Equator Re business review

"Equator Re remains core to the management of the Group's risk appetite and capital through its role in optimising divisional retentions and managing the Group's innovative global ceded reinsurance program."

Jim Fiore

Group Chief Reinsurance Officer & President • Equator Re

Gross written premium US$ million	Net earned premium US$ million	Underwriting result US$ million	Insurance profit US$ million
1,349[1]	468[1]	137[1]	164[1]
up 34% from 2015	up 28% from 2015	up $97M from 2015	up $61M from 2015
		Combined operating ratio 70.7%[1] (2015 89.0%)	Insurance profit margin 35.0%[1] (2015 28.1%)

2016 overview

Equator Re continues to assist the divisions in managing their balance sheet and capital requirements and, in 2016, provided a number of innovative and bespoke solutions that assisted Group capital optimisation.

Equator Re successfully developed divisional covers to complement the Group Large Risk and Catastrophe (GLRC) aggregate reinsurance program, providing increased certainty for each division around their expected large individual risk and catastrophe claims. Equator Re's top and bottom line result benefited from the provision of these divisional large risk and catastrophe (DLRC) protections.

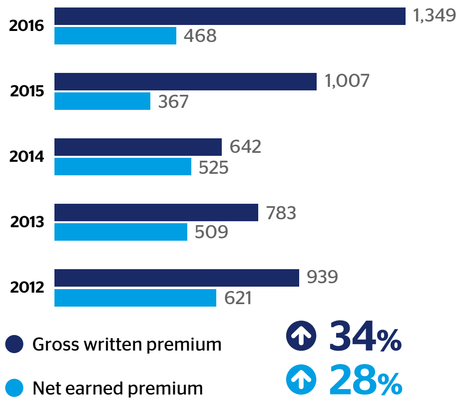
The result also benefited from the divisions electing to novate their rights to future recoveries under the Group Aggregate Risk (GAR) reinsurance program to Equator Re. In so doing, the divisions achieved certainty with respect to these potentially volatile recoveries.

Equator Re also completed a loss portfolio transfer (LPT) transaction with North American Operations to assist in the management of commercial auto liabilities. The effect of this was to increase net earned premium by $183 million and net claims incurred by approximately $185 million. Although largely profit neutral, as highlighted in the table overleaf, the LPT transaction adversely impacted Equator Re's combined operating ratio by 8.6% (with a 12.3% adverse impact on the net claims ratio partially offset by a 3.7% positive impact on the combined commission and expense ratio).

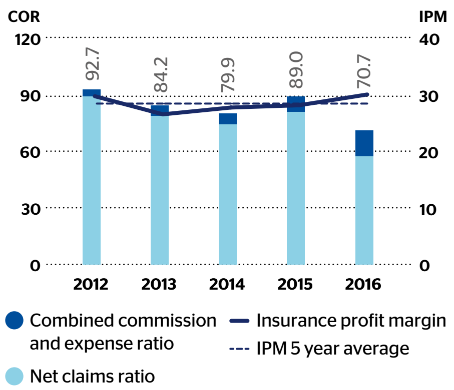
In order to assist year on year comparability, the commentary hereafter refers to the 2016 results excluding the impact of this LPT transaction.

1 Adjusted for North American Operations LPT transaction.

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



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



Operating and financial performance

Underwriting performance

Equator Re delivered a strong underwriting result in 2016, recording a significantly improved combined operating ratio of 70.7% compared with 89.0% in the prior corresponding period.

At the same time, Equator Re was able to increase gross written premium by 34% and net earned premium by 28%. This premium growth resulted from the successful completion of a number of initiatives implemented to assist the divisions and the Group in managing their respective balance sheet and capital requirements.

An important contributor to the improved 2016 underwriting performance was positive prior accident year claims development, largely generated by increased recoveries on the novated GAR contract. During 2015, the level of recoveries under that same reinsurance program reduced (largely due to adverse currency movements), thereby contributing to the significant adverse 2015 prior accident year claims development.

As previously noted, the development of bespoke DLRC covers benefited Equator Re's premium income and profitability.

Equator Re's result was also impacted by an increased volume of proportional business, as a result of both increased shares in divisional programs and underlying growth in the relevant divisional portfolios. This business typically generates a higher (but arguably less volatile) combined operating ratio than Equator's existing excess of loss portfolio, and will therefore create upward pressure on the combined operating ratio. In 2016, this pressure was more than offset by the profitability of the DLRC covers.

