Q3 2016 Earnings Call

Company Participants

- Roland Vogel, Member of the Executive Board - Chief Financial Officer
- Ulrich Wallin, CEO, Chairman of the Executive Board

Other Participants

- Andrew J. Ritchie, Analyst
- Edward Morris, Analyst
- Frank Kopfinger, Analyst
- In-Yong Hwang, Analyst
- Jonny Urwin, Analyst
- Kamran Hossain, Analyst
- Vinit Malhotra, Equity Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, ladies and gentlemen and welcome to today's Hannover Re International Conference Call on Interim Results Third Quarter 2016. For your information, this conference is being recorded.

At this time, I would like the hand the call over to your host today, Mr. Ulrich Wallin, Chief Executive Officer. Please go ahead, sir.

Ulrich Wallin {BIO 4863401 <GO>}

Thank you very much and good morning, ladies and gentlemen, and thank you for joining the Hannover Re conference call. As usual, I'm joined by our CFO, Roland Vogel and we are pleased to present to you the figure for the first nine months of 2016.

We are very pleased that our net income for the first nine months saw an increase compared to last year and now stands at €790 million. We feel that this increase is remarkable for three reasons. Firstly, last (0:58) result was aided by a positive one-off effect to the tune of €39 million which, of course, was not repeated this year.

Secondly, business environment for reinsurance remained difficult due to the continued soft market in the P&C reinsurance business and due to the continued low interest rate environment. Thirdly, the absolute level of profitability displayed in the first nine months is fully in line with our profitability target. At least from the favorable results for the nine months, we are increasingly confident that we will reach our full year net income guidance, provided that the large losses as well as the capital markets develop, in line with the expectations.

Adjusted for foreign exchange rate movement, the growth premium income is slightly down by 1.7% whilst the net premiums earned, at the same time, are slightly up again by 1.7%.

The reason for this is mainly the result of some discontinued large transactions in particular on the Life & Health side, which however had significant amounts of (2:33) on them so that the effects are more pronounced regarding the gross premiums and less on the net premium side.

On the P&C side, whilst the volume is a little bit down after nine months, our fee income increased premium on the third quarter on a stand-alone basis. This is due to new business being written in the third quarter, and thus, we can expect that this development will continue into the fourth quarter.

Shareholder's equity increased by 8.8% and the book value per share stands at €72.81. The reason for this will be explained by Roland. Nevertheless, due to the favorable earnings, the ROE continues to remain at attractive levels, well above our minimum target with an ROE for the first nine months of 12.5%.

The combined ratio, as well as the resultant increased underwriting result, is very much in line with expectation and the third quarter did not benefit from any reserve releases over and above the usual positive runoff result. Following the benign third quarter of large losses, we are well below our large loss target after nine months. However, in line with our usual practice, we largely kept the unused part of the large loss budget for the remainder of the year.

Our Life & Health business developed somewhat above our expectation even though last year's result was benefiting from the already mentioned positive one-off effect. The EBIT increased by 17.9% compared to last year and this increase in profitability in particular stems from our Paris branch that last year we had experienced some problems. This, of course, will not repeat it this year, and our Paris branch is back to the normal level of profitability.

Despite the fact that we saw some adverse claims experience on our U.S. Mortality business, overall, the profitability of our U.S. business on the Life & Health side is up. The net income or the income from our investments under management is fully in line with our full-year target. So, return on investment from assets under management reached 3.0% which is even slightly more than our full year target of 2.9%.

With this rather positive note, I would like to hand over to Roland who will explain to you these figures in more detail.

Roland Vogel {BIO 16342285 <GO>}

Yes. Good morning and thank you, Uli. As usual, I will focus on the nine months figures and try to keep my comments as brief as possible, not the least because the quarter is fairly straightforward, and does not include too many extraordinary effects.

The slight decrease in the top-line is in line with our expectation for the full year, especially in light of the strong growth we recorded in the previous year. Net premium income increased by 1.7%. This is driven by the change in unearned premium in our P&C segment on the one hand and by the slight increase in retention on our Life & Health segment on the other.

Investment income is in line with our expectation excluding the €39 million positive one-off effect in Life & Health in Q1 2015. Investment income from assets under own management is on the level of the previous year, which I feel can be seen as a success in the current yield environment.

Other income expenses decreased mainly to less positive currency effects. We are still in positive range, but not to the extent we had experienced last year. Last year, the depreciation of the euro against the U.S. dollar had that significant positive effect, which again didn't repeat itself. At 27%, the tax ratio was only slightly higher than in the previous year.

