S&P Capital IQ

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Allianz SE DB:ALV

FQ2 2016 Earnings Call Transcripts

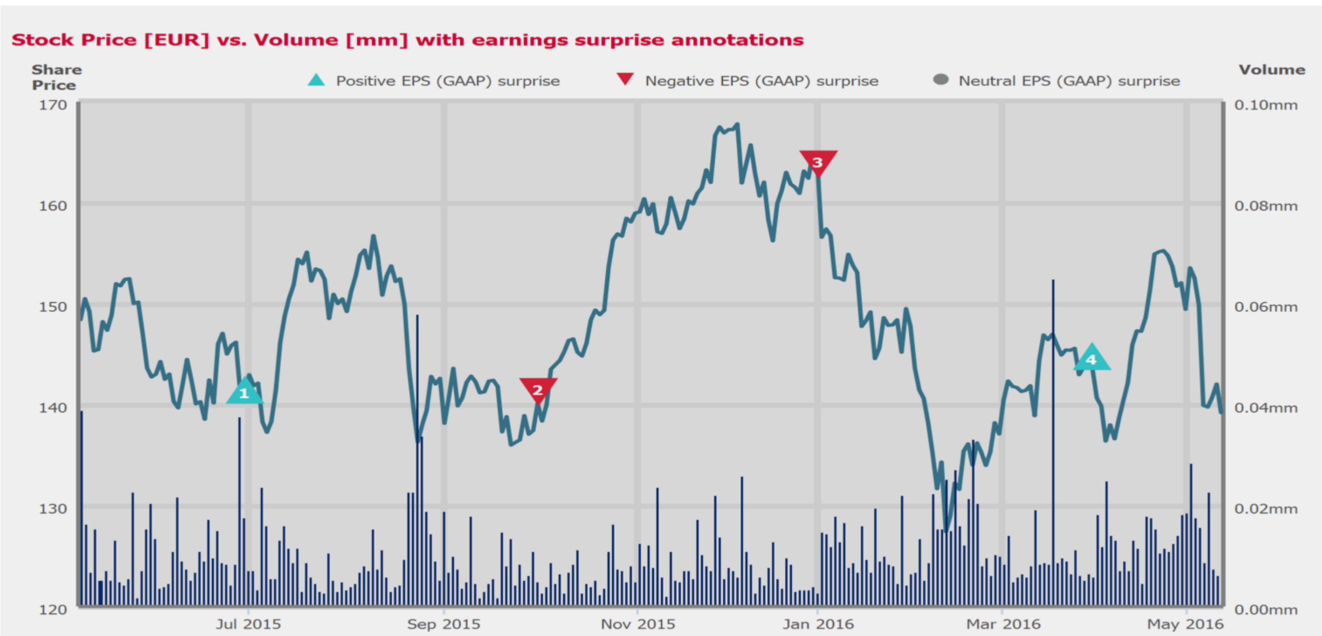
Friday, August 05, 2016 12:00 PM GMT

S&P Capital IQ Estimates

	-FQ2 2016-			-FQ3 2016-	-FY 2016-	-FY 2017-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS (GAAP)	3.67	2.35	(35.97 %)	2.72	14.31	15.37
Revenue (mm)	29275.50	29400.00	0.43	-	123371.38	126305.81

Currency: EUR

Consensus as of Aug-05-2016 12:00 PM GMT



- EPS (GAAP) -

	CONSENSUS	ACTUAL	SURPRISE
FQ2 2015	4.01	4.38	1 9.23 %
FQ3 2015	3.49	2.98	2 (14.61 %)
FQ4 2015	3.53	3.12	3 (11.61 %)
FQ1 2016	3.48	4.70	4 35.06 %

Call Participants

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Presentation

Operator

Good day, ladies and gentlemen, and welcome to the Allianz conference call on the financial results for the second quarter of 2016. For your information, today's conference is being recorded.

At this time, I'd like to turn the conference over to your host, Mr. Oliver Schmidt, Head of Investor Relations. Please go ahead, sir.

Oliver Schmidt
Head of Investor Relations

Yes. Thank you, Susan. Good afternoon from my side as well, and welcome to our conference call about the results of the second quarter 2016. There's nothing specific to be added from my side today, so without further ado, I hand over directly to Dieter.

Dieter F. Wemmer
CFO & Member of Management Board

Yes, thank you very much, Oliver, and also a warm welcome from my side to our second quarter results call.

I dive directly into the presentation. I hope you have it all opened in front of you. So I start on Page 3, first discussing the overview of the 6 months figures. Group revenues, EUR 64.8 billion, minus EUR 4.7 billion adjusted for currency movement and acquisition disposal, and that is 2.5% decline in the revenues driven by our Life and Health segment, which, on the internal measurement, reduced 6.5. P&C is up 3.1, and Asset Management is declining more than 9%. That resulted into an operating profit of EUR 5.1 billion for the half year. That is roughly 49% of our EUR 10.5 billion target for the year, which we, by the way, confirm and stick to.

Our net income was EUR 3.3 billion, it's 14.5% lower than last year. However, when you look at the full year 2015, we are, after 6 months in '16 exactly on half of last year's profit, that means for the people who are always doing the little calculation on the dividend, we are, at the moment, at least on last year's level, which I think is a great starting point for the second half of the year.

Combined ratio is up against last year, and, in particular, it worsened substantially in the second quarter due to, well, actually normal insurance volatility. I will talk about it in more detail.

New business margin continues the trend of the previous quarter. Our new strategy is manifesting it's -- in substantially higher new business margin despite the low-yield environment.

Cost income ratio for Asset Management is shown flat 6 months over 6 months, but actually, we are making nice focus in the second quarter, also a good story to talk about later on the details slide.

So with this one, let's go into the second quarter. Certainly, below EUR 2.4 billion operating profit is not the number that you and also us were hoping for. However, there are good reasons that we are where we are. The whole drop is in the P&C segment. Life and Health is actually nicely up. Asset Management, stabilizing even over 2Q '15, actually up 8% against Q1, and so rest is normal, little noise around a couple of segment and consolidation.

Net income, almost cut in half, driven by the lower operating profit factor, number one. Factor number two, recognizing an anticipated disposal loss using the IFRS 5 accounting rules for Korea of EUR 352 million. And number three, additional impairments on equity investments coming from the volatility of the Brexit mess after end of June.

So let me now go to the balance sheet. Actually, shareholders' equity is further up. Not surprisingly, our unrealized gains and losses got a real boost with the low-yield environment. And actually, also our unrealized gains in the equity portfolio is unchanged, but we have to recognize, on a gross basis, EUR 1 billion write-downs on our equity investments.

