Q1 2015 Earnings Call - Q&A

Company Participants

- George Quinn
- James Quin

Other Participants

- Andrew J. Ritchie
- Andy D. Broadfield
- Dhruv Gahlaut
- Farooq Hanif
- James A. Shuck
- Michael I. Huttner
- Niccolo C. Dalla Palma
- Nick Holmes
- Paul C. De'Ath
- Stefan Schürmann
- Thomas Seidl

MANAGEMENT DISCUSSION SECTION

Operator

Ladies and gentlemen, good morning or good afternoon. Welcome to the conference call on the results for the three months to March 31, 2015. I am Sarah; I'm the Chorus Call operator. I would like to remind you that all participants will be in listen-only mode, and the conference is being recorded. After the presentation, there will be a Q&A session. The conference must not be recorded for publication or broadcast.

At this time, it's my pleasure to hand over to Mr. James Quin, Head of Investor Relations and Rating Agency. Please go ahead, sir.

James Quin {BIO 18345789 <GO>}

Good afternoon, and welcome to Zurich's Q1 results call. Our CFO, George Quinn, will make a few introductory comments, and then we'll take your questions. As usual, please stick to two.

Now, I'll hand it over to George.

George Quinn {BIO 15159240 <GO>}

Thanks, James, and good afternoon or good morning to everyone on the phone. To just begin with, overall business operating profit for the group was $1.3 billion in the first quarter, and net income total for shareholders is $1.2 billion. Both numbers are about 5% lower than in the prior-year period.

As you all know, currency has been a significant feature of the first quarter, and it's likely to continue to be a feature over the course of this year. Currency is mainly a translational issue for us because we typically match the local currency liabilities and assets, and on a constant currency basis, both would have been broadly flat, and the 5% decline in gross premium written we've announced in GI would have been a 5% increase.

From an operating performance perspective, we see this as a solid start to the year, both in terms of top line and BOP, albeit with results for both Q1 and the prior period benefiting from a very low level of catastrophes and we have a number of positive one-off items in both.

Let me turn to one other topic before I start the Q&A. With respect to solvency, you've seen that both Z-ECM and SST ratios have declined in the second half of last year. Z-ECM ratio reduced from 126% at the half year to 122% at the end of the year, and SST declined from 215% to 196% over the same period.

There are three moving parts. So the first, impact of net market movements is mainly flatter and lower yield curve, which reduced Z-ECM by around 6% and SST by around 13%. It's not all yield, but most of it is. Second, allowing for the expected growth that we expect to see in the business in 2014 (sic) [2015] (02:52) sort of negative 4-point impact on Z-ECM and a negative 5-point on SST. And then, thirdly, for Z-ECM only, these factors were partially offset by a change on how we model certain investment risks. This had a benefit of around 6 percentage points.

The interest rate sensitivity that you see and the capital figures that we disclosed today is greater than the previously disclosed simple parallel shift that we've given for two reasons. First and most important, is convexity and positioning. And the second is the second and third dollar effects that interest rates have on risk capital but now has particularly pronounced impact on SST.

Looking into the development since the end of last year, we'd expect to see the Z-ECM ratio move lower in Q1 given the combined impact of currency movements, and the further flattening and declines in bond yields amongst other factors. And our best estimate is that we'll see a ratio in the upper half of our target range. In other words, still a very comfortable level. And given the levers that we have at our disposal to manage the overall risks, this does not impact our view of the deployable capital that we hold.

With that, we'll open up for Q&A.

Q&A

Operator

The first question is from Michael Huttner, JPMorgan. Please go ahead, sir.

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

Hello. Actually, thank you very much. Two questions. And I must say, I actually thought these were really good results. But within that because you've beaten a number of my estimates, where is – you have this target range for return on equity of 12% to 14%. You reported 12.9%, which is excellent, excluding one-off, 11.2%. So my two questions which are both on these. Which from your point of view, is actually the right figure, is it the reported or the adjusted? And where is the main miss coming from, is it still in Life or we're seeing a bit of a drift also in non-Life now? Thank you.

A - George Quinn {BIO 15159240 <GO>}

Is that both of your questions, Michael?

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

That's it. Yeah.

