S1 2010 Earnings Call

Company Participants

- Frank O'Halloran, CEO
- Neil Drabsch, CFO

Other Participants

- Andrew Cannon, Analyst
- Daniel Toohey, Analyst
- James Coghill, Analyst
- John Heagerty, Analyst
- Kieren Chidgey, Analyst
- Nigel Pittaway, Managing Director, Insurance and Diversified Financials
- Richard Cole, Analyst
- Ross Curran, Analyst
- Siddharth Parameswaran, Analyst
- Unidentified Participant, Analyst

Presentation

Neil Drabsch {BIO 2093435 <GO>}

Good morning, ladies and gentlemen. I would like to welcome you to QBE's 2010 announcement of our annual results. The presentation this morning will be webcast and live. Just for those that are listening into the webcast there's one small technical problem, you won't be able to see Frank speaking but you'll hear his voice and you'll see the slides. Following the presentation and online we will have a full video recording of the session for those who wish to look. With that understanding that this is a live call and when questions will be asked at the end if you would kindly put up your hand and a microphone will be made available and also could I ask that mobiles be switched off. With that I'd like now to introduce our CEO, Mr Frank O'Halloran for the results presentation. Thank you.

Frank O'Halloran

Thank you, Neil and welcome to those present in the room and those on the webcast. First of all I'd like to introduce you to the QBE team here today. We have Vince McLenaghan, the CEO of Australia-Asia Pacific, Duncan Ramsay, Company Secretary and General Counsel, John Neal, the Chief Executive of our global underwriting operations, Jenni Smith in charge of Group HR, Blair Nicholls, Group actuarial, George Thwaites, Chief Risk Officer, Gary Brader, Chief Investment Officer and Belinda Hutchinson, our Chairman.

Today I don't think we'll be getting any surprises on the results because we've already announced them on 4 February but I think what the market does want is some clarity on the numbers and in particular our outlook. Not for growth because we've locked in a substantial amount of growth for 2011 in particular. The clarity really is around guidance or our target of 15% to 18% insurance profit. So in terms of an overview of the past 12 months strong underwriting profit with premium growth ahead of target.

All our divisions in great shape and at the back are the slides that are being presented to the market is a slide as an attachment which gives our underwriting results over a number of years from each of the divisions and I think you'll see the consistency in our performance. Lower investment yields affected the 2000 margin and I'll give a fair bit of detail on that. A strong balance sheet, with lots of flexibility for further growth. Acquisitions in 2010 and 2011 to date expected at over $3.4 billion in gross written premium for a full year.

We have new comprehensive global reinsurance program in place, substantially locked in for 2011 to 2013 at a lower cost and I'll provide some of the benefits and hopefully answer some of the questions that investors and analysts raise at the end. The dividend has been maintained. That was confirmed by the Board this morning at $0.66 per share franked at 10% and we have a positive outlook supported by our acquisitions expected to improve combined operating ratio and an increased yield on our cash and fixed interest securities. I won't go through the results in detail but a 21% growth in top line, 19% growth in our technical results in the underwriting profitability offset by lower investment yields and our lower average for the period we hold the premiums and more about that in a few moments.

In terms of our score card I won't go through that in detail but obviously we are ahead of target on the top line, behind target on the insurance profit and just better than target on our condition expense ratio, our capital adequacy including the underwriting of the 2010 dividend ahead of our 1.5 times; and excluding that underwriting dividend ahead of the 1.5 times. All divisions delivered a strong underwriting profit and return on allocated capital above our minimum 15% ROE and when I mention allocated capital we allocate capital to each of the divisions at the beginning of the year based on an A+ S&P rating.

Our underwriting profit, as I mentioned was up 19%. A combined operating ratio of less than 90% at 89.7%, it's the sixth consecutive year in a row that we've been below 90% and I don't think there's anyone else of our peers in the market place can actually claim that record and when I talk about the market place I'm talking the global market place. Gross written premium was up strongly and I think it's important when you look at our growth in gross written premium that we've grown on a compound growth rate at 14% per annum over the past five years and obviously we're looking at fairly strong growth in 2011.

So strong growth supported by strong underwriting results. Average premium rate increases up by 2.5% on renewed business. It's above the market average and a bit more about that later on. Our claims ratio was down slightly from where we were in 2009, with low attritional claims ratio offset by a higher than normal frequency of catastrophe claims not experienced since 1999 and of course it's continued into 2011. Insurance profit was up

6%. The insurance profit margin, 15%, was below our guidance primarily due to the fact that our yield on our policyholders' funds was down from 4.4% to 3.3% in the lower average period premiums are held which dropped from 1.5 years to 1.4 years and the two of them together adversely impacted the insurance margin by 1.9%.

There's a slight change in risk free rates which gave us a negative impact of .2%. The large risk and catastrophe claims during the year were 9.5% on unearned premium compared to 8.6% including 1.2% for GFC claims last year and we also experienced increased premium taxes in Australia and other parts of the world and additional Lloyd's levies from the 2009 year which increased the expense ratio by 0.5%. We had a low release which is very much in line with what we told the market, about 0.4% release from central estimates and obviously they've had a positive impact on the claims ratio. That compared to 0.7% the year before.

