Q2 2018 Earnings Call

Company Participants

- Christian Becker-Hussong, Head-Investor & Rating Agency Relations
- Joachim Wenning, Chairman and Chief Executive Officer
- Jörg Schneider, Chief Financial Officer & Director

Other Participants

- Andrew J. Ritchie, Analyst
- Frank Kopfinger, Analyst
- James A. Shuck, Analyst
- Jonny Urwin, Analyst
- Kamran Hossain, Analyst
- Michael Haid, Analyst
- Michael Huttner, Analyst
- Roland Pfänder, Analyst
- Thomas Fossard, Analyst
- Thomas Seidl, Analyst
- Vikram Gandhi, Analyst
- Vinit Malhotra, Analyst
- William Hawkins, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good day and welcome to the Munich Re Half Year Financial Report to 2018 Conference Call. At this time, I would like to turn the conference over to Mr. Christian Becker-Hussong. Please go ahead.

Christian Becker-Hussong {BIO 19080254 <GO>}

Thank you. Good afternoon, ladies and gentlemen to our Q2 earnings call. I have the pleasure to welcome Joachim Wenning, CEO of Munich Re Group; and our CFO, Jörg Schneider, this afternoon. Joachim will kick it off with his statement. As Jörg already commented on our results in his audiocast this morning, we will then go right into Q&A.

So Joachim, please go ahead.

Joachim Wenning {BIO 16273429 <GO>}

Thank you, Christian, and welcome also to all of you out there on the phones. In the name of Jörg and myself, welcome to this call. You all have already listened I guess to the podcast that Jörg has produced, including the slides highlighting the key drivers of the first half year results and business development. Before, I'd like to offer you my executive summary, before we enter after that into the Q&A, I'd like to offer you three comments on relatively recent news.

So let's start with news number one. News number one is that Jörg is having his 60th birthday next month. But more importantly than that, he has decided to leave the board towards year end, and the successor as announced will be Christoph Jurecka. There is no strategic impact that we should expect from this. The reason why I mentioned this I think is only correct and fair that I mentioned it after it had only been announced after the supervisory board meeting mid-July, and all the acknowledgments, Jörg, you're going to hear very comprehensively then towards the year-end.

News number two colleagues was a small structural adjustment with regard to the board responsibilities in the reinsurance area. There the specialty businesses like aviation, like space, marine, credit, agri, et cetera, since the beginning of this month, they have been reallocated to the regional divisions where most of the marketing or market activity is actually happening. Plus, the German market falls now into the responsibility of the business division Europe and Latin America, and Doris Höpke is leading this business division since last week.

And news number three is Munich Re's focus in climate activities. You all know that the energy transformation, the transformation away from fossil energy consumption towards non-fossil energy consumption is crucial for the achievement of the 2 degrees centigrade target as defined by the Paris Agreement. And 90% practically of all the fossil energy consumption needs to replace between now and 2050 to achieve this target. As you can imagine, new non-fossil climate-friendly energies they will bear new and potentially also higher risks that will seek insurance/reinsurance.

Munich Re with all its competencies, with all its risk appetite, has proven that we are there when we are needed. Evidence is the output insurance that we have offered in the context of photovoltaic power, and we are going to enable any of the other new energies there are apt to come. This is so key. This is our priority. But besides this enabling, enabling the energy transformation priority, we have also precise our disabling activities with regard to coal. As you know coal carries the highest CO_2 emissions. And by 2050, practically 80% of the carbon in the world would need to stay in the ground and not be used. So we think that it wouldn't match if we will continue to insure/reinsure new carbon power stations which typically have a lifespan of 50 years or even longer.

So that's why we have decided to divest from any equity or loan investment into industries or companies that generate more than 30% of their revenues with coal. Plus, as a matter of principle, we will no longer insure and/or reinsure new coal power stations or mines, and this with regard to the facultative, with regard to the single-risk business where we actually have the possibility to not only see but also assess the risk. All that said, there will be only a few exceptions to this, all very well-defined on the basis of very restrictive criteria.

First off, I make this comment because there had been a recent more public debate around all this topic, and I wanted to let you know our positioning. And to my feeling, I think this has been perceived broadly pretty well so far. So now let me turn to offering you my executive summary for the first half year results. The overall result is really good, and it suggests that we should reach our resolved target for the full year, so to reach the range €2.1 billion to €2.5 billion. When it comes to the composition of the result, the composition suggests that the reinsurance segment, life and non-life, performed well.

On the P&C Re side, it's better than expected with the actual combined ratio, first half year of 95.5%. However, the combined ratio of 102% in Q2 only at first side felt a little bit on the high side to us as well. So that's why we had a deeper look into it ourselves, and what we found out is that the actual claims experienced, as highlighted by Jörg in his podcast, explains actually a big part of that. If we ask ourselves, was there any evidence of that underwriting, clearly, no. So our judgment is it's then bad luck, and we have nothing to blame ourselves, and if there was, we would.

And then there was the next question, has there been any recent growth activity that suggest that we have done so on the basis of a soft and and say, underwriting approach, and the clear answer is simply no. There have been structured deals. Those who also reach a volume range of sometimes three-digit million euro premium income. They by nature tend to have combined ratios closer to 100% than for example, the nat cat business, but all of them good and attractive, good underwriting.

The rest is some seasonality in the claims experience with regard to the U.S. business, more concretely, to the (00:08:57) business, which is well understood by us and happens in half year one rather than in half year two. So all-in-all, our firm assessment and judgment is the P&C result is very solid. So a lower than expected underwriting result but good underwriting. And on the life re side, we had a very strong first half year as reported by Jörg. And if you want, we can go deeper into it during the Q&A.

