Q3 2017 Earnings Call

Company Participants

- Christian Becker-Hussong, Head-Investor & Rating Agency Relations
- Jörg Schneider, Chief Financial Officer & Director

Other Participants

- Andrew J. Ritchie, Analyst
- Guilhem Horvath, Analyst
- James R. Oram, Analyst
- Jonny Urwin, Analyst
- Kamran Hossain, Analyst
- Michael Haid, Analyst
- Michael Huttner, Analyst
- Nadine van der Meulen, Analyst
- Paris Hadjiantonis, Analyst
- Thomas Seidl, Analyst
- Vinit Malhotra, Analyst

MANAGEMENT DISCUSSION SECTION

Christian Becker-Hussong {BIO 19080254 <GO>}

Thanks for joining us for our Q3 earnings call. Today, a very simple procedure, as always, very straightforward, after my short introduction, we will hand it over to Jörg – or rather to your questions. And we will go right into Q&A. And may I please ask you, as always, to limit your questions to two per person in order to give everybody a fair chance to raise questions. So, thanks for that. And then I'll give it back to Sylvia, and we can start with the Q&A right away.

Q&A

Operator

Thank you, sir. Thank you. We will take our first question, Nadine van der Meulen from Morgan Stanley. Please go ahead. Your line is now open.

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

Yes. Good afternoon. Thank you for taking my questions. I suppose, firstly, perhaps you can comment on your expectations on sort of broad based pricing into next year, and maybe not just on the loss impact areas, but also outside of the U.S., and (01:47) but casualty, et cetera, so in different lines of businesses. Any anecdotal comments will be very much appreciated.

And then the – yeah, and then perhaps also in light of retrocession cost, to what extent you see that going up for you next year or maybe now with the renewals already that you've done. And then, the second question is on Life and Health Re, that continues to be impacted by negative captures in the U.S.. When should we expect this to turn around? Thank you very much.

A - Jörg Schneider

Thank you, Nadine. Good afternoon, ladies and gentlemen. Our expectation for the development of the pricing, especially in the incoming renewal round for January 2018, overall, I must say we are optimistic after five years with very low nat cat losses, we saw price declines since 2013, albeit at a lowering pace. In the most recent nat cat events, a lot of capital has been destroyed; a lot will at least be trapped for a couple of months. But there's also capital spending at the sideline. But when it comes in it, will come in with high return expectations.

So, overall, the background for the negotiations is substantially improved. We see positive dynamics for the worldwide insurance market. But competition is still strong. As we are at an early stage of the January 2018 renewal season, we can only talk about trends. I hear one or two examples each day from my colleagues where we see substantial rate increases, but I do not want to fuel an unrealistic fantasy here. Overall, prices should at least stay flat. That is the least we can say overall wherever we look. Price reductions will not be accepted anymore in that market. The extent of the price increases will depend on the individual segments and/or whether losses have occurred or not. So, the closer to the events, the closer to Southeastern USA and Caribbean, the higher the price increases will be. But any quantification would be unrealistic at this point in time.

With regard to the retrocession costs, they will also go up. For Munich Re, this is not a major issue. As you know, we are a gross-equals-net writer and, therefore, also the relief from retrocession from the enormous loss costs of this quarter is somewhat limited. And therefore, we are not so sensitive here yet. So, we will see, we are, in a way, somewhat opportunistic here. The more attractive the terms are the more we will buy and vice versa, but we are absolutely not dependent. That is currently an advantage of Munich Re.

With regard to Life and Health Re, we've been doing active portfolio management for a couple of years now, and it's, in a way, by chance that we see now a kind of accumulation at the moment here. And if I may add, we took the most worrying contracts and concentrated our efforts in the negotiation with the respective clients.

So, therefore, I do not expect the current pace to go on like that. We are flexible, we do not have a budget, we do not have a timing. What you don't see in the numbers is that we also talk with our clients on price increases. When these happen, they will typically not have an impact on our IFRS numbers of a given quarter. So, therefore, it's very active scene and very difficult to predict. There might be additional recaptures, but currently, as far as I know, none is directly in the pipeline for the fourth quarter. I hope that it helps a little bit, Nadine.

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

Very clear. Thank you so much.

A - Jörg Schneider

Thank you, Nadine.

Operator

Thank you. And now we'll take our next person from the queue, Paris Hadjiantonis from Credit Suisse. Please go ahead. Your line is now open.