The risk margins in outstanding claims up at 89.8%. I think it's fair to say that they were bolstered by acquisitions. Excluding acquisitions the probability of accuracy would have been around close to 86% so you can see we got a good boost from the acquisitions we made during the year. In terms of some significant items that have impacted the net profit you will see the lower cash and fixed interest yields impacted profit by $325 million when compared with last year. We had realised and unrealized losses on our equity portfolio compared to; $48 million compared to $78 million gains and we had a few other items, not the least of which was the one off gains that we had in 2009 from the cessation of the capital hedging and the buying back of our debt securities.

In terms of the underlying business, the underwriting of our business, we are very, very pleased with where that is heading. You can see from the accident year central estimate claims ratio this is looking at pure accident year where we look at the claims that actually occurred in 2010 including incurred but not reported claims and see what's happening to our attritional and large claims and you will see there that our attritional claims ratio dropped slightly from 1.4% from 2009.

It's higher than it was at the half way mark but you need to take into account that we purchase NAU which came into the second half which is a claims ratio which is all attritional at close to 60% and that was the main driver of the increase between the first half and the second half. The large risk in catastrophe claims came through at 9.5%, as I mentioned earlier, compared with 7.4% or 8.6% if you include the GFC claims. It's important to note there that the aggregate protection we purchased three years ago did not include acquisitions. So the catastrophe claims on the acquisitions obviously were not covered by the Group aggregate cover which expired at the end of 2010.

Claim settlement costs are fairly consistent and the discount is up slightly on the previous year at 3.6% versus 3.1% and that's really due to the fact that the timing for settlement of our outstanding claims has increased from 2.8 times to 3.0 times, so you multiply .2 by 3% and you will see the difference arises from that. So in terms of our net central estimate of claims, as I said we're very happy and you'll see that there's been a slight reduction from 2008 to 2009 to 2010.

In terms of the accident year combined operating ratio you can also see that from 2008 when the accident year combined our central estimates combined operating ratio was 90.5%, it is now down to 88.4% which converted into a contribution to the insurance profit margin is 11.6%. In terms of the reconciliation to the financial results of our accident year results we had 11.6% contribution from the central estimate underwriting profit compared to 11.2%. We had savings at 0.4% compared with 0.7% of net earned premium. We had a release of discount from prior years and that movement in risk margins which adversely affected the profit by 1.7% compared to 1.5% in 2009 and 1.3% in 2008.

There's a lot of noise in those numbers in this attachment which we can walk those that want to go into the detail through at a later date but not necessarily today. The big noise in our results is obviously investment income and policyholders' funds which as I said dropped from 6.6% to 4.7%. In 2008 it was 8.2% and if you look at the movement from 2008 to 2010 that's 3.5% movement which is a large part of the drop in insurance profit between 2008 and 2010 in terms of margin from 19.7% to 15%.

Obviously the big question is where to from here? Just before I get into that looking at the weighted average discount rates for the year, and there were some reports coming out through the half year from analysts, what we've done here is clarified it. You will see the Australian dollar risk free rate rose slightly, the US dollar down quite substantially compared to the end of 2009. Sterling down quite substantially, the Euro up but of course the Euro impact really doesn't come into play because Secura acquisition was consolidated from 1 November.

In terms of the impact of the discount movement you've got an impact of minus $25 million on the profit and loss account and an impact of minus $42 million on our risk margins, both negative. In terms of our investment income it's probably better if I move to the next slide which is a comparison of the cash rates with actual yields and it's very important for all our investors in particular to look at the currency mix of our fixed interest investments and cash investments.

We are required to comply with various regulations around the world which requires to hold investments in the currency of our liabilities. We also have a policy of matching liability exposures in currencies with assets of the same currencies. So we must hold US dollars, we must hold Sterling and we must hold Euro to match those liabilities. In terms of what would happen if we invested everything in AAA cash we would have earned 1.5% in 2009 and 1.9% in 2010, the increase mainly driven by the rise in Australian interest rates.

In terms of actually what we achieved, we achieved 3.8% in 2009 and 2.5% in 2010 and basically the major difference was because the yields were not available, the cred expense blew out in April 2009 as we all know and we were not able to achieve or get the same sort of yields that we did in 2009. Our target for 2011 is based on our current portfolio which is a targeted yield of 3.3% to 3.5% and a large part of the increase is driven by the fact that close to 60% of our fixed interest portfolio is now in quality corporate paper, primarily financial.

So looking at the first half, second half split and the reason why we put this here is because there's been a great focus on our insurance profit margin and you will see there that the split shows that we earned 15.7% insurance profit margin in the first half and 14.4% in the second half with a fall of 1.3% all driven by the investment yield on net earned premium. The average premium held, as I mentioned earlier, dropped in the second half due to the acquisition of NAU country portfolio which has a very short term for holding the premium but it increased quite considerably as a result of the Secura acquisition and we're looking at with the Secura acquisition followed by the Balboa acquisition, assuming it is approved by the regulators, staying around 1.4 times net earned premium for 2011.

So rather than wait till the end we thought we'd take that 14.4% or the 15% for the full year and look at what it does in terms of a waterfall chart. First of all I should mention that our guidance for net earned premium is up from 22% to 25% and more about that later because it is slightly higher than what we mentioned in our announcement on 4 February. Our starting point for 2011 is 15%. That included 1% for FX gains. Based on the current yield; or the current fixed interest portfolio we believe the yield will increase by 1.1% excluding FX gains in 2011.

The impact of the Balboa acquisition is 0.3% and that's assuming an 18% insurance profit margin on the Balboa business and the reason why it's 0.3% is because the starting point is 15% and we're looking at the total impact on the Group's business not just the Balboa's business. The new global reinsurance program where we talked about saving $300 million in reinsurance costs will have approximately 0.5% impact on our COR. In additional to that the aggregate covers we purchased cap our large risk and catastrophe claims around 9% net earned premium. That obviously assumes we don't go through the top of those aggregate covers in 2011.

