Q4 2017 Earnings Call

Company Participants

- George Quinn, Group Chief Financial Officer
- Mario Greco, Group Chief Executive Officer
- Richard Burden, Head Investor Relations & Rating Agency Management

Other Participants

- Andrew J. Ritchie, Analyst
- Andy Hughes, Analyst
- Dhruv Gahlaut, Analyst
- Farooq Hanif, Analyst
- James A. Shuck, Analyst
- Johnny Vo, Analyst
- Michael Huttner, Analyst
- Nadine van der Meulen, Analyst
- Peter D. Eliot, Analyst
- Ralph Hebgen, Analyst
- Thomas Seidl, Analyst
- Vinit Malhotra, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Ladies and gentlemen, good afternoon. Welcome to the Zurich Insurance Group Annual Results 2017 Conference Call. I am Alice, the Chorus Call operator. I would like to remind you that all participants will be in listen-only mode, and the conference is being recorded. After the presentation, there will be a Q&A session. The conference must not be recorded for publication or broadcast.

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

Richard Burden {BIO 1809244 <GO>}

Good morning, good afternoon, everybody, and welcome to Zurich Insurance Group's full year 2017 results call. On the call today is our Group CEO, Mario Greco, and our Group CFO, George Quinn.

Before we start with the Q&A session, I will just hand over to Mario to make a few introductory remarks to the results. Mario?

Mario Greco {BIO 1754408 <GO>}

Thank you, Richard. Good day to all of you ladies and gentlemen, and thank you for joining us. Let me make a few remarks before George and I get to your questions. First of all, I'm very, very pleased with our full year results. I'm pleased because it demonstrates that we're making progress against the targets that we set in November 2016, and we're getting traction in achieving these targets.

2017 has been a challenging year, so nothing has been really easy and which makes our achievements even more relevant, especially given the weather events that we faced. The expense plan is well on track as we wish it to be, $700 million of achieved savings at the end of 2017. I think it is a good demonstration of the discipline that we have been introducing, and we followed through the years. And it talks well about what we will deliver over the next two years.

The Property & Casualty business has clearly improved in the second half of the year. The top line is not just stabilized, but it started growing again. The composition of the new business through 2017 has been what we wanted to achieve, which also says that we have reestablished clear communication of our strategy, of our appetite, of our underwriting priorities with the markets and with the brokers.

The underwriting performance has also moved for better. The accident year loss ratio shows a clear improvement and the same is for the other underwriting expense ratio. I'm also pleased to see that our reinsurance program, which we changed a year ago, has worked less and has protected effectively the capital and the P&L of the company in such a tough year. We are definitely focused on improving the underwriting performance.

In underwriting, we're pleased, but we know that the journey is a much longer one and that we have to continue making improvements. But we're confident now that we know what improvements are and that they can be achieved. Pricing is getting better. We do see positive pricing movement, especially in North America. And we expect this to continue during the year and to give us some good support.

Life had an extremely strong year. BOP is up 11%, even taking into consideration in that the UK recent changes on taxes of unit-linked products. The product mix has improved and this has sustained our margin growth in the year and the new business value increase.

The bank distribution, which has been a strength of Zurich, has continued to be very successful. The South American business has further developed the Spanish business with the banks, but then has also grown very nicely. And we added, at the end of the year, a new business in Australia with ANZ Bank which we think will perform equally well starting from this year.

Farmers had a very tough year, especially for the natural catastrophes. But through this year, they have improved combined ratio very effectively and they ended up the year with much better customer results, customer satisfaction and retention. And they reached the highest historical peak of customer satisfaction at Farmers.

Premium growth has been very successful, and again, all these evidences support us in being optimistic and confident on 2018 and following year. Capital has always been a strength of Zurich and still at the end 2017, our capital position is very strong. Z-ECM is at 132% and, of course, we will continue managing our balance sheet in an active way, and we will continue looking for ways to further improve our capital position.

Now, coming to capital into the decision we proposed yesterday to the board, the most visible and relevant one is about the increase in the dividend. You all know that George and I've been speaking about raising the dividend since November 2016. We knew that this was in the plan. We're pleased to see that we can do this already this year. But we knew that this was achievable for us anyway.

The reasons that we gave to the board were the strong performance of 2017, but even more the confidence we have in further improving this performance in 2018 and in the following years. The business is getting better. We're getting better traction on the business and these are the two elements that convinced the board to approve the proposal and bring it to the AGM.

We also proposed a change in the capital policy in order to avoid dilution to shareholders from the past and for the future. And again, the board has supported that as a wise policy for shareholders' rights. Just to sum it up, before I leave it to questions, we're pleased with the results. We think that we are delivering on what we promised to you, and we have confidence that this will continue in 2018 and in 2019, and we will continue delivering on the targets that we announced to you in November 2016.

I'd like to stop here. And George and I are happy to take all your questions.

Q&A

Operator

We will now begin the question-and-answer session. Our first question comes from Farooq Hanif from Credit Suisse. Please go ahead.

Q - Farooq Hanif {BIO 4780978 <GO>}

Oh, hi there. Thank you very much. Given the statements that you've made about your confidence on the 95% to 96% combined ratio, where does that leave us in 2018? I mean to ask in a clunky way, do we just assume that you're kind of halfway there? And to what extent does the expense ratio play a part now in that?

And then, very quickly on the Life business, it looks like if you add back the UK one-off that you're getting to, sort of the $340 million to $350 million-ish run rate, obviously, we have to take currency into account relative to the factors, but where would you say the run rate is and the growth prospects for that? Thank you very much.

A - George Quinn {BIO 15159240 <GO>}

Hi, Farooq. It's George. So I'll take those. So starting with the combined ratio topic, just a reminder for everyone that we're looking for a combined ratio of 95% to 96% by 2019 given the plans that we've got. I guess it might be a bit generous to say that we're halfway there.

