Munich RE

Audiocast for Q2 2015

Jörg Schneider, CFO of Munich Re (Group)

Ladies and Gentlemen,

Welcome to the presentation of our Q2 results. My name is Jörg Schneider, and I am the CFO of Munich Re. As usual, I will now provide you with the main messages, facts and figures. The conference call this afternoon – where I will be joined by our CEO Nikolaus von Bomhard – will then mainly focus on Q&As.

In Q2, we observed a reversal of important capital market parameters compared to the first three months of the year. There was a sharp rise in interest rates across the board, and stock markets declined. The euro recovered against major currencies, and we had even lower major losses than in Q1. The net impact on our IFRS earnings and economic capitalisation was positive, and was negative only for IFRS equity.

With strong net earnings of €1,076m in Q2, Munich Re even exceeded its good Q1 result. Operating performance in most lines of business remained sound. After six months, our net result amounted to €1,866m – up almost 10% year on year. For 2015 as a whole, we therefore expect to beat our €2.5–3bn profit target.

This is very pleasing, because even when adjusted for non-recurring items in our P&L – and allowing for a normalised tax rate – Munich Re's Q2 net result still looks pretty strong.

Our operating result in Q2 was supported by the weakness of the euro, but less than in the first three months. The strong profitability of our reinsurance business outside the eurozone – especially in the US and the UK – continues to have a strong impact on the technical result in euro terms. The returns from non-euro investments also strengthened the reinsurance result.

The negative non-operating FX result is due to accounting inconsistencies, a long position in the weakening US dollar, and a short-position in the strengthening British pound.

Q2 investment income for the Group increased substantially over the previous quarter, with a return of 4.1%.

We use a number of derivative instruments for asset-liability management on an economic basis. Depending on market movements, these can cause significant volatility in the IFRS investment result.

As stock markets rallied in the first three months, the derivatives we use to protect the value of our equities caused substantial losses. In Q2, the trend reversed sharply as markets corrected, and equity derivatives delivered positive earnings contributions. This was offset by write-downs on swaptions for hedging long-term guarantees in our primary life business, and some losses on fixed-income derivatives as interest rates rebounded.

The Q2 investment result again benefited from substantial gains on the disposal of equities and fixed-income instruments, although not quite to the extent as in Q1. These gains mainly emerged as an unavoidable side effect of our asset management, which had to be quite active in volatile markets. But with the exception of funding the ZZR in primary life, our approach is still to not actively harvest investment gains in order to limit attrition of the running yield.

The running yield remained resilient against low interest rates, reaching 3.4% in Q2, and included a 0.4 percentage point seasonal impact from higher-than-normal dividend income. We continue to benefit from duration management and ongoing diversification efforts. The average re-investment yield edged up only slightly to 2.1% for Q2. As long as spreads do not appropriately reflect risks, we must accept the depressed return, but will not move significantly up the risk curve.

The tax rate was more or less in line with expectations, and just below our normal 20–25% range – at 19% in Q2, and 18% for the first half.

The annualised return on risk-adjusted capital amounted to 13.8% in the first half, and the return on equity totalled 11.7%. Both figures are very pleasing.

Let me now give you the highlights by business segment.

In P&C reinsurance, the combined ratio of the second quarter was 93.3%, after 92.3% in Q1. This was again due to below-average major claims of only 4.8% of net earned premiums. But in Q2, the basic loss ratio increased over the first quarter. Some of the carriers of our risk-solution business experienced an accumulation of major claims just below the €10m threshold which – according to our definition –- separates attritional from major losses.

This largely explains the increase of the normalised combined ratio, which amounted to 99.9% in Q2, after 98.1% in the first quarter.

We continue to set provisions for newly-emerging claims at the top end of the estimation range, and expect corresponding profits from their run-off over time. Notifications for losses from prior years remained significantly below the expected level in Q2. But reserve releases amounted to around 3 percentage-points of net earned premiums, which is somewhat below our guidance for the full year. This run-off result is within the normal fluctuation range in any single quarter. But when we carry out a broader and deeper portfolio-review in Q4, we will probably release more reserves.

The technical result in life reinsurance of €30m remained well below expectations in Q2. This was due to a number of reasons only partly connected to current business operations – such as the impact of improved projection models, or the effect of lower interest rates on the valuation of provisions. In contrast, claims experience in US mortality business and Australian disability business was in line with projections.

