from that point of view, we should see the improvement. But I come back to the point, the biggest thing is not to see this kind of volatility either from natural catastrophe or also from the large (cost) that we saw. This year already is going to show very different numbers. Then the additional improvement should lead to our target combined ratio of 96%, potentially even 95%. But I would say, 96% by 2021. So that's in AGCS. Then you have a question on the Solvency II and this price of government -- to government bond. I just tell you that -- and the question is also how much is Italy? Since we are stress testing the thing in a very automatic way, we just take 50 basis point on everything, including the German bond. And so in reality, you can apply a percentage of how much Italian bonds we have on the portfolio. That's about 10%. So I would say that about 1% of the sensitivity might come from Italy. Now the point is, it's most likely that we get sensitivity out of Italy as opposed to getting the sensitivity out of a German bond. But the contribution to the sensitivity is more or less a proportion to the portfolio. The likelihood that we are going to see sensitivity from Italy is stronger. Now there is a feature, which is called the volatility, the country volatility adjusted debt might kick in, in some situation and even dampen their volatility. So there is a point where, in reality, you get almost a cliff effect. Now to your question to what we want to do on that? I just tell you that in the case of Italy, as Oliver was referring before, we have a kind of program where we are, over time, reducing the exposure. But I would not necessarily divest from German bonds because of a sensitivity, which is, we know, a flaw, if you want, of the Solvency II calculation. So there might be other reason not to invest in German bonds because you get 0 interest rate. But not because of a sensitivity to Solvency II. So the answer to your question is, yes, for some country where we see higher risk, we have already decreased our exposure. And we are going to take the opportunity to further the risk. But fundamentally, we don't think that having a sensitivity to government bonds is a bad thing. And we also can see that our solvency ratio is extremely high. So also from that point of view, we can definitely afford this kind of sensitivity.

Q - Jonathan Michael Hocking

Just to come back on AGCS. You're writing business here motivated by technical price not a desire to get the expense ratio down faster?

A - Giulio Terzariol {BIO 17125489 <GO>}

I think you have to repeat the question because I didn't get it. Our cost actually -- can you repeat the question, sorry?

Q - Jonathan Michael Hocking

Yes. So on AGCS, just to be clear, you're writing the business based on technical price not a desire to get the expense ratio down faster?

A - Giulio Terzariol {BIO 17125489 <GO>}

No, no, absolutely. Absolutely. So no, no, we are using technical price. Maybe sometimes also a difference between technical price, actual pricing and then you have to go through the portfolio. But absolutely, we are driving to -- for further portfolio on aggregate on getting the technical price. And there is no misunderstanding that writing business just to sustain the expense ratio is not a good idea. And indeed, I tell you even more, the fact that we are putting so much emphasis on productivity takes, in reality, to be disciplined on underwriting because the pressure on bringing down the expense ratio and to be productive is there. And we pay attention that there is no growth that is used to somehow get a better expense ratio.

Operator

And we have a question from Vinit Malhotra with Mediobanca.

Q - Vinit Malhotra {BIO 16184491 <GO>}

There's 3 questions, please. One on P&C, one on Life and one on Asset Management. Start with P&C. So just the large losses have been a bit of a pain last year, also very much in Fourth Quarter. Are you thinking a bit about them as something that will go away? Or maybe more reinsurance? Or is there some link in your models around the very high growth and some of these large losses? If you can just comment on that or if you could provide any numbers from the Fourth Quarter without large loss. That will be excellent. Second thing is just on the Life. So I hear these -- the conservative approach and market risks. But this 80% to 85% suggests what exactly that you think markets will be more volatile? Or do you -- or is there other -- is there some other reason for downgrading the investment margin? Lastly, on the PIMCO fees margin, which has been very surprisingly positive, amazing result. Is this simply because more structured credit kind of products are being sold and less because -- so is it more that? Or is it the retail institutional? Or are these one and the same thing? Or maybe you could give us sense of the flow between these 2 lines, if possible.

