Q3 2015 Earnings Call

Company Participants

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

Other Participants

- Andrew J. Ritchie, Analyst
- Andy D. Broadfield, Analyst
- Farooq Hanif, Analyst
- Frank Kopfinger, Analyst
- Jon M. Hocking, Analyst
- Michael Haid, Analyst
- Michael I. Huttner, Analyst
- Nick Holmes, Analyst
- Paul C. De'Ath, Analyst
- Vinit Malhotra, Analyst
- William H. Elderkin, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Ladies and gentlemen, welcome to the Allianz Conference Call on the Financial Results for the Third Quarter 2015. For your information, this conference is being recorded.

At this time, I'd 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. Yeah. Good afternoon from my side as well and welcome to our conference call about the results of the third quarter 2015. There's nothing specific to be added from my side today.

So, without further ado, I hand directly over to Dieter.

Dieter Wemmer {BIO 4755450 <GO>}

Yeah. Thank you very much, Oliver. And good afternoon to everybody on the call. Let me just dive directly into the presentation.

And I'll start with the business highlights. We continued to focus on new product developments in retail property, in the Life & Health space also, mainly retail, and then in Asset Management. And I think, in all categories, we are seeing very good progress, which is then also visible into our profit margin and new business developments in the segments. I will come to this later.

In the investment space, we had a successful quarter with some really headline-making large investments in Germany, UK, but also in Ireland, helping to diversify our investment portfolio.

So, now let's start with the numbers.

So, page 5 on the group of all results, a €2.5 billion operating profit, might have seemed by some of you as a small disappointment. Actually the underlying operational results are unchanged on a high quality level and also very good. But financial markets had some particular volatility in Q3. So, FX results, volatility in equity markets also influenced the P&C and Life & Health segment results. So, that created some negatives, and I will explore on the details of this when I come to the specific segments.

Total revenues down, mainly coming from the Life segment, because P&C and also Asset Management is in revenues up in the third quarter. And the reduction in Life & Health is very welcome by us because it's an evidence of our expansion strategy that we are clearly reducing the volume in traditional single premium business and replacing it with new products. But, so far, the lower volume and new business value and new business margin, when we come to this page, is clearly demonstrating that the strategy is working.

Net income is more down than the operating profit. Added to the reduction in operating profit is a higher tax rate and some more impairments also coming from Q3 number, the financial market movements, that explains the difference. But already, to be mentioned here, I'll come back to this also at the end of the presentation. We stick to our operating outlook for 2015. We are well prepared for a very good year-end, as predicted.

Now the capital page. Shareholders' equity actually slightly up in total. Unrealized gains did not move a lot. We had offsetting effects between European government bonds and corporate bonds. So, one has widening spreads, the other has a reduction in spreads, and also base interest rates.

And in the equity markets, actually the unrealized gains stayed quite stable. The stocks which were impacted by the market actually directly go through the 20% hurdle and we have impaired them in the quarter. That should not surprise you. That is quite a lot of stocks in the energy and commodity sector, which mainly created immediate impairments.

So Solvency II capitalization at 200%, and we are now really converging to the number, and IMAP approval I would expect in the next couple of weeks.

The 12 percentage point down is split into three categories. Number one is market movements, these are just 5 points. And if you want to test it against our published scratch numbers from last quarter, use 20 basis points on the interest rates and 7 percentage points on stock market movement, and that gives you both sensitivities combined 5 points movement.

The next 5 point is coming from adjusting to EIOPA rule on how to calculate U.S. equivalent. And we moved from the 100% CAL to 150% CAL, and that is the recommended formula by EIOPA. And the last 2 percentage points are final adjustments coming from the German regulator on our IMAP, mainly affecting our German solvency ratio. And then the 2 percentage points effect on a group level.

And then, there were some smaller changes coming from the IMAP approval process, which are adding up to 0%, because there are pluses and minuses. So, overall, a very comfortable level, ready for the final goal on Solvency II and still the same dividend level as promised last year being accrued.

Now, moving to the P&C numbers.

Internal growth, nominal 2.4%. If you correct for acquisitions and FX, only 0.6%. Actually we still have a pretty good growth in our core markets. However, in Germany, same strategy as we do in Life, we reduced traditional products with guarantees. And please be reminded that we have a fairly large book in Germany in the retail accident business, which is the savings product with guarantee, which is sold as a single premium product and therefore the same strategy as in Life has been applied here.

When I ignore this product line and I go to what you would also see as European fee business, Germany has actually a growth rate above 3% or even close to 4% in the quarter.

The other reductions are coming from Brazil, further cleaning up of the portfolio, but I would say aggravated by the macro picture in Brazil which clearly darkened. Then the run-off of our Russian retail, we are now with our Russian retail business year-to-date 95% down compared to the year before. And then Fireman's Fund has also continued to reduce volumes. So, there are the negatives in the overall growth.

And then we are very more careful underwriting in our global line business, credit insurance as well as the large corporate business and specialty business. So the growth is really coming more from the retail and mid-corp businesses. I would really positively highlight our Allianz growth by partners, that is the Global Health and other response (8:58) business, as well as Australia and Spain, who has a real run in its business development because you will see that I highlight Spain also on the following pages further.

So, moving to the results in P&C. Combined ratio at the first glance could be flat with 94.1%, so a tick-up in total, but underlying some moving figures. So, first of all, last year was free of cat events. This year we had 120 basis points. Last year we had a run-off result of 2.6%, where we had a big negative coming from Fireman's Fund, about 1.8 percentage points this year. We don't have a negative from Fireman's Fund. So, the positive run-off across the segment is roughly the same, the 4.4%.

Expense ratio tick-up, there is a one-off effect, as we have reallocated in our expense (10:10) business some numbers between loss ratio, so service provided versus expense ratio. That is neutral for both numbers, but it is a shift between the two lines. And then we see also a further mix change with the trends to higher commission and acquisition cost. So, therefore, the expense ratio is up.