I think if you look at the results, I mean they're strong in almost every single corner, other than this area around the P&C result where we're not quite yet where we want to be. And I think if you look at it, I mean the biggest challenge within that is commercial. It's a topic that we had already started to look at in depth as we put the plans together for 2018, so this was back in September where we've all worked hard with Jim Shea on what changes are required in the portfolio to really drive the improvement that we need to see. I mean we can see a number of areas where we can make significant changes. Those are steps that we put in motion already. So I mean this is a year where we expect to see significant improvement.

I'm going to avoid giving combined ratio guidance for 2018. I think it's important to focus on where we're trying to get to overall. I mean if you look at the entire business, we've obviously benefited from a very strong performance around the retail/other side of things. But commercial is the one standout area we've got more work to do.

Expenses will certainly help contribute. I mean we still have $800 million to go. You can expect the bulk of that to fall into P&C, and as we talked about before, that's why there are only a couple of points on the combined ratio. But overall, from a technical performance perspective, we do still expect to see improvement from where we are now.

Q - Farooq Hanif {BIO 4780978 <GO>}

So just – I'd just quickly follow up on that point. So you think the expense ratios have mix effects which make it look like it hasn't gone down even though it sort of has. But do you think that will now start to show a lower ratio going forward?

A - George Quinn {BIO 15159240 <GO>}

So I think if you look at the ratio, I mean over the course of the year, you see a reduction already. I mean, you look at the – I mean the different components we got about a 1 point reduction on expense, 1 point on the accident year loss ratio, and we're about 1 point up on commissions and the mix change. We're slightly light overall on PYD compared to our normal expectations. We're in the range, but slightly low in the range, and of course, you all know why that is, that's because we resolved Ogden over the course of the year.

I mean having said all of that, I do expect to see the expense ratio improve. I mean there will still be some mix movement, but we're also expecting to see a technical improvement, so loss ratio improvement, a continuation of what you've seen already on the accident year loss ratio with a particular focus on commercial.

Q - Farooq Hanif {BIO 4780978 <GO>}

Okay.

A - George Quinn {BIO 15159240 <GO>}

On the Life BOP topic, so I mean you asked around the numbers, I think we would be slightly more cautious on Life, so that means the guidance we're giving today is I think if you look at the headline number, I don't back out the UK yet, start from the headline number and anticipate something in the mid-single-digits for growth. That would be our guidance for Life.

Q - Farooq Hanif {BIO 4780978 <GO>}

Okay. Thank you very much.

Operator

The next question comes from Nadine van der Meulen from Morgan Stanley. Please go ahead, madam.

Q - Nadine van der Meulen {BIO 15200446 <GO>}

Yes. Hello? Can you hear me?

A - Mario Greco {BIO 1754408 <GO>}

Oh yes, Nadine.

Q - Nadine van der Meulen {BIO 15200446 <GO>}

Sorry. Good afternoon. Thank you for taking my questions. I suppose firstly on Life, the new business value, very strong. The margin was particularly up, 23.3%. Can you talk to us about how sustainable you see that being?

Second question on excess capital, the 132% Z-ECM, Mario just mentioned you're looking for ways to improve the capital position. I suppose it's not optimal, the 132%, because you show on slide 37 the target of 100% to 120%, which I mean quickly translating that into dollars, if you take the midpoint of that, you're talking about a $6 billion, $7 billion excess. So perhaps, you can elaborate a little bit more on that, what your plans are there and over what time period?

And then, lastly, on the U.S. commercial side, premiums in large commercial were down. What should we expect in terms of volume growth going forward? And we've seen rate increases, competitors have shown similar indications. So what is the outlook in terms of claims inflation there relative to these rate increases? Thank you very much.

A - George Quinn {BIO 15159240 <GO>}

So I'll start with the new business value. I think if you look at the detailed picture on new business value, I mean there are one or two items that we would see more one-off in nature. So we have a restructure of a large corporate contract in the U.S. But I mean by and large, I mean the biggest driver of what we see is combination of economic variance. So the interest rate environment certainly helped us last year. And then, mix, so I mean, we have an improved mix, particularly in Europe. And that's a combination of I mean actively selling some of the higher-margin products and in absence of some of the lower margin, higher volume stuff that we did in 2016 and we talked about it before. So I think with one exception, I mean most of it is something we would anticipate selling in the current environment. We can continue to drive.

On the capital topic, so you've seen today that we've announced 132% including the impacts of the share repurchase for the anti-dilution program. And as you pointed out, that's still well ahead of our target capital level. I mean, our capital management policy is completely unchanged. So I mean we'll continue to do the same things you've seen us do before. Our priority would be growth, and if the growth exists, then that growth can be either organic or inorganic. And absent that, if we really can't find ways to deploy the capital in the interest of shareholders, we will look to return it. But obviously, we prefer to find the growth if we can.

Mario?

A - Mario Greco {BIO 1754408 <GO>}

Yeah. On the business, the premiums and the claims, Nadine, so first of all, we don't see much evidence yet of any inflation creeping up or developing itself. Claims numbers are quite stable and frequencies falling down and the cost of the claims is barely positive. So it's all very quiet from what we've seen so far.

On the premiums side, I mean we see movements in North American property rates definitely. The market has alerted all of you on that and we just see that ourselves. We don't know for how long this will continue, but that definitely will be through this year.

The growth that we see coming is it comes from two different sources. First of all, we are gaining back in the retention rates. So we're doing much better than in the past years in renewing with the customers. And the other thing which we've been quite successful through 2017 that we planned to continue is developing the lines that we're pursuing. So we have been growing on specialties quite successfully, where we've been growing on credit lines. So short-tail business has been successfully targeted by us during 2017, and we will continue growing on these businesses through 2018.

But the message that underwriters have is to grow the profitability, so to go for bottom line not to go for top line. And we're happy to get to top line moving positively, but the targets, the priority that the underwriters have is that on the bottom line results of their lines of businesses.

