S&P Capital IQ

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Allianz SE DB:ALV

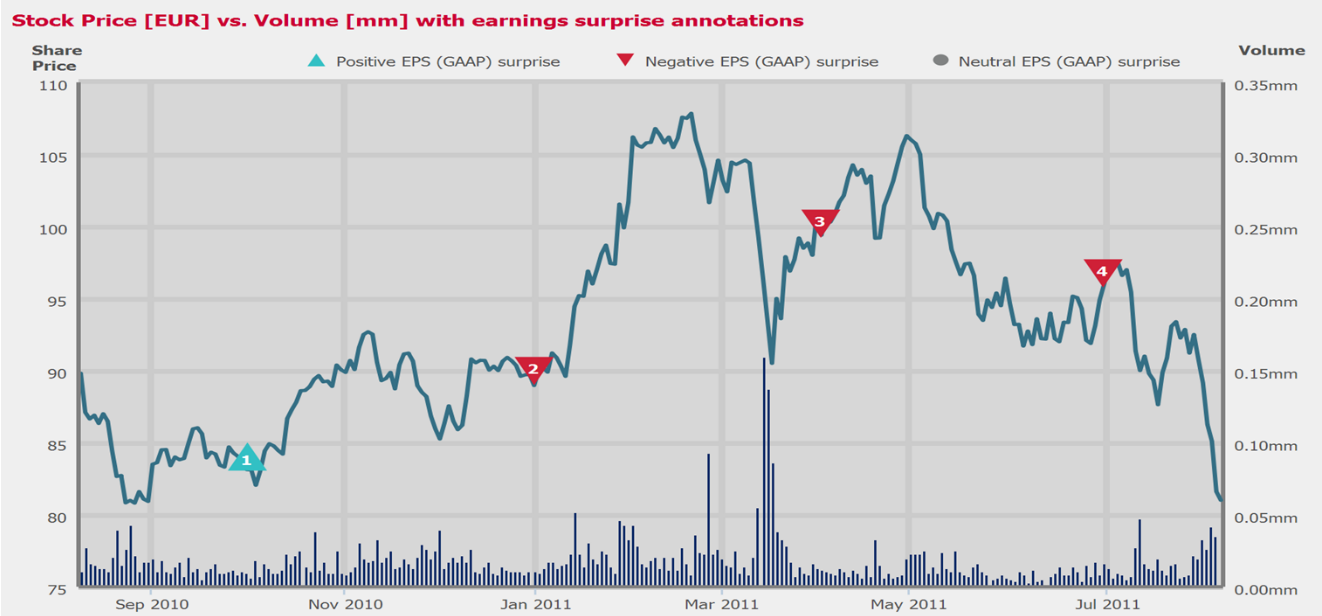
FQ3 2011 Earnings Call Transcripts

Friday, November 11, 2011 1:00 PM GMT

S&P Capital IQ Estimates

	-FQ3 2011-			-FQ4 2011-	-FY 2011-	-FY 2012-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS (GAAP)	1.65	0.34	(79.39 %)	3.27	8.14	12.13
Revenue (mm)	23646.00	24070.00	1.79	23288.00	99680.45	105230.95

Currency: EUR
Consensus as of Nov-11-2011 9:36 AM GMT



- EPS (GAAP) -

	CONSENSUS	ACTUAL	SURPRISE
FQ3 2010	2.72	2.78	1.83 %
FQ4 2010	2.62	2.49	(4.96 %)
FQ1 2011	1.99	1.88	(5.53 %)
FQ2 2011	2.57	2.17	(15.56 %)

Call Participants

EXECUTIVES

Oliver Bäte
Chairman of Management Board & CEO

Oliver Schmidt
Head of Investor Relations

ANALYSTS

Andrew Broadfield
Barclays PLC, Research Division

Brian Shea
BofA Merrill Lynch, Research Division

Fabrizio Croce
Kepler Capital Markets, Research Division

Jean-Francois Tremblay
RBC Capital Markets, LLC, Research Division

Maarten Altena
ING Groep N.V., Research Division

Meyer Shields
Stifel, Nicolaus & Company, Incorporated, Research Division

Michael Hermann Haid
MainFirst Bank AG, Research Division

Michael Igor Huttner
JP Morgan Chase & Co, Research Division

Nick Holmes
Nomura Securities Co. Ltd., Research Division

Paul F. Goodhind
Redburn (Europe) Limited, Research Division

Spencer Horgan
Deutsche Bank AG, Research Division

Thomas Jacquet
Exane BNP Paribas, Research Division

Unknown Analyst

Vinit Malhotra
Goldman Sachs Group Inc., Research Division

William Hawkins
Keefe, Bruyette, & Woods, Inc., Research Division

Presentation

Operator

Good day, ladies and gentlemen, and welcome to the Allianz conference call on the financial results for the third quarter 2011. For your information, this conference is being recorded. At this time, I would like to turn the call over to your host today, Mr. Oliver Schmidt, Head of Investor Relations. Please go ahead, sir.

Oliver Schmidt
Head of Investor Relations

Thank you, Tom. Good afternoon, ladies and gentlemen. Welcome to our conference call about the results of the third quarter 2011.

As always, our CFO, Oliver Bäte, will present the key facts and figures to you. But before I hand over to him, one quick remark regarding time. Our colleagues from Generali will hold their conference call in 2 hours time so for the sake of everybody we intend to close this call at 4:00 p.m. at the latest. I hope that's fine with you. Time is exciting enough, but I think that 2 hours would be enough to cover all your questions.

With that said, I hand over to Oliver.

Oliver Bäte
Chairman of Management Board & CEO

Good afternoon, everybody. Welcome to this quarter's call. Like the last time, I will try to be slower and briefer than in the past, 30 minutes is the objective and I'll be closely watched by my colleagues here to deliver on this promise.

I'll start with a few messages top down, then move on to the various segments and try to summarize what we believe are the highlights for the quarter, and then we'll get to Q&A as always.

Let me sort of start with Page 3 in the top-down messages, not just the numbers. With the revenues on the revenue side, we are satisfied in operating profit as well. It's actually better than expected, and it shows how resilient the portfolio is. We had severe headwinds in the literal sense of the wording because we've had 4 points NatCat loading again this quarter and despite that, our combined ratio has been fairly strong, particularly as compared to the rest of the industry.

Asset Management has performed outstandingly as well, continues to do that. Even in October, we saw no negative flows and the asset base has been growing very strongly. So Asset Management policy had in balances the decline in income that we recorded in OP in Life/Health. We had around EUR 224 million estimated impact out of the lower investment result due to the crisis. We'll talk about that, and particularly, we had some Greece government effect in the net income, you'll see on the operating profit side that is actually benign.

Now Life/Health is also holding up better than expected and it sounds the good diversification we have in the asset base. The issue is net income as is easily -- can easily be detected from our numbers. Net income at EUR 258 million and EUR 196 million for shareholders, is very heavily impacted by the financial market turmoil. This have been particularly around Greece, Commerzbank and the Hartford where there has been enormous pressure. Equity markets while they were down only a quarter, financial has been down up to 40%. The Hartford, for example, has had a 39% hit on the share price and the volatility of that share price stands at 36%, so that drives the value down of the Hartford warrants by EUR 208 million just this quarter and the accounting now is we directly take to net income. Why do we directly take it to net income, I think that was a little bit of a miss in the market. We hold most of these investments in Germany and jurisdiction where there is no capital gains tax and, therefore, no tax protection on the downside. The effective tax rate for this quarter was 60%, 25 percentage points only from the special effects out of these investments. So if you want to go to a more normalized tax rate that would have been around 35%. I think that explains the volatility here. Are we concerned about that? Yes, we are concerned, but we do not worry because our capital position continues to be strong, and we are resilient in our operating performance. Now the key question that many of you will have on their mind that so what does this net income movement mean for the year and what will it mean for dividends? Now on the year, we do not want to speculate where the fourth quarter will go. We have 7 more weeks to go and, therefore, we need to be very careful. However, what we know the net income will not reach the EUR 5.2 billion we had last year. So that is fair to say and we've written that in the interim report. We believe that we will see a recuperation of the markets. With the new government in Italy coming in, the speculation should be driven out of market volatility and we expect improvements in the fourth quarter, but we will not give a speculative outlook on what the fourth quarter will bring. We'll look at it and then see how big it is.

Now given the fact that the underlying capital position is sound and that the operating performance continues to be strong, we reiterated our outlook for the year with EUR 8 billion operating profit plus or minus EUR 500 million.

Now let's get quickly to dividends. In the past, we have normal business results, i.e., normal realizations around EUR 500 million and normalized tax rate of 30% to 35%, maintained that we would have a dividend payout of around 40% of net income, reflecting continued investment into growth of the company.

In this market environment, just sticking to this quarter does not make sense, let me reiterate, it does not make sense because of the nonoperating impairments and the tax effects really impact negatively and distort the relationship between operating earnings, cash flow and our net income.

Based on the continued strength of the operating business going forward and the stable capital position, we, therefore, believe this 40% can only be the lower boundary of a dividend position. However, this stays under the caveat that our capital position will continue to be strong and that we generate the operating profit and cash flow required to support the results. So that is the outlook. I will not commit to any specific dividend number today but, again, you can assume the 40% is off or the lower number if our capital position remains strong and operating performance continues to reach our target.

So that is what I'm going to say today about dividends and let's stick to that.

I would like to now move on to the document, starting at Page #4, where you see the overview of quarterly results. A couple of technical comments: while total revenues look 1.8% down, FX adjusted, it's 20 basis points actually plus so revenues have been stable. Operating profit down to EUR 1.9 billion. This is EUR 149 million, P&C is only EUR 11 million, Asset Management is EUR 16 million up so well balanced, Corporate’s EUR 37 million up, but Life is down EUR 135 million. You'll see later that it's solely related to the impairment side.

