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2008 General Insurance Industry Survey

Direct Underwriters, Reinsurers and Brokers



Insurance

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This is the result of a joint research effort between J.P. Morgan and Deloitte

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Executive Summary

We highlight here the key themes to emerge from the 2008 survey and our analysis:

- 1. Profitability unchanged in 2008; will modestly deteriorate in 2009.** In the 2008 financial year, respondents reported an overall industry combined ratio of 94%, in line with last year's result of 94% and better than the 2009 forecast of 96%. Respondents once again noted high storm activity, coupled with reserve releases (both of which they expected to reduce into the future). There was a noted difference between classes, with participants expecting sharp improvements in combined ratios in personal lines, coupled with significant deterioration in long tail commercial lines. Whilst combined ratios may hold up, we believe there will be added pressure on profits at least in the short term from the effects of the financial crisis on both claims and falling yields.
- 2. Premium rates in commercial classes are stabilising.** Rates in the long tail classes fell further during 2008, although the trajectory of rate reductions slowed. Long tail rates fell 7% on average this year compared to a fall of 10% last year. Rates in short tail commercial classes bottomed in 2008, with short tail commercial rates increasing by 1% this year compared to a 7% fall last year. We expect commercial rates to bottom or turn in 2009 given the deterioration in profitability in some lines, coupled with expectations for higher claims costs and falling yields as a result of tougher economic conditions. Survey respondents also expect to see commercial rates bottom in 2009 and increase in 2010.
- 3. Premium rates in the personal lines increased, and are expected to continue to rise.** Rates in the personal lines increased 3% on average this year, compared to a 0% move in rates last year (mainly as a result of 2007 rate reductions in CTP after regulatory change). We expect rates to continue to rise in the coming year given falling investment yields, the oligopoly structure of the market, and the consensus opinion by the large players that rates in personal lines need to increase. Lack of profitability in NSW CTP, and changes in profitability in QLD CTP were a major concern though – and large rate rises would be needed here to restore margins seen in the past.
- 4. Weaker economic outlook could have adverse impact on claims.** A number of respondents indicated that a poor economic outlook for the coming year was a concern. Generally speaking, the number of fraudulent claims and litigation increases during weak economic conditions, which can have an impact on Professional Indemnity, Director's and Officers, Workers' Compensation and Commercial Property. We believe some classes such as motor and householders' could actually face lower claims costs from reduced vehicle usage and lower building costs.

Survey Description

This is the sixteenth edition of the J.P. Morgan Deloitte General Insurance Survey.

The 2008 J.P. Morgan Deloitte General Insurance Survey provides a detailed overview of the current state of the Australian general insurance industry and the industry's expectations. The report delivers critical information on the key elements of the industry from direct underwriters, reinsurers and brokers, including:

- detailed product information for the current period and industry expectations for the next two years covering issues such as premium rate trends, capacity changes, claims inflation, loss and expense ratios
- perceptions of product profitability
- distribution trends
- key issues
- broker's perceptions of underwriters.

As has been our longstanding custom, we have also provided editorial comments from J.P. Morgan and Deloitte on key industry issues which serve as a commentary on industry developments and compliment the survey results and respondent feedback.

Sources of Information

All of the information in this report is sourced from a survey of the major underwriters, reinsurers and brokers in the Australian general insurance industry. A complete list of the participating companies is contained at the end of this report.

The survey is the sixteenth consecutive data collection and accordingly there is now a substantial body of trend data available and many of the comments and observations in the body of the report have been drawn from this information.

Acknowledgments

This report has been produced with the support of the Australian insurance industry. The insurance industry's support has been generous and is greatly appreciated.

The J.P. Morgan and Deloitte teams hope you find this a valuable reference.

Part 1: Editorial Comments

Rates bottom but pressures on profits

Siddharth Parameswaran and Liam McCarthy, J.P. Morgan

Rates slid downwards in FY08

Rates slid in commercial lines by 2%

Personal lines rose 3%

This year premium rates across the commercial lines fell further, partly as a result of competitive pressures. Some participants have noted a particular increase in competition from offshore underwriters in the liability and professional indemnity classes. For the year to June 2008, commercial rates fell an additional 2% while personal lines rates increased on average by 3%. We note a message to brokers late in December 2008 from one major market participant suggesting rates would need to rise substantially – perhaps indicating that this trend would turn in 2009. In the domestic home and motor classes, premium rates increased in response to previous weather-related claims and moves of major players to restore profitability.

Inflation picked up a little, CTP and Workers impacted

Personal short tail lines showed frequency and inflationary pressures – but it was to some extent one-off due to storms.

Commercial short tail inflation was largely in check ex storms and large claims.

Liability showed inflation – but from a very low base

CTP showed strong inflation

Claims inflation for the year increased in all but one class. Claims inflation in the motor classes of 5% has been driven primarily by higher repair costs partly as a result of more expensive motor components and increased labour costs. A number of respondents have indicated their concern over the future direction of claims inflation in the motor classes as a result of a weaker Australian dollar. Since the end of June 2008, the Australian dollar has depreciated by 31% against the US dollar, which should increase the cost of imported motor parts. Offsetting this, we note that a large percentage of parts are sourced domestically and a large proportion of repair costs is labour (which should be under less pressure). Short tail commercial faced some inflationary pressures in 2008 (+5%), although this appears to have been driven by an increase in large claims particularly in cold storage facilities. There was strong inflation evident in CTP (both Queensland and NSW – driven by superimposed inflation) and in Workers' Compensation (driven by the very high increase in average weekly wages in Western Australia). Our survey respondents indicated some reasonable inflation in liability, although we flag that this is from a low base and also that it is at odds with external feedback on trends in the class.

Until recently, QLD CTP was the only class showing signs of superimposed inflation – although we believe that both NSW CTP and some pockets of liability (once again in Queensland) are also now showing signs of modest superimposed inflation.

Frequency rose... from storms and economy

Frequency trends are of most concern looking forward in professional indemnity and directors and officers.

Claims frequency also increased in a number of classes, although much of this appears to be due to one-off impacts. In particular, claims frequency in the personal lines (motor and home) increased, mainly as a result of continued abnormal storm events. Claims frequency in the long tail liability classes (such as professional indemnity and directors and officers) also increased a little. Respondents indicated that weakening economic and financial market conditions may have resulted in an increase in claims in these classes. In our view, claims frequency in professional indemnity and directors and officers is likely to increase further over the coming year given the weaker economic outlook. We believe that certain professions (e.g.: financial advisers, mortgage brokers) are likely to see an increase in the number of class actions given the fall in equity markets and property prices. Similarly, the

directors and officers class could face higher claims frequency as a result of Side-C cover, which provides cover for shareholder litigation. Workers' compensation frequency fell, we suspect largely due to increasing wage-roll and the economic disincentive to claim. We suspect this strong trend will not continue in 2009, due to the change in the economic climate. NSW CTP frequency fell, no doubt as a result of continued lower road fatalities. Queensland CTP showed a surprisingly strong increase in frequency, probably due to signs of greater utilisation of Severity 1 economic loss claims, and some workers' compensation recoveries against CTP. This class has been under some pressure since 2007.

Table 1: Selected data from 2008 survey – Changes over the year

| | 2008 (%) | Premium rates | Claims inflation | Claims frequency |
|--------------------------------------|----------|---------------|------------------|------------------|
| Domestic classes | | | | |
| Domestic motor | | 3 | 5 | 5 |
| Householders | | 4 | 4 | 7 |
| CTP (NSW) | | -3 | 6 | -5 |
| CTP (QLD) | | 3 | 6 | 9 |
| Weighted average | | 3 | 5 | 5 |
| Commercial classes | | | | |
| Fire & ISR (Commercial property) | | -3 | 5 | 3 |
| Commercial motor | | 9 | 6 | 4 |
| Public & Product Liability | | -6 | 6 | 2 |
| Workers compensation (WA only) | | -12 | 9 | -4 |
| Workers compensation (TAS, NT & ACT) | | -8 | 4 | -1 |
| Professional indemnity | | -7 | 3 | 2 |
| Directors & officers | | -6 | -1 | 9 |
| Weighted average | | -2 | 5 | 3 |

Source: 2008 General Insurance Survey

Short term pressure on returns

Overall then, we believe that lower commercial premium rates in 2008 coupled with some claims costs and frequency increases and of course falling yields are likely to put further downward pressure on industry profitability in 2009. However, we believe premium rates will stabilise / start to increase in 2009 onwards. Respondents have indicated similar expectations with further rate increases expected in personal lines and flat to increasing rate movements in commercial lines. In our view, underwriters will need to increase rates in order to offset higher claims costs and weaker profitability. Personal lines (particularly short tail) in our view are much more likely to show margins holding up or increasing than commercial long tail lines.

But industry appears set to increase commercial prices

The industry has already demonstrated that it is willing to respond to weaker levels of profitability as seen in the commercial motor class. Profitability in commercial motor deteriorated markedly last year with the combined ratio falling to 103% in 2007. This year, respondents have indicated that rates in commercial motor have increased by 9% in response to weaker levels of profitability. We have also seen in December 2008 one very large participant seek rate increases in the commercial market of 7.5% to 10% rate increases across the board. In our view, it takes about 12 months for the full impact of rate increases to be felt through earned premiums, whereas some of the claims and yield pressure are felt immediately. We, therefore, expect to see some recovery in 2010 profitability.

Short term pressures on margins inevitable... particularly for commercial long tail lines.

Clear signs that the industry is starting to raise commercial rates.... to follow in the footsteps of personal lines.

Table 2: Historical premium rate movements and expected rate movements

Rate rises expected to be strongest in personal lines (+5% in personal lines)

| (%) | 2006A | 2007A | 2008A | 2009F | 2010F |
|--------------------------------------|-----------|-----------|-----------|----------|----------|
| Domestic classes | | | | | |
| Domestic motor | 0 | 2 | 3 | 4 | 3 |
| Householders | 4 | 4 | 4 | 6 | 5 |
| CTP (NSW) | -2 | -12 | -3 | 4 | 8 |
| CTP (QLD) | -5 | -1 | 3 | 7 | 7 |
| Weighted average | 1 | 0 | 3 | 5 | 5 |
| Commercial classes | | | | | |
| Fire & ISR (Commercial property) | -7 | -9 | -3 | 4 | 7 |
| Commercial motor | -8 | -2 | 9 | 8 | 7 |
| Public & Product Liability | -10 | -10 | -6 | -1 | 3 |
| Workers compensation (WA only) | -9 | -14 | -12 | -6 | 0 |
| Workers compensation (TAS, NT & ACT) | -7 | -11 | -8 | -1 | 4 |
| Professional indemnity | -7 | -9 | -7 | 0 | 6 |
| Directors & officers | -6 | -8 | -6 | 4 | 8 |
| Weighted average | -9 | -8 | -2 | 3 | 6 |

Source: 2008 General Insurance Survey

But the increases have to be large just to offset the pressures from falling yields, higher claims costs and diminishing reserves

The next article looks at the impact of the financial crisis on insurer returns

We would note, however, that the industry has been forecasting a turn in the cycle for the last three years. We believe that this year is indeed the last year of rate reductions given the future headwinds likely to impact the industry and the expected deterioration in future profitability. In our view, the level of excess reserves releases has slowed significantly, which will expose the underlying profitability in the industry. Rates will also need to rise in order to offset the lower levels of reserve releases.

Table 3: Previous forecasts of commercial rates during previous cycle downturns

| (%) | Current year | 1 year forward | 2 years forward |
|---------------------------------------|--------------|----------------|-----------------|
| Current downturn in the cycle | | | |
| 2008 | -2 | 3 | 6 |
| 2007 | -8 | -3 | 1 |
| 2006 | -9 | -3 | 1 |
| 2005 | -9 | -3 | 2 |
| 2004 | -4 | -4 | -2 |
| Previous downturn in the cycle | | | |
| 1998 | -10 | 1 | 4 |
| 1997 | -15 | -7 | -2 |
| 1996 | -8 | -4 | 1 |
| 1995 | -3 | -2 | 1 |

Source: General Insurance Surveys (1995 to 2008)

Industry profitability to worsen initially

The table below shows the combined ratio by class and for the industry as a whole for the last 3 years, and expectations for the future.

Table 4: Combined ratios

| (%) | 2006A | 2007A | 2008A | 2009F | 2010F |
|--------------------------------------|-----------|-----------|-----------|-----------|-----------|
| Domestic classes | | | | | |
| Domestic motor | 90 | 89 | 93 | 88 | 87 |
| Householders | 92 | 96 | 91 | 88 | 83 |
| CTP (NSW) | 102 | 100 | 112 | 110 | 109 |
| CTP (QLD) | 76 | 86 | 103 | 105 | 106 |
| Commercial classes | | | | | |
| Fire & ISR (Commercial property) | 92 | 93 | 99 | 89 | 83 |
| Commercial motor | 98 | 103 | 103 | 98 | 93 |
| Public & Product Liability | 87 | 88 | 84 | 86 | 86 |
| Workers compensation (WA only) | 93 | 90 | 94 | 98 | 96 |
| Workers compensation (TAS, NT & ACT) | 93 | 93 | 95 | 101 | 100 |
| Professional indemnity | 82 | 92 | 86 | 89 | 90 |
| Directors & officers | 86 | 76 | 88 | 90 | 91 |
| Total | 91 | 94 | 94 | 96 | 96 |

Source: General Insurance Surveys (2006-2008)

Table 5: Change in the combined ratio

| (%) | 2007A | 2008A | 2009F | 2010F |
|--------------------------------------|----------|----------|-----------|-----------|
| Domestic classes | | | | |
| Domestic motor | -1 | 4 | -5 | -1 |
| Householders | 4 | -5 | -3 | -5 |
| CTP (NSW) | -2 | 12 | -2 | 0 |
| CTP (QLD) | 10 | 17 | 2 | 0 |
| Weighted average | 0 | 3 | -3 | -2 |
| Commercial classes | | | | |
| Fire & ISR (Commercial property) | 1 | 6 | -9 | -6 |
| Commercial motor | 5 | 0 | -5 | -5 |
| Liability | 1 | -4 | 2 | -1 |
| Workers compensation (WA only) | -3 | 4 | 4 | -2 |
| Workers compensation (TAS, NT & ACT) | 0 | 2 | 5 | -1 |
| Professional indemnity | 10 | -6 | 3 | 1 |
| Directors & officers | -10 | 12 | 2 | 0 |
| Weighted average | 3 | 1 | -4 | -4 |

Source: 2008 General Insurance Survey

Industry combined ratios in FY08 were flat on the previous corresponding period (pcp)

CTP (particularly NSW) was very poor. Commercial long tail was very strong (but reserve release assisted).

The industry has reported an overall combined ratio of 94% in FY08, in line with that of last year's results. Personal lines had a mixture in terms of performance, with short tail being quite profitable (92%), offset by CTP which had combined ratios well over 100% (particularly NSW CTP). Commercial long tail classes continued to show excellent profit trends – although some participants flagged that these were reserve release assisted, and the releases are slowing. Short term commercial was poor again.

Profitability in the domestic motor class deteriorated on last year due to continued adverse weather events. The market expects domestic motor profitability to improve as the beneficial impact of previous rate increases take hold. The householder's class saw profitability improve on last year, although we would note that last year's combined ratio was severely impacted by large storm costs. Looking forward, the industry is expecting a 5% improvement in the combined ratio for motor and 3% for householders in FY09

Expectations are for strong improvements in combined ratios in motor, householders, fire and commercial motor.

Deterioration is expected in long tail commercial – but from very favourable levels. We suspect the deterioration could be stronger than indicated.

The profitability in the CTP classes has deteriorated markedly this year. In our view, the weaker combined ratios can partly be explained by much lower levels of reserve releases from the CTP class, and excessive competition in the earlier part of the year. A number of large, public industry players have been flagging the slow down in long tail releases, which had supported long tail profitability in recent times. Participants have also noted higher superimposed inflation in QLD and higher claims costs from CARS decisions in NSW. We suggest that interest rate reductions will provide further downside. In Queensland in particular, rates cannot be refiled to account for the lower yields until 1 April 2009. The likely stress on profitability adds incentives for further rate increases.

