S&P Capital IQ

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Allianz SE DB:ALV

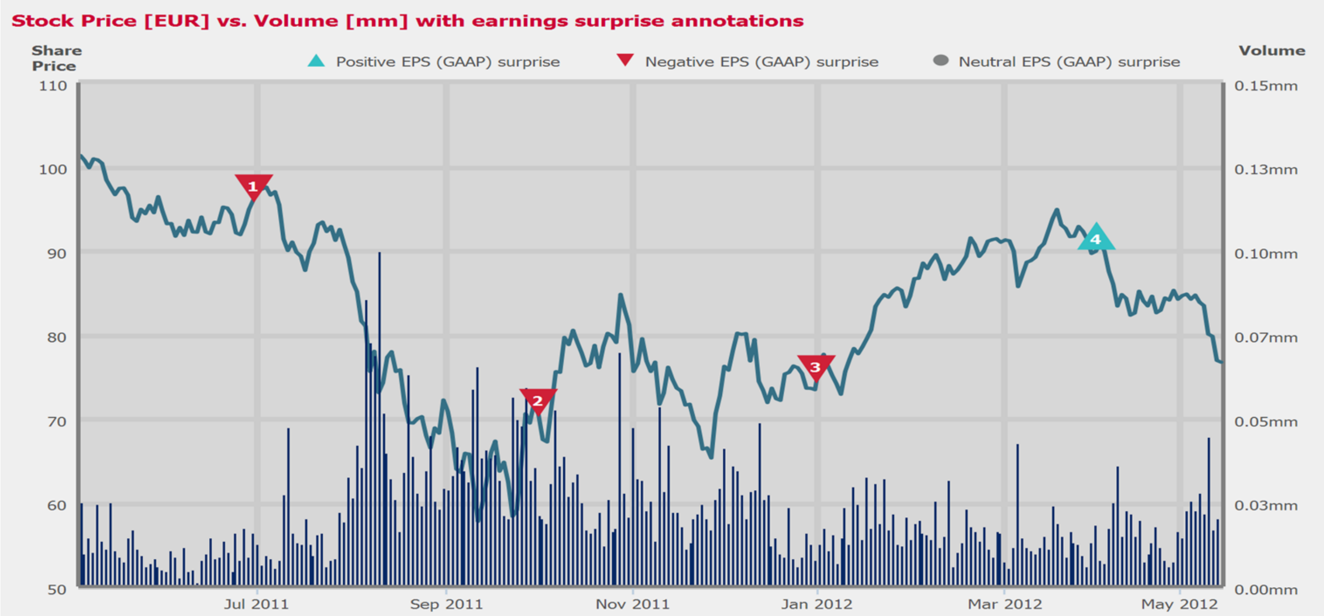
FQ2 2012 Earnings Call Transcripts

Friday, August 03, 2012 12:00 PM GMT

S&P Capital IQ Estimates

	-FQ2 2012-			-FQ3 2012-	-FY 2012-	-FY 2013-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS (GAAP)	2.70	2.68	(0.74 %)	2.84	11.43	12.14
Revenue (mm)	24919.00	25196.00	1.11	24583.00	101691.85	103146.47

Currency: EUR
Consensus as of Aug-03-2012 8:47 AM GMT



- EPS (GAAP) -

	CONSENSUS	ACTUAL	SURPRISE
FQ2 2011	2.57	2.17	1 (15.56 %)
FQ3 2011	1.65	0.34	2 (79.39 %)
FQ4 2011	2.17	1.06	3 (51.15 %)
FQ1 2012	3.00	3.02	4 0.67 %

Call Participants

EXECUTIVES

Oliver Bäte
Chairman of Management Board & CEO

Oliver Schmidt
Head of Investor Relations

ANALYSTS

Andrew Broadfield
Barclays PLC, Research Division

Atanasio Pantarrotas
CA Cheuvreux, Research Division

Brian Shea
BofA Merrill Lynch, Research Division

Giulia Raffo
Autonomous Research LLP

Jochen Schmitt
Metzler Equities, Research Division

Jonathan Michael Hocking
Morgan Stanley, Research Division

Maarten Altena
ING Groep N.V., Research Division

Marc Thiele
Mediobanca - Banca di credito finanziario S.p.A., 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

Spencer Horgan
Deutsche Bank AG, Research Division

Unknown Analyst

Vinit Malhotra
Goldman Sachs Group Inc., Research Division

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

Presentation

Operator

Ladies and gentlemen, welcome to the Allianz Conference Call on the Financial Results for the Second Quarter of 2012. For your information, this conference is being recorded. At this time, I would like to turn the call over to the CFO of Allianz, Mr. Oliver Bate. Please go ahead, sir.

Oliver Bäte
Chairman of Management Board & CEO

Thank you very much. Good afternoon, everybody. Thanks for joining us while you're probably in parallel watching the Olympics. We're not missing Olie Schmidt, he's actually sitting next to me. But we thought we'd speed things up given other priorities. He is obviously listening in, and happy to answer any of the detailed questions that you might have. We'll try to keep it mercifully short today, so spend the roughly next half hour to lead you through our Q2 numbers, and then move on to Q&A.

Before we go into the second quarter number, I'd like to give -- provide you a little bit of a background on where we're headed for the full year. The 6 months performance for the group has been very, very good. Revenues stood at EUR 55.2 billion. The operating profit relative to the 6 months of 2011 is up 18.5% to EUR 4.7 billion. Net income is even up almost 40% to EUR 2.8 billion, and our capital position remains very strong. We've provided you with one slide summarizing the 6 months numbers on Page #4, and you see improvement on all critical KPIs and across all segments. And that's why we're very pleased overall with the 6 months results.

Now what are the details for the second quarter? Now I'll begin on Page #6 with the key messages. We had revenues up 2.5 percentage points to EUR 25.2 billion, operating profit up to EUR 2.4 billion, net income up to EUR 1.3 billion. And yes, you will see capital still strong. And particularly we have been further derisking in the eye of the storm. We want to remain very strong, and so we have further divested risky positions, particularly in the financial sector.

Page #7 gives you an overview as usual on the development of revenues, operating profit and net income over the quarter and give a nice picture of very solid numbers even in a timeline comparison.

Shareholders' equity, Page #8, is basically flat, despite the fact that we've paid out more than EUR 2 billion in dividends in the last quarter. The key additions have been net income, EUR 1.2 billion and around EUR 600 million of foreign exchange earnings that are in the equity side.

The conglomerate solvency on Page #9 is up another 3 points relative to the end of the first quarter, and we remain fairly shock-resistant.

On the economic solvency side, Page #10, we saw a decline of 20 points. We have taken all of the model movements in the first quarter. We spent a lot of time in the last call to explain to you what we have done, a number of the things being actually -- taking a more cautious view, for example, on this transferability on having more strict interest rate shocks and moving to a more what we believe the new environment will look like. We have refrained from any more changes to the model this quarter, and this shows you the sensitivity.

Now why has been there a 20-point sensitivity? It's 10 points from lower AFR and 10 points from higher capital requirements.

On the AFR decline, please remember that EUR 1.7 billion was because of the redemption of the hybrid capital that we've done that explains the majority of the movement here, and we feel very comfortable in this environment to have called the debt as you expected in difference to what others have done and remain a very reliable fixed income issuer.

On the other hand, required funds has moved up due to lower interest rates, higher implied volatilities and obviously, lower policyholder participation in case of stress scenarios. That's driving the numbers. We still feel comfortable with the capitalization in this environment of record-low rates that we have never seen.

So let's move on to the group number, starting at Page #12, where you see the revenue development by the segments. You can see very nice growth, more than 5%, Life and Health, minus 0.9%, we'll talk about that. But we are focusing on maintaining margins here and not on top line. And Asset Management continues to power ahead, 14.9% growth, a significant part, of course, related to foreign exchange movement. On the other hand, U.S. dollar earnings are what we need at this point in time. And as you know, Asset Management is about cash.

