Q3 2016 Earnings Call

Company Participants

- Dieter Wemmer, Chief Financial Officer
- Oliver Schmidt, Head-Investor Relations

Other Participants

- Andrew J. Ritchie, Analyst
- Farooq Hanif, Analyst
- James A. Shuck, Analyst
- Jon M. Hocking, Analyst
- Michael Igor Huttner, Analyst
- Nick Holmes, Analyst
- Paul De'Ath, Analyst
- Sami Taipalus, Analyst
- Thomas Seidl, Analyst
- Vinit Malhotra, Analyst
- William Hawkins, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Ladies and gentlemen, welcome to the Allianz Conference Call on the Financial Results for the Third Quarter 2016. For your information, this conference is being recorded.

At this time, I would like to turn the conference over to your host today, Mr. Oliver Schmidt, Head of Investor Relations. Please go ahead, sir.

Oliver Schmidt {BIO 2473131 <GO>}

Thank you, Jennie. Yeah. Good afternoon from my side as well and welcome to our conference call about the results of the third quarter 2016. There's nothing specific to be added from my side today, so I keep it brief and turn it over directly to Dieter.

Dieter Wemmer {BIO 4755450 <GO>}

Yeah. Thanks so much, Oliver, and also good afternoon, everybody, on the call, or good morning for the ones who dialed in from the States. It's a great pleasure for me to present to you our Q3 results. When we start, as usual, using the presentation on page 3, operating profit of €2.9 billion really supported by all areas and, in particular, by the Life and Health segment and I will then dive into the individual segments later on in the presentation.

Shareholders' net income close to €1.9 billion, 36% up compared to a year ago, a strong evidence of operating performance and also good financial market results. Also the revenue growth of 0.5% is translated into internal growth, that means adjusted for currency and other effects, 1.7% is a pretty good and strong result on an organic growth basis, here coming from P&C as well as our Life segment.

But let me first go a little bit deeper into the balance sheet. Increase in shareholders' equity of more than €2 billion, driven by unrealized gains and losses in fixed income and equity within earnings, but also consuming actually an increase in our pension liability, because the valuation rate for the pension liabilities is down to 1.3%, which is a clear evidence on how low interest rates in Europe got.

And in this low-yield environment, we are defending our Solvency II ratio with 186% very strongly, and I think that Solvency ratio is really doing well with what you can see then on page 7 where we have detailed in the waterfall the own funds development and also the development of the risk (03:14) required solvency capital.

Own funds, it's in the end pretty flat and development. The earnings are consumed by a little bit of market impact and some other changes. And the dividend capital management number, which is a positive, despite that we, of course, have recorded another €0.9 billion for the 50% payout ratio at year-end is positively influenced by the hybrid of €1.3 billion we raised in August. The capital requirement on the risk side is mainly driven by market impacts, while swap rates were down another 13%, but also equities up mean more risk consumption of the equities by market value.

Credit spreads on BBB bonds was 20 basis points down that created actually a positive impact and not a negative, that means less capital consumption. But the change by EIOPA of volatility adjusted formula and application has overall reduced our Solvency ratio by 2% that is mainly in the SCR because we are applying the dynamics of VAs.

Management action, actually better hedging our investment results. Our input rate sensitivity has reduced the risk by €0.3 billion and that is also the reason – what I have forgotten to mention on the previous page that interest rate sensitivity came a little bit down further in the direction of our target. Overall, still a very good number, and before the question is being asked, Korea is still fully consolidated and included in the numbers.

Now, let's move to the P&C segment. As I said at the beginning, a strong underlying growth, 3% half price half of volume. And you are always concerned about that some underwriting cycle is getting weaker. Actually, when I look at the list of countries you see here on page 9, only Italy and the large corporate business show a negative to great development. All others are in the positives, which is I think a very good evidence that broadly diversified that portfolios on the good track also deliver our midterm underwriting targets.

And that leads me already to the operating profit of the P&C segment, €1.4 billion operating profit based on a good previous year underwriting results, still a little bit improvement with a 93.5% combined ratio, a little bit better expense ratio, but mainly a better loss ratio driven by low NatCat. A pretty normal large man-made losses, so it's actually falling in our long-term average and that was related actually (07:08) I would say medium level, not low and not particularly high.

So normalized – the run-off result, not the normalized. The run-off result is 3%, a bit below our long-term average of 3.5% in the quarter, but still the nine-month figure is a little bit above our long-term average. So overall, the traditional loss ratio very much comparable to 12 months ago and I think on a good track for our future development.

Let's then move to the breakdown into the individual countries. Well, not surprisingly, the combined ratio of the individual countries, in particular, the large one are pretty good, otherwise, we are not getting to a 93.5% average. Latin America is now – it's the last place above 100%, although we are seeing also here a movement in the right direction. Profitability, actually, in Latin America, we would have shown a positive operating profit, but we had a one-off booking on an old life book in run-off we have for more than 10 years ago in Brazil, still a life book in run-off.

This is protection business where we have had increased reserves. Otherwise, the operating profit would have been €5 million, €6 million positive. So that means for the quarter to come also Latin America could return to a positive. I think it is overall a very good development in the numbers.

So investment income in P&C. Well, the running interest income falling parallel to the yield environment we are living in, no surprise, but what we show under net harvesting and other was a year ago a negative number driven by FX losses and other derivative losses. So this year a small positive. So that is actually the swing factor which allows us to have a better total investment income than a year ago. So it was also in this aspect with €10 billion plus, just above normal quarter but nothing negative.