A - George Quinn {BIO 15159240 <GO>}

Okay. So which is right? I mean, obviously, they're both right because they're both calculations. One is the headline number. But I think the more meaningful one is the underlying ROE performance because that gives you a better sense of what you could expect from a go-forward. And of course that's particularly relevant for the remainder of this year, and next year to make sure that we're in that 12% to 14% ROE range. If you look at the driver of kind of why we're not where we expect to be, I think there are probably two key pieces, I mean, one is the same thing that you have from us at the end of last year. So it's mainly GI. If you look at the GI combined ratio, if we adjust for CAT except for one-off expense on both sides, I mean, the underlying ex-CAT combined ratio hasn't changed by much, in fact it's almost exactly the same.

If we drill into – we have a small improvement in attritional which we believe is offset by large loss, but of course the large loss pieces and estimate rather than (06:34). Overall though, we need about 2-point to 3-point improvement over where we ended last year on GI. We really made a relatively small step in the right direction, so we need much more from GI to be in that 12% to 14% range. Second is capital. We're still carrying more capital than we need, obviously, depresses the overall ROE. And as we've highlighted before, and I guess we'll discuss during the course of this call, certainly we'll discuss again on May 21. Capital deployment also has the figure and is achieving that 12% to 14% ROE.

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

And that's perfect. Thank you so much.

A - George Quinn {BIO 15159240 <GO>}

Thank you.

Operator

Your next question is from Andrew Ritchie, Autonomous. Please go ahead.

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

Well, hi there. One straightforward question, the large loss noise you alluded to in Q1, is that still the same area generating large losses – that generated large losses in Q4, which I think was things like, for example, U.S. commercial auto, Brazilian surety or is it new areas? And maybe just give us a sense, is that revealing any issues or is it genuinely random. And then, on capital; you said in your opening comments, maybe I misheard you, that there was an effect in the required capital for 2014 growth. But I thought the Z-ECM and SST took into account anticipated organic growth for 2015, so it's forward-looking in its requirements. Maybe if you just clarify that. And if that is the case, what level of organic growth is kind of penciled into that number? And is that one of the levers, I guess, the financing of that future growth that when you talk about levers and things you can pull? Thanks.

A - George Quinn {BIO 15159240 <GO>}

So on the second one, first. Sorry, I misspoke, it's absolute 2015. Thank you for that. I guess, as one of the levers – I guess, levers (08:41) I guess, it's a margin of prudence that we have in the calculation. We've got about negative 4 points and negative 5 points on Z-ECM and SST. I apologize, I don't really want to give you a forecast of volumes for the year, but even with the growth that we see in Q1, we're well beneath the level of growth that we had planned for, and (09:04) capital calculations that you see. So we'd have a significant reduction in both 4 points and 5 points if the current trend continued through the remainder of the year.

On the large loss theme, I'm not sure whether it's good news or bad news, but they are completely different from Q4. We have a large corporate loss in North America. It's by far the largest single loss in the quarter. And we have some large losses in Europe, and in particular, the municipal business in the UK stands out as the source of two of them. So they're completely different from what you saw last year.

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

The issues that cropped up in Q4, are these calmed down, any development on them, or have they just not really come across your desk in Q1?

A - George Quinn {BIO 15159240 <GO>}

If you look at large losses overall, it's actually a touch higher than it was in Q4. But the theme – I guess, there are no themes in large losses are there, but the large losses that have occurred, you don't see the Brazilian topic crop up again, and the other items you saw – I mean, even then looked as though they were one-offs. And so the themes in Q1 are completely differently than the large loss theme.

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

Okay. Thanks.

Operator

Next question is from Andrew Broadfield, Barclays. Please go ahead.

Q - Andy D. Broadfield {BIO 7273415 <GO>}

Hi there. Good afternoon. Two questions. First one, on the need for capital, for the growth, you mentioned just now that you – that Q1 have missed what you had hoped to achieve and therefore to consume. Can you just give us a little bit of outline on where that – why you failed to reach that growth target, what part of the business it was in and where you think you might be able to catch back up over the course of the year? And then the second question is also in relation to solvency. But in terms of what you anticipate, you've talked about levers. Does it take into account things like the sort of steady decline in Farmers Re, quota share, et cetera, that although, I know it's not in stone your intention I see (11:14) the surplus improved again in the quarter at Farmers. So does it capture those sorts of actions within your plan?