Q - Paris Hadjiantonis {BIO 19703051 <GO>}

Yes. Thank you very much. Good afternoon and thanks for taking my questions. The first one will be on the development of your Solvency II ratio, despite the very large losses, that is down only 3 percentage points. And I understand that you do have some positives from the recapture in Life Re and some others. If you quantify some of that, that would be very nice.

And then, secondly, on all of these press reports, we have been hearing about ERGO, the German Life, the runoff portfolios, where do we stand with regards to a potential sale of those portfolios? What is the rationale for selling those? And if you potentially give us an idea of what the Solvency II benefit could be from a sale of those very large portfolios that would be helpful. Thank you.

A - Jörg Schneider

Good afternoon, Paris. Thank you for your questions. First: Solvency II development. Yes, I also admit that I saw with some pleasure that our Solvency II ratio went down by only 3 percentage points from 261% to 258% of the SCR, and this in a situation where the major loss impact was very substantial, so clearly, north of 10 percentage point. But you correctly quoted one of the positive countervailing effect that was the beneficial impact from the in-force management measures in our Life Reinsurance business.

Also, we had economic earnings coming in as expected in all other areas except for property-casualty reinsurance. And at the same time, the solvency capital requirement declined a little due to various effects, one of the decline of the eligible owned funds as well as decline of the SCR was due to currency effects, which were relevant in more or less all categories of our risks.

But I would also like to emphasize market rates went down due to the increase in interest rates and a slight decrease of credit spreads. And credit here, that should be mentioned also, the tightening of credit spreads had a positive impact on the eligible owned funds as well as the positive impact with regard to a decline of the solvency capital requirement. That was an important driver of this mitigation of the hurricane loss effects.

Second question about German Life, the closed ERGO classical book; in June 2016, we had announced that we would separate the management of our traditional life insurance portfolio from our new business and pool this in another organizational unit. And even at that time, we had not entirely ruled out the sale of this business as a strategic option. Currently, we are sounding out all the opportunities and, meanwhile, we also got first indicative offers from interested parties, but it's much too early to speculate about the fact whether the overall view on the topic is attractive.

Potential benefit would be reduction of the SCR. The impact of the eligible owned funds would be dependent on the purchase price, but after diversification, the SCR effect could be somewhere around 20% of our overall SCR. It's not so easy to calculate due to the enormous diversification effects which play substantial role.

For IFRS, the impact would be dependent also on a potential purchase price. But, please, I beg for your understanding that I do not want to speculate on specific numbers now because it's much too early, and such a sale would only happen if we achieve very good solutions, not only for the number from the number side, but also in the interest of our clients, employees and sales forces. Therefore, it's still a long way to go with that.

Q - Paris Hadjiantonis {BIO 19703051 <GO>}

Thanks, Jörg.

A - Jörg Schneider

Thank you.

Q - Paris Hadjiantonis {BIO 19703051 <GO>}

Can I just follow up on the life recapture on Solvency II? Can you give us an idea of how much that benefit is on a Solvency II basis?

A - Jörg Schneider

I would love to because it's very substantial. But here, again, I ask for your understanding not to dig too deep into that because you must imagine we have an enormously high impact on our IFRS result over €100 million just from one transaction. And you also can assume that we wouldn't do that if it were not for a very attractive economic effect. But this economic effect is exactly the difference between our best estimate of future liabilities here and the payment we had to do to decline and to quantify that right after you close the deal, that wouldn't be fair, I think. And it – take it – it's a window of opportunity to a win-win situation due to different preferences, perhaps also due to a different view on the future of this contract. For us, it relieves the risks from that contract and it will also have a positive impact on future IFRS earnings. Thank you, Paris.

Operator

Thank you. And now we'll take our next person from the queue, Jonny Urwin from UBS. Please go ahead. Your line is now open.

Q - Jonny Urwin {BIO 17445508 <GO>}

Hi there. Good afternoon. Thanks for taking my questions. So, firstly, we've obviously just had one of the most severe quarters for nat cats on record, and this Solvency II ratio is largely unmoved, 3 points or so. So, I appreciate you like to hold high Solvency II buffers over and above the target range given markets and losses can be volatile. But I wondered, has this experience of the Solvency II ratio through the third quarter changed how you think about the buffers that you need? Does it suggest that you could hold less and still have plenty?

And then, I guess, in that context, should - obviously, should you get rid of ERGO, the closed book, successfully for a good price? I guess there could be a further significant uplift in that Solvency II ratio. So, how should we think about these buffers?