On the next page, you see that shareholders' equity increased by 8.8%. On the right hand side of this slide, you can see that in addition to our very positive result, most notably the capital contribution from valuation reserves in our investments increased by nearly €700 million as a result of low interest rates, thereby more than compensating the dividend payment.

On one the hand, it is good to see our capital strengths improving even further, while on the other hand, the increased valuation reserves loan are diluting our return on equity by more than 50 basis points. Without that additional increase in reserves, the ROE would have been over 13%.

At €1.7 billion, cash flow continue to be very positive in the first nine months of 2016, again demonstrating the strong cash flow production of our business model. Supported by this, assets under own management increased by 3.4% to more than €40 billion, increasing valuation reserve had a positive effect of around €1 billion while the negative impact from foreign exchange rates on the other hand was around €700 million, to especially the weakening of the British pound after the Brexit decision has materialized.

As a result of our strict margin oriented underwriting approach, P&C gross premium decreased by the mentioned 1.5% on an FX adjusted basis. This decrease is less pronounced and reported at the time of the half year results, driven by a favorable premium development in the third quarter, which showed an increase of 6% on a stand-alone basis.

Please bear in mind that we had a non-recurring effect associated with the accounting of our facultative business in the previous year, where we booked almost €100 million in additional premium. Moreover, we scaled back our involvement in Chinese motor business as well as in our specialty lines particularly in aviation where rates did not justify a continued participation. This was partly offset by business opportunities especially in the U.S. and additional contributions from our structured reinsurance team.

Net premium earned increased by 0.9% on an FX-adjusted basis. This is as already mentioned, not the result of a higher retention which actually decreased slightly, but rather it is due to the change in unearned premium driven by the strong growth in 2015. Following a very benign first and a very active second quarter, loss activity was clearly below the expected level in the third quarter with net large losses amounting to only 41% versus the quarterly budget allocation of €265 million. As a result, the overall large losses were 6.6% of net premium income for the first nine months and, therefore, significantly below expectations.

However, in line with our usual practice, we have capped the yearly large loss expectations in our reserving assumptions which provides us with a comfortable buffer for the rest of the year. On that basis, the pleasing underwriting results leads to a combined ratio of 95%, clearly beating our maximum target of 96%.

In the third quarter, the run-off of reserves was positive within the expected range and we did not benefit from any extraordinary developments here.

You will remember that we did mention an extraordinary positive run-off of around €150 million at the end of the second quarter, which largely is still included in the year-to-date number. At that point in time, the confidence level of reserves were slightly down when compared to the end of the 2015. I here do refer to the number we have published during our Investors Day of nearly €1.9 billion. With the positive result in Q3 stand-alone, the confidence level of our loss reserves should have at least remained stable or even slightly improved when compared to the end of June.

On the reinvestment income here was in line with expectations, the total investment income decreased slightly. I will explain the details later. The tax rate increased slightly compared to last year mainly as a result of a less positive result from our Bermudian subsidiary. Altogether, with an EBIT margin of more than 15%, the P&C segment again delivered a very pleasing performance in the light of a challenging market environment.

As already mentioned, the overall large loss situation was below budget for the first nine months. As a result, the unused part of our large loss budget was boosted or has boosted the remaining large loss budget for the rest of the year to €432 million at the end of the third quarter. Based on a recent conservative, but of course still uncertain first calculation, Hurricane Matthew led to a loss of slightly below €100 million and with some smaller losses from Italy and the larger fire loss in Germany. Today we should have approximately €300 million left for the remainder of the year when it comes to large losses.

After nine months, 14 losses are showing up on our large loss list. The overall benign large loss experience can be attributed mainly to the very moderate situation in the third quarter, which was one of the least affected quarters if I look at that recent past. The absence of a major Atlantic hurricane, as mentioned Matthew was a fourth quarter event, is not the only factor here because other losses were also below the expected level.

Looking at the technical profitability of our P&C book by line of business, but first to confirm the favorable development in the business line as explained in connection with the half year results. The combined ratio in Marine includes a positive run-off of reserves of roughly €40 million in total in the second quarter. As expected, the combined ratio for the first nine months here is trending higher again, but it is still below the normal level.

On a nine months basis, various lines made good contributions to the very positive results and in particular, the target markets driven in part by the volume of the segment. Our NatCat segment is also back below the MtCR, thanks to the absence of Cat losses in Q3.