Plus, ERGO delivered in a very solid way with a particularly strong ERGO International business. So from all these angles, we can only say we are happy with a pretty good first half year 2018. It goes so far that we actually asked ourselves at the board and said, with the first half year result that corresponds to more than 60% of the committed full-year results, is the reason that we should probably adjust our result indication upwards, and our response is a very clear no. And the reason why I think they were offered in the podcast from Jörg saying, we know that on an expected basis, probably the second half year will not be as strong as the first half year. Nat cat in Q3 is the reason, the low tax rates in first half year are another reason, et cetera. And that's why we say no. But I dare saying that as it stands now and on the basis of an ongoing normal evolution of claims but also of capital markets, we think that we would stand rather in the upper half of that range than in the lower half.

So far my summary, and I hand back to Christian.

Christian Becker-Hussong {BIO 19080254 <GO>}

Thank you, Joachim. So we can now start with the Q&A. We will go right into it and I'd like to remind you to restrict the number of your questions to two per person as always. Thank you. And please go ahead. Looking forward.

Q&A

Operator

Our first question today comes from James Shuck of Citi. Please go ahead.

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

Good morning. Thank you for taking my questions. The first question is really around the exposure growth that came through up to the July renewals, in particular plus 41%. I think you mentioned the Australian (00:12:09) had some stuff in the U.S. It's very difficult to get a picture of the underlying growth. Obviously, the rate environment hasn't really changed. If I look through some of those large numbers, it still looks like you've grown quite significantly without a real material change in the pricing environment. So could you just flesh out a little bit more about where the exposure growth is coming from, please.

Second question is sort of conceptual one. I'm interested just to understand a bit more about how you're managing your peak apparel exposures. I think, the PMLs up to full year haven't really shown that much change over time in terms of your exposures, whether that's to Atlantic hurricanes. I think there was definitional change at full year from LA earthquake to North American earthquake. But at the same time, you do talk about using retro more, and you've given some interesting extra disclosure over time. So I guess the question is, how should we think about the packaging risk, and perhaps for you to emerge as just really kind of more of a passing on of that risk to some of the financial markets, particularly as we move through up to the July year-to-date renewals. And just kind of connected with that very loosely at least is, if it would be possible to get some kind of guidance around the net earned premium expectation for full year because we can't see - the GWP is growing very strongly year-to-date, but obviously (00:13:39) net earned, that's very difficult to forecast and will have an impact on the combined ratio. Thank you very much.

A - Joachim Wenning {BIO 16273429 <GO>}

James, I will take the first one, and Jörg maybe take the second one and the third one with regards to net earned premium expectations for the full year. So where is the growth coming from? As you said, roughly half of the absolute growth volumes, they are related to a large structure deal, one that we already know which has been renewed, and the other half is going back to growth impacts or I would even call it growth successes in those regions or those areas where we want it to grow. So we have explicitly said, we have a growth appetite primarily in the established markets in the U.S., maybe in the broking segments, also with regard to regional clients because historically, we have been there relatively on the way compared to our global market share, and this is where we have seen some growth. But then, we have also said, we see growing in emerging markets. Take for example, in the ERGO segment and we see growth there. So one half of it is due to one large transaction, and it shows a high increase rate because we didn't have any piece of this 12 months back. Have we compared the growth by 1.7 with 1.1 (00:15:35), the growth rate would have been smaller. Jörg, I hand over to you.

A - Jörg Schneider

Yeah. Thank you, Joachim. Good afternoon. How do we manage our peak risks? The growth part which Joachim described is well in line with our risk appetite, and we do not have increased budgets for risks. And so there's slightly higher usage of these budgets at the moment, but mostly due to currency effects because the euro has become a little bit weaker in comparison to the U.S. dollar, and that has been the main driver also for our risk capital in the last three months. So therefore there's absolutely not a quantum step with regard to our risk exposure. And there are also no major changes with regard to our retro coverage. With regards to your third question about net earned premiums, so it's a little bit difficult even for us at the moment with this strong growth from the renewals to see the impact. But as a rule of thumb, I would say it should be roughly €18 billion for property casualty reinsurance, including primary insurance out of reinsurance. Is this okay, James?

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

Yeah. That's helpful. I mean, I guess, just on the exposure to peak parallels, I guess, my point is that you've increasingly used the retro market as to kind of pass on that risk. And it's not coming through in the PML. And then I take your point that there is an FX impact. But I just would expect the PML exposures to come down given that great uses of retro. But if you're saying it's kind of on an underlying basis, it's kind of broadly stable and I take that, I suppose.

A - Jörg Schneider

And James, it has been a more opportunistic usage of the retro market, but no major change here, especially not such an enormous increase. We use more sidecars than we did in the past. But the traditional retro has reduced to the same extent. Therefore, it's more or less an unchanged policy here.

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

Yeah. Okay. Thank you very much.

A - Jörg Schneider

Thank you, James.

Operator

Our next question comes from Michael Huttner of JPMorgan. Please go ahead.

Q - Michael Huttner {BIO 1556863 <GO>}

Thank you very much. I have two questions. First one is on the topic of the ZZR, so Generali Leben said that these ZZR might get to lease and they'd get some money back on the Generali Leben deal. And I just wondered if you can give an idea of how much the - what the sensitivity would be for Munich Re if there were a change in these rules? And I suppose the second question and probably a bit annoying for you, how much assurance do you have that the quality of the business is the same? I mean, the growth rates whether Q1 or I mean January or now are very high, and you've looked at it and you say, well, it's good, but we don't know. When will we find out if the growth is really good value, and it'll produce earnings, or how long do we have to wait to be sure? And have you taken in any extra kind of precautionary measures like adding to reserves or whatever for that? Thank you.