So you can see there that a guidance of 15% to 18%. We got some criticism about the 15% but we felt that it was important that we didn't start off with a base that was higher than 2010. So we started off on a base of 15%. There was no specific reason why we chose 15% other than that was the 2010 number. Remember in that guidance we've given you we've assumed the full utilization of the 9% catastrophe and large risks claims allowance. We have assumed no savings on commissions and expenses and we're obviously not doing a lot of work in terms of synergies. No FX gains in the numbers and no allowances to changes in risk free rates and no allowance for further rises in interest rates that may occur or may not occur this year.

So looking at each of the divisions, I won't go through them in detail. Americas underwriting profit up 19%. Combined operating ratio 89.7%, insurance profit margin dropped slightly, primarily due to the interest rates and the return on allocated capital at the beginning of the year was 17.7%. A very important part of this slide is that our average premium rate increases on renewal business was 1%. Market Scout, which is a publication in the US was showing minus 5%. So what we're really saying there is we've got an entirely different portfolio than what Market Scout covers and that's largely driven by the fact that we have a number of specialized businesses which probably are not included in that survey.

So be very, very careful when you read about what's happening to premium rates when you look at Market Scout. We have no objections to what they do because they do it very thoroughly. Our Latin American division, which is included in the Americas numbers, and you will note in the end report we actually separate Latin America out from the US. It grew by 59% to $559 million and you will see from the annual report we're talking about growing that to over $800 million mainly from acquisitions that we've made in 2010. So we have a fabulous business in Latin America. In terms of Europe combined operating ratio slightly down, growth up about 5% in Sterling and US dollars, insurance profit margin down slightly mainly on the back of interest rates again but a solid return on equity of 22.5% on the allocated capital that we give to our European operations.

The expense ratio has got a bit of a noise in there mainly relating to the costs of the transformational projects that we've got going on at the moment to consolidate all our systems and to improve our efficiency in our processes and we've bought the expenditure forward so that we can actually get the benefits sooner than we anticipated and the additional Lloyd's levies which was about GBP10 million that we had to absorb during the year. In terms of our Australian operations a fantastic result from Vince and the team. Growth of 15% in Australian dollars driven mainly on the back of the Elders acquisition. Premium rate increases and new distribution channels.

Again I point out that be careful about what you read in terms of market information on premium rates. The JP Morgan, Deloittes survey said minus 1% on commercial loans. We actually achieved 4.9% on commercial loans, rate increases that is. So be careful about what you read and how you apply it to different companies. In terms of the insurance profit margin down to 17%, primarily driven by the fact that there's no FX gains included in the investment yield for 2010. Return on equity on allocated capital 19.3%, a very solid result.

In terms of Asia Pacific a growth of 9%, 86.7% combined ratio which is from the 15 countries that we operate in Asia Pacific. A tremendous result. Insurance profit margin up 18.3% and return on allocated capital of 25.2%. In terms of Equator Re, which is our captive and remember that the captive actually provides reinsurance protections between the Group's tolerance for risk and the divisions' tolerance for risk, and that's what it does and the results deteriorated on the combined operating ratio from 88.2% to 90.1% and that's largely driven by the number of catastrophes and claims they had during the year and insurance profit margins fell by 17.4% to 14%. Now Equator is obviously a very, very important part of managing the Group's aggregate exposures to catastrophes, the maximum event retention and the relationship between the divisions and the Group when it comes to, as I said, tolerance of risk.

In terms of capital adequacy you will see there that we show 1.6 times including underwriting of a dividend or 1.51 times excluding the underwriting of dividends. We have $2.2 billion of excess capital or in fact $2.7 billion including the underwriting of the final dividend. In terms of our balance sheet solid growth in shareholders' funds during the year, improvement in the probability of adequacy of our outstanding claims to 89.8% and our depth of equity remaining low at 31.5% with plenty of room to move when the market is right for tier two debt securities.

Our global reinsurance program which we announced on 4 February is unique to the world. It enabled us to not only reduce the maximum event retention to around 4% including the recent acquisition of Balboa, that's compared to 4.3% last year, the actual catastrophe covers and the per risk covers, covers multiple products, it's a single layer. So effectively what we purchased is two layers for the cats for example, $1.3 billion in excess of $200 million which is our retention, the $200 million and basically what it means that we've got $2.6 billion of protection and any time a loss goes above $200 million we claim against those covers until it reaches $2.6 billion.

Now obviously we never want that to happen, otherwise we're going to have some pretty unhappy reinsurers but it's a single layer so there's not layering which means that if you utilize one layer you have to reinstate your covers. We don't have to reinstate our covers, the costs are all pre-paid upfront. The risk and the catastrophe cover are actually supported by aggregate covers. In the event of accumulation of individual risk losses above $400 million we actually get to claim; we've got a cover of $200 million. In the event of individual risk losses accumulating up to $300 million and catastrophes adding to that that go above $800 million we've actually got a cover in place to claim another $170 million from an accumulation of large individual risk and catastrophe claims.