The underlying loss ratio is suffering a little bit from large losses more, but not significant. I think that is some 40 basis points, 50 base points. And then, we see also, clearly, a deterioration of the numbers coming from Argentina. And we have booked in Argentina actually additional $50 million split between prior year and current year.

That is a catch-up on the deterioration of the inflation rate in Brazil. And we have to turn this business. This might be – that is in Argentina easier than in Brazil. We are already on a track to increase at the moment our prices by 2.5% to 5% per month, because Argentina motor runs on 30-day policies and not 6 months or 12 months policies.

So the operating profit in P&C is down compared to last year by €70 million. And it is all coming from the investment results, underwriting a very small reduction that is the slight uptick in the combined ratio. And I'll come to the investment results in a moment.

Let's look, first, at the operating profit development country-by-country. And the combined ratio, when you look at the individual combined ratio, I think the strong combined ratio is really supported by a broad basis of successful large entities, our Continental European home and core markets, Germany, Italy and France. That is AGCS, which continues to have a very good result.

The 98.6%, which you find here on the page, you have to split into the old AGCS business and the Fireman's Fund commercial business addition. AGCS standalone is below 91% and Fireman's Fund is 117%, So, still above 100%. We have actually in this quarter still booked some cleaning up. We have not increased reserves, but we have cleaned up some other commitments from full participations receivables or other smaller balance sheet items. And then we had a final settlement with the disposal of the businesses with ACE. So, all-in-all, that cost us about €45 million in operating profit for the quarter, so that was a smaller clean up.

The Latin American number, the big negative is coming from Argentina, as I explained already, and Brazil is also still negative as the environment really delayed I would say the recovery quite some time. The other numbers are still all very strong. And again, I would point out to Spain, which is not only growing but with a 85% combined ratio also doing a great job on creating margin.

The other businesses are pretty much in the area what you would have expected, where I should add here that we see in Germany, France and also Belgium actually quite some smaller weather-related claim events in the third quarter, nothing which has been called a cat, something which is just costing some money.

And for example, in Germany, our normal quarterly budget would have been 6.3% for weather and we consume 6.7%. So, that is – and for France, the difference is big, and also Belgium has some effects of this that affects us this part of the continent.

If we move to the investment numbers of P&C, so page 15. The running yield income is pretty stable. So, all decline in yield has been compensated by higher asset volume and we run pretty flat on investment income. However, foreign currency investments held in the hard currency balance sheets created some €70 million loss in the quarter, because foreign currency goes trading directly with exchange of the currency. And that is all of the reduction in our P&C number here.

And I just mentioned FX. In the total group balance sheet, the FX trading result of the quarter was on a gross basis €600 million loss. In P&C, the share growth straight (16:01) for the shareholder. In Life, it's of course depending on what balance sheet it is split with the policy holder.

So, that is the volatility of Q3. In October, actually a third, so around €200 million of the €600 million returned to the positive. So, even if you don't know what will it be on December 31, it is at least a good start into the year-end quarter. And with the other information, I think on the reinvestment rate duration, there is nothing to talk about in particular, it's all business as usual.

Let's move to the Life business. Yes, 10% reduction in volume, a lot of single premium reduction. Actually, when we would use what we are not doing but maybe here for comparison with our peers, the APE terminology. Our APE is actually 9% up in new business year-over-year, because we are writing a bigger fear in recurrent premium. And single premium is down. We are in recurrent premium slightly up.

So, that is the first visible change in the mix. And when we then go to the different markets, you can see in detail that the traditional business, so the traditional guarantees in Italy, in France and in Germany is down and we have placed it with unit-linked business in Germany with the product with the new lean guarantee type, which is consuming less capital.

And we will actually on our Capital Markets Day explore this section much more to show you also the effect on capital consumption and what does it mean long-term. The only volume number where you could say, well, that is not great, is actually the new business volume in the U.S., which is currency adjusted 30% down.

So our market share in fixed index annuity moved from 30 percentage points we had last year to 20 percentage points in 2015. 20 percentage points is still at the upper end of our long-term market share in the fixed index annuity space and we have probably a bit underestimated how fast the competition will copy our (19:01) product. And not only copying it, actually putting it with more aggressive terms into the market. The new business value we have generated out of the business this quarter is really very good. And I would come to the new business value in a moment. Let me first spend a minute on the operating profit development.

You see an increase in the investment margin that is sometimes a bit difficult to understand the effects that we have in the policy holder, shareholder split in Germany to do the catch-up for the whole nine months, depending on how the realized gains and losses and overall investment income develops for the full nine months.

And the low participation for the shareholder in Q1 is now turning into a higher participation in Q3. And overall, we are still on track for the full-year result. I think the German results are much easier to understand as we have the 12 months together because that is then the legally binding allocation of the profits to shareholder and policy holder. So, therefore, during the year, it is always a bit of volatile proxy for really targeting the policy holder credits.

That grows the investment margin here in numbers up. However, we have two big individual negatives in this P&L for the quarter that is on one hand another write-down of Korea of €148 million. This time it is both Life product with traditional guarantees above 6% of the guarantee levels of this block. And in the last quarter, we had old block of Health business, which also has high guarantees, which was being evaluated and being written down.

For the next quarter, as we have now covered both blocks of business which could create trouble, we are not seeing any further write-downs. Actually last year, we had this Life block write-down in Q4, and now it is in Q3. So it is a bit also advancing, when you want to compare it to 2014 what we had a quarter later last year.

So the other negative one-off in the overall numbers is actually out of the dynamic hedging process of our old VA business. We had a €100 million base risk negative. The base risk in the old VA block is very simple, coming from the fact that customers' money is in actively managed equity funds and the hedging goes to index funds.

And when active managed equity fund moves differently than the index, you create a base risk. And that base risk was actually very benign, and in the last two years, in most quarters slightly positive. This quarter, it created a €100 million hit, which is buried here in this operating profit development.

So now coming to the new business margin. We put the new business margin in the heading because 3.0% is the second best new business margin the group ever reported. Only before the financial crisis, there was one quarter or two quarters with a better number. So 3.0% is a tremendous success in this environment and it is a tremendous success for our business mix change strategy.