Solvency II capitalization, 186%. So we focus, not only on the Life segment, but also keeping in this volatile times the Solvency II capitalization in good faith was clearly one of the focus areas.

And when we go to the next chart on Page 9, then let me explain what special actions did we do, which were not I think of -- not obvious in the normal sensitivities announced. First of all, we did hedge or sell some banking exposure in April. But also we hedged all currency exposures we had from the British pounds in all other balance sheet which were non-pound denominated. And then we did additional credit spread hedges on some more southern government bonds. So that helped us actually, that we could keep our own funds very stable, because when you look at the own funds development, the little pluses and minuses between the various segments, ended up in total versus 0 trade -- 0 impact of the market impact. So certainly, lower interest rates were compensated by falling credit spreads, and our loan credit bond investments helped us in the quarter.

And in the derisking, there was only small that was mainly a reduction of the bank equity, which created the little reduction in the risk capital. The operating Solvency II earnings are lower than in the first quarter, and probably you are asking, well that is again a volatile number. In particular, the Life segment has some ups and downs, and the up and down is coming from operating experience or operating assumption changes in combination, so mainly operating experience. I would say, when you take the half year figure, then the half year figure is probably a good combination. That means instead of the 4 points of capital generation you see here on the chart, we had 9 in Q1, I would probably use somewhere in the middle between the two, so let's say around 6 as a good average between the two numbers. So that is the main explanation why we stick to 186, and I think it is a good work of the risk and investment team that we ran through difficult times fairly untainted.

P&C, actually good growth, internal growth accelerated to a 3.7%. That is 0.5 point more than in Q1. Good basic growth in Germany and France. Allianz Worldwide Partners, Spain continues to perform excellently, because in Spain, most of the increase is still priced, but is actually a very good development. And then 2 markets, which are not individually shown here, is Turkey, where we still grow market share, and also Argentina, where we take rates as recovery for last year's substantial underperformance.

When we go now to the combined ratio, that is probably the story we will discuss in the Q&A afterwards the longest. Quite a drop in operating profit for the P&C segment. Actually in all 3 areas, the area other is easy explained. We had, last year in this category shown as a one-off coming from the disposal of Fireman's Fund. So that was a EUR 200 million gain so that obviously has not been repeated this year.

Investment is mainly falling interest rates reduction and also capital upstreaming to the center, therefore, less investment income allocated to the segment P&C.

And now the underwriting results. Quarter-over-quarter, we have an increase in -- of 3 points in the combined ratio. The 3 points could be explained at face value with the increase in cat losses. We had EUR 500 million this quarter. Last year, it was some EUR 120 million, EUR 130 million so that is a simple explanation. But as we have also an increase in the runoff ratio by another 3 points there are still 3 points missing.

So we have, besides the cat loss increase, we have actually also an increase in other man-made losses. So the large losses are more than 1 point up, plus we have additional smaller weather-related events, which are not included in the cat definition. So I would say the net increase quarter-over-quarter last year is about 60, 70 base points in underlying attritional loss, a number I would have not liked to talk to you about because I was still confident that we could compensate the markets, which obviously had a tough environment like Italy, the credit insurance, but also our large corporate business. And our assumption was that the rest would make up for it. But we are behind the curve again in our development in Latin America. So that is the main driver I think, which makes probably most of the 60 base points. So it is a delay, but still thinking that getting to the 94% by 2018 with recovery in loss ratios, but also there's more work on the expense ratio, which is at the moment more, showing the effect of additional investments instead of reduction is probably a fair assumption.

So when you go on Page 15 into the detail page, there you can see actually which countries were mainly hit by catastrophe events. Germany, it was a series of bad spring, summer weather events. France, the same, floods and hailstorms. Not yet on the list, Belgium and Netherlands, affected by the same series or similar series of events. Our global corporate business has some European damage, but also a little bit of the Japanese earthquake, a piece of the Canadian bushfire and also of the hailstorm in Wylie, Texas.

But probably we will talk about it later more, so I would now go to the investment area. I said already investment income for P&C down. The reduction is a little bit smaller average asset base, that is a reduction you see on -- shown in the bubbles, plus a reduction in yields, which you can see on the right-hand side, which is very much expected in this environment. I think we are still doing a very good job on keeping the reinvestment yields at a 2% level, which is a good number. And certainly, we have increased slightly the duration in our P&C segment, also to keep the yield up.

So moving to Life. Actually, Page 19, is an excellent proof point that our life strategy is working, that we can adjust to the current market environment. Volume-wise, in the second quarter, we are almost catching up with the strong year, strong quarter in 2015. And the main contributors in growth are actually Germany and the U.S. We see a reduction in business -- well, we have, first of all, we have to exclude the Korea from the operating numbers because we moved Korea to nonoperating. But also we see a drop in our new business volume in Taiwan, that is a unit-linked business and unit-linked market, both substantially smaller in Taiwan as customers are more nervous about equity volatility in this part of the world. So that explains also why the category, unit-linked without guarantees, was smaller, where the category capital-efficient product, that is mainly U.S. and Germany, are substantially up. That is also -- well, the new business is actually not resulting in a good operating profit because we have still coming out of the new business roughly EUR 100 million loss from the new business written in the specific quarter. So that is obviously included in the overall operating cost.

Operating profits at EUR 1 billion. This is a good and extraordinary number. No, I think it has normalized in a lot of categories. But Korea is excluded as we affirm that Korea -- that the disposal of Korea will be completed during the year. So -- and the investment margin, which is slightly up, that is mainly Germany that is normalizing an ultralow investment margin we had in the second quarter at 2015. So actually, it is a pretty good picture of the earnings power of the Life segment at Allianz.

So when I go to new business, also new business generation is at a very good level. That is enough value generation, actually to replace in the operating profit maturing business. And I think we are on a good track with our overall outlook for the Life segment.

Page 25 is the usual page on demonstrating how this guarantee move, how much yield are we still producing, I think that is more as a proof point that the guarantees are not biting, that there is still enough for the customer and also the shareholder coming from the investment returns.