Turning into the Life business, our execution of the new business strategy continues to play out very well. When you look at contribution of the various business classes, we moved in the right direction and are able to deliver overall a strong new business margin with 2.8%, but not only that we moved and mixed in the right direction when you look at the little table on the right-hand side, the PVNBP is up by 8%. That means also sales is growing with the right product mix.

So, I think our Life story continues to be a real success story, and the real success story is also falling down to bottom line, €1,129 million is a very strong operating profit for the quarter. We have a higher investment margin in the quarter, and then there is a positive impact from the base risk on the old – the A block in our U.S. Life business, plus good growth in our U.S. Life business so that the drivers of our operating profit increase.

Is €1,129 million a reasonable number to use this as basis for future quarters? We would normalize the number more at €950 million. That means investment margin, which is the number here included is 98 basis points, we would normalize more to 90 basis points and then we would go back for the base risk and then some other small figures. So, overall, it would be €950 million plus in the future years, whatever you have in growth on the size of liabilities that would, of course, then dynamically develop the figure into the future. So, those are the Life result in total.

Page 21. Value of new business, €318 million, very much on last year's level because last year we had even a slightly better new business margin, but that was at a substantially higher interest rate level. So, in light of today's interest rate level, I think we are defending the value of new business very strongly.

And you can see that actually Germany is the main driver of it. The U.S. is fairly low in the third quarter because the fixed index annuity business is very sensitive to the 10-year treasury rates. That means when we look at the screens to-date, we are probably now back to the good new business margin in the 3% category because U.S. 10-year is back to 2.2%, where in the summer, it's a low point, was at 1.4%, 1.3% so that makes a huge difference. But on top, we had taken end of the quarter measurement to improve the profitability. So, the U.S. would have been even with unchanged interest rate also show better new business margin in the last quarter.

So, overall, a broad contribution for many countries, and I think overall doing well. Page 23 is a detailed presentation of the investment margin. I think I gave already the more relevant information. So, annualized 98 basis points margin in the quarter and that means 25 basis points for the quarter specifically and normalized for the quarter to 3 basis points down.

So that leaves me to the Asset Management business, which is, I think, completing the positive stories of the quarter. PIMCO is reporting for the quarter net inflows of €4.7 billion. The October also ended with a positive number. So, I feel that our prediction we did already almost a year ago, we are actually in last year in the third quarter presentation, I said that we are expecting more positive flows for the second half of 2016. And I think that statement is at the moment being on track.

I can't tell you what will happen at year-end. There is now a big shift in the U.S. also and how the market views future development. So, therefore, it would be a bit too naïve to say that we can exactly say what is happening. But I think PIMCO is on a good track to have overcome the problems from three years ago and are back as a well-recognized great platform and asset manager.

We have also placed over the last months, two private funds where we have quite some billions of committed dollars to invest, but they will only show up as inflows when the money is being called from the investor.

AuM, in total, up besides the inflows, a good help from the market (16:36) a little bit spoiled story. And I should not forget to mention that also Allianz Global Investors had another very good quarter with plus €1.5 billion, which then translates also into a good revenue development overall.

Allianz Global Investors, growing revenues, baseline as well as performance fees and PIMCO still suffering from the outflows of the last 12 months, but I think we see a pretty stable fee margin. Allianz Global Investors, I should say that dilution of the fee margin has, of course, something to do with the Rogge acquisition and then all the changes I explained already in previous quarters on mix in business.

So, when we come to the operating profit, a small positive compared to last year, which is a very good development compared to the previous presentations I did. Cost income ratio, a sharp improvement on both sides; PIMCO with 57%, I think that is a very good number; and Allianz Global Investors going to 67.3% and delivering €150 million operating profit is a great step forward to really becoming more and more important in our Asset Management segment.

Now, Corporate segment, actually, nothing special, normal. I would say noise in the numbers, nothing really to mention, so that we can just have a short look at the net income. €2.9 billion operating profit. Non-operating items are pretty small, driven by €220 million realized gains, small impairments.

So that, we end up with 2.8% pre-tax income and 30% taxes, which is the tax rate this quarter without any special elements. It is just important with the normal tax rate applied so that we end net with €1.855 billion for the shareholders, which is, I think, a very good number and makes me confident that we can deliver for the year-end an outlook of €10.5 billion operating profit which probably also a good number for net income.

When I look at the 2015 net income we delivered for the full year, then our nine months figure at the moment is 78% of last year's full-year profit. So that means we have good chances for year-end to come out with a nice net income figure.

And here I would stop, and open for questions because I think that it's probably a better use of our time.

Q&A

Operator

Thank you. Our first question comes from James Shuck from UBS. Please go ahead. Your line is open.

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

Thank you. Good afternoon, everybody. Hi, Dieter. I had three questions, please. Firstly, just on the change in the VA reference portfolio, I think you said too (21:06) in the presentation, seem to be one on the actual bridge. It's a much lower kind of impact than one might have expected. If you could just explain a little bit about the change to reference portfolio? Why it had such a limited impact particularly to the dynamic elements of the VA?

And kind of linked to that, if I compare the sensitivities because you're the first to display the updated sensitivities on the new reference portfolio, and there's been some big changes going on in terms of the different sensitivities. So, in particular, your sensitivities at government bonds has more than doubled and you're now showing zero sensitivity to corporate bonds. If you could just explain that bridge a little bit. And kind of in the same vein, I mean, what does this mean for how you actually manage your Solvency II ratio going forward if kind of overnight we've had such a big change in the perceived volatility?

My second question is a shorter one, just around potential modeling changes to the Solvency II ratio itself. I think earlier this year, you talked about things you could do to refine the treatment of negative rates and that might have positive impacts. Could you just help quantify your visibility on that going into next year and any other things you might be contemplating?