Now net income, significantly down, I mentioned the 60% tax rate, the non-OP effect has been EUR 1.139 billion, and we'll be talking about that in a second. The number for 9 months is minus EUR 1.784 billion, that's why I understand that some concerns were around dividend, and as I said, that is nonmaterial relative to what we see because of the volatility.

Equity is actually up, that's Page #5. We had a number of factors, shareholder net income EUR 196 million up, foreign exchange EUR 665 million up, unrealized gains EUR 100 million up and various counter effects here, debt up and equity is down that balance each other out to let the equity position grow 2.2% to EUR 43.564 million. The sharp scenarios are clear from accounting perspective, interest rate up, sharp matters the most.

Conglomerate solvency. This is the requirement that we have to pay attention to, now and for the next 2 years, that drives our regulatory concerns and that number is still very stable at 179%. And I'd like to reiterate, we don't know when Solvency II is going to come. In the meantime, we need to make sure this number matters and it does, and we are fairly resilient in terms of shocks. In this number, there is a 40% agglomeration quarter involved that we do for mathematical reasons in order to not overstate the conglomerate solvency. Again, it's not an indication of what the dividend is going to be finally.

Page #7 shows you the development of the economic solvency at a 3 basis point confidence interval. I'd like to remind everybody that Solvency II operates at 50 basis points so the equivalent would be 186 at the end of the third quarter. However, there will be lots of moving parts going forward both in terms of benign effects for us, for example, the yield curve anchoring at 20 years, which we expect, but there can also be negative effects from various items that we do not want to speculate on. We feel comfortable with the capital position. Now what personally worries me is the volatility of the numbers and we'll be talking about that going forward. It reflects lower interest rates in particular and credit spread widening that directly translate into movement of the available financial resources, in particular, credit spread widening had a significant effect in the West and in Italy. I consider them to be temporary, and in particularly, the Italian side to be noise driven.

Now let's move on to the group numbers. Quarterly revenues on Page #9, the comment I'd like to make here that beyond the internal growth number for the group, there are 2 things to be recognized. The P&C numbers look very high on a local level, there is a special effect in there. We had heavy impact from the U.S. crop business. After the storms, crop prices have really rocketed and, therefore, we have a much higher revenues, EUR 300 million to be precise, that are distorting this growth number, both on the U.S. level and for the segment. Overall, we're basically flat. Life and Health is down relative to prior year. We have effect in the U.S. and Asia. The U.S., we had spikes in sales last year that didn't repeat themselves; and in Asia, we had decided because of the fundamental change in outlook on the Japanese economy to discontinue our Life operations in Japan. That's also weighing on the segment in a positive sense from my perspective. And Asset Management is up 13%, so the strong story continues is really, really, really great.

Now operating profit on Page #10 and, I think, this gives you a very nice picture of how resilient our portfolio is in these difficult times. P&C is basically flat despite 4 points on the combined from NatCat continuously now we see Asset Management growing further. We see corporate and others improving, and we are taking the down on Life and Health. The investment income dropped overall 1.1% to EUR 3 billion, I’m hoping you will see that later and after policy participation this is just a EUR 200 million -- EUR 240 million hit, and we think we need to understand this is exactly what makes the shift from prior year.

Net income from -- impact from impairments are EUR 52.9 million, and then we have an impact from the CIPC investment in the segment of around 171% and that translates into an OP impact of minus 10% and a net effect from minus 7%, so we have a lot of policy order participation, and I think not everybody understood that when the numbers were being computed.

Let's move on to Page #11, nonoperating items. Two things that are remarkable here. The first line, the change in the impairment side. On the right-hand side, you'll see both equity impairment significantly up and debt securities on equities as Commerzbank, CIPC, UniCredit as mentioned. Commerzbank has been EUR 347 million, CIPC EUR 57 million and UniCredit EUR 45 million. On the debt security side, we do have impairments on Greek government debt and various entities and then we have a guarantee for a former Dresdner bond that is now with Commerzbank, the so-called HT1, that's the provision of gross EUR 54 million. That drives the debt impairment. And then you have the third line from the bottom, the income from financial assets and liabilities carried at fair value. The key component here has been the Hartford investment that is extremely volatile as 2 things have happened. The Hartford share price changed by 39% in the third quarter and volatility is up to 36%, so that creates a significant accounting volatility hit here.

Am I worried about it from a cash flow perspective? I don't. Overall, we are significantly in the plus on this investment that I made a comment on the dividend. We need to differentiate underlying business trends from the earnings volatility.

Page 12 gives you our exposure to selected sovereigns. Italy is included. We'll talk about it more. You see the carrying values and unrealized losses at the end of the third quarter. Obviously, these numbers have in some part deteriorated until today. Some have actually improved. So for example, the Portuguese numbers have improved.

Now Italy is a big debate, we'll have more of that later. We believe all of the noise in the last few days are sort of dumbfounded and stupid speculation, but we'll have more probably in the Q&A.

Page 13, give you the effective tax rate. We split that out 60%, 25% from the special effects and you see that we paid EUR 386 million on a net income of EUR 644 million gives you the very high rate. So that's it for the segment.

Let's quickly go to P&C, and let me give you the top numbers. Revenue is EUR 10.8 billion, up 2.2%, operating profit was very resilient at 1.1%, combined ratio of 97.6%, 4% NatCat, positive run-off 3.6% and we'll talk about the components as we go forward.

Page 16 gives you the growth numbers, I don't want to make any particular comment other than explain to you some abnormal affects. One is reinsurance. We had Munich Re quarter share last year that ran off. And at the end of 2010, U.S. is driven by crop. I had mentioned that before and a number of other markets are just doing really well on growth, that's reinsurance -- excuse me, that's South America, the U.K., Credit Insurance Australia and Asia-Pacific. Germany is still weak on top line on a comparable basis and Switzerland has a price war where we are protecting the margin. Spain is the same effect.

Operating profit, Page 17, underwriting results EUR 70 million down, investments EUR 48 million, that's a special effect because of special dividend out there for private equity fund, so don't -- we need to normalize for that.

Negative effect on the underwriting was NatCat, EUR 106 million more than in the prior year, particularly in Germany, the U.S. and Switzerland and we had some profitability worsening in Germany and the U.S. that we were able to offset to a significant degree by the strong turnaround in Italy and France and positive price momentum. We also had some reserve releases on asbestosis. I'll talk about that later because we've done as in the prior year a very diligent bottom-up review of the non-U.S. exposures.

Now Page 18 gives you the combined ratios by segment and shows you the huge local impact NatCat activity has had again in the third quarter on a number of markets, in particular Germany, Switzerland, Reinsurance, AGC&S and the U.S.

Just to clarify, we also had significant NatCat in prior years. Germany also had significant NatCat in the prior year that we need to bear in mind. And only Switzerland is sort of a one off. They had 8.4% more NatCat than in prior year. For Germany the number has only been 3% more. If you include severe weather events it was plus 4.5%, so also last year, we had 6.5% NatCat.

Our expense ratio just to mention is at 27.1%, and I'm expecting that with current, the current forecast, we might achieve an expense ratio below 28% that would very well bode on our continuing efforts to get expenses under control and drive productivity.

Page 19 gives you the accident year loss ratio development. Here the lower left-hand side matters the most. You’ll see the price effect in severity and frequency more strongly up. There are some special effects. We had large claims 20 basis points up and frequency and severity, particularly driven in the U.S. and in U.K., up; and then we have some effect in Germany, if we run the numbers right. The U.S. reserve additions, obviously, are distorting the numbers somewhat. Therefore, you need to normalize that over the first 9 months to get a better picture and here, the pricing relative to frequency and severity look much better. We had particular storms. We've had a few questions already today, what were these storms in the third quarter, particularly 230 million storms in Germany, they had male names, [indiscernible] and Frank and we had Hurricane Irene, 82 million in the U.S. that is the difference to what we normally see.

Expense ratio on Page 20, EUR 27.7 million. I've mentioned that you see the continuous decline in admin and now stability and acquisition expense.

Investment portfolio grows and yields are stable. I'd like to turn your attention to Page #22. My comment is interest and similar income was for the quarter EUR 957 million with declining rates, we cannot continue at that level. Probably over time our plans have assuming a run rate of EUR 900 million just to be clear. Net harvesting was also late around the numbers that you see on the page and the investment expenses are between EUR 55 million and EUR 65 million. I hope they are more on the EUR 55 million number, side number going forward.

Now pricing trends Page 23, we've been taking positive price momentum through price increases throughout the year at 9 months, at 2.8%. On the renewals, it was effective price impact of 1.5% and then translate itself over time for these or even the business.

On the right-hand side, you see AGC&S and credit. On the credit side, we have deliberately decided to reduce prices because we were driven by dramatically falling frequency last year having had the prices too high, but had a very positive impact on client demand and we're managing this really carefully. So far my comments for P&C. Let's move to Life.

Starting Page 25, revenues EUR 11.8 billion. We believe with the fairly healthy product mix we are looking to restrain growth and product that have a lot of base in them. Operating asset base is slightly up despite some heavy market movement downwards. Operating profit at EUR 520 million, we'll talk about it. Value of new business EUR 223 million and business margin 2.7% up. These are beginning of the quarter numbers. You probably have a question how would they be end of quarters? We do publish them based on the beginning quarter, like everybody else and the numbers would have been around on the new business margin. At the end of the quarter, we saw -- we monitor them, very, very carefully overall, and satisfied with the margin that we're getting on new business. Where the margins are going down quickly because of declining rates, we’d rather not have top line, particularly if we get irrational competition not just from within the industry but also from the banking side. So for example, France banks are paying in excess of 5% for 36 months’ money. It doesn't make any sense to try to compete with that, and we'd rather let top line go if required. That is reflected on Page 26. The only comment, again, I have on Asia Pacific here, Japan had a EUR 290 million effect and Taiwan EUR 202 million net expense. Almost all of the variance and the U.S. movement is relative to a spike we had in the last year on the index annuity out there. We had announced product changes in 2010. So it's on the right track relative to our expectations.