A - George Quinn {BIO 15159240 <GO>}

So Andy, on the first one, I mean, all I can say in response to that, I mean, it's broadly across GI. If you look at GI in Q1, we've got pretty strong growth on global corporate that we actually think the headline there tends to overstate the growth that we expect to see from global corporate for the year. I mean, rate is generally still modestly positive. It continues the trend that we've seen through the course of last year, even if the absolute numbers by the various businesses or territories move around. I mean where can we catch up? I mean, I don't know yet. I mean, we're obviously looking to same sources of profitable growth, and we've allowed for that in the capital requirements that we forecast for the year. I think it's too early to be clear that we will or won't achieve that, albeit, we're behind already in Q1.

On the solvency side, the anticipated levers, I mean Farmers Re is – I mean, I guess it's not a lever currently because it's – I mean, we'll have the reduction already baked into the new figures for this year which are the benefit of the – the immediate benefit of the piece that's reinsured into ZIBB or Zurich Bermuda Branch. I mean the levers, I was thinking of are more of a combination of our ability to manage the required capital on the risk side because of the choices that we take. I mean, we allocate that capital. I mean, there's no surprise that the main consumer of capital requirement is market risk, I mean that's something that the firm can choose to have more of or less of as it sees fit. On the available sides, it's obviously a bit slightly trickier to manage it. We can manage capital structure which can be helpful, but mainly on the available side, it'll be the outcome of the year in terms of our financial performance and the impact of financial markets on the overall equity position that we have. The levers, for me, and we're obviously focused on the risk-based capital requirements and what we can do there to influence capital consumption.

Q - Andy D. Broadfield {BIO 7273415 <GO>}

So is it fair to assume that you make no assumptions around reduction in capital needs because of the natural one-off or changes that we anticipate – as a market, I guess, we're expecting of Farmers Re and other areas?

A - George Quinn {BIO 15159240 <GO>}

No.

Q - Andy D. Broadfield {BIO 7273415 <GO>}

Okay. All right. Thank you.

Operator

The next question is from Paul De'Ath, RBC. Please go ahead.

Q - Paul C. De'Ath

Yeah. Hi there and a couple of questions on the Life performance, and on Latin America basically there you've had obviously good performance in the Santander JV, but slightly disappointing in the Zurich branded vehicles in Latin America. And what was the driver there? Is that kind of an active choice to favor the Santander JV or is there something else going on there? That's question one. And secondly, I'm just looking at the flow, the net flows in the Life business, the European flows, I think very strong in the quarter compared to prior years, and what was kind of the key drivers behind that? Is that the Corporate Life and Pensions business in the UK, and how much of that is coming from winning new schemes and how much is from sort of general auto (15:01) enrollment type growth?

A - George Quinn {BIO 15159240 <GO>}

Thanks, Paul. So first of all on the late performance in Latin America, it's not that we prefer the joint venture. But we have one particular large contract that we haven't rewritten this year, so that's largely why you're seeing the underperformance on the, I guess, the Zurich brand an element of Latin America. Having said that, of course, the – I guess, the contract is sharper because of the very strong performance of the JV has produced very, very strong growth in Q1. On the net flows in Europe, I guess, the two or three main drivers of – I mean, as you hint, CLP in the UK as a piece of that, it's a combination of both new schemes and continued enrollment. And also new product in Germany, so we have a new product that we distribute through bancassurance partner and that also had a positive impact on flows rather than (15:59) Q1.

Q - Paul C. De'Ath

Is that a unit-linked type product or is it protection or what?

A - George Quinn {BIO 15159240 <GO>}

I guess, we would describe it as a hybrid product. I mean, if you look at our product mix, we don't sell significant volumes with guarantees. But typically many of the products have guaranteed elements, and this is a new product with a guaranteed element rather than an overall guarantee.

Q - Paul C. De'Ath

Great.

Operator

The next question is from Stefan Schürmann, Bank Vontobel. Please go ahead.