And secondly, just thinking about how potential price increases could work through to the combined ratio next year and, more importantly, the year after? I mean, theoretically, if the underlying profitability of the book does start to improve, would you then taper reserve releases back down from the current 6 points to the full point sort of normalized run rate? Thank you.

A - Jörg Schneider

Thank you, Jonny. Yes. For us, it was a good experience for the resilience of our Solvency II position, but it just came by chance that, at the same time, when we had the losses from the hurricanes, we had the enormous relief from the recapture in Life. We had the tightening of credit spreads. We had a very strong performance of our equities. None of these developments was a clear response to the hurricane experience. That means it could have also gone in the opposite direction. But it is clear that we do not need a 260% SCR ratio. The optimal range would be above 175% up to 220% or so.

So, I would not insist on having these high buffers. But we also have to look at the other metrics, and one important metric is rating. The other is local GAAP balance sheet of the parent company, and as you know, we hold an equalization reserve, which by the way was pretty helpful in this quarter. And therefore, our distribution capability is somewhat limited from that side, yeah. So, I'm also fine with it because it mitigates the risks and it stabilizes our distribution going forward. But we have to look also at that metric.

Therefore, I have always said, and I continue to do so, I'm very much in favor of higher distributions, but I rather think in terms of reliability of these distributions instead of doing extremely generous one-time steps. And this also applies by the way for the situation after a potential sale of the Life back book, that would be another relief that would hurt our Solvency II ratio, but the impact on local GAAP would be minor.

Potential price increases and the relationship to combined ratio and releases of our reserve. The releases of reserve in the last couple of quarters were not a function of our willingness to pep up our results. It was rather the reaction to a very impressive difference between actually reported losses and the estimations which were in place. So, we had a constantly positive difference between expected losses and our loss experienced for the back book here. And therefore, what we did was more or less forced by the accounting rules here.

We are already at the upper end of the reasonable range of best estimates in spite of the 6% reserve releases. How will it go on? I assume that, in the long run, we cannot persist having a 6% ratio because inflation has been low for a while, now it has increased a little bit, and perhaps with the time delay, there will also be another spike in claims inflation. But I'm pretty confident that the level which we indicate of 4% as being that of an on ongoing basis, that this can be sustainable. But it's pure speculation at the moment. All the indications we get, including our experience from the opt-in table range are very positive. Thank you, Jonny.

Q - Jonny Urwin {BIO 17445508 <GO>}

Thank you very much.

Operator

Thank you. And now, we take our next person from the queue, Vinit Malhotra from Mediobanca. Please go ahead. Your line is now open.

Q - Vinit Malhotra {BIO 16184491 <GO>}

Yes. Good afternoon, Jörg and everybody. Just sort of my two questions. One is on the P&C reinsurance, the normalized combined ratio has been maintained at 100% for the year. Although my expectation from earlier conference calls and conversations was that 3Q would be the period when it seasonally will be stronger. But now, it seems obviously 99% kind of level will be needed in the fourth quarter. Is there any underlying indications that give you that confidence, because typically it should have been third quarter? So that's the first question on the normalized part.

Second question is just on trying to understand the Life Re guidance, I mean, maintaining this €400 million odd even though there is a €170 million recapture, so just obviously, if there were no recaptures, the number should be much higher than the €450 million. Could you just help me square that? And also, obviously, fourth quarter would need to be a bit higher than the usual run rate of – or sorry, both questions on the target. Thank you.

A - Jörg Schneider

Good afternoon, Vinit. Thank you for these questions.

Q - Vinit Malhotra {BIO 16184491 <GO>}

Thank you.

A - Jörg Schneider

First, PC non-life, it was more or less always 100% in this year from quarter-to-quarter, and the volatility around that number was purely random. So, I wouldn't see a positive movement, perhaps there's a little bit in the fourth quarter because we had a very good renewal at 1/7, but there was also some casualty business involved. It was a mix of property and casualty quota share treaties, and therefore, the impact does not have to be combined ratio lowering. The impact from the hurricanes will be totally minor because there were some backup covers, but they don't play a major role in our portfolio at the moment. Therefore, I would be more confident for 2018 than for the fourth quarter, and I personally expect for the fourth quarter the adjusted combined ratio, which is again in the order of 100%.