A - Giulio Terzariol {BIO 17125489 <GO>}

Okay. So I'll maybe start from the large losses. So clearly, we are looking to that to see whether any kind of large losses are consequence of bad underwriting. And indeed, we have a loss review, a post loss review. Every time there is a large loss, we are going to -- or the underwriter, they are going to look into that and determine whether there was an error in underwriting or not. But maybe I want to give you a little bit of sense of what we are dealing with. In -- I'm just looking at the losses of a EUR 10 million. In 2017, we had -- in 2018, we had about, let's say, 27 losses over EUR 10 million. And in 2017, we had like 21. So 6 more losses but the average loss is about EUR 20 million. So you already get EUR 220 million and this already makes 30 to 40 basis point to our combined ratio, loss ratio. Now we are speaking of 27 losses as was 21. So it's not -- that's something also that we can definitely argue about should be 20, 27, 30, 19. So it's something that is very difficult to give an answer. So we go back to the underwriting point. The only thing you can do is to go through the review with the underwriters. And when the underwriters say it is okay. And we would rewrite that business, that's something that tell us that from an underwriting point of view, we are now making a mistake. But we are not taking this lightly. Clearly, we're looking into that. I don't think is a major issue anyway. We are speaking here of 20, 30, 40 basis point. And there can be some volatility over the years. On the Life/Health side, the 80 to 85 basis point, I would say, is twofold. So there -- on the one side, clearly, we are kind of cautious because of the volatility that we saw. But we also know that some other recent pressure on the investment margin, especially in Europe because we have a low interest rate environment. So from that point of view, to expect that there will be some sort of compression in the margin is reasonable. On the other side, we shouldn't forget that there is a -- basis is also growing. So there is a little bit of an offset on the absolute amount. Then 1/3 element, which is placed around 2. When we look at the United States, we had that tax reform. And the tax reform leads to a lower tax rate, which means you can get to the same ROE if you want. So IRR, because we are speaking in terms of IRR in pricing by having a little bit of a lower spread. And so now, we didn't pass all the spreads -- all the tax reform benefits to the policyholder. So we kept something for the shareholder too. But somehow, we are sharing part of it with the policyholder. This means that we can get to a slightly higher return compared to before having a lower investment margin. So you need to add up a little bit of caution because of the market, a little bit of the impact on the tax reform. And the United States is a big market for our numbers. Then also some compression and then you can understand why we are putting down the margin between 80 and 85 basis points. Then coming to the last question, which is Asset Management. I will say that in reality, when you go into all these alternative products, you might have rather increasing performances as opposed to see an increase in the fee margin because the fee margin is without a performance fee. So indeed, that might be even playing against the fee margin. I just go back, let's say, PIMCO, they increase one year ago, about one year ago, the fee on the income fund. So when you have a performance, which is as strong as the performance of PIMCO, then clearly, you can have also a pricing strength and you can see that. In the case of AGI, as I just tell you, they are not giving the set targets. They don't give targets to the distribution based on flows. But they give targets based on run rate revenue on the flows. And this makes a big difference. So when you look at the number of AGI, you try to make a relationship between their run rate revenue on the flows. And the flows, you get very strange numbers because you might have negative flows and positive run rate revenue and that's because of a focus of management of AGI about getting quality business with good margin and is not about chasing flows at low margin.

Operator

And we'll take our next question from Nick Holmes with Societe Generale.

Q - Nick Holmes {BIO 3387435 <GO>}

A couple of questions. I wondered if you think your new targets are stretching enough since you actually seem to be achieving most of them already. And a good example is expenses, your P&C expense ratio is starting to come down but I wondered, could you give us more about your ambition here. I notice, for example the German expense ratio is very attractive at 25%. Is this something that could be viable for the whole of the group?

A - Giulio Terzariol {BIO 17125489 <GO>}

So when we look at -- the ambition is -- the ambition that we spell out in the Capital Markets Day just a few months ago. So for example, when we said that on the expense ratio, we like to be at 27.5%, clearly, if we can run as fast as we had been doing in 2018, if we continue to see growth, I would expect that we are even going to be better than the 27.5%. But we need to see how the next years are going to play out. And on the combined ratio, we said we want to go to 93%. So at the end of the day, it's going to be a combination of productivity improvement. But also working on the technical excellence. We also need to assume. And I'm going to be very clear on that, we are not going to have the same runoff for the foreseeable future. Rate runoff is going to come down and we are aware of that and that's the reason why we are working already now on technical excellence to improve further our numbers. On the life side, I think we discussed that we're going to put a lot of focus on the value of the business growth because the value of the business growth is converting into operating profit. Also from an analytical point of view, we want to do more work on that. Then in Asset Management, we gave us targets also on the cost income ratio. In the case of PIMCO, we're keeping the targets that we had in the past, which is cost-income ratio below 60%. And as you know, PIMCO is heavily investing in the business. And in the case of AGI, we want to push the cost income ratio below 67%. So to your question whether we're making our life easier, I don't think we're making our life easy. We have work in front of us. But I also confident that we can achieve our numbers for 2021 and let's see how much progress we do in '19.