The acquisitions at Balboa are not included, the acquisition of Ren Re US was included and further acquisitions cannot be included unless they are under $250 million in premium. The pricing has actually all been locked in and the pricing will only move based on what happens to what they call growth net premium income which is actually net written premium in our terminology. What the covers have done is they have reduced the overall expenditure because we do not have to buy a lot of proportional reinsurance. We've been able to reduce our overall costs by about $300 million and the expected benefits of about 0.5% on the combined operating ratio but because of the aggregate covers it also reduces the large individual risk and catastrophe claims to around 9% of net earned premium.

I'm happy to go through a lot more detail with you. They are very comprehensive covers but remember that we've already pre-paid our costs and we've also locked in our pricing for 2012 and 2013 for over 80% of our covers. I think I should say at this point in time and maybe I should mention in respect to this slide, is an update of the market on the storms. Now cyclone Yasi, there's a lot of noise, it could be regarded as two losses by the market particularly as most of the reinsurers and most of the brokers are saying the storm that hit Victoria was the second loss. We've counted it here as one loss. The US winter storms that you saw at about $10 million, Queensland storms about $100 million and we've put the maximum net loss from the Christchurch earthquake, although it's very early days, at $175 million.

So as at today's date, the end of February, we utilized $385 million. On the right hand side you will see that 9% of net earned premium included in our COR is $1.3 billion and we have aggregate cat and risk covers of $350 billion. So we've actually got an allowance of $1.65 billion including our reinsurance protections for large risks and catastrophe claims in 2011. I think the important point is that there's been a lot of noise in terms of talking about what all this means. All I can say to you there isn't a reinsurer out there who is not burning and not thinking through what its strategy is going to be for Australia and New Zealand. So be prepared for pretty tough terms and conditions and pricing and higher deductibles coming through from reinsurers and some of them may not even want to reinsure businesses in Australia or New Zealand.

The good thing from QBE's point of view is we have locked in our covers for the next three years and as I said our pricing. Obviously a lot more is going to be said about this as time goes forward but the reinsurance market has taken a hammering from Australia and New Zealand in the past 12, 18 months and probably two years now, two and a half years. In terms of our acquisition strategy we made over 48 acquisitions between 2005-10 and two this year. The growth in top line has been 90% of which just over 90% has come from acquisitions. It is probably more than that now but at the same point in time we've been able to grow our underwriting profit by 90%.

So we're actually squeezing the same level of underwriting profit out of the business out of the acquisitions that we did out of our business that we had in 2005. Our insurance profit has grown by 73%. Obviously a difference between the 90% and the 73% are the lower interest yields that are currently prevailing. We still have a number of acquisitions that we are considering. Obviously more about that at another day. In terms of the acquisitions I won't go through in detail there but you can see we've listed the acquisitions that we've made in 2010, the largest one obviously being the NAU Country, the US multi-peril crop insurer and more recently the Balboa transaction and then followed by the Renaissance Re US.

What we've done now in the US is we've actually built our business so that 75% of our Americas business is now specialist business and 25% is subject to the same sort of business that Market Scout refers to. So it's been a deliberate strategy of QBE's, to get into the specialized segments where there's fewer players. We've got quite substantial market shares, particularly in lenders-placed insurance and crop insurance now and the specialty program business. So we're very pleased where we're placed in our US business and we're very pleased with the results that are coming out of those operations.

In terms of the Balboa distribution agreement and portfolio transfer I won't go through too much in detail. The important point is that the acquisition of Balboa does contribute $200 million to our maximum event retention but including that there's still 4%. So you can actually see what we really did with the global reinsurance program, the unique program that we purchased, in terms of driving down the MER and of course, as I said, the Balboa transaction basically doubles the number that we had after we purchased that contract. We do mention there the estimated annualized insurance profit margin of 18% to 20% but that is after an accelerated amortization of the $700 million consideration and after an allowance for catastrophes that may or may not occur.

In terms of the outlook we've slightly upgraded our gross earned premium growth and net earned premium growth and we call it gross earned premium here because what will actually happen with the Balboa transaction is because there's a portfolio transfer $900 million of that portfolio transfer will be counted as gross written premium in 2010 but it won't affect the net earned premium. So it's a quirk of the accounting standards. So we're focusing on gross earned premium, 19% to 22% growth. Net earned premium we've pushed that up slightly to 22% to 25% and that's following a detailed review with Steven

Burns and Vince, Mike Goodwin and John Rumpler last week in terms of where our numbers are after the December and January renewals.

Our reinsurance expense ratio around 12% and obviously if we do have some catastrophes, not on the worldwide programs but in terms of our reinsurance sitting at 1036 and the ones that are not covered by the worldwide program. That reinsurance expense ratio is subject to reinstatement premiums. A combined commission expense ratio of 31%. Now, that's up from where we are at the moment, and that's driven by the Balboa transaction, particularly the amortization of the upfront $700 million payment consideration.

Insurance profit margin of 15% (sic; see press release) to 18%. I hope that everyone found that (inaudible) chart helpful in terms of describing how we got to that range. Tax rate, around 23% and a gross investment yield, which is based on our current portfolio. It doesn't include any allowance for FX gains of 3.3% to 3.5%.

In terms of what does this all mean, and I know there's a fairly substantial range in terms of our insurance profit, but the reality is we're saying our minimum growth and net end premium is going to be 22%. It could be as high as 25%. Obviously, if you take an insurance profit margin of 15%; that's what we achieved last year; and we grow by 22%, our insurance profit, in dollar terms, will grow by 22%.