The earthquake loss in Ecuador explains the high combined ratio in the worldwide treaty business, and credit and surety was mainly affected by one large claim. As mentioned, our P&C portfolio, as a whole, continues to perform well below the maximum tolerable combined ratio.

As we explained in our Q2 call, premium growth in our life and health segment was particularly strong in the third and the fourth quarters of the previous year, and, hence, our premium decreased by 2% adjusted for currency effects here. This is mainly driven by the discontinuation of individual large treaties in China and Australia, marking the continued demand in Longevity especially from the UK.

Net premium earned increased by almost 2.8%, adjusted for currency effects, and the increase in net retention reflects, first and foremost, the reduced need for repossession premium Ulrich has already mentioned.

Even without adjusting for the €39 million positive one-off effect in the previous year, the EBIT for the first nine months of 2016 has increased significantly as compared to 2015.

Our financial solutions business continues to show excellent profitability with an EBIT margin of more than 19%, Longevity also favorable with an EBIT margin above the 2% target.

The unfavorable development of the US mortality experienced in the second quarter is the main reason for the missing mortality and morbidity. Here, the third quarter, US mortality came in with the results slightly above expectation. Overall, the 4.3% trigger is definitely an improvement as compared to 2015.

On the investment side, ordinary investment income here was similarly in line with our expectation, realized gains a little bit higher than normal, and I will come to this on the next slide. The effect from our ModCo derivatives was close to zero for the first nine months. And again, all together, net income increased strongly by nearly 18%.

Looking at the investment, the development is very satisfactory with investment income slightly above our expectations. The decrease in ordinary investment income mainly due to the last year's one-off effects from the termination fee in Life & Health. Additionally, the decreased reinvestment yields have the expected effect on our fixed income portfolio although this was, at least, partially compensated for by higher returns from real estate and private equity.

Realization; slightly above last year's level with the majority driven by structural changes in our private equity portfolio but also some turnover in our L&H portfolios, partially driven by the restructuring of our US collateralization requirements to decrease the respective costs. Other than that, we did not harvest the sharply increased unrealized gains on our fixed income portfolio. Overall, realization of this asset class have actually decreased compared to the previous year.

As you know, the volatile equity markets following the Brexit referendum resulted in some impairments on individual stocks within our equity portfolio in the second quarter. Overall, the equity portfolio even including such write-downs is well in the positive range. Apart from that, impairments mainly consisted of regular depreciation on our real estate portfolio. The return on investment was 3.0%, slightly ahead of the 2.9% we are targeting for the full year.

And the next slide shows an overview of how the different asset classes contributed to the ordinary investment income compared to where we are invested. On the right-hand side, you can see what we have – that we have kept the asset allocation rather stable. As I also explained in our Investors Day in October, we are still following a strategy of investing in – of more investing in the highly liquid government bonds in combination with some higher-yielding asset classes when it comes to the investment of new cash.

Altogether, this may lead to a slightly higher utilization within the existing risk appetite on the capital market risk side and is increasing the liquidity of the overall portfolio. At 38%, corporate bonds have, by the far, the highest share, and our investment income, real estate and private equity are contributing significantly more than their respective share in the asset allocation.

Finally, the modified duration of our asset portfolio has slightly increased to 4.8. But I think I should now conclude.

And as usual, I leave the target matrix to Uli.

Ulrich Wallin {BIO 4863401 <GO>}

Thank you, Roland. Yes, on the target matrix, you can see that despite all the challenges we would like to comment on continuously we see ticks on almost all our profitability target. Keeping in mind the strong growth that we saw in 2015, it does not concern us that the premium income has fallen short of our growth targets for the first nine months. I already explained and Roland as well the development that is the result of that.

Our guidance for 2016 remains unchanged, purely based on the results after nine months and disregarding the possibility of major losses exceeding the expectations or a distortion of the capital markets. The net premium income target of €950 million at least appears to be well within reach. Based on such a result like in previous years, we would, again consider to pay a special dividend over and above our usual payout ratio of 35% to 40%.

Looking at the individual segments of our well diversified P&C business. You can see that the premium income looks rather flattish for the entire year. North America, we already mentioned we have written some new treaties in the third quarter, so we will see an increase there, maybe a little bit more pronounced even than we have seen after nine months.