Page #13 gives you the movement on operating profit. I'll spend some time to explain the Property, Casualty numbers. The most important driver here is prior year movements. Last year, we had runoff gains on the number of items, in particular WTC. This year, we had negative runoff from the Thai flood like the rest of the industry. That explains the vast majority of the movements.

Life and Health is ahead of plan actually with EUR 821 million, the more normalized number would have been around EUR 700 million. Here, gains from selling the Hartford debentures have increased the investment income. And Asset Management is doing truly well, operating profit up 20%. Corporate and other is in and on plan.

Therefore, let's move to the nonoperating items, Page #15. A couple of comments here. You've probably seen the second quarter was not nice to equity, so we had EUR 200 million of equity impairments. On the other hand, the realized gains and loss position has improved relative to the prior year, where we saw a write-down, in particular, on debt securities for the - in form of Greek sovereign bonds that we've been taking last year. The number was then EUR 326 million, if you may remember, and then we have few others that added up to the EUR 366 million that you see here.

Interest expense, there's nothing to comment on, it's in plan -- it's on plan. On the fully consolidated private equity investments, we've taken a EUR 40 million charge on selected. [ph] On the restructuring charges, we had 2 significant investments in this quarter. Number one, we continue to rightsize and focus our Allianz Global Investor operation, particularly in the U.S. that's producing positive results as you will see later, and we've taken some restructuring charges in Germany in order to rightsize our bancassurance operations.

Acquisition-related expenses were very low for the quarter, no B shares to be purchased and the other items are not really meaningful. I just would like to point out despite the realizeds gain that you saw that the -- unrealized gains and losses on fixed income have actually increased, another roughly EUR 1 billion.

Now let's move on and focus on the segments, and I'd like to talk about P&C in particular. Page #19 gives you the key messages. Again revenues up 5%, operating profit at EUR 1.1 billion due to prior year impacts. And our combined ratio for the quarter is EUR 97.4 billion with 1.7% NatCat and 2.1% favorable net runoff.

Now Page #20 gives you an overview of the revenue development. What is really nice is that we are growing across the portfolio. Except for Spain, here, the economic environment is terrible and we are doing really, really well, not just in revenue share but particularly in terms of profitability.

In Eastern Europe, the situation is impacted by the cleaning of the portfolio we had in Russia on selective loss-making contracts in health insurance that's been set correctly, the combined ratio is back where it needs to be and some MOD claims that had to be rightsized.

In every other market, we are growing very significantly, and we're very happy to report that we're growing both in terms of higher prices, that's about 1.4 percentage points and higher volume, that's 1.8%.

In terms of combined ratios, let's move to Page 22. The key items are not listed. While overall NatCat remains within budget for the second quarter, we still had a number of our businesses that were affected. Just to mention Germany, where we had hailstorms particularly at the end of June. We had the earthquake in Italy that has not just hit the Italian operations, with 3.6 points. But also AGC&S that had significant losses on top of the U.S. tornado losses they had in the second quarter. So NatCat was significant again for our large corporate business.

In addition, it is to be mentioned that we have still reserves strengthening and at Fireman's Fund. I've mentioned that in the past and we already had question, what is the outlook? I cannot exclude further additions to reserves as we continuously review them for the rest of the year. We are particularly looking at workers' compensation. The review is due at the end of the third quarter.

Now in terms of accident year loss ratio, please turn to Page #23. We stand at 71.5%. That's up relative to the last year, but slightly down relative to the prior quarter. And particularly without NatCat, it's very important to understand that the -- x NatCat, accident year loss ratio has gone down below 70%.

Now the development relative to the prior year we split out on the lower-left hand side, and I've taken the credit insurance in a separate bucket to show you that the most economic sensitive loss ratio has moved up. We see a lot of claims frequency now in Southern Europe and partially also in Germany, which indicates that the economic environment is deteriorating. The price increases are banishing out. Severancy and frequency increases relative to prior year. We should see more positive development in the next few quarters as the higher prices should lead to lower claims ratios.

Our runoff ratio is lower than expected because of the negative runoff out of Thailand. Adjusted for that, it should be more around 3% for the quarter.

Now in terms of expenses, please turn to Page #24. Our expense ratio is flat at 28% and stable across all of the components from admin to commissions. And again, we should see over time an improvement here with the top line effect at least giving us some scale effects on the admin side.

What is happening on investments? Page 25 show you that our average asset base is growing significantly, which helps it to offset the decline in the fixed income yields, which you can see on the right-hand side, slowly but surely coming in. So we are able to maintain stable investment returns, which you can take from Page 26.

Our invest -- interest and similar income and net harvesting are basically flat at a very high level, so our investment colleagues in name [ph] are doing a very nice job.

Where is pricing going? Page 27. We are still operating in a very benign pricing environment, and we expect some -- quite some additional price movement, particularly in Germany for the remainder of the year. But also in other markets, we should see more pricing strength coming through. The window is very important because if the economic slowdown continues, latest by the end of next year, you will see to start market share price wars again. Therefore, we need to take the pricing power now and bring it to the P&L.

So much for my comments now on P&C. Let's already move on to Life and Health and give you the top news here. Revenues are essentially stable at EUR 12.9 billion. Our operating asset base, which gives us the vast majority of the income has grown again to EUR 452 billion. Our net flows were also positive with EUR 800 million, double that, what we had in the prior year quarter and operating profit is up 20% to EUR 800 million.

New business margin stands at 1.7% and the value of the new business exceeded EUR 160 million.

Now Page #30 gives you an overview of the movements. We have stable premiums from IFRS products, the investment-oriented products, particularly VA is coming down. That makes all the sense in the world where you have a very high cost of hedging investment risk and where the interest rates are at record low, particularly in the U.S.

On the German Life side, you might have a question why is that. We are really reinforcing a focus on margin. So we saw a particularly strong decline in single premium business from corporates and retail clients that are suffering from low margin. I think that's exactly the right thing to do.

And we had some negative effects in Asia-Pacific. Here, you still have the effects of Japan that we have closed down last year and very, very irrational competition in Taiwan through the bancassurance channel. And again, margin is here the focus and not the top line.

In the U.S., the same, the VA market given where interest rates are is highly competitive, and we want to only write the business that we can make money on. The same is true for FIA, given the spreads. We need to be very cautious on top line here.

In terms of looking at profitability, the new business margin, as I said, is 1.7%. Let me remind you this is the beginning of the quarter assumptions. We obviously then over time get reflected -- the lower rates get reflected in the margin. The present value of new business premiums was at EUR 9.6 billion to explain the EUR 163 million new business value.

Page 32 gives you the split of the value of new business, new business margins, and that's at capital returns here. I thought it's quite interesting to see what our payback periods are. There's a lot of speculation, particularly on Germany, how long it takes to get the money back. It's just not true, because we aren't able to leverage the fund RfB to fund the new business. And you can see also that we need to work on margins, both in the U.S. and in particular and invest in Europe, which is by and large, France and Italy. And work is underway to make sure that we stabilize margins. We have good margins still in the German-speaking countries and very nice margins in the growth markets and in Iberia and Latin America where a lot of the growth potential is.

I mentioned that the operating asset base has grown to EUR 452 billion. Page 33 gives you the various components. EUR 800 million of that is coming from net flows, and it's particularly positive. While we are still not happy with our top line in Italy and the flows particularly from the bancassurance channel and the margins, it's better than last year. We are sort of coming back on track. We still had outflows in France, but all the other markets were positive and significantly improved over the prior year quarter.