Q - Stefan Schürmann

Yes. Good afternoon. Two questions. The first one, still on the Life part, you show basically new business margins down in so-called other retail, which I think it's mostly down due to the traditional agent business in Germany and Switzerland. I mean, can you – maybe can we expect that to stabilize or do we take any corrective action here like cut in commission or will that continue? And then the second one on the Farmers surplus ratio, that's standing at 39%, and you guide towards a decrease to 33% to 36% in the near future. So I mean, I'm not quite sure to understand why that should drop there.

A - George Quinn {BIO 15159240 <GO>}

Okay. So Stefan, on the first one, you're right, it's mainly Germany and Switzerland, and it's the impact of rates on the business there. I think, in the short term, I don't expect it to stabilize. So I think you'll see a further reduction in new business values given the further reduction we saw in rates in Q1 for both of those markets.

Q - Stefan Schürmann

I mean, volumes basically are up, new business volumes are up and margins are down. So you just continue like that, or you don't take any corrective action there?

A - George Quinn {BIO 15159240 <GO>}

So two things. So I guess we do take corrective actions. So I mean, if you look at where we sit in the league table on certain key measures such as bonus, we're not at the top end by far. I mean it's too early to determine what the outcomes for this year will be. But I mean that's one of the levers that we have to significantly impact the overall financial performance. And there has to be a close correlation between what we're earning on the portfolio and what we share with the policyholder. So I mean that's one of the key levers for us.

I think – I mean just to be clear, on new business value, you could optimize purely for new business value and I think you'd end up with potentially an even more negative outcome. So we try and look at both new business value and BOP when we try to make decisions of where we would prioritize growth. I mean, Germany (18:30) it's very difficult though because of where interest rates are.

On surplus, for Farmers, so the key reason you haven't seen it fall straight back into the target range it's because of where the calculation is done. The calculation is based on net written. So essentially as they recapture the reinsurance, you'll see a bit more streams, a few more quarters come by and that will cause all things being equal. And dependent on earnings at the exchanges, the surplus ratio to fall and we would expect to see it – again depending on the actual financial performance fall back into the exchange's target range.

Q - Stefan Schürmann

Okay. Thanks.

Operator

The next question is from Nick Holmes, Société Générale. Please go ahead.

Q - Nick Holmes {BIO 21515144 <GO>}

Hi there. Thank you very much. Two questions. First is on the GI expense ratio, just wondered if you could share with us how you see the Q1 result developing throughout the year. I was really thinking, I guess the upfront distribution costs that have taking us up to 31%. Are they going to continue, and is 31% the sort of number that you would expect to see? And then second question is on U.S commercial pricing. Just wondered, again, how you see this developing. I mean, 2% rate change seems pretty good result. Does this sum, do you think, throw doubt out on what market scouts have been saying about the appearance of a soft market? Thank you.

A - George Quinn {BIO 15159240 <GO>}

Thank you. So on the first one, on the GI expense ratio, I mean what you see for this quarter, I mean before we take action on the efficiency side is pretty much what you'd expect. So there's no reason why, for example, the impact of the distribution even would increase or decrease through the course of the year. But having said that, I mean, I guess we've made it clear at the year-end, and we're working on it currently, that the expense ratio that we see is too high. And as a topic, we'll specifically address when we have the investor updates on May 21. So I mean for the time being, based on what you see currently, the current level is reasonably indicative of what you would expect, but we have intentions to bring that number down.

Q - Nick Holmes {BIO 21515144 <GO>}

Right. And sorry, can I just ask, would that be for this year, or is that sort of looking out over the medium term, sort of two years, three years, or perhaps you prefer to wait until the Investor Day to tell us?

A - George Quinn {BIO 15159240 <GO>}

Well, I guess the one thing I will say, Nick, is that medium term would be too long...

Q - Nick Holmes {BIO 21515144 <GO>}

Right.

A - George Quinn {BIO 15159240 <GO>}

...two years to three years. As I mentioned to Michael, in response to Michael's question, an improvement is required to make sure that we achieve the required return on equity that we have as a target. So that means it needs to be achieved over the course of the next 18 months.

Q - Nick Holmes {BIO 21515144 <GO>}

Okay. Thank you.