And on Life Re, yes, if we adjust for the minus €170 million for the recapture, it looks bright, but this also includes there's another one-off effect on which we reported in very general terms in the second quarter which mitigated the effect of the first recapture. So, therefore, if we adjust also for that, then we are very close to what we expected before the year. And this also gives us the confidence that €450 million is a realistic number for 2018 nor conservative neither aggressive.

We will continue seeing volatility in the quarters because, when you have an assumption change which meets the hurdle of the IFRS relevance, then you have to build it into your quarterly number for the whole term of the respective contracts, yeah. So, therefore, it's an unavoidable consequence of the current accounting. It will change with IFRS 17 where we have a little bit more economic reporting on these contracts, which is from that angle helpful. So, therefore, my best guess, and I assume that this will be also the guidance we will give in March is that we continue with the €450 million number.

Q - Vinit Malhotra {BIO 16184491 <GO>}

Thank you. And can I just quickly follow up on the normalized you said you are more confident for 2018. That is for an improving trend or for a flat trend? Could you (23:10)?

A - Jörg Schneider

I would expect an improving trend for 2018 in property-casualty reinsurance due to the effect of the improvement of the market after the storms.

Q - Vinit Malhotra {BIO 16184491 <GO>}

Sure, thank you very much.

A - Jörg Schneider

Thank you, Vinit.

Operator

Thank you. And now we'll take our next person from the queue, Kamran Hossain from RBC. Please go ahead. Your line is now open.

Q - Kamran Hossain {BIO 17666412 <GO>}

Hi, just one question for me. I guess from the way I read your comments on German GAAP development, you already have strong capital position, there's no reason, in my mind anyway saying that you're not going to do a share buyback next year. Now, before I think about that, you and your largest payer continuing the capital returns despite these enormous cat losses, how long do you think discipline in the reinsurance market will last because to me it feels like there is definitely a focus on getting prices higher next year, but actually beyond that maybe we've seen that? So any thoughts on that would be most helpful. Thank you.

A - Jörg Schneider

Thank you, Kamran. First, our capital situation under German GAAP will be affected by the event. I can give you a little bit of guidance on that. Of the major losses of the third quarter, €3.2 billion, a small part happened in the U.S. (24:45) with our U.S. subsidiaries, be it in primary insurance and especially our subsidiary in Munich Re America.

The buyer directly went into Munich, understood the book of the parent company, and of that share, which remains in the U.S., it will also find its way to Munich in the form of a cut in dividends of – in group internal dividends. That means that a part or large part of the loss will appear in the Munich books. Part of that will be mitigated and compensated by a release of the equalization reserve, I would guess, some half of it.

The reason why it's not more is that it's derived from difference between the high actual combined loss ratio and the average loss ratio. And the average loss ratio is substantially higher than the planned loss ratio. That means, let's say, half will be absorbed by the equalization reserve, then we have a full tax relief on it because, for those losses which happened in the U.S., we can immediately compensate the losses by a tax relief. And same applies for the German book. That means, overall, you will see it in our local GAAP results, but only in a very moderate way.

That means our distribution capability remains intact and there is no reason, from my personal point of view, to cut the dividend. And there is also a continuing ability to continue with the share buybacks. But this is not an announcement. We never made an announcement before the month of March as far as I remember.

With regards to the discipline, the continuation of paying a high dividend and perhaps maybe also continuing with the share buyback is a sign for us that repatriation of capital is important also at times when you are faced with these challenges from the current loss experience. And it's for us also part of our discipline in the market. And perhaps some of you may have missed stronger signals and stronger wordings from us with regard how bullish we are about price increases and that we want to grow now aggressively. We think that we would destroy part of the positive momentum by being now too bullish and attract too much capital. Therefore, this is also a little bit of a background.

And therefore, I think that paying off the dividend is so important. With the discipline, at least what will happen is that the enormous loss burden will be a wakeup call that the low loss experienced in the years 2012 to 2016 is not normal, and that will help and that will be more sustainable than just for one quarter of one renewal, how long, we would see. Thank you.

Q - Kamran Hossain {BIO 17666412 <GO>}

That's fair. Thanks very much.

Operator

Thank you. And now, we'll take our next person from the queue, Michael Huttner from JPMorgan. Please go ahead. Your line is now open.

Q - Michael Huttner {BIO 1556863 <GO>}

Fantastic. Thank you so much and thank you for this lovely level of disclosure. On the buyback, you sound more positive, which makes me think – and I may be wrong, but you could even consider going forward at some stage a higher level of buyback than the current €1 billion that you've done. And I just wondered if that's a better way of thinking about the capital and the discipline and all this than a one-off or even potentially a large deal to absorb the excess capital?

