

Australian & New Zealand Operations business review

“A disciplined approach to pricing and underwriting over a number of years in an increasingly competitive market has seen Australian & New Zealand Operations deliver an excellent result with a combined operating ratio of 87%. Continued focus on underwriting controls and operational efficiencies while driving transformational change has underpinned our strong result.”

Colin Fagen

Chief Executive Officer • Australian & New Zealand Operations

Gross written premium US\$ million	Net earned premium US\$ million	Underwriting result US\$ million	Insurance profit US\$ million
4,392	3,834	498	680
⬇️ 9% from 2013	⬇️ 5% from 2013	⬆️ 2% from 2013	⬇️ 2% from 2013
		Combined operating ratio 87.0% (2013 87.9%)	Insurance profit margin 17.7% (2013 17.2%)

Competitive landscape

We have delivered excellent results in a slowing economy characterised by low interest rates and, in the insurance industry, heightened competitive pressure.

Low discount and interest rates is always challenging for our industry and the second half of 2014 reflected this as consumer confidence softened. The Federal Government deficit continued to deteriorate, commodity prices retreated and concern regarding China grew. When interest rates eventually revert to more historic levels, there will be a significantly positive impact on our results, albeit this scenario is unlikely to materialise in the near term.

Strong industry returns combined with excess capital in local and international markets have seen competition intensify, resulting in the need for an increased focus on business retention. Reflecting more limited revenue growth opportunities, insurers continue to drive operational efficiencies further reducing acquisition costs. We expect this competitive environment to continue into 2015.

Although there has been consolidation in the market amongst the larger players, the challenger brands are gaining market share in personal lines.

Despite the lower levels of consumer confidence, house prices have remained strong, particularly in Sydney. State governments have announced significant infrastructure projects that have added much needed economic stimulus; however, the shortage of housing stock is not expected to materially change in the medium term. Though unemployment increased marginally across 2014, employment and job creation have remained relatively positive compared with other world economies.

Underwriting performance

Our change program, coupled with ongoing portfolio restructuring, was instrumental in achieving these excellent results. Australian & New Zealand Operations performed extremely well in 2014, delivering a combined operating ratio of 87.0% and an insurance profit margin of 17.7% compared with 87.9% and 17.2% respectively in 2013. Although most classes were profitable, the property portfolio

continued to experience pricing and profitability pressure. Our longer tail portfolios including liability, compulsory third party (CTP) and lenders' mortgage insurance continued to outperform expectations despite the low interest and discount rate environment.

Our lenders' mortgage insurance business had an especially strong result and continues to benefit from effective credit and underwriting controls as well as the strength of the housing market, which is not expected to materially change in the foreseeable future.

Operating in an increasingly competitive market, the implementation of our refreshed customer value proposition ensured policy retention remained stable at 81% and a renewed focus on targeted sales initiatives delivered around \$1.2 billion in new business with policy counts rising in a number of portfolios. We remain focused on retaining our profitable renewal portfolio and sourcing new business within our risk appetite.

Underwriting result

FOR THE YEAR ENDED 31 DECEMBER		2014	2013	2012
Gross written premium	US\$M	4,392	4,805	5,008
Gross earned premium	US\$M	4,386	4,626	4,801
Net earned premium	US\$M	3,834	4,028	4,149
Net claims expense	US\$M	2,242	2,347	2,501
Net commission	US\$M	532	572	555
Expenses	US\$M	562	623	701
Underwriting result	US\$M	498	486	392
Net claims ratio	%	58.4	58.2	60.3
Net commission ratio	%	13.9	14.2	13.4
Expense ratio	%	14.7	15.5	16.9
Combined operating ratio	%	87.0	87.9	90.6
Insurance profit margin	%	17.7	17.2	15.7

Premium income

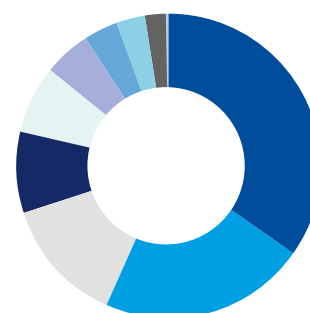
Gross written premium declined by 9% compared with 2013, largely reflecting the 7% depreciation of the Australian dollar against the US dollar. On a constant currency basis and allowing for a \$32 million impact from the abolition of the fire service levy (FSL) in Victoria, underlying gross written premium fell by only 2% reflecting the competitive landscape.

