Q4 2014 Earnings Call - Pre-Recorded

Company Participants

- George Quinn
- Martin Senn

MANAGEMENT DISCUSSION SECTION

Martin Senn {BIO 3241585 <GO>}

Welcome to Zurich Insurance Group's Results Presentation for the 2014 Financial Year. Business operating profit of $4.6 billion, is down 1% from the prior year and flat in constant currency. Net income attributable to shareholders of $3.9 billion, is 3% below 2013.

As I will explain shortly, we made good progress last year in number of key areas, in the execution of the strategy we set out in December 2013. Nonetheless, results for 2014 are below our expectations and a clear indication that we need to do more to improve our profitability. This is particularly the case given the external headwinds faced in the insurance industry from the current macroeconomic environment.

In terms of our three targets, while we continue to generate a good ROE, our business operating profit return on equity of 11% in 2014 is below our target range of 12% to 14%. In terms of our second target, Z-ECM solvency, we remain very well capitalized with a ratio of 127% at the end of the third quarter. And third, cash remittances for the full year of $3.7 billion are ahead of post 2013 and the run rate implied by our three year target of more than $9 billion. The strengths of our capital and cash flows underpins, our very attractive dividend with the board of directors proposing an unchanged dividend of CHF 17 per share.

While our financial results are not yet showing the full benefit of the initiatives underway, we have made a positive start to the plans we set out at our December 2013 Investor Day. Building on our progress in the first half, we have laid the foundation for future investment in priority markets in each of our customer segments. To give you some examples, in corporate, we have established a unified market development function for global corporate and corporate life and pensions. We more than doubled our new common customers across these two businesses while seeing continuing improvement in product density and have rolled out a predictive analytics initiative to 21 countries.

In North America commercial, we implemented innovative customer segmentation that allows us to identify the most attractive commercial and global corporate customer segments. We are also piloting a new single customer view, to improve cross selling and achieved higher conversion rates based on a new broker model. The new Zurich way of predictive analytics and new predictive models also lay the ground for better customer and pricing insights.

In the retail space, we completed customer segmentation analysis in five European markets and entered into new distribution agreements with Via Varejo in Brazil and Banco Sabadell in Spain. The latter arrangement gives us success to an additional 2.4 million customers, while we sell a warranty for furniture or appliances roughly every ten seconds through Via Varejo.

As expected, returns in the businesses that we're managing for value were not that different to what we showed at the 2013 Investor Day. However, we have taken a number of important steps in our GI business and in evaluating our options in Global Life. For 2015, we intend to largely complete the work on turning around underperforming term insurance business units and on the first phase of the live in-force management actions, we continue to look closely at structural options to improve manage for value returns and expect to implement changes in this area over the course of the next 12 months.

In relation to growing our operating earnings investment management completed the objective of deploying an additional $2 billion of risk capital, mainly through the purchase of equities and corporate bonds, and have already invested or committed to invest over $1 billion into less liquid assets.

In addition, we streamlined our organization structure above the business unit level. This is intended to speed decision making and optimize our governments, but is also expected to deliver annual cost savings of $250 million by the end of 2015. This is progressing according to plan, but further simplification and a continued focus on efficiency will be key objectives in 2015 throughout the group.

Our program to transform our group operations and technology will be an important part of this initiative, and will continue against the set of accelerated goals.

Turning to progress in each of our three segments starting with General Insurance. Gross written premiums in our priority markets grew by 3% in local currency, adjusted for a non-renewed fronting contract. Despite competitive pressures, we delivered growth in global corporate and in our commercial insurance operations in U.S. and UK. Gross written premiums in our priority retail markets also grew. For example in our Switzerland personal lines business as well as through new distribution agreements in Brazil and Spain.

As you can see from this slide, our priority markets continue to account for the vast majority of our GI operating earnings, but when these markets fell due to lower reserve releases in our Swiss business and in global corporate, but with a clear improvement in our current year profitability. We have also made progress in the General Insurance businesses that we are managing for value. We sold our Russian retail business and initiatives in other markets are showing positive early results, while more work remains to be done in Latin America.