And the second is on the recapture deal, I understand that you don't want to say too much because you just closed the deal and it would be a little bit unfair to kind of say, oh, it was so good. But would it be fair to say that your €450 million technical guidance could possibly improve because, as you've said, the IFRS earnings profitability is looking better now that these deals have been done?

And then the final question is kind of asking for reassurance. There's a headline yesterday that the head of ERGO might go and run Deutsche Börse. And immediately, I had some calls and investors are saying, oh, but does it mean that ERGO is not on track? Are we worried? And I just wondered whether you can give us reassurance on that front. Thank you.

A - Jörg Schneider

Thank you, Michael. First, higher level of buybacks, I would personally exclude, yeah, as I did more or less in the past also, because in a situation where you experience these losses, and more or less, they'll find their way into the bottom line, except for the tax position, then this is not the right moment to say now we do more on that front, yeah. And it's highly open whether we see attractive growth opportunities which would require a capital or things like that.

So, I do not want to anticipate the decision whether there will be any buyback, but I would personally not be in favor of doing more than €1 billion for the next phase between May and April 2019. And the recapture, as I said, there had been a one-off which mitigated part of the very bad effect of the recaptures. So, therefore, the net of this overall one-off effect is quite high. And it is clear that there will always be volatility, and the drivers can be very diverse ranging from pure claims volatility to reserve updates, recaptures and so on.

So, sorry, if after having been over 16 years in my current position, I've seen too many surprises here and I've constantly heard that the old business is bad, but the new one is in good shape. You get a little bit skeptical about that over time. I believe that we learned our lessons from this – from especially in Life Re from the pre 2009 business, but who knows, yeah. So, I would be very satisfied if the colleagues will deliver €450 million as announced. Thank you.

Q - Michael Huttner {BIO 1556863 <GO>}

And the last point?

A - Jörg Schneider

Sorry, the last question, yeah. I also read that and I think it's not up to me to participate here in the speculation. And so, I have no information of that kind. And with regard to ERGO, at least, would not deliver a reason to step down for the CEO because the ERGO strategy program is running well and that – and the programs are more or less in line with the expectations. And I'm very confident that we will be successful in the end and achieve the new level of profitability on a sustainable basis. Thank you, Michael.

Q - Michael Huttner {BIO 1556863 <GO>}

Thank you very much. Thank you.

Operator

Thank you. And now we'll take our next person from the queue, Thomas Seidl from Bernstein. Please go ahead, your line is now open.

Q - Thomas Seidl {BIO 17755912 <GO>}

Yeah, thank you. Good afternoon. First question is on the yield. I think you commented that the gap between re-investment running yield especially in reinsurance is narrowing. I mean, just looking at the number, it's 2.7% running versus 2% reinvestment. So, I wonder how quickly you will see the inflection point here coming.

And the second one is I think already asked early February but it's topical again now. The upcoming or potential change in U.S. taxes, how would impact Munich Re?

A - Jörg Schneider

Thank you, Thomas. With the yield, when you compare 2.7% to 2.0%, the 2.0% is just yield on the fixed income part of the portfolio. And that's also another contribution from the real assets which is higher. That is the average for the group. For reinsurance – for a reinsurance P&C, which is the – one of the main driver of our result here, we have a re-investment yield for the fixed income part which is 2.2%. This is due to the fact that it's a lot of U.S. dollar investments and a running yield of 2.4%. So just the difference of 20 basis points at the moment, and therefore, the decline will be minor, yeah. So it's converging at the moment, that is what I wanted to express before.

Q - Thomas Seidl {BIO 17755912 <GO>}

And in Life Re?

A - Jörg Schneider

With regard to the U.S. tax reform, many companies have large deferred tax assets, we don't. That means, if the investment – if the tax rate on U.S. income would be decreased by 15% from 35% to 20%, that wouldn't have a negative impact on us with regard to the deferred part. So, therefore, we would be a beneficiary of this decline for our ongoing return from the business – for our ongoing profits from now on.

On the other side, there are also elements in the tax reform with regard to cross-border payments, intra-group cross- border payments, which would require changes to our internal reinsurance structure, yes. So, therefore, it's not only a positive development, but I would say basically it would be very positive if this tax reform would be successful.

Q - Thomas Seidl {BIO 17755912 <GO>}

Very good. On the Life Re side, can you remind me how the gap is there, reinvestment versus running, please?