Premium rates increased by 0.1% on average in 2014; however, pricing trended downwards throughout the year. Retention has been stable at 81% on a policy count basis for renewable portfolios. New business growth was strongest in our Australian CTP portfolio and across most lines of business in New Zealand. Lenders' mortgage insurance saw significant growth in the first four months of 2014, with growth slowing thereafter as a direct result of APRA's pressure on ADIs regarding mortgage origination and desire to restrict residential lending for investment purposes.

During the year, the earnings pattern of the lenders' mortgage insurance business was reviewed and explicit consideration given to diminishing volatility in our claims experience. Our annual review of the earnings patterns and our excellent historical claims experience over the past five years better informed our earnings assumptions, resulting in an earnings profile more appropriate to the flow of risk and the incidence of claims. Earned premium benefited by \$82 million.

Net earned premium fell by 5% to \$3,834 million. On a constant currency basis and allowing for the FSL impact, net earned premium actually increased by 3%, significantly higher than top-line growth, mainly reflecting the revised premium earning pattern in the lenders' mortgage insurance business.

Gross earned premium
by class of business 2014



	2014 %	2013 %
Commercial & domestic property	34.8	37.2
Motor & motor casualty	21.9	20.2
Financial & credit	13.5	10.3
Public/product liability	8.5	9.0
Workers' compensation	7.2	8.2
Agriculture	5.2	5.5
Accident & health	3.4	3.6
Marine energy & aviation	3.0	3.2
Professional indemnity	2.4	2.6
Life	0.1	0.2

The reinsurance expense ratio decreased to 12.6% of gross earned premium compared with 12.9% in 2013, reflecting reduced reinsurance costs across most classes and a change in the mix of business from short tail catastrophe-prone products to longer tail products – predominantly CTP. This was partially offset by an increase in our lenders' mortgage insurance business quota share arrangements to 25%, up from 12% in 2013.

Claims expense

The net claims ratio moved marginally to 58.4% from 58.2% in 2013.

Pleasingly, the attritional claims ratio improved by a further 0.8% to 49.7% despite the growth in CTP that naturally generates a higher attritional claims ratio relative to most other products. Large individual risk and catastrophe claims costs were 2.2% higher than in 2013. Although lower than medium-term averages, catastrophe claims costs increased significantly following an exceptionally benign 2013. Our Brisbane hail net claims cost of \$85 million (A\$94 million) was within expectations and less than our national market share based on the expected industry loss. Large individual risk claims across both long and short tail classes were higher than expected and higher than prior years. There is no emergence of any patterns associated with large individual risk claims and our underwriting standards continue to be refined in order to manage the impact.

Risk-free rates fell further in the second half, contributing to a \$62 million or 1.6% adverse impact to the 2014 net claims ratio which was more than offset by favourable prior year development of \$114 million or 3.0% and a \$75 million or 2.0% net impact from the revised earning pattern for the mortgage insurance business.

Divisional risk margins were unchanged with releases in QBE LMI retained in the property and casualty business.

Commission and expenses

Australian & New Zealand Operations' combined commission and expense ratio improved to 28.6% from 29.7% in 2013.

The commission ratio fell slightly to 13.9% from 14.2% in 2013, reflecting a reduction in commission rates in corporate partners and direct as well as financial institutions and New Zealand coupled with strong growth in the relatively low commission paying financial institutions segment.

Notwithstanding the slight reduction in premium income, Australian & New Zealand Operations' underwriting expense ratio improved nicely to 14.7% from 15.5% in 2013, largely as a result of our focus on operational excellence coupled with the removal of FSL in Victoria.

During October and November 2014 we moved into our new premises at 2 Park Street, completing the rationalisation of our previously extensive Sydney office footprint. This has delivered improved staff collaboration, operational efficiencies and productivity and will deliver further expense savings in 2015.