And then, finally, around the combined ratio in the third quarter, so, 93.5% headline, obviously, there is a low level of NatCat in the period. There's a level of PYD that's broadly in line with the way you would want it to be, and then you have large losses. Could you just give an indication of kind of what the normalized underlying level is, and how that compares with the below 94% that you're targeting for 2018, please?

A - Dieter Wemmer {BIO 4755450 <GO>}

Okay, James. So, thank you for your question. Let's first start with VA reference portfolio. In the update of the reference portfolio is one change, which you could see is normal procedure and then there is one change where we are, at the moment, still struggling a bit, but we have applied it. So, the first change is, yes, EIOPA analyzed how people are invested and shifted the reference portfolio more to corporate funds. So, less government bonds, more corporate bonds. Okay? That's fine.

But also, they added in their reference portfolio at least that it's how we read it, the asset of the unit-linked business. And concluded that this is not interest rate sensitive, which is correct, but the consequence for the VA is that they reduced implicitly the application ratio by, well, if you calculate it through, the application ratio fall from 65% to 46%. That is the indirect impact of enlarging the reference portfolio with unit-linked business, where I'm at the moment still struggling why you would at all consider unit-linked business.

And you are the right. The new sensitivities and the big shift came to all of us as a surprise. It's very hard. What you can do? You can certainly not adjust your investment portfolio after you have read the paper. However, it is in the end confirming our long-term strategy to go more into corporate credits and reduce government bonds. The sensitivities you can reach in a way that we are still too long in gov's (25:21) and too short in corporate bonds and that we need further to balance. That is what the sensitivity say and whether the volatility adjuster reference portfolio, whether this unit-linked business stays in it or not, I don't know yet. But actually I hope that we can have still a discussion there with all the regulators and more understand what is the idea behind it.

Model changes. There will be nothing happening end of the year. I would expect that the model changes is more coming in Q1 2017. And maybe what I should have mentioned on the volatility adjuster, it overall dropped 8 basis points, of which 6 basis points was roughly to market changes in the credit spreads and 2.5 basis points is the change coming from the new formula of EIOPA. So, I mean, this helps you.

So, in general model changes before Q1, nothing. And I would expect that on all the model changes we have applied for, there might be a small positive overall, but not, that means a few points and nothing too dramatic.

The combined ratio, 93.5%; what is our normalized combined ratio? Well, I thought I mentioned that the large losses are included in Q3 roughly at normal level with some 4%. When you normalize it completely, where would you put it? I think to get to our 94% target in 2018, we have still to go for another, well, around 50 basis points maybe plus/minus, so, but I think we are on a good development path that we get to our 94% target.

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

And then just on the point about how you manage the Solvency II ratio. I mean, obviously, the sensitivities haven't changed so much. And you have a target level for your capital. I mean, what does that mean for actually how you address kind of that volatility?

A - Dieter Wemmer {BIO 4755450 <GO>}

Yeah. We will first see how we can shorten certainly spread sensitivities that is what we have to look at. And, obviously, what is showing up more and more, this ultra-focus on Solvency II on credit spread development is probably not the right approach for long-term investors.

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

Yeah. Okay. Thanks a lot, Dieter.

A - Dieter Wemmer {BIO 4755450 <GO>}

Okay. Thank you, James. Next.

Operator

We will now take our next question from Farooq Hanif from Credit Suisse. Please go ahead. Your line is open.

Q - Farooq Hanif {BIO 4780978 <GO>}

Hi, everybody. Thank you very much. Three questions also actually. First one, if you take out performance fees in Asset Management, then your cost income ratio is still down. There's a real good nominal reduction, but Q3 tends to be, obviously, very much lower than Q4. So, just wanted to get your sense of the path of cost now and what you're targeting and how quickly you'll get there.

Second question is on the performance fees, you gave some kind of guidance about private funds and private equity related business that had performance fees coming. I was wondering if you could give us another sort of bit of outlook on what you think is special that's going to come in the next couple of years.

And lastly, could you comment on the Italian pricing where it was weak in P&C? Just what you're seeing in terms of pricing in motor and non-motor. Thank you.

A - Dieter Wemmer {BIO 4755450 <GO>}

Okay. So, let's start with Italian pricing. It's still in motor, from our perspective, slightly softening, but the speed of softening is going down and it might go a little bit better. In the non-motor business, we don't see any negative price points. I think it is a little bit up but nothing very special.

Also, in commercial, I think we are holding up. It's more the motor liability business, which is still under pressure. And I think that is pretty much in line with also the result presentation of the two large peers, which also came out yesterday and today. So that means when your X is three up (31:06), you have come 80% of the motor market in Italy. I think we are holding up in profitability still quite well. And I assume that we will see sooner or later the turning point also for Italian rates and then people need to turn it back to higher rates.

Taking out the performance fees, we have still an improvement of the cost income ratio year-on-year actually still some 3.8% if you're not mistaken. So, that is a good number. I cannot give you a performance fee outlook for 2017, but you should really consider that it's from the closed funds, but it's also from a very normal institutional mandates. And PIMCO has, actually, also a sizable hedge fund business, which we should not forget which also lives on performance fees.

What can I say about 2017, well, November 1, that means a good week ago, Manny Roman joined as CEO? He is at the moment, well, I would say putting his office in place and really trying to understand PIMCO's business in all details. And I think it is fair when we give him some days or months, actually to learn how the business works and then comes with the proposal where do we have the best opportunity from our current strong position to get even stronger.

Q - Farooq Hanif {BIO 4780978 <GO>}

Okay. Thank you very much.

A - Dieter Wemmer {BIO 4755450 <GO>}

Did I cover everything, Farooq?

Q - Farooq Hanif {BIO 4780978 <GO>}

Yes, you did. Thank you so much.