In the commercial lines, profitability in the short tail classes has deteriorated. The combined ratio in the fire/ISR class has fallen to 99% this year following another year of high storm costs. The commercial motor class has reported another year of weak profitability as the full impact of previous rate reductions takes hold. Survey respondents expect rates to increase in these classes in the coming two years, and for fewer large claims in order to restore profitability.

As mentioned above, the level of profitability in the long tail commercial classes remains attractive. However, respondents indicated that profitability in the long tail classes is likely to deteriorate. We believe that a deterioration in future levels of profitability in liability classes is realistic given the weaker economic outlook. We believe that the professional indemnity and directors and officers classes could face higher claims frequencies in a tougher economic climate.

Changes in Capacity

The change in capacity can be seen as a measure for the change in the level of competition within the industry. In the domestic classes, the level of capacity has remained little changed on last year. The market does not expect capacity in the personal lines to alter much over the coming year.¹ The results indicate that the competitive climate in the personal lines is more rational than in the commercial lines, where capacity changes more dramatically. In our view, the personal lines market is essentially an oligopoly market dominated by three large underwriters. As a result, the personal lines market should not experience the level of price-based competition seen in the commercial markets. In addition, the oligopoly structure of the market gives us some level of comfort that rates in the personal lines will increase in the coming years. Large personal lines underwriters have publicly indicated that rates need to increase in personal lines in order to offset previous large weather-related claims.

In commercial lines, capacity has increased in some classes but at a lower rate than in previous years. Some respondents noted this year that competition from offshore participants increased in a few of the long tail, liability classes, which would partly explain the continued increase in capacity in professional indemnity. The market generally expects capacity growth to slow in the coming years and even go backwards in some classes (particularly liability, professional indemnity, directors and officers).

¹a although we do note more vigorous advertising from smaller players, and the entry of YouI and potential entry of Progressive into the Australian market

Some increase in capacity in professional indemnity and directors and officers – at arguably the wrong time in the cycle.

In our view, the slower growth in capacity in some lines is the result of weaker levels of profitability in those lines. Commercial motor has been unprofitable for the last two years, which has seen the level of capacity stabilise. We find it particularly interesting to see that the market is expecting capacity in professional indemnity and directors and officers to retreat over the coming two years. We believe that the expected slide in capacity coincides with an expected increase in claims in these classes as the economic outlook weakens. We note that capacity from international players tends to move in and out of the Australian market fairly quickly. When profitability is good, offshore capacity increases but when profitability deteriorates, capacity can leave the market fairly quickly.

Table 6: Changes in capacity

| (%) | 2006A | 2007A | 2008A | 2009A | 2010A |
|--------------------------------------|-------|-------|-------|-------|-------|
| Domestic classes | | | | | |
| Domestic motor | 3 | 4 | 0 | 1 | 0 |
| Householders | 1 | 1 | 1 | 1 | 1 |
| CTP (NSW) | 0 | 1 | 0 | 0 | 0 |
| CTP (QLD) | 1 | 2 | 0 | 0 | 0 |
| Commercial classes | | | | | |
| Fire & ISR (Commercial property) | 13 | 4 | 6 | 3 | 0 |
| Commercial motor | 4 | 4 | 2 | 0 | 0 |
| Public & Product Liability | 19 | 13 | -1 | -1 | 1 |
| Workers compensation (WA only) | 5 | 2 | 0 | 0 | 0 |
| Workers compensation (TAS, NT & ACT) | 2 | 2 | 0 | 0 | 0 |
| Professional indemnity | 14 | 11 | 9 | -1 | -3 |
| Directors & officers | 24 | 10 | 7 | 0 | -6 |

Source: General Insurance Survey (2006-2008)

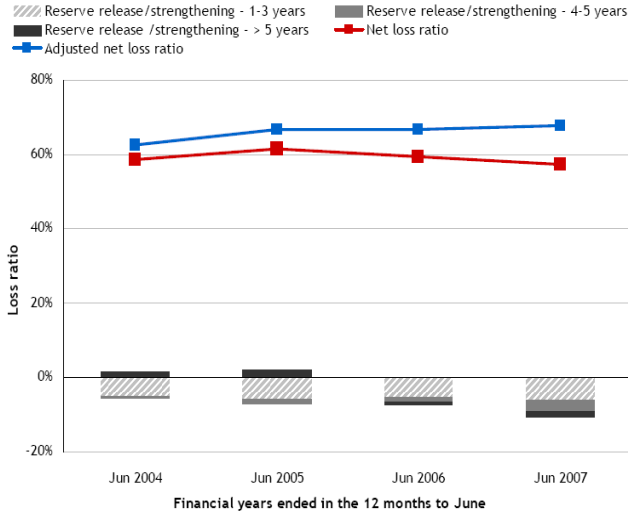
The reserving cycle

Reserve releases were such a major part of previous results and must now be slowing.

Long tail lines will face the greatest threat to their margins from this...

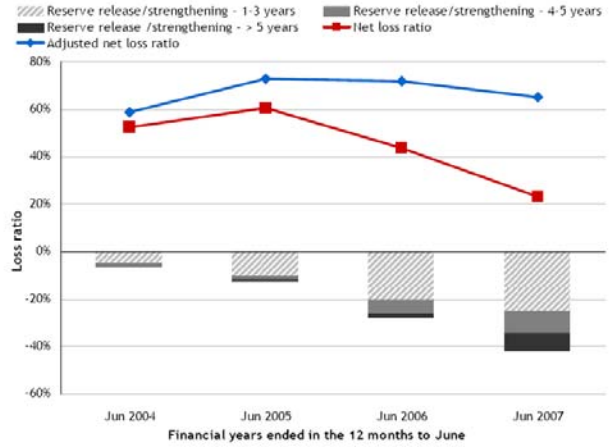
Reserve releases have been a feature of insurance results for a number of years. The impact of tort reforms has had a beneficial impact on long tail claims, allowing underwriters to release redundant reserve to support profitability. Reserve releases were once again a feature of insurance results in the year to June 2008. However, we believe that reserve releases have slowed. A few listed insurers have in fact indicated that reserve releases in the coming periods will be substantially lower than in prior years. We show below some graphs from APRA that indicate just how substantial a proportion of recent insurer profits they have been.

Figure 1: Reserve releases in direct insurers - Industry



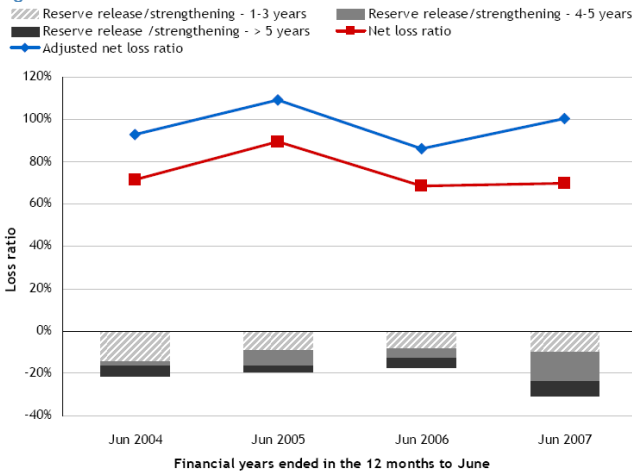
Source: APRA

Figure 2: Reserve releases in direct insurers - Liability



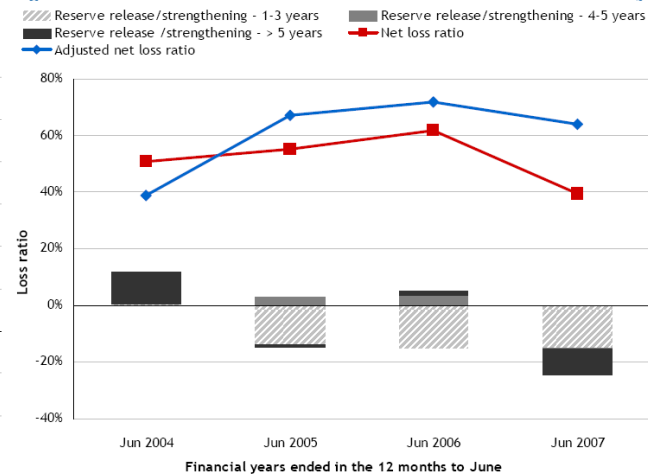
Source: J.P. Morgan, APRA

Figure 3: Reserve releases in direct insurers - CTP



Source: APRA

Figure 4: Reserve releases in direct insurers - Professional Indemnity



Source: APRA

We expect the reserve releases in the CTP class to be negligible in coming years. Survey participants have indicated that Queensland (QLD) CTP is facing high levels of superimposed inflation. The QLD scheme actuary indicated in July that rates would need to rise by 15% in order to adequately price risk in the face of superimposed inflation. The QLD regulator, however, has only allowed rate increases of 7.7% over the last two quarters. Similarly, some respondents have noted evidence of superimposed inflation in the NSW market as well. However, we understand that the NSW regulator is much more proactive in taking action to limit any superimposed inflation. We do not believe that reserve releases from CTP will be significant in the coming years, given that allowable rate increases in QLD are not likely to offset the full impact of superimposed inflation, and given that superimposed inflation seems to have arisen in NSW. In our view, reserving actuaries are likely to maintain a cautious approach in the face of superimposed inflation.

The impact of a weaker economic outlook

This year a number of respondents expressed their concern over the potential impact of a weakening economy on the industry. We discuss this in much more detail in the next article. Key points to note are:

- We believe that different classes of business will be impacted differently.
- In our view, short tail motor and home lines will feel less of an impact than the longer tail liability classes. Whilst the number of theft and fraudulent claims may increase, this we believe will be largely offset by people driving less (using public transport more) and lower building costs.
- We believe that the professional indemnity and directors and officers classes could feel a bigger impact to claims costs than the short tail lines, as litigation is likely to increase against many finance related professions. Survey respondents have indicated that they expect frequency to increase significantly (19%) over the coming year.

How the Financial Crisis impacts insurers

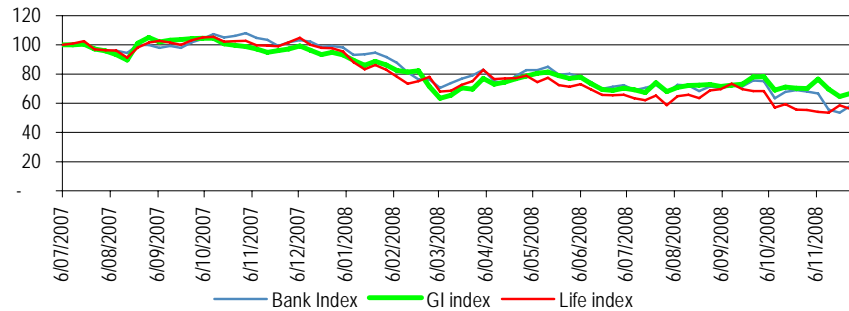
Siddharth Parameswaran and Liam McCarthy, J.P. Morgan

The recent “financial crisis” has had very large and deep impacts on both fixed interest and equity markets. It is arguable that it has just started having an impact on the real economy as well – and it will take some time to wash through. The financial sector is facing the greatest challenges amongst the different sectors of the economy in our view.

We show in the chart below how the different indices for financial stocks have reacted in Australia since the crisis began back in August 2007.

Whilst all financial stocks have fallen since the beginning of the financial crisis, Australian general insurers have fared better than life insurers and banks.

Figure 5: Index of Price Returns for Listed Financial Stocks in Australia



Source: IRESS, J.P. Morgan Arithmetic Price movement index, using market cap weights at 4 Dec 2008

It is clear that whilst general insurers are faring better than other financials, they have not escaped unscathed in terms of financial performance (although arguably most of the downside has not been caused by the financial crisis).

We cover in this article what is causing the financial crisis, how general insurers are likely to be affected by it and the impacts that it could have on profitability.

What caused the crisis?

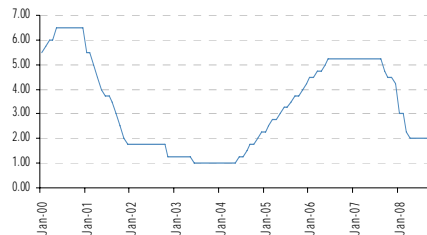
The current financial crisis had a long lead time.

- Decisions were taken in late 1999 in the US to weaken credit standards at Government mortgage securitisers Freddie Mac and Fannie Mae.
- As a result, mortgages were supplied to those with poorer credit histories and weak incomes. The size of this sector started to grow, eventually becoming 20% of total loans issued by 2006.
- Between 2001 and 2004, cash rates reduced, which supported seemingly favourable default experience. Credit standards as a result were allowed to decline further in the quest for growth, with lenders able to borrow more than 100% of the value of their housing investment, and some loans being made to people with no income or assets.

Crisis was building for a few years...with sub prime exposures building throughout the financial system.

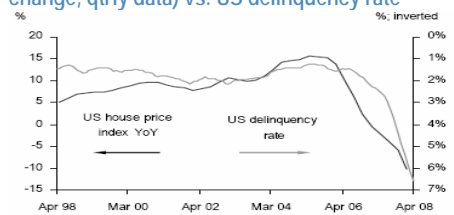
- These loans were packaged and securitised into Collateralized Debt Obligations (CDOs). They were on-sold to hedge funds, investment banks special purpose vehicles. The understanding of the credit quality backing the securities was very poor and proved to be highly optimistic
- When interest rates started to rise, house prices started to fall, resulting in a sharp increase in the rate of defaults (see following charts showing rate rises from 2004 until 2006 and rising delinquencies and falling house prices)

Figure 6: Cash Rates in US



Source: US Federal Reserve

Figure 7: US Case-Shiller house price index (YoY change, qtrly data) vs. US delinquency rate*



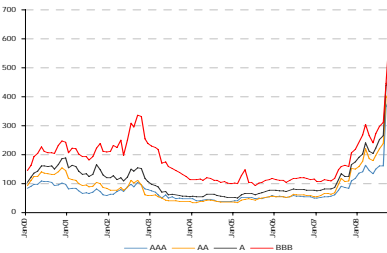
Source: J.P. Morgan European Rates Strategy Research. * Weighted average of agency, subprime, Jumbo, Alt-A delinquency rates

As delinquencies started to rise, the crisis became a crisis of confidence...

Spreads widened and loan growth slowed

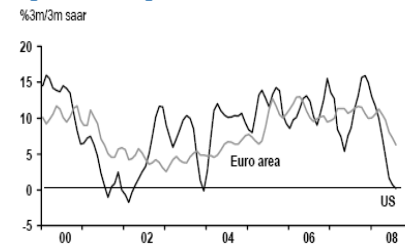
- The rising default rates and a lack of confidence in credit ratings ascribed to various debt securities led to a sharp widening in credit spreads (see left below). As a result, it became much harder (very expensive) for banks to raise debt, and hence credit started to be rationed. The chart in the centre and right below show that loan growth started to slow dramatically in the US / UK and in Australia in 2008.

Figure 8: Credit Spreads in USA for different ratings (bps)



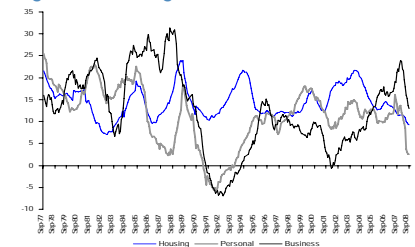
Source: Bloomberg, J.P. Morgan

Figure 9: Loan growth – US and UK



Source: Bloomberg, J.P. Morgan

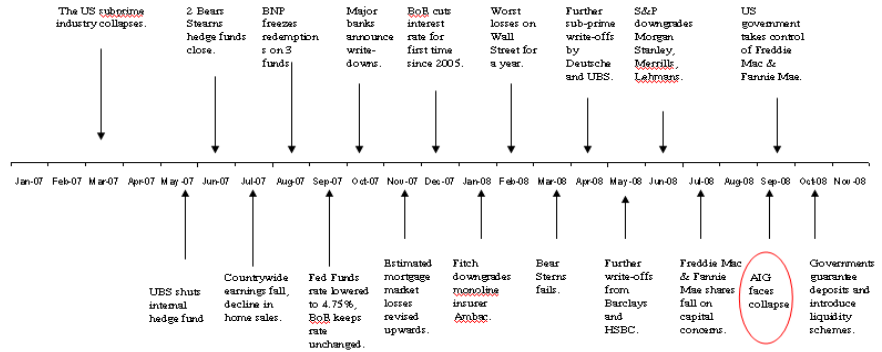
Figure 10: Loan growth - Australia



Source: Bloomberg, J.P. Morgan

- The crisis of confidence, the increase in the perceived cost of default and the difficulty in raising debt led to many failures or near failures in the financial services space through 2008 e.g. Bear Sterns, Lehman, AIG etc.