A - Jörg Schneider

Excuse me?

Q - Thomas Seidl {BIO 17755912 <GO>}

On the Life Reinsurance that you mentioned, P&C Re I think was the number that you gave. On the Life Re side?

A - Jörg Schneider

Yeah. Excuse me. That was a mistake I made, Thomas.

Q - Thomas Seidl {BIO 17755912 <GO>}

Okay.

A - Jörg Schneider

It was the overall P&C business, yeah. So, I mixed it up. Sorry. Overall reinsurance business, that is property-causality and Life and Health Reinsurance. So, therefore, a pleasing picture for the whole reinsurance book, which is so important because here it goes after taxes directly into the bottom line.

Q - Thomas Seidl {BIO 17755912 <GO>}

Yeah. Correct. Thank you very much.

A - Jörg Schneider

Thank you.

Q - Thomas Seidl {BIO 17755912 <GO>}

Thank you.

Operator

Thank you. And now we'll take our next person from the queue, Andrew Ritchie from Autonomous Research. Please go ahead. Your line is now open.

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

Oh, hi, there. Two very quick questions. Your new CEO, when he started earlier in the year, talked about one thing to ensure Munich Re was more nimble than it had been in the past taking advantage of opportunities. I guess, this is potentially an opportunity if rates truly are going to harden. Maybe, Jörg, could you tell us how much room there is for you to materially increase your risk appetite, particularly for U.S. property cat?

And in the past when there'd been harder markets, there hasn't been a huge expansion of volume. Do you think things are different now and the group is truly more nimble or you are more likely to quite significantly tactically expand your exposure in harder lines?

Second question. On the ERGO back book, I appreciate the liabilities on non-core, but are the customers non-core? There's still 6 million policies or thereabouts, how do you ensure the welfare of those customers if they do go to a third party or how do you ensure or will you need to ensure that you still have access to those customers, because I'm guessing some of them have also more profitable products?

A - Jörg Schneider

Thank you, Andrew. I'll start with the second question. Yes, that is exactly what we have to ensure. And I can't go into detail now, but this is the reason why it's a complex talk and also a complex evaluating of chances and risks in such a transaction. Because, you're absolutely right, it's our clients and still our clients and we take that point very serious. On the other hand, their respective specialists do treat their customers fairly. So, they are forced by law, they are forced by regulators and they have very good practices and a good track record from other countries. In Germany, this market hasn't been developed as it was, for example, in the UK.

With regard to Munich Re being more nimble, more opportunistic perhaps in a situation like the current, yes, we are determined to be very flexible, but not stupid. We also have to look at our risk profile. And as you know, the affected area, Southeastern U.S., Caribbean is that where we have already the highest risk exposure. That means, since we run our business on an economic basis and since diversification plays a role, it's a relatively high additional capital requirement here in our internal risk model.

Therefore, prices have to be really attractive, which we believe will be the case. Therefore, we want to grow. I am pretty sure that we will grow, but we won't do it without an eye on our economic steering of the business. Thank you, Andrew.

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

Okay. Thanks.

Operator

Thank you. And now, we'll take our next person, James Oram from Citigroup. Please go ahead. Your line is now open.

Q - James R. Oram {BIO 19736003 <GO>}

Hi. Good afternoon. This is James from Citi. I've got two questions, please. The first one, Jörg, is on the gross versus net comment you made earlier. I can see that the ceded share of technical provisions went up about €700 million quarter-on-quarter in P&C Re. And I assume that that would mostly have been driven by the losses ceded from the recent cat events. Is that not the case? But, if it is, could you go into a bit more detail on where those losses were ceded to?

And the second point is, going back to ERGO, I can see from the report that the group's overall head count fell by around 500 people during the quarter. And I'd assume that this is mostly in ERGO. We've already started to see improvements in the expense ratios there and does the drop in head count mean we should expect that churn to accelerate into 2018? And related to that, would you say you are currently ahead or sort of in line on expense beginning (41:02) at this stage within ERGO? Thank you very much.

A - Jörg Schneider

James, could you be so kind to repeat your first question? You...

Q - James R. Oram {BIO 19736003 <GO>}

Yeah.

A - Jörg Schneider

...caught me with the wrong foot with that. Sorry.

Q - James R. Oram {BIO 19736003 <GO>}

Yeah. Sorry. I was just saying that I can see a sort of €700 million increase in the ceded share of technical provisions to P&C Re from the half year to Q3. And I was just wondering if you could tally that with your comment earlier that sort of it's a gross equals net position for Munich Re more or less. So, that €700 million, I was assuming, was related to the recent cats.