Underwriting result

FOR THE YEAR ENDED 31 DECEMBER		2016	2016 [1] ADJUSTED	2015	2014	2013	2012
Gross written premium	US$M	**1,532**	**1,349**	1,007	642	783	939
Gross earned premium	US$M	**1,429**	**1,246**	994	764	802	922
Net earned premium	US$M	**651**	**468**	367	525	509	621
Net incurred claims	US$M	**453**	**268**	297	389	400	553
Net commission	US$M	**50**	**50**	17	18	21	17
Expenses	US$M	**13**	**13**	13	13	8	6
Underwriting result	US$M	**135**	**137**	40	105	80	45
Net claims ratio	%	**69.6**	**57.3**	80.9	74.2	78.6	89.0
Net commission ratio	%	**7.7**	**10.7**	4.6	3.3	4.1	2.7
Expense ratio	%	**2.0**	**2.8**	3.5	2.4	1.5	1.0
Combined operating ratio	%	**79.3**	**70.7**	89.0	79.9	84.2	92.7
Adjusted combined operating ratio [2]	%	**78.9**	**70.2**	89.9	75.0	–	–
Insurance profit margin	%	**24.9**	**35.0**	28.1	27.7	26.5	29.7

1 Adjusted for North American Operations LPT transaction.

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

Premium income

Gross written premium increased by $342 million or 34% to $1,349 million from $1,007 million in the prior corresponding period. This growth was largely due to the provision of DLRCs to all divisions and growth in our proportional book. Growth in proportional premium reflects new cessions to Equator Re as part of the Group's external reinsurance cost saving initiative, as well as growth in the underlying business that is subject to the proportional quota shares, particularly the growing Specialty business in North America.

Net earned premium increased by $101 million or 28% to $468 million from $367 million in 2015. Gross written premium growth generated from the DLRCs was largely offset by increased outwards reinsurance expense, with Equator now incurring the entire cost of the GLRC (that was previously incurred by all divisions). In comparison, growth in proportional premium income was largely retained.

Reduced external excess of loss reinsurance costs also assisted in increasing Equator Re's net earned premium.

Claims expense

During 2016, Equator Re's bespoke catastrophe programs assisted Emerging Markets and Australian & New Zealand Operations in limiting the cost of a number of major catastrophic events, including Cyclone Winston that impacted Fiji in February, a devastating earthquake in Ecuador in April and a significant earthquake in New Zealand in November. Whilst the impact of these events was offset by a relatively lower frequency of northern hemisphere catastrophe activity resulting in an average catastrophe result overall for Equator Re, this nonetheless represented a deterioration compared with the especially benign 2015 catastrophe experience.

Equator Re's property risk and trade credit programs were impacted by a higher frequency and severity of claims across most divisions. Equator Re was able to absorb this adverse claims experience due to the comprehensive protection offered by the Group's large risk and catastrophe aggregate program.

The result benefited from $56 million of positive prior accident year claims development compared with $120 million of adverse development in 2015, largely reflecting increased recoveries on the novated GAR contract as previously noted.

Commission and expenses

The combined commission and expense ratio increased significantly to 13.5% from 8.1% reported in 2015.

Equator Re's commission ratio increased to 10.7% from 4.6% in the prior corresponding period, reflecting growth in proportional business that incurs higher commissions relative to the excess of loss portfolio. This was partially offset by a reduction in the underwriting expense ratio to 2.8% from 3.5% in 2015, which was largely driven by strong net earned premium growth.

In real terms, expenses of $13 million were in line with the prior period. During 2015, the transitioning of the majority of finance and policy administration roles to our Group Shared Services Centre (GSSC) in Manila generated a number of one-off transition related costs that were not repeated in 2016. However, the build-out of our capability in Bermuda to meet the increasing needs of our divisional customers did generate an increase in Bermuda based run rate costs in 2016.

Summary

Overall, 2016 was a very successful year for Equator Re. We delivered a strong underwriting result while increasing the portfolio of products offered to our divisional customers. Many of these new initiatives facilitated the release of excess divisional capital, thereby assisting the Group in meeting its financial strength and capital flexibility ambitions. At the same time, Equator Re was able to pay a $450 million dividend to our parent entity.

From an operational perspective, having transitioned a number of activities to the GSSC in 2015, it was pleasing to see that we are now starting to leverage that investment. Equator Re now has a stronger platform from which to continue to support new global initiatives in a cost effective and efficient manner, with approximately 50% of our staff based in the GSSC. As part of QBE's finance transformation program, we are continually reviewing the mix of work between onshore and offshore locations to ensure the most optimal cost structure for the Group's captive. We also leverage divisional and Group resources and look for ways to better collaborate globally to create further efficiencies.

I would like to thank the Group's Global Reinsurance Operations team for all their hard work and dedication during 2016. Whilst the financial results indicate an impressive performance, this has not been achieved without significant input and effort from all of our worldwide teams.