Q - Nick Holmes {BIO 3387435 <GO>}

That's great. Very clear. Just as a follow-up, sorry, on the subject you mentioned about sort of runoff is 3%, I think you said that is your, kind of, normalized level, you're running at 4% at the moment. Should we expect 3%. And if so how quickly?

A - Giulio Terzariol {BIO 17125489 <GO>}

I would say that that's my working hypothesis. We don't know how things are going to play out. It will depend on the inflation. But I will say, yes, when we -- our working hypothesis is that over time the runoff is going to stabilize to a 3% level. This is not something that necessarily is going to happen anywhere necessarily in 2019 or '20. But I will say, by 2021, that's the working hypothesis. So we need to fix a few assumptions too and then we need to work around these assumptions in order to give us also the targets that we want to have from an accident year loss ratio and expense ratio point of view. But that's the number that we are using in our thinking.

A - Oliver BÃ¤te

Nick, just to show you the 10-year average is anywhere between 3.5% and 3.7%. So we've always had a strong reserve base. So I and Giulio do not expect a sudden drop off of the reserve runoff levels. But more a slow sliding scale on that. As inflation picks up, I think the key long-term driver has been declining inflation in the industry. And we have been reserving to a higher reserve levels that is normalizing. But it's slowly but surely normalizing.

Q - Nick Holmes {BIO 3387435 <GO>}

That's great. And so the reserve ratio, I notice, has been dropping a little bit. Is that something you would recognize? The P&C reserve ratio has been falling, I think, in 2018?

A - Oliver BÃ¤te

Yes. The issue is that it is bit distorted by higher NatCat events. The way, when we have NatCat, we reserve a lot and then we ran that off relatively quickly. And then you see that volatility -- so as NatCat reserves go down then you have higher -- sort of less high reserves and that normalizes. So there is no decreasing trend in the numbers.

Operator

And we'll take our next question from Farooq Hanif with CrÃ©dit Suisse.

Q - Farooq Hanif {BIO 4780978 <GO>}

Just going back to the Allianz customer model, I liked your Spotify description as kind of a good way of understanding it. But it is quite radical and it is resulting in a lot of change in a way that you do business and the way your peers do business. So just wondering what the -- your employee response has been to it? How they feel about it? And importantly, also, your agents, how on board are they with it, particularly given development of the direct platform. Second thing is, you used to have EUR 400 million or so of annual spend on digitalization, has that continued? Because I know your IT budget has gone up a little bit? So I just wondered what your annual spend is? And lastly, going back to the expense ratio reduction. From switching off legacy IT as you move to the ACM, how quickly will we see the impact of that in cost cutting?