So let's move over to the Asset Management. Sure, assets under management, 5 points up. Outflows at PIMCO, EUR 18 billion at Allianz Global Investors, EUR 1 billion compensated by market movement, which makes 2% FX, also 2% and other is the first time integration of the Rogge acquisition of roughly EUR 30 billion assets leading to the overall EUR 1.3 trillion figure. The outflows at PIMCO, higher than in Q1, but we are still sticking to our statements that we are expecting 0 number for the second half year of 2016. Actually, when I gave some message in May, the outflow of EUR 18 billion at PIMCO was already unknown because it happened very much in the beginning of April, we had institutional money of EUR 17 billion leaving the door, and the rest of the quarter and all customers together generated just minus EUR 1 billion, which I think is a very good confirmation for the direction overall.

The margin in Asset Management are holding up. We are even a little bit higher than, actually, in the first quarter, but that is a usual story about the number of fee days. So I would say it is unchanged level to Q1, and therefore, we see actually in the operating profit an unchanged figure to the year ago, and a slight positive figure or actually, a good positive development against Q1. Operating profit in Q2 is 8% higher than in Q1, mainly driven from PIMCO. The nonpersonnel expenses at PIMCO have reduced. PIMCO had a 62 cost income ratio in the second quarter. We still have some of the special retention package we created after Bill Gross' departure for 18 months ago. When I take this booking out, then we would be at

61.1% cost income ratio for the second quarter. So actually, I think we are also here on a good track for development in the direction of 60% as we have stated as one of our 2018 targets.

And with this one, I am coming already to the end of the operating profit story. Corporate segment, almost no movement again. Last year, we are now back to a normal quarter. The first quarter had a special effect from own pension transfers already at a year ago, we are now here at a normal quarter. Therefore, when we take the first half year, takes the one-off out, we are very much on track with our overall operating outlook for the year.

So page -- summary page showing the translation from operating profit to net income. I would really like to spend first a minute on Korea. We have signed the sales agreements to Anbang on April 6, and decided that we would show the business from April 6 on -- as nonoperating as we are working with the buyer on actually, execution the transfer. We had also agreed with them certain changes we managed for them already in the company, that is a restructuring, but also agreements with the trade unions and so on. Therefore, I think it is really an entity, which is not anymore being run as an Allianz managed company.

So the IFRS 5 rules, when you move something as held for sale is a quite complicated standard. Therefore, we could impair all noncurrent asset in the balance sheet of the Korean subsidiary, that is in total EUR 209 million, and that means there is no other noncurrent assets left in the balance sheet. Additionally, the operating losses, which we crystalized in the second quarter of EUR 250 million, plus the tax effect, brings us in total to EUR 352 million net impact. And this number brings us fairly close to the results when the disposal is then finalized after all regulatory approvals have been arrived.

So that is a complex process, but I'm not the owner of the IFRS rules, we are only the owner of the execution of the IFRS rules, and that we have done according to textbook.

So the other important number to mention is, besides Korea, we had more impairments coming from the equity market. Even as the market after the Brexit referendum after some volatility recovered quite well, actually, the DAX was, quarter-over-quarter, only down 3% or 4%, while, actually, the FTSE100 was even up. The market movements of individual stocks showed much more volatility. Therefore, we had actually to recognize quite a number of impairments in the second quarter from this big, big swings in individual stock prices, but overall, our stock portfolio is in very good shape, and actually, when I look at it today, they are substantially above half year level. And we decided, at the end of the quarter, not to start now to sell some equities with positive development to make up for the impairment losses because we felt selling was end of June really bad timing as we felt that the market would continue to recover more, which seems to be, at least as of today, be a reasonable strategy.

So with this points, I think we are coming to the end. Let me summarize the overall results. Q2 hit by a lot of additional volatility and Korea one-off, in particular, still besides, if you want to say so, a lackluster second quarter, our half year is still resulting in an annualized RoE of 12%, which I think is still an outstanding number in the world of financial institutions. For 2018, we feel also that our P&C combined ratio still on track to achieve the 94%. Life strategy making good progress, we believe we will move the segment to the 10% hurdle to a very large extent. New business margin, very well on track. Cost income ratio for PIMCO on track. And the other parameters will be updated over time. But none of the parameters giving us, at the moment, any concerns that we will not -- cannot find with them in 2018.
So with this one, thank you very much, and I'm interested to learn about your questions.

Question and Answer

Operator

[Operator Instructions] Our first question comes from Peter Eliot of Kepler Cheuvreux.

Peter Eliot
Kepler Cheuvreux, Research Division

I have 3 questions please. The first one was, I wondered if you could give us a bit more color on the AGCS claims. I mean, there seems to be a bit of trend and weak results from corporate solutions businesses across the industry, especially from large losses and I was just wondering if you could comment on to the extent that you think this is one-off or an ongoing trend? And secondly, on targets. I mean, you mentioned how we can get to the 94% by cutting expenses, turning around LatAm. I guess you're always probably going to have, by the nature, if it's going to have some underperforming businesses, and you've got some adverse trends, which give you a little bit less wriggle room on the combined ratio. And unlike one of your peers, I guess you've chosen to go for a point target on the group EPS. You've got a bit more visibility now on how you might get that. I was just wondering if you could comment on the sort of the confidence on the EPS targets as well. And then finally, maybe a bit lighter off the results. I was very interested in your press release on the 15th of June on the use of block chain technology to cut swaps. I was wondering if you could comment how quickly you anticipate that sort of technology being rolled both for yourself and across the industry, in general, and sort of relative and absolute responses that might bring?

Dieter F. Wemmer
CFO & Member of Management Board

Thank you very much, Peter. So AGCS, I don't think that we can recognize a claims pattern. Let me take the example of the hailstorm in Texas. Wylie is a nice little town in Texas, which was hit in March 23, actually on -- and April 11 again by a big hailstorm. It is actually, I think, the April 11 event results in a 1.5 billion to 2 billion event for the whole insurance industry. So quite substantial. And we have only a very few customers there, but it would cost us $80 million. The April event and we had already in March something to book, so for the half year, it was EUR 100 million, which we have to recognize for this event only. Then there was the bushfire in Canada. There were some EUR 20 million, the earthquake in Japan. And then we had also a few large man-made losses here in Europe, but also Latin America, I would not say that we can really say there is a claims trends which should worry us. I think we are -- and then the aviation losses, I think that is just -- I would never cover. This quarter had none, but actually, the third quarter, started already with a smaller aviation loss, that's one everybody could see in the news. So the 94% combined ratio. Yes, there will be ups and downs. But I think at the overall portfolio management, and we are, in total, not so far away from the 94%. I think when you look at our numbers over the last years, we are below the 95% level, so the 94%, it's the last percentage point we have to move the average to. Quite some levels, quite some different events, and I think we are still believing we can move at least there. The EPS target, you can say, a point target, sure. And I said when we introduced it, that is about having in 2018, 15% more than 3 years earlier. Not that we go quarter-by-quarter with a growth rate of 1.25%. Certainly, this year, we have actually to bear some extras, but even in the year 2016, where we bear some extras, I think we have still a good chance that we finish the year with a higher EPS number than last year, and I think that is pretty much intact. We are, at the moment, running at exactly 50% of last year's earnings per share, if you want to say so. So there is -- when you assume that we have a higher operating profit in the second half of the year and nothing special in plus and minus also on the financial markets, then we are actually very much on track to end up also the year here more in the plus category than in the minus category. So we are not giving forecast on our net income, but then you add up all numbers then the potential should be visible to everybody. The block chain technology that is our ART team, which is using it, I think that is certainly a very interesting test to implement it. Will it create huge volumes of new business? I think that is a bit too early to say it, but I think it shows that we are in all categories really running forefront technology and shows the positioning of our company. And I assume it will add a nice additional profit line. But cat bonds is not yet such a huge business that it can even with the best technology to change our overall operating profit.