Page 27 gives you the flows, and you'll see that they are still positive despite the fact that, in Italy, we had our banking partner managing their liquidity and, therefore, we had net outflows of EUR 300 million. They were expected. It's normal that banks in these times trying to maintain their own liquidity at the expense of distributing alternative products. Germany is up significantly. The U.S. is up in terms of inflows. And Asia Pacific, we had some outflows in portfolios, some of them with not so attractive margin so I am not concerned about the outflows, actually the opposite.

On the market effect, 2 comments. Number one, the EUR 6.1 billion were concentrated, especially around equities and govies, the losses were EUR 2 billion in Italy, the U.S. EUR 1.3 billion and Germany EUR 1.8 billion. That is market value declines offset almost by foreign exchange. EUR 5 billion out of the EUR 5.4 billion, that's my second comment, are coming from easy Life because the U.S. dollar moved 8.1% in the third quarter.

Now Page 28 give you the movement of the operating profit. Investment result I have explained to you and we had some unfavorable fair value changes also in there. Lower net unrealized and impairment hedge efficiencies we had just a little bit. The key thing that you might ask, what about the expense result, is that sustainable? Now this is EUR 53 million of this are one offs that we had in the U.S. That explains a significant part of the movement. For example, we had a back-end locking in Eastern Europe. And in 2011, we had some back-end locking in Germany. So you cannot extract fully that number and expect the flat number for the overall year.

Now asset base growing is on Page #29. Let's hit Page 30 quickly. Here, I'd like to turn your attention to the decline in the operating investment income. That's down EUR 1 billion and when you look at the driver, it's clearly associated to the net harvesting position. A movement from EUR 620 million down to minus EUR 715 million and you have 2 components as evident in the table that I provided you with at the bottom. Impairments moving to EUR 979 million and income from financial assets carried at fair value down from EUR 127 million plus to a minus EUR 325 million. So that shows you the movement. On the other hand, I was worried about more volatility. We get actually significant balancing through good diversification.

Value of new business. I'd mentioned to you these numbers are beginning of the quarter number so the 2.7% is relative to today somewhat and the average somewhat overstated. Present value of new business, EUR 8.7 billion so the value of new business continues to be stable. I think that is the key message and 32 shows you the various movements in the different markets. They're all reflecting interest rate sensitivity, and we're making sure we're not writing negative value business.

I'd like to then spend some time on MCEV on Page 33. You also have in the back half not just the MCEV movements relative to 12 months 2010, but the various drivers in free surplus, required capital and the value inflows.

Let me make a couple of points. Number one, it is quite remarkable given the enormous volatility that the negative impact were significantly balanced by the business in force contributions and the value of new business and that we have EUR 21 billion left. We are also one of the few companies that still have free surplus despite all of the noise and significant these movements in the business are fully evident, they're significantly less that some of us have managed and I want to mention that the EUR 7 billion movement is actually very significant, but less than what some people have expected now because we do have taken various measures to balance that. But it is what it is. It shows the full volatility that we have relative to interest rate movements.

The other component I'd like to point out is that we continue to, however, generate profit out of the business and that's also very important to bear in to mind. The business trend particularly has to be -- has to also be kept in mind, EUR 683 million new business capital strain and EUR 439 million of that is new business cash strain. You have some economic variances and split of that between Germany and the other market. It is not the book in Germany alone. We also have because of spread widening in the U.S., this movement of EUR 1.8 billion.

So that's the Life side, let's move to Asset management as the last chip [ph], and it's always great to conclude the segment with our outstanding performance in Asset Management. Assets grew 10.3% to almost 1.6 trillion, internal growth of 5.7%, net inflows EUR 10 billion for the quarter. This is no small feat given the environment. Operating profit up to EUR 537 million, growth of 10.6% FX-adjusted and the cost-income ratio was 59%, I would still consider to be an outstanding result in this environment.

The subsequent pages give you the details. Let's go to 37 where you see the net flows of EUR 9.8 billion and then 38 gives you 2 pieces. Despite the fact that performance fees are down, the overall net fee and commission income was significantly up. The AuM base helps but also let me point that out specifically, our continued improvement in third-party AuM driven margin. We're having more retail business, more stable business, more profitable business coming in.

Page 39 gives you the movement on operating profit and this is reflected still that we have to do investments in order to manage the much larger asset base and are positioning us for further growth through investment and new product and distribution, not just at PIMCO, but also in AGI.

Pages 40 and 41 give you an overview of the various segments. Outstanding performance still in fixed income. Operating profit at EUR 489 million, the cost-income ratio 51%, 3-year outperformance 95%. Now we know that there is an issue on the 1-year outperformance that needs to get addressed, but this is a long-term business and we're doing fairly well and the same is true for the equity business. I'd like to also point out on 41 that outperformance as planned is going towards the 70%, which we need to have. Operating profit is down to EUR 25 million and the cost-income ratio is up because of outflows in the market turmoil. Our target should be 75% cost-income ratio and we will work strongly to achieve that. I think we're doing well given the environment, and I'm confident that the new setup will deliver further synergies also on the productivity side.

So let me sum it up. Exactly 30 minutes after we started. Page 43, all operating segments are on track. Our capital position is resilient.

The net income is heavily impacted by the financial market turmoil, but we have refrained from taking gains on the bond portfolio, you see that from the increase in unrealized gains, in order to make up for that. We also have not done asset sales in order to support net income. We don't believe that investors should appreciate that and are looking through accounting gimmicks and, therefore, we are confirming our operating profit outlook for the year of EUR 8 billion, plus or minus EUR 500 million.
Thank you very much. And now, I'm ready for your questions.

Question and Answer

Operator

[Operator Instructions] Our first question today comes from Thomas Jacquet of Exane.

Thomas Jacquet
Exane BNP Paribas, Research Division

I have 2 questions. The first one is regarding the cost of natural catastrophes. You highlight that 4% is above average, but for the past 7 quarters now, we had 3.7% on average. So isn't it a beginning of a trend or do you -- what is your view on this significant increase compared to the previous history? And my second question regards the new business value in German-speaking countries. There is a sharp increase in margin. I understand that it's beginning of quarter market conditions, but markets were not that different at the beginning of the quarter. So where does it come from and is there something unusual there?

Oliver Bäte
Chairman of Management Board & CEO

Yes. Let me start with the second question, Thomas, and thanks for the question. The first thing is in Germany, we've had recorded higher rates at the longer end for a while and we also are driving business exchanges, which is very important. People believe that Germans are very stubborn, we are indeed, but we are also taking over time into account changes environment. So the unit-linked share of the business, which has very nice margin is going up over time, and we're also having more risk riders in the business. So we are driving the margins and trying to make them less sensitive to interest rates even in Germany. The first question was related to the NatCat activity. And you're absolutely right, we see an increase in the underlying trend, that is not just large NatCat, but the small local tornadoes have dramatically increased in frequency. According to numbers we have been exchanging with Swiss Re and Munich Re, 2011 will probably be the second-worst year in our history in terms of NatCat. Now so this is an extraordinary year, but the trend is there. Now we've been reacting to that. If you follow our planning communication. We've already increased over the last 2 years our NatCat loadings in the combined ratio to 2.8% from 2% and 2.2%, and we will be adjusting our plans going forward if we assume because of higher net retention that our NatCat loadings will go up. We just need to make sure -- and I am not worried about NatCat, we just need to make sure we get compensated for that. My worry is that in the number of markets, the NatCat pricing is not kept pace with the inflation. We need to either get the price or get out of these exposures. So volatility is what we are here for to take. We just need to make sure we get compensated for that.

Operator

We take our next question from Spencer Horgan of Deutsche Bank.

Spencer Horgan
Deutsche Bank AG, Research Division

Two things, please. First is if I look at Slide 18, the combined ratio. I wonder if you could just zoom in on 3 countries for me, particularly Germany and the U.S., which look sort of quite poor; and then Italy, which looks surprisingly good. I guess in the U.S. there is some reserve additions, maybe you could give us the accident year number there? In Germany, even if you back out the NatCat we still seem to be above 100% and I guess we were probably expecting to see some improvement there by now, I may be wrong. And then in Italy, again, maybe there's some reserve issue there. I think 6 sounds like a surprisingly good number. And then, the second thing was on Slide 12 where you sort of give the various sovereign bonds and the unrealized gains, losses. If I look at Italy, the net unrealized loss is about 17% of the gross unrealized loss. And obviously, Italian bonds yields are moving around quite a lot. I'm wondering is 17% still the right ratio to apply even with Italian bond yields at these levels or should we be assuming that ratio goes up as Italian bond yields go up?