Figure 11: Timeline of Major Events in Sub Prime Crisis



Source: J.P. Morgan

- In the general insurance space – whilst there have been a few notable names that have suffered large impacts from the credit crisis (e.g. AIG, XL Capital, Hartford and Swiss Re), the exposures have not been as a result of their insurance operations. A lot of the losses stemmed from the writing of credit default swaps², which are not traditional insurance products.

The impact the crisis will likely have on the real world:

Inevitably the financial crisis will spill over into the real world. Our J.P. Morgan economist believes we are only at the start of the crisis in terms of seeing the full economic impacts. Some of the key changes we are already starting to see include:

The financial crisis will impact:

- economic growth & unemployment
- gearing and asset prices
- yields and returns on assets
- currencies such as the A\$

- Economic growth is slowing and could turn negative (i.e. a recession or depression). This will reduce consumption and growth.
- There could be a reduction in the level of debt in the economy as highly geared companies de-lever, and credit standards tighten.
- Unemployment globally will likely rise
- Asset prices could start to fall. We have already seen this on equities and bonds – other segments could follow.
- The Australian Dollar, as a currency that tracks commodity prices could fall substantially (as prices fall in line with lower growth).
- Interest rates around the world are falling – as monetary policy is used to boost growth.
- Governments around the world are going into fiscal deficit in order to try and stabilize demand in the economy.

General insurers better off than other financial companies

Given the financial world and real world impacts, we believe that general insurance companies are in a much better position than other financial entities:

General insurers much better off than banks...and life insurers

² Credit Default Swaps are derivative contracts guaranteeing the credit quality of debt instruments. Credit insurance involves a large accumulation of risk. When losses come through – the insurer is likely to have large volume of losses come through at the same time.

When compared to banks:

- They face much less credit risk (although there could be some risk of default on some corporate bonds that are held, by and large the credit quality is very good.)
- No liquidity risk – as they have incoming stream of premiums to fund payments (cash positive).

When compared to life insurers / wealth managers:

- They do not write guaranteed investment product liabilities (which are susceptible to large falls in asset values and yields).
- They do not get revenue that is largely a proportion of (falling) asset under management balances. Instead – the rates they charge can and do vary – driven by supply and demand factors that are largely independent of the outlook for the broader economy.
- The biggest cost in general insurer is claims - which is highly scalable. As such - if growth slows they are in a relatively favourable position of having lower premium volumes offset by lower exposure - and hence claims costs. Life insurers have notoriously fixed costs.

But general insurers still face substantial headwinds:

We still believe that general insurance companies face substantial headwinds from the crisis. How the profitability of the industry holds up depends on the action taken by underwriters:

General insurers face the following:

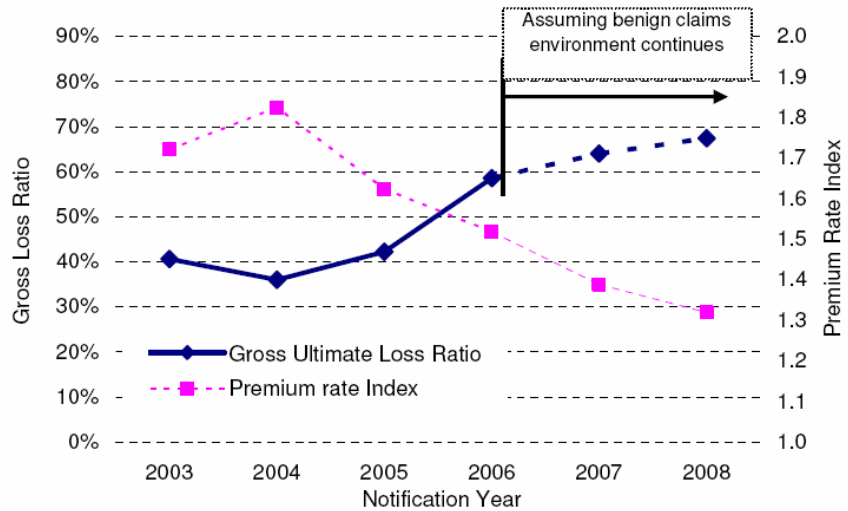
- increase in claims costs in particular lines
- falling interest rates will impact investment yields
- policy growth will slow
- capital may become scarce.

Claims costs could increase – particularly in long tail.

- We believe that some classes will face a large increase in claims costs as a result of the financial crisis. The most obvious classes include Professional Indemnity and Directors and Officers (see figure below). We understand that 2007 estimates suggest that industry profitability was only just meeting its 15% RoE target (with a 65 – 70% accident year loss ratio). With further reductions in rates in 2008 – this may have reduced closer to a 10% ROE on an accident year basis, *ceteris paribus*. We believe claims costs are likely to rise going forward on this class in light of the large falls in asset values seen and the likely increase in litigation that will follow. As we understand, there are already greater than 50 class action suits pending in Australia – including Allco, ABC Learning, Amcor /Visy, Centro, Opes Prime, West Point etc. As such, final returns could be hit very hard. We have anecdotally heard from some actuaries that they would not be surprised if loss ratios reached 150% on this class.

Figure 12: Professional Indemnity Loss Ratios in Australia -by accident / notification year

Figure 2.4 – Ultimate Loss Ratios by notification year

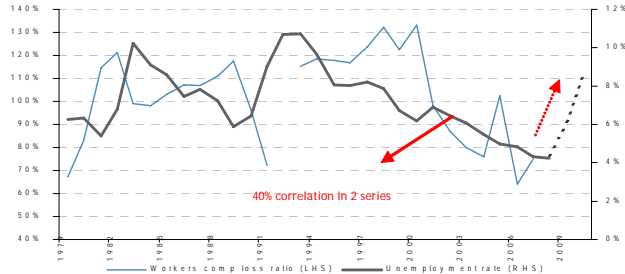


Source: "PIDO – Challenges for the Actuary" IAAust General Insurance Seminar 2008. Tim Andrews, Susie Bowden, Robert Cameron, Pravesh Ponna.

“incorporating expenses and an allowance for profit margin this suggests that in aggregate premiums were at borderline adequacy for a benign economic environment. Given the deteriorating financial and claims environment – it seems likely that current premiums are inadequate in aggregate”... “PIDO challenges for the actuary” - Tim Andrews, Susie Bowden ... presented at 16th IAAust General Insurance Seminar.

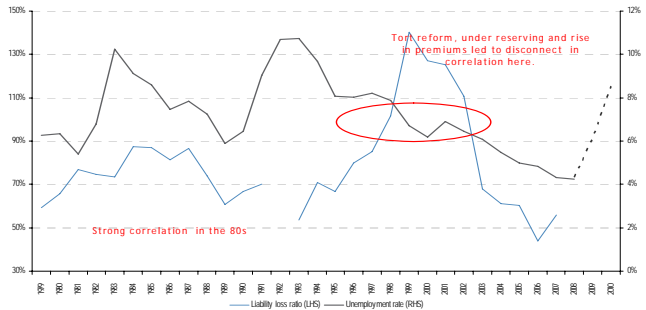
- Other commercial classes that could be impacted include workers’ compensation and liability:
 - Whilst we do not expect workers' compensation claim numbers to increase as a result of the sub-prime crisis - we do expect the "return-to-work" rates to decline as injured workers face difficulties in finding jobs to go back to if unemployment rises. There historically has been a reasonable correlation between unemployment and loss ratios as can be seen in the following chart (below left).
 - Liability had also historically had a very strong correlation between loss ratio and unemployment (see below right). However, this broke down due to bouts of superimposed inflation coupled with under-reserving in the mid 1990s and due to the liability crisis in 2001 onwards triggering rate rises and tort reforms. Conceptually one would expect fraudulent claims to rise during weaker economic times and hence for the link between loss ratios and unemployment to continue. We suspect tort reform reduced the risk here, as it was aimed at reducing the accessibility to compensation for lower severity claimants (which is where fraud is likely to be more prevalent).

Figure 13: Workers' Compensation loss ratio vs. unemployment



Source: J.P. Morgan, APRA, ISC

Figure 14: Liability loss ratio vs. unemployment

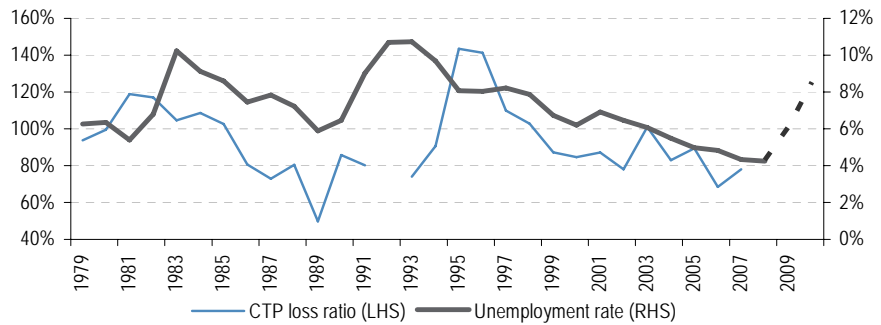


Source: J.P. Morgan, APRA, ISC

Short tail personal lines likely to be much better insulated than commercial long tail lines in an economic downturn...

- In personal lines, we expect CTP to show some correlation to the economic cycle. Historical evidence suggests that this is the case. In a similar vein to workers' compensation typically recovery rates may slow in times of economic stress as uncertainty about alternative income flows increases.

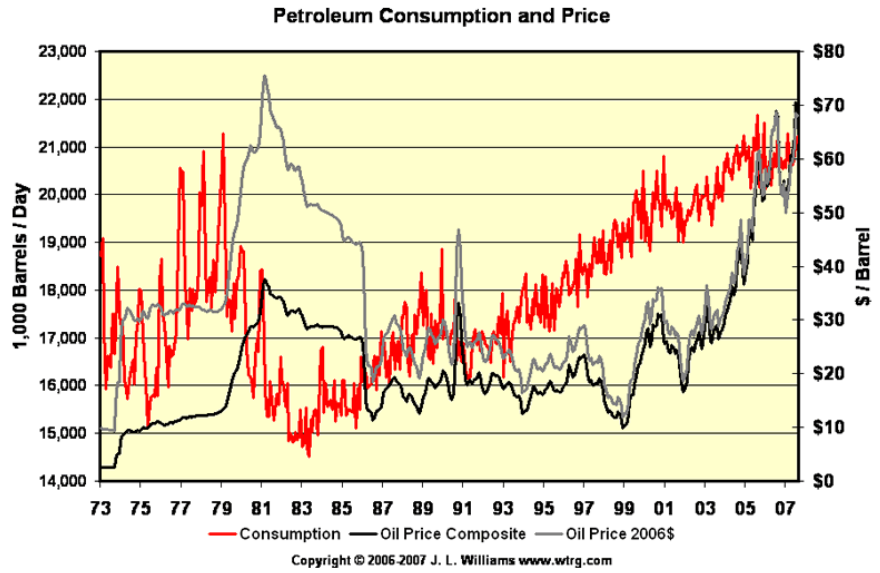
Figure 15: CTP loss ratio vs. Unemployment



Source: J.P. Morgan, APRA, ISC

- There appears to have been much less of a link in short tail personal lines as can be seen from the following charts. **In some ways there has almost been an inverse relationship in householders as building costs usually rise in times of low unemployment.** In motor we believe the relationship is confounded by at least 3 different factors – which overall leave a small but not insignificant link between loss ratios and unemployment:
 - economic growth linked to commodity booms in Australia is usually linked with strong exchange rates and hence making imported parts less expensive. We note however that the majority of repair costs is labour, and many parts are sourced domestically.
 - weaker economic times are often associated with less driving and less petrol consumption (see chart on left showing consumption reducing in the late 1970s, 1982, early 1990s and 2001 – 2003 in the US). Collision claims make up the bulk of claims costs.

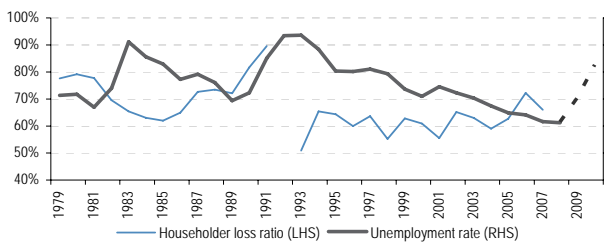
Figure 16: US consumption of petrol



Source: J.L. Williams

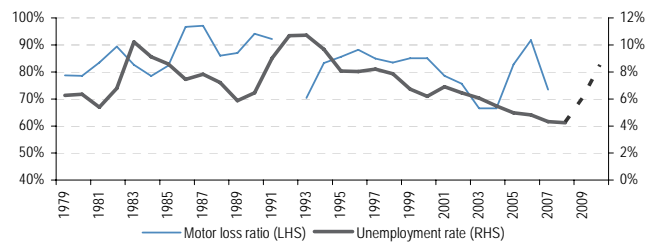
- But theft claims (which make up about 10% of claims costs) we believe are likely to increase in tougher economic times.

Figure 17: Householders' loss ratio vs. unemployment



Source: J.P. Morgan

Figure 18: Motor loss ratio vs. unemployment



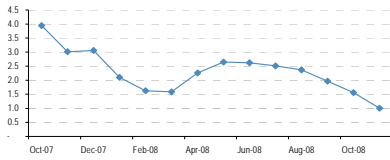
Source:

Yields have fallen on government debt up to 3% in a short space of time –offset a little by a widening in spreads

Falling interest rates and widening spreads will impact investment yields

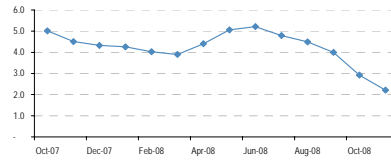
- Interest rates have fallen dramatically around the world over the past 2 months as central banks have moved to try and ease pressures from constricted debt markets. The charts below show this in the US, UK and Australia.

Figure 19 US 2 yr government bond rate



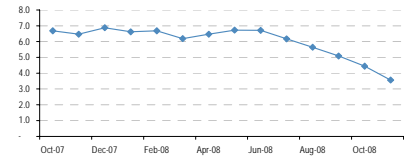
Source: Bloomberg, J.P. Morgan

Figure 20:UK 2 yr government. bond rate



Source: Bloomberg, J.P. Morgan

Figure 21: Aus 3 yr government. bond rate



Source: Bloomberg, J.P. Morgan

- This has been somewhat offset by widening spreads (see chart below showing spreads on AA rated bank debt in Australia relative to the bank bill swap rate) – although we note some of the widening reflects increased risk of default.

Figure 22: Widening in Spreads (bps) on Australian 5 year AA Bank Debt issued in Euros



Source: J.P. Morgan, Secondary Market Spreads in Europe

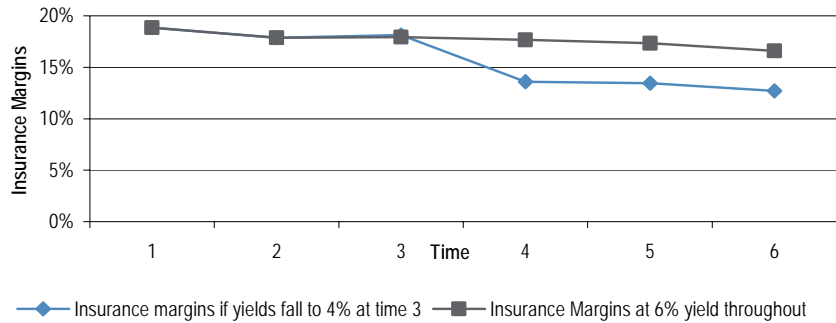
Long tail lines face the greatest risks from falling yields. This is particularly on new business being written.