As you can see from this slide, our operating profits in the turnaround businesses improved in 2014, although there is still some way to go before these operations are delivering hurdle rate returns. We expect to see more progress here in 2015. Our primary objectives for the next year are to drive further improvement in accident year profitability, complete turnaround actions in several markets and prioritize initiatives in corporate, commercial and select retail markets.

In Global Life, overall annual premium equivalent was up 19% with slightly stronger growth in our priority markets. We expanded into corporate life and pensions business in the UK and we had successful execution of growth strategies in bank distribution in Spain and Latin America, and our IFA distribution business in the U.S. Overall, new business value is up around 7% adjusted to be on a like-for-like basis. We're pleased with our progress here.

In our managed for value operations, we have exited marginal positions and have also developed a unified approach to in-force management. This has already been rolled out in the UK, Germany, Switzerland and U.S., which account for about 65% of Global Life's in-force book. We anticipate this could contribute up to $100 million in business operating profit by 2016. We have also seen some encouraging signs of progress at the Farmers Exchanges, which returned to growth in the second half. Gross written premiums at the Farmers Exchanges, which are owned by the policyholders were flat for the full year, but showed good momentum in the second half of the year.

Excluding 21st Century and business insurance sold through independent agents, gross premiums increased by nearly 5% in the fourth quarter. This is just another indication that Farmers' go-to-market strategy is beginning to pay off. Customer satisfaction, as measured by Net Promoter Score, improved considerably in the fourth quarter, while customer retention rose to 76.8% at the end of 2014 from 74.8% 12 months previously.

The Farmers Exchanges have also seen growth in the total number of agents, adding more than 400 agents in the year as retention rose to its highest level in over five years and exceeded its aim of generating 100,000 omni-channel policies by 20%. The company also continued its expansion into the Eastern U.S. opening operations in Connecticut to add its sixth eastern state. In summary, while we cannot be satisfied with our 2014 results, we see signs of progress in our business that are not fully reflected in these numbers.

In General Insurance, we continued to improve our current year ex-cat combined ratio, although clearly, there is more to be done here in 2015 and beyond. In the life business, we are making good progress in bank assurance, corporate life and pensions and in rolling out our in-force management strategy. We have also seen very pleasing developments in the Farmers Exchanges, which bodes well for the future.

And we remain a very well capitalized and cash generative business, underpinning an attractive dividend of CHF 70 per share. We remain convinced that a strategy we set out in the 2013 is the right one. Our goals are built on three strategic cornerstones with actions to improve our profitability and address the challenges of a prolonged low yield and low growth environment. We look forward to updating you on our progress at our Investor Day in May, and we will provide you with more information on the steps we will take to ensure we deliver on our 2016 targets.

Thank you for your attention, and your continued trust and support.

George Quinn {BIO 15159240 <GO>}

Good morning or good afternoon. My name is George Quinn, and I am the Chief Financial Officer of the Zurich Insurance Group and I'll take you through our results in a bit more detail. However, before I go into the numbers, I'll start with the overall picture. The most important metric in our financial statements is the BOPAT ROE of 11% is below our 12% to 14% range. And if I adjust for the things we don't control for, cat experience of one-off expense benefits, the underlying ROE is around 10.5%. This is not a satisfactory result.

Improvement year-over-year is visible, particularly in our GI results. But we intend to continue to improve our profitability with a relentless focus over the next two years on underwriting improvement and efficiency.

We said last December how we could get to 13% BOPAT ROE in 2016, achieving our BOPAT ROE target of 12% to 14%. And while the continued to decline in reinvestment rates doesn't make it easier, this remains our top priority.

On the positive side, our cash and capital metrics remain very strong, and we expect this to continue. This will provide us with the reinvestment and capital management options that will become an increasingly important lever in achieving our ROE goals.

Turning to the details, I will cover the operating performance of our segments shortly, but will briefly highlight four points on this slide. First within BOP, we have $142 million loss in non-core in 2014. This is mainly due to an adjustment of our U.S. asbestos and environmental reserves in the fourth quarter as part of our normal review cycle. Second in the reconciliation of BOP to NIAS while we have a very high tax rate for the full year of around 27%, this is slightly lower than we had indicated at the time of our Q3 results. There are various non-recurring factors at work here but we expect the Group's tax rate to be around 25% in future.