Q - Nadine van der Meulen {BIO 15200446 <GO>}

Thank you very much. Just a quick follow-up on the growth, as George mentioned, the growth organic or inorganic, and Mario as you said, you've targeted short-tail lines, is that sort of the P&C short-tail lines that I should be thinking about when you're talking about that growth organic or inorganic?

A - Mario Greco {BIO 1754408 <GO>}

Yeah. I'm really meaning organic growth.

Q - Nadine van der Meulen {BIO 15200446 <GO>}

Okay.

A - Mario Greco {BIO 1754408 <GO>}

So what we have been doing since 2016 is to be very clear internally, with our underwriters, and externally, with the brokers, with the distributors on which portfolios we would like to go for and also which if any portfolios, we will not like to underwrite. Consequently, we saw the new businesses started shifting, and we're quite happy with the composition of new business that we saw coming in through 2017.

And by having had already meetings with all the main brokers through January, I can say that they well understand what we want. They well appreciate what we're after for in 2018. And I think they would support us in growing in the lines of businesses that we're targeting.

Q - Nadine van der Meulen {BIO 15200446 <GO>}

Thank you very much.

A - Mario Greco {BIO 1754408 <GO>}

You're welcome.

Operator

The next question comes from Peter Eliot from Kepler Cheuvreux. Please go ahead, sir.

Q - Peter D. Eliot {BIO 7556214 <GO>}

Thank you very much. The first one was just on the sort of the group underlying. I mean you've given us the underlying BOP. I'm wondering if you could also just share your view on the underlying net income for 2017 just for us to gauge how the dividend – how the payout ratio compare to the sort of 75%?

And secondly, on the Life, I take your comments earlier. Just looking at Life Asia Pacific in particular, BOP was about – was nearly $100 million in H2, a lot stronger than it has been before. I'm just wondering if you can comment on that specifically. Were there any one-offs in there, what we should expect there going forward? Thank you.

A - George Quinn {BIO 15159240 <GO>}

Peter, thank you. So we've worked on quite a few underlying and adjusted numbers, but I haven't done one on the NIAS. I mean I think if you look at the numbers and you look at history, I mean I think you can see that, I mean, the realized gain component can be plus or minus quite a lot depending on what's happening on the asset allocation.

I mean probably the thing that would stand out has been an obvious one-off and the results from a NIAS perspective is not involved is the impact of tax reform and the DTA position that we have. So you maybe got about $219 million. I think trying to normalize NIAS is really quite difficult given the nature of the thing that drive NIAS. I think we're trying to take a longer term view. We expect BOP and NIAS to be in line, and typically NIAS will be slightly higher because of course, there, we pick up I mean the spread beyond the – or the return beyond the coupon that we achieved within BOP.

On the second question on new business value, I mean generally, been a very strong year for new business value in Asia. We've seen both Japan and Australia perform strongly, I mean different drivers in the two different markets. I mean for Australia, it's really growth of the overall portfolio. That's mainly driven, of course, by the fact that we'd be bringing on the Macquarie transaction after that acquisition a bit more than a year ago.

On Japan, it's different. I mean we went back in the early part of the year to look at, I mean, how we assess the profitability of some of the products and they rate us and based on the experience that we've seen, we formed a more positive view. So we've lifted the view of profitability. I'm not aware of substantial one-offs in Asia Pacific.

Q - Peter D. Eliot {BIO 7556214 <GO>}

Yeah. Just to clarify, it's actually – it was BOP for all the new businesses that I was asking about there.

A - George Quinn {BIO 15159240 <GO>}

So from a BOP perspective, I mean so, for example, on the new business value topic around Japan, I mean that will have had some small positive impact from BOP that is more one-off in nature. I mean that's not a substantial number than the overall Life performance.

Q - Peter D. Eliot {BIO 7556214 <GO>}

Thank you. And just quickly back perhaps on the first point, I mean, I guess I'd sort of understood that the dividend policy was really driven by your view of underlying net income. I mean it sounds like this year, it's more a qualitative assessment rather than a quantitative one on a sort of specific payout ratio and that the payout ratio will apply more going forward. Would that be fair?

A - George Quinn {BIO 15159240 <GO>}

Not quite. I mean so what we did in the conversation we had with the board actually only yesterday, I mean we built up a model of – I mean it starts from the operating profit and then runs through to what we think the equivalent NIAS number would be. And we take, I think, the obvious things that we expect to see in there, so things like impact of restructuring, the things that we've talked about already and the operating profit, and we looked at the totality of all of the other movements to try and form a conclusion as to whether we think there's another item we should exclude or not. And the only significant adjustment that I made to this model NIAS number for the board was to not realize gains there into a number that's probably more consistent with a longer term expectation than the figure that you see in the results today.

So I mean this was not qualitative position. This was a hard decision based on a combination of what we think we achieved last year, and actually, more importantly, what we think we're capable of achieving this year.

Q - Peter D. Eliot {BIO 7556214 <GO>}

Okay. Thank you very much.

Operator

The next question comes from James Shuck from Citi. Please go ahead.

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

Thank you. Good afternoon, everybody. I had a few questions please. Firstly, I just wanted to come back to the loss ratio improvement. So George, you illustrated BOPAT ROE walk, the famous one, which you update now for 2017 through to 2019. If I compare that what was given at the time of the Investor Day, there was 0.5 to 1 points of loss ratio improvement coming through plan by 2019 from the Investor Day, that's now at 50 basis points from 2017 to 2019. So it's come down a little bit.

I guess when I look at the accident year loss ratio improvement, that actually improved by 1 point over that same timeframe, which is roughly what I would have expected over the whole planning period. So my question on the loss ratio is, are you running ahead of what you were planning there? Are there Life losses distorting that number still in any meaningful way?

Then, secondly, on the ROE target itself, you're kind of gapping away from this 12% BOP ROE number target, which actually hasn't been changed even though we've had the U.S. tax reform, and also, you've been deploying capital via acquisitions. You've got 14% target by 2019, but that increased drag from buildup of equity in particular, which presumably you'll do something about. So my question really is, is that appropriate target level? I mean your 14% should presumably be rising as you deploy surplus capital. Is this a number that's going to come down over time or is it kind of a slow level? How should we think about the volatility on that going forward?