Operator

We will now take our next question from Paul De'Ath from RBC. Please go ahead. Your line is open.

Q - Paul De'Ath

Yeah. Hi, there. And couple of questions if I can. And firstly, just looking at the Department of Labor changes, couple of points here. Firstly, have anything changed on your view in terms of the impact on the Life business changes? Also, do you see any impact on PIMCO from the upcoming changes? Or indeed, as I read earlier today, do you think that the new President might well cancel them and therefore, it will be a somewhat fitness (34:07) exercise? That's kind of question one.

And then the second point, just looking at the Life business, you're guiding again to the, I guess, ongoing normalized level of investment margin at 90 basis points for the year. I mean, going forward, given the shift to the new types of business has been so strong and the investment margin on that business is broadly doubled what it is on the sort of traditional savings business. Do you see the opportunity for that to grow over time, or do you think the underlying lower investment return environment is going to counteract that and the 90 basis points is kind of an ongoing target? Thanks.

A - Dieter Wemmer {BIO 4755450 <GO>}

Thank you, Paul. It's actually good that you asked the question about investment margin. Obviously, I did not say precisely enough. I'm not guiding to an average investment margin of 90 basis points for the full year. I'm guiding to the 90 basis points as expected number for a quarter, but what we have in the bank, we have in the bank. That is quite a different statement. So, it is my expectation for a new quarter without knowing anything, would be that we make the 90 basis points. And then we see, end of the quarter, whether the volatility allows us to be a little bit higher or a little bit lower. That is how I wanted to be interpreted.

So, DOL. Yeah. That is a mystery and the mystery is certainly not getting easier with the recent developments in the U.S. First, in Asset Management and Life, we are fully working on being prepared when DOL (36:28). However, we are still all a little bit struggling with the interpretation and when you look at the large broker dealer networks in the States, well known brand names have taken opposite directions actually how they deal with the whole, that shows you that there is still a lot of uncertainty around how to go for it.

So that is how that advise working, can you only do fee business, and any first year commissions are being seen as not good enough as advised. So there are different interpretations at the moment. And there is a lot of uncertainty around it where we assume it would be clarified over the next months.

Now, with republicans in control in all three key positions, so to speak, Congress, Senate and President, yes, there is now, I think, the possibility that things are changing. And when I look at the stock markets the last two days, the market seems to know more about it but as an industry representatives, I would say too early to say and let's wait what is going to happen.

Q - Paul De'Ath

Okay. Great. Thanks.

Operator

We will now take our next question comes from Thomas Seidl from Bernstein. Please go ahead. Your line is open.

Q - Thomas Seidl {BIO 17755912 <GO>}

Yeah. Thank you. Good afternoon. First question is on Life. Quite impressed, you grew the share of Life businesses up (38:39) from 34% to 75%. When I look at Western Europe, it's particularly interesting U.S. flat operating income but the ROE for the segment rises from 7.9% to 10.6% quarter-on-quarter. So, I'm assuming you have also done some capital action to boost the ROE. And I just wonder if you could give some color here what exactly you have done to get this strong ROE improvement in Western Europe and in France in particular where ROE doubled.

Second question. Could you give us an update on the Asian Life disposals that has been a bit quiet on that one? We've heard peers have sold Korean Life businesses. So, are we here on the process? Can we still expect the closing Q4?

And finally, I think, €2.5 billion is what you have in the M&A budget. You basically said this morning that cost is the biggest hurdle to do M&A. For sure, the price level doesn't change for the rest of the year. What keeps you basically from announcing the buyback that is the indirect consequence of not doing M&A?

A - Dieter Wemmer {BIO 4755450 <GO>}

Look, well, thank you for the question, Thomas. Yeah. I think, let's start with the Life ROE improvement. We have a nice increase in France and the operating profit and net income, hence also the ROE is stronger. We are working with every country as I explained last time to get ready for the sustainable 10% ROE target by 2018. Some will be a bit earlier. Some will be, I think, then only 2018. So, therefore, it should not surprise you that the numbers are getting better because we are really continuously working with all the markets on this direction (40:52).

So, there is a mixture and I can only repeat what I said last time, there is certainly capital actions being taken, but also improvement of the underlying operating results and both together should stand for the whole Western European portfolio bring us in the right direction.

Korea closing, yes, fourth quarter is our anticipation. It is besides formalities. That means regulators saying yes and giving a green light. There is nothing else open. I think both parties have done everything what the regulator asked for and have delivered everything and all documents are clean and in good shape. So we can now only wait for the official approval.

And, yeah, with the M&A budget, the latest day is when we announce our year-end results, then you will know when and how we have built this M&A budget. But I can only tell you, we are completely sticking to our promise. That means it is M&A or share buyback, not used for anything else.

Q - Thomas Seidl {BIO 17755912 <GO>}

But if you don't hear by year-end about M&A, we basically can conclude the buyback is coming?

A - Dieter Wemmer {BIO 4755450 <GO>}

Yeah. It would be, one version. Yes.

Q - Thomas Seidl {BIO 17755912 <GO>}

And on the ROE, sorry, one follow-up question here. With this lower equity consumption you see in France, why did we not see more benefits on the economic capital side? I would have expected that if you get France more capital efficient, you get some impact on group capital, but it's not visible here.

A - Dieter Wemmer {BIO 4755450 <GO>}

I think, for this, we need to change even more that is also in the doing and making that it's not being completed in 2016. That will happen more in 2017 and 2018, but it is a very good question and good observation.

Q - Thomas Seidl {BIO 17755912 <GO>}

Okay. That means the capital impact is yet to come? Yeah.

A - Dieter Wemmer {BIO 4755450 <GO>}

Further on, yes.