Third, we had a high level of realized gains for the full year and particularly for Q4. The gains in the fourth quarter were on a mix of bonds and equities. And fourth, we include a $247 million loss on the sale of our Russian retail business in our full year and Q4 results. This loss is lower than the $300 million that we've previously indicated that we'd take in Q4 mainly due to currency movements between July and October. As we mentioned before, most of this loss is due to the realization of previously unrealized currency losses with only around $40 million impact on shareholders' equity.

Turning to the performance of General Insurance. Gross premiums written grew by 2% in local currency in 2014. Excluding the impact of a large discontinued fronting contract, to which we referred throughout the year. For Q4, our top-line in U.S. dollars was down 4% compared to the prior year quarter due to the strength of the dollar against most other currencies and notably the euro and the pound.

In local currency our top line was up 3% and this includes $115 million from the new distribution agreement in Brazil, which commenced in the quarter, although this will not have an impact on earned premiums until 2016.

Rate increases on renewal remain stable at 2% for Q4 compared to Q3, we saw a slightly lower rate increasing in global corporate, while rates were a touch better in NAC, but the overall picture is very consistent.

Looking at the top line development for the different regions, for the full year, global corporate reported an increase of 3% in local currency. This is due to higher retention and new business production in the U.S. while premiums are down in global corporate and Europe mainly driven by re-underwriting actions. For NAC gross premiums were up 2% excluding the discontinued fronting contract I mentioned before with growth in target areas and a small increase in retentions.

Looking at our European business, the top line was flat for the full year in local currency. We have seen some solid growth in some key European markets such as the UK, Germany and Personal Lines in Switzerland offset by some top line pressure in Italy as well as in some of our turnaround markets.

In international markets, premiums increased by roughly 3% in local currency. We're still expanding the business but our underlying growth rate has slowed mainly due to re-underwriting actions in Brazil and a competitive environment in the Commercial Lines business in Australia.

Let's now move on the combined ratio. Before we go into the details, let me step back and can give you a high level view of our performance in General Insurance. For Q4 standalone, our combined ratio was 99.4% a disappointing outcome in a light quarter for catastrophe losses. The main reason for this is an ex-cat combined ratio for the quarter of 98.2%. This is higher than we're targeting albeit due to some specific factors which are not reflective of our run rate profitability. And we would focus instead on full year 2014 results. Looked at on this basis, we made good progress although we need to continue this improvement in 2015.

With that in mind, let me walk you through the numbers. For the full-year, our accident year ex-cat combined ratio was 95.6%. This is 1.6 points better than in the prior year, mainly due to a 2.4 point reduction in current year ex-cat loss ratio. Consistent with what we've told you though in previous quarters in 2014, around 1 point of improvement is from a lower level of large industrial losses with the balance due to a better attritional loss ratio.

For Q4 discrete, the accident year ex-cat loss ratio was 67% roughly 2.5 points higher than at the nine months stage. This is mainly due to losses in our crop business in the U.S., some large individual losses in the UK and Brazil, and a modest deterioration in the attritional loss ratio booked for the year. It's a disappointing end to the year, but it should not overshadow the improvements in performance for 2014 as a whole.

Our overall expense ratio for the year of 30.5% is 0.8% percentage points higher than in the previous year. Excluding one-off factors in both years, we see can increase of 1% percentage point, around half of which is due to investments in our priority markets. The impact from catastrophes was 2.3% for the year around 1.5 points below our five-year average and about 1.3 points better than our pricing assumption. In terms of prior year development, the results for the year is a 0.6 percentage point benefit. This is slightly lower than the indicated range of 1 percentage point to 2 percentage points and again this is due to some identifiable and specific factors, like the adverse development on a number of large individual claims in global corporate in Q2 or APH liabilities in the UK and a discontinued line in global corporate in Q3. We expect positive PYD of 1% to 2%.

Turning to the performance by region. We saw good improvement in global corporate current year profitability, but with a small level of adverse development in 2014 compared to a material level of prior year reserve releases in the previous year. The decrease in EMEA's combined ratio is mainly due to an improved accident year ex-cat combined ratio, due to lower large losses and a better attritional loss ratio. And lastly, the combined ratio in our international business is 2 points higher than in the previous year.