So how do I get from the last quarter's maybe disappointing number to this quarter's 3% number? First of all, we are using for the evaluation of the new business margin always the interest rate curve at the beginning of the quarter. So we talk here the Q2 was evaluated at April 1. And when you would evaluate the second quarter at July 1 interest rates, then we would have seen 2.6% new business margin at last quarter. So here you have 3.0%, so it's 40 basis points to mix change. And we are expecting that in the next year to continue our trend to move the new business mix.

Also, I told you already sometime ago that we are adjusting in the U.S., the fee schedules as expense charges to price for higher new business margin. That is now becoming visible in the Q3 numbers with 3.8 percentage points new business margin. And again, Spain has not only a very good growth in new business, but also this 4.8 equates average interest rate and is producing a nice new business value.

As we have a look at the overall investment margins, the investment margin overall is 22 basis points. Our midpoint new business margin is 17 basis points a quarter. That is our expected value for each quarter. So therefore 22 basis points is at the upper end. So, from a structural point of view, the investment portfolio and the numbers are very strong.

But you can also see that the net harvesting number was negative which has equity impairment and the FX losses, but mainly coming from Germany compensated by the policy holders. Therefore, you see in the mechanics an offsetting effect under the profit sharing and the net margin for the shareholder is pretty stable.

That does not mean that the policy holder are not getting anything in Germany. Actually, for the whole nine months, the profit sharing percentage for the policy holder is slightly higher than the year before. And duration we are managing to a fairly high level. So we continue to run our duration gap below half a year, which is I think a good and stable evidence of our risk policy.

Now coming to the assets under management. I believe that this is the second positive story I can talk about today. PIMCO's outflows €16 billion. That is certainly substantially less than the previous quarter. So we are very well on track in the reduction of the outflows and that is further evidenced by the October numbers.

In October, we have for both asset manager achieved positive net inflows. So PIMCO has in October, since April 2013, the first positive inflow month. And Allianz Global Investors had in October another good month. Here the quarter number for Allianz Global Investors is €1.3 billion. Now the last four quarters I think aggregated some €18 billion of net inflows.

The assets under management were affected by markets, equity markets down and also corporate bond market, the credit spread widening down, so 2.8% market value loss. Also this is looking completely different in October. So, therefore, we had certainly for asset management a very good start into the last quarter of the year and we are looking forward to the year-end results.

The revenue development for asset management are now on 27. It's 1.1% up where the underlying fees and commissions 11%, down on currency adjusted that is still driven by the outflows we have experienced over the last four quarters obviously. The plus is coming from the performance fees which we first booked in September. And I told you in the beginning of the year that you will see in the PIMCO operating profits a big anti-load as development that we are expecting in the last month of the year, starting in September, a series of one-off performance fees where we have booked the first number here in September as just being mentioned.

The revenue margins are pretty flat in development, actually PIMCO with €39.7 billion in 2015, and this margin excludes obviously the performance fees, we are a pickup against second quarter and a further pickup against the first quarter, so all very stable developments. In Allianz Global Investors, there is some more complex stories because we included and changed beginning of the year some advisory mandates, which we included in our assets under management calculation. That is the main driver for the shift of the fee margin. When I do it on a like-for-like basis, the margin development is very unexciting, flat.

So now what does this mean for the operating profit of the asset management space. Clearly, when you start with last year's third quarter, the volume effects are what they are. The performance fee is the positive impact and then we also have made in a like-on-like basis improvement in our cost to income ratios.

When I start with Allianz Global Investors, here showing a 74.5%, but we have booked in the third quarter €34 million restructuring charge to really improve the cost to income ratio in the upcoming years more, and that is the first half of the restructuring charge we will probably see in 2016, more of it. When I take out the restructuring charge, AGI was already at 68.5% cost to income ratio which is, since we started the setup in the current form, the best cost to income ratio so far and clearly below the 70%.

PIMCO, including performance fees, below the 60% level. But let's do a fair comparison to the second quarter and ignore the performance fees for a moment, then we can actually see a 2 percentage point improvement against the second quarter for no additional one-off burdens, but also improvement in the underlying expenses, in particular back-office administration also offshore services.

So, overall, the €600 million operating profit for the asset management business looks not only very good, I think, but the underlying explanation makes really hope and appetite for the future in asset management.

Corporate segment with the uneventful flat, nothing really especially to report on it. And then I would go to the last page of my presentation, the translation from operating profit to net income. Clearly, additional write-downs driven by Q3 markets. That was €100 million more than last year.

And when we ignore the slightly complex tax treatment last year where we did win with our Life business a big court case for old tax claims, when we leave this aside, our tax rate worsened by 6 percentage points compared to last year. We had last year some tax-free realized gains. This year we have more tax-free realized losses. And also we have actually a planned restructuring in Italy where we are merging and collapsing some scaffolding structures, which cost us some money. Therefore, the tax rate in Q3 is higher than what we would like to see as the long time version.

And now I'm coming to the summary. Nine months revenues still up. Clearly, the Life volumes trending down, but I think to the benefit of shareholder and also policyholder because they are now getting the better product with the lower guarantees and higher returns.

Operating profit flat against last year. So, therefore, a very promising starting point for the last quarter of the year, where we have to expect at least some of the things we can control, less one-offs when the financial market goes yo-yo around Christmas that I cannot influence.

And shareholders' net income is 4% up compared to last year, with a positive outlook for the year-end operating profit. So, that number should be then also relative to last year improved further. And we are in a very strong capital position and balance sheet position, a 200% Solvency II ratio and we are seeing the IMAP approval shortly happening and we are very well prepared for it.

And with this one, I will stop here and look forward to your questions.

Q&A

Operator

Thank you. We will now take our first question from Farooq Hanif from Citigroup. Please go ahead. Your line is open.