Q - Thomas Seidl {BIO 17755912 <GO>}

Yeah. All right. Thank you very much, Dieter.

Operator

We will now take our next question from Vinit Malhotra from Mediobanca. Please go ahead. Your line is open.

Q - Vinit Malhotra {BIO 16184491 <GO>}

Thanks. Good afternoon. Just one question on PIMCO, please, Dieter. So, is it a fair assumption that the institutional mandates are now sort of under control? And is possible that we assume that the pressure on that side of the outflows has now abated and is expected to remain like this? So, just some more color, please, would help there.

And second, just one very quick clarification, sort of – thanks for clarifying again on the VA change by EIOPA. Is it a fair understanding then that EIOPA is now able to direct the industries asset allocation because it should have been the other way around. But it seems that with you moving and EIOPA controlling so much through its VA reference portfolio, is it a fair understanding that they are now controlling where assets go or is it too much of a statement here? Just want your thoughts. Thanks.

A - Dieter Wemmer {BIO 4755450 <GO>}

Okay. Yeah. Good afternoon, Vinit. Let's start with EIOPA. Well, in the end, it's a mutual process because the reference portfolio they have used is really from the market data they collected in Europe. So that that more seems that in the market data that our portfolio had obviously still a bit more government bonds than the average, which actually still surprised me a bit. But I think I have to accept it when this is EIOPA statistics.

On PIMCO, yes, we have fairly stable inflows on all the funds and strategies these people like and that has really is on a good level quiet over some quarters now. I think the institutional decisions are yet under control as maybe, but not a good point when you are in a client service business. We are servicing clients and not controlling them. But some of these mandates got also cancelled because the people just needed cash. And can I predict who needs cash? That is very difficult to say. And therefore, we feel comfortable and in general the acceptance of the existing clients and the satisfaction with what PIMCO is doing is high. And that gives us, I think, the confidence that today's development in the third quarter was not only by chance.

Q - Vinit Malhotra {BIO 16184491 <GO>}

Sure. And Dieter, the reinvestment rate in P&C for example went down 30 bps in the third quarter versus second quarter. Is that somehow linked to this portfolio change you had to do from EIOPA?

A - Dieter Wemmer {BIO 4755450 <GO>}

No. It's 10 basis points underlying 20 credits.

Q - Vinit Malhotra {BIO 16184491 <GO>}

Okay.

A - Dieter Wemmer {BIO 4755450 <GO>}

Pretty much how the market moved in the quarter.

Q - Vinit Malhotra {BIO 16184491 <GO>}

Fair enough. All right. Thanks, Dieter.

Operator

We will now take our next question from William Hawkins from KBW. Please go ahead. Your line is open.

Q - William Hawkins {BIO 1822411 <GO>}

Hello, Dieter. Just a small numbers on slide 7, the roll forward of own funds, the €1.1 billion from the Life business. Could you just try to help me understand the breakdown of that figure? In the past, you've guided that the in-force runoff is about €900 million. And if I were to add €400-million-or-so for pre-tax new business that would imply some negative operating variances, but you maybe remind the €900 million is the wrong starting point for in-force runoff. So, could you just give a bit of color about how that €1.1 billion breaks down please? Thank you.

A - Dieter Wemmer {BIO 4755450 <GO>}

Yes, Will. Thank you. It is the expected business contribution as this quarter only €600 million, or bit more. So, with €400 million new business, well, you get to the €1.1 billion, but that is most obviously for you already easy to see. The €600 million has actually some small variance still included. I think we assumed before that we would probably see more ongoing contribution also from positive experience that will might have been a little bit too optimistic when we said €800 million, but I think we will see the next quarter where are we again. That number is maybe a little bit weaker this quarter despite all the positive numbers we have in the overall results, and it will also not be fully stable.

Q - William Hawkins {BIO 1822411 <GO>}

That's great. Thank you.

Operator

We will now take our next question from Michael Huttner from JPMorgan. Please go ahead. Your line is open.

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

Hi. Thank you very much. Great numbers. Really great number. Well, you must be very happy. Just really the question I have is, is there anything really which worries you in all this? Because everything seems so good. But in a detailed manner, and the U.S. NAIC proposal, pricing in German motor, I don't know how do you see this developing particularly versus claims?

And the U.S. NAIC, I suppose, the bigger question is what would the Solvency look like at year-end given what we know today? So interest rates, potentially career, accretion of earnings. And why didn't you raise your target guidance? So €8 billion, nine months, the run rate looks like 2.7%. So we'd be at 10.7%. There looks to be a few good luck factors coming from performance fees at PIMCO. So yeah, so I was just wondering a little bit.

And what – I suppose it's a question on my colleagues, competitors (50:50) I'm getting very slow these days. And the issue when we met with one of your colleagues in Germany at the end of June, he explained that Allianz Leben profits coming down, which means the dividend coming from Allianz Leben also come down, but then, with these fantastic numbers on the new products, there's obviously going to be the old business decline will be offset by this new stuff. I just wondered if you can give a feel for when Allianz Leben profits might grow again, thanks to all this new business? Sorry, if it's too many questions.

A - Dieter Wemmer {BIO 4755450 <GO>}

Yes, Michael. Indeed, that is a long list of questions. So let me start in the order you asked it. So NAIC proposal, we look policies lack (51:45) so it's all the testing we have done on the current proposal. It changes our capital requirement in the U.S. almost not. It's really rounding, I would say, so therefore, we are relaxed. I personally think it's a fairer comparison between the fixed index annuity writer and the VA writer, and any fair comparison across the market, I'm always appreciating. And it would certainly be good for the fixed index annuity specialists.

