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Calliden Group CEO - December Quarter Update

FIRST Interview with CEO Nick Kirk

Topics of discussion

- *Update on Implementation of the MGA Model*
- *Overview of Profit drivers in the second half of FY12*
- *Update on capital adequacy and FY12 earnings*
- *Outlook for FY13*

Update on Implementation of MGA Model

FIRST Interview

Following the announcement at the half year of the farm portfolio being moved to the Managing General Agency Model, Calliden has since reported that it will cease acting as underwriter for the joint venture strata underwriting agency, QUS. Both arrangements come into effect as of January 1, 2013. *Was the QUS move the final step in the execution of the MGA business model or is there more to come?*

CEO Nick Kirk

Our target was to be 50% agency and 50% insurer for 2013 and with the movement of the strata portfolio we have achieved that. This change also means that we can look forward to our 50% share of growing profits from QUS as an agent and a continued increase in the value of that business.

We are committed to growing the agency side of the business and will continue to be on the look-out for new agency opportunities rather than simply transferring existing products. Calliden's new model provides insurers with the opportunity to quite simply plug into our capabilities and access new markets to them in a risk managed way. We would also like to widen our panel of capital providers over time.

FIRST Interview

The arrangement with GLA covering the Business Pack has been in place now since May 2012. *Has the business performed to expectations over that time, and what changes have happened within Calliden to accommodate the new business model?*

CEO Nick Kirk

Transitioning business from one model to another always has the potential for surprises but that has not been the case so far.

The underwriting review we completed prior to implementing our new pricing model in November has given us a good base for future growth. The initial indications of how the new pricing model is working are encouraging, which gives us confidence we can grow this book in 2013.

In common with most agency businesses we are adding an admin fee to each policy that we provide and the IT changes needed to implement this for Business and Farm Packs have now been completed. From the 1st January our revenue will benefit from the collection of admin fees which will be an important part of our revenue in the agency business in 2013 and beyond.

We have also changed our internal structure to reflect our two businesses, Calliden Insurance Limited (CIL) and what we will be calling Calliden Agency Services (CAS). From now on CAS will be operating as an agent backed by Great Lakes for the business and farm packs, Lloyds for the Mansions business, SiCorp (the NSW government) for NSW home warranty and Calliden Insurance Limited for the home, motor, non NSW warranty and IUA business. The insurer CIL will then only deal with underwriting agencies including CAS and a range of specialist underwriting agents including our JV agency Arena. We are working on the planning for the legal structure to reflect the internal structure and aim to have that in place in 2013.

In the meantime Mike Hooton has been appointed as the Executive responsible for CAS and Stephen Fay as the Executive responsible for CIL. They have both developed plans and have targets reflecting the separate but complementary objectives of both businesses.

Overview of Profit Drivers in the Second Half of 2012

FIRST Interview

We are now in the final quarter of 2012 which is one of two 'high risk' quarters in terms of weather events. To date there have been no catastrophe events but last year Calliden's bottom line was also negatively affected by year-end financial adjustments in relation to the valuation of its insurance liabilities (the LAT) and also the fall in interest rates. *How would you characterize the second half in relation to these financial adjustments and are there any other factors in 2012 that you would view as particularly unique to Calliden's year of transition?*

CEO Nick Kirk

Last year's catastrophe losses had an impact on our regulatory capital, reducing the multiple below the level we set ourselves as our minimum. We addressed this in a couple of ways. Firstly we injected more capital into the insurer using existing resources from the group and secondly we purchased more reinsurance to reduce exposure ahead of the transfer of 50% of our portfolio to an agency basis. This was vital to rebuild our capital adequacy ratio and to protect the company's capital from any continuation of the catastrophe events of 2011.

With the continued underwriting action and price increases the loss experience to date has improved significantly. This has meant that the cost of this reinsurance has increased as the level of recovery has dropped with the improved underlying experience. The single largest impact on our 2012 result has been and continues to be the cost of that reinsurance programme. While this may be frustrating, the cover was necessary and it has done its job. The underlying improvement in underwriting performance should have a positive impact in 2013 as we will need significantly less reinsurance.

In addition the successive reduction in interest rates has increased existing claims reserves as the rate at which we are obliged to discount those reserves decreases. So far those reductions in interest rates have had only limited impact on our investment returns as the majority of our reserves were in longer term deposits. However as these deposits mature, future investment return are expected to be lower.

FIRST Interview

Cutting costs and getting the Expense Ratio down was also a focus for this year. *Can you provide some context on how that has progressed and will you be providing some transparency at the full year results on the expense ratio as it impacts both the underwriting part of the business and also the agency model?*

CEO Nick Kirk

We set ourselves a target to reduce our expense spend by 10% - 15% on an inflation adjusted basis. Taking out accounting fluctuations like the Liability Adequacy Test our expense for 2011 was \$47m, we brought that down to \$44m including restructuring costs in 2012 and it will reduce further to \$42m in 2013. Which means we have met our target.