Q - Farooq Hanif {BIO 4780978 <GO>}

Hi, there. Thank you very much. Firstly, I've got two questions really, but firstly on Life. In terms of your outlook for earnings growth, there's two contradictory things going on here. Firstly, obviously your new business sales are down a lot, but new business margins are sort of – sorry, new business profit is kind of flat.

But, on the other hand, the IRR has gone through the roof. It's really strong annual payback period on that business seems to have fallen to four years based on your current assumptions. So what I wanted to ask is, are we kind of going into a new paradigm of halting growth for the sake of Solvency II and low interest rates and margin management? Or do you actually think, if you add these three things together, your positive earnings can actually grow?

That's a long question. So, I got question one. And the second question, in LatAm, you talk about the sort of delay in the turnaround progress. Does this feel a bit like Russia?

Obviously, for different reasons, different drivers. So, I mean, is this not high in the agenda for exiting? Thanks.

A - Dieter Wemmer {BIO 4755450 <GO>}

Okay. So, thank you very much. I think the better IRR is coming very much because the products are consuming less good capital and that is clearly a driver and improvement for it. So, for the customer, the products are actually more attractive, but also for the shareholder. I think we have adjusted really very well this year to the Solvency II world a big time.

You could argue that we maybe started later than some others, but I think we are now running a more complex strategy not only to moving to unit linked and risk products, our strategy is uniquely in risk products, yes, but a big focus on the capitalized or capital-efficient product for this other alternative guarantee concept, which we are running now, whether it is the fix index annuity in the U.S., then copies of this product in the German markets plus some new and innovative developments for the German market specifically. And that allows us actually to show the bigger IRR. That this product needs to be training with all the sales forces and also with independent financial brokers that therefore the volume is going down when you say, I don't want to give you the traditional product, I would say that is a transition phase.

I don't think it has anything to do with the product that is now acceptance and training. And when more – actually in Continental Europe, it would be good for us then more market participants would copy our product strategy, because then it is becoming much easier as a market standard. And then we can, I think, with the size of our organization and the advantages we have in having dealt with this product earlier, I think also call our market shares further.

LatAm, I would not compare it with Russia at all. Russia was a structural problem of the market, which disadvantaged foreign players against local players. I cannot say the same in Brazil. I think in Brazil is an open market and everybody who is doing the right things can be successful. And we are still believing that we can do the right thing.

But the economic outlook in the country has changed quite a bit. And therefore the transition, in particular in hotels (40:34) but also in motor retail, it's a bit harder. Customers are really very keen to get the best price offer and the negotiations are tougher when an economy is not doing well. And that is the main reason for the Brazilian delay, but we stick to our plans. So, don't mind this answer. Sorry.

Q - Farooq Hanif {BIO 4780978 <GO>}

So, yeah. And sorry for the long questions as well. But just quickly, so are we within sight of profitability within a year, two years?

A - Dieter Wemmer {BIO 4755450 <GO>}

I think it takes a year longer than we have hoped. But I think we are turning. And still for me Brazil, but also now Argentina is clearly important upside potential for next year.

Q - Farooq Hanif {BIO 4780978 <GO>}

Okay. Thank you very much.

Operator

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

Q - Michael I. Huttner {BIO 1556863 <GO>}

Fantastic. I'm going to lobby for you, obviously this is not a real question, but I was just a bit surprised that you're cutting costs at AGI when they're doing so well and I just wondered why that is? It's a bit of a lobbying question, I apologize for that.

And then as a completely off the world question, and I may have misunderstand these things, since you're writing new business in Life, capital light and you're stopping the capital intensive, presumably the Life's embedded value account is slowing up, is releasing lots of free surplus. What are you doing with that money? Thank you.

A - Dieter Wemmer {BIO 4755450 <GO>}

Yeah. So AGI, the cutting cost exercise, these are mainly on back-office and administrative functions. We are actually globalizing functions. We could have globalized already sometime ago, but it's the finance function and other back-office function. So it will not stop the great distribution and products development as well as product successes. So we do it really in a very measured basis to the benefit of both sides.

The new business in Life, yes, that is the long-term idea that the new business mix is creating a higher Solvency ratio for each of the balance sheet. That will be one of the levers we are using to improve the IFRS ROE of our Life OEs. And exactly on this point we will explore further on the Capital Market Day on November 24.

Q - Michael I. Huttner {BIO 1556863 <GO>}

Thank you. That was really quick. Thank you very much.

A - Dieter Wemmer {BIO 4755450 <GO>}

But, well spoken.

Q - Michael I. Huttner {BIO 1556863 <GO>}

Sorry. No, thank you.

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>}

Hi. Afternoon. I've got three questions, please. Firstly, on capital. Given these are sort of nominal (43:50) numbers, and you've included a couple of IMAP adjustments, are these basically your sensitive numbers, obviously, without the formal approval, first question.

Second question, on performance fees, can you comment on a little bit how much your freed up performance fees, and I was expecting more of this to come through 4Q and 3Qs. I want to know how much we've got less for 4Q. Can you give some guidance, please?

And then just, finally, just a follow-up on the Life product changes. Obviously here this is a good news for ROE. I just wonder whether you need to do more in terms of expense management at some point on the back, but given I think should not replacing the nominal profit you'd be generating on traditional products for this new style guarantee Life products? Thank you.

A - Dieter Wemmer {BIO 4755450 <GO>}

The performance fees, certainly there is substantially more to come, but I would not guide to a specific figure because the booking and accounting of this performance fees is spread over September till January, potentially February. So how much will exactly hit three months, I think, that is too difficult for me to estimate it precisely. And you would only shoot me afterwards and I'm giving the wrong number and I want a peaceful Christmas this year.

So, on Life, well, in a number of policies, we are not reducing. So, therefore, the admin task as such will stay the same. The new products are not less complicated. So, that is not a natural source of savings. And actually when you want to improve the IFRS result and CRE, the risk management actions what you can take are bigger drivers than admin costs.

Before you'll see the impact of admin costs in the Life ROE for our Continental European businesses, I think you'll have to send every second employee home that you'll see something and that I wouldn't see possible to run the business like this. So, therefore, it is a driver, but in magnitude pretty small.