A - Jörg Schneider

Yeah. Sorry.

Q - James R. Oram {BIO 19736003 <GO>}

And if it is that – yeah.

A - Jörg Schneider

Yeah. It's okay. Thank you. Thank you. It's too much, yeah, so there must be other reasons behind it, which I cannot identify at the moment. But the retrocession is lower in our case.

Second, the job cuts have begun last year. We had the restructuring expenses there. We started the negotiations with the staff councils and with the other representatives of the staff. We came into good results of these negotiations. And the first colleagues have left the company meanwhile, but we are not ahead of our plan. We are more or less in line with the plan. And part of the expense drop, which you can see in the numbers especially for the third quarter, is not only due to that fact, but rather, due to a new allocation of expenses between the various lines of business and between the operating side and the non-operating side, because we have a higher share of expenses booked into non-operating because it refers to general IT matters which have little to do with the current business, yeah. So, there is a kind of artificial effect in that. Therefore, we can't overestimate the effect, but we are on track. Thank you, James.

Operator

Thank you. And now we'll take our next person from the queue, Michael Haid from Commerzbank. Please go ahead. Your line is now open.

Q - Michael Haid {BIO 1971310 <GO>}

Thank you very much. Good afternoon. Two questions. First of all, on retro again, you said and we all know that, Munich Re essentially is gross or net underwriter, but nevertheless, to my understanding, you benefited from retro in the third quarter. And can you say how much and do you draw any conclusions from what happened in the third quarter regarding your future level of desired retro protection?

Second question on the equalization reserve, there was a relief in the equalization reserve after 15 years after 9/11, to what extent do you have to refill the equalization reserve going forward from the Q3 net cat events and could this become, at some time again, a bottleneck for your distribution for your capital repatriation capabilities?

A - Jörg Schneider

Thank you, Michael. The first on retro, I envy my colleagues from the competitors for the strong relief they get from retro. I don't envy them with regard to future expenses on retro. That is two sides of the same coin. The relief from retro was in line with our expectation and with our risk appetite, so it worked in a way. I would have preferred that the hurricanes combined forces into one because that would have been extremely beneficial for us, because then we would have had a relief of up to €1.5 billion from a combined event. Since it was three events, it was only a minor relief.

But the retro strategy has been recently after the storms confirmed by the board because it's somewhat opportunistic, it has an element of continuity. And it's fully in line with our risk appetite and it protects us especially in the most exposed areas here.

Q - Michael Haid {BIO 1971310 <GO>}

But would you not prefer – sorry.

A - Jörg Schneider

Excuse me?

Q - Michael Haid {BIO 1971310 <GO>}

Would you not prefer to increase your retro towards more protection against frequency instead of severity?

A - Jörg Schneider

That is an interesting remark. Perhaps that could be a learning here. But it also has a price impact, yeah, so it's always two sides of the coin. It would increase the probability of a relief from retro, but that would also have an impact. And we also have an aggregate element in it, yeah. So it's a typical XL cover plus an aggregate element which worked in our case. Otherwise, we wouldn't have a release of a couple of hundred million – relief.

Then equalization reserve, first of all, the required amount really went down as predicted last year. But unfortunately, this was not the reason why we reduced the equalization reserve. It was rather the difference between the actual loss ratio of this year and the average loss ratio. And it is right that, going forward, we will have to refill the equalization reserve especially in the line of fire. And it will be low triple-digit million amounts per year, yeah, so for 2018 – a little bit lower than for 2019, 2020, not huge amounts, not really game changers for our distribution capability. But the equalization reserve – how should I say – confirms its character, yeah, but it's a very slowly moving beast.

Q - Michael Haid {BIO 1971310 <GO>}

Excellent.

A - Jörg Schneider

Thank you.

Q - Michael Haid {BIO 1971310 <GO>}

Thank you very much.

Operator

Thank you. And now we take our next question from person from the queue, Guilhem Horvath from Exane. Please go ahead. Your line is now open.

Q - Guilhem Horvath {BIO 18460437 <GO>}

Yes. Thank you. Good afternoon, everyone. The questions are – I have on ERGO. And my first one is on the 2017 profitability. We are, if I'm correct, year-to-date already within the target range for the year. What should we expect, what should we be aware of for Q4 which could lead the overall net income to stay where it is more or less? Or should you expect to be at the very top end of this range?