- We believe that long tail lines face major issues from reducing investment yields, as a significant proportion of the returns they make come from investing in assets where yields have fallen:
 - Whilst most insurers seek to match the duration of their assets and liabilities, some may face immediate losses if they are mis-matched – with their bond assets not rising as much as their liabilities.
 - Duration matching of assets and liabilities is at best an imperfect hedge. We have seen credit spreads continue to widen on highly rated investment – which would imply asset values would not rise as much as liabilities even if insurers are duration matched.
 - Most importantly – on new business falling yields are equivalent to a large rate cut. On business such as liability or CTP where average durations from the date the policy is written to when weighted average claims costs are paid the duration is typically 5 years. As such a 2% reduction in risk free yields can mean a 10% rise in the discounted value of claims, which can imply a 7% hit to margins (= 5 * 2% * 70% loss ratio). We show below what the hit to insurance margins could be for an

insurer that writes a mixture of long and short tail business. It could be in the order of 4% of net earned premium.

A 2% fall in yields could reduce insurance margins by 4%.

Figure 23: Impact of a 2 % cut in yields on insurance margins at time 3 for pro-forma insurer

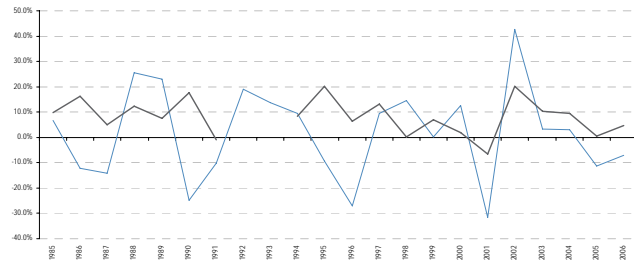


Source: J.P. Morgan Dynamic Financial Analysis Model of a Pro-Forma Insurer. Yields are assumed to fall just before time 3 from 6% to 4%. Impact is initially immunized at time 3 because of duration matching. New business however comes on at the lower yield. Mean term on outstanding claims for the insurer assumed to be 2.2 years.

Policyholder growth will slow

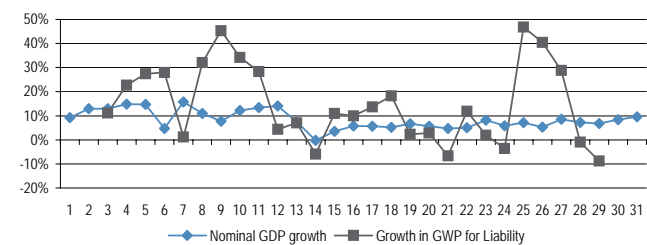
- We would expect policyholder and Gross Written Premium growth to contract in many lines, in step with the economy slowing. The correlation we believe would be greatest for Motor and Householders, where we expect new car sales and housing construction to slow. Commercial lines are influenced much more by the insurance cycle than the economic cycle. The differences between commercial and personal lines can be seen in the following two charts.

Figure 24: Householders GWP growth vs. Building Approvals



Source: ABS, APRA, J.P. Morgan/Deloitte General Insurance Survey, J.P. Morgan estimates

Figure 25: Commercial Liability GWP vs. Nominal GDP



Source: ABS, APRA, J.P. Morgan estimates

Capital could be seen as scarce and could lead to a market hardening... It is still early days to see if this plays out

Could the hits to capital positions lead to rate rises?

- There is no doubt that with the falls seen in equity markets, the falling yields and changes to APRA's rules on equity investments and reinsurers, many insurers will face a tighter capital position at 31 December 2008 than they did even 6 months earlier.
- Some such as Munich Re's chairman Von Bornhard are expecting rate rises to follow on the back of scarce capital and the higher cost of obtaining capital.
- We are in agreement with the latter point on the implied cost of capital increasing, as equity values around the world have plummeted. Any capital raising in the current market would lead to substantial dilution on existing shareholders.

- There are signs that rates are rising in reinsurance markets and some commercial markets in Europe. It is still early days to see if they will follow in Australia and in the US.

Financial crisis implies at least short term margin pain...:

As we highlighted before, we think that general insurance companies will perform better during the financial crisis than life insurers and banks. .

However we expect there will be some pain for insurers and reinsurers that have exposure to commercial, long tail insurance lines in particular. The table following shows our view on the exposure by class from both the impact on claims and the impact on yields.

Table 7: Ranking of Impact from Financial Crisis by Class of Business

| Classes | Possible Impact on Margins from Claims | Rank - Claims | Possible Impact on Margins from Yields (-2.0%) | Rank - Yields | Possible Impact on Margins - Total | Total Impact - Rank |
|-------------------------|--|---------------|--|---------------|------------------------------------|---------------------|
| Directors and Officers | -25% | 1 | -7% | 1 | -32% | 1 |
| Professional Indemnity | -7% | 2 | -7% | 1 | -14% | 2 |
| CTP | -3% | 4 | -7% | 1 | -10% | 3 |
| Public Liability | -2% | 5 | -7% | 1 | -9% | 4 |
| Workers' Compensation | -4% | 3 | -4% | 5 | -8% | 5 |
| Fire and ISR (Property) | -2% | 5 | -1% | 6 | -3% | 6 |
| Motor | 0% | 7 | -1% | 6 | -1% | 7 |
| Householders & Other | 2% | 8 | -1% | 6 | 2% | 8 |

Source: J.P. Morgan Views. Yields are assumed to reduce 2%

How insurers deal with these stresses depends ultimately on how quickly they move to increase rates. We believe the classes where rates are likely to rise the fastest are those where:

- Capacity is constrained and there are significant barriers to entry stopping new entrants.
- Where there has been significant consolidation, leaving a more rationale, less competitive environment.
- Where losses have been felt – providing an excuse for rate increases.

The industry has not had a good history of responding to pressures and we suspect that it will take a few months at least before adequate rate increases flow through - implying some short term pain to insurance margins.

Insurers with exposure to long tail commercial risks (particularly PI, D&O) will in our view have the most exposure to higher claims costs and lower yields.

There will be some short term pain to margins...

Is the global rates cycle turning?

Siddharth Parameswaran and Liam McCarthy, J.P. Morgan

The global rates cycle is very important for Australian insurers, as the supply of capital for commercial markets is global, and trends overseas will have impacts on rate trends domestically, as insurers seek markets to maximise their return on capital.

Up until the recent global financial crisis, premium rates around the world had been falling, and the consensus expectation was that global commercial and reinsurance rates would continue to fall into 2009. However, since the emergence of the credit crunch, a number of insurers have fallen on more difficult times:

- Global underwriters have suffered from equity market losses,
- they faced large weather related losses in the US in particular
- they are facing lower yields on assets going forward
- and they have had their surplus capital positions eroded as a result of all of the above.

As a result, we are seeing a change in views on the rates cycle around the globe. A number of large international insurance underwriters have recently been calling for rate increases. For the moment it appears that whilst rates appear to be hardening modestly in some reinsurance and some European direct insurance markets, rates in the US remain soft.

Reinsurers call for reinsurance rates to turn...

Munich Re comments

Some global reinsurers have indicated that rates need to harden soon. In particular, a member of Munich Re's board of management (Ludger Arnoldson) made public statements that it is expecting fairly large rate increases in reinsurance.

***Munich Re (Oct-2008):** "In view of the increased cost of capital, the growing demand and the changed risk environment, we expect significantly higher prices, with percentage increases definitely going into the double-digit range. Where Munich Re is unable to obtain the requisite prices, we will not write the business."*

- Munich Re has indicated that the capital base in the global reinsurance industry is likely to fall by 13% for the year ended 2008 as a result of the financial crisis and equity market falls. The Company also indicated that primary market capital will also be impacted.
- Munich Re believes that lower capital in the industry coupled with fewer refinancing options for the insurance industry in general will increase the demand for reinsurance.
- In addition, the Company believes that there will be a flight towards quality reinsurers with high credit ratings, which will further increase demand for reinsurance. Tougher economic conditions are also likely to put upwards pressure on claims frequency and claims inflation, which again will provide

further incentive for higher levels of reinsurance cover. As a result, Munich Re believe that higher demand will, in turn, put upward pressure on reinsurance rates.

While Munich Re may be looking for double digit rate increases, J.P. Morgan's UK analyst expects rates to increase by 5% for Munich Re, given that rates are likely to be renegotiated downwards at the start of a turn in the cycle given some reinsurers will likely try to win business in that environment.

Comments from brokers on December renewals suggest that there have been modest improvements in reinsurance rates.

Swiss Re comments

Swiss Re has also noted that a tougher financial market outlook could impact the rates cycle. Swiss Re's CEO in November, Jacques Aigrain, indicated that reinsurance rates were increasing.

Swiss Re (Nov 2008): "What is positive for us is that the premium rates in the reinsurance market are picking up again. We are seeing that the conditions and margins in the actual reinsurance business are improving."

Hannover Re comments

J.P. Morgan's UK analyst has indicated that Hannover Re is looking for strong premium increases (potentially double) in the Gulf of Mexico in the marine offshore lines. However, he has noted that increases in this class should come as no surprise given the losses from hurricane Ike.

Catlin and Amlin comments

We note that both Catlin and Amlin have also indicated that reinsurance rates are set to increase given the destruction of capital in the industry. Comments from the two insurers are outlined in the section below.

UK rates showing signs of increasing...

J.P. Morgan's UK Insurance analyst believes that the rate cycle in the UK is set to turn. The comments are consistent with those of Royal and Sun Alliance (RSA) which has indicated that it has managed to achieve rates increases in a number of commercial lines. RSA indicated in November 2008 that it increased commercial liability rates by 4%, commercial property rates by 7% and commercial motor rates by 9%. Other underwriters have noted that reinsurance rates could rise in the UK and that primary market rates are showing signs of stabilising.

Catlin comments

Catlin also expects reinsurance rates to increase given the reduction in capital in the industry resulting from the financial crisis and catastrophe events. Catlin expects rates to turn in the reinsurance market first with rate increases expected to spread to other lines in 2009.

Catlin (Nov 2008): "...these challenges – including Hurricane Ike and the turmoil in the financial markets – together with events affecting some of our major competitors have removed significant amounts of capital from the marketplace and are causing the market to turn. Rates for some types of reinsurance are already rising as a result, and we expect significantly

improved conditions for most classes of reinsurance and some classes of insurance by year-end renewals. We believe rates for many other classes of insurance will begin to rise later in 2009.”

Amlin comments

Amlin has commented that it expects rates to increase given the destruction of capital in the industry as a result of the financial crisis fallout and as a result of greater catastrophe losses from Hurricanes Gustav and Ike. The Company also expects reinsurance rates to increase before primary market rates. Amlin has indicated that UK commercial motor rates are increasing although liability classes still face discounting.

Amlin (Nov 2008): “Overall our expectation is that the rating environment will improve for many classes of business although the speed and extent of change will vary... Many insurance markets, such as the US and UK property and casualty industries, were already towards the bottom of their cycles. The difficulties experienced by a number of major participants should provide an impetus for rating improvement. We believe that reinsurance market trends will also add pressure for positive rate adjustments...The UK Commercial account remains mixed, with commercial motor now achieving modest rate increases although liability classes continue to see rate reductions.”

But the US rates are still soft...

In the US the picture on a turn in the rates cycles is less clear. We would note that comments issued along with third quarter results in the US did not offer a consensus opinion on when rates would turn. Some US underwriters indicated that rates need to increase, while others indicated that rates were still under downwards pressure.

Table 8: Rate expectations of certain underwriters from 3Q08 results season

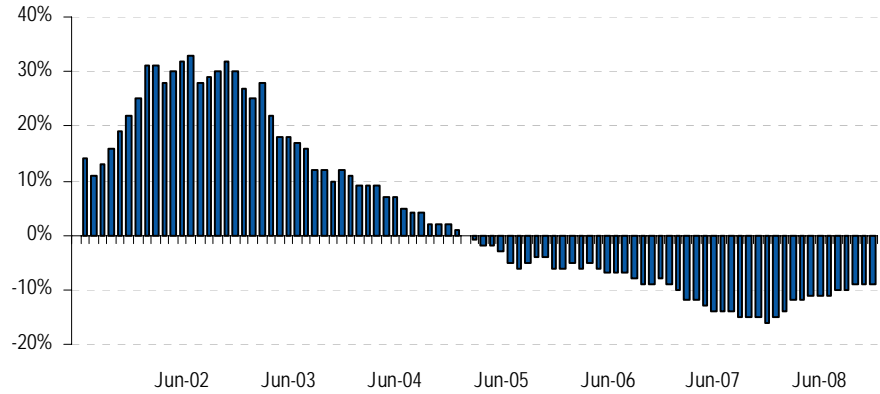
| Company | Indicating hard market (rate increases) | Indicating soft market (rate reductions) |
|---------------|--|---|
| ACE | ✓ | |
| AIG | | ✓ |
| Chubb | | ✓ |
| CNA Financial | | ✓ |
| Endurance | | ✓ |
| Hartford | ✓ | |
| Liberty | | ✓ |
| Markel | ✓ | |
| WR Berkley | | ✓ |

Source: Companies

J.P. Morgan’s US insurance analyst believes that reinsurance rates in the US could rise but remains sceptical on any rate recovery in the primary market.

At the end of 2007 the US primary market had US\$470bn in statutory surplus/capital. Our US analyst estimates that capital had fallen by 8% to November 2008. However, he notes that primary insurers still have capital levels similar to 2006 levels, which he feels places the industry in a more adequate capital position rather than being over-capitalised. As a result, while capital has fallen, the industry remains well capitalised to support further competition. A lower level of capital has resulted in a slow down in rate reductions, but overall rates are still falling.

Figure 26: US commercial rate movements



Source: MarketScout

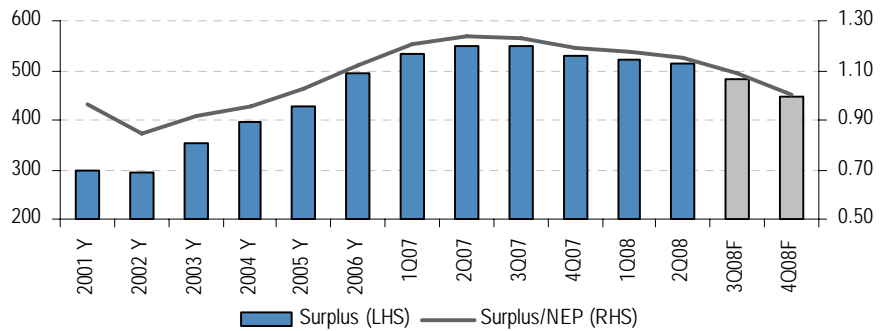
We would also note that actions at AIG could also delay an upswing in rates. Many competitors are seeking to attract their existing customer base and exploit their weak reputation. This is putting downward pressures on rates as AIG needs to maintain insurance volumes in order to sustain value in the business in light of desired asset sales. In our view then, competition in the US is likely to remain high and commercial rates are likely to remain under downwards pressure.

Rates turn on capacity; quickest in rational markets...

We believe rates turn quickest in markets where:

- There has been a significant reduction in capacity e.g. (1) after an insurer bankruptcy where suddenly many clients do not have existing insurers, or (2) if the ability of insurers to write business has been limited by a lack of capital. Whilst balance sheets have been impaired by the sub-prime crisis and weather events, we are not as yet convinced that this by itself has caused enough stress on the industry in all markets - as we were coming from a period where balance sheets were very strong and some insurers were engaging in capital management initiatives.

Figure 27: US property and casualty insurance industry capacity



Source: SNL, J.P. Morgan estimates

- Rates can also turn quickly in consolidated markets, with pricing power resting in the hands of a few. We believe reinsurance markets and the Australian personal lines markets are examples of this.