Peter Eliot
Kepler Cheuvreux, Research Division

If I could just come back very, very quickly on the targets and the sort of point nature, I guess I was referring also to the fact that it's not dependent on the sort of economic environment, which, obviously, has deteriorated over the last year. I mean, it sounds like that hasn't dented your confidence too much that you may not want to comment.

Dieter F. Wemmer
CFO & Member of Management Board

Well, clearly if -- and if this is your question, there is still the unused M&A budget, which is at the moment, still piling up. And end of the year, we are sticking to our promise. If it has not been used for M&A, we give it back to our investors. So that means either M&A increases the earnings or we give it back and then the number of shares is being reduced. Though in both cases, clearly EPS enhancing, and that's part is certainly part also of the 5% EPS logic. And in all discussions that over the last 12, 24 months, I think we have never hidden that the EPS target is influenced by capital management as well as organic earnings development.

Operator

Our next question comes from James Shuck of UBS.

James Austin Shuck
UBS Investment Bank, Research Division

Dieter, it's James Shuck from UBS. I had 3 questions please. First one, sorry to return to the combined ratio in the second quarter, but some -- I just wanted to understand that the source of the underlying deterioration in the quarter. That you mentioned kind of if we adjust the large losses in prior year and all sorts of things, then the 60 basis points of underlying deterioration in the quarter. The commission ratio also got worse, which presumably should be a high commission so quite a better profitable business. So the net deterioration in the quarter is actually 1 point year-on-year. And on your current disclosure, it's quite hard to see exactly which territories and OEs that's coming from. So if you could just shed some light on the OEs that the underlying deterioration is coming from that would be helpful. Obviously, LatAm actually you got a bit better in the period so I don't see that as being a drag on the year-on-year comparison. Secondly, from a capital generation point. So I think previously you had indicated that your net capital generation net of tax and after dividend accrual should be about 10 points some on a normalized basis in a year. So if I kind of backs off from what you were saying previously, where you would take the average of the Q1 and the Q2, you end up with the kind of 24 points pretax annualized. So net of tax, that's closer to 17. I may be nitpicking here, but I just wanted to understand, are you -- sorry, that’s predividend accrual so the 17 then goes minus 10 to get you back to 7, so are you actually kind of saying that the capital generation is a bit less than when you had last indicated it? And when I think about that capital generation, is there any reason why it should be growing faster than earnings, obviously, you got the growth in the new business as very strong and that should monetize. So how should I think about the growth trajectory on that either 7 or 10 points whichever the number is that you're guiding to now. And then thirdly, I'm interested in your RoE target. So you've increased your RoE target at the Investor Day. At the same time, the EPS growth target and if you just run through what 5% EPS growth gets you on the RoE based on your current payout ratio and allowing perhaps for other deployment of the M&A budget, it still doesn't get you anywhere near 13% RoE in 2018. And the implication is you have to take -- make quite a sizable move on the equity base. So could you just tell me is there anything I'm missing in that kind of simplistic calculation? Are you planning on doing any debt reduction? Or is it a simple case of you're going to end up with more equity than you actually need, particularly given you're currently very well capitalized on a Solvency II basis?

Dieter F. Wemmer
CFO & Member of Management Board

Okay. James, that is a lot of very technical question, but let me start with the combined ratio that is more the easier one. The commission ratio increase is quite often also for a segment, the mix change and even currency rates change the average commission ratio and nothing had changed in the original business. So therefore, it's always a bit of a complicated story. But certainly, our expanding business, Allianz Worldwide Partners, which is also over the last years one of our fastest-growing business, in general, the commission ratios in this business are substantially higher than what you have seen there. So what we have seen, so therefore, a 10, 20 base points movement is fairly fast achieved. But we have also seen in markets like France or Germany a little bit increase in average commission. The markets, which certainly, and that was never hidden has -- are facing, I think soft markets. It starts with Italy. So therefore, when you see a decline in our Italian premium and you compare that also with the announcement you have seen from the Italian market in recent weeks, whether it was Victoria, whether it was Unipol or Generali, everybody reports in a decline of motor premiums of 6% to 7%, which is also roughly our figure, around 6%. Yes, that is mainly a rate decline as it is when the whole market is moving in this as the number of cars has not changed in a material way. So that is an example, but also the credit insurance and also our corporate business are writing more carefully because the markets are softer. So as a correspondence, you see increases in the attritional ratio. Overall, we see decreases in the attritional ratios in countries like Spain and the U.K., in Australia, in Turkey, in Argentina. And I think that is overall, I think going into the right direction. So when we go to capital generation, I think we are still pretty close to the 10% number. Because the number exactly, what is a Life producing every quarter is a bit tricky to say, and when I meant actually around 6%, that is actually -- that is a pretax number and that means when -- I rounded it down. We actually had the first half year, the 9 plus 4 is 13. You subtract 30% taxes, you are at 9 and either you multiply it now by 2 or you say the other half is a dividend, so you get to roughly 9.5 year, and I must say that it's probably as precise as I can say it, and maybe it's rounded 10 or it's rounded at 9 that I can really not tell you. And it will vary a little bit every quarter. The RoE targets. Well, with an unchanged equity, it would mean to move from 12% to 13%, you need actually over the 3 years and my math is not wrong, a 6% net income increase on unchanged equity. Then you would achieve the 13%. So with, either you reduce now the equity or you get to a combination of profit increase and equity reduction, I think there are plenty of combinations which would allow us to end with the 13% RoE. I think you can also test it the other way, when P&C makes the 94%, Asset Management stays stable, and we move our life OEs as announced to the 10% minimum RoE then you are also ending up at 30%. So you can actually test it and verify it in various methodologies. I think the chances are quite intact. And it was now -- it was not an announcement about the results, that was just back of the envelope test to make you, James, comfortable with the number.