One issue that is worth highlighting when talking about expense is the amortization costs that we carry, mainly for the systems conversion work that we carried out to get ourselves on to one modern platform. In 2012 the amortization expense will be \$4.6m which will reduce slightly to \$4.3m in 2013. While we will continue to have capital expenditure on an ongoing basis, we have no plans for the scale of costs we incurred in the conversion programme. The bulk of the costs associated with the conversion process will have been amortised by 2015 with just a small balance remaining in 2016.

FIRST Interview

Calliden and the insurance industry in general have been very successful in getting strong premium increases through over the past year. *What has been Calliden's experience in recent months of premium rises and retention rates?*

CEO Nick Kirk

Actually premium increases have been quite mixed with strong rises in personal insurances, particularly home, and much less on commercial. Our home premiums have pretty much doubled over the last two years and motor has increased by a steady 10%. Our latest increase in home premiums that went through in June did lead to a drop off in retention rates although in the last month or so that has started to come back as other insurers have continued to increase and catch up with our premium levels.

On our commercial book the overall increase is single digit. For us the imperative was the creation of a smaller but better performing insurer where we held more net so we could improve the returns from writing risk. That meant that where a portfolio would not take price increases we discontinued our involvement. The trend of reducing our top line in order to improve the 2013 bottom line, continued in the second half. We believe that we have now taken the action that we need to take.

On our agency book we implemented our new pricing algorithm for the commercial pack book in November. This new pricing model provides us with a far more granular approach to pricing and positions us well for profitable growth in 2013 and beyond. The combination of the AA- (very strong) Standard & Poor's rating of our carrier and this new pricing engine will enable us to grow in areas not traditionally open to us.

Update on capital adequacy and FY12 earnings

FIRST Interview

Calliden Insurance's capital adequacy multiple (CAM) or minimum capital requirement was 1.9 times at the half year with further improvement expected over the course of 2012. *As the insurance industry prepares for introduction of APRA's new prudential requirements on 1 January 2013, how would you assess the strength of Calliden's capital position?*

CEO Nick Kirk

From January 1, 2013 APRA's new Life and General Insurance Capital (LAGIC) standards apply, replacing a Minimum Capital Requirement with a Prudential Capital Requirement, which is calculated on a more risk-sensitive basis and is not directly comparable to the old CAM. In anticipation of the new standards, Calliden undertook increased reinsurance support in 2012 to ensure that it comfortably exceeds the new Prudential Capital Requirement.

FIRST Interview

Calliden moderated its guidance at the half year to a net profit for the FY12 at the lower end of its original \$1-3m guidance. *As we move to the close of the financial year, given your previous comments on the discount rate, is this now looking optimistic?*

CEO Nick Kirk

Our guidance was prior to further interest rate reductions which have had an adverse impact. The catastrophe experience has continued to be favourable although this is almost entirely balanced by the effect of reduced recoveries on our reinsurance programme. At the end of the financial year we will perform a full actuarial valuation of our insurance liabilities which at the half-year were in excess of \$100m. Consequently a small change in the actuary's valuation assumptions may have a noticeable positive or negative impact on the anticipated small profit this year. Therefore, based on what we know today, we remain comfortable with the current guidance.

Outlook for FY13 under the new Operating Model

FIRST Interview

You must be close to finalizing the details of your reinsurance programme for 2013. How is it likely to differ from 2012?

CEO Nick Kirk

As I said before, the transition to the new model was to achieve a smaller, better performing insurer with a portfolio of risks that fits with our capital base and a large viable agency with excellent capital providers.

One essential ingredient to making the model work is to reduce the amount of reinsurance that the insurer purchases. For 2013 the proportional reinsurance will therefore reduce from 60% to 25% with the structure of the balance of the programme remaining pretty much the same. This should enable us to produce a reasonable return from the insurer, albeit recognizing that 2013 will therefore be a blend of the higher 60% reinsurance for unexpired risks and 25% for new and renewed business.

FIRST Interview

From January 1, 2013 half of Calliden's revenue will come from its agency business and half from its traditional insurance underwriting activities. A key benefit of shifting more of its business to the MGA model was a more predictable earnings stream over time so are you able to provide some indication of what that might look like in FY13?

CEO Nick Kirk

When we started this process our profit target for 2013 was around \$10m and that remains the case. 2012 has been a year of transition between the two models and a year in which we needed to rebuild our regulatory capital ratios. In 2013 we need to deliver on the new model and hit that profit target. Everything that we are doing and planning for now is focused on achieving that target. We are, for example, actively working on building and launching our new middle market initiative in the agency business which will complement our product suite to intermediaries. The insurer has a new motor agency which has developed a very innovative approach to private car insurance. Both of these will launch in the first half of 2013.

We see real change coming in the Australian intermediated market and our focus now is firmly on how we take advantage of those changes. We will be entering 2013 with a leaner business model due to the strategic and structural changes that have been implemented during 2012. We have made good progress, in my view, towards achieving our overall aim of building a sustainable model that is capable of paying regular fully franked dividends to our investors in the future.