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

Okay. Thank you. And just on...

A - Dieter Wemmer {BIO 4755450 <GO>}

As far as the Solvency II, yeah, that is my understanding of the final approach to the approved number.

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

Okay. Fantastic. Thank you.

A - Dieter Wemmer {BIO 4755450 <GO>}

Of course. If there is any last minutes incoming from the regulator, I'm not assuming it, but that is still the caveat I have officially to make.

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>}

Oh, hi, there. Thank you very much. Couple of questions. The first is actually again on Solvency II. Dieter, I just wonder how you justify the 150% CAL coverage when, as you know, peers are on 250% and 300%? And then different probably just wanted to look at Italy, and the combined ratio is exceptionally good. And just wondered if you could explain a bit more how sustainable you think that is? Thank you very much.

A - Dieter Wemmer {BIO 4755450 <GO>}

Yeah. Well, I think the justification is pretty simple on the U.S. equivalent. That is the official rule communicated by EIOPA and the German people are obviously very simple, they just follow rules. And but also for the CAL it is a more complex concept because, depending on your business mix in the U.S., 100% CAL is translated in European language quite different depending on what business you are writing.

And when you look at our net asset value levels in our U.S. Life business, which are substantially higher also when you divide it, for example, by the asset of the balance sheet, you see that our capitalization and our U.S. subsidiary is substantially higher than some of the peers you have mentioned. And that it won't be another explanation why 150% is sometimes a better number and a bigger number than 250%.

Q - Nick Holmes {BIO 3387435 <GO>}

Dieter, that's very interesting. Can I just follow up on that? I mean, do think other regulators who are requiring 250% and 300% are interpreting EIOPA's 150% guidance in the same light that you described, i.e., they are looking at the quality of the CAL ratio?

A - Dieter Wemmer {BIO 4755450 <GO>}

I think that is clearly among the European regulators an understanding that regulation for VA and the U.S. has not moved a lot since the financial crisis, and the European regulators still they are watching this development. And that is always when you have any discussion on the international capital standard between U.S. and Europe, that is the main discussion point. And therefore, the CAL is would say is VA-adjusted in its interpretation by the European regulators. We all have developed a good understanding of this and the regulators in Europe are smarter than many people believe here.

Q - Nick Holmes {BIO 3387435 <GO>}

But, just one final question. I mean, is that interpretation entirely judgmental or is there any additional guidance that you're giving over how to measure the relative risks of the VA book and stuff like that? Well, is it entirely out of the judgment of the Dutch regulator, and the French, and the British?

A - Dieter Wemmer {BIO 4755450 <GO>}

I think, what you – the latter you said is true.

Q - Nick Holmes {BIO 3387435 <GO>}

Okay.

A - Dieter Wemmer {BIO 4755450 <GO>}

I'm not going to – maybe they have an internal discussion about this and discussed it in the EIOPA board meeting together, but I am not participating in this month. So, then you'll have to ask the regulator on this one.

Q - Nick Holmes {BIO 3387435 <GO>}

That's very helpful. Thank you.

A - Dieter Wemmer {BIO 4755450 <GO>}

Yeah. And the Italian combined ratio, sure it is a really good combined ratio, and we have a strong advantage over the markets since many years and quarters. So the distance to the market has not moved a lot. And we should also – actually we included the Unipol business in this and still the combined ratio stayed at a very excellent level.

And I would expect that we still see pressure from the motor business. But we have, for example, when I compare it with a year ago, we have a 10 percentage point improvement in our commercial business. And so, to reduce Italy to motor-only is maybe not fair to our Italian colleagues.

Plus, what I mentioned on the first page, our retail non-motor product, which we are selling now with large number of pieces, is also contributing to a stable good combined ratio and that effects we are managing. And I would see, yes, clearly pressure from motor in the next year, but also positive in the other categories. So, overall, still a very strong outlook for our Italian business.

Q - Nick Holmes {BIO 3387435 <GO>}

And just as a very quick follow-up, what percentage is motor of earnings would you say?

A - Dieter Wemmer {BIO 4755450 <GO>}

You mean in Italy?

Q - Nick Holmes {BIO 3387435 <GO>}

In Italy.

A - Dieter Wemmer {BIO 4755450 <GO>}

Around 60% premium.

Q - Nick Holmes {BIO 3387435 <GO>}

60% premium.

A - Dieter Wemmer {BIO 4755450 <GO>}

Maybe a bit more because we have also the big direct business included in this year.

Q - Nick Holmes {BIO 3387435 <GO>}

Right. Okay. So, yeah.

A - Dieter Wemmer {BIO 4755450 <GO>}

I have to look it up. I don't know it by heart.

Q - Nick Holmes {BIO 3387435 <GO>}

Okay. Thank you very much indeed.

Operator

We will now take our next question from Andy Broadfield from Barclays. Please go ahead. Your line is open.

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

Oh, hi. Good afternoon. A few questions for me. So, the first, just on reserves, can you just give us a bit of a feel for where the release is coming from? Whether there's been any changes over the last few periods, as to whether they're rising from, whether they're fairly poorly set?

And also just you've clearly focused on the Latin American business, basically Argentina on the cleanup and you have also did with Russia. How should we think about the temptation from our side is to say, well, where we dealt with next year, and then we can improve your numbers by that amount. You're clearly an organization that always has things going right and wrong all the time. Do you view these as exceptional restricted jobs or they just kind of run-of-the-mill? Do you see them more as like run-of-the-mill for an organization like yours?

And then just, finally, on the Life, just returning to the life product mix shift and the hope that – or the expectation to shift the products. Is it right to assume that the profits you generate on a €100 of unit linked product will be in absolute terms less than €100 of traditional product? And therefore, when we think about absolute profitability of the new products, it should be lower than on the traditional products? So, if you can just give us a feel for that absolute level of profits generated by those unit of premium?