So we might roll it (52:27), yeah, well, actually, the share price is still too low. And why did we not change the guidance? Well, probably, we are more a humble German company. So I think that the 10.5% is a pretty good number. Some of your colleagues questioned over the summer whether we would make it. I think we are well set and can reconfirm our 10.5% outlook, and that is what we want to do. German rates in motor, yes, the increases are not as strong anymore as they were, but still, I think very sustainable figures in particular, a good combined ratio.

And in the German Life business, I think we have tested and verified that we can keep in our German Life business the profit margin very stable and, hence, the profit overall will grow with the underlying business that means that there was, let's call, some maybe 4%, 5% a year. Then, the profit would, at stable margin, do the same.

Q - Operator

Well, that's fantastic. Okay. Lovely. Thank you so much and congratulations.

A - Dieter Wemmer {BIO 4755450 <GO>}

Yeah. Thank you.

Operator

We will now take our next question from Sami Taipalus from Berenberg. Please go ahead. Your line is open.

Q - Sami Taipalus {BIO 17452234 <GO>}

Hi. Afternoon, everyone. Thanks for taking my question. The first one really just is on the P&C pricing, there was quite a nice uptick about 1 percentage point in Q3 versus Q2. I'm wondering if you could just give a little bit of detail of where that came from. And I think at Q2, you said pricing is running. They're roughly in line claims inflation. Do you think pricing is running ahead of claims inflation now? So that's the first question.

Second question is a bit more philosophical on the Solvency II ratio. You've taken a number of actions over the last few quarters, as these ratios kind of approached the 180 range to, I supposed, to keep the ratio up. I wonder if you would have taken these actions, you've not had the adverse market movement that you've had and whether effectively your target range is influencing your investment decision, hedging decisions there. And I'm obviously not talking about the Korea sale here, but more about hedges and various tweaks you've made in investment portfolios. Thank you.

A - Dieter Wemmer {BIO 4755450 <GO>}

Thank you, Sami. Yeah, I think, in general, I would still, well, outside Italy, (55:33) pricing is line with inflation. There are some positive aspects, but I think there is certainly Spain, there is Australia, and maybe in some pockets, also the UK, where I would make a different point that it is actually getting better. So overall, a little bit more positive picture.

The quarter-over-quarter comparison are a bit tricky, because you are not reviewing every quarter the same business. The mixes in each quarter are very specific. It depends on which markets have strong renewal dates in the summer, on year end, or after nine months. so therefore, you have really quite a mixture. And I would not look at roll forward from Q2 to Q3. In the end, you have only – we do the Q3-Q3 comparison, then we can say that is roughly a mix as the year ago, because that when you stand according to local market practice. So that conclusion is a bit more difficult, but I would say, in general, it looks a little bit better than when we discussed the same question six months ago.

The Solvency II management action, I think we would have taken some of them without the market movement, because it's just a better use of risk capital. Otherwise, we are always trying also to allow risk taking to make money. So we are not derisking just for the derisking. It is a dynamic movement backward and forward, because in the end, the capital has to work and create the returns.

So therefore, we will always be dynamic in our management actions, some of them which clearly improve things and not harm returns. We would do anyway and we will do some of them going forward. But on asset allocation, we are flexible.

Q - Sami Taipalus {BIO 17452234 <GO>}

Okay, great. So does that mean that if the market movements sort of (58:38) we should expect some of the actions that you've taken to unwind then go the other way?

A - Dieter Wemmer {BIO 4755450 <GO>}

Yeah. Well, we, for example, always look at our equity exposures, how we run it, that is constantly being updated. It's certainly not a stable number. That is on one hand, the equity portfolio, but on the other hand, we move puts. We use also futures either to extend risk or to reduce risk that is just depending on the specific situation. For sure, at the moment, when you look at your swap 20 (59:08) as some almost 50 basis points higher than beginning of the quarter, we have seen an unbelievable volatility in interest rates in the last two weeks.

Q - Sami Taipalus {BIO 17452234 <GO>}

Okay. Thanks very much.

Operator

We will now take our next question from Jon Hocking from Morgan Stanley. Please go ahead. Your line is open.

Q - Jon M. Hocking {BIO 2163183 <GO>}

Good afternoon, everybody. I've got two questions please. First one is inflation. I wonder whether you could give us what level of general inflation you've got baked into your P&C reserves in the sort of big geographic buckets and whether your view about inflation is changing from a pricing new business perspective [Technical Difficulty] (59:52-59:57) indicate which are basically driving the growth and the outflows. Thank you.

A - Dieter Wemmer {BIO 4755450 <GO>}

Jon, could you repeat your last question, because you are cutting in and off. Your microphone was not really easy to follow.

Q - Jon M. Hocking {BIO 2163183 <GO>}

Sorry, Dieter, is that better?

A - Dieter Wemmer {BIO 4755450 <GO>}

That's much better.

Q - Jon M. Hocking {BIO 2163183 <GO>}

Okay. Sorry. The second question was around PIMCO. So I was just wondering if you could give us a little bit of color about the types of products that's driving the inflows and also the residual outflows. Thank you.

A - Dieter Wemmer {BIO 4755450 <GO>}

Okay. So, your inflation question. We are analyzing in each market and each line of business the average past five-year inflation and then we do adjustments for step changes in the market more to the conservative side when we see upswing when it goes down, we are probably stick to our slower moving five-year average number.

So that is how we handle it. Therefore, to say what general inflation is based, it's very formulaic and very precise on each business, as you know, when a line of business is driven by medical inflation, then you get to different numbers than what Draghi is looking at when he is calculating the inflation for Europe. And he would use medical inflation, we would be at a different input rate level.