Oliver Bäte

Chairman of Management Board & CEO

Yes. Spencer. Thanks for the questions. Now Germany and the U.S. In Germany, we have -- do not have a good year. We expect the combined ratio to be above 100% for the year. That is, however, significantly driven by weather-related events. The traditional NatCat definition doesn't give you the full picture as you see that. We do have additional attritional losses. So for example from electricity cost and we do have elementary claims that have been going up. Again here, the same thing is we need to make sure we get price for it, and we are planning significant price increases in Germany to catch up with claims inflation going forward. And the history that we've been discussing, the improvement on the claims handling side will make progress in 2012. On the U.S., the negative runoff has been 16.3% on that, and what I wanted to mention in Italy is we did do -- and that applies to France and [indiscernible] as well, we've done last year like in 2010 a very detailed bottom-up study on asbestos and because of that we have booked both result additions locally and we've attributed a group level offset to make it very clear. The offset is a positive 4.7% in Italy, after 0.2% in the third quarter of 2010. So you cannot extrapolate the Italian third quarter number for the year, which is the key information that you're looking for. I think that's very, very important. Now on the U.S. as you can imagine and personally, I'm not excited about the numbers that we see in the U.S. We have systematically employed a new approach to look at our reserves. We had a complete management change in the middle of the year and that goes across also the finance function, and we are looking at all lines of business in detail. Why? It's not just related to Fireman's Funds, the U.S. market in the commercial lines arena is anywhere between 30% and 40% below technical pricing and we need to absolutely protect our balance sheet, and we have been reviewing in particular Workers' Compensation, the General commercial line portfolio, construction defect and asbestosis and environmental, not just this quarter, and we will continue to review the results there throughout the year. The second thing is we'll have a new strategy, basically, coming in at the end of the year by new management. The situation has to be very carefully reviewed because the market shows no sign of turning. People are actually using capital gains on the bonds to pump up EPS earnings and the market appears to not mind. Therefore, I don't expect unless we get a major NatCat to see the cycle turning. What we are doing, we are bringing the cost down, which is the most important thing we have to do. Two years ago, we took the marine portfolio out and left Fireman's Fund with a consistently excessive cost base, and we are reviewing the underwriting components across high net worth individuals, commercial lines and our personal lines portfolio and that work is ongoing. I expect the portfolios and the number to stabilize by the first quarter of next year. Now please don't forget we continue to have NatCat impact here as well, just 5.8% in the third quarter. That's Hurricane Irene that has hit us here. So these would be my answers on that. I think you asked on Page 12 something around the sovereign exposure. Let me just go to Page #12 and what the numbers are on Italy. Let me -- can I get the question again?

Spencer Horgan
Deutsche Bank AG, Research Division

Yes. So basically the question was we're just looking at the shareholders' share of the gross numbers so if I compare the net to the gross in Italy, the net is EUR 385 million, the gross is EUR 2.228 billion at 17% and the basic question was is that a sensible ratio to assume as Italian bond yields continue to go up or how should we see the sensitivity there?

Oliver Bäte
Chairman of Management Board & CEO

No. You can't really run linear sensitivities on this. This is a point in time observation and if the unrealized losses go up and you have less interest earning capacity on the portfolio, that ratio might change over time and I can only give you a number for the in point, point. Now let me give you the following observation. This is really relevant for 2 reasons. The first one, if you were to assume that there is a default, we do not assume or model a default of Italy because, not because I don't like it, the fact of the matter is, if there was we would have very different problems in Europe. Now I also don't speculate on the default of the U.S. government and what the consequences will be because their numbers are as bad as the Italians. Second observation, what does matter, however, when you have high-spreads risk is that if you have a sudden shock of lapsation, and then you have to sell assets at a loss, that's why we are carefully monitoring 2 aspects. One is the stability of our liabilities and lapsation behavior, which has not considerably changed over time and we keep a close eye on it. The second is the structure of our asset tower. Can we prevent ourselves from having to sell these papers as discounts? That's why we have dramatically increased the cash holdings on the asset side to be prepared even if there are shocks. That's why I do not worry about these numbers whatever they are at this point in time. Third comment is a general one. I'm totally dumbfounded by the volatility in the Italian market. They have nothing to do with economics. Basically driven by a biased strike, no support from the ECB and the American hedge funds sorting the state paper. We have to deal with that, but that is noise somewhere in the system that has to get addressed politically. We need to watch out and protect our balance sheet and I feel very good about that.

Operator

Our next question today comes from Jean-Francois Tremblay of RBC.

Jean-Francois Tremblay
RBC Capital Markets, LLC, Research Division

I have 2 questions please. First of all, in the Life Insurance business, I note in your report concerning the U.S. Life business that you -- you do highlight the fact that you've seen the decline in the sales of the index annuities, but your variable annuity product’s performing still well. What would you say regarding your strategy, your focus on exact sanity [ph] would you consider a reemphasis on the variable annuity product? And the second question on the P&C, can you discuss [indiscernible] in Germany, so clearly I understand you’re predicting your margins but how do you see the market evolving in P&C from here?

Oliver Bäte
Chairman of Management Board & CEO

Yes. Thank you for the question. Let me start with Germany first. Germany is still a very, very competitive market, but we see in the most difficult part of the industry, that is motor insurance, prices going up and we are planning also price increases this year in high-single digit numbers. So pricing power is improving and that should be good news for the industry going forward, and that is across the various players and channels. Now as I said before, we've had a lot of NatCat and I don't believe the prices in the elementary covers are sufficient, so they need to go up much more. There, we do not have yet enough rational pricing, it has various reasons. In particular, you have a lot of former monopoly insurers that are pricing on the margin, not are bringing up the prices as required. We will, however, not be held back by that, but we'll bring prices up on where we have NatCat exposure or have to over time reduce our exposure. So I personally believe results in the market should improve next year, in particular, on our accounts. Now a part of the issues in our numbers are actually homemade. We've had trouble in our claim shops, particularly because we lost a lot of very experienced claims handlers and that is being addressed as well through very, very intensive training of our claim shops and changes to processes, particularly in terms of claims reporting. We need to dramatically increase the speed of reporting in order to bring the average claims down and client satisfaction up, and that's also underway. Now let me talk quickly about the U.S. Life question that you had. You had sort of 2 observations: fixed index annuities declined relative to prior year and DVA numbers up and what the strategy around that was. Now the first thing is on a quarter-to-quarter basis, some of these, in fact, are just noise. Last year, we had a particular sales affect in the third quarter because we have announced last year that we would change product features. That typically takes a little while to do. The features were very attractive so we had a spike. Now this year, we have a more normal development, that's why the number’s 18% down relative to prior year, but we are happy with this product. I actually believe this is a very good product because a lot of the spread risk in the product is shared with policyholders, the shareholder returns are good. We just have a problem still in modeling that under Solvency II, but I'm very hopeful that, that gets improved. Now the A sales are up because we have in 2009, relaunched the product in [indiscernible], but we are very, very cautious on the VA side because this is an extremely dangerous market. Now sometimes competitors are overbidding each other with more exotic options. We would not like to go there, and I remain extremely cautious on these channels. Particularly, if you are reaching a certain size and have to do a lot of hedging on the derivative side that might become very difficult, so we will have a clear target of how much we want to sell and we will not become, just to be very clear, a market leader in VA in the U.S.

Operator

Our next question comes from Andy Broadfield of Barclays.

Andrew Broadfield
Barclays PLC, Research Division

Two questions please. One quick one actually on the Dresdner debt that you assumed, and just why that got impaired, what the trigger was. And the second one, a little bit broader, but on solvency, given the quite sharp movement which was a little bit of a larger delta than certainly I and I think many expected, I'm just wondering about how you are approaching that now in terms of protecting the balance sheet? And are you or do you have particular triggers where you might consider slightly greater volumes of hedging? I know in the past, you've typically hedged a little bit less than some of your peers. And in particular, I'm interested on the interest rate side, and given your significant exposure on the German portfolio, which I don't recall too much disclosure around your hedging, if any, on that portfolio?

Oliver Bäte
Chairman of Management Board & CEO

Yes, let me start with, Andy, and thanks for the question, on the second component. We do indeed hedge, but we also bear in mind the cost of the hedging relative to other measures that we have. Now you will get a little bit of counterintuitive comment from me now because I basically believe this financial crisis can create on the investment side sort of a win-win. Let me explain to you what do I mean. The banks in order to meet the increasing requirements for capital and liquidity will be in the process of shedding significant part of their long-duration assets, in particular long-duration mortgages and notes. And we've seen a lot of activity. Most of the banks are obviously starting with the pieces they don't like, so we're looking at them very carefully. But over time, I do believe that a lot of assets that are less liquid, however, that meet our requirements for long duration and return will come to the market and will allow us to reduce the duration mismatch without locking ourselves in at very low rates. And I think that's very important that our investment teams stay on top of that and get us the assets in over time. And there's lots of supply coming to the market. We have lots of banks calling us. Again, the quality of the assets is not yet what we want to see, but I believe there will be more. That's a very personal observation on the opportunity that will arise from people having to move to the Basel III environment. Now I would like to reiterate that point. The fundamental value proposition that insurance should have in society and that should be well managed is that we do create illiquid liabilities that are shock resistant. By the way, we don't have that everywhere in the industry. And then therefore, be able to either have more illiquid or more spread-sensitive products and not worry about it because we do not suffer from spread movements. This is really what we are after. So there's a two-pronged approach. The first one is to make sure that we monitor and manage liquidity shocks very carefully and protect ourselves against sudden outflows of liquidity. Second, optimize the asset structure in a way that we're not exposed to spread risk or illiquidity risks. And again, we will see more of that because the banking system will be less and less able to hold either illiquid or spread products. That should give us a competitive advantage. It sounds very strategic. Has a very, very practical relevance both in terms of yields and actually addressing the interest rate mismatch in Germany over time that we need to manage down, just to be very clear. The second point that I'd like to have in terms of the Solvency II numbers. Now the model that we have again is calibrated to 3 basis points consistent with our AA rating. None of these are cast in stone and they show you and they rather show you the sensitivity but will you please also bear in mind we are going to work with 50 basis points approach, most competitors only give you the 50 basis point number. Second, let me explain to you what the movement are. The movements have been most importantly coming from 2 sources, only one of them being the interest rates reduction in Germany. At the same time, we have spread widening that you saw in the U.S. and in particular, in Italy that if you take the MCEV analogy would directly impact available financial resources because you use the spreads to discount the asset side and then the risk-free rate and at the bond rate -- European bond rate to the liability. So there's obviously a little bit of a distortion, particularly if you are confident that your liabilities are in check. First, oversensitivity there, but I'd rather want to see it because it's a great risk management tool. The second thing is that risk capital has been significantly up more than EUR 1 billion by the way of the increase was from underwriting risk where we've been updating model assumptions and have moved to be even more conservative than we were in the past so you have some model effect in there as well. You also, obviously, have risk capital increases from the lower value of the inforce of the Life book as the options and guarantee moving them -- move into the money, and you have a tax effect that is worth more than EUR 1 billion because if the value goes down, you get less tax protection. So it's totally clear what the movements are, and we manage them very carefully. So the question is what do we do going forward? Number one, what is most relevant for us is the conglomerate solvency and it's going to be here to stay for 2 years, just an obvious statement. Second, the rating is important and we monitor that and we need to make sure that we have a view on what rating do we want to have and how do we keep it. The outlook continues to be stable so from an investor standpoint, you should be happy with that and we are then managing the internal solvency to make sure that we protect ourselves in the future from too much swing, that's one. The volatility that has been more than some people anticipated, but also the level. However, given that we are almost in a perfect storm and the number of the indicators are worse than in the fourth quarter of 2008, let me remind you, the bond is lower than it was in the middle of the storm, and we're still holding up fairly well with the numbers that we have. And I personally believe and that's the last comment we will see a number of significant changes coming through Solvency II and our model, some of them very positive. For example, like yield curve anchoring at 20 years. Some of them less benign, for example, questions around how risk gets calibrated. Overall, to summarize, we are confident that capitalization for Allianz is solid.