A - Jörg Schneider

Michael, first on the ZZR, the original rules had been somewhat over-calibrated, and after now I think four years or five years of building up of the ZZR there's an urgent need for change, and I'm confident that we will see that change in the course of this year that we see a change in rules towards what is called a corridor method. The impact is still difficult to estimate for the market. We do not expect the ZZR to be reduced from that moment on, but we will not have a similar need for an increase, and therefore, we would be very happy if this rule change will take place very soon.

Q - Michael Huttner {BIO 1556863 <GO>}

And if you don't have the increase, is there a kind of what is the benefit to the group?

A - Jörg Schneider

The benefit at the moment is mostly that we do not have to realize a valuation reserve on our investment portfolio to the same extent as we did. And you can see that already in the Q2 numbers that we stood on the break here.

Q - Michael Huttner {BIO 1556863 <GO>}

Okay.

A - Joachim Wenning {BIO 16273429 <GO>}

Maybe I add one thing, Jörg, that is the benefit to the market and it's not an economical benefit yet, but it gives them some relief that is, that with the new rule for building the ZZR, the buildup of the ZZR that has been happening for some years and would continue continuing for a short while, that would mean a very sharp increase in the build-up of ZZR this year and next year, I'm not sure 2020, but I'm sure this year and next year. And then a very sharp release of the ZZR reserves, and this new rule would bring that the buildup get softened or smoothened out a little bit, but then also the future release will be slightly shorter. So it's just smoothening impact of the buildup in the release of the ZZR reserve.

Q - Michael Huttner {BIO 1556863 <GO>}

Okay.

A - Joachim Wenning {BIO 16273429 <GO>}

Quality of business assurance was another question of yours, Michael. So why are we confident that the business that we have written, that shows growth in our books is of good quality. For a big chunk of the business, we can explicitly state that because we have looked into it with all divisions. Why is that? As I said, one half of that is one structured deal is one. I mean, it's so large into this one, I would say, everybody in this group looks into it. So if you're confident that when everybody looks into it then the quality is good, then you can be comfortable. Plus, not a big chunk, but also some smaller but also structural deals which typically gets submitted into central capital centers are also approved by them. Plus when it comes to the specialty businesses like ERGO, they follow a pretty central approach, meaning, the underwriting rigor by nature and by structure is very high, and only the smaller part of that growth if you like is decentrally written, but it's no other business than that, that we have seen in previous year only that'll be right a little bit more of that.

Q - Michael Huttner {BIO 1556863 <GO>}

And has there been - have you been extra careful on the reserving yield?

A - Jörg Schneider

You mean overall with the basic loss reserve?

Q - Michael Huttner {BIO 1556863 <GO>}

No. Well I suppose (00:23:37), well either on this one, on the (00:23:40) in Colombia, it feels like you kind of rejoice, and you're so, I double the numbers.

A - Jörg Schneider

Yeah. That can be - I can't exclude that. You know that we tend to be on the somewhat more careful side, and that explains perhaps part of the difference between us and some peers at the moment. But it's difficult for myself to make a judgment because as you know, we always reserve for the best estimate.

Q - Michael Huttner {BIO 1556863 <GO>}

Thank you.

A - Jörg Schneider

Thank you, Mike.

Operator

We will now move to Jonny Urwin of UBS.

Q - Jonny Urwin {BIO 17445508 <GO>}

Hi, guys. Thanks for taking my questions. Just two from me. So I mean, firstly, the 2020 net income ambition is in part based on some combined ratio improvement driven by growth in shorter tail lines. I wonder, does this growth we're seeing in structured reinsurance products, I appreciate it's just one, but this come with a structurally high combined ratio. So does this make it harder to drive that planned improvement in the combined ratio particularly given the pricing environment is fading a little bit, or does it mean you need to grow by even more than initially planned in shorter tail lines which would obviously be quite challenging today? That's the first question.

And secondly, I guess, just going back to the growth and how you get comfortable with that. I know it's a bit repetitive, but I think it's an important area today. I mean, how can investors get comfortable with the profitability of this recent growth given we're seeing deterioration today in the headline result. There's been an outsized manmade loss which we're not used to from Munich Re. And it's also been accompanied with normalized combined ratio deterioration as well. So I guess just to go over your thoughts again there, please. Thank you.

A - Joachim Wenning {BIO 16273429 <GO>}

So Jörg, I will start with the first question. So with regard to the 2020 net income, you're right that the expectation for 2020 is based on the assumption that the combined ratio will probably go down to a level of 97% on P&C Re. That means that some short tail business will have to make a contribution, whereas, structured deals alone, they couldn't provide that. They couldn't provide the whole result contribution, but they also would lead to typically higher than 97% combined ratios. That's why structured deals are only one part of the new business portfolio that we are seeking, but it's not the major part. The major part is shorter tail business, as for example, we see in the U.S. market. But also, don't forget that we expect ERGO to also increase its contribution to the group by some €250 million between this year and then 2020. Both components will pay into it. Jörg?

A - Jörg Schneider

Yes. You asked Jonny, you asked about how can investors get comfortable with this strong growth. So if I look at our numbers and all the internal material where do you - where you do not have access to, that it clearly points to substantially increased profitability, including the interest rate effect. So markets are not softening, but they are slightly hardening at the moment. First remark. Second, when you look at the adjusted combined ratio, we are also not in use about the 100.3 in the first half but there is really clear evidence in the numbers that beside some accounting noise which comes from earning patterns, currency impacts and things like that which are explainable but very difficult to present to the public.