We had very clearly – at PIMCO, the shift in products is continuing and it's not new. I think since I reported here as CFO, my first quarter in 2013, we spoke about already that the old core products of PIMCO around total return funds losing importance and all the other products income, global credit, et cetera, are going in importance and that trend actually continues.

We had more than €7 billion net inflows in the newer product innovation and around the total return fund type of strategies we still have outflows, but that is not surprising. And we had also a positive on the mutual fund side and I think it is also geographically very mixed where our policy is (01:02:48) still stronger in Asia and Europe and less in the U.S.

Q - Jon M. Hocking {BIO 2163183 <GO>}

Thank you. Can I just ask a follow-up? I know it's very early days, but if the curve steeps, as we've seen in the U.S. over the last few days, persist, do you think that product mix is going to continue? Would you expect to see different products come to prominence?

A - Dieter Wemmer {BIO 4755450 <GO>}

Well, that's in the end now the crystal ball question. I think that it's much too early to make any statements about it. But it seems from a macro view that interest rate, the long end of the interest rates are going more up and inflation could return in the U.S. faster.

Actually, when you look at the spread curve between 10-year and 2-year treasury, that means look how steep is the interest rate curve, that is clearly rising already over the last two months. That is not an effect from the Tuesday. It is already a trend for now more than two months that the curve is steepening that has certainly accelerated in the last days, so that means people are seeing a recovery of the long-term rates.

What impact does this have on all the asset management products? I believe as a active fixed income player, we are very well-positioned to service the needs of our U.S. customers and elsewhere very well.

Q - Jon M. Hocking {BIO 2163183 <GO>}

Excellent. Thank you, Dieter.

Operator

We will now take our next question from Andrew Ritchie from Autonomous. Please go ahead. Your line is open.

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

Hi, there. Just two quick questions. First of all, can you just clarify what it was when you changed the modeling of new business value of capital-efficient guaranteed products? The margin went up there. You cited the model change for Germany. What are the sort of features that you've modeled better or we appreciated that (01:05:22) drove that?

And second question, in the second quarter, Dieter, you kind of expressed a view that to hit your targets in non-Life, you may have to look a bit more at expenses and efficiency, because you were seeing a bit more margin erosion than maybe you thought. I mean it sounds like there's been a complete sea change on that in Q3. You're now much more confident. Is that a fair comment?

I mean I'm struggling to see why pricing has really picked up. I know you mentioned a few markets where pricing is harder, but those are markets that are also seeing the most inflation. So maybe just clarify, either a real sea change or is it just the normalization and maybe you were a bit too pessimistic in Q2. Thanks.

A - Dieter Wemmer {BIO 4755450 <GO>}

Well, Andrew, let me start with the combined ratio question. I still think, and that is unchanged, that the expense ratio needs to improve and support the development even when now the rate changes are a bit more helpful than we thought. I'm not sure that this is stable enough that you can fully rely on it for the year 2018. And when it doesn't work out with the rate changes, you cannot start in July 2018 to work on your expenses to make a target. So therefore, what I said before what we are doing operationally is completely unchanged. So we have to work on the expense ratio and that is clearly a must do.

So the new business margin change, yeah, very simple. We had in our model which was also approved by the regulator for the Solvency II model, which we also – as we run everything, integrated new business margin and everything, we had not modeled in our new business margins the reset option on the annuity phase.

So we have in the end modeled our new product in the German old system like the traditional products. And the shortened duration and the reset of the guarantee and conversion interest rate at annuity phase was left out and that makes huge difference that moves in the end the new business margin for the whole German new business from 2.8% to 4.2%.

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

Okay. Great. Thank you.

A - Dieter Wemmer {BIO 4755450 <GO>}

Because this new business makes now in retail 90% of the whole.

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

I thought you had already – that was one of the reasons why it was more profitable already, because of the change and the nature of the currency, but I hadn't realized you...

A - Dieter Wemmer {BIO 4755450 <GO>}

Yeah. Well, it was already more profitable, because it had lower guarantees. That was in the model, but not – it's a more complicated reset option, which was not in the old system foreseen. And that is pretty complex to get it into the model. And then, through the approval with BaFin is not yet there. So actually, we are disclosing for the new business margin something which we have not yet in the Solvency II calculation included, because BaFin and other regulators in Europe, approval is still missing.

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

Okay. Great. Thank you.

Operator

We will now take our next question from Nick Holmes from Société Générale. Please go ahead. Your line is open.

Q - Nick Holmes {BIO 3387435 <GO>}

Hi there. Thank you very much. I had a couple of questions on Life. First of all, returning to the DOL, I noticed that your hybrid variable annuity product is selling extremely strongly. I wondered if you could give us a bit more color on what these are. Are these sort of DOL-friendly, are they fee-based, what sort of guarantees you're offering stuff like that?

And then, secondly, also on Life. I noticed that you took some pretty big DAC true-ups, positive true-ups in the U.S. and France, I think. I wondered if you could, basically, just give us a bit more color what's going on. Thank you very much.

A - Dieter Wemmer {BIO 4755450 <GO>}

Yeah. Thank you, Nick. The true-ups in the U.S. is just a consequence of the normal formulas, when the base risk is positive, that means when you judge the ratio between past and future earnings, you adjust from your likes of DAC, so that is a normal true-up, in France, similar, and then, I think also in Germany, we had a DAC true-up, but that is – in the end, the formula depending on the profits.

In the U.S., we are developing the DOL-friendly hybrids for next, but they are not yet in place. What is doing more is the index-based VA business, and that is certainly growing slowly, and you can, of course, call this also a DOL-friendly, because when you have a passive fund as the underlying in your variable annuity product, then, of course, the best interest advice has one hurdle less to pass. That is quite obvious.