Operating profit is also very good. Page 34 gives you the movement analysis. The EUR 821 million benefit from improvement across 4 operating profit drivers. The technical result, the investment result and the expense result are all up. So the margin on reserves for the quarter stood at 76 basis points, which is a very nice result.

Let me move to the investment income, Page 36. As I said, it's slightly higher than planned, and some of the harvesting benefits have been reflected. We had realized gains on debt of a total of EUR 418 million, in particular the Hartford debentures have been a big contributor, it was EUR 256 million. So you will not see a repetition of that.

If I may guide you, overall the operating profit for the segment, the upper end was EUR 2.8 billion. If we normalize the first 6 months, we stand at almost exactly 50% of the upper range. So please don't get too much ahead of yourselves in terms of operating profit forecast for the Life and Health segments.

Now moving to MCEV on Page 37. The movement analysis has -- needs 3 comments. Number one, the adjustments in the beginning reflect the anchoring of interest rates, in particular that we have done consistently with our internal model. We have a very strong in force contribution of EUR 1.2 billion that has been driving MCEV up. And then economic variances, in particular have been driven by decline of the value of in force of EUR 2.3 billion due to significantly lower rates, and that was to be expected.

Now I'll comment on the so-called negative free surplus. It reflects our internal capital model. It doesn't reflect the Solvency II guidelines. We have an internal guideline of maintaining at least 130% of SCR. And the computation therefore, is purely theoretical. So it doesn't mean that in a Solvency II environment, we would have to adjust that money. We're just trying to be consistent according to MCEV principles, which we at least still adhere to between internal model and MCEV reporting.

So these would be my comments on the Life and Health side, and with that I'd like to move on to the Asset Management section.

Page 39 gives you the top messages, and I'd really like to point out this is outstanding performance again, and that in an environment that is not really conducive to Asset Management. Assets under management have grown again 15.9% to now a staggering EUR 1.7 trillion. We have third-party net flows of more than EUR 18 billion. The operating profit is up 20% to EUR 600 million, and that's despite very low performance fees. And that cost-income ratio has improved to 57.6%.

Now let's look at some of the facts in detail. Page #40 gives you the movement of the AuMs. Both for Allianz Group assets and third party, all trends are positive here. The net flows are quite remarkable.

Page 41 give you the EUR 18.6 billion net flow. We talked about the first quarter, all the other numbers are very strong. And I can without giving you details tell you that just for the month of July, we had again a double-digit billion inflows into our Asset Management businesses. So the story continues despite the storm, and that's really, really important to understand, because it's cash coming to Allianz and supports us in this very difficult market environment.

Therefore, revenues have reached EUR 1.5 billion, as you can see on Page 42. And again, let me reiterate, it's not true that with increasing scale the margin of profitability goes down. In our books, the opposite has been true. We've increased our third-party AuM margin from 39 basis points 2 years ago to now 41.9. So we are growing not just assets, not just top line, we are also growing the margins in the business.

Page 43 gives you, therefore, the development of the operating profit. It has reached EUR 635 million and being driven out EUR 197 million increased net fee and commission income and that operating expense base that has only grown by EUR 87 million.

Page 44 provides you with an overview of the key metrics for PIMCO. AuM in the new setup, which basically has separated the European business into what is PIMCO and has been PIMCO in the past. However, in the past we sub-mandates into direct client access for PIMCO, they now stand at EUR 1.4 trillion, had total net flows in the second quarter of EUR 19.5 billion and a 3-year outperformance for the first 6 months of 2012 of 96%, that's cleanly an industry benchmark. The operating profit stood at EUR 543 million, I think that's outstanding in the scheme of things.

Now in terms of the net flows, you also need to understand this reflects both third-party flows and the internal flows. This is particularly important when we now look at Allianz Global Investors on Page 45.

Here we have a new setup EUR 291 billion in assets. We have 3 outperformance of 56% and net flows of cumulatively EUR 2.9 billion negative. However, third-party flows were much better than this number would suggest. We've had EUR 1.1 billion negative flows, particularly on the equity side. That is better, relative to the portfolios, than what most of the market has done. And our operating profit stands at EUR 97 million and income ratio of below 70%.

I cannot promise you that it will stay below 70% as this is the target for the overall year, but we're clearly, given the excellent work of the team, on the right track in terms of productivity.

So these were the messages on the 3 segments. So please let me summarize the message for the second quarter on Page 47. We have a solid second quarter with total revenues of more than EUR 25 billion, operating profit exceeding EUR 2.4 billion and net income of EUR 1.3 billion, while maintaining a very strong balance sheet that we have further derisked and will continue to derisk to weather the storm.

If you then look at the delivery across the last 6 months, we have had more than EUR 55 billion, EUR 4.7 billion in operating profit and net income being up almost 40% to EUR 2.8 billion. And therefore, we believe we are fully on track to achieve our outlook for the year of EUR 8.2 billion plus or minus EUR 500 million, given the usual caveats around NatCat and financial market conditions.
And with that, I'm ready for your questions.

Question and Answer

Operator

[Operator Instructions] We will now take our first question from Maarten Altena of ING.

Maarten Altena
ING Groep N.V., Research Division

Three questions from my side. The first is on Germany. You witnessed a nice pickup in the German P&C premium growth after quite a difficult period. Should we see this as sustainable? Or was it impacted by maybe also nonrecurring items? The second is on U.S. Life. I witnessed you're reversing trends in the U.S. new business margin, likely on the back of successful repricing or redesigning actions. What should we expect here going forward? And at what level will you be satisfied? And last question is on economic solvency. One of your peers earlier announced a relief on economic solvency stemming from the U.S. equivalents. How will you ultimately capitalize your U.S. franchise? And will it be under U.S. capital requirements? Or would you just stick to your internal capital model that might not allow for this capital relief?

Oliver Bäte
Chairman of Management Board & CEO

Thank you for the questions. Let me start with the last one. We do not comment on any of our peers, but we would not use U.S. equivalents in our model. We haven't done. So it will also not have a very significant impact on our numbers because it particularly affects the variable annuity business, which we -- is not the vast part of it. And being applying equivalents, we first have to see what Solvency II will finally brings us. It's totally up in the air now. So as we said in the first quarter, we've given it our best shot based on current draft of the statutes, but we are not applying any things that provide further relief on the numbers. Therefore, we wanted to show you how the movements translate. Now that directly correlates to the second question you had, where's the U.S. Life business? The A business is very difficult to do if interest rates are basically at 0 and the capital markets are very volatile because the writers are very expensive to hedge. Therefore, margins are low, and we need to make sure that product design gives us cost of capital under all circumstances. With the margins that we had at the end of the second quarter, we are comfortably covering cost of capital, but we need to maintain repricing action in order to make sure that that happens under all circumstances. And we will continue to let volume go if that is not feasible. Now the question on Germany, no, I don't expect this to be a one-off. We expect further positive pricing actions, further momentum, particularly on the pricing side. And we are also seeing some volume growth now in various elements of the business model, so this is not a one-off.

Operator

We will now take our next question from Vinit Malhotra of Goldman Sachs.

Vinit Malhotra
Goldman Sachs Group Inc., Research Division

Just on this economic solvency, I noticed that between the EUR 195 million we had in the first week of May and the EUR 178 million now, it seems that it's not really the level per se but the volatility in interest rates that is hurting here a bit. But could you just shed some thoughts on how you perceive this or how volatility has harmed the solvency -- or impact to Solvency now? And just any thoughts here. That's the first thing. Second thing is on Italian combined ratio, if we exclude the NatCat, it's a pretty strong number, in the mid-80s. Is this something that is just a double whammy of price increase plus frequency for that? That's the other question. And lastly, I'm sorry I couldn't really understand the -- you mentioned something about the Life and Health guidance that you mentioned 50% or something. If you can just clarify that.

