Australian & New Zealand Operations business review

"Increased average claim size and frequency saw our attritional claims ratio deteriorate in the first half of 2016. Decisive action undertaken since, including premium rate increases and claims cost management initiatives, has seen the attritional claims ratio improve in the second half of 2016 with further improvement expected in 2017."

Pat Regan
Chief Executive Officer • Australian & New Zealand Operations

Gross written premium	Net earned premium	Underwriting result	Insurance profit
US$ million	US$ million	US$ million	US$ million
3,933	3,410	250	418
↑ 4% from 2015[1]	↑ 4% from 2015[1]	↓ $36M from 2015	↓ $49M from 2015
		Combined operating ratio 92.7% (2015 91.3%)	Insurance profit margin 12.3% (2015 14.2%)

2016 overview

Three factors combined to drive an increase in our attritional claims ratio during the first half of 2016: premium pricing pressure coupled with heightened claims inflation impacted our short-tail business; increased small claims frequency in the NSW compulsory third party (CTP) scheme; and increased claims frequency and severity in our trade credit business.

During the second half of the year, we acted decisively to address the deterioration in our first half performance, implementing a comprehensive remediation plan with a strong governance framework. The division has been divided into 44 business "cells" with regular, detailed reviews undertaken for each cell to ensure that new underwriting plans and remediation actions are being executed and are generating the desired outcomes.

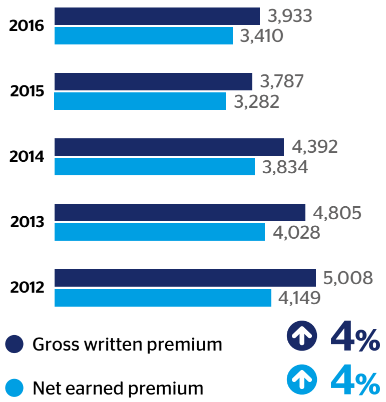
Key remediation initiatives undertaken to date include premium rate increases, revised policy terms and conditions, improved risk selection, tighter management and control over claims expenses (including the removal of delegated authorities where appropriate), focused supplier management, greater emphasis on salvage and third party recoveries and enhancements to our management information lead indicators.

Strong distribution partnerships have enabled us to lead the market in taking remediation actions. While these initiatives will primarily benefit our 2017 results, early benefits from rate increases and reduced claims costs are evident in our fourth quarter results.

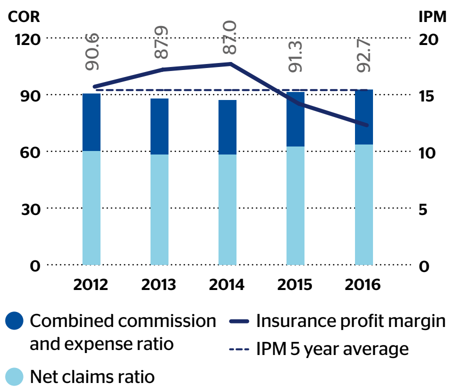
The impact of pricing initiatives undertaken to date are best evidenced by the trend in our Australian premium rate increases, up 1.7% for the full year compared with a decline of 0.1% at the half year, including a fourth quarter increase of 4.5%.

1 Up 5% on a constant currency basis.

Gross written premium and net earned premium (US$M)



Combined operating ratio (COR) and insurance profit margin (IPM) (%)



Operating and financial performance

Underwriting performance

Australian & New Zealand Operations reported a combined operating ratio of 92.7%, up from 91.3% in 2015. Positive prior accident year claims development, particularly in our NSW CTP and liability portfolios, largely offset the deterioration in the attritional claims ratio which increased to 60.2% from 55.1% in the prior period.

Pleasingly, the attritional claims ratio improved from 62.0% in the first half to 58.6% in the second half, driven by a significantly improved attritional claims ratio in the final quarter.

While the gross cost of catastrophe claims increased year on year due to the New Zealand earthquake and the large number of second half storms, the net cost was in line with expectations as a result of our aggregate reinsurance covers.

Our lenders' mortgage insurance (LMI) business reported a combined operating ratio of 34.9%, up from 22.2% in the prior period but broadly as expected. Premium income has continued to decline driven by regulatory pressure on mortgage lenders and stricter lending criteria. While the number of pending properties in possession and loans in arrears increased during 2016, this was partly offset by a decrease in the number and severity of claims.

Underwriting result

FOR THE YEAR ENDED 31 DECEMBER		2016	2015	2014	2013	2012
Gross written premium	US$M	**3,933**	3,787	4,392	4,805	5,008
Gross earned premium	US$M	**3,924**	3,753	4,386	4,626	4,801
Net earned premium	US$M	**3,410**	3,282	3,834	4,028	4,149
Net incurred claims	US$M	**2,172**	2,054	2,242	2,347	2,501
Net commission	US$M	**511**	481	532	572	555
Expenses	US$M	**477**	461	562	623	701
Underwriting result	US$M	**250**	286	498	486	392
Net claims ratio	%	**63.7**	62.6	58.4	58.2	60.3
Net commission ratio	%	**15.0**	14.7	13.9	14.2	13.4
Expense ratio	%	**14.0**	14.0	14.7	15.5	16.9
Combined operating ratio	%	**92.7**	91.3	87.0	87.9	90.6
Adjusted combined operating ratio [1]	%	**92.4**	91.1	85.4	–	–
Insurance profit margin	%	**12.3**	14.2	17.7	17.2	15.7

1 Combined operating ratio adjusted to exclude the impact of changes in risk-free rates used to discount net outstanding claims. Management-basis results were not reported in 2013 and prior.