Conclusion

- We conclude that rates appear to be turning around the world in most commercial markets except in the US, but they have to given the impacts of the financial crisis.
- Rates in Europe and the UK are turning but we would note that higher rates were required given the poor level of profitability. In the US, we remain sceptical of a turn in the rate cycle given that capacity remains high by historical standards and that large participants are likely to fight to retain business.
- We believe that commercial rates in Australia have bottomed and will rise in 2009 and onwards.
- In our view, reinsurance rates are likely to increase before we see a full blown recovery in primary market rates. Demand for reinsurance products is likely to increase in the future given the uncertainty surrounding economic conditions and because of capital concerns. We would note that there is likely to be a flight to quality in the coming economic uncertainty, which should also increase demand for reinsurance. In addition, we would note that the reinsurance market has seen a good deal of consolidation, creating a more condensed market. At the end of 2005, Swiss Re purchased GE Insurance Solutions (at the time the fifth largest reinsurer) to create the world's largest reinsurer. All of these factors combined should give reinsurers a good degree of pricing power and we expect to see reinsurance rates increase quicker than primary market rates.

Performance Management

Deloitte

The Deloitte team has put together a number of articles under the common theme of performance management for this 2008 J.P. Morgan Deloitte General Insurance Industry Survey.

Insurers are facing increased competition and uncertainty from the current global economic conditions, therefore, success for insurers in this environment is likely to come from innovative business strategies and improved business operations.

The following articles explore current developments and include:

- **Distribution Channels:** a reflection on predicted and current trends - Elaine Collins and Catherine Dube
- **Granular pricing:** apply the science of predictive models to the art of underwriting – Elaine Collins and Kelly Cusick
- **Regulatory reforms:** threat or opportunity – Stuart Alexander and Siddhartha Medappa
- **Carbon emissions and oil prices:** turning challenge into opportunity – Paul Goswamy and Catherine Dube
- **Location Intelligence:** technology and data mining – Raffae Margossian
- **Talent:** identifying and retaining critical skills – Nicky Wakefield and Catherine Dube

These points of view offer insurers ways to differentiate themselves and leverage their strengths.

Distribution Channels: A reflection on predicted and current trends

Elaine Collins and Catherine Dube, Deloitte

This year, with the release of the 2008 survey, Deloitte and JP Morgan have completed a total of 16 years of General Insurance Industry surveys. Through this process, we have collected an impressive body of data, covering numerous facets of the Australian General Insurance Industry. In particular our data includes historical information on revenue by distribution channel since 1999. With each survey, in addition to collecting factual information, we have also recorded the underwriters' predictions on the makeup of the distribution channels two years and five years after a survey year.

A number of participants were interested, following the 2007 survey, to find out more about distribution trends. In response, we went back to the survey data collected since 1999 and looked at trends and predictions against actual experience.

Looking back, we identified the direct channel as one distribution segment within the commercial sector, which has failed to meet underwriters' predictions over the last few years. We also observed that underwriters had expected a significant growth in internet distribution, which has also failed to materialise. We explore these findings in greater detail below.

Current Distribution Network

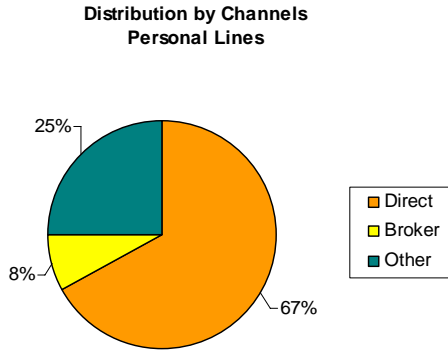
We categorised the distribution channels within both Personal Lines and Commercial Lines into three major categories:

1. Direct
2. Broker
3. Other

As illustrated in the charts below, the respective market shares within the Personal Lines segment as at November 2008 were: Direct: 67%, Broker: 8% and Other: 25%.

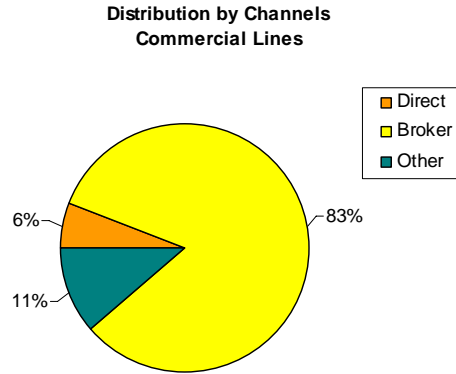
For the Commercial Lines, the market shares are as follows: Broker 83%, Direct 6% and Other 11%.

Figure 28: Distribution by channels - Personal lines



Source: Deloitte

Figure 29: Distribution by channels - Commercial lines



Source: Deloitte

Note: The “Other” segment includes General Insurance Agents, Underwriting Agencies, Strategic Alliance Partners, Affinity Group and for the Personal Lines only, it also includes Other Financial Intermediaries.

Direct growth: not as forecast

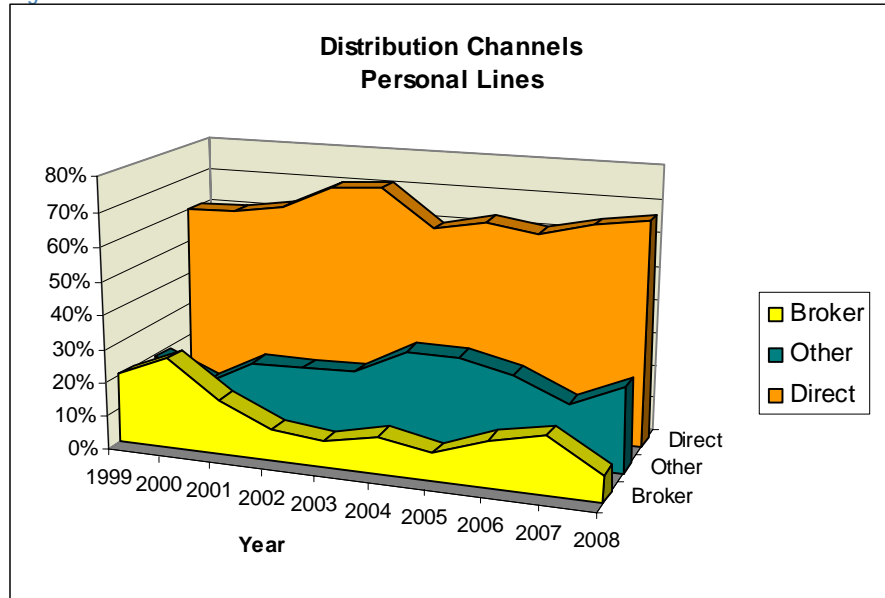
For some time underwriters have been predicting an increase in direct sales. In the commercial sector in particular, our historical data shows that underwriters in 1999 and 2000 had predicted this segment would generate up to 30% of total sales for the years 2004 and 2005. However, direct sales in the commercial sector remained low, reaching a market share of only 6% by 2008.

The advent of the internet was touted to become a major driving force revolutionising the way insurance products would be distributed. While the internet has changed business in many ways, it has not yet contributed greatly to the proportion of general insurance business generated through direct distribution in Australia.

Personal Lines

Figure 30, shows the historical split of business by distribution channels for Personal Lines business. Although the direct distribution channel makes up a significant proportion of total sales, it has not significantly increased since 2003. However, the graph shows an increase in broker usage since 2003. We believe this increase to be complementary to commercial lines being sold to corporate clients.

Figure 30: Distribution channels - Personal lines



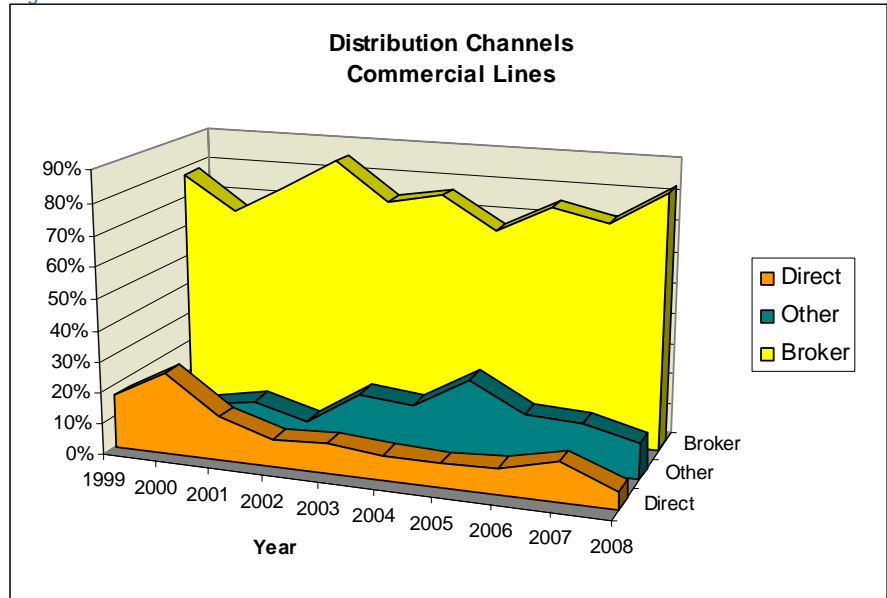
Source: Deloitte

For Personal Lines, the call centre channel has consistently been the predominant channel within the direct segment. In 2008, call centres made up 49% of direct sales, while the branch network (33%) and other channels (internet, direct mail, salaried staff and other direct) made up 18%. In 2008, underwriters are predicting that Personal Lines direct sales will grow to 88% of total sales by 2010.

Commercial Lines

Figure 31, displays the historical split of business by distribution channels for the Commercial Lines. The graph shows that Commercial Lines overall have not experienced an increase in direct distribution over the last six years, with the exception of 2007, where there was a slight increase.

Figure 31: Distribution channels - Commercial lines



Source: Deloitte

For the commercial sector, underwriters are not currently predicting any further increase in the proportion of sales via the direct channels over the next five years.

What happened to the internet?

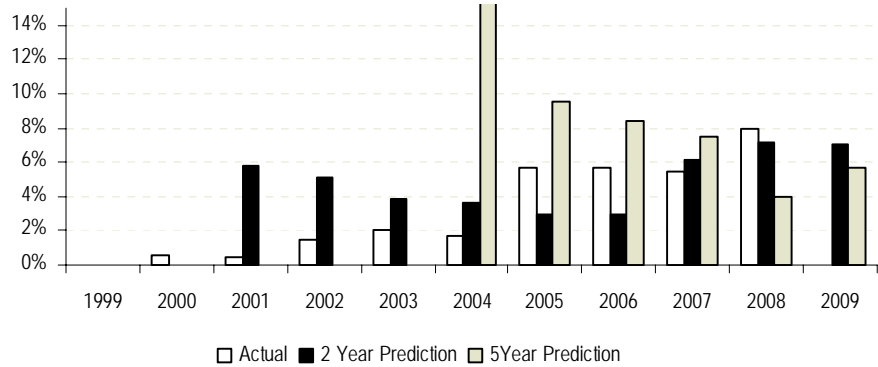
Underwriters have historically predicted, and continue to do so modestly, that the internet will be more widely used as a direct distribution channel for Personal Lines. However, our survey data shows that the internet is not growing as quickly as originally predicted by underwriters for either Personal or Commercial Lines.

Personal Lines

In 1999, underwriters were predicting that internet sales within the Personal Lines segment would make up 18% of total sales by 2004. A review of our survey results for the last few years paints a different picture. Although internet sales have grown, they have only reached a modest market share in 2008 of 8%. Underwriters have readjusted their estimates over the last few years and are now predicting market share for this segment to reach 8.5% and 9.2% of market share in 2010 and 2013 respectively.

Figure 32 compares the underwriters' two year and five year predictions for internet distribution of Personal Lines business, with actual reported figures.

Figure 32: Prediction Internet Distribution Personal Lines



Source: Deloitte
Note: The first five year prediction was made in 1999 for the year 2004

Current market developments

Despite our survey results showing modest growth prediction for internet distribution, current trends overseas and local developments indicate stronger growth than anticipated.

For instance, aggregators, or the operators of price comparison internet sites, are shaking up the UK car insurance market.

These operators are causing established insurers to look closely at their existing distribution operations to such an extent that one insurer, Norwich Union, has taken the unusual step of bringing the aggregator’s function under its own roof and displaying competitors’ prices on its own website. While the aggregator is playing a major role in UK distribution, we note that in the US, the expansion of the aggregator sites has been more limited due to the high level of price regulation.

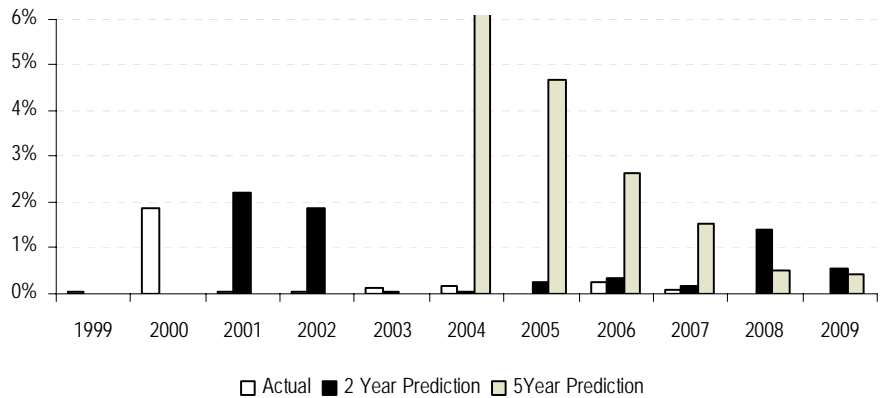
Although there is not a proliferation of insurance aggregators in Australia, there is, for example, one operator, RateCity, providing price comparison for auto insurance. In addition, insurance providers that operate purely online, such as Budget Direct, Bingle and more recently Youi have emerged in the Australian market. These insurers can achieve cost savings, which can be passed on to customers in the form of lower premiums by streamlining processes and allowing consumers to manage their policies online. The online insurers are not only limited to auto insurance. Budget Direct also offers home and contents insurance, travel insurance and pet insurance, and Youi is planning to offer home and contents insurance next year and eventually an even broader insurance offering.

Commercial Lines

In 1999, underwriters were predicting that internet sales would make up 8% of total distribution in the Commercial Lines market by 2004. The internet did not match these expectations, with sales showing internet having a nil market share in 2008. Currently underwriters are not predicting that internet distribution will have any further market penetration over the short term and are only predicting a negligible market share of 0.18% by 2013.

Figure 33, offers a comparison of the underwriters’ two year and five year predictions for internet distribution with actual reported figures.

Figure 33: Prediction Internet Distribution - Commercial lines



Source: Deloitte

Note: The first five year prediction was made in 1999 for the year 2004.

Insight from brokers

We gained qualitative evidence from a sample of brokers as to why the internet had failed to gain popularity within the commercial sector, and collected their opinions on the potential for its use.

Brokers expressed the view that the potential for internet sales in the commercial sector is limited because customers prefer to talk to brokers - they want a customer advocate to ensure that services are comprehensive and targeted in line with their individual needs.

Brokers see the internet as more of an interface between the broker and underwriter than between the customer and underwriter. Some large brokerage firms have established their own platforms to facilitate the entry of data and the automatic transmission of information to multiple insurers. These platforms seem to be mainly used for the small/medium enterprise businesses. For major corporate clients, brokers still tend to want to talk with the insurer (although the data may be transmitted electronically). Nevertheless, brokers see the internet as a way to improve their effectiveness and expect further improvements in platforms and internet use between brokers and underwriters to increase over time.

Where to from now?

In our opinion given the current economic conditions, insurance purchasing decisions are more likely to be driven by price, and insurers that can offer customers products at a cheaper price are likely to be at an advantage. In the Personal Lines market we are seeing the entry of smart online operators offering products at a lower price with unique online features and services. Although these players are of modest size, they are leading the way with continued innovation in distribution, pricing and product design. The cost advantage inherent in a business model built around the internet is likely to encourage more insurance providers down the internet path.