A - Oliver BÃ¤te

So -- and Giulio can also chip in as he feels fit. So the employee base is actually static in a positive sense because we're finally starting to produce benefit from innovation in one business to moving that to another one. And the key thing is, again, you create modules for people to use. So for example, we have established the Allianz product library and a product configurator in the Allianz business model, which allows you to bring product design much quicker to the marketplace, bring innovation much faster to the marketplace and then get benefits out of it. For example, our top OEs in Motor are going to be on all of the same pricing -- real-time pricing model, relatively soon. So you can see benefits from comparing pricing algorithm across markets and that gives us competitive advantage. On the direct platform, there is always nervousness. But I call that phantom pain. It's like people that have no arm talking about the pain in the finger. Why do I say that, because there is no cannibalization. There is no cannibalization between direct and non-direct. We can see that in Italy and we manage that, by the way, very carefully in the way we approach the market. The client, however, he or she decides at the end of the day how and where they want to buy from us. That is the person who decides what we do is neither the distributors nor the product people. And we need to have a competitive offer that is scalable in the direct world. That is actually the key item when you think about competitive dynamics, sorry for being a bit strategic. The digital players have one big advantage. They work on platforms that are scalable. So with every additional clients, the average cost declines. We have, unfortunately, the reverse business model that shows that it's 250 years old. Our costs are unit links step upwards for every volume increase and every price increase, we pay more cost, mostly on distribution. And we need to get out of that trap. It's a long-term journey. But it's essential for us to get started as quickly as possible. On IT, we're spending EUR 3.6 billion a year on IT globally. About EUR 600 million for that is on Asset Management. By the way, they are going up because, for example, PIMCO is massively investing in technology with its new tech center in Austin. That also explained a bit the increase in the cost-income ratio there for the year. And that will not go away. What we have to do is invest it more smartly. We always say that we have been taking older business models and put them into new bodies, i.e. new IT. We need to make sure we switch off the old stuff and use the money wisely to simplify our product. Now in terms of benefits coming through, great question, don't know the answer yet. We are starting and we're going to exert enormous pressure on product and systems retirement, not just for productivity reasons, gentlemen. But also for IT security reasons. The biggest source of IT risk is old, undocumented IT systems that we run. So we need to make sure that we retire our old legacy systems as quickly as we can. I cannot give you a specific number on what the cost benefits are. Giulio has some estimates and with that, I hand over.

A - Giulio Terzariol {BIO 17125489 <GO>}

Yes, I wanted just also to talk about your question about how much we are spending on digitalization and similar. So we changed a little bit taxonomy of how we are tracking the IT spend. But I can give you an idea. When we look at the IT change, which is about EUR 1.5 billion for 2019, we are spending about 1/3 of the IT change in productivity measure. That has a lot to do with digitalization, simplification of products. So 1/3 of this budget gets into productivity. Then we have about 20% that we are spending in growth and innovation that's also tied to the topic of changing processes as we also interface with the customer. Then, we have about 10% to 16%, which is the commissioning. That's not necessarily about investment in digitalization. But that's about removing legacy system. This will allow us then clearly to free up resources for further investment in digitalization. So a lot of the budget that we are deploying in IT goes into the topic of productivity, digitalization, removal of obstacle, if you want, to have a easy infrastructure to deliver our services.

Q - Farooq Hanif {BIO 4780978 <GO>}

So that EUR 1.5 billion, that's an annual number or is...

A - Giulio Terzariol {BIO 17125489 <GO>}

Yes. That's an annual number. It's about EUR 1.5 billion that we are spending on an annual basis on change the company's IT budget is.

Operator

(Operator Instructions) We will move on to Peter Eliot with Kepler Cheuvreux.

Q - Peter Eliot {BIO 7556214 <GO>}

The first area I really wanted to discuss is just have deep-dive into the drivers of the Life business. I mean, I presume that investment margin is going to come down much slower in the future. So I'm just wondering if you can give sort of rough guidance as to how you expect that to develop in the future years? And when I look at the results you just reported, Q4, in particular, I guess, it was a little bit light. When I look for the whole year, you say loadings and fees. You say we're up in line with growth. But -- plus the EUR 100 million, I guess, is a little bit lower than the growth rate you are seeing. So I'm just wondering if you could square that. And when you look at guaranteed savings and annuity business, that's been a very stable quarterly contributor to operating profits. But Q4 was down I think about 200 year-on-year. You talked about U.S.A. and unit-linked reclassification in France. But I don't think those were huge drivers. Looked like the U.S. Q4 result was reasonably good and maybe a huge driver. So just wondering if I can understand those moving parts. Then very quickly, on Asset Management, you said you'd had a good start to the year. I was wondering if you could just give an update on flows or any other comments you want to make.