And then, finally, just a quick one on the efficiency side of things. So you're halfway – more than halfway ahead of the plan by 2019. Anyone can hit an expense ratio target if they put back on certain discretionary spend. You haven't shed any insights into what your discretionary spend on digital and data or other initiatives has been, and whether you've actually been curtailing that in any way, please? Thank you very much.

A - George Quinn {BIO 15159240 <GO>}

Thank you. Well, I'll try and keep the answer as short as possible. So on the loss ratio improvement, I think you're great...

A - Mario Greco {BIO 1754408 <GO>}

Don't be short on the capital targets.

A - George Quinn {BIO 15159240 <GO>}

The ROE target.

A - Mario Greco {BIO 1754408 <GO>}

Yes.

A - George Quinn {BIO 15159240 <GO>}

Yes. Okay.

A - Mario Greco {BIO 1754408 <GO>}

Don't be short on that, please.

A - George Quinn {BIO 15159240 <GO>}

On the loss ratio improvement, I mean I think you're right on the analysis of the comparison of where we are to what we had put up on the slide back at the end of 2016. But I mean I think everyone can see from – I mean what I've told you to expect, and then, what we've actually delivered, we're short against the expectations on the P&C performance. And we still have work to do there.

So I think the – we're still targeting to get it to 95%, 96%. Expenses are still the biggest part of that. I mean we have made a lot of improvement. I think maybe more than the 98.2% would necessarily suggest today, but I mean we look at the commercial performance, I mean we appreciate it's a difficult market. But we want more – we want a greater return of the capital invested in that business. And Jim Shea and the team are well aware of that and they're working on it.

On the ROE topic, so I think maybe important point to make is that when we did the – again, we did the investor presentation back in November of 2016, we said more than 12%, so maybe that's a bit cute but I think we had – we certainly had a 13% written on the slide somewhere. So I think the expectation was that we start slightly over 12% and we drive it higher over the periods.

We're resisting the temptation simply to revise that target. So I think it's important that we try and, I mean, maintain the integrity of what we said at the beginning. But I think we can all see that from a combination of – I mean, with the progress we've made so far, what we're going to do around the Australian acquisition and, most recently, the impact of U.S. tax reform that, I mean, simply mathematically that won't make our performance better than the one that we had planned for.

On the equity drag side of things, so I mean we've left that in the chart. I mean we're handing back in the form of the dividend and the anti-dilution share repurchase we've a pretty chunky piece of capital. Last year, we also invested quite a bit, it's important to remember, by almost $3 billion. I mean let's see what happens there. I mean we want to use the capital wisely. We don't intend to do anything that is not in the interest of shareholders. We're under, I mean, no pressure from a performance perspective to do something at speed. We either find a way to use it or we look at returning it. I mean it's the same policy as before.

On the efficiency thing, so maybe I take issue that anyone can have an expense target, I think very few people can have expense target. I mean again, I think if I run you a bit through the history of what we've done here, I mean we started with the easiest stuff. I mean discretionary was the first thing that Mario asked us to tackle when he arrived back in February of 2016, just to get a bit of discipline into the organization, a really long path, (29:21) discretionary.

And in fact, on the technology side of things, I mean a large part of what you see by way of restructuring last year and you see this unusual thing where we got part of the restructuring charge is in NIAS, part of it's in BOP and the reason for that is that some of this is us investing in technology to reduce expenses in 2018 and 2019. So I don't think we've done anything that is not sustainable around the expense base. In fact, as I look around the organization, I think we actually operate far more effectively for being lighter and I think we can take that a bit further still, as we achieve the remainder of the goal. It's not driven by a starving investment in the digital side, quite the opposite.

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

Okay. Thanks very much, George.

Operator

The next question comes from Andrew Ritchie from Autonomous. Please go ahead.

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

Hi there. First of all, thanks for the dividend increase. I'm just moving to the questions, the commercial lines unit, I guess I had hopes you could improve the attritional performance there in 2017 given all the issues that you were tackling, I'm a bit surprised it's deteriorated by nearly 2 points. Could you just clarify where exactly are the problem books? Is it U.S.? It looks to be partly kind of Europe I think. Is it – a lot of it auto liability, financial lines, D&O, are we talking about a couple of lines of disproportionately high combined ratios? I appreciate you're still trying to improve it, but I think the degree of improvement was disappointing in 2017.

Second question, tax, what were the negatives from U.S. tax reform? Are you going to have to keep more P&C business onshore U.S. and will that affect fungibility, ability to upstream cash, et cetera? And related to tax, what's the kind of long-term tax rate of the group going to be? I mean I think part of the reason the group tax rate is still high is because of weak P&C profitability in Europe. I imagine that was the normalized underlying for U.S. tax rate, what will the kind of ideal 2019 and onwards tax rate kind of be for the group?

And the final question just a clarification thing, on the anti-dilution, is that now an ongoing – I appreciate you're doing some historic catch-up and the next couple of years of options. But is that now an ongoing commitment as far as employees share options are concerned?

A - George Quinn {BIO 15159240 <GO>}

Yes. Thank you, Andrew. So yeah, I mean we're in charge of it, but I share the disappointment on the commercial side of it. I think if you look at what drives it, I don't see that we have new issues. I think we have some of the same concerns that auto continues to be a problem. I think if you look at it, I mean if you look at the rate entries, it shows up as the most attractive line of business bar none from a rate perspective. But unlike retail auto in the U.S., we don't see the change in claim trends that the retail side has been experiencing. So the improvement there has been far slower than we had anticipated, and we do intend to take action around how much capital we allocate to that line of business to drive a more rapid improvement.

I mean besides that, I mean we had issues back in 2016 around financial lines. There's still some of those mainly in Europe in 2017. But I mean the issues overall are not different. We're trying to drive out the necessary return that we have here. So I mean we are focused on it and do expect we'll improve it.