Operator

Next question comes from Michael Huttner of JPMorgan.

Michael Igor Huttner
JP Morgan Chase & Co, Research Division

You actually answered almost all my questions and so I'm struggling a bit, and nice presentation. I like the certainty of the consonance on the 9% or 10%. And just a few numbers. Could you say what the pro forma solvency is? So adding your run rate of capital generation plus the Korea and Taiwan benefits, I'm getting to a figure of...

Dieter F. Wemmer
CFO & Member of Management Board

Michael, I have not understood you. What...

Michael Igor Huttner
JP Morgan Chase & Co, Research Division

Yes. I'm sorry, sorry. I'll say it again. What's the pro forma solvency if I include Korea, Taiwan and your organic capital generation so maybe in December '16. I'm guessing with somewhere around between 196 and 200. And also can you give a figure for these large claims? And just, it just make -- would make my life a lot easier because then I could just pin it down and move on. And then more conceptually, the EUR

1 billion figure in Life, which very few one-offs, so maybe dividend is a bit unusual or the hedging benefit. So maybe the run rate is closer to EUR 900 million or EUR 950 million. How would you explain -- how does one explain that to a journalist, that even though interest rates have never been lower in history, Allianz Life earnings continue going up, that would be, if I can do that, then I think the rest is actually not so important.

Dieter F. Wemmer
CFO & Member of Management Board

Okay. On the Solvency II number, I'm not doing a pro forma forecast. You have to wait for the announcement of the final disposals of Taiwan and Korea as well as on the progress on the operating Solvency II earnings. I think we are -- as I've said before, we are really firm that we are managing our solvency ratio in this range, 180% to 220%, and I think we are also on good track that we can deliver also on all promises we made with our dividend policy. So what explains the good profits in the Life segment? Well, I think the -- yes, you can say we still have a duration mismatch, so we are not fully hedged against the falling interest rates. However, as we are hedged, for example, in Germany, for the first 30 years where we have actually -- we are not only cash flow matched, we actually have more assets there than liabilities in the cash flow models. That means that also, the relation between guarantee and investment income we are making there is actually fixed for this period. So the interest rates in the market may swing, but our cash flow matching for this year is not changing. That means it's just run off. And all this tail discussion and solvency ratio goes up and down, that is from an operating profit point of view, we are talking here always of the years 2045 and later. And that I think is always forgotten in all this debate about mark-to-market. In times where interest rates are 0 or even negative, things which are 50 years away now are being looked at a magnifying glass and actually become bigger in year 1 than in year 50. That is the effect of negative rates, something we are absolutely not used to, whereas accounting runs off year by year and we have to wait to the next generation of actually CFOs and accountants actually to force this operating profit. Therefore, we are really mixing the timeline up based on this complicated long-term models. And the new business margin and the new business value we generate is actually only to replace the operating profit which is maturing. So as a policy, old policy is maturing, falling off as the value in force, that operating profit is gone, sure. And now the only question is, is maturing business being replaced by the operating profit coming out of the new business generated? And with a new business margin of 2.5% and our current volumes of new business, the answer is yes. I -- we calculate actually internally. That's even more precise, but I'm not making specific long-term forecast for the Life segment. But you can hear that we -- none of us is in tears here. We are actually quite confident.

Michael Igor Huttner
JP Morgan Chase & Co, Research Division

And just on the cost of the large claims?

Dieter F. Wemmer
CFO & Member of Management Board

The large claims figures, yes. I think I gave the absolute number this morning also with the press because they asked me also on absolute figures. And the total out of large losses, cat and other weather-related was in total close to EUR 1.2 billion in absolute figures. We discussed before the relative change to previous year, but the total number is EUR 1.2 billion, is roughly the number.

Dieter F. Wemmer
CFO & Member of Management Board

I think -- I hope I covered here the pro forma. I'm sorry, you have to be patient.

Michael Igor Huttner
JP Morgan Chase & Co, Research Division

No, that's fine. I'll pretend it's 200 and I'll be fine.

Operator

[Operator Instructions] Our next question comes from Thomas Seidl of Bernstein.

Thomas Seidl
Sanford C. Bernstein & Co., LLC., Research Division

Three questions. First, on your 2018 targets again. I think last year, in November, you've told us your assumption was flat interest rates but rising interest rates. But since then, the 20-year rates has fallen from 150 to 75, and I simply assumed that like in the past, your reinvestment here is going to drop in line with those swap rates. I mean, that has been the pattern for the last 5, 6 years, so why should it be different now? So what are you doing in P&C and Life to still allow you to achieve less than EPS growth target, more important for me, the RoE target? So what additional actions you are going to take to fight this unexpected and as the last November, unplanned dramatic drop in yield? That's the first question. Second, I'd like to have a bit more clarity on M&A please. In the past, I think also to the -- [ph] challenges you talk about the strategic fit. So in P&C, would you include greenfield markets where the market is attractive but you are not yet there in the strategic fit? Or must it be like I have invested in the past, a market where we're already operating and have management capability on the ground? And regarding Asset Management, I think Oliver Bäte said in March he wants to bring down the beta of the group, how does that fit to doing potential M&A in the Asset Management space? Isn't that basically increasing the beta of Allianz group? And third question, if I may, on PIMCO just very briefly. You are assuming now flat assets under management going forward. There was a one-off exit from one client in April as we learned. How -- and -- but at the same time, you're saying you are not planning to run a cost cutting, so I don't square it even if I assume a rising second half performance which I don't get to the 60% number. So what am I missing here?

