GENERAL INSURANCE FUNDAMENTALS

March 2011

Insurance Australia Group

AGENDA

Part 1 – Understanding insurance basics

Part 2 – Industry thematics

Part 3 – Key drivers in an insurer's financials

Part 4 – IAG's businesses

Part 5 – Capital management

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PART 1
UNDERSTANDING INSURANCE BASICS

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WHAT AN INSURER DOES
BASIC PRINCIPLES

- **The advantage of obtaining insurance is that it allows the pooling of risks and reduces the probability of one party bearing the entire cost of a loss**

- **Insurance policies originated in 17th century London coffee houses which became the place for sharing information on agreements of pooled risks between merchants, ultimately leading to the formation of Lloyds of London**

- **In the aftermath of The Great Fire of London, Nicholas Barbon an English physician opened "The Fire Office" to insure London's brick homes, and established insurance policies as we know them today**

- **Today, an insurance contract is a contract in which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policy holder. (AASB 4)**

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WHAT AN INSURER DOES

Differences to assurance and other financial products

- **Insurance pools the risk of uncertain future events. This is different to assurance models which pool the risk of events which will happen such as death, retirement or paying interest**
- **The actual cost of providing the general insurance product is *not known* at the time of selling the product**
- **The product being sold only has *intangible* attributes such as selling a promise to pay and the likelihood of a claim occurring**
- **The product is often a 'grudge' purchase and a 'need' rather than a 'want'**

WHAT AN INSURER DOES
BASIC PRINCIPLES

SIMPLIFIED CONCEPT – RISK OF A LARGE AND INFREQUENT LOSS

Every year 1 in every 1,000 houses suffers a fire at a cost of $100,000.

An individual risks having to finance $100,000 if it is their turn for the 1:1000 loss.

A group of 1,000 householders pooling together pay only $100 each to rebuild the house each year. Even after 10 years the individual has only paid $1,000 to protect their risk of $100,000.

WHAT AN INSURER DOES
BASIC PRINCIPLES

SIMPLIFIED CONCEPT – RISK OF SMALL FREQUENT LOSSES

Every year 100 in every 1,000 houses suffers a burglary at a cost of $1,000.

An individual risks having to finance $1,000 if it is their turn for the 1:10 loss.

A group of 1,000 householders pooling together pay $100 each to reimburse the cost of goods stolen. Over 10 years the individual has paid $1,000.

WHAT AN INSURER DOES

PRODUCTS

SHORT TAIL

- Claims usually known and settled within 12 months
- Less complexity in managing claims
- Less risk in predicting final settlement
- Generally based around property

LONG TAIL

- Claims may not even be reported within 12 months
- Settlement can take 3-4 years
- Greater complexity in managing claims
- Higher risk in predicting final settlement
- Generally based around medical and legal outcomes

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WHAT AN INSURER DOES

PRODUCTS

	PERSONAL LINES	COMMERCIAL
SHORT TAIL	• Private Motor • Home, Contents • Personal Effects • Boat • Caravan / Trailer • Health • Travel • Transport Accident • Consumer Credit	• Fleet Motor • Fire, Explosion • Burglary, Theft • Goods in Transit • Construction • Personal Accident / Travel • Credit • Political Risks • Kidnap & Ransom
LONG TAIL	• Compulsory • Third Party (statutory) • Home Liability	• Workers Compensation (statutory) • Public & Products Liability • Product Recall • Professional Liability • D & O Liability • Defamation • Environmental

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WHAT AN INSURER DOES
UNDERWRITING

An insurer manages the pooling of risks to optimise the result (underwriting profit) – not all risk attributes in the pool are the same:

SPECIFIC	SOCIO DEMOGRAPHIC	ECONOMIC	CATASTROPHIC
<u>Individual Risk</u> • **Driver ability** • **Driver age** • **Gender** • **Ethical profile** • **Moral risk** ***<u>Asset Risk</u>*** • **Type of car** • **Type of finance**	• **Area** • **Average income** • **Level of un-employment**	• **Inflation** • **Exchange rates** • **Cost of parts** • **Fuel prices** • **Level of employment**	• **Hail** • **Earthquake**

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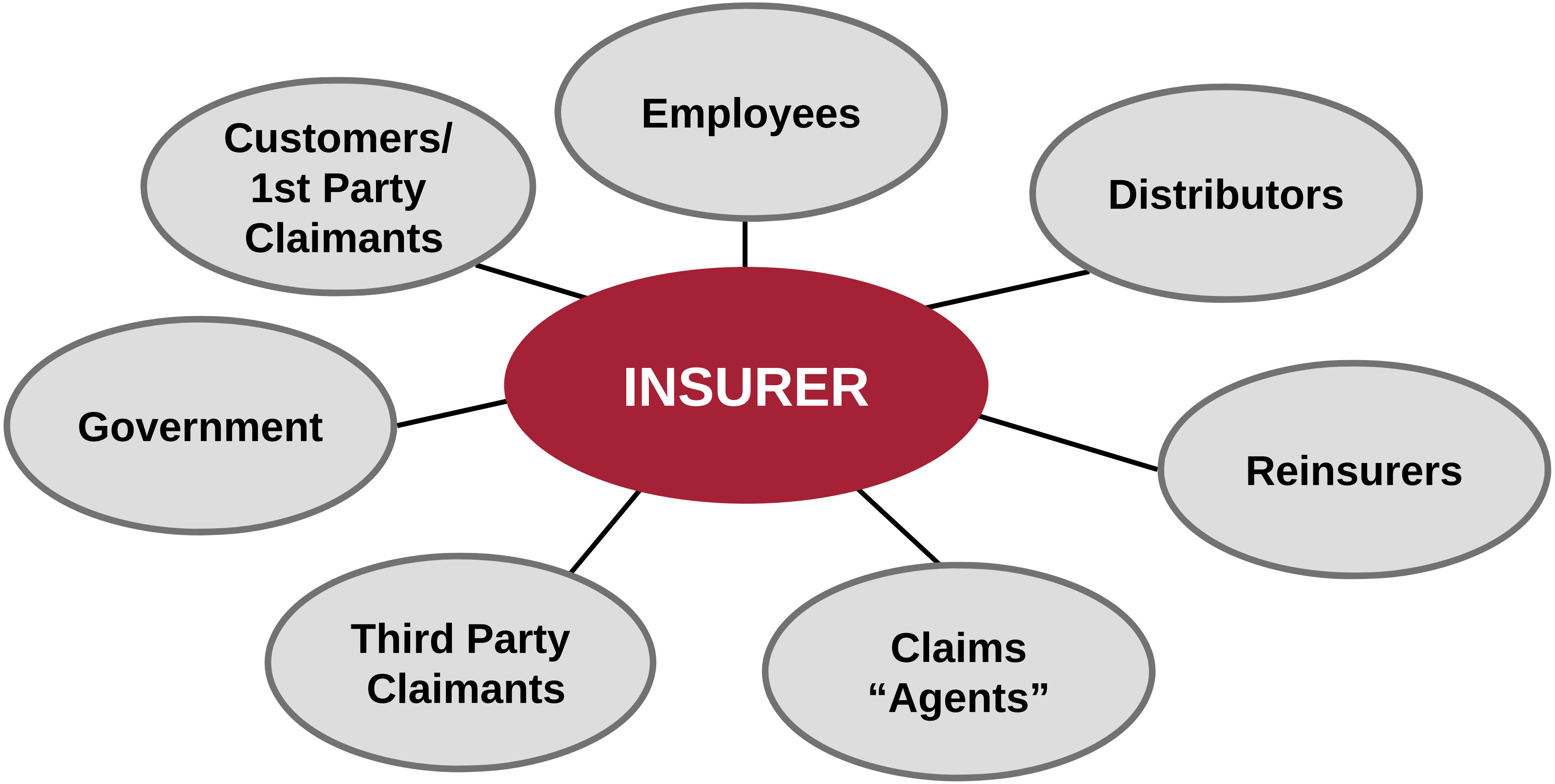
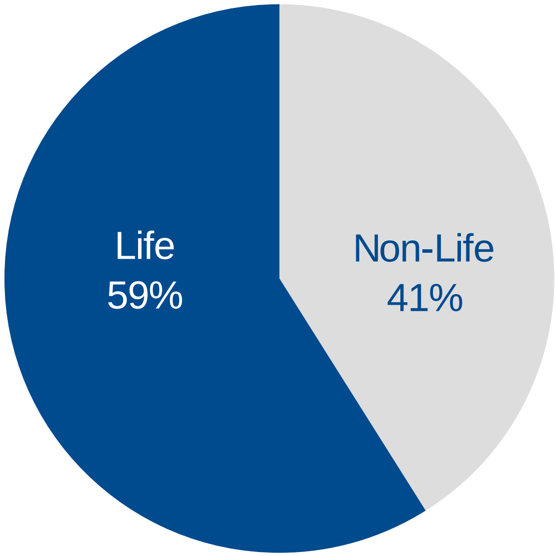
KEY STAKEHOLDERS IN INSURANCE TRANSACTIONS