Q - Nick Holmes {BIO 3387435 <GO>}

Right. That's very interesting. Can I just ask on the DAC true-up, is the positive variance policy holder behavior assumptions or would it be market performance? I'm just wondering what's actually driving the positive outcome against your assumptions.

A - Dieter Wemmer {BIO 4755450 <GO>}

No. Look, you have – what I said, the DAC level which you keep is determined by the ratio for a policy what profit will emerge in the future, what profit emerged already in the past, so it is in the end of ratio. Future profits divided by past profits, or a single policy, or a single group of policies, and then, you compare this with the deck to be amortized in the future versus the past and that ratio is the same.

So that is very simple how DAC works in the life insurance industry. As the profit stream is not stable, you have in the end two moving parts here, which are then being aligned and, usually, we are not doing this every quarter, so we are usually doing this on four quarters of rolling because, otherwise, everybody would constantly recalculate everything.

And the third quarter is where most of our OEs do this calculation, and then, it can come from everything. I think here in the VA book in the U.S. that is market driven, that was positive base was development by and large, but then, it can also be changes and less assumption mortality whatever, but it is mainly just the actual development which is the driver and not assumption changes about the future.

Q - Nick Holmes {BIO 3387435 <GO>}

Yes. No. That's very clear. So it's a mix of market and better policyholder behavior than you (01:14:08).

A - Dieter Wemmer {BIO 4755450 <GO>}

Not at all, yeah, because we've just had...

Q - Nick Holmes {BIO 3387435 <GO>}

Yeah.

A - Dieter Wemmer {BIO 4755450 <GO>}

...less profit now and more in the future or the other way around. That is very, very different.

Q - Nick Holmes {BIO 3387435 <GO>}

That's great. Thank you very much, Dieter.

A - Dieter Wemmer {BIO 4755450 <GO>}

Thank you.

Operator

We will now take our next question from James Shuck from UBS. Please go ahead. Your line is open.

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

Thanks for taking my follow-up. First off, Dieter, I just want to return to the sensitivity on the credit spreads, in particular, between the two periods, because the change in the reference portfolio actually reduced the waiting (01:14:45) of corporate credit in the reference portfolio. And other things being equal, that should lower the benefit that you get from the dynamic volatility adjustments. So I'm starting to see why in Q2 you showed 400 (01:15:00) basis point reduction, also increase in credit spreads had a 10-point impact on your Solvency II ratio, why with less of a benefit you would now show zero impact from wider credit spreads?

A - Dieter Wemmer {BIO 4755450 <GO>}

No. The share of corporate got bigger, so that means you are actually getting relative to our portfolio more on corporate. The VA reference portfolio, the share on government bonds did fell (01:15:38) more and on corporate, less and that shifted the combination.

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

My understanding was the government, we can take this offline if you like, but the government went from 38% to 27% and the other went from 48% to 44%. So I don't see why there would be a benefit to you in the sensitivity, but maybe we'll take it offline. It's probably better.

A - Dieter Wemmer {BIO 4755450 <GO>}

Yeah. Maybe we'd take it offline.

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

Thank you.

A - Dieter Wemmer {BIO 4755450 <GO>}

Okay. Thank you.

Operator

We will now take our next question from (01:16:19) from BNP Paribas. Please go ahead. Your line is open.

Yes. Thank you. Good afternoon. My first question is on the motor business across Europe, because in the last few quarters, in the U.S. where the focus has been on the increased repair cost on one side and some pickup in the frequency that is moving quicker than the actual process (01:16:44). So just wanted to get your views on whether you're seeing anything similar across the European book by and large, not specifically one country or whether it's not really the topic on the European side, even though it may be temporary any way.

And the second question is a follow-up on Andrew's question regarding the model change around the reset option for the German annuity products. You mentioned that it's not yet included in Solvency. Can you quantify what the benefit would be of including that calculation in Solvency? Or is that too early? Thanks.

A - Dieter Wemmer {BIO 4755450 <GO>}

Okay. So on the motor business across the Europe, this repair situation in the U.S. is not visible, but the movements in motor claims in Europe is very much dependent on bodily injuries. There was the paper changes in Spain this year than also in Germany when we see movements at all, it is much more bodily injury. That is certainly an upcoming question for the whole industry is how much bodily injuries are we seeing in future based on smartphone used during driving. That is not a joke. That is certainly a question, because we have seen over years, due to the technical progress in the cars, that bodily injuries are going down in frequency. That is coming to a stop.

You still see it in the expensive cars. So when you look at cars €50,000, €60,000 and more, there is still a reduction in large claims. However, when you look at the less expensive cars, then there is really the question what drives increases in frequency. And then, I would say, playing with the toys during driving is certainly a very serious topic.

So on the model changes, we will probably see some positive impact and also a little bit better interest rate sensitivity from the new model. The new model contains more changes than just mapping the new products correctly. So the new business value is certainly supported. That means you have also a more positive development in own funds. What the new model certainly support is that over the long run, our produced Solvency over consumed Solvency by new business in Germany will improve further. That means the 5-year and 10-year outlook is much stronger also in Solvency terms. Of course, that assumes then always that interest rates stay stable over the whole time.

So I think that were your two questions.

Q - Operator

Yeah. Thank you very much.

A - Dieter Wemmer {BIO 4755450 <GO>}

Okay. Thank you very much and I wish you all a great rest of the Friday and a great weekend. Thank you for listening in.

A - Oliver Schmidt {BIO 2473131 <GO>}

Thank you from my side as well. Bye-bye.

Operator

That will conclude today's conference call, ladies and gentlemen. Thank you for your participation. You may now disconnect.