Dieter F. Wemmer
CFO & Member of Management Board

Well, let me start with the PIMCO at the end. First of all, PIMCO has announced in June actually quite some additional expense cutting, which also affects the HR base. So therefore, that improvement is coming into the second half of the year. When the question this morning was about additional announcement and there, I said I'm not expecting, for the time being, additional announcement. And I think with -- the performance fees should bring us actually already closer to the 60% level. And what I also said before in my first presentation that actually, we still have 1 percentage point in the cost income ratio, which is coming from the pension plan, which is maturing and will be focused the last time in Q1 2017. So that means there is -- and then I hope also, and not only hope, we are confident that we also bring additional new developments also with the new leader for PIMCO. I think this till 2018, we want to see also some positive development. PIMCO has already some beta in its portfolio. I think when we would isolate the PIMCO's hedge fund business, which is already existing for quite some time, we would rank standalone among the top 10 hedge funds managers globally. So therefore, it's not that we are [indiscernible] a beginner, we are actually doing already quite a bit. So we would -- yes, if start-ups -- the right approach to acquire, I think we are looking also in the Asset Management field in many opportunities, whether it's start-up or whether we find other things which could fit the same as we are twinning [ph] the insurance M&A market. I think in insurance, the start-ups are probably -- we are creating our own start-ups certainly in the digital space but also in other spaces. But acquiring them could make in the digital sector be of sense. [ph] Otherwise, our main M&A strategy has still to be creating scale in the P&C markets where we have already a good starting point. That would be still my point. Then you have the question about the assumptions that changed for our 2018 targets. Yes, you are right. The investment income topic became much tougher. That is certainly -- I think the Life topic, we have discussed separately because the new business margin has already been adjusted to the new interest rate environment. So in Life, we are already doing the right things. Therefore, the open point is the falling investment income in P&C, how can we compensate. And I believe that the expense topic is certainly topic #1 to look at.

Thomas Seidl
Sanford C. Bernstein & Co., LLC., Research Division

On the -- maybe one follow-up question on the M&A side. So you said when you have a starting position, that means you must have an operation in such a country where you're looking for accretive P&C acquisitions?

Dieter F. Wemmer
CFO & Member of Management Board

That would be the main point to look at because otherwise, it doesn't move the needle too much. Yes, we do also some wide spot [ph] acquisition, most recent, our acquisition into Morocco. There was, so far, no question about it. We have, so far, 12 smaller countries in Africa, actually, all in the French-speaking part of Africa. Therefore, actually, we will use Morocco then also as a center for driving our African developments. It's also, from a language point of view, a good combination. And then we will start more systematically to build up our African businesses, which are growing fine, but they never make it even to any disclosures in our report because the operating profit numbers are still too small. So therefore, Africa will not close the gap for the 2018 targets, but it is certainly a very good basis, and we want to be an early mover because for the next generation, it might be a very important market.

Operator

The next question comes from Andrew Ritchie of Autonomous.

Andrew James Ritchie
Autonomous Research LLP

Just one quick question. The reinvestment rate -- first question, the reinvestment rate in P&C, the economic reinvestment rate actually went up 30 basis points Q2 versus Q1, which was a bit surprising given what's happened to yields in the market. I think there's a footnote saying you may have changed the calculation basis. So if you could just clarify what's going on, that will be helpful. The second question, Life RoE, that target still looks like the nice challenging target for 2018, especially in the current rate environment. If I look particularly at France, the French Life RoE is very low. Is that a problem of R or a probably of E? And finally, just on PIMCO, I can't decide whether your outlook has changed or not, because when I look at the transcripts from Q1, you were talking about small inflows that you expect in the second half of this year. I think you're now saying breakeven or maybe you think breakeven for the period as a whole, but you still expect to get these small inflows by the end of the year. What -- is there a change or not? And do you expect the new CEO to bring a meaningful change of strategy at PIMCO or is this sort of evolution?

Dieter F. Wemmer
CFO & Member of Management Board

Okay, Andrew. I go also back, so let's start with PIMCO. No, I think that is just a nuance in language, not a nuance in statement between 0 and small positive. I think that we get to 0 small positive is probably the number I would expect. But I would not -- I'm -- I think I'm pretty unchanged in the statement, not only compared to Q1 actually, but even to Q3 last year. The RoE is at 10% for everybody. That is indeed a challenging target. But when we keep the returns, that is an E question in France, and we have a clear execution plan with our French team, what are we changing, what are we doing, and we will be at the 10% level in 2018. So the reinvestment rate, there are 2 -- well, it's actually quite a number of explanations. First of all, the definition has not changed second quarter over first quarter. However, the cash which was reinvested had more emerging market share in Q2 than in Q1. It was actually 16% versus 14% because we had more fresh cash in emerging markets that is also -- I think Turkey and Argentina play a little role here. Further, we have increased duration. But you can also see, when you look at our Q2 '16 duration number, we have started to buy longer in the market and then also, we are buying less government bond and go more in the corporate space. So I think the 3 things together add to this little increase.

Andrew James Ritchie
Autonomous Research LLP

So is the emerging market just because the timing of reinvestment there? Or is it a deliberate increase in exposure there?

Dieter F. Wemmer
CFO & Member of Management Board

No, no, that is in the local market. So it's not taking more, let's say, in Germany by buying Indonesian bonds. It is really -- we had -- I think second quarter, our premium income in Argentina grew 56%. And in Turkey, Malta, we are also more than 50% growth in premium income. And when you can invest in Turkey or Argentina, you get slightly different yields than investing in Frankfurt with Mr. Draghi.

Andrew James Ritchie
Autonomous Research LLP

And just a question on the new CEO at PIMCO. I think you're trying to suggest that PIMCO does a lot of things already. For example, when you talk about hedge funds, I mean, how -- what's the color behind his appointment? Do you see it as a meaningful strategy update and change or is this more an evolution?

Dieter F. Wemmer
CFO & Member of Management Board

I think evolution is the minimum. And when he has more ideas and brings more interesting proposals, well, I think we should give him a chance to onboard, starting his job on November 1. So it's still some time from today. And then I think that's probably a good question to ask in a year from now or maybe in Q1 but not earlier.

Operator

Next question comes from Paul De'Ath of RBC.

Paul De'Ath
RBC Capital Markets, LLC, Research Division

Just a couple of questions on the Life business, if I may. And firstly, on the new business side, obviously, you've been doing very, very well in the capitalization product, particularly in Germany. Wonder if you could give any comment on sort of where the competition is with that? Are you expecting others to copy your products and take some of your very strong market share in that going forward? Some guidance on that will be good. And secondly, just kind of to clarify really, on the investment margin, and so I think you guided to 90 basis points for the full year on the investment margin. Where does that go further out than that? Should we be expecting a slight decline in that investment margin? Or after your comments on the sort of cash flow matching in Germany, is that going to be a lot more stable than that?