PART 2
INDUSTRY THEMATICS

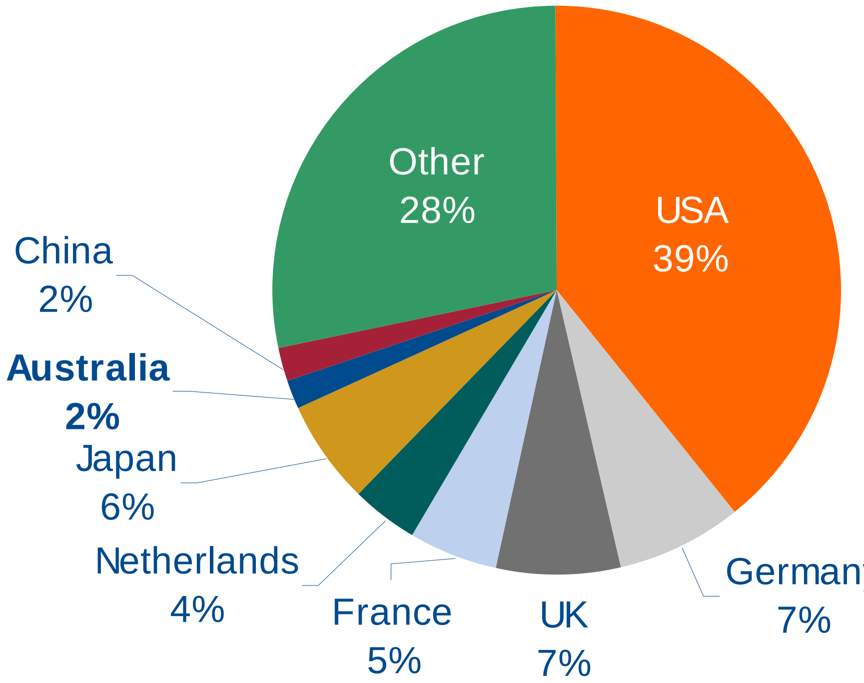
INDUSTRY THEMATICS
GLOBAL

Global Insurance market (US$4,060bn)



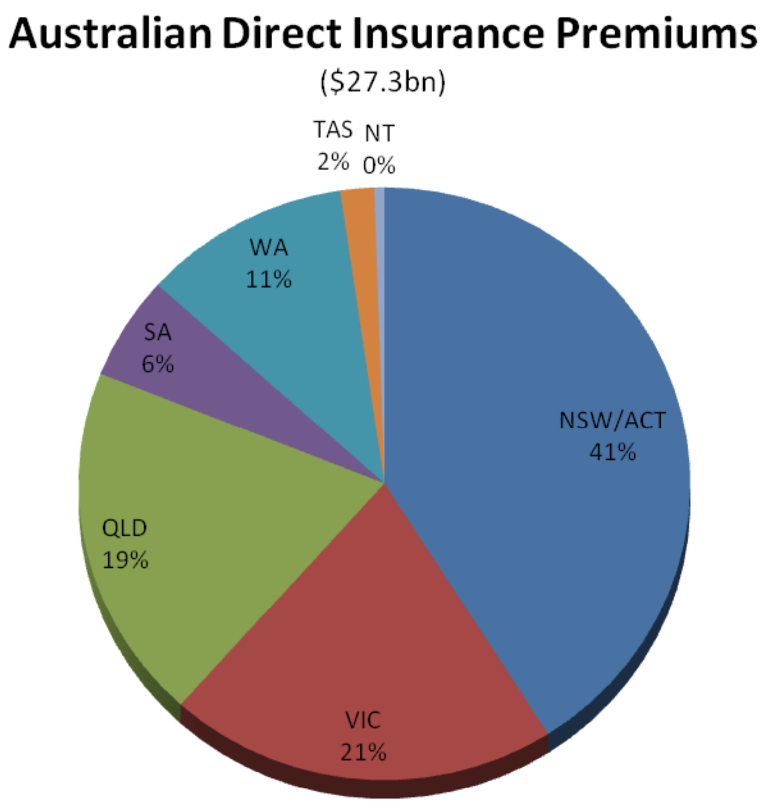
Source: Sw iss Re Sigma No3/2008. Data as at December 2007.
Notes: Includes non-life health premiums