While the underlying performance of the business slightly improved, catastrophe losses were 0.5 percentage points higher and were flat to prior year reserve movements compared to some significant releases in the previous year in the Asia Pacific region.

The Q4 standalone combined ratio deteriorated by roughly 8 points, mainly driven by some reserve strengthening and large losses. We still have a lot to do to bring our LatAm business to the level of profitability that we require.

On the next slide, I'll explain the breakdown of the GI BOP. GI BOP was $2.9 billion for the full year, broadly unchanged in comparison to 2013 in both dollars and in local currency. An improved underwriting result was offset by lower gains from hedge fund investments and higher non-technical costs. The BOP contribution from investment income is essentially flat on a full year basis, and marginally up at constant currency. The Q4 discrete number stands out on the low side, particularly compared to a $70 million higher number in Q3. One-off impacts in Q3 and Q4 accounted for around $45 million of the difference, with the balance of the difference due to currency movements. And lastly, the 2014 non-technical result benefited from currency gains and losses of $48 million. Excluding this positive effect, the non-tech result was $160 million, in line with the run rate guidance given at the half year results reporting.

To summarize on our General Insurance business, while there were some encouraging trends in the overall results, we have much still to do in terms of delivering on our turnaround plans and further portfolio actions. These actions will include deriving further benefit from active portfolio management, including rate tiering and a continued focus on expenses.

With that, let's move to our Global Life business. As measured by APE, new business volumes increased 19% in local currency compared to the previous year, driven by strong performance in our main growth areas in the U.S. and Europe. The U.S. showed good progress, increasing IFA in new business volumes by 49% year-on-year in local currency, while bank distribution volumes in Spain and UK corporate life and pensions increased by 135% and 60% respectively. And of particular note was a discrete fourth quarter. The UK wrote a large single premium pensions contract, which was a strong positive impact on APE and net influence.

Latin America also showed growth in local currencies, with an increase in new business at Zurich Santander of 14%, partly offset by a decrease in the Zurich Life business. As reported our year-to-date new business value was slightly down year-on-year, but this masks an improving underlying picture. Adjusted for methodology and assumption changes that we made at the beginning of the year, new business value would have grown by around 7%.

And finally, net inflows were very positive for the year, primarily driven by increased volumes in the UK pensions business, while assets under management were flat due to FX movements offsetting inflows and market growth. While we're still early in the strategic cycle, the strong growth in our target markets of U.S., UK retail, bank distribution and corporate life and pensions shows that we're making good progress.

Turning to life operating profitability. Business operating profit of $1.3 billion was flat compared to the prior year in dollars and up 2% in local currency. BOP for Q4 of $308 million would have been around $20 million higher on a constant currency basis. As part of our in-force management strategy, there were a few one-off negative items in these results caused by actions that we took during the year. These were however broadly offset by some non-recurring positive effects, with limited overall net impact.

We show on this slide the source of earnings analysis for our Life business that was first introduced for Q2. We've also updated the separate briefing document that explains our approach and the linkage to our products and KPIs. Adjusting for the various one-off factors and as explained in the briefing document, our revenues grew 5% in 2014, and the main driver was a 6% growth in loadings and fees, driven by an 11% increase in unit-linked fees in Europe, as well as higher loadings in all regions other than Europe. As expected, the overall investment margin is broadly flat, excluding the impact of discretionary policyholder dividends, while the technical margin, when adjusted for one-off items grew by 4% benefiting from strong sales in U.S. protection products and Zurich's Santander growth.

Overall expenses increased by 6%. The main drivers are a 12% increase in operating expenses and a 3% increase in acquisition costs. The increase in operating expenses is driven by investments in priority markets such as the U.S. and the UK as well as central project costs as we execute the strategy that we set out in 2013.

Looking forward, we will continue to invest in our priority markets. And it will take some time for us to see the full benefits of this in our earnings. At the same time though, there was considerable operating leverage in our business as we get to scale in priority markets and make progress with in force management initiatives and manage for value operations.

