Growing QBE's fundamental value

QBE recorded a 2016 financial performance at the better end of our target range. We believe this result is a milestone in the journey to delivering steady increases in QBE's fundamental value even in the face of challenging market conditions and an increasingly uncertain global political environment. We are confident shareholders will be rewarded as we work to further strengthen QBE's global franchise through a relentless focus on underwriting excellence and operating efficiency together with measured customer and partner-led growth.

The market

The insurance market of 2016 continued to be characterised by surplus capital with corresponding downward pressure on pricing across most of the globe, particularly in commercial lines. Despite this dynamic, industry underwriting profits have generally been sustained by relatively low catastrophe claims coupled with continued prior accident year claims releases and cost efficiencies.

The near-term pricing outlook is broadly flat in most territories with the exception of Australia, where the insurance market started to harden in mid-2016 following a period of unsustainable price declines coupled with claims inflation. This means that as we look forward to 2017, the "day job" for insurers of generating underwriting profits is, as yet, no less challenging than a year ago.

Insurers are also grappling with a more uncertain political backdrop. This was evidenced in 2016 by increased anti-globalisation sentiment and concerns over immigration contributing to the Brexit vote and boosting support for populist politicians.

In the United States, proposed economic policies include large tax cuts for individuals and businesses, additional spending on infrastructure and defence and new trade barriers. Implementation of the President's policy proposals would likely provide a short-term economic stimulus; however, if enacted, these policies may lead to large budget deficits, creating inflationary pressures and increased pressure on the Federal Reserve to be more aggressive in raising interest rates.

Meanwhile, evidence is now emerging that Britain's vote to leave the European Union is feeding through to the economy of the United Kingdom in the form of rising inflation.

Predicting the impact of political change and geopolitical tension is notoriously challenging; however, it is reasonable to conclude that current uncertainty may contribute to more supportive conditions for the insurance industry. I say this because, broadly speaking, there are two things that make the operating landscape more favourable for insurers – if insurance prices are increasing or interest rates are rising. There are currently grounds for optimism on both fronts. Increased inflation in Europe will inevitably place upwards pressure on insurance pricing, while the pace of interest rate increases in the United States may accelerate as the Trump administration's impact on the economy becomes clearer.

Whether or not the headwinds faced by insurers in recent years ease, I believe we have the right strategies in place to grow QBE's fundamental value without reliance on rising interest rates or an improving pricing cycle. QBE has a differentiated global franchise and our business plans assume that the marketplace we see today is the one in which we will continue to operate.

2016 performance

Notwithstanding the challenging external environment, I am pleased to report that QBE delivered on our plans for the year with a financial result that was at the better end of our target range.

A notable aspect of the full year result was a substantial improvement in the performance of our Australian & New Zealand Operations in the second half of the year. Shareholders will recall that we reported an unsatisfactory performance in our Australian home market at the half year. This resulted from cumulative pricing declines coupled with heightened claims inflation in several short-tail classes, exacerbated by deterioration in the NSW compulsory third party (CTP) scheme.

While it takes more than a year for the full benefits of corrective action to be reflected in financial results once a commitment is made to remediate an insurance business, the Board is encouraged by the early progress made by Pat Regan and the team in Australian & New Zealand Operations. A carefully executed plan to restore pricing to more sustainable levels saw a 0.1% decline in Australian premium rates at the half year reversed in short order such that a full year price increase of 1.7% was recorded, including a 4.5% increase in the fourth quarter. The early benefits of these rate increases coupled with claims cost initiatives can be seen in a meaningful improvement in the division's combined operating ratio between June and December 2016.

Our North American Operations, which welcomed Russ Johnston as Chief Executive Officer during the year in a seamless transition from Dave Duclos, continued on its trajectory of performance improvement. The division is benefiting from portfolio rationalisation

and a tighter focus on core businesses, with the ongoing growth of Specialty an important contributor to the result.

Our European Operations had another strong year in a marketplace that is increasingly difficult and our Emerging Markets business continues to make progress, adding meaningfully to our future growth opportunities.

We have a stated objective of achieving gross written premium growth of 3% per annum across the cycle and early in the year we anticipated that growth of around this level would be achievable in 2016. While the target was not ultimately achieved due to a combination of prudent underwriting in a challenging marketplace and our own internal remediation initiatives, in our view this level of growth remains a reasonable objective over a planning cycle.

Our balance sheet remains in excellent shape, as reflected in Standard & Poor's decision in May 2016 to revise the rating outlook on QBE's core operating entities to "positive" from "stable".

Moreover, it is pleasing to note that we have now reported five consecutive half years of positive prior accident year claims development.

Looking to the future

This is my third annual message as Chairman, having taken on the role in April 2014 in the midst of a difficult period for the company.

Reflecting on the progress that has been made over the last three years, it is apparent that the QBE of 2017 is a hugely different company from the one that I took over as Chairman. Yet even in our darkest hour I was confident QBE had the essential attributes required to return to being an industry leader. Importantly, there was no question of QBE's solid underwriting DNA, the quality and commitment of our people or the latent benefits of being one of only a handful of truly global insurance franchises.

Achieving a return to stable and predictable earnings required that we first match these fundamental qualities with a more robust balance sheet while continuing to transform the business to strengthen and differentiate our global franchise.

The success that John Neal and his team have achieved in meeting this challenge is reflected in consecutive annual results towards the better end of our published targets and a balance sheet that is in excellent shape. Only with this hard work completed did we have the forward visibility to set out clear medium-term financial targets for QBE at our May 2016 Investor Update. These targets covered a range of metrics from growth in gross written premium to operating expense savings, reinsurance cost savings, claims efficiencies, return on equity and cash remittances.

Your Board recognised this strength in our mid-year action to increase the dividend payout ratio to up to 65% of cash profits as well as our recent action to adopt a share buyback facility.

Importantly, QBE's transformation extends beyond financial measures and I am delighted that in the last year we have attracted three exceptional candidates to provide stewardship at Board level. Recent Board appointments include two of the insurance industry's foremost leaders of recent decades, Rolf Tolle and Mike Wilkins. Our third new director, Kathy Lisson, brings a rare skillset spanning digital technology, cyber security, IT risks and data analytics that is essential to shaping our company's strategic direction.

Your Board is also acutely aware that there is no room for complacency in the insurance industry of 2017. There is still work to be done to ensure our global business is operating as efficiently as possible, while the impact of technology, including disruptive technologies, on the insurance industry will only increase in coming years. More than $4 billion has been invested in Insurtech startups in the last two years and we are committed to being at the forefront of industry developments. I'm delighted that Kathy Lisson is chairing a new Board committee focused exclusively on technology and operational transformation at QBE.

While there has been a great deal of change at QBE over the last three years, one constant is our cautious approach to the way we go about our business. Whether it's through the comprehensive reinsurance we buy or our reluctance to go too far up the risk curve in our investment strategy, our over-riding goal is to deliver stable and predictable earnings.

In closing, I remain enthused and optimistic about QBE's ability to deliver high quality financial returns for our investors while fulfilling our mission for our customers through an increasingly talented global workforce and leadership team.

W. Marston Becker
Chairman