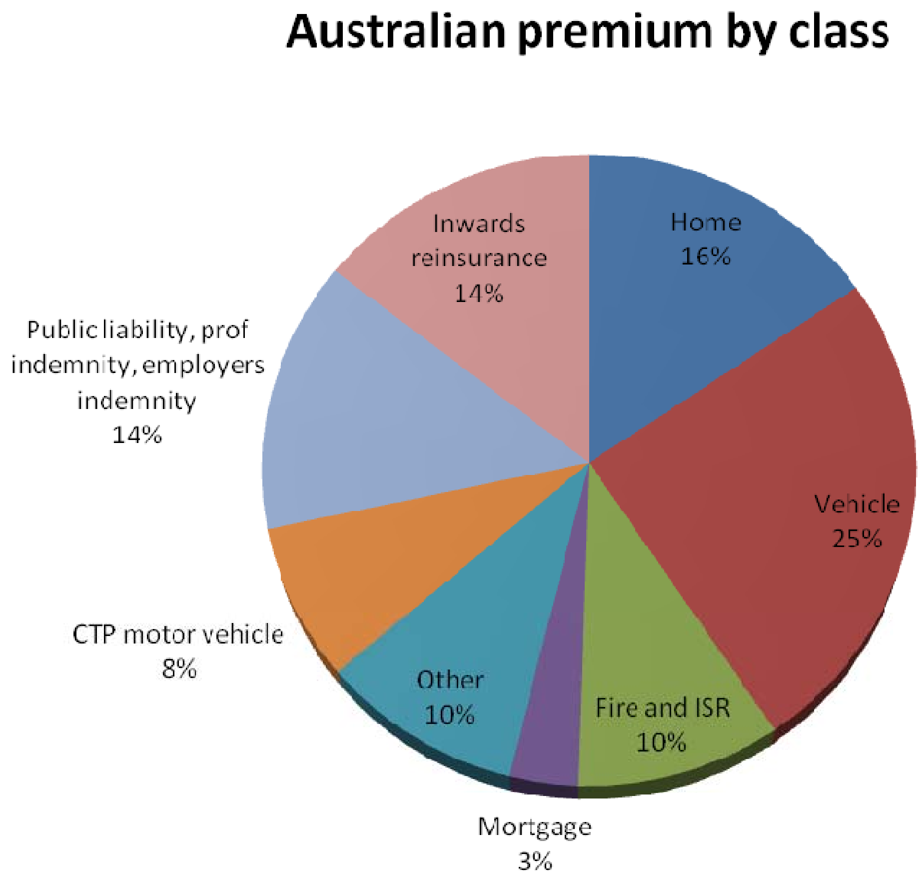
Global GI market (US$1,667bn)



Source: Sw iss Re Sigma No3/2008. Data as at December 2007.

INDUSTRY THEMATICS
AUSTRALIA





Source: APRA Industry Statistics, June 2010

INDUSTRY THEMATICS
AUSTRALIA

Over the last decade there has been a trend of privatisation, demutualisation and consolidation.

NRMA, SGIO, SGIC, CGU, Swann, RACV (JV), State, Circle, NZI		**IAG**
Allianz, MMI, Switzerland, Federation, FAI, CIC, HIH Personal Lines		**Allianz**
Royal, Sun Alliance, Promina/Vero,Phoenix, AAMI, RAC (WA), APIA	**Promina (RSA)**	**Suncorp**
Suncorp, AMP, GIO, AGC, RAQ (JV), TGIO	**Suncorp**	**Suncorp**
QBE, Australian Eagle, MLC, UAP (port), Mercantile Mutual (jv),ITT Hartford (port), Kemper, CE Heath, HIH (Commercial & Travel), Carlingford, Nat Ins Co of NZ, Colonial Mutual, Trade Indemnity		**QBE**

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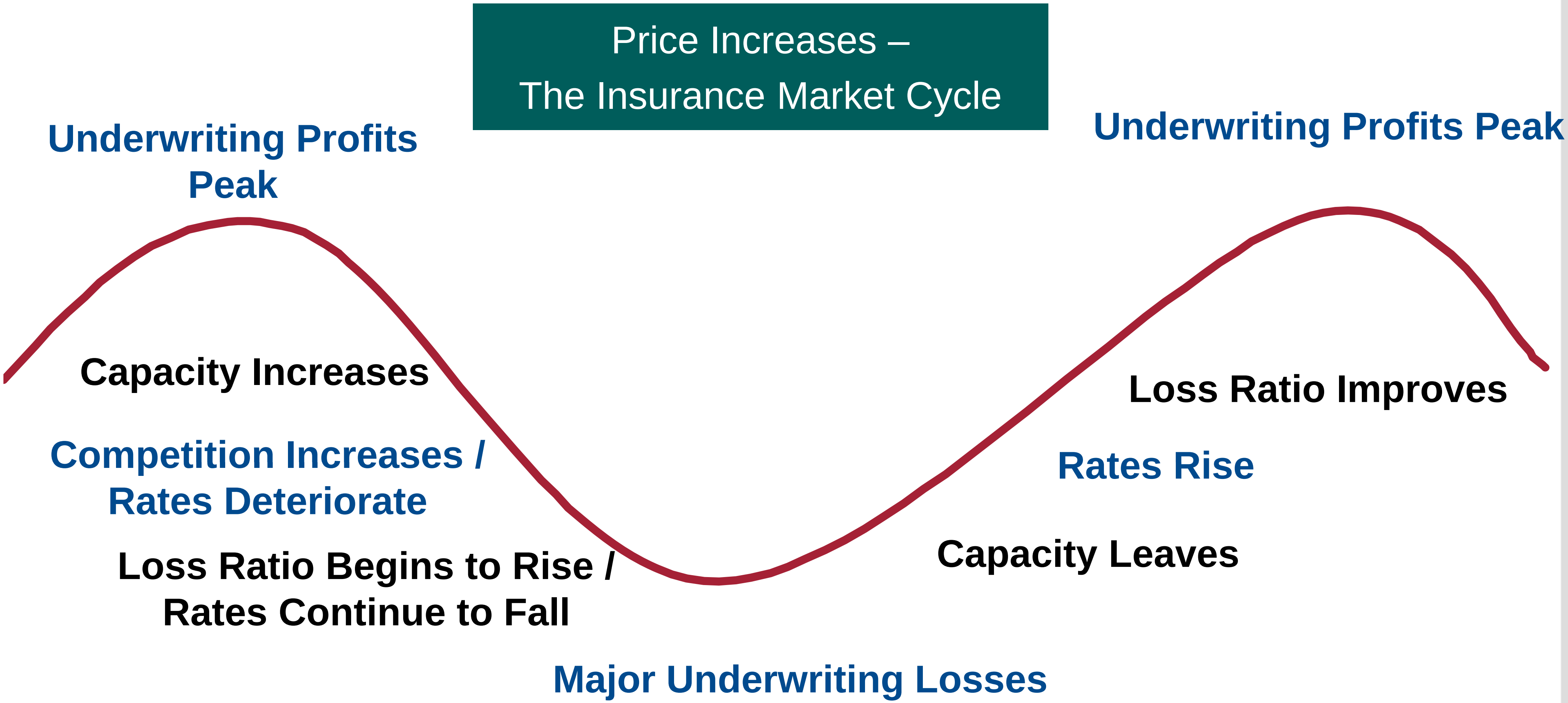
INDUSTRY THEMATICS
TRENDS