Also, this is aided by the Canadian business because following the large wild claims, we saw opportunities to grow our business in Canada at a very acceptable and increased rate.

Continental Europe, it's very competitive at this point in time, particularly if you go outside Germany. Therefore, in order to safeguard profitability, we expect that the premium income will be slightly down, but (24:08) only slightly down.

On the Marine side, we feel that we have quality book. However, we try to keep the book as pure as possible and therefore under current market conditions, we see premium reducing but the profitability will continue to be favorable.

Aviation, as mentioned, very soft market. We have changed our portfolio back to a soft market portfolio which we have in the late 1990s and before. There of course, reduced the premium volume, very significantly, but we feel that the business on that basis can be profitable and we are pretty confident that it will be profitable this year, largely also because of the very conservative loss reserve position we are seeing there.

Credit and surety and political risk, volume quite stable. Results, we had one large claim Roland mentioned, but also we saw increasing frequency of claims in the developing world and the developing markets due to the turmoil that you have seen in some of the economies there.

UK, Ireland, London market and direct, going fine. Profitability should be above the cost of capital, and we would also expect more or less a flat volume. Facultative, due to the one-off effect already mentioned, premium volume is down, but profitability should continue to be above the cost of capital.

On worldwide treaty, we have continued to see growth in Asia, and therefore premiums, despite the soft market, should be flat. And for the full year, we expect the results to return to be within the maximum tolerable combined ratio.

On the cat side, there's some business that we write in Bermuda, and again, flat premiums. Well, I mean, if we have significant losses in the last weeks of this year to bring up the overall loss levels to the expected losses, then we will not earn the cost of capital. However, for the remainder of the year, that would, of course, be a very, very negative result.

And we are very happy with the development of our structured reinsurance. We see increased demand here that we were able to fully compensate the discontinuation of some rather large Chinese motor quota share new business and also, I mean, going forward, we can expect growth from this segment.

Coming to the Life & Health business, we can see that our volume should remain largely stable. This growth on Longevity and some reduction of premium income. On the mortality side, again, as this is due to the treaty set that are discontinued that have already been mentioned.

Profitability, overall, pretty good. Particularly exciting on the financial solutions side. The business is actually developing very well. And particular in the US, we have very good pipeline of new opportunities as well. As I've said, Longevity business continued demand from the UK, but also continued competition. So, we see some growth opportunities there.

Coming then to the guidance for 2017. As we have done in previous years, we would like to give you a guidance for next year. This is a report of the nine months of the current year. In general, we feel that for next year, we should largely be able to maintain our gross written premium at the levels of the current year. And this is both true for the gross and the net premiums. And also, pretty much stemming from both of our business group.

On the P&C side, we expect soft market conditions to continue. But at the same time, we feel that we have very good quality book and we've also seen some slowdown in the rate reductions. And on the Life & Health side, we expect continued underlying growth of the profitability of our business. Therefore, we feel that the group net income should again be more than €950 million for next year. I mean, all pretty much in line with what we have seen for the current year.

The return on investment. Of course, as Roland explained for many years, continues to go down in relative to – by 20 basis points to 2.7%. However, this downward trend will be mitigated by expected increased assets under management because we continue to expect a positive cash flow from our business.

This basically shows, I mean, (30:46) development of the results, we will again consider paying special dividend also for 2017. Of course, considering that all things being equal, capital level remains comfortable. And, of course, the large losses and the capital markets develop in line with expectation. This, of course, is also the provider (31:14) for our net income guidance.

This slide may be familiar to you, if you watched and listened to our Investor Day in October. As you can see, we believe that our business model would allow us to grow the bottom end of the top line in the medium term, fueled by improved profits on the P&C side with an improving market and increased profits on our Life & Health side once the legacy problems of some of our US mortality business are solved.

For investment returns, we assume that they should be largely stable in absolute terms due to the continued low-interest rate environment. In the short term, however, we expect profits to remain stable so that we will continue our policy to pay extra dividends to manage the growth of the capital.

With that, this concludes our presentation. And we look forward to your questions. Thank you very much.

Q&A

Operator

We will now begin our question-and-answer session. One moment please for the first question. The first question is from Kamran Hossain of RBC. Please go ahead.

Q - Kamran Hossain {BIO 17666412 <GO>}

Hi. Good morning, everyone. Two questions. The first one is just on – so you were seeing a bit of a shift in yields in the last day or so and kind of a little bit before that as well. If yields continue to go up, how will that change your investment strategy going forward? That's the first question.