Granular pricing: apply the science of predictive models to the art of underwriting

Ellaine Collins and Kelly Cusick, Deloitte

In a highly regulated, capital intensive, price sensitive, mature industry like general insurance, the ability to differentiate and emerge as a market leader is a challenge faced by all competitors. Market leaders emerge through innovative business strategies, improved business operations and the leveraged and strategic use of analytics and technology.

Historically, general industry performance has been at the mercy of catastrophic events and pricing cycles. Unless general insurers embrace analytic and technology enabled strategies for growth and profitability, they will continue to operate in an environment where they are swapping risks in a highly commoditised industry resulting in a 'zero sum game'.

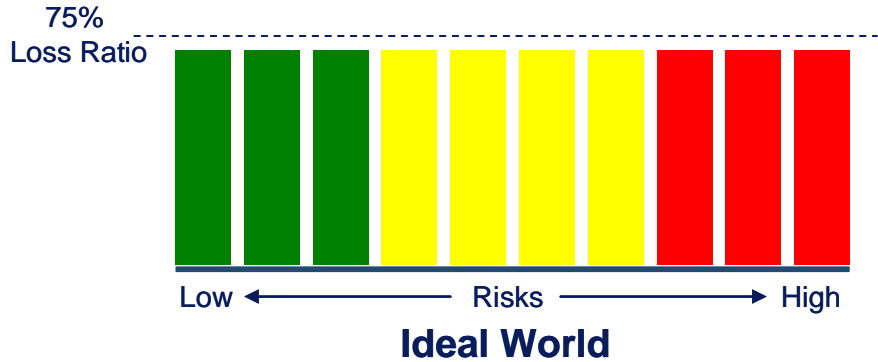
One way to break away from the competition and achieve profitable growth is through more granular risk segmentation and pricing using data mining techniques and predictive modelling. These tools provide general insurers with an enhanced ability to identify and target the most profitable customers, even within traditionally challenging risk classes, and then offer a price commensurate with the underlying risk.

The business problem

It is understood that detailed underwriting is the cornerstone of a profitable book of business. Many underwriting decisions include a subjective component, which leads to a great deal of variability in underwriting and pricing decisions and from market pressures from intermediaries.

Traditional underwriting has consisted of the endless search for more meaningful insight into individual policyholder risk characteristics that would improve an underwriter's ability to distinguish good risks from the bad and to accurately price each risk accordingly. In theory, policies across the risk spectrum should be priced appropriately such that insurers can service the claims and earn a profit, as illustrated in Figure 34.

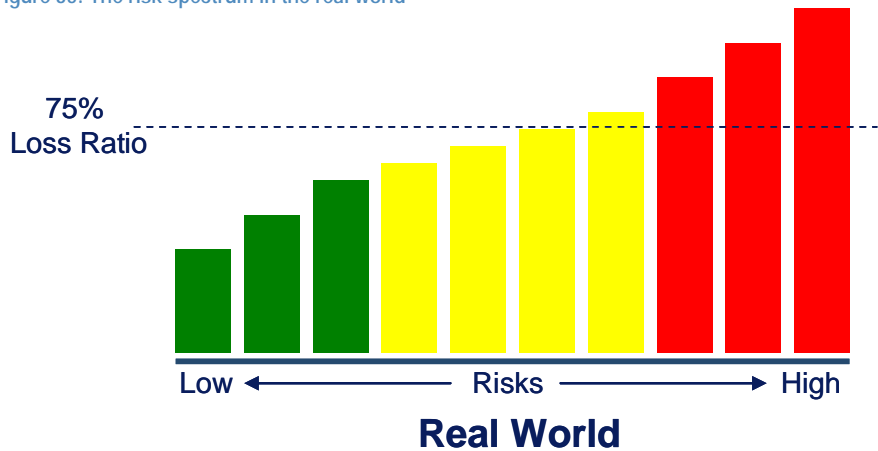
Figure 34: The risk spectrum in the ideal world



Source: Deloitte Actuaries & Consultants

However, in the real world, this is rarely possible. The underwriting process is impacted by pressures to grow profitably, often counter-intuitively in soft markets, with few truly insightful underwriting tools to help improve segmentation and pricing discipline concurrently. This results in a loss ratio pattern, as illustrated in Figure 33, where potential disparities in pricing exist because risk exposure cannot be properly identified or pricing categories are too broad.

Figure 35: The risk spectrum in the real world



Source: Deloitte Actuaries & Consultants

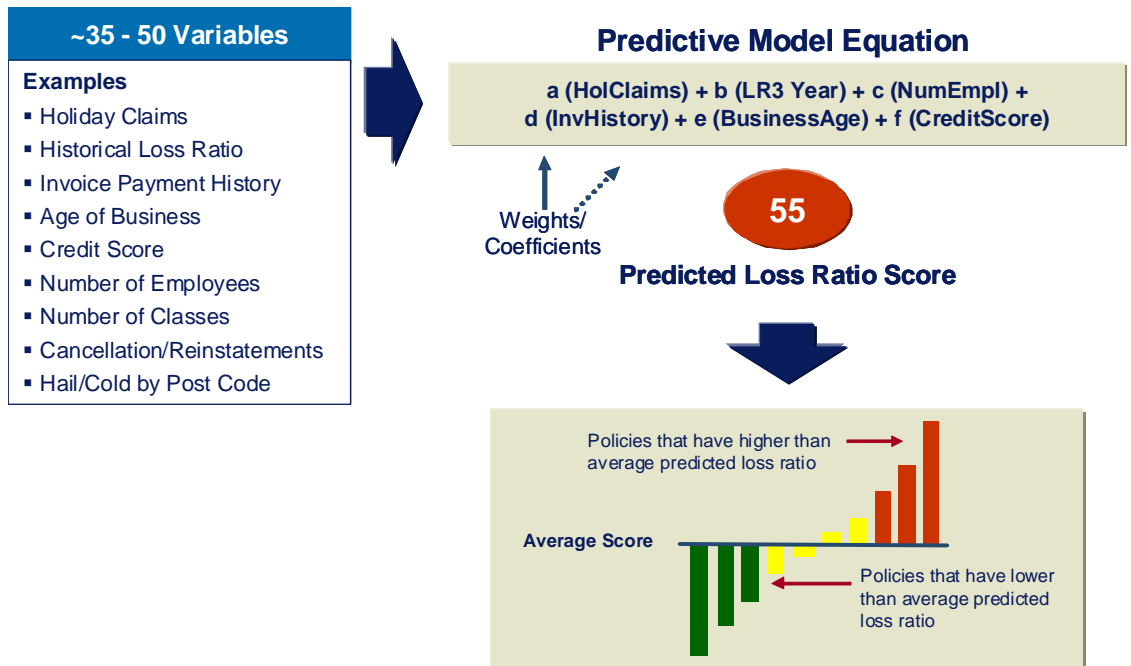
Tools such as predictive models offer underwriters a statistically sound, objective and consistent method to improve underwriting and pricing sophistication that can dramatically affect the bottom line. In addition, these tools can help insurers differentiate themselves and remain profitable in a highly competitive market.

Predictive modelling enables granular pricing

Data mining and predictive modelling is the process by which historical data is carefully examined to identify patterns in the data, many of which were previously unknown, to formulate an algorithm that can be used to solve a specific business problem. For underwriting and pricing applications and historical internal customer data, supplemented with external data sources, this can be examined to develop a

solution that can be used to predict the relative risk of an individual policy in the future term.

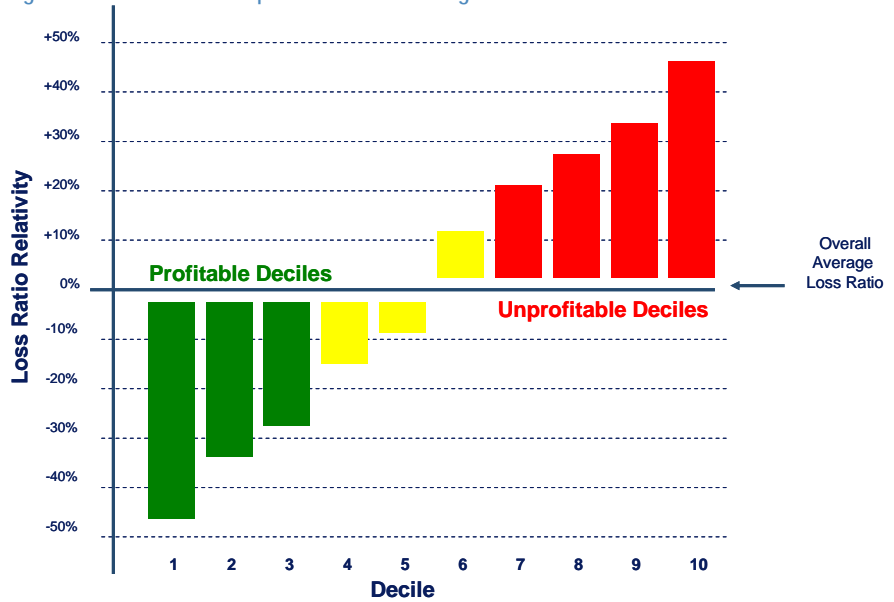
Figure 36: The predictive modelling process



Source: Deloitte Touche Tohmatsu

The predictive model equation can then be used to forecast a loss ratio score for a particular policyholder based on its risk characteristics. This is repeated for a portfolio of policies. The overall output of the model is a 'lift curve', where policies are grouped into deciles based on their relativity to the average loss ratio, as shown in Figure 37.

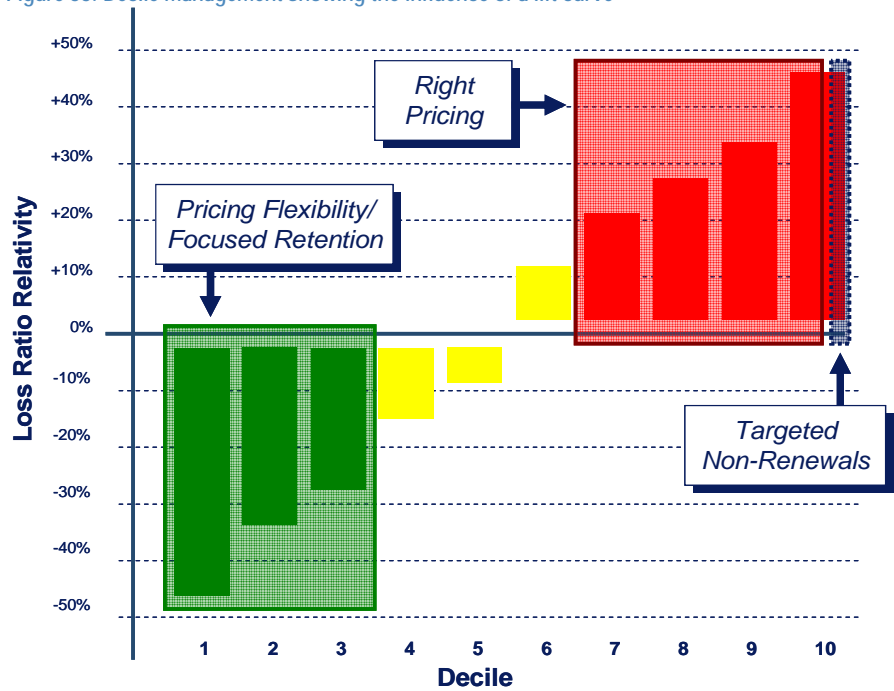
Figure 37: An illustrative depiction of decile management



Source: Deloitte Actuaries & Consultants

Decile management, or the ability to accurately and objectively price risks across all risk segments, is the cornerstone of achieving financial benefits from a data mining and predictive modelling solution that is fully integrated into an insurer’s underwriting business processes. Figure 38 illustrates how a lift curve can be used to make tactical underwriting decisions.

Figure 38: Decile management showing the influence of a lift curve



Source: Deloitte Touche Tohmatsu

Underwriters can leverage these tools to prospect for more profitable books of business. With the ability to identify sub-segments of business with a greater likelihood of generating profitable future returns, underwriters now can more adequately price prospective books of business in a much more uniform manner than ever before and pick the best risks, even from some of the more challenging classes. Most importantly, this targeted pricing deters underwriters from over pricing books since they can employ a tool that 'right prices' the risk and its exposure.

Integration with business processes brings models to life

Data mining and predictive modelling solutions go beyond the purely technical. Organisations that take a holistic approach to predictive modelling projects, involving key resources from underwriting, actuarial and IT departments, can achieve maximum success by aligning various business functions and implementing change management principles to incorporate these solutions as part of their day-to-day operations.

Predictive models do not replace underwriters. Rather, they are tools which facilitate the creation of a streamlined back office processing environment, allowing underwriters to manually review only those risks which do not readily lend themselves to an automated solution. Therefore, underwriter input into development of the model and business process redesign is critical.

When delivered properly, the output from predictive models provides valuable insights and guidance. For instance, reason code messages, which are based on the variables that impacted a risk's model score most highly, can be used to better explain resulting policy actions and validate underwriting beliefs. Model output can also be used to selectively apply expensive supportive underwriting services, such as targeted loss control and audit services, only to the accounts that warrant them.

The business value

Early adopters are provided with the ability to better select, manage and price risks. Although the larger insurers are making progress in the personal lines, widespread adoption of predictive modelling has been slower as have been with predictive modelling approaches for Commercial Lines. However, industry enthusiasm for predictive modelling in commercial insurance is growing and has been proven successful in markets.

First movers in implementing predictive modelling approaches noted the following benefits:

- competitive differentiation due to unique insights into risks and more precise rates
- attraction of intermediaries' business due to pricing consistency and faster decision making ability
- operating efficiencies through automation
- improved monitoring capability, enabling quick response to changing market conditions.

The combined effect of these benefits results in an enhanced opportunity for profitable growth.

By leveraging the new insights uncovered through data mining and predictive modelling, insurers are better able to identify accurately and compete in their existing businesses and a variety of new markets.

Insurers that fail to pursue similar underwriting tools will be facing adverse selection on a broad scale, leaving them subject to outdated underwriting processes in the face of another softening rate environment.

Regulatory Reforms – threat or opportunity?

Stuart Alexander and Siddhartha Medappa, Deloitte

Introduction

Since the Australian Prudential Regulation Authority (APRA) introduced the regulatory supervision framework for general insurers in 2002, the industry has been subject to a strong regulatory discipline. This has resulted in a well capitalised industry with more accurate pricing of risks, stronger governance frameworks and prudent liability provisions. Australian insurers are, therefore, managing the current financial crisis well.

As the general insurance industry has evolved in its risk management practices and capital adequacy frameworks, APRA introduced further refinements to the supervision framework for general insurers in 2006 and 2008.

APRA's regulatory reforms moved from a predominantly prescriptive 'rules based' approach to a 'principles based' approach. The main components of the evolving regulatory framework are capital, governance, risk management and reinsurance.

Regulatory reform may create both threats to, and opportunities for, profitable growth. As long as compliance costs can be proactively managed, reforms that recognise marketplace advancements can ultimately lead to positive outcomes for responsible insurers.

What are the key implications of the current reforms?

A robust and progressive regulatory framework has several key implications on the market as a whole. Adoption of the following suggested strategies for implementing APRA's current refinements may enhance a company's ability to achieve profitable growth.

Set the tone from the Top

The Board and senior management of insurance companies set the tone for risk management, compliance and governance throughout the organisation. The leadership needs to define a consistent set of practices across the enterprise and make sure the employees within the organisation are aware of these practices. The principles should be clearly articulated, incorporated into training and reinforced by management.

Adopt an enterprise-wide approach to risk management

Organisations in the past operated with a silo-based approach to risk management, which resulted in fragmented risk management policies and practices. The refinements to the regulatory framework, in step with emerging practices in the competitive landscape, have pushed insurers to adopt a holistic view to risk management. The benefit of this approach is it allows leadership to manage the spectrum of risks across the organisation and to better understand their interrelationships.