And the second is, what should we think about profitability for 2018? If I'm correct, we don't have that many indication for next year. If you could be a little bit more precise than that, that would be great. Thank you.

A - Jörg Schneider

Thank you, Guilhem. With regard to ERGO in the fourth quarter, I do not expect a lot of disposal gains because they had been done in the first quarter to finance (48:54). And I expect a little bit of a catch-up effect for the expenses for the strategy program which will have a negative impact. There could be a low amount of the typical DAC impairments. I do not expect it to be a lot has been done more or less in the third quarter. And except for that, I do not see any reason of a deviation from the situation in the third quarter.

So, most probably, ERGO will stay within the range of the Q3 results and within the range of the prognosis for the full year, which is €250 million upper end because there were also some weather-related claims, we had some very strong precipitation losses here in Germany especially.

With regard to 2018 for the whole group, if you had asked me until August, I would have been very skeptical. We have appetite for selectively choosing more risk here and there, less on the asset side than on the insurance side, that had been already communicated by our CEO, Joachim Wenning, where we have much better expertise and data, meanwhile, we can carefully take more risk here and there, but that is not quantum leaps. On the other side, the investment income is slowly declining a little bit, almost coming to an end in 2018. But now, we very much hope and I believe that there will be a positive impact from price increases after the hurricane events. So therefore – and, sorry, yes. Guilhem, yes?

Q - Guilhem Horvath {BIO 18460437 <GO>}

Yeah. Maybe specifically on ERGO, the profitability for 2018?

A - Jörg Schneider

Yeah. ERGO will deliver according to its plan most probably which should be a little bit north of €300 million, I think. But I look at up, yeah, from this – yeah, this year was higher than expected. This should have been €170 million and now we are ahead of plan; so between €200 million – but I will give you the number later on. Can we take the next question?

Operator

Certainly, sir. Thank you. And our last question is coming from Michael Huttner from JPMorgan as a follow-up. Please go ahead. Your line is now open.

Q - Michael Huttner {BIO 1556863 <GO>}

Hi there. It's – thank you very much for this opportunity, and it's not actually linked to the results, I apologize here, you might decide on it's too general. But the – I listened to the (51:55) conference call on Tuesday, and then moving in a big way to the artificial intelligence and replacing effectively people, but also front-office people and I felt very sensitive here, because I could be replaced by machines and with algorithms and artificial intelligence and such.

I noticed you'd launched this new direct (52:20) machine driven, and I just wondered whether – and this is a phishing question really, at what stage or at what level do you think that these more automated processes could affect the – your own core business (52:36)? Thank you. And I'm sorry it's a very general question.

A - Jörg Schneider

Thank you, Michael. You are talking about nexible, our fully automatic – automated insurance company. For us, it's an experiment. First experiences are quite good. And we built it up in just a couple of months. For us, it's kind of second option, yeah. So, it's not a move away from our sales force driven traditional insurance company, but its second option plus positive impulse for the remaining organization because we exchange – definitely, we exchange experience, we exchange tariffs. This company also benefits from the loss data and the experience of the traditional companies. So, therefore, we see it as a tool for experimentation plus interaction with the existing organization.

I would like to revert your attention – to point your attention to the Digitalization Day we have in about 10 days or so where we also on the 21st of November, where we will also talk about nexible and where we'll have presentations and share our experiences and our strategy with that regard.

With regard to Guilhem's question about the 2018 profit of ERGO, we do not make public announcements right now at the moment. It's part of our outlook which we will give March. But you can expect an increase from what we originally expected there, that was a number below €200 million, yeah, €150 million to €200 million.

So, our experience for 2017 was better than expected partially driven by tax one-off effects which will probably not repeat in the next year. Therefore, I wouldn't be too optimistic about that. For us, much more important is the long-term development and especially the path at the end of the strategy program and the sustainability of what we'll achieve by that time. Are there any questions?

Operator

There are no further questions over the phone at this time, sir. So, I would like to hand the call back for any additional or closing remarks.

A - Jörg Schneider

And thank you very much from my side. I hand back to Christian.

A - Christian Becker-Hussong {BIO 19080254 <GO>}

Thank you, Jörg. Not much to add from my side. Thanks for joining us to all of you. And I would like to remind you that we will, as Jörg just mentioned, have our Investor Day on Munich Re driving digital transformation on the 21st of November, and I hope we will see many of you here in Munich. Thank you very much, and good-bye.