And the second question, I guess again, related to the impacts of what's going on in the US, we heard, yesterday, there might be some more spending on infrastructure. There might be some new opportunities coming out in the US. Can you just, maybe, give a few comments on what you think, I guess, the business potential is in the US in the, I guess, in this new world? Thank you.

A - Ulrich Wallin {BIO 4863401 <GO>}

Well, I mean, for the second question, I will hand the first one to Roland in a second. Of course, I mean, you say it's a new world, but it's a very new world, and I would say what actually will develop in the US from recent events is difficult to predict, I would say. I mean, for the time being, we assume that we will continue to do business as usual in the US and – I mean, outside from any political events, we see further good prospects to grow our business there.

Q - Kamran Hossain {BIO 17666412 <GO>}

Okay.

A - Roland Vogel {BIO 16342285 <GO>}

And with regards to the investment strategy, although this might not really increase fantasy, I don't see us changing the strategy a lot because if you go back two or three years, and you had looked at our composition of the overall portfolio, and that was at times when interest rates were low, but still remarkably higher than they are today. So, if we go back to those levels, this wouldn't change the overall investment strategy.

Of course, if you see some volatility, it may make sense to follow a strategy a little bit in accelerated terms, and - but also here (35:25) yesterday, didn't give us a lot of opportunities. I'm sure some - we're waiting for that, but it didn't materialize. So, overall, the composition shouldn't change much even if it goes up. I did mention the impact that the additional valuation reserve after Brexit had on the ROE. But when it comes to the overall portfolio composition, nothing would change that much. Yes, of course, if there is volatility, one would try to take benefit out of that, but only to a small extent.

Q - Kamran Hossain {BIO 17666412 <GO>}

Okay. Perfect. Thanks very much.

Operator

The next question is from Edward Morris of JPMorgan.

Q - Edward Morris {BIO 16274236 <GO>}

Good morning, everyone. Thanks for taking my questions. First is on the net income guidance for the current year. Obviously, given what you've done over nine months and the unused budget that you're carrying into Q4, it looks very conservative, I would say. I think I remember asking the same question last year. If you could just talk a little bit how we should think about that for Q4, particularly given that you released the extra €150 million in Q2. Is there any temptation to kind of top that up again if you're doing much better than expected by the end of the year?

And then, the second question is on capital and potential special dividends. Given that you are guiding again to stable to slightly down on premium, is there any particular reason not to return all of the capital that you've generated this year or how do we balance the year - the choice between operating at the most efficient point and sort of steady progression on a year-on-year basis? Thank you.

A - Roland Vogel {BIO 16342285 <GO>}

Yeah. I mean, on the net income guidance, I already said that of course this - the results that we have achieved after nine months and with still quite comfortable level of unused large loss budget, at least €950 million would now probably put a higher emphasis on the - at least, rather than the €950 million. But nonetheless, we said we keep the guidance stable also in order to - or readily display that we see for 2017 a similar situation from the outset than we had for 2016.

The guidance, of course, always assumes that the large loss budget will be used completely. Regarding the special dividend, yeah, I mean, we will, of course, again after the fourth quarter look at the capital ratios. I mean, your colleague has just mentioned some possibility of interest rate increases which might already take out some of the growth of the capital. But, once we have done that, we will then consider how much we pay out. I would say that, at this point in time, I not see us going below the €4.75 that we paid out for 2015.

Q - Edward Morris {BIO 16274236 <GO>}

Okay. Thank you.

A - Roland Vogel {BIO 16342285 <GO>}

It's sufficiently vague (39:03) to answer your question.

Q - Edward Morris {BIO 16274236 <GO>}

Yeah. Thanks. And just on the first point about the reserves, the additional reserve release that you saw in Q2, is that something that you would allow to be offset by the end of the year?

A - Ulrich Wallin {BIO 4863401 <GO>}

No. I think we will probably keep – not put that back into the buffer because – I mean, at the end of 2015, the buffer has gone quite high also in the eyes of our auditors. So, I don't think we will have, really the room to put that back.

Q - Edward Morris {BIO 16274236 <GO>}

Okay. Great. Thank you.

Operator

The next question is from Jonny Urwin of UBS Limited. Please go ahead.