Dieter F. Wemmer
CFO & Member of Management Board

Well, actually, we are stable in the individual country numbers. We raised it to 90 basis points compared to earlier years because the rate of the U.S. business and the overall segments got bigger. And certainly, Korea did also not help this investment margin. So therefore, I think the 90 basis points is an intact guidance. On the German competition and the German new business margin, actually, a very good question you are raising, Paul. We are, at the moment, still showing our German new business margin in a very conservative manner. Due to the complex processes to apply for our internal model, we could not adjust the German internal model to the new products which we are selling so well and also some legal changes. We had actually to deal with this changes with add-on and on a bulk basis, that we could really keep the timeline for all this internal model approvals. We are filing this August an updated internal model for our German Life business, which will then also be used for the official Solvency II calculation beginning of '17, assuming that the regulators approve our changes. But what we will do is, even without approval of the regulator, we will use it for calculating the new business margin of our German Life business from third quarter on because it measures more precisely the capital-efficient products we have missed there, actually, a part of the new business margin. And this recalculation will lead to a nice uplift of the German new business margin, which is a better reflection of what we are really doing. So does this mean that we need to be frightened of our competitors? Well, even as they are now copying our products one on one, on average, the German competition has 100 basis points disadvantage on the expense ratio in Life. And the lower the yield environment is, the more its competitive disadvantage on the expenses biting. Therefore, we are not concerned that the competition can really reach us and new business volumes and what we are doing. And some more we sell, actually, that clearly helps our expense positioning.

Operator

The next question comes from Vinit Malhotra from Mediobanca.

Vinit Malhotra

Dieter, a few years ago, when the new dividend policy was introduced, you had also mentioned the stock of capital and not just the flow. And I was just wondering what your thoughts are on that because obviously, this new target you have mentioned time and again, does depends also on the E. And even if you look at 186 now, there is a couple of billion sitting there versus the 180%. So I was just wondering what your thoughts are on that? That's the first question. Second question is in the Life RoE discussion, the metric that you show on the slide shows the percentage of the business that is producing the 10%. This has fallen from 1Q to 2Q. But obviously, you need to get it to the 100% stage. And you mentioned France where there seems to be the labor law problem related to some changes, which has specialized technical margin but also subsiding [ph] -- and maybe could you just comment on which of these markets which led to be compression in this metric that we see on the slide? And just very last, very quick one, yes-no type of answer, the frequency for large losses you talked about today, does it prompt you to change anything in the reinsurance? Or you think this is purely one-off, no pattern kind of situation here?

Dieter F. Wemmer
CFO & Member of Management Board

Yes. Okay. I think the large losses -- we have not changed our reinsurance purchases. We are constantly discussing with our in-house reinsurance as well as this large OEs what is the optimal retention you should take. Is there a possibility to take advantage of the soft reinsurance market? What are still played off, we have constantly this optimization questions. But so far, we have only changed some small areas that we have bought a little bit more of reinsurance but nothing very material. When -- actually, this calculation of the 10% RoE levels and I discussed actually with some of you on the call this when we had here our little Capital Markets Day a few weeks ago that you are seeing while it is actually a very volatile calculation and there might be quarters up and down, and I agreed that it is very much up and down. And at the moment, when I look at the numbers, France, U.S. and Italy are really just part of the 10% a little bit. And when I would trade -- or show more an ample traffic, who is at the low 5% or traffic light logic, who is below 5%, who is 8%, 9% and who is at 10%, you would probably get a better feeling where we are, and we have maybe to consider this. It was very much also our internal communication, either you are on the right side of the table or you are on the wrong side. Therefore, we use the chart 10% in our calculation as a benchmark setting. I think that is good for internal measurement. It might give you not the right impression how close we are and how far away we are. And certainly, when we do the Capital Market Day in November, we will give you there a much deeper insight of how we are spending and how difficult the rest is. On the dividend policy, I can reconfirm that we certainly do that, what we said. It's unused M&A budget. Also, the 50% payout ratio absolutely unchanged. As our capital market actions, well, we have still to see what M&A opportunities are coming up because the race is not ending end of '16. We will continue to look around. And I think we are -- at some point, the market will start also to move, and there will be opportunities coming out of the low yield environment. We have just to be patient. We just cannot push it through for this year, then it might be next year or it might be in 2 years or it might be in 3 years. I think the market will come sooner or later with good opportunities that we have not to buy totally overpriced businesses, that the prices are coming to a more rational level.

Operator

The next question comes from William Hawkins of KBW.

William Hawkins
Keefe, Bruyette & Woods Limited, Research Division

Sorry, back on Slide 9 and the operating Solvency II capital generation. I'm getting confused over different percentages that we're talking about. So can we just try and talk about billions of euro instead. My back of envelope is if I strip out the variances of the past couple of quarters in the Life business, the equivalent of the percentage points you've been giving, is about EUR 2.8 billion per quarter of pretax capital generation. Can you confirm if that's right? And then following from that, what exactly are these variances that have bounced around so much in the first and second quarter? And how do we assume -- are these going to carry on bouncing in a big way or has something funny been happening and should they net to 0 or to something either side? You've been doing a lot of hedging. Does that start to drag the capital generation at some point? Because there must be an opportunity cost of managing your Solvency II ratio to be as stable as it has been. And then finally, on this point, how are you thinking about this capital generation figure versus your distributable free cash flow? Because there’s a temptation to say that this is free cash flow because it looks like regulatory earnings. But actually, it's basically just an embedded value profit dressed up in another way. And for sure, if you're doing EUR 500 million a quarter of new business value, for example, I can't believe that a regulator on the ground would consider that distributable earnings on day 1. So you might want to be briefer on that last point, but just how you're reconciling with free cash flow. And then to the extent that -- that's 5 questions and my first. Very briefly on the last one. I thought your U.S. sales could have been weaker this past quarter because of the impact of DOL on your fixed index. But that clearly was completely wrong. You've had another great quarter. But is the DOL change at some point likely to have a more visible impact on your sales and why didn't it hurt the second quarter very much?