Of course, if we've got 25% growth and a 15% insurance profit margin, we actually grow our insurance profit by 25%. If you go to the middle of the range or, say, around 17%, we get very, very significant growth in our insurance profit. At 17% and 22% growth in net end premium, our insurance profit will grow from $1.7 billion to $2.35 billion, which is very, very significant indeed.

Please remember that we haven't made any allowance for potential rises in interest rates that may occur or may not occur this year or next year in the US and UK and Europe. In terms of our performance, it's interesting; having a look at the combined operating ratios of many of our competitors around the world, and you can see from there that the market is getting close to 100 in many places or over 100; the key for us is to continue to look at all our key profit drivers, look for acquisitions, look for ways and means to make the key (inaudible) and combined operating ratio less than 90% because, obviously, as you are all aware, it's a key driver of our share price and our insurance profit margin.

So in summary, we're expecting around 2% increase in overall average premium rates on renewed business, and that excludes our specialized business. We haven't included crop or lenders' mortgage or LMI in those numbers. We've got some synergies coming through from expense and claims initiatives, particularly in 2012/13 where we're saying, in Europe, that we're looking at a 2% reduction in the claims and expense ratios from efficiencies in 2012 and in Americas, we're saying 3% in 2015.

I've talked about the forecast investment yield. We do have increased exposure. I think, Neil, it's grown from about 35% to 57% in terms of quality corporate paper, and that will improve our yield. We will maintain our focus on a successful strategy of growing by acquisition. We are always looking for acquisitions so the EPS accretive in year one. We have not reduced our minimum requirement from all our products and all our divisions at a 15% return on the capital we allocate them.

The new reinsurance protections came at the right time, and took about five or six months to negotiate, but we did get them off the ground. We do have substantial allowances remaining, even after the first two months for large reaching catastrophe claims this year. Our insurance profit, even at the current level of 15% will grow by 22% to 25% next year. When you add all this up, all the work we did last year, in terms of acquisitions and new initiatives that were announced, over the next three years, we're expecting those acquisitions and initiatives to add $600 million to our net profit after tax.

That's it from me, so I'm more than happy to answer questions so thank you.

Questions And Answers

Q - Andrew Cannon {BIO 16402861 <GO>}

Hi Frank, Andrew Cannon of Merrill's. The attritional loss ratio in the second half of the year lifted around 2 points on the first half of the year. It was a little surprising in the context of the acquisitions which came through the NAU acquisition, in particular. I thought that would go down. Can we talk about the trends, please?

A - Frank O'Halloran

Yes. The NAU acquisition gives us a 60% claims ratio. Now, that's counted all as attrition so that impacted, I think, about 5.7 or 5.8. The rest is a little bit of noise between the first half and the second half. If you look back at 2009, first half and second half, you've got the same scenario, Andrew. We're very, very happy with 50% now that; the recent acquisition of Balboa will, obviously, drive down the attritional claims ratio. I think in these numbers, you'll see that we're actually targeting a 49% attritional claims ratio in 2011. It's a bit of a noise from the acquisitions, moving the numbers around.

Q - Andrew Cannon {BIO 16402861 <GO>}

Sorry, is there some seasonality in that as well because, again, the first half seemed (inaudible) last period as well.

A - Frank O'Halloran

Not in the attritional claims ratio for Balboa but, obviously, the catastrophe exposure comes in from 1 June to the end of November. In terms of seasonality on attrition, I doubt it on the Balboa. Basically, what actually happens in these; and we do the same in Sterling; what actually happens is we actually conservatively reserve for claims in the first half with some allowance for catastrophes in the second half.

There may be a bit of noise in that but if there are, we'll actually split Balboa's numbers up, when we come to the half year, between attrition and large risk in claims cap allowance.

Q - Siddharth Parameswaran {BIO 15037291 <GO>}

Hi Frank, Siddharth Parameswaran from JP Morgan. A couple of questions if I can. Firstly, just on the probability of adequacy which arose over the half. I was actually expecting that probability of adequacy to rise because of interest rates rising. You mentioned that there was a benefit from the acquisitions as well. Could you just comment on how much that actually added?

A - Frank O'Halloran

Yes. If we didn't have the acquisitions in 2010, our probability of adequacy would have been just on 86% so that explains the acquisitions. The reason why it's fallen compared to December 2009 from 88.1%, if you look at the chart on interest rates, you'll see that Australia is up slightly, the US is down quite substantially on a year on year basis and so it Sterling down quite substantially so that's where the impact.

One of the great things about QBE is we can go out and make these acquisitions, and we usually find balance sheets that help us from time to time.

Q - Unidentified Participant

Was the impact all in the second half?

A - Frank O'Halloran

In terms of the acquisitions?

Q - Siddharth Parameswaran {BIO 15037291 <GO>}

Absolutely, yes.

A - Frank O'Halloran

Mainly driven by the secure acquisition.

Q - Siddharth Parameswaran {BIO 15037291 <GO>}

Right, okay. Just a second question just on --

A - Frank O'Halloran

I should say, Siddharth, when we buy, say, a company in Europe, the secure (inaudible) was undiscounted claims reserve. With the Euro going from 1.8% at the beginning, a risk free rate at the date of acquisition to 2.5% of the Euro, it was quite a nice little handy boost.

Q - Siddharth Parameswaran {BIO 15037291 <GO>}

Fair enough. Just a second question just on Cyclone Yasi. If it was two events, what would the difference be?

A - Frank O'Halloran

It wouldn't change our numbers --

Q - Siddharth Parameswaran {BIO 15037291 <GO>}

Wouldn't change?