A - Giulio Terzariol {BIO 17125489 <GO>}

Asset Management. Maybe let's start from the Life side. Your other question about how the investment margin is going to develop, I guess, beyond 2019. The range for '19 is 80 to 85 basis point. I would say that the new business margin should -- not the new business margin, sorry, the investment margin should somehow stabilize towards the 80, maybe could go down to 75. But then I would say that will be where the new -- the investment margin is going to stabilize. Always keep in mind that the reserves are growing. So there is an offset. But that's also the reason why when we had the Capital Market Day, we also said that the growth rate in Life is more about 3%. That's the reason why we need to get. And value new business to go up. So that we can add to the growth level operating profit. So that's already all reflected in our thinking. You were asking questions about the guaranteed savings in annuity. And you are referring to the federal number both for the year and also for the quarter has been low. This is also driven by the VA, variable annuity. Just trust me, when you have volatility up and then VA is going to go down and when you have volatility down, VA is going to have a very nice profit. Just to give you an idea, in 2017, the VA operating profit, just from the United States, was EUR 260 million. That's a big number. That's a block, which is less than EUR 30 billion. So when you have a 1% margin on the VA reserve, that's a huge, huge margin. Now this year, we had EUR 40 million, which is clearly not as good and that's because the volatility has been higher. But you really need to normalize the 2017 results. And the same applies also to the quarter. When you look at the quarter, clearly, the volatility was very high. I just also tell you that in the quarter, in VA, in the U.S., we had a small loss. So the numbers up to September were indeed not that bad. Then in the Fourth Quarter, clearly, you have a loss. That's also the reason why we stopped doing VA many years ago because we don't really like this kind of volatility. Then I think you had a question on the loadings. And this is honestly speaking a little bit too detailed. I believe there is always some sort of noise. So I wouldn't just necessarily (notate) the growth and say automatically is going to reflect in the way we are calculating the loadings here. Then on the flows, I can tell you that the flows in Q1 or in January have been good. For PIMCO, we had EUR 5 billion of flows and that's important for me. When you look at 2018, it's true that we had negative flows at PIMCO. But what is important, you don't see a trend. I will be concerned if you see a trend. But when you see the flows are positive in some quarter and we have a very good quarter and then sometimes are negative and then they go back to be positive, then I would really say this has to do with volatility. Sometimes you might lose some big mandates and they might not really be mandates with a high fee. Then a while back you get -- later you get this money flowing through. So I really don't think there is any issue. PIMCO, on the opposite, the performance is so good that I believe PIMCO is the place you want to go and invest if you are an investor.

Operator

And we have a question from Jonny Urwin with UBS.

Q - Jonathan Peter Phillip Urwin {BIO 6126952 <GO>}

Just 2 quick ones on P&C, please. So what drove the 1.2 points of attritional pressure on the loss ratio in Q4, please? I suspect it's just large losses, quarterly volatility. But any color on the underlying development would be good. Secondly, on average, across the booking and P&C, could you give us a rough estimate of where claims inflation is running? And is the trend positive or negative?

A - Giulio Terzariol {BIO 17125489 <GO>}

Okay. So coming from the -- answering the question on the attritional loss ratio. I will say that in reality, this year you see less of a volatility compared to the volatility we saw last year. And up here really looking at the attritional loss ratio even adjusting for weather-related and large losses. So that's the number that you don't see but I see. So last year in the Fourth Quarter there was, if you want a drop in the attritional loss ratio compared to what we saw during the year, this year you see more stability. And I believe the figures that we see this year are more reasonable because you should anticipate a bit drop in the loss ratio towards the end of the year. And this has to do, yes, with some volatility. But this has to do also with the fact of when they actually start doing also the review of the true-ups. And this year, there is more stability throughout the year compared to what we saw in 2017. So I will say, there is nothing to read into that. One thing that we are looking. So if I just had to go into the details, it's the development on the property portfolio in Spain. But here, we are speaking of a EUR 400 million to EUR 500 million portfolio. There were some weather-related losses in 2018. But also we think there is more than that. But we need really to go into the details, otherwise, on the macro level, I don't see any reason to look at the 2018 number. So the last quarter and in clear from that, that there is a deterioration on the overall book. And there was another question?

Q - Jonathan Peter Phillip Urwin {BIO 6126952 <GO>}

Claims inflation. I'd say it's -- we don't see a lot of claims inflation clearly. If you are in Turkey, you are going to have a different view. You're going to say there is a huge claims inflation. If you are in the U.K., you might have a slightly different view because of the pound depreciation. There might be some more claims inflation. But in general, when we look at markets like Germany or we look at Italy or we look at France, we don't see necessarily claims inflation. Also, when I go through the different entity, you might see sometimes an increase in severity, not necessarily because of claims inflation, can be because of other reasons. But usually, you see a decrease in frequency. So we don't see markets where you have, for the same time, an increase in frequency and severity. So usually, you might see one thing going up, the other one going down. So there is not much pressure from a overall claim situation on our numbers.