Andrew Broadfield
Barclays PLC, Research Division

Can I just say, very quickly follow up on...

Oliver Bäte
Chairman of Management Board & CEO

HT1, sorry I forgot to mention you the accounting thing that you asked. Sorry. We had issued a bond at Dresdner Bank and in order to improve their conditions, Allianz had guaranteed this bond, and guaranteed the interest rate payments. Commerzbank took this bond over and whenever they don't have a certain result, we need to honor the interest rate commitment. That is a EUR 54 million gross charge after tax at EUR 37 million.

Andrew Broadfield
Barclays PLC, Research Division

Okay. So that was just triggered by lack of performance on the -- by Commerzbank as an entity?

Oliver Bäte
Chairman of Management Board & CEO

No. That's just an issue on how the earning situation at Commerzbank develops and has an HTB [ph] trigger, so to speak but that's more driven by their accounting numbers. Oliver Schmidt is just saying, lack of accounting earnings.

Oliver Bäte
Chairman of Management Board & CEO

Okay. Okay. Fine. So just back to your point about the long-duration assets potentially coming from banks which I think is very interesting. Clearly, because they predominantly be proprietary created assets the information disadvantage is potentially quite significant between you as a buyer and them as a seller. And so I'm assuming that the margins really would have to be really quite high on these assets for you to be buyers.

Oliver Bäte
Chairman of Management Board & CEO

Yes, we are very cautious. We're very cautious but don't forget, we have been doing for 50 years for example commercial real estate lending in Germany and other markets, so we are not a novice. We have been lending commercial loans but we wouldn't consider ourselves to be super experts. That's why we do have our own capabilities and we do have PIMCO, don't forget. So we’re taking a systematic look at these assets, but we're very cautious. I'm not going to take any bets on loans, even if they are retail. So we have very strict criteria, and we are very carefully looking at the portfolios. But there will be enormous asset supply strengths because otherwise, who's going to provide the capital? You know what? You read in the papers of where then they should go through the private sector and if it doesn't work, they can go to the SFS. Just run that numbers, it's not going to work, so assets have to be shed and we are ready.

Operator

Our next question comes from Michael Huttner of JPMorgan.

Michael Igor Huttner
JP Morgan Chase & Co, Research Division

I want to approach a topic I think that you weren’t too keen on but, I'll try. On Italy, I just wonder if you could talk us through the accounting for when the value changes, just to get a feel for it. Firstly, Italy has gone down a lot from EUR 29 billion to about EUR 25 billion. And the second thing is I wanted to understand how these buffers work. A little bit the question we had earlier but where are they? Is it still roughly EUR 20 million in Italy, and I'm guessing the rest is in France and then is there a limit to the buffers, is there a test you can apply? It's a little bit out of interest, but if we assume that Italy takes not just a couple of weeks, but just over the 7 weeks that we have to year end to sort out, it would be interesting to know how the accounting works, so we can be ready for it? Yes, so that was my questions.

Oliver Bäte
Chairman of Management Board & CEO

Michael, I am very happy to talk about that in more detail. Now the first let's talk about what has happened on the movement on the value of the EUR 29 billion to EUR 25 billion point something, so more like EUR 26 billion. There's a number of things and a number of moving parts that need to be borne in mind. Number one, we have, consistent with our investment strategy, concentrated our holdings of Italian debt in the domestic companies. As you know, over the last 2 years, we have whenever bonds come due in cross-border holdings, not replaced them, but focused on the domestic holdings and grown with the domestic holdings. That explains a part of it. A part of it is value reduction and a part of it is also changing durations in the Italian bonds. So a part of the normal portfolio shift you have seen here and that, in effect, has reduced cross-border holdings and there was a slight growth in domestic holdings that we feel very comfortable about. Now the second question was around accounting, that is totally clear, and different to bank accounting because we hold almost all of it in AFS. That means we will only impair it if there is a restructuring, it has nothing to do with whether it goes over year end. We've always said, if there's an announced restructuring as it happened in the case of Greece, we do take the impairment and then we take things down to market value, whatever they are at that point in time. And I'm not going to speculate on where the numbers are going to be, up and down. Market movement, therefore, as such have no accounting implication and, therefore, you need to bear that in mind. Again, let me also point out to one factor again and that is there are 2 things that people might be worried about from a shareholder perspective. One is the default and the default probability. And the other one again, as I said, is the spread that is not reflecting default and, therefore, we are only worried if we do have to sell these assets at a loss and that only happens if 2 conditions are being met at the same time. We get a like liquidity shock; and at the same time, we cannot support the outflow of cash with other instruments and credit spread product and, therefore, have to sell at a loss. Both things we are carefully monitoring and protecting ourselves against. So for example, we've dramatically increased the cash holdings in the group both at the center and the OEs to be able that in case lapses would go up, we can actually support them without having to sell spread product. And by the way, there have not been any significant uptake in lapses over the last 2 years. Okay, so that is really what we are focusing on and can feel extremely comfortable about.

Michael Igor Huttner
JP Morgan Chase & Co, Research Division

Just sort of the last, but [indiscernible] is there -- assuming Italy, just on the market value, not default, just market value were to drop quite a bit more, who knows what the number could be. How -- and this, I think, was Spencer's question a little bit, how would there -- is there a limit to how much you can allocate to buffers and policyholders and things like that? I mean, would we see much more of a swing in shareholders equity?

Oliver Bäte
Chairman of Management Board & CEO

No, the issue is because it doesn't move through shareholders equity. What, however, we have to do and I think that's important, if you have an unrealized loss position just from the accounting side, you need to do a premium refund test, i.e., you need to say if I have a policyholder participation not just in a gain, but also in a loss, you do a bottom-up test of whether you can actually do the sharing and that is actually getting audited. We've just completed that and get a full audit supply that we do not have enough reserves to actually balance it, but I'm not going to disclose, sorry to say, the accounting details on how the premium refund works. Yes, we managed that in our asset liability -- management models very carefully, but you do not have a linear relationship. Obviously at some point, the share of shareholder losses in the unrealized losses goes up. And for the year end, we'll tell you what the year end is.

Operator

Our next question comes from Maarten Altena of ING.

Maarten Altena
ING Groep N.V., Research Division

Two questions from my side. The first is on hedging. Did you make any substantial changes in your hedging strategy regarding equities and interest rates into the fourth quarter versus last quarter? And would you, for instance, also hedge bonds exposures or are these too costly, especially sovereign bonds? And the second question is regarding the short-selling bond, aren't you frustrated that your share price recently suffered disproportionately compared to those financials that are based in countries where the short selling bond is not into force? And how is your lobbying in order to implement, for instance, the Pan-European short-selling bond in order to prevent these kind of irregularities, so to say.

Oliver Bäte
Chairman of Management Board & CEO

Yes, Maarten, don't get me started on the last point because I have a loaded gun and if I see a few traders I'm actually going to use the trigger. No, kidding aside, we, obviously, suffered not just as Allianz, but any member of the DACs, and let's be more technical, the last 2 quarters we had a 6% to 9% more drop in our share price than our peers just because of the DACs being used as a proxy for global growth and a proxy for short-selling opportunities. And I find it totally unacceptable that we are not having a European strategy for this. It tells you a lot about the problems that we have in Europe in general. There should be a combined strategy. By the way, regardless of what that is, whether you allow it or not allow it, but that you can use one exchange to do one thing and the other exchange to do something else, is not what we like. The other thing is, by the way, where it’s being traded, a lot of the volumes are not even traded on the exchanges any more. I think 60% of the trading happens off the exchanges in so-called dark pools. We all know what dark pools do to your health, you don't want to be there and, therefore, there's a lot to be happening -- in my mind by the way, the biggest problem is we had a lot of promises from politicians in 2008 and '09 about reforms. The only thing that we continuously debate is higher banking equity. All the promises around more trading transparency, about more control about center counterparties, nothing has happened. And I consider this to be very, personally, a major regulatory failure and that does contribute to the mess that we currently have. I hope to see some progress going forward, but I'm not in charge so I can only pray. Now in terms of your questions, we have not dramatically changed any of the overall hedging strategies for the group. However, we added a gamma hedge in Q3 at AZ Life in the U.S. in case somebody's looking at local filings. I don't think it makes a lot of sense to start to buy CDS hedges even if they are collateralized given the costs that are associated with them, and I think the most important thing to have the right asset mix and balance over time. Our challenge has been, and let me be very honest about that. We are in the equity holdings that are 6% of the total portfolio now. We are over focused on a few titles, in particular Commerzbank, but many parts of that are non-movable than inheritance of --

at the Dresdner time, and many of them cannot be hedged, whether it's HT1 or the silent participation, we just have to live through that and in 2014, they become available and then we need to rebalance the portfolio oust.