A - George Quinn {BIO 15159240 <GO>}

On U.S. commercial pricing, I guess the challenge is that it's bumped around a bit, if you look at our rate monitor. I'm not sure I would describe it as a particularly positive environment. I mean, we've been in position in the U.S. for some time now where the rate change is, I mean, roughly in line with loss cost inflation. I mean, Q1, I think we've seen the market respond to some of the challenges that were evident from a number of companies including ours in Q4, for example in commercial auto. So you've seen a number of areas where rate entries have been pushed through. But if you look at the market overall, it was down in the position where rate is covering what we think loss cost is increasing by, which means that margin is not currently expanding. And also, if you look at the individual lanes, I mean, property still has pressures. I mean, that story hasn't changed recently, and also workers' comp has a bit of pressure currently. So I mean, while I don't think it's clearly (22:41) negative. I think I mentioned on the full-year call that – I didn't share markets goes (22:47) more negative outlook for the full year. But we certainly haven't turned any corners on the U.S. pricing environment and, to be honest, I don't expect to see that take place over the course of this year. I think we'll see continued pressure.

Q - Nick Holmes {BIO 21515144 <GO>}

Right. Okay. Thank you very much.

Operator

The next question is from Farooq Hanif, Citigroup. Please go ahead.

Q - Farooq Hanif {BIO 4780978 <GO>}

Hi. Thank you very much. I apologize if this question has been asked. I was a little late at the beginning of the call. But looking at your Z-ECM ratio, I mean, you made the comment obviously that Q1 has been tough because of interest rates, and obviously that's reversed quite strongly in Q2. So presumably, if this is maintained in the current environment, then you will recover back up to the upper end of your coverage or above the upper end. That's one question. And then secondly, you have this kind of 4 points of business profit is uplifting your Z-ECM ratio. Is that – can we just sort of normalize that for the year and presume that you'll grow pre-dividend 8 points a year in that Z-ECM ratio. Is that kind of decent rule of thumb? And lastly, in Global Life, you've mentioned that going to the €350 million, or above the €350 million was hard because of FX. Now, has that got worse or better based on movements to-date? Thank you.

A - George Quinn {BIO 15159240 <GO>}

Thanks, Farooq. So I mean, first on Z-ECM, I mean, the only comment I've provided through the end of the quarter, and I've commented on the fact that, I mean, given the continuing move on yield curves, we expected to see Z-ECM come down and we expect to be in the upper half of our range. And we still believe we're in a comfortable position because of the extent to which we can control our capital consumption. I'm going to avoid commenting on what's happened post the end of the quarter. I mean, I guess, I may mention that when we come back on the Investor Day. I mean, interest rates, as they rise, particularly at the long end, particularly in some of the European markets, certainly, would be helpful. I mean, I think we're going to a relatively volatile period for a time. So it will go up and down a bit. But I think the good news, certainly from our perspective, is that we have enough flexibility to manage.

On the business profit piece, the – I'm not sure exactly which – I guess, if you're looking at the waterfall chart, you need to be a wee bit careful that you got the business profit on one side and then you got dividend on the other. I mean, given the payout ratios, you tend to find that – I mean, we've paid back to our shareholders a very large proportion of the economic profit that we generate. So I mean, if it's 4.5 points and we have an accrual of say 3 points within the 5 points that we've disclosed, for dividend, I mean it tends to be a relatively modest addition to the overall capital base because we're handing it back.

Q - Farooq Hanif {BIO 4780978 <GO>}

Okay.

A - George Quinn {BIO 15159240 <GO>}

On the GL topic, maybe to give GL that credit for what they have achieved. I think if we had stuck simply to the more than $350 million a quarter based on the foreign exchange levels when we first announced it, we'd be there already. But having said that, I mean when we talk about a bit more than $350 million, we actually had now made a lot more than $350 million. I mean today – I mean, as FX moves, particularly euro weakens against the franc given the preponderance of earnings that GL has there, it becomes tougher. But when we looked at it earlier in the year, I mean we were just above $350 million in terms of expectation, once all the improvements that come through from GL. But the one point I'd like to add though, I was asked on the full year call about GI, and GI's expectation of growing their earnings by 5% compound. And I commented there that, of course, I didn't expect then to compensate for any possible FX movement and the same is true for GL, so we stopped to the $350 million. It's become tougher because of foreign exchange, I mean they've done a lot of what we'd expected of them already when we first announced this. But we still hold to the more than $350 million.