Oliver Bäte
Chairman of Management Board & CEO

Yes, of course, Vinit. I'll be very happy to do. On the first one, on the movement of the Economic Solvency for everybody, the question was when we had the call on May 7, how do we move that? It's very, very easy to understand. We had -- when you -- we obviously model the euro swap rates as a risk-free curve, and they have dropped significantly, particularly at the long end. At the same time, swap volatilities have shot up across all term structures. On top of that, we have seen for the Europe base sovereign's dispense widening, and this really drives the level of both risk capital and the reduction of the AFR in addition to what I had said about the redemption of the hybrid capital of EUR 1.7 billion. So it's an easy move to understand. Now the Italian combined ratio is very low because of the very consequent portfolio cleaning that we have done. And it's really funny because where I sit here, I get signs from 15 directions to answer a question I know how to answer myself, so if we can please cut that a little bit. The issue is very clear. We've had very strong price action and very, very strong portfolio actions in the past 2 years, which are strongly paying off now, because indeed frequency has been falling, so it provides an additional benefit. But it's very important that we have been also culling the worst-performing segments before anybody else has. So with overall price improvement in the market, we are now having a very distinctive level of profitability despite the earthquake in Italy that by the way not just has hit the Italian operations but also AGC&S. So we're having a record profitability for Italy at this point in time. Now this will obviously not stay this way because we already see some competitors taking pricing action on the way down. So this -- and my expectation is this will not continue to last for the market overall. However, I believe we have the strongest portfolio at this point in time because on top of the combined ratio being low, we have also the strongest result position in the industry. Now on the guidance point, what I wanted to say is the following. If you were just to extrapolate the operating profits for the second quarter to the year end, you would easily exceed the upper end of the range that we have been providing for the Life segment, which was EUR 2.8 billion. If you normalize the investment gains that we had in the second quarter, you get to -- for the total year to about EUR 2.8 billion, EUR 2.9 billion, which is exactly the upper end of the range, but not more. So I don't want expectations to get too much ahead.

Operator

We will now take our next question from Michael Huttner of JPMorgan.

Michael Igor Huttner
JP Morgan Chase & Co, Research Division

I had a couple of questions. One on Fireman's Fund, can you explain a little bit how far you are in terms of cleanup or restructuring? And how much longer and how much more costs we should see from that? Combined ratio 120% was a bit unexpected. And related to that, maybe you could say something about crop insurance. And then my other question is also on numbers. In the corporate segment, the number dropped from Q1 with EUR 284 million to Q2 EUR 192 million. I was probably not listening enough in Q1 what happened. But is EUR 192 million now the new levels for this cost center.

Oliver Bäte
Chairman of Management Board & CEO

Okay. So a couple was literally 2 questions. Thank you very much, Michael. The -- on Fireman's Fund, 2 items, where are we on the reserving? As you remember, we've instituted a very comprehensive reserve review program that has been reporting about over the last year, starting with asbestos and environmental where we'd strengthened the reserves very strongly after 5 years not having updated that. And then we moved on to the other lines. We have now completed construction defects. And the open item is workers' compensation, which we will complete in the third quarter of this year. And that should by and large address all of the reserve positions in the U.S. Why workers' compensation? Inflation -- medical inflation, particularly in the States, in the U.S. that have suffered from budget shortfalls, have tried to push up a lot and push a lot of the medical cost into the workers' compensation insurers. So medical inflation has moved from an average long-term 3% to 4% to 14%. And we have spent a lot of time to think through what the medium term expected inflation ought to be. And again, we'll conclude by the end of the third quarter. What we are also doing is our annual review of asbestosis reserves. All the good companies that I know do an annual review will do another one this year. So we will know by the end of the third quarter what the reserves position are. And to be honest, the 120% should have not surprised you because I already gave you in the first quarter clear indication that we would continue to strengthen reserves throughout the year. Now in terms of the crop business, to be honest, I don't know the answer yet. The only thing I know and you've also read in the press that we have one of the harshest drought the United States has seen in the last 20 years. There's lots of estimates about what's going to happen. Based on where we are, these numbers can oscillate EUR 50 million up and down. I cannot give you a precise number at this point in time. We will know more in the third quarter. In terms of the corporate segments, we had in the last quarter some significant value adjustments and therefore, also going through operating profit. So for the year, we've said it's between EUR 800 million and EUR 1 billion, typically negative.. We are doing a little better than planned at this point in time. Is that good enough?

Michael Igor Huttner
JP Morgan Chase & Co, Research Division

On the crop insurance, plus or minus EUR 50 million, but what's the middle number?

Oliver Bäte
Chairman of Management Board & CEO

Pick your best estimate, then you know much better than me. But I'll tell you on the third quarter.

Operator

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

Spencer Horgan
Deutsche Bank AG, Research Division

Three very fairly quick ones. The first one is to follow on from Vinit's question on the combined ratio in Italy. Could you just clarify how much of that is driven by prior year reserves versus the accident year number? And I guess the same in the U.S., I think the -- and if we you look at that combined ratio, as you mentioned that there's -- you mentioned last time around, there's more to come on reserves, and there still is. But the accident year number, I guess is still awfully significantly above 100%. So I mean, is there any hope that comes below 100% on an accident year basis over the coming quarters? And the last one is in Italy on the Life insurance side, obviously, I mean, you mentioned this briefly, we had quite significant net outflows in Q1, and that seems to have neutralized in Q2. Could you just elaborate on what's driven that recovery and what the outlook is there?

Oliver Bäte
Chairman of Management Board & CEO

Let me start with the last question. Italy Life, we had obviously significant pressure last year and in the beginning of this year, because of main banking partner was focusing on improving its liquidity and pushing new business into its deposit products. We have intensively worked with the branches at the bank in order to improve the new business production and that you see already in the numbers. On top of that, we have been allocated more branches from a competitor that has dropped out. So that is explaining the better numbers in Italy. Are we happy yet? No, we're not happy yet. We have to do further improvements also in terms of profitability and a guarantee design, but we are on a very good way. In terms of -- we do not disclose individual runoffs per country, but I can tell you that there is not a big driver in terms of runoff that is making the numbers in Italy look artificially good. The underlying profitability is just outstanding. Now the second question, sorry, I haven't understood. What was that about, the 100% combined ratio?

Spencer Horgan
Deutsche Bank AG, Research Division

It was in the U.S., I think -- if I understand correctly, the reserve additions there were EUR 90 million or so. So there, I guess, your accident year combined ratio is also still above 100% and the question is basically do you expect it to go below 100%, excluding reserve additions over the coming quarters? Or what's the outlook there?

Oliver Bäte
Chairman of Management Board & CEO

The question is over how many coming quarters. For this year, we still are suffering from the weak pricing environment in commercial lines. The private lines are doing very well. Those that are in personal lines are doing very well and have seen -- and you see that in the publications. Commercial lines is only slowly moving, we are taking about 4% price. That is not good enough in order to bring us below 100%, and the next 2 quarters need to see significant price increases in order to get us below 100%. I don't expect that for the next 2 quarters yet.

Operator

We will now take our next question from Jon Hocking of Morgan Stanley.

Jonathan Michael Hocking
Morgan Stanley, Research Division

I've got 3 questions, please. You mentioned, Oliver, that you are taking down some of the financials exposure in the second quarter. I wonder if you could give a little bit more color about that? Is it certain countries, certain parts of the capital structure? Secondly, if you could give a current view on what's going on with Solvency II process, it would be appreciated. And then finally, given the margins in Italy on the general insurance side and your comments about appetite for volume in previous quarters. Could you give us a little bit an update, please, about where you should see the tradeoff between margins and volumes in Italy in particular?