Other developments

Australian & New Zealand Operations has led the Group in the development of the GSSC and delivery of operational effectiveness. These initiatives, combined with strong and

disciplined underwriting, will enable us to remain competitive through the softening market cycle. Operational transformation has enhanced the agility and change readiness of the business, attributes that will remain critical to our ongoing success. While most of the issues that emerged during transformation were expected and have been addressed, we have identified further areas for improvement. We are importing GSSC initiatives into our businesses in Australia and New Zealand, and the focus within all our teams is to continually refine our processes to improve efficiency and customer service.

The work we have undertaken throughout 2014 to improve our customer centricity, particularly the pilot and execution of our reinvigorated customer value proposition for each of our distribution channels, will ensure that all of our customers are kept firmly in mind in our strategy formulation. This is already driving results across our business as we create models of continuous improvement and further develop our measurement methodology. It has also delivered a marked improvement in prior year outstanding claims and ongoing improvement in our claims service is anticipated.

We have materially improved our staff engagement scores in 2014, recognising the integral role our people play in delivering the exceptional products and service to our customers. This is particularly positive, recognising the disruption associated with the local downsizing and level of change implemented in 2013.

The final report of the Financial Systems Inquiry was delivered late in 2014. The insurance industry receives far less attention than other participants in the financial services sector, though the report clearly calls for insurers to improve consumer guidance (including tools and calculators) and general disclosure. While we wholeheartedly support improved consumer understanding of the benefits of insurance, the encouragement of comparison websites and increased standardisation across the industry is disappointing. We believe this has the potential to exacerbate the very lack of understanding among consumers the report seeks to address and will potentially lead to even greater importance being placed on price above product and service when selecting insurance. As a result, the true risk may not be covered and this is particularly concerning when it affects many customers' main asset: their home. While there are some positive examples of aggregator models quoted in the report in travel, life and health, it is widely acknowledged that travel products have relatively high dispute rates and appropriate consideration does not appear to have been given to the numerous examples of poor outcomes for customers buying purely based on price rather than product attributes. The industry has been working for some time on improving the financial literacy of consumers and will continue to do so.

The Australian Government Actuary's report into pricing of home and contents in North Queensland was also released late in 2014 and acknowledges the losses incurred by the industry in recent years. Perhaps most encouragingly, there is growing recognition of the importance of mitigation. We hope there will be more collaboration in the future to create initiatives with a greater likelihood of success, reducing the impact to customers and government at all levels and strengthening the resilience of communities that will ultimately benefit the broader society.



It is important that the industry and government at all levels work closely together to create positive initiatives, to mitigate risk in our society and to ensure that insurance remains affordable for as much of our community as possible.”

Australian & New Zealand Operations Outlook for 2015



2015 target
gross written
premium:

US\$4.0billion



2015 target
net earned
premium:

US\$3.3billion

We expect the Australian economy to grow only marginally in 2015 with interest rates flat and potentially a small increase in unemployment. Inflation is expected to be at the lower end of Reserve Bank targets.

The insurance market will likely remain competitive and rates will continue to be under pressure, reflecting relatively benign catastrophe experience and correspondingly lower reinsurance costs. This will restrict growth opportunities and will place margins under pressure with inflation (albeit low) still outstripping rate increases.

The work undertaken to deliver operational efficiencies will continue to provide significant cost benefits and scalability in the year ahead. The majority of our transformational change is now embedded into our operating model which will be further modified to enhance our service delivery, productivity and to drive market needs. We will also continue to focus on both our delivery to customers and our teams' engagement to achieve this.

Systems investment will complement a range of customer initiatives and will further simplify our processes, with a particular focus on improving claims service delivery while maximising productivity benefits and supporting top-line growth.

On 16 February 2015, we announced the sale of 100% of our Australian agency businesses CHU Underwriting Agencies Pty Limited (CHU), Corporate Underwriting Agencies Pty Limited (CUA) and Underwriting Agencies of Australia Pty Limited (UAA). The up-front cash consideration is A\$290 million and represents an EBITDA multiple of approximately 8x. The final consideration, however, is subject to an earn out based on performance in 2015 and 2016 relative to 2014 and will fall within the range of A\$232 million to A\$348 million. The sale is expected to complete in late March 2015.

I would like to thank our dedicated team throughout Australia and New Zealand for their continuing efforts in delivering what is a superb result in 2014. The team has fully supported our global strategy and everyone should be proud of his or her contribution to our achievements while delivering such significant change.