Q - Farooq Hanif {BIO 4780978 <GO>}

Okay. That was really clear. Thank you very much.

Operator

The next question is from James Shuck, UBS. Please go ahead.

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

Hi. Good afternoon. I have two questions, please. Apologies for returning to the Z-ECM number, but I just wanted to pick up on something you said earlier on, George, that two of the reasons why the ROE is not hitting your target at the moment is, on the one hand, the GI combined ratio, but on the other hand you have more capital than you need. And I'm just struggling to see why that's the case because you're targeting 100 to 120 (27:52) of that ECM, and you're currently, on a Q1 basis, towards the upper-end of that range. I appreciate you got some levers to manage, but I kind of just wanted to understand whether you've actually got surplus capital.

And that's the way I should look at it, or whether this is more a case of why we're going to pull some of those levers and then that will release capital. And if that's the case, so I just wanted to be clear that there's no modeling changes to the plan. It is strictly around the required capital management. And when you consider the required capital, you're also considering what the impact is on the potential earnings growth because obviously if you take less market risk then the outlook for earnings will come down even if volatility is improved. So that's my first question.

Secondly, just around the underlying accident – or the underlying loss ratio and the ex-prior year. So if I look at the accident year, loss ratio improved 70 bps in Q1 year-on-year, you had higher large losses of about 1 point and lower nat cat of about 40 basis points. So in theory, you have about 130 basis points of underlying loss ratio improvement now, and I was just hoping for some insight geographically where that's been coming from, please.

A - George Quinn {BIO 15159240 <GO>}

Okay. So let me try and do the first one. So on the first one, I guess we've been pretty clear. I mean, given the target range, we try and measure ourselves off the midpoint of the target range, so 110 (29:20). And if you think back to prior conversations about how much capital excess we had, we would often, well, I would often talk about the fact that if we have 16 points, 16 translates into, let's say, around $6 billion. But we don't have $6 billion because we have a lot of constraints, and therefore we'd use the short hand of $3 billion. And in fact, that was the basis for that, the additional step that you saw on the ROE book I presented back in London in December.

So I mean, a part of what's happened through the second part of last year and the early part of this year is that, I guess, the constraints have come more into line with each other. I mean, some of the rating models don't move as rapidly. And despite of some of these things, as the Z-ECM, in particular, the SST, so the numbers have come down, but I guess the constraint picture has changed, if that makes any sense. So I don't see a fundamental change in the flexibility that we have. On top of that, you're right, I mean, we have the ability to manage required capital. We need to be careful that we don't give up efficient earnings as part of that. But again a peak capital requirement is for financial market risk – I mean, and that's certainly something we manage actively and we have done in the past and we'll continue to do in the future.

Would modeling changes be part of the story? (30:44) I mean, I think one of the big differences you see between the two numbers today, between SST and Z-ECM, is that Z-ECM has the benefit of what we think is a significant improvement and the way that we model market and credit risks, and the tail. I mean, I think, in due course, we'll review that and we may propose that to the FINMA for inclusion on SST. But of course, the acceptance of that by FINMA is purely their discretion, and I would imagine that it would take some time from the point at which we would propose it. And we do need to manage the gap between Z-ECM and SST. So I mean, model change couldn't be a significant factor.

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

And just to clarify one point, any decision on capital that you may not need, either because you can't find sources for it, or it might make sense to return that? That presumably would be a year-end decision.

A - George Quinn {BIO 15159240 <GO>}

(31:43) yes. So I think the – I mean, we'd make it – I mean, again, going back to what I said at the year-end, I mean, broadly (31:53). So as we come up to the year-end, we make any decisions there. But what we see in terms of the inorganic or organic opportunities ahead of us versus return to shareholders. So I mean, in the early part of 2016 is decisive for us. Underlying loss ratio. So I didn't quite understand the work that you did. I mean, in my head, I guess the numbers in the combined ratio were that the – if you adjust for some of the one-off expense in the prior year, if you adjust for the cap fluctuation, we're about the same that we have a positive impact on the attritional, offset by negative on the large loss. So there's a 60-basis point, 70-basis-point improvement rather than – you mentioned 130 basis points, but you may have included some of the things I'm normalizing in my head.