Q - Jonny Urwin {BIO 17445508 <GO>}

Hi, there. Good morning. Thanks for taking my questions. Just two for me. Thinking a bit about growth firstly. So, I remember at the Investor Day, you guys were talking about growing in credit, surety, political risk in the US. I can see on the profitability matrix today that that's got a bit less profitable and that you're guiding to stable volumes overall. I mean, is it still the case that you'd like to grow in the US and you're shrinking elsewhere? Just a bit of color there would be great.

Also, on the Life division US mortality. So, I mean I remember you being quite cautious at the Investor Day. But obviously, today's results are pretty good. And there's a comment in the release that the restructuring is starting to bear fruit. So, I mean, are you still quite cautious there? Is this just a bit of a lumpy quarter where you've had no – large one-offs and we should think that the outlook is still relatively subdued? Thanks very much.

A - Ulrich Wallin {BIO 4863401 <GO>}

Well, I mean, on the credit and surety, I mean, what we write in the US is largely excess of loss business which has been extremely profitable overall those years. And as a result, of course, the credit balances – the credit balance on that business is, I mean, very, very favorable for reinsurers and that of course puts pressure on pricing.

So, I don't think that our growth on credit and surety will particularly come from US but to a larger extent presumably from the Far East. I mean, the reduced profitability on this book compared to, say, 2009, 2010 and 2011, as I said, one of the reasons is, of course, that we saw increased claims activity particular in the emerging market, but that is, of course, taken care of now by rate increases and improved reinsurance terms that is happening, hence, a positive outlook there.

On the other side, of course, if you look at the terms condition – terms and conditions of the reinsurance treaties and particularly on the credit business, of course, I mean, they have been a lot better in, say, 2009, 2010, 2011 because now, following the very good results that we have seen in those years, I mean, commission terms are pretty close to where we were as I said with our pre-cycle.

So, all in all, I mean, where we grow on that business is largely due to our position that we have reached being the second largest credit and surety reinsurer, and therefore, if there are opportunities, we normally go to see them, and that could actually result in some growth even in the fourth quarter.

On the life side, yeah, I mean, I think I'll probably remain relatively cautious when you look at the big block that we purchased in 2008 because it has continued to surprise us negatively. I mean, yes, the restructuring beared some fruit. I mean, for example, if you look at the other income line on the Life & Health business for this year, we saved, in the first nine months, €24 million in LC costs and that is, of course, directly associated with the restructuring there.

And also, our new business that we write in the US, I mean, we have been quite successful in growing that business and it is actually quite profitable. I mean, there, we actually see, for the most part, positive deviation from the expectation. So, I mean, eventually that business will get more profitable because – I mean, the new business is becoming more prevalent in the overall result and see the big blocks that we purchase becomes – I mean, loses somewhat in weight of the overall result.

Therefore – I mean, actually, I expect an improvement in our US mortality business. I mean, the remainder of our US business, particular financial solutions is performing excellent. And also what we call health and special risk is another area that we write in the US and also, there, we see increasing profitability. So, whilst the US mortality big block is not looking all that as well, our US business, nonetheless, shows increasing profitability, if you take the entire piece.

Q - Jonny Urwin {BIO 17445508 <GO>}

That's great. Thanks very much.

Operator

The next question is from In-Yong Hwang of Goldman Sachs. Please go ahead.

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

Hello. Thank you very much for taking my question. I've got two. Firstly, on the Life Re top line, third quarter saw quite a sharp decline. You pointed to some large transactions in Australia and China that were discontinued. But looking forward, do you kind of see potentially more of these discontinuations of large transactions, and is there any pattern that you see here?

And I guess, just linked to some of the largest deals you're doing based in Life and P&C, how much of the pipeline do you factor into your premium guidance for 2017? I guess they can be quite lumpy, but it'd be interesting to see whether you see the risk more to the upside or the downside regarding that side of things?

And my second question is on the Cat XL combined ratio that you've shown on slide 8. I think there's quite a big variation from quarter-to-quarter, which I guess I find slightly difficult to understand given that you booked the large loss but in full before tuning up in fourth quarter. So, if you just help us explain where the variation comes from quarter-to-quarter, please. Thank you.

A - Ulrich Wallin {BIO 4863401 <GO>}

Yes. Thank you for the question. I mean, on the Life Re top line, I think we are through, in 2016, with the effect from the discontinuation of large treaties. Because, I mean, the largest part of this has actually been single premium transactions from China where we just reached our maximum risk that we are prepared to take on these. And as a single premium, I mean, there is no further premium to be accounted on those. Of course, the margin is gradually coming out of those treaties.