Source: Ord Minnett / Deloitte Touche

LARGEST GLOBAL INSURANCE LOSSES 1970 - 2008

6 of the most costly losses have occurred in the last four years

Rank	Event	Insured Loss $bn *	Year
1	**Hurricane Katrina**	**71.3**	**2005**
2	Hurricane Andrew	24.6	1992
3	WTC Terrorist Attack	22.8	2001
4	US, Northridge Earthquake	20.3	1994
5	**Hurricane Ike**	**20**	**2008**
6	**Hurricane Ivan**	**14.6**	**2004**
7	**Hurricane Wilma**	**13.8**	**2005**
8	**Hurricane Rita**	**11.1**	**2005**
9	**Hurricane Charlie**	**9.2**	**2004**
10	Japan, Typhoone Mireille	8.9	1991

* Indexed to 2008

Source: Swiss Re Sigma No 2/ 2009. All figures quoted in USD.

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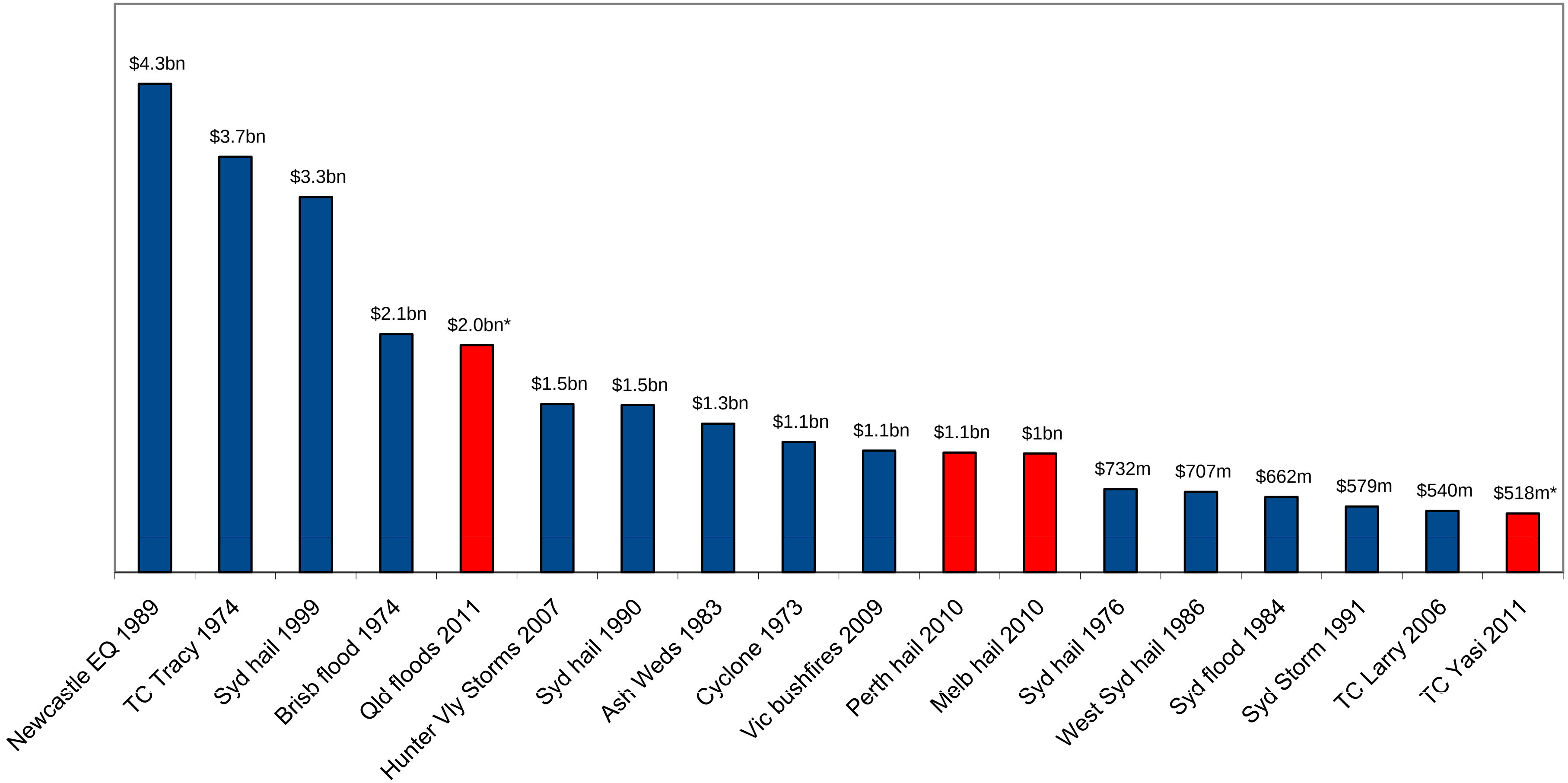
AUSTRALIA'S MAJOR INSURANCE LOSSES

WEATHER EVENTS DOMINATE AUSTRALIAN INSURANCE DISASTER STATISTICS



Source: Insurance Council of Australia (2007 Repeated Cost - $million)

PART 3
KEY DRIVERS IN AN INSURER'S FINANCIALS

HOW DOES AN INSURER MAKE MONEY ?