Operator

And we'll take our next question from Johnny Vo with Goldman Sachs.

Q - Johnny Vo {BIO 5509843 <GO>}

Just -- in the past, Guilio, you spoke about capital management in terms of 3 silos; solvency, liquidity and leverage. I'm mean, clearly, the solvency looks very strong. You've articulated that the liquidity, 3 OEs in the last business had difficulties with remittances. And I've noticed also that the leverage ratio has moved up quite substantially over the years. So can you comment on those 3 silos? Also, I just saw a headline on Bloomberg saying that Allianz makes slow buybacks to make small acquisitions. Can you talk about the interplay between the size of deal and the impact on potential buybacks in the future? And finally, just in terms of M&A internal capacity, in the past you'd said, you may have EUR 10 billion of M&A capacity. Could you give an update of where you are with that capacity given the 3 silos?

A - Giulio Terzariol {BIO 17125489 <GO>}

Yes. So the 3 components clearly are relevant. It's about the solvency, the liquidity and the leverage ratio. Nothing's changed on the 3 component. Also, when you look at the leverage ratio, it went up but just because the unrealized gains went down. If you look at our debt position, has not changed in 2018 compared to 2017. So the only reason why the leverage ratio went up is because of the movement of the IFRS equity. But not because we have increased our leverage position. So from that point of view, our philosophy has not changed. And with a different market environment, our leverage ratio would have been 26% instead of 27%. By the way, I feel pretty good at 26%, 27%, that's absolutely a good level of -- a reasonable level of leverage.

On M&A, yes the EUR 10 billion, I always said, EUR 10 billion is potentially there. But there's also a stretch. Also I said that's technically possible, I'm not so sure we will go for a EUR 10 billion acquisition where we use only cash index. But that's technically a possibility. I'm not so sure I understood your question about the buyback and the deal size and if a buyback is -- they to announce before...

Q - Johnny Vo {BIO 5509843 <GO>}

Oh no, that's just a headline -- sorry, that was just a headline on Bloomberg saying that Allianz makes slower buyback to make small acquisitions. So if you make a small acquisition...

A - Oliver BÃ¤te

No, Giulio said. And he also said -- he said, we can do the buybacks and the bolt-on acquisitions then we have no issue.

A - Giulio Terzariol {BIO 17125489 <GO>}

Must be my Italian accent that's misunderstood

Q - Johnny Vo {BIO 5509843 <GO>}

Italian accent. Difficult to understand.

A - Oliver BÃ¤te

Because I could not understand a point.

All right. Any more questions?

Operator

We do have a few more in the queue if you'd like to take them?

A - Giulio Terzariol {BIO 17125489 <GO>}

Okay. Then let's take 3 more questions, okay? Then -- or speakers, rather. And then we close out the day.

Operator

Our next question comes from William Hawkins of KBW.

Q - William Hawkins {BIO 1822411 <GO>}

I'll be quicker on star one next time. Can you just talk again about the sensitivity of your solvency II ratio to rating migration. From what I'm understanding, that's something which is effectively completely ignored on Slide B7. So with regards to your Solvency II ratio, what work have you done to think about the scenario analysis for rating migration? And what would be the impact? That's kind of question one. And for the sake of your time, just quickly. On Slide B35, in terms of your earnings per share growth, do you think your past couple of years of realized gains and impairments is a normal level that we should be plugging in as part of your earnings per share growth? Or could the normal rates be higher or lower?