Premium income

Gross written premium increased 4% to $3,933 million from $3,787 million in the prior year.

On a constant currency basis, gross written premium increased 5% due to growth across a number of portfolios. Strong growth was achieved in CTP as a result of significant premium rate increases in the NSW scheme, coupled with our entry into the recently privatised South Australian market from 1 July 2016. Modest growth was also achieved in New Zealand, Elders and our intermediary business.

Remediation initiatives undertaken during the second half resulted in average rate increases for the year of 1.7% across renewed business compared with an average rate reduction of 0.1% in the first half. Rate increases for renewed business in the fourth quarter averaged 4.5%. Importantly, and despite our focus on portfolio remediation, policy retention remained positive at 83.1% compared with 81.7% in 2015. We experienced a slight fall in retention in the fourth quarter as remediation plans were implemented, however, retention remained above 80%.

Over the 24 months to the balance date, we have increased our NSW CTP premium rates by 21% with a further 3% increase applicable from 1 February 2017. We continue to work closely with the government in relation to the proposed reforms that aim to deliver a fairer and more sustainable scheme.

Claims expense

The net claims ratio increased to 63.7% from 62.6% in the prior year due to an increase in the attritional claims ratio, which was largely offset by positive prior accident year development.

The substantial deterioration in the attritional claims ratio reported in the interim result remained a negative factor, however, and as noted previously, remediation actions have started to address this. The full effect of these initiatives will come through as premium is earned in 2017.

The increase in the attritional claims ratio was driven by an increase in NSW CTP small claims frequency (exacerbated by substantial growth in the CTP portfolio itself) and heightened claims costs across our short-tail portfolios as a result of increased average claim costs.

The gross cost of large individual risk and catastrophe claims increased in 2016 driven by the frequency of large individual risk claims throughout the year and the New Zealand earthquake in November. The net cost, however, remained within our allowances as a result of recoveries against our aggregate reinsurance cover.

Prior accident year claims development across our long-tail portfolios remained positive, contributing $147 million to the result compared with $120 million in the prior corresponding period and $83 million at the half year.

Risk-free rates used to discount net outstanding claims liabilities increased from the very low levels seen at 30 June 2016, to end the year very close to 31 December 2015 levels. As a result, the $33 million adverse discount rate impact at 30 June reduced to $9 million at 31 December 2016, in line with the full year 2015 discount rate impact.

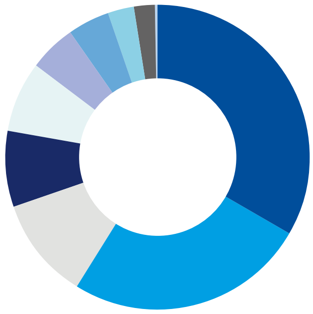
Commission and expenses

The acquisition cost ratio remained relatively stable at 29.0% compared with 28.7% in 2015.

The commission ratio increased slightly to 15.0% from 14.7% in the prior period, reflecting the aforementioned growth in our New Zealand business at generally higher commission rates compared with our Australian business. Portfolio mix changes within our intermediary business and growth in our affinity business also contributed to the minor increase.

The underwriting expense ratio remained stable at 14.0%. Continued focus on expense management, both locally and in our Group Shared Services Centre (GSSC), offset the loss of income from our Victorian Workers' Compensation Managed Fund business (from 30 June 2016), the loss of agency income associated with the sale of CHU and UAA (from 1 April 2015) and an increase in technology investment spending – specifically the implementation of the Guidewire system for our direct and CTP businesses.

Gross earned premium by class of business 2016



	2016 %	2015 %
Commercial & domestic property	33.3	33.7
Motor & motor casualty	25.6	23.1
Financial & credit	11.0	12.7
Public/product liability	7.9	8.7
Workers' compensation	7.4	7.2
Agriculture	5.1	5.2
Accident & health	4.4	4.0
Marine energy & aviation	2.8	3.0
Professional indemnity	2.3	2.3
Other	0.1	0.1

Summary

Competition remained strong in 2016. Nonetheless, our market leading position in each of the broker, underwriting agency and affinity distribution channels has stood us in good stead as we have progressed remediation actions across underperforming products.

Our remediation program, which is managed through a number of work streams with strong governance and ongoing monitoring, is focusing on improved profitability. We have already implemented a range of initiatives to improve our risk selection, claims performance and attritional claims costs.

Whilst we have acted decisively, remediation initiatives have only been in place for four months. Nevertheless, we are encouraged by the progress to date and are achieving desired premium rate increases with the market following in most areas. We have made some progress in claims management but acknowledge that there remains a significant amount of work to do in order to ensure market best practice is achieved.

The insurance market and the insurance cycle is dynamic and we recognise the need to be agile and responsive in order to ensure sustainable profitability over the cycle.

Our ongoing investment in systems, digitisation and further development of data and analytics is helping to deliver better customer experience, better customer insights and improve retention and growth.

The leadership team has been strengthened with the appointment of Declan Moore as Chief Underwriting Officer, Bettina Pidcock as Executive General Manager Marketing, Andrew Broughton as Executive General Manager Corporate Partners & Direct, Jon Fox as Executive General Manager Claims and, from 1 March 2017, Inder Singh as Chief Financial Officer.

Since assuming the position of Chief Executive Officer I have thoroughly enjoyed working closely with the talented staff in our Australian & New Zealand Operations. We have developed a strong plan to take our business forward and have already achieved a huge amount of improvement over a short period. I would like to thank everyone for their efforts and commitment and I remain optimistic and excited about the year ahead.