A - Dieter Wemmer {BIO 4755450 <GO>}

Okay. So let's start with the reserve releases. It's really oddly distributed to many OEs. Clearly, Italy is always part of it. Our large corporate business is always part of it. Oil level (55:16) is always showing a strong positive run-off, but also Spain. So, actually, all the one who show really this and excellent combined ratios always have a process of very prudent reserving and recycling then as run-off.

So, therefore, we show in these countries also a worse accident year loss ratio maybe than some others, but that comes then big later. And you cannot have every quarter a strong positive run-off result, and then not having it at the end.

Well, actually, LatAm, sure. I cannot promise to you for 100% that there will be no new LatAm next year in another place of the world. I would not see it for the moment, but you can also say, I didn't see Argentina a year ago, otherwise we would have prevented it. I'm still positive that we get LatAm moving the Fireman's Fund story. Yes, the cleaning brought actually still some more items to the surface, which need to be cleaned, but the progress at Fireman's Fund is very strong and the integration is really very well working.

So, the Life mix change, I am inclined to say no to your question because the new business margin is nothing else than the present value of the future profits. So the operating profit coming out of it, forget the taxes, stands the correction of the duration of support that over how many years it will emerge. So if €100 of premium has the same new business margin, then it will also generate the same operating profit.

Now, it gets to the more advanced calculation. You have a little bit less profit emergence on unit-linked because you have less capital charges on it, therefore also a smaller risk margin embedded, and the risk margin also comes up as operating profit. However, the unit-linked business is quite often attached to PIMCO or AGI fund. So we have also a profit emergence in our asset managers.

So, therefore, in total, taking everything into account, I would say it's equal; plus, minus around it.

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

Okay. That's very helpful. Thank you.

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>}

Good afternoon. Thank you. Just, Dieter, on the Solvency sensitivities, which seem to have changed reasonably significantly in 3Q, particularly on the credit spreads and also on the interest rate. One discussion I was having with the Investor Relations team was it's linked to the policy holder participations and indirectly linked to the level of interest rates, and that is intuitive.

But is this sort of a bit worrying that suddenly we have such a big impact in the sensitivities as well, so it's sort of a moving scale for us and the movement is quite high? And just any thoughts on that would be really appreciated.

Then two more clarification questions maybe. In Korea, the understanding I had was that, if interest rate worsen, it could again worsen. But you seem to suggest that the two portfolios which needed these charges are sort of fixed. Just could you confirm that, please? And lastly...

A - Dieter Wemmer {BIO 4755450 <GO>}

Right.

Q - Vinit Malhotra {BIO 16184491 <GO>}

Sorry.

A - Dieter Wemmer {BIO 4755450 <GO>}

Yeah. No, go ahead.

Q - Vinit Malhotra {BIO 16184491 <GO>}

Sorry. Last question is very quick one as well. The P&C in Germany, the investment contract type of business, now we can also see a material change in the investment income line, where the investment contract line shows up part of the net harvesting and quite a significant change from previous quarters in history. Is it a one-off-ish impact?

A - Dieter Wemmer {BIO 4755450 <GO>}

In which balance sheet, sorry?

Q - Vinit Malhotra {BIO 16184491 <GO>}

In the P&C investment income line, we see a – the role of an investment line for reserves and investment contracts. And that has significantly changed in this quarter, used to be minus €100 million, minus €50 million and now it's minus €8 million, and probably is linked to this AV, the change...

A - Dieter Wemmer {BIO 4755450 <GO>}

Yeah. Yeah. That is related to the Life book.

Q - Vinit Malhotra {BIO 16184491 <GO>}

But is it sustainable?

A - Dieter Wemmer {BIO 4755450 <GO>}

Yeah.

Q - Vinit Malhotra {BIO 16184491 <GO>}

So is it a sustainable effect or is it just a slot and then...

A - Dieter Wemmer {BIO 4755450 <GO>}

No, no, that is a bit also again the compensation for the write-downs in the portfolio. That is pretty much like the German Life business, because this portfolio is actually, in the mechanic, a smaller copy of the German Life book but within the P&C company.

I think it's confusing for many people what a Life product has to do in a P&C balance sheet. But that is the way how it started many decades ago. But in this yield environment, the product will probably not have such a brilliant future. And so – but it is also more driven by the financial market losses in the quarter.

Q - Vinit Malhotra {BIO 16184491 <GO>}

So it could normalize. Okay. Thank you.

A - Dieter Wemmer {BIO 4755450 <GO>}

Yeah, yeah. I would normalize it. So Korea write-down because this is a form you like, mechanical calculation. So, therefore, you can actually say with pretty high certainty. Today with today's interest rate in Korea, there will be no further write-down to this year.

Q - Vinit Malhotra {BIO 16184491 <GO>}

And is this a beginning of period point or end of period point that you measure this formula in Korea?

A - Dieter Wemmer {BIO 4755450 <GO>}

This is a 16-quarter rolling average.

Q - Vinit Malhotra {BIO 16184491 <GO>}

16-quarter.

A - Dieter Wemmer {BIO 4755450 <GO>}

So, even if the number in the last quarter moves a little bit further, the 16-quarter rolling is clearly seeing. But that also tells you that it is not going away for 2016.

Q - Vinit Malhotra {BIO 16184491 <GO>}

Fair enough.

A - Dieter Wemmer {BIO 4755450 <GO>}

And the Solvency sensitivity, I think you spotted the right driver that is the lower policy holder participation, but that is not driven by the market movement of 20 basis points. Yes, to some extent, but we had a large share of our internal model driven by the feedback from the regulator in the summer and that has increased then finally also this volatility number. So, that is also a consequence of the conversions process to the final Solvency II number.

Q - Vinit Malhotra {BIO 16184491 <GO>}

Okay. All right. Thank you, Dieter.

A - Dieter Wemmer {BIO 4755450 <GO>}

So it's not that you have to now, if 20 basis points that we move further up, that is not happening yet.

Q - Vinit Malhotra {BIO 16184491 <GO>}

Fair enough. All right. Thank you, Dieter. Thank you.

Operator

We will now take our next question from Michael Haid from MainFirst Bank. Please go ahead. Your line is open.