An IFRS technical result of around €400m per year remains a reasonable guidance for our Life Re business. But there will always be volatility. Given that the year-to-date results were below the normal run-rate, the €400m target is not realistic for 2015. We therefore expect a technical result of €300–350m for this year.

So much for reinsurance. I now turn to other parts of the business.

For ERGO, the Q2 result came in at €219m, more than twice as high as in Q1, with P&C Germany as the main driver. After the first half-year, ERGO is well on track to achieve its net earnings target of approximately €500m for the full year, even though it is reasonable to assume some earnings slowdown in the second half.

Net earnings of our German life and health primary business remained almost unchanged in Q2 over Q1. A better technical result in the second quarter compensated for a lower investment return caused by losses on swaptions.

P&C business in Germany posted a pleasing improvement in the combined ratio to 93.4% in Q2. This is mainly owing to lower major losses, and a decline in admin expenses. But the combined ratio of our international primary operations increased further to 100.4%. This was largely due to intensified competition in Polish motor and corporate business, and reduced profitability in Turkey.

In the Munich Health segment, the operating development of most companies remains largely in line with expectations. Net Q2 earnings were slightly lower than in Q1. While our subsidiaries in Spain and the Middle East continue to produce good results, DKV Belgium shows an ongoing negative claims trend that will still impact overall net earnings for the rest of 2015.

In the annex to the slide deck, we provide the usual chart outlining the major components responsible for the differences between our stated Q2 result and the analyst consensus. These largely stem from the investment result, even lower than expected major losses, and the non-operating FX result.

Our capitalisation remains sound.

IFRS equity decreased by 11.7% in Q2. High net profits were offset by ongoing share buy-backs, the dividend payment in April, currency impacts, and a reduction of unrealised gains in particular. But despite the recent surge in interest rates, shareholders' equity only reversed to the level at the end of 2014. In the first half of 2015, strong earnings compensated for high shareholder pay-outs, and the reduction in valuation reserves.

Yet the impact of rising interest rates on IFRS equity only reflects the decrease in market values of our assets. It does not show the corresponding positive effects on liabilities, which are recognised in our economic capitalisation. At the end of June, the economic solvency ratio increased from Q1 2015, back to a level similar to that at the end of 2014. This is due to an increase in available economic capital, and a decrease in capital requirements. Both developments are a consequence of the spike in interest rates, and reduced volatility. Available financial resources increased, because the rise in ERGO Life's embedded-value overcompensated for lower valuation reserves in IFRS equity.

German GAAP revenues of the parent entity Munich Reinsurance Company came in very strongly in Q2. As well as a very good IFRS net result for 2015, we expect higher-than-anticipated local GAAP earnings for the full year. This will further secure the headroom for distributions. In May, we started the new share buy-back of another €1bn, which should be completed by the AGM in 2016.

And now, let me say a few words on the renewal of our reinsurance treaties at 1 July.

This renewal involved a volume of €2.3bn, mainly from the US, Australia, Latin America, and global clients. Pressure on prices, terms and conditions prevailed, in particular for nat cat covers, which accounted for about 20%. But at 2.1%, the fall in prices was less strong than in the July renewals 2014. We think this gives a first indication of some stabilisation. Premium volume remained almost constant, as Munich Re was able to take advantage of selective opportunities in individual markets, but volume declined slightly in other areas as we gave up business due to pressure on rates. Thanks to our strict cycle management, our portfolio remains profitable.

Let me now turn to the outlook for the full year.

Premiums should be around €50bn.

In property-casualty reinsurance, Munich Re is now aiming for a combined ratio of around 96%. As in Q1, the improvement in the outlook is due to the low level of major losses in Q2.

We have amended our expectations for ERGO's property-casualty insurance from our stated outlook at the beginning of the year. We now expect a combined ratio of 95% for Germany – especially because we had to bear the cost of multiple weather events in July – and 99% for international business.

We expect interest rates to remain low overall in 2015, meaning that the reduction of regular income from fixed-interest assets will probably be more than offset by higher gains on disposal. So we now expect an ROI of around 3.3%.

Based on a net result of at least €2.5bn in reinsurance, Munich Re (Group) is now aiming for a consolidated result of at least €3bn. We expect higher nat cat losses in the second half of the year, so the normal run rate of profits should be clearly lower. However, in the last couple of years we have had overall positive bottom-line impacts from goodwill, tax and claims-reserve reviews in the course of the annual closing. I do not see why this should be any different in 2015.

Thank you very much for listening. Nikolaus von Bomhard and I look forward to our Q&A session at 2.30 p.m. Munich time.