I mean, the improvements we see are a combination of various items, so it's something that we expect to drive profitability over the course of this year. So portfolio management we describe tearing (32:58), so I mean obviously emphasizing the positive parts of the portfolio and looking for significant rates in the weaker areas. And I mentioned commercial auto earlier in the conversation. We've had some small steps on turnaround, so obviously Russia, from a loss perspective is no longer in the picture. South Africa is slightly better, albeit Brazil is probably slightly worse than it was before. But I mean, those drivers are mainly the drivers of what we perceive the attritional loss ratio improvement to be in Q1.

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

And North America commercial, how's the attritional loss ratio developed there at Q1?

A - George Quinn {BIO 15159240 <GO>}

Well, I mean, overall North America commercial has improved, I mean, both from underlying attritional and from PYD perspective. So results in North America commercial stand out as one of the – is very positive Q1 this year than Q1 last year.

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

Okay. Thanks very much.

A - George Quinn {BIO 15159240 <GO>}

Thank you.

Operator

The next question is from Thomas Seidl, Sanford Bernstein. Please go ahead.

Q - Thomas Seidl {BIO 17755912 <GO>}

Thank you. Good day, everyone. Two questions. Number one on the investment income side, we calculated you had a sharp drop year-on-year in regular investment income of 38 basis points. And I wonder although in the context of total risk adjusted costs (34:30), should we now expect Zurich to re-risk to mitigate a further sharp drop in the investment income or should we actually expect Zurich to derisk in order to get more room to maneuver in the capital side and mostly about that.

And the second question on the capital, I think they (34:54) of course but in the end would have been $116 million. The model change is not as you said available in SST, but from an outside perspective as we've seen a clear or robust metric. If I extrapolate the Z-ECM number you gave for Q1, I would say that SST is probably around (35:13) now after Q1, and I wonder if you ever have a threshold for this (35:21) metrics. So how low would you be willing to go in SST before it gets painful?

A - George Quinn {BIO 15159240 <GO>}

So let me start with the first one. Again, going back to the full year, we indicated that we had decided that we would change asset allocation in a couple of areas, and that was predominantly in equities. So we've given Cecilia and the team a 1% shift in the equity asset allocation, predominantly away from fixed income. On top of that, the IM team already had an existing strategy around the liquids. They've been completing that. They haven't completed it yet, but they will continue to do that through the course of this year. And those two steps were really the only steps that we had planned to take on the asset side to help mitigate the impact of negative rates in some of the countries we discussed earlier in the call. Whether we take further steps? No, I mean, Cecilia has the ability to tactically decide to be slightly long or slightly short depending on market circumstances. But we have no further intension to shift the SAE (36:30).

On Z-ECM and SST, I guess you can get a sense of, I mean, where we're comfortable from an SST perspective from where we've operated in the past. I mean 196% is still a very strong position for the company to operate at. I'm not sure you can do what you just did and extrapolate the things straight-line. I mean, if you look at the moves we've had both for Q1 and some of the comments around what happened in April, May. I wouldn't get to the same level that you've estimated. But I mean Z-ECM is where our focus is. I think the point that you made that we need to manage the GAAP is absolutely true. We haven't set a formal floor for SST, as we would expect over time Z-ECM and SST to remain somewhat in some kind of harmony. But I mean, SST is not a formal part of the risk tolerance, we're still very well capitalized under SST.

Q - Thomas Seidl {BIO 17755912 <GO>}

If anything, I would have expected SST to react more strongly to the macro risks materializing in (37:33) compared with Z-ECM, and that is also what you have seen in 2014. Isn't it?

A - George Quinn {BIO 15159240 <GO>}

I think that's what I said at the beginning of the call. So I mean, SST reacts more strongly, I mean, principally because things like market value margins and the way that calculation is done.

Q - Thomas Seidl {BIO 17755912 <GO>}

And hence, I would have expected that the 196% you reported at the year-end after Q1 is usually in the 180%s if you have like a 10% drop on Z-ECM after Q1 that struck my method here, (38:04) of course, with a linear extrapolation here.

A - George Quinn {BIO 15159240 <GO>}

Yeah. I tried to give guidance around Z-ECM because we see that as the essential capital measure for us. I haven't given guidance around SST.