Risk officers within organisations drive this holistic approach by standardising risk management process, aggregating a view of all risks and relating the risks to business objectives. Developing a uniform methodology for documenting risks and controls based on the risk profile, then demonstrating that these are embedded within the organisation through rigorous testing is a key challenge. However, companies that get this right from the outset are viewed favourably and can avoid the cost of persistent back-and-forth with the regulator.

Focus on risk based capital requirements

APRA's capital adequacy requirements have traditionally provided insurers with the option to maintain minimum levels of capital using a formula-based method (the Prescribed Method) or a method based on explicit modelling of the company's risks (the Internal Model Based Method).

The Prescribed Method has been the favoured option by insurers due to its ease of use and generally suitable resulting capital levels.

With Solvency 2 looming and APRA's release of a draft standard (GPS 113) for use of the Internal Model Based Method, insurers have more incentive to compare whether risk-based capital would free up regulatory capital for more efficient use, such as supporting growth initiatives. This may see subsidiaries and branches of European insurers in the Australian marketplace experience a potential push towards risk based regulatory capital from their overseas parents.

A risk based regulatory capital approach involves a robust quantitative modelling capability and comprehensive supporting governance and control processes. To ensure success, organisations need to deploy teams of dedicated and skilled resources. The implementation team should include a range of specialists, with expertise in risk management, actuarial, change management and IT.

Shift ownership from Regulator to Insurer

The rules based regime could be viewed as a one size fits all approach, as requirements did not substantially vary for different categories of insurer. Organisations responded to the prescriptive regulatory framework with a tick-the-box approach to compliance and risk management, depending heavily on APRA's judgement and recommendations.

The new principles based regime, which recognises differences by category of insurer, shifts the ownership of compliance and risk management back onto the company. The Board, senior management and other employees set the risk appetite and monitor the risk profile of the business. By truly understanding the risks of the organisation and armed with a clearly articulated risk appetite, managers are better able to take advantage of growth opportunities in the market. With this authority also comes increased accountability and increased data requirements which may be harder to meet for smaller insurers. Hence all insurers will need to employ, train and retain the right staff to be successful.

Think strategically about reinsurance arrangements

The recent regulatory reforms focussed quite heavily on the counterparty risk associated with reinsurers, removing previous concessions for reinsurance recovery recognition. APRA's intent is to insulate Australian insurers as much as possible

from the risk of default from non-APRA authorised reinsurers with the ultimate aim of protecting policy holders.

In the past, APRA provided capital relief for intra group reinsurance arrangements and no additional capital implications for placement with non-APRA authorised reinsurers. However, the revisions introduce new capital factors for unsecured recoverables from non-APRA authorised reinsurers and clearly specify the minimum standards for collateral.

The following table highlights the dramatic change in capital charges for reinsurance recoverables once the revisions have been completely phased in:

Table 9: Capital charges

| Counterparty Grade | Current Capital factor: APRA authorised Reinsurers | New Capital factor: Non-APRA-authorised Reinsurers | Future Capital Charge (for reinsurance recoverables from contracts on or after 31 Dec 2008) |
|--------------------|--|--|---|
| 1 | 2% | 3% | 20% |
| 2 | 2% | 3% | 40% |
| 3 | 4% | 6% | 60% |
| 4 | 6% | 9% | 100% |
| 5 | 8% | 12% | 100% |

Source: APRA

The new capital factors, in addition to other changes related to reinsurance contractual agreements, pose a threat to profitable growth if not managed strategically. Insurers should understand how current and future reinsurance arrangements impact capital utilisation and the risk profile of the company.

The example below illustrates a potentially tricky situation created by the revisions. Despite a clear distinction in the S&P Ratings of a Grade 3 and Grade 4 insurer, the same capital factor is applied to reinsurance with a Grade 4 APRA authorised reinsurer and a Grade 3 non-APRA authorised insurer.

Table 10: Capital factors

| Counterparty Grade | Standard & Poor's | Capital Factor: APRA authorised | Capital Factor: Non-APRA authorised |
|--------------------|-------------------|---------------------------------|-------------------------------------|
| 3 | A+, A, A- | 4% | 6% |
| 4 | BBB+, BBB, BBB- | 6% | 9% |

Source: APRA

As a result, insurers may select a lower rated reinsurer over a higher rated, potentially superior, reinsurer if the lower rated insurer provides a better price for the placement. Therefore, insurers and reinsurers will need to be very clear about the counterparty risk resulting from reinsurance strategies and understand the capital implications.

Furthermore, reinsurance capacity in the Australian market might be affected if changes in reinsurance placement are widespread. This poses an additional threat for insurers who wish to rely on reinsurance, particularly from overseas markets, to minimise risk while prospecting for new areas of profitable business. Some smaller insurers, heavily reliant on reinsurance, have voiced concern over the impact of the new requirements on their business models.

Ensure that compliance collaborates with business

Using the current global financial markets as a yardstick, organisations need well trained compliance professionals with relevant business experience more than ever. Taking a holistic approach to risk management means that compliance is built into oversight, systems, process and performance. Most importantly, when compliance is integrated into the business and day-to-day processes, it is easier to create a risk management culture, enforcing responsibility and accountability at all levels within the organisation.

Be aware of new market entrants

The introduction of Direct Offshore Foreign Insurers (DOFIs) in the Australian market place has the potential to increase competition and further diversify the current insurance market. In the past DOFIs were used to provide specific classes of business at more competitive rates. For instance, large law firms utilised DOFIs for “top up” professional indemnity cover when commercial market rates were prohibitively high. The threat of DOFIs capturing underserved profitable business creates the added incentive for Australian insurers to innovate and expand their product offering.

Conclusion

APRA continues to reform regulation to ensure that the general insurance sector is well capitalised with healthy solvency coverage to provide policy holders with adequate protection.

Ongoing regulatory evolution will rely increasingly on principles and outcomes rather than prescribed rules. This provides incentive for insurers to enhance their governance, risk management and improve their capital efficiency in the business. Likewise, this means APRA must remain consultative and develop the right skills to be efficient in its approach to market supervision.

Though regulatory reforms often bring the spectre of increased compliance costs, the recent revisions to APRA’s regime largely mirror global developments in enterprise risk management and principles based regulation. By proactively implementing the strategies outlined above, Australian insurers will gain a better understanding of current risk profiles and the ability to take advantage of market opportunities thereby creating a competitive advantage in the future.

Carbon emissions: turning challenge into opportunity

Paul Goswamy and Catherine Dube, Deloitte

Introduction

Global warming is expected to alter the world as we know it and insurers are feeling the heat. We are seeing increases in the frequency and severity of weather-related events as worldwide the oceans are warming, forest fires and floods are increasing and more severe hurricanes are forming.

In light of the increasing certainty of climate change, some insurance companies are beginning to adopt a new business perspective by building their knowledge on environmental issues and identifying business opportunities. These visionary companies are providing products and services that speak to the “green” revolution.

We explore in this article the potential for motor insurers to introduce products which will assist consumers to reduce their fuel consumption and help reduce greenhouse gas emissions. With consumers now facing volatile oil prices, there is an opportunity for motor insurers to play smart and make the most of the situation.

Green Insurance – An example of an innovative initiative outside the motor industry

We have seen globally a number of innovative, environmentally friendly insurance initiatives in recent times. One such example of these is the introduction of “green” insurance programs that will allow homeowners to reconstruct their insured property with more environmental friendly building materials, appliances and landscaping, even if it costs more than the replacement value stated in the policy. This is quite a significant departure from the traditional concept of insurable interest where insurers typically only pay to return clients to their original position.

Insurers see the product as a way to hook a consumer market that has grown increasingly conscious of environmental issues and they see this as a new way to attract and retain customers. Furthermore, these insurers consider the program to be in their long term interest since they will also eventually benefit from any resulting “slow down” in climate change. These insurers are seizing on what they see as a significant growing green movement.

Although green products may be sold initially at a premium in some areas, in the future, homeowners who build to greener standards may be seen as lower risks and could be rewarded with insurance discounts or credits. This is already happening in the commercial building segment and in motor insurance, where insurers in some jurisdictions are offering premium discounts to hybrid car drivers. Adopters of climate-change mitigation technologies, being socially conscious individuals, are considered by these insurers as being low-risk customers.

Transport sector and carbon emissions

In Australia, emissions from road transport account for 12.6% of national greenhouse gas emissions, with passenger cars accounting for around 7.8 per cent of total national emissions (a). The transport sector was described in a recent government media release as being “the third largest and one of the fastest growing sources of carbon pollution in Australia, with more than 14 million registered vehicles on our roads”.

The Australian government is exploring potential measures to tackle the issue and recently released the *Vehicle Efficiency report*. The report evaluates eight measures designed to improve the fuel efficiency of vehicles operating in Australia, with each measure falling under one of the following objectives: (a) measures to increase the supply of low emissions vehicles, (b) measure to increase demand for low emissions vehicles and (c) measures to improve consumer awareness.

In response to reducing oil supplies and environmental issues, we are seeing changes in consumer’s car purchases, driving patterns and attitudes towards alternate modes of transportation. The composition of new passenger vehicles has changed significantly in recent years with a marked increase in the sales of smaller cars. While sales of hybrid cars remain comparatively low, there are a growing number of imported diesel powered passenger cars coming onto the market which offer improved fuel and greenhouse efficiency (b). According to media reports in July and August 2008 a surge in passenger numbers using public transport in response to increases in oil prices was reported (c). People were also reported to be holidaying closer to home.

(a) Federal Chamber of Automotive Industries. CO2, Emissions & Climate Control

(b) Vehicle Fuel Efficiency – Public Discussion Paper

(c) Gerard Burg, a minerals and energy economist with NAB Age 31 May 2008

Pay as you drive: recognising and rewarding lower fuel usage

Motor insurance rates are directly correlated to the risk of accident. Insurers assess the risk profile of a particular driver and charge a premium commensurate with the established risk profile. Motor insurers currently consider a range of factors when assessing risk profiles and determining premium rates such as driving history, suburb, credit history (in some jurisdictions), gender, age and car model and make.

Another factor that influences the risk of collision and should therefore influence the premium paid, but that is largely ignored by Australian Motor Insurers, is the amount of time a car is driven. Insurance rates should be directly correlated to the risk of accident, which is tied to how often, how far and under what conditions a vehicle is driven.

Some insurers overseas have already introduced distance driven as a rating factor. A few actively check odometers for the exact distance driven but the majority only require the “mileage” estimate to be provided by the insured. Policies covered under such programs are known as pay-as-you-drive insurance. Recently, the first pay-as-you-drive scheme was introduced in Australia.

While this is still in its infancy, pay-as-you-drive technology is emerging for insurers to accurately reward drivers with a small carbon footprint. A device is installed to the car that tracks how far it travels. This data can be uploaded to the insurer or sent to

them automatically. Users are charged for their car insurance on a monthly rather than annual basis.

As well factors such as location and type of car, the cost varies according to how often and at what time of day the driving takes place (e.g. accidents are more likely during peak hour).

The technology also has the potential to reward drivers for safer driving by capturing other information such as whether the driver drives at low speed and more softly hits the brake. These actions reduce both a drivers' chance of accident and carbon footprint.

In addition to rewarding drivers for lower mileage, there are other positive benefits from the technology, such as the ability to locate a vehicle in the event of theft and the ability to charge younger drivers more for kilometres driven at night (since they are more likely to have an accident at night than during the day). The technology also has the potential to provide insurers with instant notification of accidents and further enhancements such as panic buttons could also be considered.

By determining premium rates based on how often, where and when people drive, insurers give consumers greater control to adjust their driving patterns to lower their fuel costs and reduce greenhouse gas emissions.

California's proposed pay-as-you-drive Auto Regulation

California's Insurance Commissioner, Steve Poizner, recently proposed the introduction of a pay-as-you drive program for auto insurers operating in the State of California.

Under the proposed regulation, motorists will be able to choose insurance plans with premiums partly based on the number of miles they drive within a year. Insurers will track mileage in a number of ways from checking odometers, readings from auto repair shops or even installing devices in cars. However, to protect driver's privacy, the insurance commissioner promised that he would "not approve any auto insurance policy that aims to utilize GPS devices in order to obtain location data from consumers".

The program is planned to start by October 2009. Other States are also considering similar programs. The Brookings Institutions' Hamilton Project predicts that a pay-as-you-drive plan in California could reduce distance driven by light-duty vehicles by 8 percent.

But it might be a bumpy ride – the Norwich Union experience

Being an early innovator does come with some risk as the Norwich experience with pay-as-you-drive illustrates.

A few months ago, Britain's biggest insurer Norwich Union withdrew its pay-as-you-go insurance offering – one of its flagship insurance programs – less than two years after its launch.

The number of customers that had signed up had been much lower than anticipated.

Norwich blamed a slow take-up rate of the technology amongst car makers. Norwich expected the motor industry to readily adopt the tracking devices, which would have brought the insurer's costs down, but the expectation did not materialise. What's more, concerns over the tracking capabilities were a contentious point as potential policyholders expressed concerns over privacy and the use of the data generated from monitoring vehicle movements.

The Norwich experience highlights the importance of getting the timing right and of working with governments to enact sensible laws and regulations to support socially and environmentally beneficial programs.

Embrace the opportunity

Historically the insurance industry has led the way in addressing mitigation and risk management. With new business opportunities to embrace and the ability to influence public policy, the time has come to move beyond talking about the weather and to do something about it. Furthermore, the public has largely accepted climate change as a fact of life and is looking to government and business to respond.

The Australian Government is responding and has committed to cutting greenhouse gas emissions by sixty percent from 2000 levels by 2050. In addition to the implementation of the Carbon Pollution Reduction Scheme (CPRS) expected to commence in 2010, the government is also considering complementary measures within the road transport sector.

Motor insurance companies are facing the opportunity to actively participate in lowering green gas emissions and create for themselves a positive image of a caring and environmentally responsible organization. Insurers are facing a consumer market that has grown increasingly conscious of environmental issues and insurers will need to take action in order to attract and retain consumers.

Some motor insurers have already put in place tools on their website to help their customers deal with the increased petrol prices, such as offering fuel efficiency driving tips or fuel prices information. The emergence of new technology is giving motor insurers the opportunity to work even closer with consumers in helping them reducing their fuel bill by rewarding changes in driving habits that commonly reduce the risk of accidents and greenhouse gas emissions.

Furthermore, the access and use of technology by insurers to track distance driven will give insurers a foot in the door to eventually track other driver behaviour and further refine their rating capabilities. Insurers that lag behind are likely to find themselves at a competitive disadvantage.

Australian Motor Insurers have the opportunity to create a competitive advantage for themselves by taking an active part in bettering the environment, becoming proactive in working with government, and helping consumers. And the best thing about it is that everyone will benefit.

Location Intelligence: What is it? How can it be used, and what value does it provide?

Raffe Margossian, Deloitte

Raffe Margossian a Financial Services Industry Director with Deloitte explores how more and more Australian insurers are using a technology that makes use of geographic or “location intelligence” as a “business intelligence” service to deliver superior customer, product and channel insights.

Research³ shows that more than 60-80% of all insurance data is geographically based. Consequently, leveraging location is important in improving profitability and reducing cost.

Location intelligence helps executives and enterprise-level users make critical business decisions by using economics, demographics, geography, customer profitability and other location-based data.

Using location intelligence, life insurers for instance can answer key customer questions such as:

- Who is my ideal customer?
- Where are these “best customers” located?
- What is the most appropriate imagery, messaging, and media to use to appeal to the demographic, lifestyle, and consumption patterns of my highest lifetime value customers?
- Which products are best to cross-sell to various customer segments?
- How can I optimise distribution to cover my most valuable customer segments?

Target customer clusters and areas of opportunity can then be more effectively reached by sales, distribution, and marketing.

More and more life insurance companies are employing location intelligence to help them better identify, measure, and report on business metrics such as available market, market penetration and producer effectiveness.