Oliver Bäte
Chairman of Management Board & CEO

Yes. Obviously -- I'll start with the third question. On Italy, we need to grow, and we have enough profitability to support that, so we are pulling all the triggers to drive profitable growth. But -- and the issue is that a number of tariffs in the market are not efficient. So there's a huge divide between the profitable segments and the unprofitable available clients. So it's easier said than done that you just reduce prices and then see the number of clients go. On the Solvency II process, I wish I knew. To be very frank, there is now a summer break and people will reconvene in September. What we do know that the long-term package will get tested in the QIS 6. The specifications are ongoing. There will be tests, particularly with regards to the CCP and the matching adjustments that are specified now. My personal estimate is that these tests will take a vast majority of the remainder of the year, and then there will be a review of the outcomes in the first quarter of 2013. Therefore, there's a significant chance of a further delay in Solvency II implementation, to be expected. We are, as you, very excited to understand what is happening. By the way, a final comment, Oliver Schmidt just gave me the correct in. In terms of what we are doing in Italy, we have a very, very good presentation from our Italian team that we've delivered to our Capital Markets Day in Milan a couple of days ago. So they gave you a couple of hints on where the margins are and how have -- they have developed. And if you have further questions, Oliver Schmidt and team will be happy to point out the relevant slides. Now in terms of the financial exposures, I would be very unhappy to point out to ongoing sort of selling and buying actions. We don't want to do that, as you can imagine. The general story is what I've been telling you the last 18 months, which is we have been -- had a double-edged sword in our balance sheet, that is exposure to the banking sector in particular through equity subordinated and other papers and at the same time, on the interest rate side, due to the ALM mismatch. And whenever the banking sector goes down, the central banks have been flooding the markets, with liquidity hitting us twice. Now starting to hedge against the low interest rate by buying derivatives is not what we like. We'd rather like to lengthen the duration. That's easier said than done given the large portfolios. But we have been consequentially doing that, for example, bringing up the duration of our German assets book by almost a year and over the course of the last year. At the same time, we have been either hedging or selling out of our so-called strategic participations as they've been a key part of the concentration risk. We've talked a lot about Commerzbank, for example. We've mentioned that we sold the Hartford warrant debentures. And these types of activities will continue to go on, and you will see further derisking. But again, please excuse me, I do not want to give any leads to the market of where we are selling and where we are buying.

Jonathan Michael Hocking
Morgan Stanley, Research Division

Okay. I'll just come back quickly on the Solvency II points. On QIS 6, is that going to be a broad QIS 6? Or is it going to be QIS 6 specifically on those 2 issues you mentioned in terms of CCP and margin adjustment?

Oliver Bäte
Chairman of Management Board & CEO

It's going to be a QIS 6 on the long-term guaranteed package. So it would include anything and everything that is needed in order to allow the industry to continue to sell products with long-duration guarantees and pension products.

Jonathan Michael Hocking
Morgan Stanley, Research Division

It seems quite tight timing to get that done by the end of year, so what -- when will the specification be published, do you think?

Oliver Bäte
Chairman of Management Board & CEO

In September, the idea is to have the specs published in September. EIOPA is working on it. They will have a proposal ready by the end of the month, then it goes to the commission. We are involved in, from an industry perspective, in helping EIOPA to get it done as quickly as possible.

Operator

We will now take our next question from Andrew Broadfield of Barclays.

Andrew Broadfield
Barclays PLC, Research Division

One point of -- couple of points of clarification. Just on the last guidance and this should be quick. I think you said the normalized first half numbers was about half of the EUR 2.8 billion, on your own calculation. And so I'm just -- very simple mathematics, but what you're implying if you are saying stick to the EUR 2.8 billion, is it the second half will be below the run rate that you've guided? Have I understood that right? That's the first question. And the second question, just on the equivalents issue again, which I thought was interesting from AXA's point. I know you don't want to talk about the other companies, which is fine. But Aviva made a similar comparison. I mean they took their U.S. business on a U.S. specialty requirements and they put 20 percentage points on their Solvency, given they have a reasonable fixed income, equity indexed annuity portfolio as well. I'm intrigued that you said that it doesn't make a lot of difference to you because it's really a VA problem, not on EIA. So just a bit of clarity on the -- not on the other companies, but just on was there anything I missed in that. And just very, very quickly, on Fireman's Fund, just on the construction and defects, I was just -- I think -- is that a consequence of sort of current economic climate? Is it business you've written? Is it stuff that's noncore? And are there other business lines that we seemed to -- if it's economic, are there other business lines in particularly you're worried about that may have something that we should be looking at there?

Oliver Bäte
Chairman of Management Board & CEO

Yes. Andy, let me just start with the last question, Fireman's Fund construction defect. It's actually an economic consequence. Because in the real estate slump in the U.S., people have been using every opportunity to increase their value of the houses, particularly those on sales. And it's very popular, particularly for new houses to go back and to claim under the construction defect clause in order to do home repairs and home improvements. And the whole industry hasn't, from our experience, properly reserved against this development as that could have not been forecast because we are in the fourth year of a slump here in the U.S. real estate market. In terms of equivalent, I'm sorry, to be honest, I do not know the Aviva methodology, so I'll have to pass on this one. However, I know because when we look at the AXA numbers today, we did the comparison, and again I can tell you for us it would have been only about a 4% lift. I cannot comment on Aviva, I'm sorry. In terms of the Life guidance, what I wanted to say is that this quarter, the level of real life gains on the fixed income side has been elevated above what the normalized level would be. So if you're trying to forecast what the overall year, I would rather stick with our outlook maybe a little better, but not double the number for the first 6 months. That would give you probably too high an estimate.

Operator

We will now take our next question from Giulia Raffo of Autonomous.

Giulia Raffo
Autonomous Research LLP

I have a few questions. First one is on your new business margin, which has fallen to 1.7%. I would have expected given that you used, start of quarter assumption, I would have expected margin not to fall because if I compare the swap curve at the end of March with the swap curve at the end of 2011, interest rates didn't fall. And at the same time, you have equity markets going up, spread coming in and BICs [ph] are declining. So I was just trying to have a bit of clarification as to why the new business margin fell? And my second question is on required capital. You explained in detail in the speech that the main driver were lower interest rates volatility ticking up. I just would have thought that given that you released capital from having sold the debenture of Hartford and having derisked in terms of like cross-border sovereign exposure, equity gearing, I would have expect some sort of offsetting. And so I just wonder out if you can quantify for us what was the interest rate impact stand-alone? And my final question is on the U.S. fixed annuity. When I read your interim statement, it seems that you sound more cautious on fixed index both in terms of volume prospect and in terms of profitability. Can you give any flavor on that? And is there any irrational competition in the fixed annuity space, too?