Operator

Our next question comes from Vinit Malhotra of Goldman Sachs.

Vinit Malhotra
Goldman Sachs Group Inc., Research Division

Vinit from Goldman. My favorite slide was the accident year loss ratio by country, and I was just wondering the small worsening and you do mention the reported frequency and severity. Can you tell us a little bit more please, is it some just economic effect or is it some extra reserving or just what's going on there? Sorry.

Oliver Bäte
Chairman of Management Board & CEO

Yes. First general observation even though I'm an economist first, and I love the numbers, please do not forget that this is a quarter-over-quarter comparison. At some point in time, I think, it would make more sense to also look at 9 months versus 9 months some more on the fundamental trends, which are better than what you see in the quarter. What we are trying to do is to actually balance the frequency and severity of movements with price increases. The last quarters were actually positive. We had in the second over the second prior year a higher positive price impact from frequency and severity. Now the second observation or third actually is that we have a few special effects this quarter that you cannot really extrapolate. Again, a few large claims that I don't believe are part of the normal driver are in there about 20 basis points I explained by that. The U.S., in particular, drives a significant part of the 1.2 remaining effect and then you have some movements on severity in some of these markets. We have looked at them in detail, and we believe that overall, we can balance frequency and severity increases with pricing, and I think that's very important. The other lever then is productivity on the cost side, and we need to go below 28% expense ratio. And currently, we have a forecast that confirms that but I am not sort of ringing the bell yet before the numbers are in the house. So that's very important. The outlook has to be that we balance the severity and frequency with higher prices. Now the last few years actually frequency across the industry has been down and managing the severity has been the key objective, and it will remain the objective going forward. Final comment is again, Fireman's Fund needs to be taken out so a significant portion here is driven by the U.S. business and the reserve changes there, so do not extrapolate the 1.6 going forward.

Vinit Malhotra
Goldman Sachs Group Inc., Research Division

Just if I can ask on the comment you had earlier in the presentation on the German loss, just what happened, suddenly a lot of people quit the industry or went to the competition or...

Oliver Bäte
Chairman of Management Board & CEO

I think you weren't here, I wasn't here either. But we had a major reorganization in Germany 2005, 2006, where we took a lot of employees out of the system and reorganized the company in across Germany. A lot of people don't remember that we had 7 insurance companies in Germany, not just one, all of them having their own organizational structures. They need to be brought in line and many of the things actually worked very well. The area where it didn't work too well is the restructuring of the claims shop because in claims experience of the settlers is extremely important, particularly about lower middle management that have a lot of the experience and there, we did lose a lot more people than planned. And in order to rebuild, you need about 3 to 5 years to get that back in shape. That's unfortunately the outcome, that wasn't planned at the time, and it's being addressed now.

Vinit Malhotra

Goldman Sachs Group Inc., Research Division

Okay. So it wasn't a quarterly effect. It was a mid-term...

Oliver Bäte
Chairman of Management Board & CEO

Yes, it was a significant mid-term. We actually used to have a lower loss ratio than the industry and it actually deteriorated quite significantly, but if you take the NatCat out, we are seeing 3 quarters of improvements now.

Operator

Our next question comes from Paul Goodhind of Redburn.

Paul F. Goodhind
Redburn (Europe) Limited, Research Division

It's on the non-Life side, and I'm wondering whether you could just give us a bit more detail on the U.S. reserve increases. Which accident years are we talking about here? Are these in recent years or are we going way back in the past? And also, are these policies that were written on a occurrence or a claims made basis and, therefore, are these just brand new claims that you’ve had in from 10 years ago that you didn’t know about before or were these -- already having case reserves set up for them and you’ve changed your view as to what the case reserve should be?

Oliver Bäte
Chairman of Management Board & CEO

Yes. We’ll have some of the detailed questions if I may, Paul, with Oli next week but I'll give you the top-down view. We have 2 things happening here at the same time, I'd like to separate them. The one is I've moved when I took over to an annual review of asbestosis and environmental. We have a major reserve increase already in 2010 based on the reserve review that you might remember. The second one is we are doing an update every year. So there are actually updates. Now we do that every year and we also are -- have using what we have what we call the group level reserve because we've been preparing for that. Now the second component is the accident years. We also had reserve additions for this year because based on fundamentally new reserving processes, following the change of total management, we also are fundamentally changing how we do reserving, and that is affecting 3 lines: general liability, workers' compensation and a few other lines. I don't want to go into the details too much, but the significant impact is on general liability and more importantly, on workers' compensation. And here, it's not just an Allianz issue or Fireman's Fund. It's an industry issue because we had a spike in medical inflation, particularly the last 2 years and this year, that have led us to really change the inflation assumption on workers' compensation claims. Therefore, we increased reserves quite considerably and we are continuing our reserves reviews until the year end. And that's very important. By the way, we just not only do that for the U.S., we are also doing now asbestosis reserves for our non-U.S. companies, that's particularly AGC&S, France, Italy and the U.K. Very important reserve strengthening for the quarter and that was your concrete question, has been EUR 74 million and respectively 8.2 percentage points.

Paul F. Goodhind
Redburn (Europe) Limited, Research Division

So most of it was more recently written business? Is that what you're saying?

Oliver Bäte
Chairman of Management Board & CEO

Yes.

Paul F. Goodhind
Redburn (Europe) Limited, Research Division

Okay. Great.

Oliver Bäte
Chairman of Management Board & CEO

But we don't -- sorry for that, but we don't disclose individual underwriting information like what is occurring, what is claims made on the individual line of business, I don't think that makes a lot of sense. It also provides information to competitors that we do not like to release. But again, my overall comment would be, while I'm very unhappy with the financial results, we're making a lot of progress in cleaning up the reserving and pricing processes there, and in light of the fact that we have anywhere between 30% to 40% prices that are below the technical requirements, that's really important that we keep the reserve base in the balance sheet fully intact.

Paul F. Goodhind
Redburn (Europe) Limited, Research Division

And does this change your view on the sort of -- on the long-term status of the U.S. business in terms of is it a -- it’s obviously a very tough market strategically, it's a long-run profitability, it's challenging and you have to be dramatically better than average to make a return that's reasonable to shareholders. I guess given all this, are you confident that you can be [indiscernible] decent outperformer such that it justifies actually owning this business longer-term?

Oliver Bäte
Chairman of Management Board & CEO

Are you talking to me personally or Allianz board? No. Kidding aside, since I worked a few years in the U.S., I can only confirm what you said. The market is extremely difficult, but we have also have some homemade problems. There are 2. The first one is that we have been taking businesses out of Fireman's Fund. For example, just 2 years ago, the Marine business to create the world market leader for Marine insurance inside of AGC&S, but we didn't do a great job in bringing the residual cost base down in light with the revenue base because the industry was sliding. So even at the time when we took the revenues out, it was already a very high cost base. With the decline in the market and our revenues, that situation has worsened. So the key thing will be can we get the cost base in line and flexibilize it enough to be able to withstand the high volatility that we have in the top line in the U.S. Second, we are very strong in the number of leeches. High net worth individuals to take one, entertainment to take another one, are these segments dependable in light of an overall market deterioration, yes or not? Based on the answers, we'll come back and say how sustainable is the business model and that review is currently ongoing.

Operator

Our next question today comes from Brian Shea of Bank of America.

Brian Shea
BofA Merrill Lynch, Research Division

I wanted to ask about the -- on non-Life. Oliver, you mentioned a 28% expense ratio target a couple of times. At the 9 months, though, you're at 27.7%. I don't know if there's an apples and oranges issue here, but it looks like that 28% is not aspirational. It's already sort of in the bag. And I guess going forward, other companies have targets that they've shared with us for how they want to cut expenses going forward. Is there room to keep this expense ratio coming down in future and can you share any plans with us? Then the other question is on the running investment income in non-Life. You were good enough to give us a couple points on this already, but just to understand the moving parts, what was that special effect? How big was the special effect in Q3? I think the private equity dividend, and what is your new money yield, please?

Oliver Bäte
Chairman of Management Board & CEO

Yes. Now on the expenses there, Helmut Schmidt once said the most beautiful room of all is the room for improvement. That certainly holds true for our productivity in P&C. But before we become world champion in terms of announcements again. I can only reassure you that we have a number of plans that I don't

-- can't go into detail here to bring that down. While you are saying that's around the corner, there's a lot of volatility between quarters, particularly around DAC, so why I am confident that we stay below 28% for the year, and we do have a plan that is actually over the next 3 years to go below 27%, I don't think we should spend the time on where and how and what will be. Just going to happen. But the plans are in place and they are very tightly tied to P&C, to the compensation of management now. So that's a significant improvement over time. The second thing I'd like to mention on the expenses. It's funny that you mentioned all the plans that people have. If I look at their actual results for the industry without mentioning a specific company, expense ratios have been going up in this industry, particularly in the traditional companies, and why? Well, everybody's working on reducing admin expenses, you see that on Page 20. For us, we have been able to reduce that in 2 years from 8.6% to 6.8%, the issue is that in a declining market, the competition for revenue is so high that those that control clients, be it agents or broker, strive to get an increasing share of the value chain. That you can only balance if you have direct customer controls, so those that have a stronger direct distribution on DAC control will do better, and that's why we need to significantly go direct. By the way, this quarter, our Direct business grew 20%, but we need to accelerate the shift from non-control to controlled distribution. So that's really going to be the real driver. I personally believe at around 5.5% admin expense ratio we sort of will flatten out, so there is at least 1.3%, 1.5% more to be done and then it's going to be about business model changes that will drive expenses. Just as a sort of strategic response in a down cycle, as we have experienced from 2006 where prices peaked globally down to where we are 5 years later, this has been driving expense ratios up across the industry and the rest is accounting gimmicks. Now private equity question was what was the increase we had? Dilution of our private equity fund and the exact number was EUR 47 million. We booked that in Italy.