A - Giulio Terzariol {BIO 17125489 <GO>}

I'll start with the second one. I would tell you, when you look at the -- below the line item. So we're not just focused on realized gains and impairment, I would also take into consideration for restructuring. I will tell you that on the below the line items, you can work with an assumption of about minus EUR 1 billion, right? So which will be more or less the average between what we had this year and what we had in '17. So that could be your working hypothesis on how you look at the below the line items. And on the question regarding the solvency ratio sensitivity and the impact of credit immigration. We did some exercise and -- which, in my opinion, is conservative -- sorry, not conservative, it's aggressive because we said that if we have one notch of rating migration, the Solvency II ratio of Allianz group would drop by 9percentage point. To me, looks like maybe it's a little bit aggressive. I think it might be a little bit worse than that. But the point is, if you ask me, there's not really a meaningful sensitivity. And that's the reason why we decided to show at Page A12, what would happen to our solvency ratio if we have a crisis like the

2018 crisis, which was a credit crisis. Because if you just look at the one notch rating immigration, everything else doesn't change. Honestly speaking, that's really not a big deal. But we know that we have really a one notch rating migration. There is nowhere that equity market are not going to go down. There is nowhere that the boons is not going to become negative. So we need to start doing all these kinds of exercise. And we believe that, what we showed at Page A12, it's a fair representation of what would happen in a major credit crisis, which we saw, by the way, that's the beauty. We have seen that just 10 years ago. And so that's how we look into this kind of question. So we are not ignoring the point. I tell even more that we set our management ratio based on this scenario. We set our liquidity position that we want to keep at the holding level based on this scenario. So that's part of our management thinking and of our risk management appetite. And that changes is much more severe than just saying one notch less credit rating and everything else is unchanged.

Operator

And we have a question from Michael Haid with Commerzbank.

Q - Michael Hermann Haid {BIO 1971310 <GO>}

Just one question. In P&C insurance the price increases on the renewals, they were 1.2% after the 9-month period and 1.4% for the full year, which implies an acceleration of price increases in the Fourth Quarter. Can you say a little bit about where this price increases came from? And is there a trend somewhere, a new trends or new initiatives, anything like that?

A - Oliver BÃ¤te

Yes. We see a little bit of an improvement compared to what we had in -- reported a few months ago. And this is mostly driven by little bit Australia, then Italy. But especially AGCS. I mentioned AGCS before, that's -- there is a little bit of turning in the market. Now there is no doubt and that is also not immaterial now, we need to see how significant it's going to be especially in the sense of the length, right? Because if you adjust a little bit of an adjustment and then rates are going to stabilize or go back pretty quickly, this is most likely not going to hurt much. But if we continue to see this kind of acceleration in the renewal rates. And maybe also little bit more widespread then I think that could be a strong sign for the future. Now it's a little bit too early. But definitely we see signs. As I told you before, I had a meeting going -- line by line with the management team of AGCS. And you can see that there is some signs of strengthening, call it, a hardening, not yet is a attempt of hardening. And I think that might turn quickly also real hardening.

Q - Michael Hermann Haid {BIO 1971310 <GO>}

And was this happening in Italy?

A - Oliver BÃ¤te

In Italy, the -- we -- it's happening that we tried to get a little bit more pricing strength. And we had a good growth and we are happy. And now we also see that we can push little bit stronger on the rates.

Operator

And we'll go to the final question from (Ibrahim Saeed) with Deutsche Bank.

Q - Unidentified Participant

Just a short one. With respect to the bolt-on acquisitions, you suggest there was some speculation about Allianz looking at VIVAT in the Netherlands. Would that sort of qualify within those bolt-on metrics that you speak of? Then the commentary you made around leverage. And I appreciate that your debt stack hasn't moved. But is it fair to assume (inaudible) from you this year?

A - Giulio Terzariol {BIO 17125489 <GO>}

Okay. Oliver said no comments.

A - Oliver BÃ¤te

I will say, you should not expect any issuance in the normal course of activity. And with regard to the VIVAT, that's what you mentioned. Let's put it this way, clearly acquisition of this size might be bolt-on. But as usual, we don't speak about individual companies but yes any acquisition, which is in the EUR 1 billion premium, something like that's might be a bolt-on acquisition.

Thank you very much for spending the time with us. And for your strong support. Thanks to our people. And by the way thanks to the team. And this was Giulio's first year. Thank you very much, great job.

A - Giulio Terzariol {BIO 17125489 <GO>}

Okay. Goodbye to everybody. Have a nice weekend. Thanks for joining.

Operator

And once again, ladies and gentlemen, that concludes today's conference. We appreciate your participation today. You may now disconnect.