Oliver Bäte
Chairman of Management Board & CEO

Okay. Let me do the following. The second question, in terms of rate movements, Oliver Schmidt will answer after the call because there are a couple of detailed numbers that you need. In terms of the new business margin question, in fact, what has been driving -- the new business margin went down 80 basis points, and let me go through the most important margins and how have they moved. There are basically 3 countries that have had a negative impact. The first one is the U.S. We had particularly significant declines both in VA and FIA new business margins, driven by the extreme drop in swap rates relative to the numbers we have seen before. So one has to look at the Europe and one has to look within the U.S. In Italy, we had declining rates and increasing volatilities, in particularly driving up the cost for hedging options and guarantees. And that has been going on across all of our products, that's why we are redoing that. In terms of Germany, we had an impact from declining rates and particular from increasing volatility. And that's very important. While we had some benefits from reducing the guarantee level from EUR 225 million to EUR 175 million, please don't forget, in the first quarter we still had some after sales on the old guaranteed products of EUR 225 million that now has moved to EUR 175 million environment. We had some positive effects as well that helped us a bit, particularly in Asia-Pacific because we have a lot of high margin business coming now from Indonesia. And we had, as I said, reduced our volume in the low margin environment of Taiwan. So if you factor in all of these points, you get exactly to the 1.7%. And again for more detailed questions, Oliver would be very happy to address that. Now in terms of the FIA business. This is priced off of long-term rates. If the treasuries are at 0, it's very difficult to provide a lot of value to clients unless you charge them very high fees. So we need to see volumes coming down for this product as well, given the ultra low interest rate environment. And therefore, we need to be cautious to sell a product that is both good for the consumer and good for shareholders, and I expect the volumes to be significantly lower than the planning -- in the planning exercise we've done at the end of last year given where rates are. And that again is not just true for the A business. So I think it's really important. Now what we've done in -- for July, we have done another round of repricing action, both across VA and FIA, and we need to see how volumes respond to the repricing. You asked about irrational competition, I cannot tell you how rational or irrational people are. Some local competitors do not operate with the value-based pricing environment. They still work with deterministic interest rates, mean reversion assumptions that we don't share. And therefore, whether it's irrational, I don't know, but they certainly use more aggressive pricing assumptions that we would allow ourselves to be using.

Operator

We will now take our next question from William Hawkins of KBW.

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

Two questions. My first question, Oliver, on your Solvency ratio, I think you still have a deficit against your required capitalization for AA using the S&P model. Could you give us an indication of what the size of that deficit may be? And to the extent that your answer is no, could you just remind me what the key differences are between the S&P model and your own? Because there's quite a stark difference between your own numbers showing that you're very, very comfortable and the implication of what they're saying, which is there is less so. So if you could directionally help, that would be kind. And then secondly, sorry to come back to it, but in Fireman's Fund, are you guys planning on learning, or learning any strategic lessons from what's going on? I mean I'm taking your guidance of what you said, but it really sounds like we're now at the stage where Fireman's is just repeating the terrible mistakes it had made 10 years ago. I mean, this time last year, you were talking about expense overruns, and that was all fair enough. But now you're talking about medical expense inflation and basic under-reserving in workers' compensation. That's exactly what went wrong 10 years ago. So is anything strategic going on in that country?

Oliver Bäte
Chairman of Management Board & CEO

Okay, let me address that one. For you it's Groundhog Day, because you've been around a long, long time. I wasn't there, so I don't know what happened 10 years ago. But I can understand your frustration, but it has a very pragmatic answer. And the pragmatic answer is even if I took a strategic lesson out of that, it doesn't help much at this point in time because as prices are at record lows, industry profitability in commercial lines is not good. So the real strategy unfortunately is fixing this thing, and then we worry about everything else later once it's on a good footing. So the productivity improvements are coming through. The cleaning up is happening and we'll pursue that, and then we worry about the strategic consequences once we've seen how we come through the low point of the cycle. So, sorry for that, but that's all I can tell you at this point in time. But since Michael has been here much longer than me, I think he's certainly taking the lessons out of this. Now, Will, the second point was around Solvency II and our internal model. Now we are currently calibrating at a 50 basis point approach and the AA rating is 3 basis points, so that's the first just level of confidence difference. The second point is the S&P model has a much more simplistic outside in view. For example, on asset allocation and the charges they do apply, there is no diversification benefit. And most importantly, they're taking the risk for the required funds before policyholder participation. So we're getting huge capital charges for the Life business, particular for the German business where we are uniquely privileged because of our strong free RfB position and the management levers we have available. So for example, the fact that we can move annual credits and annual crediting policy and put this into final bonuses, which is an economically dramatic step in terms of protecting capital is not echoed and mirrored in the S&P model. We're talking to them about that. We are in a process of getting so-called internal model approval, like -- for the other one that will be finalized by the end of the year, we expect. So we hope to see some convergence between our internal model and the Standard & Poor's model. Now as you already correctly assumed, I cannot give you the number. But I can tell you we're working very hard to keep that in the targets that S&P has set. Let me repeat that, they basically expect very strong earnings through the year, more than EUR 7 billion. They expect us to maintain a capitalization comfortably about a single A level, for example. And on all of these criteria, I can reassure you, we're comfortably above where we need to be at this point in time.

Operator

We will now take our next question from Aaron Shea of Bank America Merrill Lynch.

Brian Shea
BofA Merrill Lynch, Research Division

If my line is on, it's Brian Shea. I'm not quite sure where Aaron came from. I just want to ask about your new money. What are you buying and at what yield? I know sometimes -- you have had this question in the past, you've given an answer that's maybe an average over a period, maybe a 6-month period. It would be great given how quickly things are moving if you could give us as current an answer as possible, I would really appreciate that and if possible, if you could also separate that into Life and Non-Life?

Oliver Bäte
Chairman of Management Board & CEO

All right. I thought you wanted to ask me about the CFO Forum and discipline around publication, but we'll probably do that later.

Brian Shea
BofA Merrill Lynch, Research Division

If that's an invitation, I will. But given it's an alias calling, [indiscernible]

Oliver Bäte
Chairman of Management Board & CEO

I'm just kidding. It bought me seconds to address your yield question. Now so talking about what we're doing on the Life side, the new yields, we typically have that for the first 6 months total, because we're obviously not only continuously investing but we have some lump sum investments, for example, in real estate and others that are helping our yield. The overall new money yield for the first 6 months in Life and Health has been 3.7%. The P&C number has been 3.1%. Is that good enough and current enough? You know that's very current for the insurance industry.

Brian Shea
BofA Merrill Lynch, Research Division

Well, I mean, if that's all you've got, I'll take it. It would -- I just thought that whatever you got today will be very different from what new money you're getting in January. But if you don't have the information, that's fine.

Oliver Bäte
Chairman of Management Board & CEO

Now what I can tell you, however, is the following. It depends very much on the mix of investments that we can achieve. So we are trying to have less government and more covered. So for example, let me go a little -- one step deeper on the Life and Health side. The yield has been 3.7%. On the ABS -- MBS side, we've had 3.9%. On corporate, around 3.4%, as well as on covered. The more good, high-quality ABS we can get, the higher the yield will be. And it also helps us on the duration side because the maturity is around 16 years. So we are really trying to get the numbers where they need to be. Now in terms of the yields coming down, you're absolutely right. Over the course of the years, it would go down. I would expect that the last 3 months on the P&C side, the yield is down by about 10 basis points and probably on the Life side, it's between 10 and 20 basis points down given the duration. Do I now get a bonus? First, I was wondering whether you were asking where I'm putting my money. It's all in real estate by the way. I have a lot of exposure in Allianz my friend.

Operator

We will now take our next question from Marc Thiele of Mediobanca.

Marc Thiele
Mediobanca - Banca di credito finanziario S.p.A., Research Division

Two questions, please. One is how do you think about the LIBOR investigations, both in terms of the potential offsets, as well as your appetite for writing D&O coverage. And then my second question is a bit of understanding question of the Life earnings. When I first saw the good numbers, I thought it was mainly driven by realized gains. But then looking at the sources of the results, there has been a very good result in the technical component. Actually that's a big number compared with the previous quarter. So I was wondering, are there one-offs in there? And what's the extent of that? And is the underlying closer to EUR 200 million? Can you explain a bit the results sources here?

