

North American Operations business review

“In 2013, North American Operations launched a comprehensive business transformation. That journey continued in 2014, with major changes to our business portfolios, structure, people and processes. The overall result is a significant improvement in financial performance and an organisation that is well positioned to deliver sustainable, profitable growth.”

David Duclos

Chief Executive Officer • North American Operations

Gross written premium US\$ million	Net earned premium US\$ million	Underwriting result US\$ million	Insurance profit US\$ million
5,310	4,471	(38)	8
↓ 11% from 2013	↓ 11% from 2013	↑ \$542M from 2013	↑ \$543M from 2013
		Combined operating ratio 100.8% (2013 111.5%)	Insurance profit margin 0.2% (2013 loss of 10.6%)

Competitive landscape

North American Operations consists of five major business segments: standard lines, specialty lines, mortgage services, crop and assumed reinsurance.

Standard lines (formerly P&C) includes our program, middle market and risk management businesses, writing multi-line commercial and personal lines business produced through managing general agents, independent agents and brokers. Given the similar product focus, this segment now includes our consumer business (formerly part of FPS providing voluntary property insurance). Specialty lines is focused on management liability and professional lines, accident and health and aviation as well as trade credit and surety, and is sourced through brokers and managing general agents. Mortgage services (formerly part of FPS) underwrites lender-placed insurance sold through partnerships with banks and mortgage servicers. Crop includes multi-peril crop insurance (MPCI) as well as hail and is largely produced through independent agents. Assumed reinsurance sources business primarily through reinsurance brokers.

Whilst competition increased in 2014, particularly in the standard and specialty segments, North American Operations was still able to achieve an average premium rate increase of 1.0% (excluding lender placed business and crop). In terms of specific classes of business, competition increased materially in property resulting in rate decreases of 5% in this line.

Underwriting performance

Notwithstanding another challenging year in crop coupled with more challenging market conditions that continue to affect mortgage services and some property portfolios in the standard lines segment, North American Operations' underwriting performance improved substantially in 2014.

Despite these challenges and expense ratio strain associated with significant premium contraction, North American Operations recorded a significantly improved combined operating ratio of 100.8% compared with 111.5% in 2013, largely reflecting reduced adverse prior accident year claims development and a significant reduction in underwriting expenses including a reduction in restructuring charges. At the same time we achieved

strong and profitable organic growth in specialty lines and the actions taken to enhance risk selection have seen the underlying attritional claims ratio improve slightly in 2014 and we believe will drive further improvement in our claims ratio going forward.

Having incurred \$51 million of adverse prior accident year claims development in the first half of 2014, we are pleased to report \$10 million of favourable prior accident year claims development during the remainder of the year. We are extremely pleased to put the significant prior accident year claims development challenges of the past two years behind us, thereby enabling a heightened focus on achieving further cost efficiencies and delivering profitable growth for North American Operations overall.

In addition to \$32 million of adverse prior accident year claims development in the first half of 2014 relating to late claims notifications, our crop portfolio was heavily impacted by severe hail losses and a steep decline in commodity prices without a sufficiently large offsetting uplift in crop yields. As a consequence, crop reported a disappointing combined operating ratio of 108.1% in 2014, up from 102.8% in 2013. Excluding hail and prior accident year claims development, the MPCI portfolio reported a near breakeven underwriting result despite the aforementioned steep decline in commodity prices. We have significantly restructured the reinsurance arrangements protecting the crop portfolio for 2015, including the purchasing of additional hail quota share reinsurance to reduce underwriting volatility going forward and are investigating the purchase of derivative protection to limit the downside risk of further material commodity price declines.