Mario?

A - Mario Greco {BIO 1754408 <GO>}

Yeah, can I jump in, because I hear you and I don't disagree on the results. However, I think I always, always repeated that these are big books, and they don't change one year from the other. The issue is the book composition. You move it year-after-year, which is what we're doing, and the books are getting better, and the books are moving in the right direction, but it takes years. I mean it wasn't as simplistic as there was one chunk which was underperforming. If you run with a high-90% combined ratio, it is because of book composition. I mean the Zurich underwriters are not more stupid than the underwriters, and actually, I think they're skilled and prepared.

In order to achieve better combined ratio, we have to compose the books in a different way, which is what we started in 2016, we progressed in 2017, now, we're going to have the compounded effect of two years, plus the new business of 2018 kicking in on the year-end results of 2018, and this will progress as towards the targets that we announced.

So I wouldn't be that negative although I understand and, of course, I agree on what you say, but bear the perspective, please, that we are shifting the book composition towards shorter tail lines, towards different – and if you look at the new business development of 2017, that clearly shows it. And this will start producing gradually year-after-year the results that we're looking for.

A - George Quinn {BIO 15159240 <GO>}

On the tax, so negative from U.S. tax reform, so maybe again just for everyone's benefit, I mean we clearly have a change in the rates. We have an element of the structural change which is penal for cross-border transactions. And of course, that's problematic from a global insurance perspective, because we like to carry risks back to where we have most of the capital which is back here at home.

We took steps as of January 1 to change some of the internal structuring. That means that we no longer have the same quota share in place from the U.S. or out of the U.S., but that will slowly build premium volume in the U.S. over time. And of course, we have to carry capital to support that premium volume.

Not everything is precisely clear at this stage. So with that caveat, I mean at this point, we would anticipate that, by and large, any negative cash fungibility issues will be financed by the positive cash issues that this thing also generates. So over the next, say, two to three years, one will finance the other. And then, once we fully finance the capability to hold more of the risk locally, we'll get a pickup in the group's overall cash flow. But in the short term, one finances the other.

On the anti-dilution topic, it is our intention that this will be something that we will do consistently in future.

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

And the long-term tax rate?

A - George Quinn {BIO 15159240 <GO>}

Sorry, long-term tax rate, so the...

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

Beyond 2018, I mean.

A - George Quinn {BIO 15159240 <GO>}

Yeah. So I mean we talked before about – I mean 29% type rate. I mean this is a three-point improvement over that from a long-term perspective and maybe even 1-point beyond that.

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

Right. And the 29%, though, still factored in relatively low profitability of P&C, didn't it?

A - George Quinn {BIO 15159240 <GO>}

So I mean you mentioned there's a mix issue in it, but we're seeing more of a contribution come from, example, from Farmers disproportionately because of what happens elsewhere, also from Latin America where the rate tends to be much higher. I mean there will be a shift as we restore profitability in some of the European markets, but the biggest impact will come from the tax reform.

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

Okay. Great. Thank you very much.

Operator

The next question comes from Thomas Seidl from Bernstein. Please go ahead.

Q - Thomas Seidl {BIO 17755912 <GO>}

Thank you. Good afternoon. First question, back to ROE, slide 9. You show us the new walk which is, as you say, it shows 1 percentage point higher than the previous one. And I wonder with the LTIP targets being 9.75% to 14.25% and the cash targets $8.5 billion to $10 billion, is the management of Zurich confident enough to sign up to higher targets now, because it strikes me that what you're planning for is exactly in line with the upper end of the current LTIP targets? That's the first question.

Second one, on Farmers, last year, double-digit loss in policies in force was more than compensated with double-digit rate increases. What do you think is the outlook for Farmers? Are price increases still setting off policy losses in 2018 and 2019 or is there a risk that we see actually shrinking top line of Farmers once the price increases in U.S. more to flatten off?

The third one is maybe on Life. You show on slide 20 that, on an underlying basis, you think that profits are up 22% with investment margin up 16%. Some of your peers have also reported very strong Life numbers and have said that this was mainly driven by benign capital markets. So I wonder is $1.4 billion the new run rate of Zurich or would you also say that there is a $100 million, $200 million from just very benign capital markets in 2017.

A - George Quinn {BIO 15159240 <GO>}

Thanks, Thomas. So, on the LTIP topic, I mean the point to remember that – well, first of all, we don't set our own targets for LTIP. That's the decision that the board themselves make.

We present the plans to the board and the board decides how they reward the management. I mean I think we've made it clear already that, I mean, there are things that as we come forward that we need to work into targets. For example, the acquisition of ANZ Life business in Australia is something that we said we did, because that would lessen the targets, but obviously, it doesn't have an immediate impact right now. But I think, I mean, certainly, over time, given the outlook that we have, I think you would expect that we would be challenged by the board in this topic, but we don't set those targets, board does.

On the Farmers side of things, I mean actually, I mean the message we're trying to get today is actually quite positive. I think if you look at the key metrics around the business, both from a top line underwriting profitability perspective, even if you look at some of the leading indicators that the team used to judge, I mean what we could expect to see in the future, I mean most of them point positively.

We have achieved or I mean the Exchanges here have achieved a very significant improvement in profitability which, as you point out, is a rate-driven. I mean we look around the market who we think is competing with Farmers in that particular customer segment. And we think that entire segment of the market is going to continue to push for further improvement.

I mean if you look around selling more some of the mutuals, you will see very substantial underwriting losses. So we expect next year to see growth in the Farmers business, together with further improvement in the profitability for the Exchange.

On the Life side of things, I mean I'm not sure I would say, I mean, much more than I said to the earlier question. I mean where do we see, I mean, the BOP run rate. I would take the headline number, I'd allow for something like a mid-single-digit growth rate. And then, to the extent that I mean, if there's anything that was benign or favorable, I mean, that's incorporated in that guidance.