A - Frank O'Halloran

-- because our catastrophe covers attach at $200 million so it wouldn't change the numbers.

Q - Siddharth Parameswaran {BIO 15037291 <GO>}

Okay. Thanks.

Q - Nigel Pittaway {BIO 3406058 <GO>}

Hi, Frank, Neil. It's Nigel Pittaway from Citi. A couple of questions if I could. First of all, just on the European margin, it's come down from 18.1% in the first half, I think, to 11.3% in the second half, so quite a big fall there. Can you give us a little bit more color as to why that occurred?

A - Frank O'Halloran

My guess is that it's all entirely due to the foreign exchange gains in the first half. Neil?

A - Neil Drabsch {BIO 2093435 <GO>}

That's part of the test.

A - Frank O'Halloran

The combined operating ratio is slightly down on the first half, I think. I haven't actually got the detail with me. I can look at the first half, yes, Nigel.

Q - Nigel Pittaway {BIO 3406058 <GO>}

Okay.

A - Frank O'Halloran

It would all be entirely due to (inaudible). The actual underwriting profitability during the first half and the second half is fairly consistent. In actually fact, as an attachment here, at a group level, you'll see that our claims ratio, our commission and expense ratio for the last three half years, each of those ratios have been within 0.1% of each other over a three half year period which is, probably, showing the consistency of our numbers.

A - Neil Drabsch {BIO 2093435 <GO>}

Also, Nigel, you might just look at, I think, the expense ratio would have moved in that half year. There's a bit of a timing difference when we look at some of the commissions that we earned on our 386 but that comes in and that was adjusted in the second half.

Q - Nigel Pittaway {BIO 3406058 <GO>}

Alright. The second question is on fixed interest securities, short term money and cash within shareholders' funds. The number there, I think was around about 50 the first half. It's round about 100 the second half so a huge increase. I know you've had an increased allocation there. Any comments as to why that leapt so much?

A - Frank O'Halloran

I think, Neil, you're closer to the allocation than I am, but the allocation has been done on the same basis from 2009 to 2010. Neil, do you want to add to --

A - Neil Drabsch {BIO 2093435 <GO>}

Well you've certainly got a higher level of insurance funds in the second half with the acquisitions, and that's the majority of it. The foreign exchange, as you said, was mainly skewed at the first half and the second half. I'm happy to go through it with you later on, Nigel. Nothing stands out at the moment.

Q - Nigel Pittaway {BIO 3406058 <GO>}

Alright, and then just on slide 13, the movement in discount rates, I mean, if you do compare those with movement in bond yields, they seem to be relatively modest. I mean, is there anything to which they're not just capturing movement in risk free rates, that there is actually a lessening of allowance there that would have allowed you to have discount rates above risk free rates, or is there anything peculiar in there?

A - Neil Drabsch {BIO 2093435 <GO>}

I'll probably just talk to that, if you don't mind, Frank. Remember, these are not the bond yields you're looking at.

Q - Nigel Pittaway {BIO 3406058 <GO>}

No. I know.

A - Neil Drabsch {BIO 2093435 <GO>}

These are weighted; basically, on a six month weighting where you work out our liability, and then match it with the bond rates as they go through and then it weights itself back so it's an accumulation. For example, if in year 6, you've got 10% of your portfolio then earning; sorry, go out to year 10, you've got the portfolio earning, say, an extra 0.6% over, that will multiply by five years. You might add that extra amount to the total. Overall, what you're seeing here is an aggregation of rates so just be careful you don't look and try and find a bond rate that matches it. It's all relevant to the portfolio.

Q - Nigel Pittaway {BIO 3406058 <GO>}

Thank you.

Q - James Coghill {BIO 14006200 <GO>}

It's James Coghill, UBS. Frank, just a question on the year and your premium assumptions there for '11. One number that looked quite aggressive -- $7.5 billion so if I just estimate roughly what the acquisitions are adding there and I appreciate you can't comment on this but it's around $2 billion uplift from acquisitions, so that's implying organic growth in the order of around 5% for the US and (inaudible) refers to programs that are going to be cancelled and that seemed a bit high.

I wonder if you could just comment on some of the underlying assumptions in the US -- what areas you think might grow and where we're likely to see shrinkage?

A - Frank O'Halloran

Yes. In the Annual Report, there's a breakdown of the $7.5 billion. The $7.5 billion is made up of $1.3 billion from crop, $1.5 billion from program business, $2.1 billion from financial institution business, $1.3 billion from regional and major brokers -- that's our winter portfolio, $800 million from Latin America and reinsurance $500 million. I thought you were going to ask the question the other way because if you added all the numbers up and the acquisitions, you actually come up with a figure higher than $7.5 billion but we've allowed for about $300 million in business to be tossed out that's not meeting our profit criteria.

Q - James Coghill {BIO 14006200 <GO>}

The one number that's quite tricky to get one's mind around is Balboa. How much premium comes through at that line for Balboa? Are you factoring in a proportion of the $1.5 billion?

A - Frank O'Halloran

We're factoring $1.35 billion and the rest of it is Sterling. Remember there's about $700 million of Sterling business that's coming through.

Q - James Coghill {BIO 14006200 <GO>}

Can you just comment on the tax rates? (inaudible) has been below 24% for a couple of years and you've got that rising to 23% in your guidance.