REVENUE = **Premiums** + **Investment Income**




LESS EXPENSES = **Claimants** + **Govt. Taxes & Levies** + **Reinsurers** + **Salaries & associated admin expenses**

PROFIT

Distribution to Shareholders (return on their investment)

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IAG 1H11 PROFIT & LOSS

	1H10 A$m	2H10 A$m	1H11 A$m
Gross written premium	**3,863**	**3,919**	**3,936**
Gross earned premium	3,872	3,749	3,938
Reinsurance expense	(229)	(327)	(228)
Net earned premium	**3,643**	**3,422**	**3,710**
Net claims expense	(2,335)	(2,737)	(2,359)
Commission expense	(341)	(317)	(336)
Underwriting expense	(689)	(707)	(694)
Underwriting profit/(loss)	**278**	**(339)**	**321**
Investment income on technical reserves	210	344	149
Insurance profit	**488**	**5**	**470**
Net corporate expense	8	(4)	-
Interest	(43)	(45)	(44)
Profit/(loss) from fee based business/share of associates	11	(1)	17
Investment income on shareholders' funds	91	5	147
Profit/(loss) before income tax and amortisation	**555**	**(40)**	**590**
Income tax expense	(156)	(56)	(223)
Profit/(loss) after income tax (before amortisation)	**399**	**(96)**	**367**
Non-controlling interests	(58)	(41)	(44)
Profit/(loss) attributable to IAG shareholders (before amortisation)	**341**	**(137)**	**323**
Amortisation and impairment	(12)	(101)	(162)
Profit/(loss) attributable to IAG shareholders	**329**	**(238)**	**161**
Insurance Ratios			
Loss ratio	64.1%	80.0%	63.6%
Immunised loss ratio	65.0%	78.0%	66.4%
Expense ratio	28.3%	30.0%	27.8%
Commission ratio	9.4%	9.3%	9.1%
Administration ratio	18.9%	20.7%	18.7%
Combined ratio	92.4%	110.0%	91.4%
Immunised combined ratio	93.3%	108.0%	94.2%
Insurance margin	13.4%	0.1%	12.7%

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KEY DRIVERS - HOW INSURANCE WORKS
TERMINOLOGY

Premiums =

Gross Written Premium (GWP)

Is the total amount we received from customers for the payment of their insurance policies.

Gross Earned Premium (GEP)

When we calculate our results for the year (financial) we only include the portion of policies up to June 30.

Net Earned Premium (NEP)

Our net earned premium is our gross earned premium minus reinsurance costs.

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KEY DRIVERS - HOW INSURANCE WORKS

NEP	-	Net Claims Expense	-	Underwriting Expenses	=	Underwriting Profit/Loss
Is the total amount we received from customers after making adjustments for ‘unearned premium’ and ‘reinsurance’ costs		This is the gross amount paid out during the year, as well as an estimate of how much we need to pay on future claims which have been incurred (whether reported or not). It also includes the cost of processing claims. We deduct from this gross amount any recoveries (reinsurance, salvage, third parties, etc, which arise from the gross claim.		These are costs associated with researching risk and determining appropriate premiums, administering policy information, marketing, distribution, etc.		This is the profit/loss we make from our insurance business before we consider related investment income

KEY DRIVERS - HOW INSURANCE WORKS

Underwriting Profit	+	Investment Income from Technical Reserves	=	Insurance Profit
This is the profit/loss we make from our insurance business before we consider related investment income		'Policy Holder Funds', this is the income received from investments that were made using funds received from customers paying their premiums		Our insurance profit is determined by adding net earned premium to the investment return from our technical reserves and subtracting claims and underwriting expenses

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KEY DRIVERS - HOW INSURANCE WORKS

Insurance Profit	+	Investment Income from Shareholders Fund	-	Tax and other costs*	=	Net Profit/Loss
Our insurance profit is determined by adding net earned premium to the investment return from our technical reserves and subtracting claims and underwriting expenses.		This is the income received from investments made using shareholders funds. These investments are usually more aggressive than those made using technical Reserves.		* Other costs include interest, amortisation, etc which is specific to a company.		This is the net result after allowing for income taxes and the share of profit owing to minority shareholders/ unit holders within the Group.

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KEY DRIVERS - HOW INSURANCE WORKS

TERMINOLOGY

Loss Ratio	The ratio of net claims expense to Net Earned Premium (NEP)
+	
Expense Ratio	The ratio of underwriting expenses to net earned premium
=	
Combined Ratio	Our claims and underwriting expenses measured a a percentage of our net earned premium
+	
Investment income on technical reserve	
=	
Insurance Margin	The pre tax profit margin of the general insurance operations as a percentage of net earned premium

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KEY DRIVERS
USE OF CAPITAL

Policyholders Funds
(“Technical Reserves”)
Provisions made for unearned premiums & outstanding claims

More conservative investment approach 100% Fixed Interest

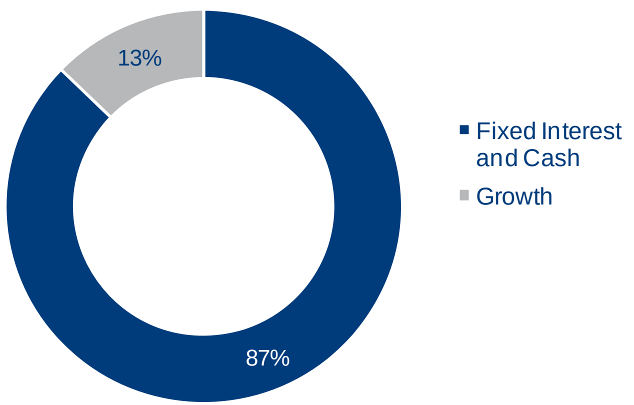
Capital

(“Shareholders Funds”)

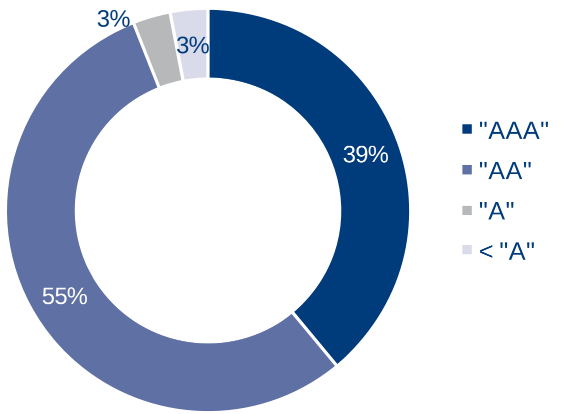
More assertive, includes investment in equities