And the other just was a large Australian group business, which unfortunately we lost, but there is – I mean, in Australian business, we are back to underlying growth there. So, I mean, we will have to make up for this lost transaction, I think, in the next two years, because as the rest of our Australian business is growing actually quite favorable.

But we take into account in the premium guidance for next year, both for P&C and Life & Health, are not the assumptions that we should be able to write any loss transactions. But if we do, they would come on top. What we take into account is the usual developments that we expect. For example, on the Life & Health side, on our U.S. mortality business, the new business, I mean, that will grow because we have certain assumption on new business that we write. And, also, on the existing business, yes, it's YRT due to the premium increases year-on-year as that automatically would create some growth and then as if that is included. And the same as the growth we are seeing, for example, on our Australian retail business. In the normal course of business, that's included. But any extraordinary large transaction that may or not come about, we not include that in our guidance as we also don't include it in our planning.

On the development of the combined ratio on the Cat side, I mean, on the Cat business in the second quarter, we just went above the large loss budget.

And whilst during the year when we don't reach the budget, we are not released that. However, then in a quarter, we have losses that are above the budget, we were booked for those rather than using the budget of the next quarter, and that explained why the combined ratio on Cat segment, jumped up in the second quarter and a step down in the third quarter.

A - Roland Vogel {BIO 16342285 <GO>}

If I may add, you should also bear in mind that it's not always a direct correlation between something happening and the business line as we present it here. So, for instance, I did mention, I think the earthquake in Ecuador made itself felt mostly in the worldwide business because it was more per risk book rather than a Cat XL book. If you go back to, for instance, to Sandy that was more a marine loss event than anything else, so you should bear in mind that also the losses, even if we see them as Cats, do not only show up in that business line. There can be a different composition as well.

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

All right. Thank you very much.

Operator

The next question is from Vinit Malhotra of Mediobanca Securities. Please go ahead.

Q - Vinit Malhotra {BIO 16184491 <GO>}

Okay. Thanks very much. So, just two very quick fact-checking questions, please. On the Life margins, from speaking with IR team today, it appeared there are some realized gains as well as part of this restructuring of the collateral business. Could you quantify that please, so we can get some idea of what is the underlying sort of EBIT margin in Life, if you don't mind?

And second question is just to clarify, this merely 7% growth in premiums in CapEx adjusted in P&C in 3Q stand-alone. Just to clarify, is it coming from U.S. or is it coming from some structured facultative, those kind of lines? Just want to clarify that please. Thank you.

A - Ulrich Wallin {BIO 4863401 <GO>}

Well, if I may take the second and leave Roland the first one. Yes, I mean, this stand-alone third quarter growth for the most part is actually U.S. business. And partly that U.S. business on advanced solutions and partly its traditional U.S. business, largely property rather than casualty. That is the reason there.

And in Asia, of course, the facts of the discontinued motor quota share are no longer prevalent if you could compare third quarter to third quarter. And the compensating business that we wrote in particular in Eastern Europe, of course, is making itself felt in the third quarter numbers. That actually as I've said will continue into the fourth quarter.

And with the Life question, Roland is working at it and he will answer that now.

Q - Vinit Malhotra {BIO 16184491 <GO>}

Thanks.

A - Roland Vogel {BIO 16342285 <GO>}

Vinit, of course, we do not exactly track each and every security which is sold, as to why it was sold. But if I – and this is a little bit of gut feeling and a rough number, I would say, at approximately or around €20 million was the extraordinary number. We may come back to that but that would be my first gut feeling that this has increased from quarter-to-quarter. It may even be a little bit less than that if you make it €15 or so. That would be the number which just came through by touching some of the portfolios where we had changes from deposits and collateral provisions here.

Q - Vinit Malhotra {BIO 16184491 <GO>}

Yeah. Thanks, I appreciate your color here. Thank you very much.

Operator

The next question is from Andrew Ritchie of Autonomous Research. Please go ahead.

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

Hello, hi there. I just wanted a quick update on Australia from a Life claims perspective. You start to see primary insurers taking into account the new mortality tables and talk about still elevated claims levels and disability and individual income per section. How are claims running for you relative to the adjustments you've made a couple of years ago? And what's your general view on new business opportunities in the Australian Life market? Thanks.