There's this impact of the major losses below the $10 million line which come from our primary insurance activities in the United States, mostly referring to tornadoes, thunderstorms and these types of mid-sized events. And they also appeared in the last couple of years. So we had this seasonal pattern and I believe that this is really something which we'll get reversed in the second half. And third remark on that, that is my personal experience. There is not at all any change in the reserve quality. That means there are really I wouldn't call it buffer, yeah, but wherever we have an estimation range, we use it in a somewhat conservative way as far as rules permit. And this also happens for these major structure tiers, this happens for all the areas where we want to grow, like Joachim said before, it's highly controlled by central functions, and therefore, there's not this – what would worry me is this broad aggressive underwriting behavior because we want to grow.

Now, it's absolutely not that. It's precisely explainable more or less year by year. And that makes me at least confident, and I hope that I share a little bit of that comfort with you.

Q - Jonny Urwin {BIO 17445508 <GO>}

Great. Thanks very much.

Operator

Our next question today comes from Vinit Malhotra of Mediobanca.

Q - Vinit Malhotra {BIO 16184491 <GO>}

Yes. Thank you very much. So I think some of the topics have been addressed. Thank you. But I guess if I can talk about two more things, one is the running income or the regular income which I understand is coming from increased corporate bond, emerging markets, higher U.S. rates.

I mean, if – out of these three, probably the emerging markets is the more volatile one. But Jörg, just a sense of how much would you say is sort of a one-off-ish effect in this very strong (00:30:26) P&C Re has almost €83 million higher running income in 2Q versus 2Q last year. So how much should we think about this running income?

And also, on the Life Re, I mean, I think in 1Q we had been flagged that there was – the fall in premiums was coming from a treaty which was canceled. But is it the same effect in 2Q? And this doesn't seem to be – is this really driving the very strong technical result as well, and how should we think about the technical results this year for Life? Thank you very much.

A - Jörg Schneider

Hello, Vinit. First, on the running yield, the regular income from our investments, as you said, it's coming from small increase of corporate bonds and somewhat lower focus on government bonds, but that is not a major development, also not the emerging markets impact. We've always been somewhat active in emerging market fixed interest instruments. You ask about one-off-ish effect, and I confirm – I can confirm that there are some in this reinvestment yield of 2.8% in reinsurance, this mainly comes from fixed interest securities. And there is an element of a strong restructuring of our portfolio in U.S. life reinsurance.

And this goes along with the lengthening of duration and benefited from the increase in yields for government bonds, as well as for corporate bonds. And I cannot promise that this will be repeated to the same extent in the two incoming quarters. So I would personally expect for the reinvestment yield, with unchanged markets, a little bit lower than for Q2, but still on a level which is substantially higher than for the preceding quarter. So somewhere between 2% and 2.3% perhaps in the upper half of that range.

And another effect was, therefore, our associated companies, due to the U.S. tax reform, there was a revaluation of (00:33:08) in these companies and we had our share in the profit which comes in as running yield and that was in a way a small one-off effect, not important to mention, but I should have said it when you asked so precisely. So to summarize, it's a good environment and we expect the level between 2.7% and 2.8% to persist, perhaps second quarter was a little bit on the upper end of the reasonable range for future reinvestments. Joachim?

A - Joachim Wenning {BIO 16273429 <GO>}

Yeah, thanks, Vinit. This is Joachim. So the fall in premiums on Life Re side, this can be explained by two effects, very clearly. So it's structured transactions and typically those structures they are designed to hold for a period that is limited for three years, four years or five years, because both the client and ourselves, we agree that's the time period for which we seek the financial impact for what it was designed. And beyond that period, nobody knows if that need would still exist.

One of these transactions still ended by that time and didn't get renewed because need wasn't there. Had it been renewed, technical result would have even been higher than the one we show.

The second phenomenon is, again, same type of structured transaction, but one which got renewed, but got renewed in a completely different structure than before where the previous structure was volume intense, the new structure isn't any longer, with absolutely no negative impact on technical results, if at all, rather on the contrary. So you cannot possibly conclude that the high technical result would have gone back to some divestment from this type of transactions.

Q - Vinit Malhotra {BIO 16184491 <GO>}

Thank you very much.

Operator

We will now take a question from Thomas Seidl of Bernstein. Please go ahead.

Q - Thomas Seidl {BIO 17755912 <GO>}

Yeah. Thank you. Good afternoon. First, on ERGO you say it's well on track on the turnaround. It seems though that the Life business is a bit lagging expectations. When I look at the operating expenses, they seem to be up 11% at half-year year-on-year. So I wonder if you could comment on beyond the lower gains that you outlined in the webcast. Basically, what has been driving the lower operating result of Life Germany?

Secondly, large losses, you say you have nothing to be blamed for. I just wonder if you could comment on whether those large losses, which are €320 million above the long-term average, come from the Risk Solutions business, which has been grown close to 20% over the last years. And also, if you have nothing to blame, should that not just mean that we go from a 4% to, let's say, a 5% load for the combined ratio going forward if this is sort of a normal quarter every now and then?

And thirdly, if I may, on the CFO, you say no strategic impact from the change. So I just wonder, Jörg, if I could ask you because you will be around for longer, how we should think about the growth in absolute dividend next year, assuming you're now more confident you say in the webcast you achieved €2.3 billion, €2.4 billion net income this year. What would drive your decision by how much to increase the absolute dividend next year given the capital is still enormously strong?

A - Joachim Wenning {BIO 16273429 <GO>}

Okay. I – Thomas, let me start with the large losses, if you like. I'd like just – Jörg and colleagues, if you can research if there is more to say than what I know from the top of my head. So does this come from Risk Solutions business? Thomas, that was one of your questions, and the answer is no. That's very classical, very traditional business, the large losses.

Let me add maybe one aspect, because I'm hearing and I was – I'm hearing from this conference call, but also from before that it is somehow surprising that our share in the Colombian claim seems over proportionately high. And in fact, it is. There is a reason which I cannot possibly disclose to you because it's client-specific. So there is one-half of that claim that typically is placed in the market and we, as Munich Re, we would have our fair market share in such a claim, as the other reinsurers would have.