Q - Michael Haid {BIO 1971310 <GO>}

Thank you very much. Two questions. First, on the payout ratio. I am a big fan of your payout ratio, 50%, on stated net profit and on the dividend continuity. And to my understanding, the 50% goes for the stated net profit. What do you do in a year when if the net profit goes what you think is above the normal level? Do you adjust for one-offs or is it just the stated net profit, and you try to manage down earnings in other ways?

Second question, German Life business, you mentioned that the first quarter and second quarter you had assumed lower policy holder participations. In the third quarter, it goes up. Is it that usually in the fourth quarter we see a burden in the IFRS operating profit from German Life or should we expect just no seasonal impact here?

A - Dieter Wemmer {BIO 4755450 <GO>}

Okay. So, first of all, the payout ratio is our stated policy that 50% of the net income is paid out as dividend, and we clearly said we want to stick to this dividend policy for a number of years and it was not meant as a one-off. And the result is what the result is. And it will be 50%, and I tried to guide in my speech that the 4% in net income cost we have at the moment for the nine months that this could further improve by year-end when you also assume that the operating profit ends up higher than at year-end. That was what I tried to say, but maybe I was not successful in what I am saying.

The German Life policy holder participation is actually pretty stable. We had in 2014 for the whole year 83.1%. At the moment, year-to-date, it is 82.3%. So, that are small movements which are mainly coming also from accounting differences between local staff and IFRS, which are always influencing also this number overall.

In the last quarter, there are sometimes effects in the German Life operating profit coming from the true-up calculation on the debt amortization, depending on the year the true-ups. I cannot tell you what would be the outcome of the true-ups this year.

Q - Michael Haid {BIO 1971310 <GO>}

Okay. Thank you very much.

Operator

We will now take our next question from Frank Kopfinger from Commerzbank. Please go ahead. Your line is open.

Q - Frank Kopfinger {BIO 16342277 <GO>}

Good afternoon, everybody. I have two questions. My first question is on the 117% combined ratio at Fireman's Fund. Can you comment a little bit there on this development? Do you expect more restructuring charges there or should we expect even there is a strengthening going forward here?

And then my second question is overall on taken goodwill impairments. As your Munich neighbor yesterday indicated that, especially in its German Primary Life business, the interest rate could be at risk triggered by the low yield environment. Do you see the same risk here not only at your German entities, but maybe broadly speaking as we just had it with the degrade of Northern Korea?

A - Dieter Wemmer {BIO 4755450 <GO>}

Yeah. That was the question I answered before that I do not see the Korean issue in any other bell on Street. Certainly, that is a normal regular amortization of deferred acquisition costs, because in the end deferred acquisition costs would have an end to their lifetime, as underlying policy is matured. So, that should be gone. That is the normal process. So, therefore, there is an ongoing amortization of it, but this one-off triggered by loss recognition event, I think that is limited to Korea.

And goodwill impairments, in particular in Germany, I wouldn't foresee in the strengths of our balance sheets and also with the money and profit we are producing. Our German Life business too, as a reminder, has a 15% ROE. When a 15% ROE couldn't support a goodwill, that would be a really sad economic situation.

Q - Frank Kopfinger {BIO 16342277 <GO>}

And maybe, for other international entities?

A - Dieter Wemmer {BIO 4755450 <GO>}

For the third quarter, we've tested all our goodwills as nobody is in trouble. Fireman's Fund, sorry, I almost forgot about it. I think we still have too much expenses and infrastructure on it and we had some cleaning of the numbers so far. So the 117% is certainly not the underlying run rate of the business.

We had still not a good loss ratio there and also the expense ratio is still too high. But in the expense ratio, we moved already to 32% now in the third quarter. And so, one who remembers the story from last year that we started in the commercial business with some 40% expense ratio, I think we have done a tremendous step forward this year. The loss ratio is mainly affected also by some cleanups or writing off on premium receivables and things like that. So it is not that we increased loss reserves in Q3 end. I would also not expect loss reserve increases in Q4.

Q - Frank Kopfinger {BIO 16342277 <GO>}

Okay. Thank you.

Operator

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

Q - Paul C. De'Ath

Hi. Good afternoon. A couple of questions for me. Firstly, just looking at the Life new business and ongoing shift away from traditional products. Clearly, you've had great success in Germany with your kind of reduced but still some elements of guarantee products and the successes (1:11:24), et cetera, and the fixed income annuities in the U.S.

I'm just wondering, in the likes of France and Italy where unit-linked seems to be coming to the full, is there any scope to put some of your I guess lower guarantee products into those markets as well or are you happy to just continue down the European (1:11:52) unit-linked route in those markets?

And then, the second question was just on PIMCO and the cost income ratio, which obviously showing signs of improvement. I think I remember, during the issues that PIMCO has been having, you've been kind of increasing the level of marketing spend, et cetera. And now that PIMCO seems to be turning a corner kind of further down the line, should we expect the expenses to start reducing again just as you're now bigger? Thanks.

A - Dieter Wemmer {BIO 4755450 <GO>}

Yeah. Thank you for the question, Paul. I think, in France and Italy, France is now running in its new business mix in the retail space at 50% unit-linked, 50% still the traditional. We are certainly thinking of whether it'll be in the next years what we call the hyper product. So fixed index annuity style could be helpful.

In Italy, we are now I think closer to 80% unit-linked, but also there the fixed-index annuity product is in the design phase, how we find a version which really is suited to the Italian market. We believe from the U.S. experience, and in particular with Italian expense structure, which should really create a very good product, and we will certainly see how fast we can bring it to the market.

PIMCO is already showing good quarter, 2 percentage point improvement in the cost income ratio, and that is certainly not coming from a recovery of the revenue line. So the 2 percentage point is really a reduction of the one-off expenses, but also a reduction of the expenses related to the volume.

I think, all-in-all, we could probably see that in the back-office processes about 40% of the cost variable. We still have the increased marketing costs and some other one-offs and the retention packages as a one-off still in the numbers. So, going forward, we are certainly – we were already I think optimistic in summer about PIMCO's development, but our optimism is growing with the development at PIMCO.