CAPITAL
CONSERVATIVE MIX – HIGH CREDIT QUALITY

INVESTMENT ASSET ALLOCATION – $11.8B

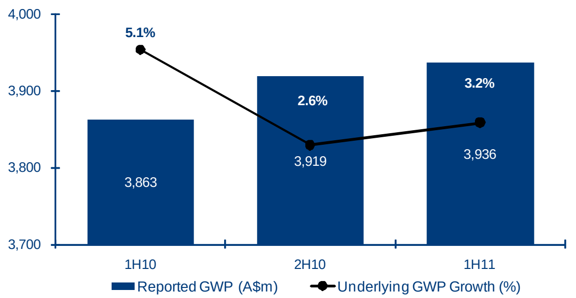


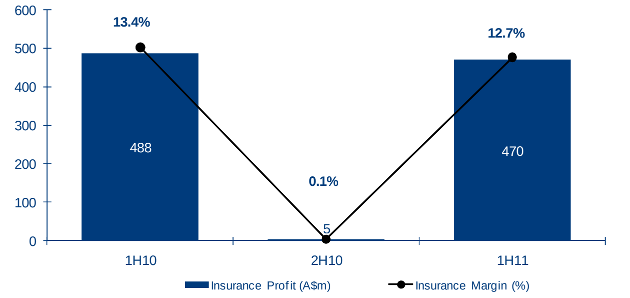
GROUP FIXED INTEREST & CASH – $10.3B

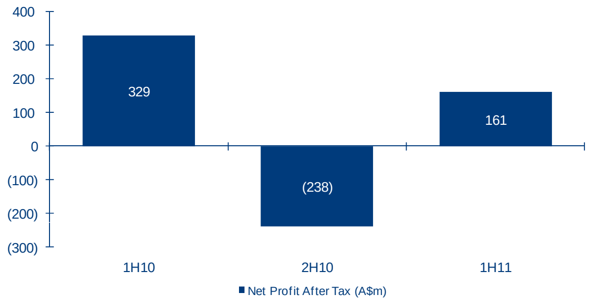


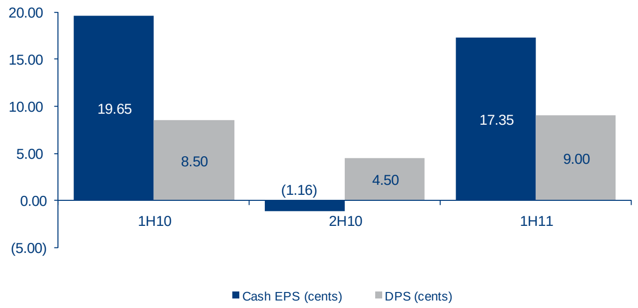
- 87% of total portfolio in fixed interest and cash
- Growth assets have risen to 40% of shareholders' funds
- Credit quality remains high – 94% of fixed interest and cash rated 'AA' or better

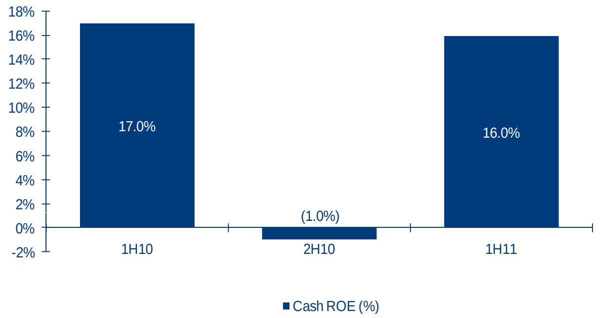
KEY DRIVERS
1H11 FINANCIAL MEASURES

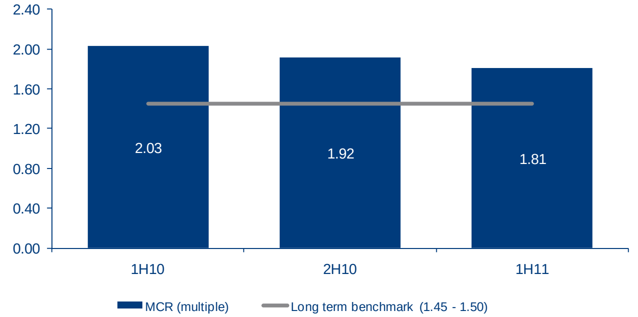












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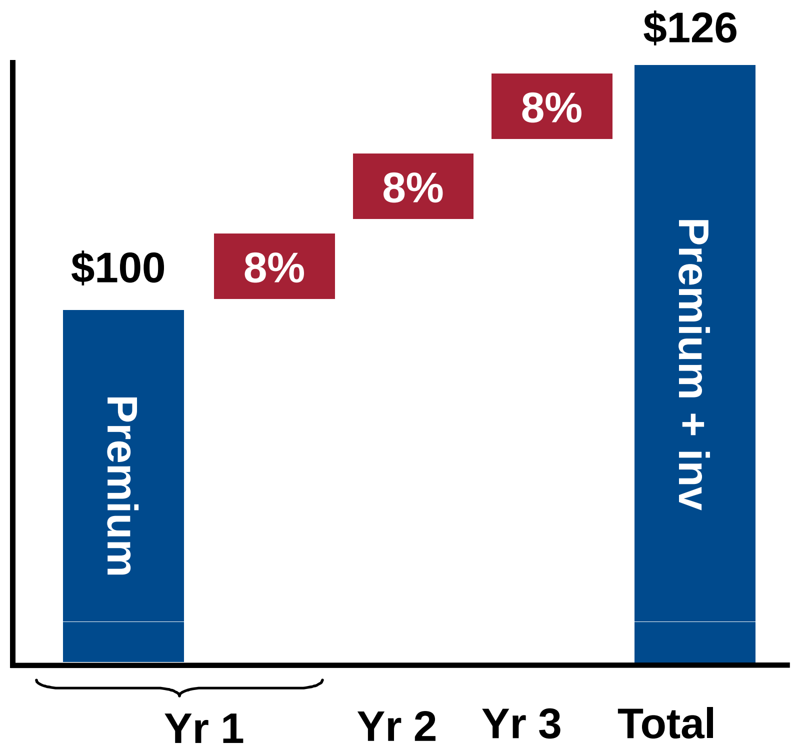
KEY DRIVERS
DIFFERING OPERATING RATIOS

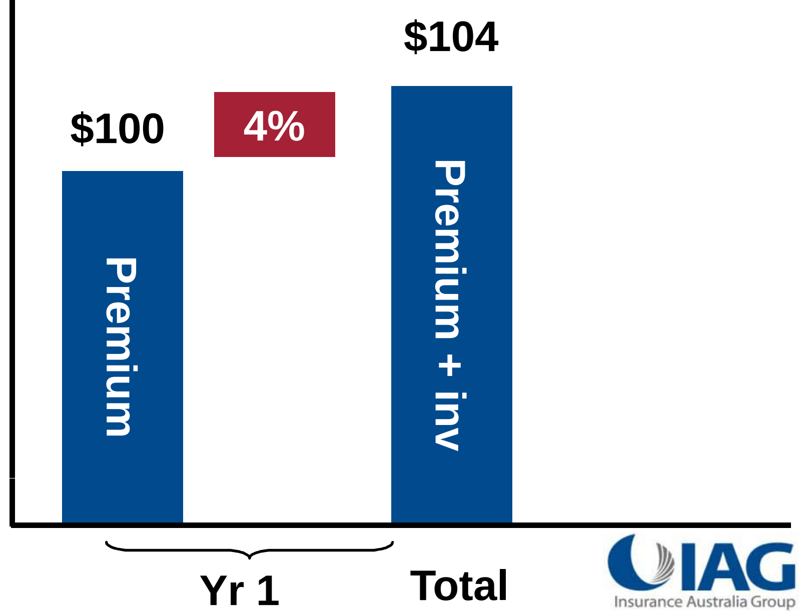
Long tail has more volatility, longer duration and higher capital

Long tail vs. **Short tail**

Long tail business has significantly longer claims payment cycle allowing investment returns to offset the higher loss ratio's:



Short tail business has average claims payment cycle of less than 12 months, so investment return has less of an impact on the insurance margin earned:



KEY DRIVERS IN AN INSURER’S FINANCIALS
WHAT DRIVES SHARE PRICE?