Considering the currency headwinds and management actions taken throughout the year, we see this as a solid result from our Life business and look forward to showing further tangible progress on the execution of our strategy at the Investor Day in May.

On the next slide, I'll give you an update on the Farmers Exchanges, which we do not own but are relevant to the performance of our Farmers business segment. As Martin has already mentioned, Farmers continues to make really good progress in the execution of the strategy launched in 2013.

Although gross written premiums were flat for the year, momentum is very positive with growth of 2.4% in the fourth quarter. Excluding 21st Century and Business Insurance sold through independent agents, the businesses considered non-core. Growth was 1.9% for the year and 4.6% for the fourth quarter. While this was helped by some $20 million of one off adjustments in the fourth quarter, this doesn't change the positive picture. Growth overall continued to be driven by rate, although we also saw a much improved picture on policies in-force, which was broadly flat for the fourth quarter. And indeed for the second quarter in a row, there was growth in auto vehicles in force sold through exclusive agents, which is a very positive trend.

In terms of profitability, the Farmers Exchanges combined ratio improved by 1.1 percentage points to 99.4% in 2014 due to lower cat and non-cat losses. In October, our Farmers Exchanges issued $500 million of surplus notes. This was in part used to fund the redemption of around $200 million of surplus notes held by Zurich. The balance in conjunction with much improved profitability helped to strengthen the Farmers Exchanges cat position by around $400 million in Q4.

This allowed the Farmers Exchanges to significantly lower the reliance on quarter share reinsurance. The All Lines in Auto Physical Damage Quota Share reinsurance treaties thus were reduced from 20% to 14% and from $1 billion to $700 million respectively. With Zurich's share of the all lines quarter share reduced to 10% and the APD treaty participation reduced to $500 million.

Reduction in quarter share reinsurance did have some immediate negative impact on the surplus of the Farmers Exchanges, but the full impact on the surplus ratio will only unfold over time, through an increase in net written premiums. Everything else being equal, we expect the surplus ratio to move back into the near term target range of 33% to 36% from the 38% shown at year-end.

From a Zurich perspective, we expect to release a significant amount of capital in the next two years while giving up a volatile earnings stream. Lastly, we note Farmers Management services and Farmers RE.

Farmers Management Services revenues declined by 1% for the full year, in line with the gross annual premiums of the Farmers exchanges. FMS operating profit fell by slightly less due to expense discipline, as well as some one-off gains, such as the gain on the sales of the old headquarters building.

Clearly the improved growth trajectory of the Farmers exchanges should allow management fees to recover over the course of the next year, as they're charged on earned premiums. The managed gross earned premium margin came in at 7.2%, which continues to be above the 7% level that we expect to see as the sustainable level. Farmers

RE business operating profit increased by more than 50%, driven by a 1.9 point improvement in the combined ratio, 0.7 percentage points of which relates to lower cat losses and with the balance mainly due to lower underlying losses.

Next I'll provide you with an update on our balance sheet and cat position. Over the year shareholders' equity increased by more than $2 billion, driven by our earnings and an increase in unrealized gains and investments, offset by an increase in unrealized currency translation losses reflecting the strength of the dollar in the second half of the year. Our cat position remains very strong, at the end of September our Z-ECM ratio stood at 127%, virtually unchanged compared to the beginning of the year, despite the additional allocation of risk capital to investment management.

Of course one topic that has received a great deal of attention this year is the volatility of the currency markets and the recent strength of the Swiss franc. For this, for us this is primarily a translation issue. While the vast majority of our assets and liabilities are currency matched, there is some impact on our group equity IDFR. For example, because we hold debt in our Swiss franc holding entities to fund investments in our overseas operations. Overall, we expect that the sharp moves in January will have had around at two point negative on the Z-ECM ratio. Although, we would expect to see a further small reduction in the ratio as we include expected growth for 2015 and required capital.

Turning to cash remittances. Cash remittances in 2014 were well above the run rate needed to achieve our 2016 target, and in line with what we indicated to you at the half year result. While all the segments made a positive contribution, there are significant year-on-year increases in Global Life and Farmers and these are largely driven by some special items, some of which are non-recurring in nature. These total around $500 million.