Q - Thomas Seidl {BIO 17755912 <GO>}

Okay. Maybe a quick follow-on on Farmers. With the U.S. tax reform, to what extent do you see Farmers or Farmers' management sets here a price competition as local peers price in the lower tax rate?

A - George Quinn {BIO 15159240 <GO>}

So again, I think you've got – I mean the most important thing here is that we see different segments of the U.S. auto market and, in fact, already – I mean, there are, I mean, very price competitive segment, price seekers that's how we describe them internally, that are typically well-served by other providers in the market. So there already is price competition. I mean this wouldn't really change things substantially.

You then got another segment which, I mean, we talked about and you heard already, I think, from Jeff, Mike and Roy back in the Investor Day in November what we see, I mean, price is not unimportant. It's clearly still something that is an important decision driver. But

I mean the extent to which service, meeting customer expectations, I mean providing with all the service they anticipate, I mean that's another very important part of the decision process.

I think the challenge overall, if you look at the U.S. market, particularly the companies that serve this particular part of it, is that profitability is still a bit challenged. So therefore, you can give – you can put a tax kind of in place. But if you're not making enough profit, it doesn't really change the equation markedly. So I still expect, based on the conversations I've had with the Farmers team, that we will see more rates to come in this business.

Q - Thomas Seidl {BIO 17755912 <GO>}

All right. Thank you very much, George.

Operator

The next question comes from Michael Huttner, JPMorgan. Mr. Huttner, your line is open.

Q - Michael Huttner {BIO 1556863 <GO>}

Fantastic. Thank you very much. And I was – really well done. What you've done is really good today. A few questions. So on the Farmers' growth, if I can put it another way, so the surplus did not change in 2017, $5.5 billion. Given what you were kind of saying in terms of Farmers' profitability, what could we see there in terms of what is the normal run rate given your expectations of profitability now? Could the surplus increase by 5% or 10%? I don't know. Just to get a feel for it. And the reason I asked for that is then we can put you on the same multiples as (44:36), which would be very nice.

On the cash flow, the $3.7 billion, can you say what the figure would be if I kind of normalize for everything? And I've no idea what I should normalize, so I imagine, you've got hurricanes, I imagine you've got U.S. tax, but these are my imaginations, I'm not 100%, but the figure is so high and I expect it to be lower because of nat cat. I'm just wondering do I add back anything and if I add back the $700 million, it's an amazing figure.

On the – and then, just really little details. In the one-offs you adjusted for in your lovely figures for BOP the $4.7 billion I think it is, what was the adjustment for wildfires? And can you give a figure for that thing you mentioned a few times, that financial reserving, which I think was Spain, and I suspect it's the thing which drives Europe combined ratio higher. I can't think of anything else.

That's it. Thank you so much.

A - George Quinn {BIO 15159240 <GO>}

Thank you, Michael. So on Farmers, I mean, without giving you a precise number, it will vary depending on the interest rate, I mean, typically, the Exchange is targeting I mean high-90s combined. They believe that it's somewhere in that range allows them to carry enough surplus to grow the types of target level that I mean we've seen if you focus on the core operations of Farmers. So they're not looking for 90% combined, they're looking for something in the 98%, 99% type target.

On the cash flow side, look, so first of all, on the cat, so the natural catastrophe, they actually have quite a small impact on the current year. I mean, maybe, a couple of hundred million dollars, I mean, really, I mean de minimis. We do have some one-off. Quite the most obvious example would be the reinsurance transaction we did around Sabadell back in the middle of the year that released maybe a couple of hundred million dollars.

I mean there are a few other small things that are one-off in nature typically positive or negative. I mean I think if you normalize that, it would be a bit lower than $3.7 billion, but it would still be slightly above the run rate required to deliver more than $9.5 billion over the planning period. But you certainly can't add back the $700 million to the $3.7 billion, I'd love to do that, but you can't do that.

Q - Michael Huttner {BIO 1556863 <GO>}

Just from the $3.7 billion, because you remember, you had this funny – I don't know if it's funny, but this reallocation of restructuring cost, is the $3.7 billion net of that?

A - George Quinn {BIO 15159240 <GO>}

No. So, the...

Q - Michael Huttner {BIO 1556863 <GO>}

No.

A - George Quinn {BIO 15159240 <GO>}

...so restructuring isn't there. So remember when we set the – I won't ask you to remember – but what I'm trying to say when we set the $9.5 billion target, if you think back, we had delivered more than $9.5 billion over the prior three-year period. And it was a big discussion about the quality of that $9.5 billion.

Q - Michael Huttner {BIO 1556863 <GO>}

Okay.

A - George Quinn {BIO 15159240 <GO>}

And in reality, that allowed for the restructuring costs that we intended to or expected...

Q - Michael Huttner {BIO 1556863 <GO>}

Yeah. Okay. Okay.

A - George Quinn {BIO 15159240 <GO>}

And your last point is about one-offs. So I mean the challenge here is we could probably spend a couple of hours in this topic. I could probably have maybe 100 different one-offs all going in different directions.

On the cat side, we picked on the hurricanes, because I mean that's really the story where you take that out and we're roughly where you expect us to be, give or take. And we picked out the other two obvious things, one which I think people knew about it, one of which we're announcing today, one being the restructuring and operating, and the other being the U.K. topic. I mean, there are impacts from wildfires, but absent the hurricanes, there was in expectations.

And there are impacts in the commercial around financial lines in Europe. But I think that topic – I mean only if we take out the good news, but at the end, try and make an argument, we should take out the bad news. I mean I think the rest of it is awash and the combined ratio in particular, the number that you've seen is a reasonable representation of where we are. We need to work to improve it.

Q - Michael Huttner {BIO 1556863 <GO>}

Fair enough. Thank you very much and really well done. Thank you.

Operator

The next question comes from Johnny Vo, Goldman Sachs. Please go ahead.

Q - Johnny Vo {BIO 5509843 <GO>}

Yeah. Hi. Thank you for the questions. Just a quick question on investment income, can you just comment on the trajectory of that investment income and where we are in terms of bottoming of that particularly given the rate environment, the moving rate environment?