- **Quality & Stability of Earnings**
  - Underwriting
  - Claims management
  - Liability & risk management
  - Asset management
  - Balance sheet management
  - Stability of earnings

- **Competitive Returns on Invested Capital**

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PART 4
IAG'S BUSINESSES

IAG'S CORPORATE STRATEGY

A portfolio of high performing, customer-focused diverse operations providing general insurance in a manner that delivers superior experiences for our stakeholders and creates shareholder value

OUR TARGETS

- Top quartile TSR
- ROE > 1.5x WACC

OUR STRATEGY

- Deliver superior performance by actively managing our portfolio and driving operational performance and execution

OUR STRATEGIC PRIORITIES

- Improve our performance in Australia and New Zealand
- Pursue selective international growth options – Asia and other narrow specialist opportunities
- Driving operational performance and execution

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OUR BUSINESS MODEL AND BRANDS

AUSTRALIA

DIRECT INSURANCE

- NRMA Insurance
- NRMA Insurance
- SGIC
- SGIO
- RACV 1

INTERMEDIATED INSURANCE

- CGU
- swann insurance

ONLINE INSURANCE

- thebuzz 2 (shaping insurance. together)

NEW ZEALAND

DIRECT INSURANCE

- STATE

INTERMEDIATED INSURANCE

- NZI

ASIA

DIRECT INSURANCE

- AmAssurance 3
- Safety Insurance 4
- SBI General Insurance 5

INTERMEDIATED INSURANCE

- NZI

OTHER

- CAA 大陆汽车俱乐部

UNITED KINGDOM

INTERMEDIATED INSURANCE

- equity REDSTAR
- equity DIRECT BROKING
- BARNETT & BARNETT

ACTIVE PORTFOLIO MANAGEMENT & GOVERNANCE (CORPORATE OFFICE)

1. RACV is via a distribution relationship and underwriting joint venture with RACV Limited
2. RACV has a 30% interest in The Buzz
3. 49% ownership of AmG Insurance, which is part of AmAssurance
4. 98% voting rights in Safety Insurance, based in Thailand
5. 26% ownership of SBI General Insurance Company, a joint venture with the State Bank of India

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IAG'S HISTORY

1925	National Roads and Motorists' Association (NRMA) starts providing motor insurance to its members in NSW and the Australian Capital Territory.
1969	NRMA Insurance begins underwriting home insurance.
1994	NRMA Insurance expands interstate, launching in Victoria.
1995	NRMA Insurance launches in Queensland.
1997	NRMA Insurance acquires MLC Building Society.
1998	NRMA Insurance acquires an interest in Thailand's Safety Insurance. NRMA Insurance acquires SGIO (including SGIC).
1999	NRMA Insurance signs a joint venture agreement with RACV. NRMA Insurance acquires an interest in China's CAA.
2000	NRMA Insurance Group Limited lists on the ASX.

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IAG'S HISTORY

2001	**NRMA Insurance acquires State Insurance in NZ.** **NRMA Insurance acquires the in-force policies and renewal rights to the HIH Australian workers' compensation businesses.** **NRMA Insurance sells its Building Society.** **NRMA Insurance puts its inwards reinsurance portfolio into run off.**
2002	**NRMA Insurance changes its name to Insurance Australia Group (IAG).**
2003	**IAG acquires general insurance businesses in Australia and NZ of CGU and NZI from Aviva.** **IAG acquires Zurich Insurance's NSW workers' compensation business.** **IAG sells its health insurance underwriting and claims operation.** **IAG increases its interest in China's CAA to 100%.**
2004	**IAG sells its financial services business, ClearView.** **IAG's NZ business acquires a 50% interest in Mike Henry Travel Insurance.**
2005	**IAG's NZ business acquires specialist underwriters National Auto Club and Clipper Club Marine.** **IAG acquires Royal & SunAlliance's general insurance business in Thailand.** **IAG acquires a 30% interest in Malaysia's AmAssurance.**

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IAG'S HISTORY

2006 IAG increases its interest in Safety Insurance in Thailand to almost 100%.

IAG's NZ business acquires a 51% stake in mechanical warranty insurance company DriveRight.

IAG acquires a Lloyd's managing agency and specialist Asian syndicate, branded Alba Group.

IAG's NZ business increases its interest in Mike Henry Travel Insurance to 100%.

IAG acquires Hastings Insurance Services and Advantage Insurance in the UK.

2007 IAG acquires Equity Insurance Group in the UK.

2008 IAG's UK business acquires specialist insurance broker Barnett & Barnett.

IAG enters negotiations to form Indian general insurance joint venture with the State Bank of India.

Following a strategic review, IAG revises its corporate strategy. As a result IAG scales back its UK operations by divesting some of its UK mass market underwriting and distribution businesses.