Dieter F. Wemmer
CFO & Member of Management Board

I think the DOL effect, we will probably -- will crystallize more in 2017. But we are still optimistic that the fixed index annuity products are actually in the best interest of customers, therefore, they will continue to play an important role. So I -- that is -- therefore, I go backwards with your question. So the other one, as I think we have disclosed 9% earnings generation in Q1, we have disclosed to 4% here. So what is the driver of the ups and downs? It is not the new business volume, it is really the total operating variance as you can also see it in our old MCEV report because it is essentially the same definition even when the calculations on the Solvency II are slightly adjusted but not a big difference. The logic is still the same. We had in Q1 a positive operating variance of EUR 655 million and in 2Q, a negative operating variance of EUR 826 million, to be very precise. And that is I could now split it down into experience variance, assumption changes and other operating variances. But by and large, you can also look at our old MCEV reports that we are, in total, more on the conservative side on this one than on the too optimistic side. So that means that the long-term average of this number should be more a small positive. At the moment, in the half year, we have actually a small negative out of the 2 numbers, which is very untypical for our long-term track record. But it was a specific -- an update in Germany which had to do with the local staff [ph] numbers and the way we how we progress on quarter-to-quarter. So therefore, I still think that the average of the 2 quarters is a good starting point and is not overoptimistic. It is a good starting point. Therefore, the 9 and 4 might be, in total, at the lower long-term end, but it is a good starting point. Then you have to take out the tax rates and all of this as we went with already with James when he asked for it. So is -- how does it link to liquidity? Well, first of all, I think we have done a lot of cash upstreaming over the last years, done it in a way and also, we run the group at the range 180% to 220%, but the individual OEs, we run at a lower Solvency II target. That means the difference between our average OE level and the average group level is the central cash and at the center, there is no new business value we can hold as capital at the center. It is in the end, very liquid surplus we have in our SE. Therefore, I would say, the binding constraint is more coming from the -- our decision to run the group at the 180% to 220% Solvency ratio, and not from a lack of liquidity, that might change in the number of years when the solvency generation and new business value are becoming more and more driving elements. But I think that will take quite some time before we need to have this discussion again and rewrite the statements I have made.

William Hawkins
Keefe, Bruyette & Woods Limited, Research Division

And just finally on that, Dieter. With regards to the hedging, I mean, this is a ratio that I would've thought should've been very volatile. You're keeping it very stable. There seems to be a lot of hedgings going on. Isn't there an opportunity cost that must be creeping up somewhere from that?

Dieter F. Wemmer
CFO & Member of Management Board

No, I don't think. So from my perspective, I think the hedging can -- has still room for improvement. And still, when we -- the ALM in the Life business will also improve because old businesses are also maturing. When we keep the 30-plus year coverage, actually, that will then also, on older business, cover the last years of these policies. Actually, I would, from an ALM perspective, see that improving the hedging actually also reducing our interest rate sensitivity, which is one of our targets where we not moved too much this quarter, should actually still improve. And I still see in ALM hedging actually a reduction in costs and not an increase in cost.

Operator

The final question comes from Nick Holmes of Societe Generale.

Nick Holmes
Societe Generale Cross Asset Research

Just a couple of very quick questions. First, on U.S. Life, wondered if you could remind us of the hedging program on your fixed annuity book and -- your fixed index annuity, that is. And I just wonder, Dieter, whether you could reassure us on what protection you think there is if U.S. rates continues to fall. And then the second is also looking at low interest rates, this time in Germany. Just wondered if you could update us on the size of the RSP. And if you could remind of how long you think it will take until the current low interest rate environment really eat into the German Kapitallebensversicherung policies?

Dieter F. Wemmer
CFO & Member of Management Board

When you ask the question, I always know that I came to the end of my analyst Q&A. Yes, as I said before, in Germany, we are cash flow matched for more than 30 years. The RSP actually in Q2 was up. So also, of course, that is always the quarterly calculation in the end. The local RSP calculation is only at year-end. But we are actually in the numbers up and therefore, I see it will take quite a number of years. And hopefully will not ask this question anymore when it has eaten into the system because it will still be the case out. Our fixed index annuity business is 100% hedged. So therefore, I'm not seeing your question. Our VA business has interest rate sensitivity, and actually, our U.S. operating Life profit was lower than normal because we had a small loss of the old VA book, that is the VA book, which was written quite a number of years ago. There, we have some sensitivity. And when you look at our new business mix in Q2, VA is making below 10%, and 90-plus percent of the new business is fixed index annuity. So our interest rate sensitivity is small and is also not growing. And I think that differentiates us from other players in the market who have a very different interest rate exposure. Certainly, what you have noticed is that the new business margin in the U.S. is down because the new business margin is interest rate sensitive and we have a lower new business margin than we had in previous quarters. It's important to see, in the U.S., we are adjusting our new business assumption every 2 weeks. So therefore, we are not following their -- the general group rule that we use for new business margin. The beginning of the quarter, interest rates in the U.S., we update this every 2 weeks because fixed index annuity business is sold in tranches, and it's been repriced also every 2 weeks. Therefore, we do it like this to be always up to market and not to run any unreasonable interest rate risk in the sales process. So therefore, the new business margin in the U.S. reflects already quite a lot what has happened to the U.S. Treasury rates during the quarter. Did that answer all your questions?

Nick Holmes
Societe Generale Cross Asset Research

Well, yes, it does. Certainly most of them, Dieter. So just one very quick follow-up, which is, just to be completely clear on the fixed index annuity, are you saying that there is no rollover risk at all? There is no variable annuities, as you've explained, have dynamic hedging and therefore, some interest rate sensitivity. But is your point that the fixed index annuity has no rollover risk at all, you are completely hedged against low interest rates?

Dieter F. Wemmer
CFO & Member of Management Board

Well, what do you hedge in the fixed index annuity? The interest rates is matched because when you receive some money, you invest all the money you receive in corporate bonds, which are duration matching. So therefore, we do the repricing every 2 weeks. Let's say, in the 2 weeks, we collect from our customers EUR 250 million fresh money, the EUR 250 million are specifically invested for the new money which came in. The dynamic hedging is actually to the upside for the customers where we are investing because they are participating in the upside of the stock market or whatever the underlying index is we have sold to the specific customer. So it is actually everything else you hedge than the interest rate risk.

Nick Holmes
Societe Generale Cross Asset Research

But the fixed index annuity product doesn't have a finite term, does it? Is it not [indiscernible]?

Dieter F. Wemmer
CFO & Member of Management Board

No, it's not a finite term, but it has an experience and customers are turning. It's also used for their own pension benefits. So therefore, we use a rolling duration assumption. And so far, I think we are doing very well with this duration assumption with the business. And we have a lot of management levels actually. We can, for the old blocks, always increase the expenses. Then at some point, the product is also not so exciting anymore for the customer if you want to say so.

So then I wish you all a great summer. At the moment, it is very rainy in Munich. But for me, it is also the last working day before my summer break, and hope to see you all somewhere in the next month. And thank you for dialing in.

Oliver Schmidt
Head of Investor Relations

Yes. Thanks, and good-bye from my side as well. Cheers.

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