A - Ulrich Wallin {BIO 4863401 <GO>}

Well, if you look at the new mortality business in Australia, I mean, we have taken into account, of course, the new tables but it hasn't affected our business negatively. I mean, particularly on our retail business, results are actually above expectation. Therefore, our Australian result is in line with expectation and a little bit up compared to last year. Where we see further growth is largely in the retail business, and to some extent, also, again, in the group business, where we have improved our service levels and that is fueling some additional business.

If you look on the legacy DII business, I would say claim frequency and severity is in line with our reserve that we increased quite a lot two years ago. However, what we see is due to the reduced interest rate fee, sufficiency of the future premiums - I'm sorry, deficiency reserve for that has actually increased due to the drop in interest rates. But this, I mean, detrimental effect as a result was more than offset by better performance of the rest of the business.

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

And is the individual morbidity business also running in line?

A - Ulrich Wallin {BIO 4863401 <GO>}

No. That's what I mentioned. I mean, what we call the legacy DII business...

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

Okay.

A - Ulrich Wallin {BIO 4863401 <GO>}

Individual disability income as I said, claim frequency and severity is in line with expectation. However, the discounting of the future expected the claims and that is actually suffering from the reduced interest rates.

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

Okay. So it's fair to say the prime rate to some degree may be catching up with whether reinsurers adjusted things already.

A - Ulrich Wallin {BIO 4863401 <GO>}

That's right. Yes.

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

Okay. Great. Thank you.

Operator

The next question is from Frank Kopfinger of Deutsche Bank. Please go ahead.

Q - Frank Kopfinger {BIO 16342277 <GO>}

Good morning, everybody. I have two questions. My first question is on, again, on your unused large or major loss budget. You mentioned the €300 million that are still available as of today. How should we think about that if we assume that there are no major losses going for the remainder of this year? Would you put it again into the reserves or are you willing to put it into the P&L, so to say?

And my second question is on your credit spread sensitivity. Within your appendix, you show a sensitivity which is based on a relative term. So, increasing it by 50%, could you translate the sensitivity into basis points development?

A - Ulrich Wallin {BIO 4863401 <GO>}

Okay. Let me take the first one, and then Roland the second one of your question. I mean, if there are no large loss from now to year-end, definitely, our result will be well above €950 million. Because then, not all the unused budget will then remain in reserves. I mean, a fair amount of that will be released. And the reason for that is that, as we have shown you on the Investor Day, that level of the redundancies has increased quite significantly in 2015, pretty much above expectation and we have to take that into account. And we look at things like keeping additional redundant loss reserves somewhere on the balance sheet.

A - Roland Vogel {BIO 16342285 <GO>}

Yeah, Kopfinger, let's come back for your sensitivity question. If you go back a few years in our presentations and you look at that sensitivity which we provide, I think we had a shift in 50 basis points or 100 basis points in absolute terms. We then had a similar discussion as we now have today that this from the addressee's point of view it really doesn't make sense. If you increase in a stressed scenario AA rated bond by 50% and a BB investment also by 50%, this is not the same scenario.

As from then onwards, we changed that to percentage points. So I cannot translate that in absolute basis points of course, because if we have a corporate bond with the credit spread of, let's assume, 50 basis points then the 50% stress of course then would increase that to 75%. If we have a high yield bond with 300 basis points, that would increase the stress to 150%. We felt that this, of course, rather standardized approach provides more meaningful information.

Internally, of course, we use other stresses. You should bear in mind if something really dramatic happens, one would assume that corporate or government bonds or very high rated bonds would be a safe harbor and even potentially decrease credit spread. So there are far more complicated things available, but we felt that the percentage stress provides more meaningful information, this is why we have included it here.

Q - Frank Kopfinger {BIO 16342277 <GO>}

The issue is obviously always the starting point. And maybe it might make sense to break it down into government spreads and corporate spreads?

A - Roland Vogel {BIO 16342285 <GO>}

(1:00:35) If I can take that up, potentially, this is a good topic for the next Investors Day or something like this. And you have a special demand, again, we can cater for them, but this is what we usually we provided. And again, we changed it to make it more meaningful.

Q - Frank Kopfinger {BIO 16342277 <GO>}

Okay. Thank you very much.

Operator

There are no further questions. I hand back to the speakers.

A - Ulrich Wallin {BIO 4863401 <GO>}

Yes. Thank you very much again for joining our conference call. Thank you for your questions, and I wish you all a very nice day. And yes, thank you. Good-bye.

Operator

Ladies and gentlemen, thank you for your attendance. This call has been concluded. You may disconnect now.