And there was a second part of this claim, where we have an exclusive and 100% of that. So the over-proportionate share of us is totally understandable to us. We simply cannot disclose it.

With regard to the CFO – you didn't say CFO impact on dividends but you ask for guidance with regard to future dividends and what would drive us defining the dividend level going forward. Trust me, it's too early. So we would principally, if you ask me at this point, we would exactly apply the same set of criteria on the basis of which we would decide how much the dividend should be set. But the most important thing is, we have to have the full-year result first. And for this, we really need to wait for quarter one to know the full result, and then we are very happy to share that guidance with you.

A - Jörg Schneider

On your first question with regard to the ERGO operating expenses, especially in Life, it's a bit difficult for me to answer it in an appropriate way at the moment, because translating the German GAAP-driven business model into IFRS very often leads to surprising results also for ourselves. It has to do most probably with cost allocation between the various segments, especially with the high expenses for the strategy program itself. So we have enormous expenses in IT at the moment. Perhaps, I come back during the call with more information. But at the moment, I would ask you to bear with me, because I can't give you a reliable answer on that.

Q - Thomas Seidl {BIO 17755912 <GO>}

Okay. Maybe if I can follow-up on that dividend. Of course, we know that we have to wait for Q3 and Q4. But at the full-year number this year, it was said that you are going to grow the absolute payout in line with earnings. So my question was, with the CFO change, are you sticking to this promise?

A - Joachim Wenning {BIO 16273429 <GO>}

Yes.

Q - Thomas Seidl {BIO 17755912 <GO>}

Okay. Thank you.

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

Okay. Can we move on with the next question, please?

Operator

Certainly. Our next question comes from Vikram Gandhi of Société Générale.

Q - Vikram Gandhi {BIO 18019785 <GO>}

Hi. Thank you for the opportunity. I've got two questions. Firstly, given where the industry pricing is and given how the shift in strategy on cost cutting and business mix changes have evolved so far, what does it do to your confidence with respect to the 2020 outlook or guidance? Are you more confident, less confident about the 2020 guidance? And secondly, how are you seeing the HIM losses developing? And is there anything there that gives you comfort about the combined ratio and profitability over the full-year? Thank you.

A - Joachim Wenning {BIO 16273429 <GO>}

So thank you, Vikram. Your question with regard to the confidence level, the way that I am comfortable answering such questions is the following. When we are into the first year of three years commitment and we see that in that first year we are progressing as we expected, then my confidence level is higher than it is at the very beginning of that three-year period. So, in this sense, it's at least as high as it was six months back. Jörg?

A - Jörg Schneider

On the HIM losses – sorry, Vikram, you have an additional question on that?

Q - Vikram Gandhi {BIO 18019785 <GO>}

No.

A - Jörg Schneider

Okay. On the HIM losses, they come overall in as expected, so very small changes only and no tendency on our side.

Q - Vikram Gandhi {BIO 18019785 <GO>}

Okay. Thank you very much.

A - Jörg Schneider

Thank you, Vikram.

Operator

Our next question comes from Andrew Ritchie of Autonomous. Please go ahead.

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

Oh, hi, there. Joachim, I wonder if you could give us a bit more qualitative color on how the new product range is being received at ERGO. I mean, the size talk about that the new products are in place. It's very hard to see any sort of traction in new business momentum from the figures you disclosed. So maybe a bit more color on the new business, well, how are new products going down, both Life and Non-Life in Germany specifically?

Second question, there's been a bit of reorganization on the reinsurance reporting lines, as you've already discussed. Is anything happening on the primary Risk Solutions business? There have been various trade press reports about changes with your Lloyd's operation. But maybe just clarify, is anything happening on sort of restructuring, particularly the Risk Solutions business?

Well, final point, isn't a question, it's just to clarify, Jörg, on the ZZR changes, I appreciate there's a net present value change because the timing of ZZR additions changes, but I don't think the total quantum changes. So I'm not sure it's actually an economic benefit. And also presumably you're right, for us, earnings will go down because you'll be realizing less gains. Is that not the case? Thanks.

A - Joachim Wenning {BIO 16273429 <GO>}

Thank you, Andrew. So with regard to the new product ranges at ERGO, so ERGO has started modernizing, if you like, or if not bringing totally new P&C products starting with car insurance products to the market, then household insurance, personal liability insurance, et cetera. If you look into the rankings of these products as offered by some of the professional ranking institutes or ranking companies, then they are highly ranked, which is one indicator. It's not all. When you look into how is the productivity of the sales forces in the last 12 months, so mid-year this year compared to mid-year last year, how has that evolved? It has increased by 14%. So this is another indicator.

New products on the P&C side are having a positive impact on production level. New products also with regard to complementary health insurance is having a positive impact, where ERGO has just started. I wouldn't say lagging behind, but it comes up with it now as a second priority is new products in Life, and we hope that they will also have a positive impact.

Your second question was with regard to any restructuring plans in the Risk Solutions area. None at all.

A - Jörg Schneider

Except for changes which are necessary due to Brexit. So there will be some reorganization on the London market, but it does not refer to our Lloyd's business.

With the ZZR, Andrew, here you are right that there is a small value change, net present value change for the business due to lower reserve requirements under local German GAAP, but the impact will not be enormous. With regard to the impact on IFRS earnings, if we have to realize less valuation reserves on our investments, that means that we have lower impact also on our IFRS earnings. But these earnings are of very low quality. So, I'm absolutely not disappointed about that development. And, therefore, we anyway look at the ZZR requirement, including these capital gains as being in overall negative, in line with the economic impact. So, therefore, we will have to replace these earnings, but we are not forced doing it year-by-year at a pace which is clearly above the economic requirements. And it allows us, so a relieve of the ZZR rules allow us to better manage the business in the interest of stability and in the interest also of shareholders. Therefore, it's a small but important net positive.