Underwriting result

FOR THE YEAR ENDED 31 DECEMBER		2014	2013	2012
Gross written premium	US\$M	5,310	5,951	6,565
Gross earned premium	US\$M	5,457	6,225	6,984
Net earned premium	US\$M	4,471	5,030	5,625
Net claims expense	US\$M	3,023	3,804	4,038
Net commission	US\$M	698	795	883
Expenses	US\$M	788	1,011	830
Underwriting result	US\$M	(38)	(580)	(126)
Net claims ratio	%	67.6	75.6	71.8
Net commission ratio	%	15.6	15.8	15.7
Expense ratio	%	17.6	20.1	14.7
Combined operating ratio	%	100.8	111.5	102.2
Insurance profit margin	%	0.2	(10.6)	(1.0)

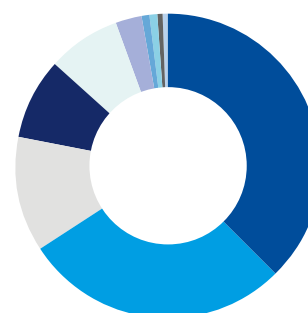
Premium income

Gross written premium was down 11% to \$5,310 million compared with \$5,951 million in the prior year, primarily driven by reductions in crop, mortgage services and underwriting revisions in program.

Market conditions were most challenging for the program business where premium income decreased by \$194 million, with the property book experiencing an average rate reduction of 5%. Premium writings also fell as a result of steps taken to improve risk selection, including the termination of 11 underperforming programs and corrective underwriting actions in the workers' compensation portfolio. These actions have already begun to manifest themselves in an improving attritional claims ratio.

Crop premium was down \$183 million as a result of lower commodity prices, while mortgage services premium fell a further \$178 million primarily due to reduced loan count in the Bank of America portfolio.

Gross earned premium by class of business 2014



	2014 %	2013 %
Commercial & domestic property	37.7	40.8
Agriculture	28.3	28.0
Motor & motor casualty	12.3	11.5
Workers' compensation	8.5	7.3
Public/product liability	7.8	8.4
Accident & health	2.7	2.8
Professional indemnity	1.0	0.3
Marine energy & aviation	0.7	0.3
Financial & credit	0.7	0.7
Other	0.3	-

Premium contraction in the aforementioned portfolios was partially offset by continued strong organic growth in specialty lines and consumer, which grew by 25% and 15% respectively. Growth in specialty lines was driven by expansion into management and professional lines during 2014. Middle market premium income stabilised with significant improvements in commercial line retentions throughout 2014 as a result of re-engagement with the agency platform and enhancements to technical pricing tools that have strengthened technical pricing capabilities.

We remain focused on profitable growth and anticipate continued strong organic growth in specialty lines supplemented by the planned launch of a range of additional specialty products in 2015.

Net earned premium declined by 11% to \$4,471 million, in line with the reduction in gross written premium.

Claims expense

Despite the challenges in crop insurance and a particularly harsh winter storm season, the net claims ratio improved materially to 67.6% from 75.6% in 2013, primarily reflecting reduced adverse prior accident year claims development following actions undertaken to address the challenges of the past two years. As noted previously, after \$51 million of adverse prior accident year claims development in the first half, we experienced \$10 million of favourable development during the second half, with modest adverse development in middle market and program business more than offset by favourable development in mortgage services, risk management and specialty.

Catastrophe experience was in line with expectations. Relatively benign experience across the majority of the property portfolios was offset by substantial catastrophe claims in crop insurance driven by the steep decline in commodity (especially corn) prices and hail claims, particularly in Nebraska. At the same time, unprecedented winter weather and hail drove 21 points of catastrophe claims in our consumer business.

Notwithstanding a 0.3% adverse business mix impact due to relative portfolio growth in specialty and contraction in reinsurance, the attritional claims ratio excluding crop and lender-placed improved to 49.1% from 49.2% in 2013, reflecting the earning of past premium rate increases and remediation efforts in program and middle market.

Lower risk-free rates used to discount net claims liabilities adversely impacted the claims ratio by \$18 million or 0.4%.