Brian Shea
BofA Merrill Lynch, Research Division

And your new money yield in non-Life?

Oliver Bäte
Chairman of Management Board & CEO

The new money yield in non-Life at this point in time depends on the asset mix. I think it's slightly above we have offered. The 3.6% is the number, if I remember it correctly, and it has various components. Governments to be 3.3%, covered 3.9%, corporate 3.5% and I think ABS around 4.4%. That's the mix, more details you can get from Oli Schmidt.

Brian Shea
BofA Merrill Lynch, Research Division

Okay. Just to be clear, I think 3.6% is an H1 number rather than today, but I'll follow up with Mr. Schmidt.

Oliver Bäte
Chairman of Management Board & CEO

That's what we used for the year. Now the issue is when we look at maturities, Brian, it's very important that we just not manage new money yield based on the same duration. We do also take duration views because if I then wanted to give you a perfectly correct answer, I would have to use the same duration, which we don't, at least I don't have at this point in time. So then you have a perfect comparison. Oli is going to give you this number, he's ready for that. Because we’ve, in some areas, actually been lengthening duration as we're finding that our ALM models are improving and we're taking advantage of the fact that our P&C liabilities can be managed very, very tightly.

Operator

We take our next question from William Hawkins of KBW.

William Hawkins
Keefe, Bruyette, & Woods, Inc., Research Division

My first question, Oliver, could you help me understand the resilience of the investment result components of your Life operating profits? My understanding is sensitivities disclosed at the beginning of this year was that roughly the 20% fall in the equity markets in the third quarter should have hurt your number by a good EUR 400 million, if not more. And yet it seems that only the downside has been a couple of hundred million. So either my understanding of the sensitivities was wrong or there's something else that's supported your investments result. Could you help me understand that?

Oliver Bäte
Chairman of Management Board & CEO

Yes, of course.

William Hawkins
Keefe, Bruyette, & Woods, Inc., Research Division

And then secondly, I'm sorry to come back to sovereign questions, but I was having a look at the movements in amortized cost of some of your sovereign holdings and your Italian holdings have gone down by about 7% in the third quarter, that's a couple of billion, whilst your French holdings have gone up by about EUR 4 billion, and I want to just understand those trends given all the other comments you've made about market prices and the rest of it. I mean it doesn't look like your reserve position have changed materially, France hasn't been growing or anything like that. Can you just help me understand in the context of what you've been saying why we've seen a big fall in the Italian sovereigns and a big increase in French?

Oliver Bäte
Chairman of Management Board & CEO

Yes. Well, thank you very much for the question. I think you're referring to the year-end information that we have distributed in the backup, the Page B19 that gives you an expected total P&L impact from equity market scenarios and the resulting unrealized gains/losses on AFS equity securities. Now that is obviously a snapshot position. As of last year and we have not obviously overly updated it. Most importantly, however, while we're obviously constantly updating and changing our asset allocation, that is not just between different asset classes, but also in the asset classes and we also are constantly shifting durations around depending on what we believe where spreads and risks are. The second thing is the financial investments have performed worse than the market average, [indiscernible] for example, and it's really important to understand. Now the last item is a technical one that we've been debating internally after we published the slide because the operating profit impact that you see below the slide was taking into account changes that we expected for associated entities that unfortunately don't move exactly like the entities do. We had some supplementary information in the interim report that you can look at that is provided by Oli Schmidt. And I think it's very, very important when you look at the footnote that the P&L impact and the unrealized gains/losses are obviously also level dependent, i.e., depending on where the market is when you do the shocks. Sorry, if that has created some confusion in terms of what the volatilities are. Again, you can get the information on Page 78 of our interim financial report in the -- for the available for sale instruments. Now the issue is we have shifted some assets between Southern Europe, that was the first part of your question, and into France, so it's an asset allocation view that we have been taking that it's reflected in the numbers between Italy and France of top of what I have been saying earlier.

William Hawkins
Keefe, Bruyette, & Woods, Inc., Research Division

That's a tactical Asset Management decision?

Oliver Bäte
Chairman of Management Board & CEO

Yes. There's nothing related to a fundamental view on what we believe certain sovereigns will do or not do.

William Hawkins
Keefe, Bruyette, & Woods, Inc., Research Division

Forgive me if I'm cheeky, but doesn’t that imply that it's not just American hedge funds that are trading this stuff?

Oliver Bäte
Chairman of Management Board & CEO

No. But the issue is very clear that when you look at fundamental risk-return expectations, we have our own model of what we believe true risk-adjusted returns are. And so for example on France, we believe, they are more attractive than, let's say, some other Southern European bonds, so if we invest your money it is not that we are selling some piece and then investing into others. We have assets coming off the books, and we are -- then the new money we are investing into new pieces. So it's very important, it is new investments.

Operator

Our next question comes from Fabrizio Croce of Kepler.

Fabrizio Croce
Kepler Capital Markets, Research Division

While I totally agree with you in considering Italian bonds noise, actually provoked from some interactive controls, financial newspaper, broker and rating agencies, my big question remains, are you going now to aggressively expand your bonds position in Italy due to the fact that it's noise and, therefore, you take advantage? Or are you thinking about adding some of the smaller Italian insurer automatically acquiring also their asset portfolio? And the second question, if I may, is about -- I know it's a little bit strange, but because you have not the information yet, but still I'm a little bit worried about this entire story in Thailand because at the end of the day, it is affecting corporate business, and you're big in corporate business. It's affecting Reinsurance -- you are in Reinsurance and it's affecting actually companies being present, that you are the biggest foreign player there. So my question is even if you could not give me a figure, I mean they are speaking about EUR 5 billion, EUR 10 billion, is a big figure. I mean, could you give me a sense, is it what I'm thinking, is it true? I mean are you really as big as I think there?

Oliver Bäte
Chairman of Management Board & CEO

Yes. I always look in the mirror and say I'm less big than I think I am, and I hope that's true for our exposure here as well. No, kidding aside, so it's a Friday afternoon. The Thailand thing is still very unclear. What we know that the losses will be massive. Now let's differentiate between 2 things. First, what is the local retention. I can assure you that the local retentions are very low. Most companies including ours have no more than a 10% net retention on that. So we checked that already. AGC&S, I do not know yet and on the reinsurance, this is the part that I personally worry about the most that we need to look at. But here, we have shares of portfolios that mostly are led by the leading reinsurers, Munich Re and Swiss Re. And as you know from Munich Re 2 days ago, they weren't able to give precise numbers so if the leaders can't do that, I'm at a loss to be able to do that at this point in time. But I cannot exclude that this is going to be a significant loss for the industry. And so it's a serious flood and it was non-modeled. It is by the way not just NatCat, part of that is actually man-made for various reasons. We didn't have very good water protection, a number of the car producers and like for Japan, it will take a while for this to be sorted out and to get the numbers. But I'm not saying that the industry or we will not get hit, I think this will be a very big loss for the reinsurers and we need to see whether we do have exposure through Allianz Re, and we'll find that out in the next couple of weeks. Now let me ask you and you asked about the bond position in Italy. Personally, I would go very long Italy and if I had any free cash, at this point in time, however, I'm 100% invested in real estate, no, for Allianz, we are actually taking, we are believing that with Silvio Berlusconi going out and Napolitano actually taking a very strong stand in bringing a new government in, we are very, very positive on the outlook that we will get a capable expert-driven government that will implement the necessary changes both on fiscal policy and also on labor productivity that are needed. Italy is a very rich country, I’ve said that before, richer than the Germans in terms of private wealth. We just need to put it into productive use in the country and for that, we need a different political environment that we see coming now. So it's very, very important that we do that and we remain positive, as I said. While we are managing carefully cross-border exposures and rather be -- on the conservative side, on the domestic side, we are investing in long-term Italian government bonds. Now your question on M&A, I obviously have to let go. We haven't seen any great assets coming to the market yet. If there were ever to come some, we would take a look.

Fabrizio Croce
Kepler Capital Markets, Research Division

But there are companies valued at about a couple of percentage points of book value?

Oliver Bäte
Chairman of Management Board & CEO

Yes, the question is what is the book value. That might be negative.

Operator

Our next question comes from Nick Holmes of Nomura.

Nick Holmes
Lehman Brothers Holdings Inc., Research Division

Just a couple of follow-ups. Firstly, on German P&C, it’s had a lot of questions, but I wonder do you think you'll ever get back to where you used to be, i.e., with combined ratios in the low 90% range or would you say that, that era is now over? A bit of a loaded question, I suppose, that one. Second one is slightly easier question. In the economic solvency calculation, do you count the free RfB as an offset to the interest rates guarantees? And if you do, why is your interest rate sensitivity so large?