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

So it wouldn't affect your expectations for 2020 ERGO Life contribution?

A - Jörg Schneider

That's any way a moving target, yeah, because we made all these plans in the year 2016, and up to now we've been very consistent and the delivery is quite strong, but nevertheless, it is so difficult to predict and forecast all these enormous expenses and earnings. We are very happy that the expense savings come in. That it's important that the reorganization of the sales forces has been successful, and that there's very good momentum, but you will continue seeing deviations in the numbers that is unavoidable.

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

Okay. Thanks very much for the color.

A - Jörg Schneider

Thank you, Andrew

Operator

We will now move to a question from Kamran Hossain of RBC. Please go ahead.

Q - Kamran Hossain {BIO 17666412 <GO>}

Hi. Just wanted to talk about cyber base (00:49:10). You called out in your growth initiatives piece, talking about continued growth in the first half of the year, is it okay to get an update on, I guess, premiums and if you have the number of reserves that you have set aside for cyber? Second, (00:49:29) kind of the loss ratio, you're booking this at the moment or kind of any comments on the claims experience year-to-date?

And, I guess, the third part of the question is, if you do get to the 10% market share, so that €800 million to €1 billion, how comfortable are you with the aggregates and will we end up with some kind of cyber PML disclosure? Thanks.

A - Jörg Schneider

So, first of all, we would not share the loss ratios with the market. They are somewhat lower than for our average business because there were – there's only very small number of incidents. We also set up IBNR, but only for claims which had occurred here, not for future claims, that is for sure.

With regard to our market share, it's a little bit below the 10%. So, the 10% was in the starting phase. Currently, we would see between 8% and 9% and the wider and the broader the market gets, we try to grow in alignment with market growth, but we would also be very happy if the market grows so dramatically that there's place for more suppliers here.

And with regard to the PML, at the moment, it is a very substantial scenario, the cyber event scenario, the accumulation of risk, but it's still far below our exposure for pandemics in life insurance or from Atlantic hurricane and from the other major most exposed periods in property-casualty reinsurance. But it's a valid point. It's important and it's observed with a lot of conservatism, perhaps there would also be room for, let's say, a more generous modeling of the risk. At the moment, we try to stay on the very tough side which also increases the cost of capital as you can imagine.

Q - Kamran Hossain {BIO 17666412 <GO>}

That's right. Thanks for the color, Jörg.

A - Jörg Schneider

Thank you, Kamran.

Operator

We now take a question from Thomas Fossard of HSBC.

Q - Thomas Fossard {BIO 1941215 <GO>}

Good afternoon. Two questions, one on the life re side, could you may be potentially comment if we have to have in mind any big recapturing you may have started to negotiate and something that we have to keep in mind for H2? I know that you are doing this on a regular basis, but anything sizeable which might be in the pipe?

And second question would be related to the PC re pricing. So, midyear, you're achieving 0.9%, but actually the cat exposure on the loss-affected contract renewing at midyear where we see probably significantly higher than the start of the year. So obviously the mix should have driven the average price increase higher. So, I'm not talking of increasing momentum, but the mix should have brought higher price increase. So, if you're getting that on the loss-affected business which have been renewed, where is the missing gap and where potentially you have been facing already significant or I would say lower pricing or declining prices already at midyear? Thank you.

A - Joachim Wenning {BIO 16273429 <GO>}

Yes. Thank you, Thomas. We do not actually budget the life re recaptures. But we continue going after recaptures as part of what we call the in-force management ambition of our colleagues in the life re space. Is there anything concrete that at this point we could announce? There isn't. Otherwise, we would have done so. Can we exclude that recapture transaction is going to happen in Q3 or in Q4? Can be. We don't push for it. When there is a win-win possibility, an economic win-win for both client and ourselves, then we will go after it.

Maybe I should add one thing, in case that these recaptures happen and if we believe that the track record, historic track record is a good indicator into the future, then for recapture, you would expect an impact of something like a low-to-mid double-digit million amount.

With regard to P&C repricing, you cite the 0.9% increase and would have expected because of a more beneficial, if you like, to be renewed portfolio structure higher impact, what you should also take into account, please, is the large contracts and they dilute this picture.

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

Okay. Next question, please.

Operator

Thank you. We will now take a question from Michael Haid of Commerzbank. Please go ahead.

Q - Michael Haid {BIO 1971310 <GO>}

Thank you very much. Good afternoon. Actually, two questions. First question on P&C re and again on the large – on the structured large quota share business. As you mentioned, they come with a combined ratio closer to 100%. And all else being equal, your normalized combined ratio going forward should go up. Can you give us some information about how this effect will be in the calendar year 2019? And should we still think or assume large losses being normalized at 12% of net earned premiums if net earned premiums include so much premiums from the large transactions?

Second question, on your 2020 guidance, €2.8 billion, from ERGO €530 million, from Life and Health Germany €90 million, and if I remember correctly, this is composed of life minus €90 million, so a loss and health €180 million plus. Is the minus €90 million for German life still realistic? It comes at a time when interest rates even in Germany were lower than they are today. The assumptions regarding (00:56:40) participations have probably changed and we have the ZZR change in the methodology ahead of us. So, what should we think about this minus €90 million?

A - Jörg Schneider

Michael, thank you for these questions. Let me start with the last one that is difficult. It could be that we come out a little bit more favorable, but it was mentioned before correctly that there's also an impact from lower ZZR requirements which do no longer force us to the same extent to realize IFRS relevant capital gains. So therefore, this could be a countervailing effect. It's too early for me to say that here.