Commission and expenses

The commission ratio improved marginally to 15.6% compared with 15.8% in 2013, largely due to reduced commission rates in program, mortgage services and specialty partly offset by an adverse business mix impact.

Notwithstanding a further significant reduction in net earned premium, North American Operations' expense ratio improved to 17.6% compared with 20.1% in 2013, reflecting a \$223 million reduction in underwriting expenses. Material cost savings were achieved as a result of continued operational transformation efforts aimed at integrating and improving operational processes, systems and resources and a reduction in related restructuring charges. Progressively increased usage of the GSSC in Manila, right-sizing efforts and expense

management resulted in a more than 21% reduction in North American staff numbers.

Other developments

North American Operations is in the midst of considerable transformational efforts focused on profitable organic growth, organisational optimisation and business enablement.

Organisational optimisation is focused on driving greater flexibility and variability of cost. Our redesign of the North American platform is well underway as we optimise structure, processes, sourcing opportunities and geographic footprint, with the ultimate objective of achieving a top quartile expense ratio.

Business enablement is about creating the right environment and tools to deliver sustainable profitable growth and quality, predictable results. Our focus includes actuarial enhancements, scalable IT platforms and data and analytics build-outs.

After three years of contraction, we expect to see gross written premium stabilise with meaningful premium growth expected in specialty lines, consumer and potentially crop subject to commodity prices. Targeted organic growth will be coupled by expansion into new specialist lines. Sales and marketing will be an area of key focus in 2015 with the appointment of a new leader reporting directly to the divisional CEO, who will be responsible for driving profitable growth with a product-centric and customer-focused approach.

We are pleased with the progress being made to stabilise and improve middle market and program. Underwriting and distribution changes within middle market, including better rate management and improved policy retention, have stabilised premium and led to an attractive underlying claims ratio. Steps have also been taken to facilitate easier access for distributors to our people and products that will help meet the specialised needs of the niche markets in which we compete. We have realigned our middle market business to deliver on our commitment to our commercial, personal and agri-insurance businesses, shifting to a more customer and product-centric service model to provide all our agents with access to the full suite of QBE products.

Under the direction of a new leadership team, pricing and underwriting actions have been implemented within program with a focus on leveraging the new product-focused structure to drive underwriting excellence. Collectively this has led to an improved combined operating ratio in 2014.

Mortgage services remains extremely challenged with ongoing pressure on premium volume and thus the expense ratio, although the result for this business was aided to a certain extent in 2014 by favourable prior year claims development. We continue to focus on right-sizing the business and stringently managing expenses.

We recently announced the sale of QBE North America's US agency businesses, which include Community Association Underwriters (CAU), Deep South and SIU to Alliant Insurance Services, Inc. The total potential sale consideration is around \$300 million including an up-front cash payment of \$217 million, with the remaining cash to be paid by way of a performance-based earn-out agreement over the next five years. The total potential sale consideration represents an EBITDA multiple of around 12x. The sale completed on 2 February 2015.



North American Operations is undertaking a considerable transformation program to deliver top quartile performance and is on track to achieve strong results in the years to come.”

North American Operations

Outlook for 2015



2015 target
gross written
premium:

US\$5.2billion



2015 target
net earned
premium:

US\$3.8billion

North American Operations aims to be a top quartile, diversified specialty insurer in the markets in which we compete. The goal is to deliver sustainable, profitable growth with a strong underwriting margin.

Under the direction of a largely new management team, this transformation journey began in 2013 and will continue through 2017. Clear actions were taken in 2014 driving significant year-on-year improvement, including remediation of underperforming businesses, specialty growth that is outpacing plan, key leadership appointments, organisational redesign and operational transformation.

Underlying trends are improving and we are pleased to see that results are stabilising.

We will continue to make consistent improvements each year, and anticipate a combined operating ratio in the mid 90% region by 2017.

I would once again like to thank my team for their hard work and perseverance during this challenging period.