Oliver Bäte
Chairman of Management Board & CEO

I was about to say because we have a funny model, but I'm not going to say that. No, but if the reality is we do take -- if you are market consistent, we need to take care of the fact that we have guarantees that can last up to 90 years. We do model them. As you know, we are extrapolating as of 30 years and there's a lot of volatility, both in the interest rate levels and in the implied volatilities of these numbers that reflect the fact that on the cash flow matching side, particularly on long duration -- on the long duration, we have a mismatch. Now by the way, interest rate’s down. We have a positive duration for the first 20 years and mathematically given the size of the reserve, Nick, this is just enormous noise that's by the way we have been advocating anchoring the rates and volatility at year 20 or 22 for the German bonds because this is when about 95% of the cash assets run out. If we were to hold liabilities in the U.K., we would go longer before we anchor because there you can actually buy long-duration assets. So our problem is we have to model with noncash instruments, yes, swaps, most importantly where there is almost 0 liquidity, which I think is a huge issue in terms of true economics. So I think it's overly sensitive and the RfB of course count as risk capital in short scenarios, and we use them. The other comp problem we have, and that's true for Solvency II as much as it is for MCEV, there is not a going concern view, Nick. And let me say also for the team, I don't want to give a lecture because I'm supposed to be very short. But the key thing is if you actually introduce a going concern view on the business, various risk components get overstated. By the way, some understated because we used RfB also to fund new business. And so we need in the future in my personal point of view for internal management purposes, not just reporting, to balance the run-off shock view with a going-concern view. And unfortunately, the run-off view gives you more volatility, but it's a great risk management tool and that is what we should be using it for. Now on your pointed question on the German profitability and whether we ever get back to the low '90s, I think this market is extremely competitive and has been much more competitive than it was about 10 years ago. So overall, market profitability has come down. This is not just Allianz. And the reason is the disappearance of growth and a lot of excess capital being in the industry, particularly through the equalization reserves that can be used and not used to support interest income. There's a lot of capital still in the industry that is not wisely being used. Second, the profitability of some lines has deteriorated more than others, in particular, motor insurance has dramatically deteriorated. And we need to make sure that the profitability shifts there. Therefore, we have been dis-emphasizing motor insurance in the past few years. Third component, the mix is shifting more to automotive and other distribution channels, that take lower profitability because they have higher distribution costs. So if your point of view is actually right, the profitability -- if business is coming from non-agency channels, it has been lower than in the traditional channels that have been losing share. So given the mix effect profitability, and the market has come down. And the key thing that we need to do is twofold. There needs to be continuous and substantial reduction in cost. The most profitable company -- or companies do also have the lowest cost base not just in terms of admin cost, particularly distribution cost, which means a systematic shift to direct over time, not shrinking the agency channel but focusing them on more commercial and higher-margin business and the other thing is business mix, we need to get better on the underwriting and claims side again. We've been a very sales driven company and the technical excellence needs to go up. Now to answer your question more precisely, are we going to hit low 90s anytime soon? I don't think so. I'd be very happy if we stay in the 97%, 98% combined ratio loan for the next 2 to 3 years.

Nick Holmes
Nomura Securities Co. Ltd., Research Division

That's a very good answer. But can I just come back very quickly on the 3 RfB. Would it be correct to say that if you were to take the German interest rate guarantees in the Life book out of the economic solvency calculation, assuming that the RfB could offset them, then that would vary considerably reduce your interest rate sensitivity?

Oliver Bäte
Chairman of Management Board & CEO

I'm constantly getting pointed out that RfB, the way we look at it is an accounting measure. It's not an economic measure. So you need to look at the risk-bearing front, so you're taking the RfB only, it's not really helpful, it's an indication so if you want to compare risk-bearing capacity, people do look at that and say, Allianz RfB is 2x the size of the next competitor also relative to resource so that gives you an indication but it's not an economic measure of risk-bearing capacity and sensitivity. We do actually look at the market value of the liabilities, how we assess them, the market value of the assets and how they match up. The accounting numbers are not really helpful in understanding these dynamics in detail.

Operator

Our next question comes from Meyer Shields of Stifel, Nicolaus.

Meyer Shields
Stifel, Nicolaus & Company, Incorporated, Research Division

Following up on that question, if we see slower economic growth in Germany in 2012, would that have any beneficial impact on motor claims frequency?

Oliver Bäte
Chairman of Management Board & CEO

Yes, a behind the corner effect. Theoretically, yes. Right? Assuming that competitors behave rationally and this is the little problem in our industry, they don't, so we need to see what the underlying price dynamics are and how people will support distribution channels or not. Underlying physics should suggest that this should be beneficial because we would have fewer accidents.

Meyer Shields
Stifel, Nicolaus & Company, Incorporated, Research Division

Okay, and I want to touch on a comment that you'd made earlier, I think you said that you hadn't seen any sign of a pricing turn in the U.S., and I'm wondering whether that's also true when we drill down to the workers' compensation level because the impression we've gotten over the third quarter earnings season is that there are at least some initial rate increases there.

Oliver Bäte
Chairman of Management Board & CEO

Some, yes, but they are far below what we need, far below what we need. The historical inflation assessment between 4% and 6%, we've seen double and triple over the last 2 years, so there needs to be a lot more pricing coming through in order to make that attractive. In particular, in California, where we are based.

Operator

Our next question today comes from Michael Haid of MainFirst Bank.

Michael Hermann Haid
MainFirst Bank AG, Research Division

Two questions. First of all, recurring investment yield in P&C, you mentioned EUR 900 million, it will go down to. How soon do you expect this to happen? Is this the new expectation for next year? And all else being equal, should this figure further decrease 2013 from today's perspective and what are the targets combined ratio you have with this recurring investment yields going down, I assume you should increase or you think about increasing prices more. What combined ratio are you targeting for 2012? Second question, on the equity exposure. Obviously, you are overweight in financials. From what you told us before, I get the impression that you are not happy with that. I also understand that some investments you cannot dispose of before 2014. But I mean, okay, this is only Commerzbank from my understanding but how happy are you with that? I mean how soon can you change it?

Oliver Bäte
Chairman of Management Board & CEO

As you know, Michael, as a CFO, you're never happy. Moving beyond happiness, I think the overweight in financials that we have particularly had in the corporate segment has to be addressed going forward and there are many activities underway to rebalance the portfolio. Let me remind you a number of, again, assets, not just Commerzbank, weren't available. Let's look at the Hartford warrant that has given up a lot of volatility particularly this year, they weren’t free to be traded. We’re in the process of addressing this, I have mentioned that before that as of October, we are in the position to register the warrants and then deal with them and we'll be addressing individual components going forward. I think that's the key message so you can have a view and say this is the EUR 5.8 million exposures, why didn't you move that for example -- but you need to look at individual components and then see how much can you actually influence and where is the liquidity. Let me give you an example. We have out of the EUR 8.9 billion subordinated bank debt around EUR 1.8 billion, Tier 1, we've been looking at subordinated debt very intensively but guess what, there are no buyers even if we want to reduce the exposures and if we were willing to take losses, you need to actually have liquidity, and there is no liquidity. So I just wanted to send the message. We are very cautious and very aware of the situation. We are managing them with the capabilities that we have, and we are going to address them going forward. My comment on the interest income, the Slide 21, was just that we had the special effects that EUR 35 million in Italy and EUR 26 million in Allianz SE out of the proceeds from private equity fund, and if we were to normalize the EUR 50 million, you get to around EUR 900 million sort of recurring base that we believe we can hold over longer periods of time. If somebody was trying to estimate that and that balances somewhat a growing asset base on the one hand and at the same time, the decline in yields. Now the laws of physics hold. You all know that in an industry that has such a significant exposure to investment income, every 1% decline in interest rate basically means that combined ratios would have to decline 2.5 percentage points to just keep profit stable. We have not seen in this industry and, therefore, earnings power of this industry has come down. The only way you can balance that is by increasing the reserve position and the duration of the reserves and that's growing the asset base and that's optimizing investment management, taking care of the fact that if we really know how the liabilities work, we can extract additional value out of holding either more illiquid or spread product that we can carefully manage. That's just the message that I wanted to send, and I'm confident our folks at AIM will be able to get that done.

Operator

Our next question today comes from Julia Rafal [ph] of Autonomous [ph].

Unknown Analyst

Just a quick question. On Slide 33, on the net capital movement on your free surplus, the minus EUR 1.15 million can you let us know how much was the dividend paid if the EUR 1.1 million was total...

Oliver Bäte
Chairman of Management Board & CEO

Julia, almost entirely.

Unknown Analyst

Almost entirely. So then following up on that, and I know you don't want to commit to any dividend, but if I'm correct, does that compare with roughly EUR 800 million of dividend that you -- like EUR 890 million that you didn't announce in 2010 from the Life business? So would you feel upset if we were to start thinking about your dividend in dividend per share terms for 2011 as opposed to payout?

Oliver Bäte
Chairman of Management Board & CEO

I think it's a very fair question and I mentioned it at the beginning of the call, and maybe that's a good closing. We are looking exactly at the cash flow generation by segment that we're getting up into the holding. Then cash flow usage in the holding and as opposed to accounting volatility, but at the same time, Julia, and this is where I would like to sort of remain cautious, the capital position and the rating position. If operating performance and cash flow generation, that's why I was very happy to provide you with the MCEV development, remain strong, again let me reiterate the 40% payout on net income can only be the lower boundary. But I want to be sure that the year is over we have 7 more weeks to go and that capital stays strong as it is, and then we'll be looking at that very carefully. We know that cash flow distribution extremely important. Michael was on road show in the U.S. to tell that to investors. We do understand that we need to be fully transparent on cash flow generation and distribution as opposed to accounting earnings only. But I'd like to leave it at that.

Unknown Analyst

Okay, that's fine. But I just wanted to check that this is correct that you have dividend out roughly EUR 250 million more from the Life business?

Oliver Bäte
Chairman of Management Board & CEO

Yes, up to the end of the 9 months.

Unknown Analyst

Yes, up to the end of 9 months, yes.

Oliver Bäte
Chairman of Management Board & CEO

Okay, would it be fair, ladies and gentlemen, if we close it with that or is there another urgent question that we have failed to address and that we can’t get from Oli's team over the next couple of hours because I'd like to pay some respect to you and the people that have to prepare for the Generali call, which is up in 15 minutes. And I'm also very happy, Oli knows that, to address questions you have to me directly, obviously, keeping Oli Schmidt and team involved. So thank you very much for your support today. For those that can actually head into the weekend, have a nice weekend and we see each other very soon.

Oliver Schmidt
Head of Investor Relations

Thank you and goodbye.

Operator

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