So, as I said before, it's so difficult to forecast these numbers. We can say wherever we have a substantial deviation from what had been planned before, it's rather on the high side then on the low side, but don't dream – at least, I don't dream of big numbers here.

Then, on your question on property-casualty reinsurance, these large quota share deals come in with combined ratios which are definitely higher than the 97% we are striving for. But I don't care, yeah. So as long as they are profitable with all respect which means in IFRS and especially also on an economic basis, it's fine because possibly they come on top of what we earn elsewhere. Therefore, they make me more confident to achieve our targets instead of less confident.

With regard to the large losses, difficult to answer whether the 12% is still a good guidance. Man-made losses had been somewhat higher, nat-cat losses somewhat lower, but remember 2017 when we had the huge impact from the large losses from natural catastrophes, 2017 will come again hopefully not very soon. So, still in our interim numbers, this ballpark percentage range of 12%, it seems to be valid. Most probably, our absolute number will be higher than €2 billion because our net earned premium is strongly growing at the moment. Therefore, there are no major changes. And overall, it's a very healthy picture. And by the way, the large deals don't come in at 100%. Yeah, they come in below 100%, so somewhere between 97% and 100%, perhaps in the middle or so.

Q - Michael Haid {BIO 1971310 <GO>}

Okay. Thank you very much.

Operator

We now move to a question from Frank Kopfinger of Deutsche Bank.

Q - Frank Kopfinger {BIO 16342277 <GO>}

Yes. Good afternoon, everybody. I have also one question for your ERGO 2020 target. One driver is obviously the 92% combined ratio for German P&C business. And I was wondering whether you see some headwinds here as the portfolio mix shift is still going on, i.e. the accident business is at the lowest level which you ever had. And on the other side, motor business is thriving, which is probably coming also in the buyer price comparison websites. So, any thoughts on this portfolio shift and your 92%?

And the other question is on your asset management business. There has been some speculation that you're looking for a partner for your AM activities. Can you please comment on what your strategy for the business is and any thoughts which help us to understand your logic?

A - Joachim Wenning {BIO 16273429 <GO>}

Yeah. Let me start with the second one, and Jörg, I don't know if you take the – take it? Yeah. I'll take the second one with regard to asset management business, Frank.

So, we have clarified – after some rumors have been articulated in the press, we have clarified that the investment function is for us, an important value lever, both on the reinsurance side, but also on the primary insurance side. I'm emphasizing this statement because in some media, we had to read something like we're going to divest from investment, so nonsense.

The second statement is that we are happy with MEAG and their asset management performance. Yet, we continuously would compare and challenge the proprietary asset management to asset management capabilities externally. So if in a defined asset class, an external manager focusing on that asset class with a large scale in this asset class could outperform MEAG, then to us, it's very logical that we would consider at least partnering with that asset manager. This is frankly what I'd like to state. Anything else is just in the realm of rumors.

A - Jörg Schneider

With regard to the business mix, Frank, the 92% is ambitious. I can confirm that especially also because the accident business is currently not growing, but rather shrinking. But this is not an one-sided development. So, we are confident that we can also stimulate the accident business going forward. With regard to the motor business, what comes from the comparison sites that is mostly (01:02:46) business. Most business apart from that in motor comes from our own sales forces and it increases the loyalty of the client and for us, it is also important to be more present in motor business in order to then provide our clients with the broader, more modern product portfolio we had set up in the last couple of months.

So therefore, we are confident that we can run the motor book in a way that is not value destructing, but profitable and that we can improve our client coverage also using motor business, but not only. So therefore overall, we are still confident that this is not an obstacle, but rather tailwind for our ambitious targets for 2020 and going forward.

Thank you, Frank.

Q - Frank Kopfinger {BIO 16342277 <GO>}

Thank you (01:03:45).

Operator

We will now move to a question from William Hawkins of KBW.

Q - William Hawkins {BIO 1822411 <GO>}

Hello. Thank you very much. First, well, sticking with ERGO, sorry, but I'm still not quite clear about why we shouldn't annualize the first half results of €185 million. So, can you just give us an indication of what should be dragging ERGO? I mean, I understand the large losses on the reinsurance side. But you said that they are – said that it all seems to be tiny, realized gains were already light in the first half. So, I'm not sure why you shouldn't annualize that. To the extent that the answer is restructuring costs, can you just remind us what they were in the first half and what they could be in the second half?

And then secondly, on the Solvency II ratio, the figure is up about 5 percentage points. I think you said in your prepared remarks that's all operating and nothing to do with markets. So, can I just clarify two things? Just technically speaking, that number is not depressed by any accrual of capital distribution because the dividend or the buyback all comes at the end of the year, so the 5 points is just a clean number? And then more importantly, how much comes from own funds going up and how much comes from SCR going down assuming it did? What's the split between numerator and denominator? Thank you.

A - Jörg Schneider

Thank you, William. Why you shouldn't annualize the ERGO profits, a couple of reasons. One is large losses were on average lower in spite of the storm, Friederike, in the first half. Second is we do not expect high capital gains in the second half, if the ZZR rules come in as expected. Third, we had a positive tax effect in the first half, which we mentioned in the first quarter. And third, the gain from disposal of our DAS Switzerland was substantial and we do not expect similar sales going forward.

Second, with regards to our economic solvency ratio, the plus 5% is a clean number. There's no accumulation of dividend. We haven't changed our methodology here. But I would like to emphasize that the capital management, that means the dividend and the share buyback of the second quarter has already been deducted as of end of Q4. Yeah. So, there was no impact from that. What was happening there was, first with regard to the solvency capital requirement, it went up slightly, first due to a small, very small impact from a higher exposure; second, from currency effect. It was mostly currency effect. But the eligible own funds increased to a larger extent and that was due to the operating earnings in spite of the negative influence from major losses in reinsurance, which were above expectation, but not far above. But this was overcompensated by positives.