Q - Thomas Seidl {BIO 17755912 <GO>}

Okay. Thanks, George.

Operator

The next question is from Niccolo Dalla Palma, Exane BNP Paribas. Please go ahead.

Q - Niccolo C. Dalla Palma {BIO 16052945 <GO>}

Yes. Good afternoon. Just one follow-up question. On the comments you made at the beginning of the call regarding the 2 points, 3 points combined ratio improvement needed in GI to bring you closer to the center of the target ROE. Could you give us any sense of how big a role expense ratio improvement compared to underlying loss ratio improvement have to play in there, or do we have to wait a couple of weeks to get more clarity on that? Thank you.

A - George Quinn {BIO 15159240 <GO>}

I mean, we'll do much more in a couple of weeks when we have the Investor Day. I mean, we already said that of the 2 points to 3 points improvement, broadly about one-third from expense, almost one-third from turnarounds, and the remainder from portfolio management. I mean, that's roughly how we expected to break that.

Q - Niccolo C. Dalla Palma {BIO 16052945 <GO>}

Thank you.

Operator

The next question is from Dhruv Gahlaut, HSBC. Please go ahead.

Q - Dhruv Gahlaut {BIO 16209870 <GO>}

Good afternoon. Just two questions. Firstly, we talked about pricing in different markets. But if you have to look at how the rate evolution has been compared to the claims, how would those two compare on a group level? Secondly, on the FMS business, there was commentary in terms of an uptick in terms of the expenses. Is that one-off or is this the number going forward?

A - George Quinn {BIO 15159240 <GO>}

So rate versus claims, I mean, broadly in line with each other. I mean, it varies market-to-market, but from a group perspective, one broadly equals the other. On FMS, the comment on expenses was due to the fact that last year we had a margin on FMS of about 7.2%. And I guess we guided that we'd be at 7% over the course of this year, next year. And we've arrived at 7%, a bit more quickly I think than we had anticipated. That's due to that expense feature, but I don't expect it to go further, 7% is where I expect it to be.

Q - Dhruv Gahlaut {BIO 16209870 <GO>}

Okay. Perfect. Thanks.

Operator

We have a follow-up question from Michael Huttner, JPMorgan. Please go ahead.

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

Yeah. And it is just one question, thank you very much for all the answers until now. So Life, €350 million, you're keeping your target, that's brilliant, over €350 million. We achieved €319 million. Which reasons or which levers or which – where do you think there is a little bit of easy wins?

A - George Quinn {BIO 15159240 <GO>}

(41:14) for describing any of what it has to do is easy wins. I mean, I think the broad buckets, Michael, will be a combination of – I guess, what we refer to is, in-force management as some of the more mature European markets. So that means expenses, persistence management, those types of things. But I mean, I think on the more positive side of it, I mean, given the growth that you've seen again from the joint venture of

Santander in the quarter, we expect that also to be appraising as a good contributor to the growth on the positive side of what Life is doing. I mean, those would be the two most obvious as we expect further improvement from Life.

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

And if I may just very briefly, if you were to consider selling the remainder of your UK business in a kind of one-off deal, closed block or whatever, what impact would that have on your ROE metric?

A - George Quinn {BIO 15159240 <GO>}

So I guess, the only straight answer I can give to that, Michael, is that we don't expect to sell the remainder of our UK Life business.

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

Okay.

A - George Quinn {BIO 15159240 <GO>}

In general, we're looking at the entire Life bank book for opportunities to try and optimize, to find maybe parts of the portfolio that we find better owners who would perceive a higher value, and that's something we continue. I mean, our Life business in general is actually expected to contribute, I mean, strongly positively to some of the strategic priorities that Life has currently (42:51) particularly CLP.

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

Great. That's really clear. Thank you.

A - James Quin {BIO 18345789 <GO>}

Okay. That was our last question. Thank you all for dialing in. We wish you a very good day, and we look forward to seeing you at our Investor Day in Zurich in a few weeks' time. Thanks very much.

Operator

Ladies and gentlemen, the conference is now over. Thank you for choosing Chorus Call, and thank you for participating in the conference. You may now disconnect your lines. Goodbye.