Nonetheless, and even allowing for the one-off nature of some of the remittances, we are well on track to deliver a target of generating cash remittances in excess of $9 billion over this three-year cycle. And this remains the case even after fully reflecting the strengths of the Swiss franc and the U.S. dollar against our main operating currencies. Since we pay our dividends in Swiss francs, the recent currency movements have naturally led to an increase in our dividend payout ratio. However the combination of our excellent capital strength, high financial flexibility, ability to upstream capital from our main operations, and positive expectations for cash remittances, mean that we remain in a very secure position.

The Board of Directors will be proposing an unchanged dividend of CHF 17 per share to our shareholders. And if approved, this would mean that we've paid out nearly 35% of our current market cap since the end of 2008. There are not many financial institutions that can make this claim.

Before I wrap up, I'd like to give you an update on some of the factors that may influence our results in 2015. Starting with General Insurance. We need to drive further improvement in the ex-cat loss ratio by improving the performance of turnaround businesses and through specific re-underwriting initiatives. We don't expect the market to help, so this is really about tackling underperforming accounts, while maintaining and growing our strongest relationship.

Going the other way, our 2015 expense ratio is likely to be higher than in 2014 with our results last year benefiting from around 50 basis points from non-recurring benefits. In addition, the new distribution agreement in Brazil will add $50 million to our expenses, while we will not start earning any premiums under this contract until the end of the year. This contract is expected to make a positive contribution from 2016 onwards.

And lastly for general insurance, we'd expect to see a decline in investment income of around $100 million compared to 2014 levels on a constant currency basis, given where reinvestment rates are now. For the life business, we expect to see continued growth in loadings and fees and in technical margin in local currency. This is likely to be offset by a modest decline in the investment margin. We also expect to see the benefit of in-force management initiatives in the results, both in terms of revenues and expenses.

In terms of Farmers, the strong progress made in the second half of 2014 should continue and this should translate into growth in FMS revenues albeit with a slight lag, since management fees are calculated off of gross earned premiums. And we expect the margin to trend to 7% in the next couple of years. For Farmers Re, we'd expect to see a sharp reduction in BOP, given the law to quota share reinsurance now in place.

And lastly a few words on the impact of currency movements on our earnings. While much of the attention this year has been focused on the rapid appreciation of the Swiss franc, the current franc to U.S. dollar spot rate is not that different to the average in 2014. In practice the bigger impact for us is likely to be the recent strength of the U.S. dollar and the Swiss franc against the euro and the pound.

To quantify this for you, retranslating our 2014 earnings at 31 January spot rates would have a negative impact on our BOP of slightly above 5%, mainly through converting the same earnings at different exchange rates, as well as the fact that we naturally have a higher weighting of our central costs in Swiss francs.

At a segment level, the biggest impact would be on our life business, since a large part of the in-force business is in Europe. Here, all things being equal, the strength of the U.S. dollar would reduce the starting point earnings by around 10% with a smaller impact of roughly 5% for the GI business. Farmers and OOB are not materially impacted. While currency movements impact our reported U.S. dollar earnings, they have relatively limited impact on our overall ROE, and they do not lead to any change in our targets.

With that, I'd like to conclude with a summary. First, in General Insurance, we continue to make good progress in improving our accident year combined ratio. Although our Q4 results show that we have much still to do in our turnaround businesses and in driving further improvements across the book.

Second, we continue to see good momentum in our priority Life markets, particularly bank distribution and CLP, and expect to start seeing the benefits of in-force management initiatives coming through our earnings over the next two years.

Third, the positive story at Farmers continues, with two consecutive quarters of growth and a continuation of positive trends in all key metrics. And last, our solvency capital continues to be very strong and we're well on track to deliver more than $9 billion of cash remittances by 2016 even with the impact on currency headwinds. Overall, while we are not fully satisfied with our 2014 earnings, we have made progress.

And as I said, at Q3 our targets are our number one priority and we will be taking all necessary steps to make sure that we deliver them. In this respect, the next investor event for us will be the Investor Day in May when we will report back to you on the progress, on our strategic priorities with a focus on our life business, on our global corporate business, and on the steps that we're taking to create a more efficient business for the future. Thank you for watching.