One was favorable development in our in-force portfolio in life and some experience variances in reinsurance life and with ERGO. And we had market variances which were largely offsetting each other in a volatile environment, positive currency effects, and the developments on our equity portfolio, as well as the investments in real estate and infrastructure positive. And on the negative side for the economic developments, we had the aggregate changes of risk-free interest rates. That means up in the United States, but down in Europe, and the widening of credit spreads which was the most important impact. Overall, moderate increase in eligible own funds on a small increase on solvency capital requirement.

Q - William Hawkins {BIO 1822411 <GO>}

So, just to follow-up briefly. To the extent that your P&C book has grown quite significantly, the fact that the SCR hasn't gone up much. Is that telling us that there's no capital strain from your P&C growth, or is it something being offset (01:08:12) life re going down or something?

A - Jörg Schneider

There is only a small increase in capital requirement for P&C on a currency-adjusted basis and some relief – and increase from currency, yeah, so both. Both going upwards, but it was tiny.

Q - William Hawkins {BIO 1822411 <GO>}

Right. Thank you very much.

A - Jörg Schneider

And there was a question for the restructuring expenses, that is – not restructuring. We call it investments here because they are not booked as restructuring expenses. They are partially booked as operational expenses, partially as non-operational, but we do no longer call it restructuring expenses. The net impact was €68 million and this is approximately one-third of the 2018 budget.

Q - William Hawkins {BIO 1822411 <GO>}

Fantastic. Thank you.

A - Jörg Schneider

Thank you, William.

Operator

We now take a question from Roland Pfänder from ODDO. Please go ahead.

Q - Roland Pfänder

Yes, good afternoon. Coming back to ERGO, could you speak about your IT modernization efforts at ERGO, is it on track? As I remember, it was one of the crucial things you wanted to evaluate in 2018 to get it more efficient and profitable going forward.

Second, coming to ERGO International, is there any specific reason for the deterioration of the combined ratios in Greece and Turkey? Maybe you could shed some light on that.

Maybe as a third question, looking at the agricultural business, do you see any losses arising here in the third quarter looking at the drought out there in Europe? Thank you.

A - Joachim Wenning {BIO 16273429 <GO>}

So, Roland, this is Joachim. With regard to ERGO IT, I would split the answer into two parts. One is the ERGO IT with regard to the administration platform for managing the old life back book. Here, ERGO has started or launched the cooperation with IBM to the end in the period of two to four years which is highly ambitious to migrate into a newly to be established and newly to be designed platform which will be then modern, which will be efficient and which will strategically also be open to administer then third-parties' books. That part is going well. It's onerous, it's progressing, but I'm saying it's four-years period ahead of us. So, we progress quarter-by-quarter, but at this point in time, we are happy with regard to the progress.

The second part of the question is and what about all the remainder of the IT work which we would then have under the heading of new IT foundation at Ergo making the IT agile, this is split into dozens of smaller IT projects all designed to strengthen then their business impact. ERGO has only recently very intensively looked into, I would call it, sort of a review of where they stand also in this regard and the review result is that they had only to reprioritize some parts of their large project portfolio. But the key elements of them, they continue to be – I would say, they continue to produce every confidence that they will deliver over time. So in a nutshell, it's underway.

A - Jörg Schneider

Roland, on Turkey, this is the known phenomenon mostly due to the third-party motor liability cap and the pool regulation, we are also suffering from like all market players and this has a negative impact on our loss ratio. And on the other side, our gross written premium, there's a decline coming from currency effects due to the devaluation of the Turkish lira. Our expectation for 2018 is that the combined ratio will be in the region between 115% and 120%. We must take into consideration that we have very high interest income in the market, but nevertheless it's a difficult environment and we have to survive in that environment as good as we can.

With regard to Greece, we had a significantly higher loss ratio due to the integration of the ATE company which we bought a year ago or so then with the closing. But it even reinforces our position in that market. So, we are very happy with the development in Greece and we have no reason to believe that our competitiveness has been suffering from these efforts, they are worth the price.

And your next question was about agricultural business, how much will be suffered from the drought. So in the drought, as far as I know, mostly refers to Central Europe at the moment to some areas. And in most of these areas, there is no coverage for drought unlike in the United States where we have this multi-peril crop business and other government supported schemes. We do not have such schemes in Europe and therefore we expect losses from fires also with regard to the drought, also from the current wildfires in California. So, the secondary effects could come in, but in the agricultural business itself, we do not expect substantially important loss development here.

Q - Roland Pfänder

Very clear. Thank you.

A - Jörg Schneider

Thank you, Roland.

Operator

As there are no further questions, I would now like to turn the call back to Mr. Christian Becker-Hussong for any additional or closing remarks.

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

Thank you very much. There's nothing to add from my side. Just, thank you for your participation and for your questions. And we are very much looking forward to speaking to you and seeing you next time, but Jörg has a final remark to make.

A - Jörg Schneider

Yes. Thank you very much.

Just a technical remark, the format for our Q3 disclosure will somewhat change because there won't be a formal quarterly result report. So, we abolished that document as others do, but unlike many others, we will provide you with a full set of information on premium income earnings as you are accustomed to. It will be concentrated on the press release plus the usual presentation which you know already from the last couple of quarters. We hope that we can make your life easier with that and the level of information will be exactly the same or more or less the same as you are accustomed to it.

Thank you very much also from Joachim's and my side and take care and a wonderful holidays for those who have it ahead of them. Bye-bye.

Operator

This concludes today's call. Thank you for your participation. You may now disconnect.