Oliver Bäte
Chairman of Management Board & CEO

Yes, very happy to do so. Yes, there were some reversal in the quarter. The technical results for the first half year was around EUR 400 million, and we're still targeting around EUR 800 million for the total year. If you are trying to update your spreadsheet, that's exactly where we want it to be. And this number has to seriously grow again. I believe the sources and the potential in the existing business model is more around EUR 1 billion. In terms of the LIBOR side, let me start with the D&O question, we're obviously asking ourselves the question very intensively, AGC&S, right, significant D&O portfolios, even though much less than AIG and Zurich for example, less than half. And at this point in time, we do not expect any net claims payments out of D&O claims around the LIBOR event. So that's a firm statement, but again, that's only as firm as the next claim that comes around the corner, so that's the current assessment. In terms of our losses, we have also looked into this. And by the way, there is a German industry investigation, because we don't want to do it as individual insurers, but we're looking at it from the German industry association,, whether there have been any significant losses and what we do about it. For -- we need to differentiate at Allianz between the money we manage on behalf of our insurance clients and our third-party assets. On the third-party asset side, we do not have assets that are directly tied to LIBOR and that have been suffering. On the internal side, we are typically balanced on the buy and the sell side, so there has been not a major loss. But we are investigating it, and we do not find it, obviously, funny what has happened. In particular what is not good is the arising implication that it's not just the banks but central banks being involved in this, that gives us really cause for concern.

Marc Thiele
Mediobanca - Banca di credito finanziario S.p.A., Research Division

So your appetite going forward would be unchanged or...?

Oliver Bäte
Chairman of Management Board & CEO

Getting the right price for the risk as always.

Operator

We will now take our next question from Nick Holmes of Nomura.

Nick Holmes
Nomura Securities Co. Ltd., Research Division

Just a few questions, please. First one is apologies to come back yet again on this economic solvency. You've made your position very clear on equivalents. I wanted to ask, could you remind us what your position is on the matching premium? And also, on the current cyclical premium. Because I think there are big differences between some companies in the way in which they calculate this full economic ratios. And overall I was just interested to know what the situation is for you? Then moving onto the Life side, just wanted to ask, the technical results improved a lot in Q2. What's the reserve release behind that? And then final question is you said competition is still strong in U.S. Life. You've elaborated on that in respect of equity indexed annuities. I wondered if you could say a few comments about variable annuities. Is that still extremely competitive?

Oliver Bäte
Chairman of Management Board & CEO

Let me start, Nick. Let me start with the U.S. We have seen a lot of product rationalization in the U.S., but given where interest rates have gone, from our perspective, it hasn't gone far enough. So you either see very low profitability or a lot of tail risks that company take by not appropriately hedging, in particular with regards to behavioral risk. I don't want to go into the details today, but less assumption in particular. There's a lot of risk in the system. In terms -- I didn't quite understand the Q2 reserve releases. On the technical results, we had on the technical result of the Life side I assume that's what you're talking about.

Nick Holmes
Nomura Securities Co. Ltd., Research Division

Yes, it was on the Life side.

Oliver Bäte
Chairman of Management Board & CEO

Yes, we had EUR 30 million -- now we had roughly EUR a 30 million catch-up because of a 2 larger reserve in the French business in the first quarter which we reversed. In the second quarter, it had something to do with the legal environment in France. But that's the only movement that we really have, given the overall EUR 400 million, and the other movements, that's a small one. What we're trying to do is to get the technical results more stable and in particular get them up, and we are slowly but surely moving. In terms of economic solvency and what is our interpretation, and if you remember, the Q1 publications, we have provided a very detailed explanation of what we've done on the model. We focused all our model changes of the last quarters into Q1 and not -- haven't done any this quarter, and we are not planning any for the next quarter in order to provide you all with more stability and not just move numbers up and down. We have on the risk capital side, just to be more precise, on the U.S., has implemented in the risk capital, not on the available financial resources side, which is very important, had put in assumption about stock scenarios for the U.S., for Switzerland and Korea, we have on the AFR side stuck to consequentially to the environment that we'v had in the past, that's the liquidity premium, that is agreed by the CFO Forum. So no special ways for Allianz here.

Nick Holmes
Nomura Securities Co. Ltd., Research Division

But can you just clarify with the -- both for matching premium and the countercyclical premium, are you actually implementing the CFO proposals to fill the Solvency II project, which haven't yet actually been agreed, have they?

Oliver Bäte
Chairman of Management Board & CEO

No. The answer is no, because there's too much speculation around what is going to happen. By the way, it's not just we have an industry package for the first time that the whole industry buys into, but we've also said we will only implement matching adjustment, once it's been approved. Did you know that there is huge resistance in Germany to the application. We don't know to what product it's going to be applied, will there be a narrow approval or wide approval. What we have agreed to, what was tested in QIS 5 was the liquidity premium that we have applied according to industry standards, and will continue to do so until we have clarity around what the rules would be. This will be not before the end of the QIS 6 testing. And before there is clarity, and that I expect earliest at the middle of next year, everything else will be. We actually have become, if you look back to the last quarter, become more cautious. Just to give you an example, under Solvency II, it should not matter for group solvency, where the capital is housed and capital within Europe should be mobile.But we're finding increasingly that local regulators and crisis scenarios put a dampener on that, that's why the last time we set the value -- that is a value of in force and Life, we do not assume to be fungible anymore, and they've taken more than a 15% deduction on our solvability to just not kill ourselves in terms of movement. Yes, so we're trying to be extremely conservative and not having to have negative surprises once the final rules come out.

Nick Holmes
Nomura Securities Co. Ltd., Research Division

Yes, that's very clear. One very last quick question, if the matching premium, countercyclical premium was to be implemented by the Solvency II projects in the way in which the CFO Forum envisages, would that have a material positive impact on your economic solvency ratio?

Oliver Bäte
Chairman of Management Board & CEO

Yes, it would be very, very positive. Because in particular, because we have very stable liabilities. Remember, the matching adjustment, the way we have proposed it, has 2 components. One is to take care of the fact in terms of computing credit spread risk of the illiquidity of the liabilities, but the second one is also to take into account what liquidity buffers we do have on the asset side. It's true, ALM requires you to look at both. So if you have in Germany, for example, EUR 160 billion in assets and out of which you have made, let's say, EUR 5 billion or EUR 10 billion in spread product and you have EUR 10 billion or EUR 20 billion in cash equivalents, I don't care about the credit spread movements. Because even under mass lapse assumptions, I will never be in the position to having to sell spread product at a loss. So if we get a proper regulation, it would incentivize the creation of both illiquid liabilities and the appropriate management of cash reserves, very much like you see it now under Basel III. And this is not where we are. And to be honest, Allianz, because we have a very prudent ALM management is suffering more than others for being conservative on our cash management position.

Operator

We will now take our question from Michael Haid of Main First.

Michael Hermann Haid
MainFirst Bank AG, Research Division

Two questions. First on P&C pricing, 2% price increase just across the group is pretty much the same as in the first quarter, and I understand this is after a bonus and malus and rebates and so on. Is it sufficient to offset claims inflation? And is it also fair to assume as your wording suggests that the accident year loss ratio, excluding NatCat remains below 70% going forward? And second question, the inevitable question in my view, the operating profit target for this year, you achieved EUR 4.7 billion in the first half. If I take the normalized midpoint, 50% of it, EUR 4.1 billion, so you get above your target upper end, EUR 8.8 billion. Is it fair to say that under normal conditions, you are heading for the upper end of the target operating profit for this year?

Oliver Bäte
Chairman of Management Board & CEO

Michael, I wish I would know. We are confident to make our targets, but don't forget Q3 is typically NatCat season. There are significant things that can happen. We still are in an environment where we have no idea what happens to the euro. Just look at the last 3 days, what has happened there. So we remain cautious. And by the way, if we were deciding to take even more risk out of the balance sheet that might come at some costs, because actually reducing some exposures might come even at operating losses. So we want to hit our targets, but we don't want to get realistic at this point in time. In terms of the pricing, the first thing is to say we have actually reduced prices in credit insurance, which has a negative impact on this percent. Without that, we are at about 2.5 percentage points. Then you have 2 drivers, one is the severity side, but you also have frequency dropping in the number of markets due to the decline in economic activity, which should also help. But you are right, we need to take price and we need to take more price, and we will probably take more price than you have on the chart already. There's a number of pricing actions that are already in the works that are not yet on the page.