And then, secondly, just on deployment of capital, obviously, your IFRS book has moved up which gives you some flexibility. Z-ECM looks very good and SST looks all good. So in terms of areas of deployment for M&A, what areas would you look at and would you necessarily use M&A to accelerate the shift in the P&C book that you're talking about? Thanks.

A - George Quinn {BIO 15159240 <GO>}

Yeah. Thanks, Johnny. So on the trajectory, two comments for me here. So I mean we think we're coming into what we expect to be the last year of investment income compression. If we compare the book yields to the investment yield, we got that 20 basis point to 30 basis point gap on the P&C book. We're guiding people to assume that we'll be down beneath this year by about $50 million to $100 million.

On deployment of capital, I mean again, I think the standard disclaimer, first of all, I mean we have no need to do M&A to achieve the targets. And I think it's important to emphasize that, I mean, all the things that we've talked about in terms of the outlook for 2018, with the exception of the Australian transaction which is now something we're looking to complete, everything else is organic and everything that's in that walk in the ROE is organic.

Now, having said that, I mean we clearly have the capability if there's something there that makes sense. I mean we would like to move the balance of the book, not so easy to do it given the pricing of some of the assets that you might look to acquire to do that. I think other priorities would be things like bancassurance. I mean we think we have the core competence there. We can do more of that. We would certainly deploy capital in support of it. And then, generally, we've made the point that as we look to simplify the organization and focus the organization in fewer markets where we have strength, I mean if we have the ability to put capital behind management teams that are doing a good job and a market where we can be more relevant, I mean that's obviously a topic that would also be on the agenda for us.

Q - Johnny Vo {BIO 5509843 <GO>}

Okay. Thank you.

Operator

The next question comes from Andy Hughes from Macquarie. Please go ahead.

Q - Andy Hughes {BIO 15036395 <GO>}

Hi, guys. Thanks very much. Three questions if I could. Just still trying to get my head around the commercial deterioration ex-weather between 2017 and 2016, sorry. I think you said you were on plan and this was kind of projected to go in the right direction. Is the problem that you weren't aggressive enough in cutting some of these lines? And maybe because you had an expense target as well as a loss ratio target, you basically are now looking at it again and going to cut these lines more aggressively on commercial auto or I mean is that what's going on here? And are we going to see kind of a reduction in the top line significantly for the commercial business this year?

And then, the second question is on the retail and other line. Could you give the kind of 2016 and 2017 numbers ex RCAS (52:28)? Because I know that on the slide you're saying ex-catastrophes, and obviously, if RCAS (52:33) had particularly good weather experience that – have you stripped that out from there or what would that look like excluding that?

And the final question is on Farmers. I mean I still don't really get the message that the forward-looking indicators for Farmers are positive, because the key for new business looks like it's in – a number, it looks like it's sort of 17% lower than it was two years ago, which kind of feed through. Are you seeing an increase in the net growth in the agent count or am I missing something that is obvious in there that is positive? Thank you.

A - George Quinn {BIO 15159240 <GO>}

So on the first point, if I have said in this call that I thought that commercial was on the line, I apologize. The team are working hard to improve it, there's plenty more we still have to do. I don't think it's because we've starved of an investment, or we're trying to focus on the expense ratio. It's a tough market. There are ratios that affect not only us, but other members or other market participants. We're now on plan and we look to improve further, and we expect to see that this year.

On retail/other ex-crop, I mean I have to be honest. It's not a key performance indicator that we focus on. In fact, I mean when we give you ex-cat numbers, we tend to exclude ex-cat even for crop or cat for crop. So I think if I was going to exclude retail – if I was going to exclude crop from those out, maybe I'd exclude commercial auto at the same time, because one is about as far as the other side of the outcome as the other one is the other way.

Q - Andy Hughes {BIO 15036395 <GO>}

I'm just – yeah, just on that point, I was just trying to work out what the improvement was...

A - Mario Greco {BIO 1754408 <GO>}

Can I – sorry, can I make a clarification? We don't exclude cats. We only called for not including in the normal definition of the run rate of the business the three events in North America which are very extreme events. That's it. We include everything else. We take every earthquake, every flood, every storm, everything, whatever in the world.

We just say the three events in America for their brutality and for the fact that they came all on top of the other in three weeks, they're quite special. And they should be considered on the side. Everything else is included, will remain included and will always be included.

A - George Quinn {BIO 15159240 <GO>}

On Farmers, Andy, I think it's safe to say that it's going to take some time before you and I will see Farmers at the same place. I mean Farmers, I mean I look at the improvements that we've seen from a profitability perspective. You see it clearly in the combined ratio. I look at the impact from the top line, and you can choose either the core growth or the all-in growth.

And on the indicators, I mean I appreciate that some of them are – maybe the best way to assume, it's slightly less negative than they were before. But you look at the trends and, in particular, you get customer satisfaction which we see is a really strong leading indicator of where the business is headed.

As Mario mentioned in the introduction, I mean we have a very strong performance from Farmers at the end of the year. So I mean we're happy with what they're doing. We're happy that you can see evidence of the progress and we expect that to continue.

Q - Andy Hughes {BIO 15036395 <GO>}

Yeah. Sorry. I mean the question about the RCS (55:53) was just to get a feel as to how much the business has improved by, that was in terms of that 94.8% going to 92.9%, just wondered how much of that was the crop business?

A - George Quinn {BIO 15159240 <GO>}

The crop is at roughly the same level in terms of profitability than it was last year.

Q - Andy Hughes {BIO 15036395 <GO>}

Okay. Well, that's very helpful. Thank you.

Operator

The next question comes from Mr. Vinit Malhotra, Mediobanca. Please go ahead.

Q - Vinit Malhotra {BIO 16184491 <GO>}

Yes. Good afternoon. Thank you. Just one question is that when we see rising interest rates and, obviously, is there a temptation within the group that some of the portfolio mixes should probably be differently done or because ultimately, when the Investor Day plan was launched, rates were far lower and there's obviously a consideration that rates would go far higher from here or there's hope there.