Q - Paul C. De'Ath

Excellent. Thank you.

Operator

We will now take our next question from William Elderkin from Goldman Sachs. Please go ahead. Your line is open.

Q - William H. Elderkin {BIO 3349136 <GO>}

Thank you. Good afternoon, everyone. Three questions. Just back on the dividends. I don't think I've understood the policy correctly. In a scenario where your capital is absolutely fine but net income for whatever reason is down a bit year-on-year, would the sort of ambition to keep the dividend flat win or would you sort of allow the payout ratio to rise above 50% if need be or is the 50%, say, a fixed number if you will?

Secondly, just on the very strong Italian combined ratio, I mean just how much of that combined ratio do you think is coming from the core Allianz business and how much being impacted by the portfolio transfer from Unipol? And finally, do you have any sort of exposure to the liability risks faced by certain German car makers?

A - Dieter Wemmer {BIO 4755450 <GO>}

Okay. So, that's an interesting new question. Yes, I did not mention the second rule of our dividend policy because I thought, when I mention it, you will all conclude on the phone that I am predicting a falling net income. So, therefore, I stayed away from this. But you are right. In case the net income would be a bit smaller than the year before, we stick to the previous year dividend, which translates then into a payout ratio above 50%. That is the a stated dividend policy. But I thought that could be misinterpreted when I use it.

In the Italian combined ratio included for the Unipol business, let's say, roughly €200 million in the quarter at a combined ratio of, let's say, €94 million. That was what you wanted to know. And then, certainly we have a share of the D&O programs of most German car makers. So, but the limit we have for our share on each policy is clearly defined. It will not create a big number when any European or U.S corporate would come with a claim under their D&O program, and that is I think well-maintained.

Well, I think our risk management in the large corporate business, you can also see, how we actually handled the Tianjin harbor claim. Our predicted loss on this is some €60 million. And actually we took very much the learnings on storage claims from the Bangkok flood event three years ago where we had this surprise concentration from many European and international corporates.

And we are now really much more careful on storage concentration and don't want all this to be hit by unknown clash. And that is a part of our overall risk strategies.

Q - William H. Elderkin {BIO 3349136 <GO>}

Very clear. Thank you.

Operator

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

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

Hello. Hi, there. Two very quick questions. Dieter, I think you mentioned that the PIMCO had positive net flows in October. Can you give us any more detail across which strategies? I'm assuming you're still seeing outflows in the traditional books. So this is presumably in the income fund. Or is there any – is it broadly spread? Just any more color as to the nature of the flows you're seeing. Is the expectation – I think your original expectation was you hoped PIMCO would be break-even flows in Q4. I guess you're now suggesting it could be positive in net flows for Q4.

And my second question, just a quick one, on the expense ratio, P&C expense ratio, you talk about special effects, business mix changes, and obviously the commission ratios edged up slightly. Is the Q3 expense ratio, is that at ongoing level or the commission ratio continued to rise a bit? I'm not sure what the noise factors are to think about on the trajectory there. Thanks.

A - Dieter Wemmer {BIO 4755450 <GO>}

Yeah. Thank you, Andrew. Well, I don't want to guide to a final number for the inflow at PIMCO for the quarter. I have absolutely just reported about the October number. And when we analyze the development in Q3, we can actually say that we have seen already with the customers in Asia, with the customers in Europe and Middle-East and Latin America, each had positive net inflows for the quarter. So the U.S. was actually from a region the area where we still have seen the outflows in Q3. So, that is then the area to turn around.

In particular, the income fund you mentioned are really doing well. For the first 10 months, we had close to $12 billion of inflows in this fund only. And our global wealth management had a very good month in October. So I think that are the main areas and the general information I would give to you, without now really going into the full autonomy of the October numbers.

Your other question was on the expense ratio. I would say there was some special effect in Q3 on the admin expense ratio, which will normalize in Q4. The acquisition expense ratio, that development is probably not rewarding as our fastest growing areas are the areas with higher commission rates.

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

So it should stay around this level then?

A - Dieter Wemmer {BIO 4755450 <GO>}

Well, in admin, maybe 20 basis points, 30 basis points down.

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

Okay. And then – okay. But I guess the commission ratio could still edge up a bit further, sounds like?

A - Dieter Wemmer {BIO 4755450 <GO>}

Yes.

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

Okay. All right. Thank you.

A - Oliver Schmidt {BIO 2473131 <GO>}

Okay. We have time for one last question, if there's any?

Operator

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

Q - Michael I. Huttner {BIO 1556863 <GO>}

Fantastic. So there was a – a few hours ago, there's a big mine flood disaster thing in Brazil. And so is there an exposure to that? And alike to that, can you say a little bit more about the trend in large losses, if it's just a term? One of your competitors clearly has issues with that and just a bit of a resource would be lovely? Thank you.

A - Dieter Wemmer {BIO 4755450 <GO>}

Michael, I won't go whole day in communication. So, therefore, I don't know what had happened in Brazil and in the mining industry there. So, therefore, I can prefer not to comment on this. I believe I mentioned that our accident year loss ratio had 50 basis points increase in Q3 from large losses and that's attributed across many. So I would still consider it as a small uptick, nothing really special.

Q - Michael I. Huttner {BIO 1556863 <GO>}

Okay. So, no special accidents and no...

A - Dieter Wemmer {BIO 4755450 <GO>}

No cleaning up of portfolios.

Q - Michael I. Huttner {BIO 1556863 <GO>}

Lovely. Okay. Great. That's all. Thank you so much.

A - Dieter Wemmer {BIO 4755450 <GO>}

Thank you. Then, I thank you all for dialing into the call and participating so actively with your questions. And I hope I see all of you at our Capital Markets Day, which is, Oliver, on...

A - Oliver Schmidt {BIO 2473131 <GO>}

On November 24. Yeah. Good bye from my side as well. And we wish you all a very relaxed weekend. Thank you.

Operator

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