Michael Hermann Haid
MainFirst Bank AG, Research Division

Coming back to the first question, if I may -- sorry, the second question, the operating profit target. The third quarter NatCat is budgeted in your target, so that is normal, if you like. And is there anything else that we should take into account as a burden for the second half that is already foreseeable? Or is it just an eventuality that it could be worse, the second half than the first?

Oliver Bäte
Chairman of Management Board & CEO

No, Michael, we have not anything specific. But we'll have less dividends. Again, there will -- could be capital market volatility. There are major things that can happen, so we don't want to speculate too much. I can tell you about the here and now, but given this environment and I feel hard-pressed to give a forecast a bit more. By the way, I'd like to remind you, most of our competitors don't even have an outlook.

Operator

[Operator Instructions] We will now take our next question from Wolfgang Pakkenstein ADP AT.

Unknown Analyst

A key problem to this ugly European debt crisis is the extreme cautious stayings [ph] of the private sector investors, including the funds and insurance companies in support of severance sector debt in general. The ECB seems to want to find a way out of this terrible trap. And if we were to believe Draghi yesterday, and then the ECB has drawn a line in a sense, which was to say if Spain submits itself to the EFSF, which is effectively a bailout, then the ECB will really step in, in a way, different shape or form than ever before. And my question is, if the ECB was to step into the market to intervene, which then essentially means that Spain has therefore bailed out, would you, and if the key market investor decides to reduce and cut further sovereign debt in Europe in general? Or would you finally, consider this a factor step on the road to stabilize Europe and increase sovereign exposure in general?

My second question is with interest rates in general, apparently negative in many well-rated sovereigns, will you keep the asset allocation and equities as low as it is right now? Or will you respond in shifting parts of that asset allocation? And thirdly, in the United States, in the fiscal cliff that supposedly constitute at least as big a risk as the European debt crisis are going forward with your portfolio be under increased stress, if that was to materialize? Or is that neutral for your portfolio?

Oliver Bäte
Chairman of Management Board & CEO

An asset manager asking for tips.

Unknown Analyst

No, not really. And just [indiscernible] is being scared.

Oliver Bäte
Chairman of Management Board & CEO

I can imagine. And many of us, including us, are. Let me start with the first one, we obviously cannot tell you what given that we are European's largest investor what we do in terms of buying and selling under certain circumstances.

Unknown Analyst

You did say that before, right.

Oliver Bäte
Chairman of Management Board & CEO

Yes. But -- so that the key thing is really the following. It's not just about what's the debt dynamics are and whether Spain gets a bailout. One of the key problems we have with government debt is what has happened in the PSI with Greece. That's number one. First, governments came to us and says, please hold on to Greek debt, we'll find a solution. And then uphill, uphill, a few months later, they say take we'll take all of your money, but we'll keep ours. And then on top of that, by the way, please recapitalize local units, if you have any of them. And that is not something that we can tell to our investors. And therefore, we cannot buy as much government debt as we'd like to, because we're running serious problems. We do not know what seniority level we have, and that's just not true for a government alone, for the government, that's the same as for bank debt. You think you're buying a senior bond and they get pledged assets to the ECB, and suddenly, you've turned out to be very junior. And somebody issues a paper like Mr. Banyin [ph] and says, "Why don't we have the holders of debt pay for all of the problems?" And that we save some money for the taxpayers. And in this environment, we need to say, "Okay, then find somebody else to do the jobs." Because we need clear risk return trade-offs in order to be able to justify investing in a certain asset class. And that is not the case anymore. Because after the fact, people can change what you consider to be legal arrangements, and that's not very good. I have the other day heard from a very serious person, this is like in Argentina and Venezuela and other places, this is a Banana Republic. And this in environment, we need to be very, very cautious. So what has to happen, to be -- put it more positively, we need to have more precise guidelines, both in terms of banking bailouts and government debt. What is the debt we can actually expect and how senior are we and what is the burden sharing between the public institutions that are at risk here, particularly the ECB and all kinds of other forms and private investors. If this is moving around, we have no way to assess risk, and therefore, price for the appropriate returns. That's why you do not have rates that as high because people they think that's the true risk-adjusted return expectations. It's just buyer strike. We cannot buy in many instances -- under all circumstances because we are not clear of what happens. That's why Mario Draghi, by the way, yesterday said they need to revisit the issue around seniority and where private investors come out relative to public money provider. Again, the PSI in Greece was the worst case, and we cannot have something like this ever again in the Eurozone. Now in terms of what do we do in the investments, do we go into equities? To be honest, we would want to have more equities, but we can't. Those are regulatory environment and the accounting environment does give us strong disincentives to invest in equities. We take all the volatility without getting the appropriate benefits. And the third one is the fiscal cliff in the U.S., yes, we agree. It's totally underestimated to a degree to which the U.S. is exposed. But the markets are currently not focusing on it. That's why since we are a very big client of PIMCO, not just for our insurance money, but generally also for advice, we take it very cautious view, relative to U.S. treasuries.

Operator

We will now take a question from Jochen Schmitt with Metzler Equities.

Jochen Schmitt
Metzler Equities, Research Division

I have one question on your German P&C operations. If I got you right, you said that the pricing in YMM [ph] environment might deteriorate till year end 2013. I guess this was a general statement rather than Germany specific. But nevertheless my question is, would this give you enough time to reduce the combined ratio in your German operations as planned?

Oliver Bäte
Chairman of Management Board & CEO

Yes, it was targeted to the overall portfolio. My personal expectation would be that the pricing environment for Germany will be more positive than for many of the other markets. There are 2 drivers for that. Number one, the economic environment is still more benign than, for example, in Italy or even in Spain. Second, the pressure from the lower rates is particularly strong in Germany. Third, the combined ratios, particularly in motor, had been extremely high, and there's a lot more needed in order to bring it online.

Operator

We will now take our final question from Atanasio Pantarrotas from Cheuvreux.

Atanasio Pantarrotas
CA Cheuvreux, Research Division

I have just one question. Life term, in regards to your Life German business. Is it correct to affirm that using the interest rate environment -- the current interest environment that your new business value should be breakeven or even slightly below? And are you going to cap the guaranteed rate in next year in the Life new business German production?

Oliver Bäte
Chairman of Management Board & CEO

The second thing I cannot answer, for legal reasons. Our Life company does make a decision on what their crediting rates are for the next year. My kind assumption would be rates remain where they are. The crediting rates are expected to go down, they have to go down, but we can't tell you by how much at this point in time. But the laws of physics will clearly hold.

Atanasio Pantarrotas
CA Cheuvreux, Research Division

So the crediting rates or the guaranteed rates or both?

Oliver Bäte
Chairman of Management Board & CEO

The guaranteed rates, we do not decide. The guaranteed rates, what happens is the maximum guaranteed rates that's set by the government as a maximum guarantee, which is currently at EUR 175 million. And the government may decide to bring that down further. Typically, the companies in the market all stick to that guaranteed level. Now in terms of -- as you saw our current numbers and the new business margin, they still stand comfortably at 2.7% for the German-speaking countries. So we have some way to go before we get to cost of capital even under current interest rates.

Okay. Everybody happy out there? Not one urgent question not answered, please speak now, otherwise, I wish you all a lot of fun with the Olympics. For those of you that have been on holidays, all the best. I'm disappearing tomorrow, and I'd like to see you all back after the summer in good health. And thanks for supporting us. Mr. Schmidt?

Oliver Schmidt
Head of Investor Relations
Thanks, everybody for joining the call. We wish you a very nice remaining afternoon and a pleasant weekend. Goodbye.