A - Frank O'Halloran

Yes. If you do the numbers I'm talking about, you have to understand where profits may end up. When we add the new businesses throughout the year, the actual number runs between 23% and 25% based on our guidance, so I think that's pretty solid numbers over the years. What we're really doing here, if you add up all the various rates, you've got the US running at 35%.

In the States, we also; for accounting purposes; have to include the tax on the underwriting agencies, and they attract an additional 6% State tax, so the US rate actually pushes quite high. US, Sterling at 28%, Australia at 30%, the equated business, there's still a tax attributed to Australia. The combination of all of those; just doing the sums; runs between 23% and 25%. Comfortable with 23%. I think that's probably about the right rate for your model.

Q - James Coghill {BIO 14006200 <GO>}

Just finally, Frank, could you comment briefly on what regulatory approvals you do require for Balboa? Just a little bit more color on that, please.

A - Frank O'Halloran

Obviously, the main one is California because that's where Bank of America are located. I think, George, there's also Pennsylvania which is our main regulator so California and Pennsylvania. APRA? We've already had long discussions with APRA about the transaction and the capital adequacy and the impact on the Group. Obviously, we wouldn't have proceeded if APRA didn't give us an okay to do so.

Q - John Heagerty {BIO 7044314 <GO>}

Thanks. John Heagerty from Credit Suisse. Just one question if I could. Just on the GWP growth, you're talking about in terms of acquisitions for the rest of the year. You're saying that will be funded by retained profit. Just out of expectations, how much capital will be required behind that on the development of GWP, all within GWP, thanks?

A - Frank O'Halloran

In the Annual Report, I think we might have mentioned it here. Our forecast, without any acquisitions for our capital adequacy, is 1.65 times by year end. Each 0.1% is equivalent to $430 million or $440 million, so if we say there $0.5 billion of capital, that's equivalent to $1 billion worth of potential growth of we wanted to maintain our capital adequacy just above 1.51 or just about 1.5.

What we're saying is if we spend some of that difference between the 1.5 and the 1.65 on acquisitions, we could fund that sort of growth.

Q - John Heagerty {BIO 7044314 <GO>}

Thanks, and in terms of underwriting other DRP for it to fund future acquisitions, would you do that if required?

A - Frank O'Halloran

I think that's something I would need to discuss with my Board after looking at each of the transactions, but obviously we have gone out to underwrite the final dividend primarily on the back of the acquisitions, but also on the need to have some money in the bank in case something else comes along in the next month or so.

Q - John Heagerty {BIO 7044314 <GO>}

Thanks.

Q - Unidentified Participant

Japan Bank for International Corporation. Just a couple of questions on your Asia Pacific business. In regards to your acquisition with PMI in mind, what are the strategies that you're looking at right now, in Hong Kong in particular, because I know that there's been a report that you'll be going into the mortgage business?

A - Frank O'Halloran

Yes. When we acquired QBE LMI or the PMI's business in Australia, we also purchased the business in Asia, in Hong Kong. They did offer the business in Europe but we declined for reasons that; understand the LMI business in the UK and Europe you know you wouldn't touch but Hong Kong was an extremely good business. Lenders Mortgage Insurance has worked extremely well for PMI, that's pre-us, and obviously worked well for the Hong Kong Mortgage Insurance Corporation.

We have a license in Hong Kong and we are increasing our writings of LMI business in that market.

Q - Unidentified Participant

Would you leverage that into, say, the China market?

A - Frank O'Halloran

I doubt it but we're obviously look at opportunities to grow our business in various parts of the world. We're looking at places like Singapore and other for that market. We really need to be satisfied that the Lenders Mortgage Insurance is not too dissimilar to what it is in Hong Kong and Australia before we went into those markets.

Q - Unidentified Participant

I guess my last question is, what is the outlook in India then?

A - Frank O'Halloran

Tough. I think it's fair enough to say that QBE -- and I hope you don't mind me mentioning some numbers. QBE has had an operation there, a joint venture. We have written $1.6 million worth of business in, what, about 9 or 12 months since starting. It's just so hard to find business so that you can get the right price and the right terms. We're taking it slowly.

It's going to be much tougher than we first thought but, at the end of the day, we're in the business of making money on the bottom line, not in the business of telling our shareholders, look, we've grown by 50% to 100%. Isn't that fantastic? It's tough in India at the moment.

Q - Daniel Toohey {BIO 16751863 <GO>}

Hi, it's Daniel Toohey from CLSA. Just a question on the PoA leverage to interest rate movements in the risk free range. You make the comment a 1% increase will improve the

PoA by around 5%. Going back 12 months, it was closer to around 3% so I'm just wondering what --

A - Frank O'Halloran

That 5% assumes that it all goes to PoA but if you look at our book of business, just 1% will improve the PoA by about 3%. I think that's right, isn't it? Yep.

Q - Daniel Toohey {BIO 16751863 <GO>}

Okay. Alright, thanks.

A - Neil Drabsch {BIO 2093435 <GO>}

It's about 60/40.

A - Frank O'Halloran

60/40, yes. I think you might have picked up a little mistake.

Q - Ross Curran {BIO 15090587 <GO>}

It's Ross Curran here from Com Bank. I'm just wondering if you could give us your thoughts on reserve releases -- the potential for it going forward?

A - Frank O'Halloran

I'll get shot by Blair Nicholls for saying this, but we believe that the 0.4% or 0.3%, anything less than 0.5% is a realistic number to use going forward. I think you might say, well, if you're doing all this actuarial work, why does it occur? Well we look at hundreds and hundreds of portfolios that accumulate into one portfolio when we present to the market.