So I'm just curious how you look at this dynamic or how your teams look at this dynamic. And just on the slide 18, again, sorry to ask, just a clarification. The EMEA movement, is there some effect of wage inflation or those kinds of things, because we have seen wage inflation being a topic even in Europe, of course, becoming a topic? Just want to understand your view there as well. Thank you.

A - George Quinn {BIO 15159240 <GO>}

So on the first one, on rising interest rates, Vinit, so maybe I start (57:31) talk about stats on asset risks. So maybe just being through the planning process this summer, I mean, Urban, our CIO, is recommending no major change on our asset stance. I think, as you guys know, we had a slightly reduced tax exposure about a year ago, and since then, I mean we've been broadly consistent. And at this stage, I mean we're not anticipating a further significant shift.

I mean on the interest rate topic in general, I mean that's typically more of an issue that feeds back into the pricing or the costing mechanisms that we use. So if we did see a change in the risk-free interest rates, I mean that's something that would certainly update our view of what the hurdle that had to be achieved would be, but not necessarily a change in the portfolio mix. So SAA or strategic asset allocation for us anticipated to be broadly stable.

Q - Vinit Malhotra {BIO 16184491 <GO>}

Sorry, George, I meant the long-tail versus short-tail, I mean, the large, I meant the business not the asset, sorry.

A - George Quinn {BIO 15159240 <GO>}

So I think, so on that, again, I think we've made a strategic choice that we think we're too overweight on the long tail side of things. I think the interest rate outlook is something that has fed into that decision already. And the view that that creates around things like inflation risk in the long-term, that's a topic you'll continue to see us where can we take steps. And already this year, we talked about the fact that reinsurance could be a step in the right direction here and we have put in place a reinsurance program to shift the mix of the portfolio. But we also intend to work on the incoming side of the book to emphasize more of the short-tail lines and trying to achieve a bit more balance and the portfolio overall.

And then, your last question was about, I mean expense is a big driver of the picture that you see on 2018 in particular, for example, in Europe and a short summary, unfortunately, it's no, but mainly driven by loss ratio.

Q - Vinit Malhotra {BIO 16184491 <GO>}

Right. And that's also motor, as you mentioned in the call already or something else?

A - George Quinn {BIO 15159240 <GO>}

So I mean, motor, it has to be a tough market pretty much everywhere. It certainly contributes to, but I mean a larger contributor in 2017 will be financial license, for example.

Q - Vinit Malhotra {BIO 16184491 <GO>}

In EMEA, okay.

A - George Quinn {BIO 15159240 <GO>}

You're right.

Q - Vinit Malhotra {BIO 16184491 <GO>}

All right. Thank you, George.

Operator

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

Q - Dhruv Gahlaut {BIO 16209870 <GO>}

Yeah. Hi. Good afternoon. Just two questions. One, could you update in terms of reinsurance program if that's changed? And secondly, on the SST framework, you seem to point out to the reserve risk change, which has led to the ratio coming down by about 10 points. Could you say a bit more in terms of where it's coming Life, non-Life, what has changed here? Thanks.

A - George Quinn {BIO 15159240 <GO>}

Yeah. Thanks, Dhruv. So on the reinsurance program, I think the only piece of substance that we renew, on the cat side, is the global aggregate cat. I mean no major changes in structure. Pricing is slightly up, as you would expect, I think given the market conditions.

On the comment on the SST slide, so that was really to reflect the process in contrary with FINMA as they review proposed models and either approve or either ask for changes. I mean we have one issue where they've indicated that they would still want to see change before they'd be satisfied with it. That's reserve risk on the P&C book. I mean we've estimated the impact that we anticipate from that. And as you can see, I mean overall, at this stage, we still expect the SST ratio when we publish it in April, I mean to be above 200% and that's a very comfortable position for us to be in. But that comment really reflects the ongoing conversation with FINMA and their expectations around how this should be modeled.

Q - Dhruv Gahlaut {BIO 16209870 <GO>}

Right. Perfect.

Operator

The last question for today comes from Ralph Hebgen, KBW. Please go ahead.

Q - Ralph Hebgen {BIO 6297020 <GO>}

Yes. Hi, guys. Ralph Hebgen from KBW. I just have one question which is left and that relates to cash gain on slide 34. I just still like to get a better handle if possible on the components of the cash which you show. So first, George, you've mentioned a few one-offs, but in particular, in Life, I mean Life is very strong with $1.1 billion shown here on slide. And I remember that your sort of guidance was to expect about $500 million or so from cash on an annual basis. So that is my first comment on the cash.

And the second one is I pick up that you're saying that the nat cats, of the nat cats, there's only about perhaps $200 million or so in this. So if it is the case, that only $200 million of the claims which you've received are cash effective this calendar year, is it therefore a fair conclusion to say that $500 million of cash negative impact will come in to this calendar year?

A - George Quinn {BIO 15159240 <GO>}

So it's very nearly on the second one. So the only thing I left out was (1:03:06) tax. So we look at the post tax loss of maybe around $600 million, so maybe another $400 million of impact from cat to come in the dividends that the businesses declare after the year end.

On the first one, I mean, obviously, one of the things that has changed since the point at which we gave the guidance around the $500 million – gave $500 million per annum, I mean a large part of the Life business is European based. Solvency II just make a difference to the expected cash flow and so that certainly helps. And of course, the one-off that I mentioned in response to Michael's question around Sabadell is also setting in the Life number.

Q - Ralph Hebgen {BIO 6297020 <GO>}

Okay. That's cool. Thank you very much.

A - Richard Burden {BIO 1809244 <GO>}

Okay. Thank you very much, everybody, for dialing in today. And we're aware that there are a number of outstanding questions from the call and we will try and get back to everybody. The IR team is available all afternoon for further questions. So thank you very much and good-bye.