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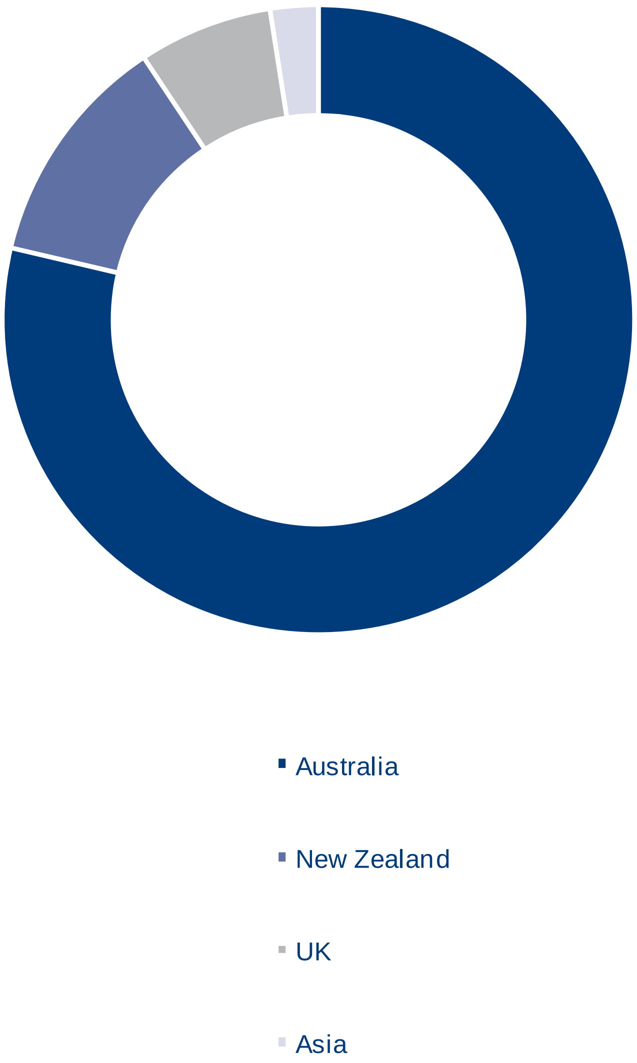
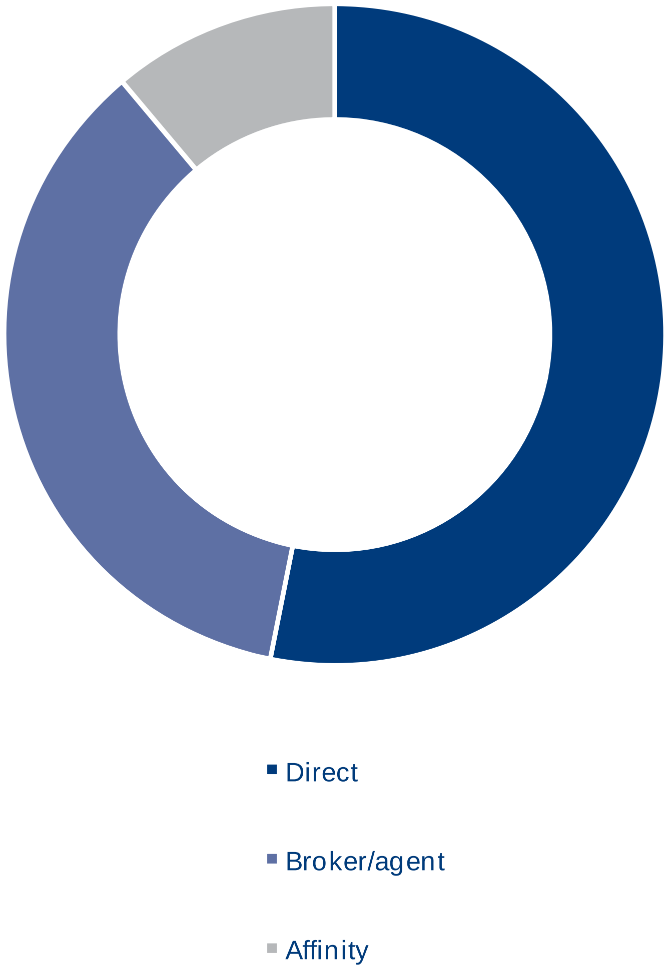
IAG'S GWP MIX: 1H11

GWP BY REGION



GWP BY CHANNEL



PART 5
CAPITAL MANAGEMENT AND PRICING

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INSURANCE BASICS

- **Outcomes of risks from individual policies are unknown when underwritten**
- **However, when many similar risks are underwritten, expected results of total portfolio become more predictable**
- **Claims processes are driven by:**
  - Frequency (or probability) of a claim event occurring; and
  - Severity (or size) of a claim if it occurs
- **Risks inherent in different classes of insurance vary:**
  - High frequency / low severity (eg motor and health) – outcomes easy to predict reliably
  - Low frequency / high severity (eg earthquake and hail) – outcomes hard to predict reliably

THE NEED FOR CAPITAL

Capital plays a central role in the provision of insurance:

- **Provides security to policyholders that claims will be paid**
- **Provides support in face of adverse unexpected outcomes from insurance activities, investment performance and operations**
- **Facilitates growth**
- **Can be defined as = Total Assets – Total Liabilities**

MINIMUM CAPITAL REQUIREMENTS

- **Capital available for regulatory purposes includes:**
  - Tier 1 (Share capital, retained earnings, eligible hybrid debt and excess technical provisions less intangible assets and goodwill) and
  - Tier 2 (Subordinated debt, non tier 1 eligible hybrid debt and other)

- **MCR is calculated as required by APRA as:**
  - Insurance risk charge, plus
  - Investment risk charge, plus
  - Maximum event retention

- **Capital strength is measured by:**
- **Capital multiple = capital available/ MCR**
- **Capital multiple must always > 1.0 to stay in business**

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IAG'S MINIMUM CAPTIAL REQUIREMENTS
A WORKING EXAMPLE

	1H10 A$m	2H10 A$m	1H11 A$m
Tier 1 capital			
Paid-up ordinary shares	5,353	5,353	5,353
Non-controlling interests	154	170	147
Treasury shares	(34)	(31)	(35)
Hybrid equity[1]	496	475	496
Reserves	(37)	(34)	(91)
Retained earnings	(362)	(775)	(692)
Excess technical provisions (net of tax)	482	522	454
Less: deductions[2]	(2,789)	(2,513)	(2,326)
Total Tier 1 capital	**3,263**	**3,167**	**3,306**
Tier 2 capital			
Hybrid equity in excess of Tier 1 limit[1]	404	425	404
Subordinated debt[3]	537	536	465
Other	4	12	9
Total Tier 2 capital	**945**	**973**	**878**
Capital base	**4,208**	**4,140**	**4,184**
Minimum Capital Requirement (MCR):			
Insurance risk	1,242	1,344	1,315
Investment risk	693	790	850
Catastrophe concentration risk	135	20	150
Total MCR	**2,070**	**2,154**	**2,315**
MCR multiple	**2.03**	**1.92**	**1.81**

[1] Hybrid equity includes Reset Exchangeable Securities and Reset Preference Shares. These securities are classified under APRA's prudential standards as "Innovative Tier 1" and are eligible to be included in Tier 1 capital up to a limit of 15% of net Tier 1 capital. The aggregate amount of these securities in excess of this limit is included in Tier 2 capital.

[2] Includes goodwill and intangibles, net deferred tax assets, capitalised software, deferred reinsurance expense and expected dividends.

[3] The amount of subordinated debt eligible to be included in Tier 2 capital excludes capitalised transaction costs and discount on issue, and for foreign currency denominated debt, the liability is translated at the current exchange rate excluding any related cross-currency swaps.

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THE ROLE OF PRICING

- **Meet expected claims**
- **Meet operational expenses**
- **Provide a return on capital**
- **Be competitive in market for risk**

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THE RIGHT WAY!

- **Analyse and understand the risk**
- **Premium comprised of**
  - Risk Premium
  - Claims administration expenses
  - Acquisition & maintenance expenses (incl. Commission)
  - Taxes, levies, duties
  - Reinsurance costs
  - Profit Margin
- **Risk Premium**
  - Expected No. of claims x Expected Average Claim Size
  - Inflated and discounted

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QUESTIONS