Just by definition, if you're reserving adequately, you should be slightly in front at the end of the day.

Operator

Your next question comes from the line of Kieren Chidgey from Deutsche Bank. Please ask your question.

Q - Kieren Chidgey {BIO 7268946 <GO>}

Hi there. Just a couple of questions. Firstly on the reinsurance costs which increased from about 13.7% of premiums to 15.4%. How significant were the reinstatement premiums incurred over the course of the year due to the high large claims in cap experience?

A - Neil Drabsch {BIO 2093435 <GO>}

Kieren, it's Neil. 0.4% was the figure for the increase. Most of the increase came out of NAU Country, the crop insurer which, because we deal with the US Government as the primary carrier, that was 1.1%. Just that alone was one of the major pushes. You'll see that NAU; just be careful of what; we'll have to have a look at that as we go through to you because that can be a variable in years when you've got a higher claims frequency because of the way we work with the US ultimate carrier.

Q - Kieren Chidgey {BIO 7268946 <GO>}

Okay. And in relation to your ITR margin guidance, I'm just a little bit unclear on what you're including in terms of large claim and cat (inaudible). You're showing on that waterfall[ph] build up slide, a 9% inclusion but then on slide 25 of your presentation, you're talking about a large claim in cat allowance of $1.6 billion which is, presumably, a higher percentage of NEP. Can you just clarify how we should be thinking about that?

A - Frank O'Halloran

If you go to slide 25, the 9% of net earned premium is our net claims and that totals $1.3 billion. What we're saying is if we had $1.65 billion of claims. Then we'd recover $350 million from our aggregate individual risk and catastrophe covers. Now, that's assuming that all the covers are triggered. In terms of the impact on the P&L, it's 9%.

Q - Kieren Chidgey {BIO 7268946 <GO>}

Thank you. It's just the difference between the gross and the net?

A - Frank O'Halloran

Yes, correct.

Q - Kieren Chidgey {BIO 7268946 <GO>}

Yes, just the last question. Just on your outlook for the APRA capital changes, obviously they're still in the process of being changed, but can you talk about where your most recent discussions were, specifically around the agency intangibles and the asset liability and mismatch position?

A - Frank O'Halloran

Yes. I think we're still in discussions with APRA. I think the best thing to say is when we complete those discussions with APRA, we'll let the market know but we're still talking about it. APRA is well aware that we do have a significant investment in agencies that's earning us a very healthy profit. At this point in time, there's no allowance for any of that investment in the allowable capital. I'm not saying there is going to be but we are in discussions with APRA on that subject.

Q - Kieren Chidgey {BIO 7268946 <GO>}

Thank you.

Q - Unidentified Participant

Brett (inaudible) from BBY. Frank, a question on the acquisitions. The outstanding claims show acquisitions added, $1.4 billion to outstanding claims.

A - Frank O'Halloran

Reinsurance recovery is $190 million at the top of that, yes.

Q - Unidentified Participant

Then the margins are $384 million so the relationship between the net addition to acquisitions of 1.4 and the margins of almost $400 million is quite a high number. Were they the numbers that the companies themselves have or have you had a look at their reserves and changed the allocation between what's a central estimate and what's a margin?

A - Frank O'Halloran

No. Look, well we're dealing with the Europeans. They don't have anything such as a central estimate but if you look at those numbers, there's 14, 12, there's $190 million of reinsurance recoveries. We say in the note, there's 11 $61 million of central estimates. To take the difference, there's about $260 million which means embedded into the secure acquisitions were embedded risk margins on an undiscounted basis by about $120 million or $130 million. The actually company had embedded risk margins in its undiscounted reserves.

Then we have the discounting on the claims which also adds to the margins. Be very careful about it because the numbers we've got in the accounts, on a standalone basis for Secura are about 85% probability of adequacy. Of course, then you get your diversification benefits when you consolidate it all through to the Group. Do you follow what I was going through then? The consolidated balance sheet you've got there includes some embedded risk margins for undiscounted claims reserves, and then on top of that, at Group level, we actually have the discounting of the claims.

A - Neil Drabsch {BIO 2093435 <GO>}

So when we assess fair value, our benchmark is 85% to 95% so it's got to have at least 85% probability. That's what you're saying. We have time for two more questions. We're happy to take them from the floor or online.

Operator

Your next question comes from the line of Richard Cole of Royal Bank of Scotland. Please ask your question.

Q - Richard Cole {BIO 1552158 <GO>}

Good day, guys. Just any commentary around the trajectory of dividend going forward or targeted payout ratios at all that you might have?

A - Frank O'Halloran

Yes. I think it's fair enough to say that's a Board decision. We're looking at maintaining at least our 2010 dividend in 2011. Obviously, if we were able to achieve an insurance profit closer to the 18%, we'd review that significantly. I think if you look at the numbers, by maintaining the dividend at last year's level and growth in insurance profit at the low end of the range, it gives a payout ratio of about 71%. As I said, it's a matter for the Board but the current outlook suggests that it will be at least the same as the 2010 dividend.

Q - Richard Cole {BIO 1552158 <GO>}

Thanks.

A - Neil Drabsch {BIO 2093435 <GO>}

Right, Frank. I think, at this stage, we might have to call a close and that'll be the end of the webcast. To all those who made the time to come in this morning, thank you very much and, as usual, post the event, we're very happy to take any calls or meet anybody to answer any further questions. Thanks again.

A - Frank O'Halloran

Thank you, everybody.