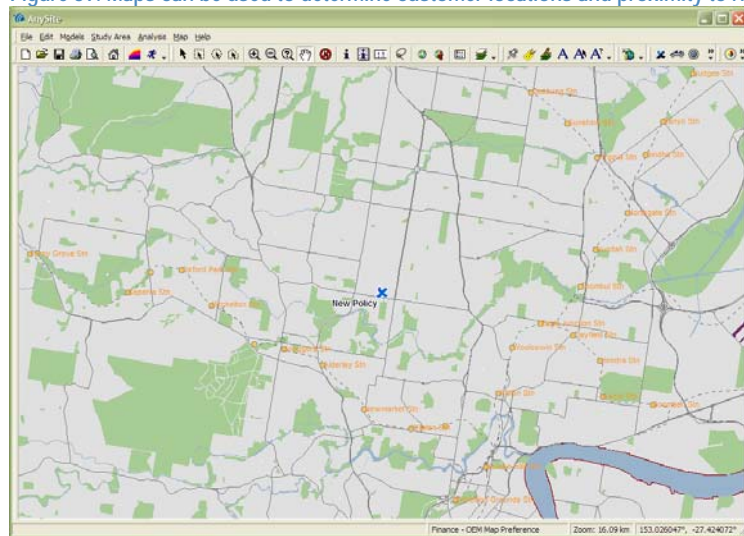
This new source of information includes the demographics, economics, physical geography, and other characteristics that pertain to location — the spatial environment in which an organisation operates, interacts with its customers, and transacts business.

³ Deloitte client research, Mapinfo (Business Wire 16 Aug 2007), Esri Australia

This data exists independent of whether or not it is noted. The data becomes valuable to an organisation, however, only when it is collected and analysed, and when the conclusions resulting from its analysis are used to inform the organisation’s decision-making.

For instance, data like a city’s population can serve as a rough gauge of a market’s potential, but only relative data — a matching of branch locations to local demographics, or the comparison of a company’s own network to those of its competitors — can yield true location intelligence.

Figure 39: Maps can be used to determine customer locations and proximity to risk factors



Source: Mapinfo

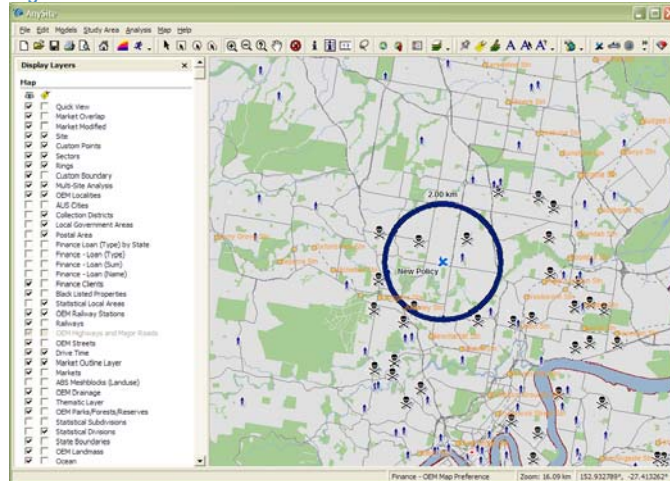
Ultimately, location ties all of the other data points in an organisation’s operations together. Similarly, basic mapping data can tell an insurance provider where its policies are located in relation to a flood zone or other high-risk areas. But only with a richer set of location-specific data could the provider automatically and accurately determine a policy applicant’s exact distance from a waterway or river, the overall risk exposure, and the optimal excess — resulting in improved underwriting, customer service, and claims management practices.

These and many comparable examples confirm that location intelligence is just what it appears to be: invaluable organisational intelligence, drawn from both the organisation’s and customers’ locations that can enhance the understanding of the organisation’s operating environment, and so be used to increase revenues, reduce costs, and improve profits.

It is the same kind of value that CRM-style analytical solutions began bringing to customer-facing organisations a decade ago. Like those customer intelligence solutions, which depended heavily on advanced information technologies for their analytical and data-management power, so too location intelligence solutions are now being powered by advanced analytical and data-processing tools that can detect patterns, risks, and opportunities that otherwise would be invisible.

By integrating and combining location-enabled technology with information, the process of decision-making is enriched. And in fact builds another dimension of business intelligence by helping detect patterns, risks, and opportunities that are often difficult to see in a basic spreadsheet analysis.

Figure 40: Locate fraudulent insurance risks



Source: Mapinfo

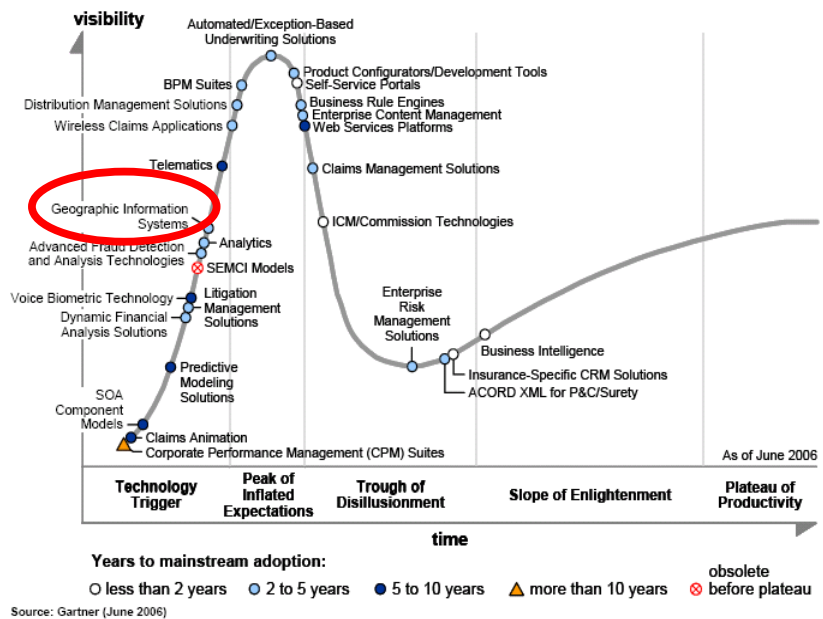
Originally used for public transport, infrastructure planning and design, location intelligence is used in the financial services sector as both a tactical solution and an enterprise strategic solution.

With the growth and availability of granular data, location now plays a greater role in better understanding segment concentration by geographic region for targeted product and advertising campaigns. It also supports financial services institutions develop product alignment strategies by projecting sales by product area, using geographic data on segment, population, and demand factors.

Indeed, the use of Geographic Information Systems (GIS) to create location intelligence is becoming mainstream.

Figure 41: Hype cycle for P&C Insurance, 2006

Figure 1. Hype Cycle for P&C Insurance, 2006



Source: Gartner (2006)

Making sense of place

Almost all activities within organisations exhibit what can be termed “a location” component – that is they happen somewhere. Every day, organisations make decisions to invest, to grow, to monitor, and to promote in support of objectives. These decisions are made by different people in different functions, but they share a common aspect – their geography.

Location intelligence is the capability to organise and understand complex information through the use of geographic relationships inherent in all information. Applied in a business context, the outcomes become meaningful, actionable and can provide a sustainable competitive advantage.

Building location intelligence successfully requires business specific domain knowledge and frameworks.

Indeed location intelligence is about transforming business processes and creating opportunities.

Location intelligence applications are generally industry specific. However, within that framework, uses of location intelligence can be sorted into three sub-categories:

Consumer applications: enterprise applications that build loyalty among customers and influence purchasing behaviours. For example, insurers can execute branch-specific promotions with more accuracy and profile and target their markets, resulting in the identification of higher value customers.

Enterprise decisioning: enterprise applications, often vertically focused, that demonstrate optimal business strategy. For example, an insurance company can link geography dependent risk elements such as proximity to a flood zone or density of coverage in specific neighbourhoods to better contain costs, and mitigate or more accurately price for risk.

Customer service: applications that facilitate customer service and self-service to improve the overall customer experience. For example, an insurance company can more efficiently measure service levels or plan for the distribution of products that are in many cases dependent on variables that change.

The profitability equation

The strategic use of location intelligence is being propelled by several key business drivers, including the need to increase revenue while simultaneously containing or reducing costs. These strategic imperatives form two sides of the profitability equation which location intelligence is well-suited to solve.

In financial services, diversification and commoditisation have forced down margins to the point that financial services firms, in order to remain profitable, must optimise every transaction and every customer touch point. Location intelligence benefits these financial services providers by helping them to:

- optimise branch performance
- consider expansion opportunities by determining the optimal number, placement, and priority of new branches
- allocate branch and sales staff
- better understand customer needs and behaviours
- match financial product mix to both customer segment demographics (e.g., increased mortgage demand in growing suburbs, retirement planning for mature areas) and life events (e.g., saving money for education)
- identify under-performing branches and determine whether to retain, relocate, or close them

Organisations that do not take full account of the locations covered by their insurance policies, do not fully understand the risks that they are assuming — and often suffer financially as a result. Hence, location intelligence tools can assist insurers to:

- accurately assess marketing potential, better focus marketing, sales, and distribution management, and maximise producer effectiveness
- improve underwriting decisions by providing more accurate exposure analyses
- increase competitiveness through more refined and accurate pricing.

- increase organisational efficiency and profitability through deployment of “low touch” or “no touch” automated underwriting systems, augmented rules engine technology, and enhanced service-oriented architectures supported by web services applications
- manage risk on a portfolio basis and comply with regulatory reporting requirements
- streamline claims handling processes and provide added-value customer service offerings

Better risk pricing

There has been an increasing use of location to better price risks, particularly for motor and home insurance. Where once pricing risk at the postcode level was sufficient, the technology and data now exists to price risk at the household level.

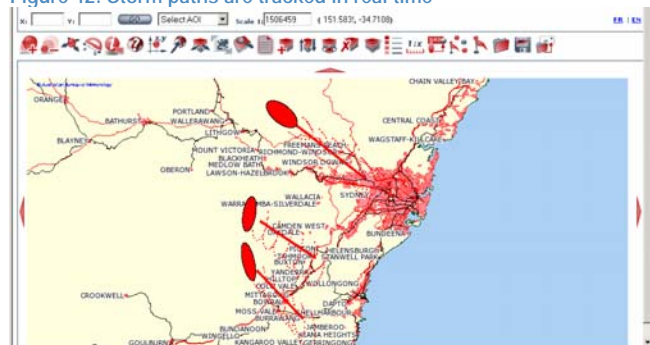
Consequently, risk prices can be differentiated say between a client who lives in a property located in a gully which is susceptible to flooding and a property only 100 metres away which is on a hill, or between properties located on the fringes of national parks susceptible to bushfires and properties within the same postcode but in a lower risk area.

Storm alert in real time

Advances in technology are enabling organisations to price the risk of storms at a much more granular level.

There are also innovations with the application of location intelligence in the underwriting arena. An example includes Insurance Alerting, where insurance customers are notified of potential storms or events via SMS. The benefits of such a solution include the ability to reduce the claim frequency and provide an invaluable service to customers.

Figure 42: Storm paths are tracked in real time



Source: Deloitte

As a result of such intelligence an insurer can notify customers in the path of the storm in real time via SMS or other digital delivery mechanisms. Insurers can also stop issuing insurance contracts in specific locations prior to a major weather event.

In summary

For life insurers location intelligence provides new insights into their customers, and producers and markets can be leveraged to make better decisions in areas such as product design, underwriting, claims management, customer service, sales, marketing, and distribution.

For financial, insurance, communications and retail operations, location intelligence can translate into increased revenues, reduced costs, and improved efficiencies.

The value lies not just in the ability to see a customer mapped, but in incorporating relevant business information from within and outside the enterprise to derive new insights and feed mission critical workflows. Organisations can get an increasing benefit from location intelligence as they move up a hierarchy of tasks, from gaining address accuracy, to mapping markets, to serving customers.

When preparing to build its capacity for location intelligence, an organisation needs to determine what it needs to drive better performance in its business processes, and its outcomes. This clearly entails more than technology, and a good location intelligence provider will approach the engagement holistically.

Finally, location intelligence solutions should not add more net cost and complexity to the enterprise's operations. They can and should be used to build revenues and reduce costs, with an implementation model that is affordable and timely. Indeed organisations should expect a rapid return on investment, as they build their location intelligence capacity and realise sustainable competitive advantage.

Case Study

A life insurance company was seeking to identify ways in which location intelligence could be leveraged to optimise and support its distribution network. In the first instance it was decided that the focus of the project would be on the financial planner network.

Customer, product and channel insights were defined and geo-maps were developed and tailored for the planner network. Planners were provided with insights as to where they should be growing their business, how best to leverage limited resources for increasing share of wallet, and identifying "white space" locations where opportunities existed for further expanding the network.

Ultimately, the organisation enabled the distribution network with its own location intelligence capabilities to support its growth ambitions. The benefits for this organisation included increasing revenue and reducing acquisition costs.

Skill shortages – Identifying and retaining critical skills

Nicky Wakefield and Catherine Dube, Deloitte

With skills shortages one of the major issues facing insurance companies, identifying and keeping the right people has become crucial. In this article, we explore the reasons why traditional methods of retaining talent do not work and suggest a new way forward.

Introduction

There is an impending shortage of ‘critical talent’ in the insurance industry – the professional talent that drives a disproportionate share in a company’s business performance - and includes underwriters, claims adjusters, sales professionals, actuaries and others.

The looming talent crisis is about to become much worse due to two emerging trends: the retirement of the Baby Boomers, who begin to turn 62 in 2008, and a growing skill gap.

Overall a large number of insurance professionals are facing retirement and relatively few replacements are joining the industry. It is becoming increasingly difficult to recruit top graduates as declining birth rates have resulted in a smaller pool of talent, who are also drawn to other industries that may be perceived as more attractive and are more aggressive in their recruiting.

Insurance companies therefore will suffer from a shortage of experienced professionals at all levels. The search for top-quality senior management has already expanded beyond the insurance sector. The recruitment and retention of middle-level managers will pose a challenge, as many experienced managers head toward retirement. There are questions about which candidates will have the necessary skills to take over existing critical operations and books of business.

In last year’s General Insurance (GI) survey, skills shortages were indentified as one of the top 5 issues confronting the industry by 80% of the respondents. In the 2008 GI survey, despite expectations under current economic conditions of a softening in the labour market, a number of participants expressed concerns over the recruitment and retention of skilled staff.

The importance of finding the right people, with the right skills, at the right price in order to maintain company performance is recognised beyond the boundaries of the insurance industry. A 2007 Deloitte survey in which over 100 company chairs and directors from the ASX 200 companies were interviewed, identified the ‘war for talent’ to be the biggest issue on a Board’s agenda. In addition to the difficult task of filling key positions, directors stressed the difficulty faced by their organisations in retaining key staff, and highlighted the importance for management to identify, develop and manage talent.

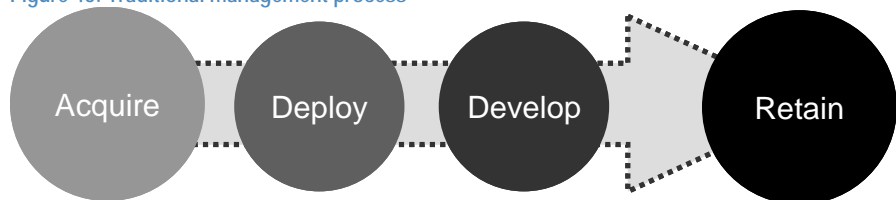
Why traditional retention methods do not work?

When labour gets tight, most organisations hunt for external candidates to fill their most critical jobs ('acquisition') and try to convince current employees to stay ('retention'). These companies offer money, perks and new challenges. But this is more of a reactive response than a clear proactive strategy. This approach is also expensive and short term. Furthermore, it does not focus on those segments of the workforce that are critical and create the most value for the company. Sometimes these reactive approaches work, but more often it delays, or even fuels, the inevitable churn of good people.

In particular, companies place too much attention on acquiring talent, the front end of the process. The average cost to replace an employee is one and a half times his or her average salary. New candidates can take a year or more to master their jobs. Moreover, a company that focuses on external talent can erode the commitment of internal candidates who perceive a bias against them.

By focusing on the end points of managing talent (acquisition and retention) rather than on the middle points (deployment and development), organisations ignore the things that matter most to employees. When this happens companies set themselves up for the inevitable churn, which becomes especially hazardous under tight market conditions.

Figure 43: Traditional management process



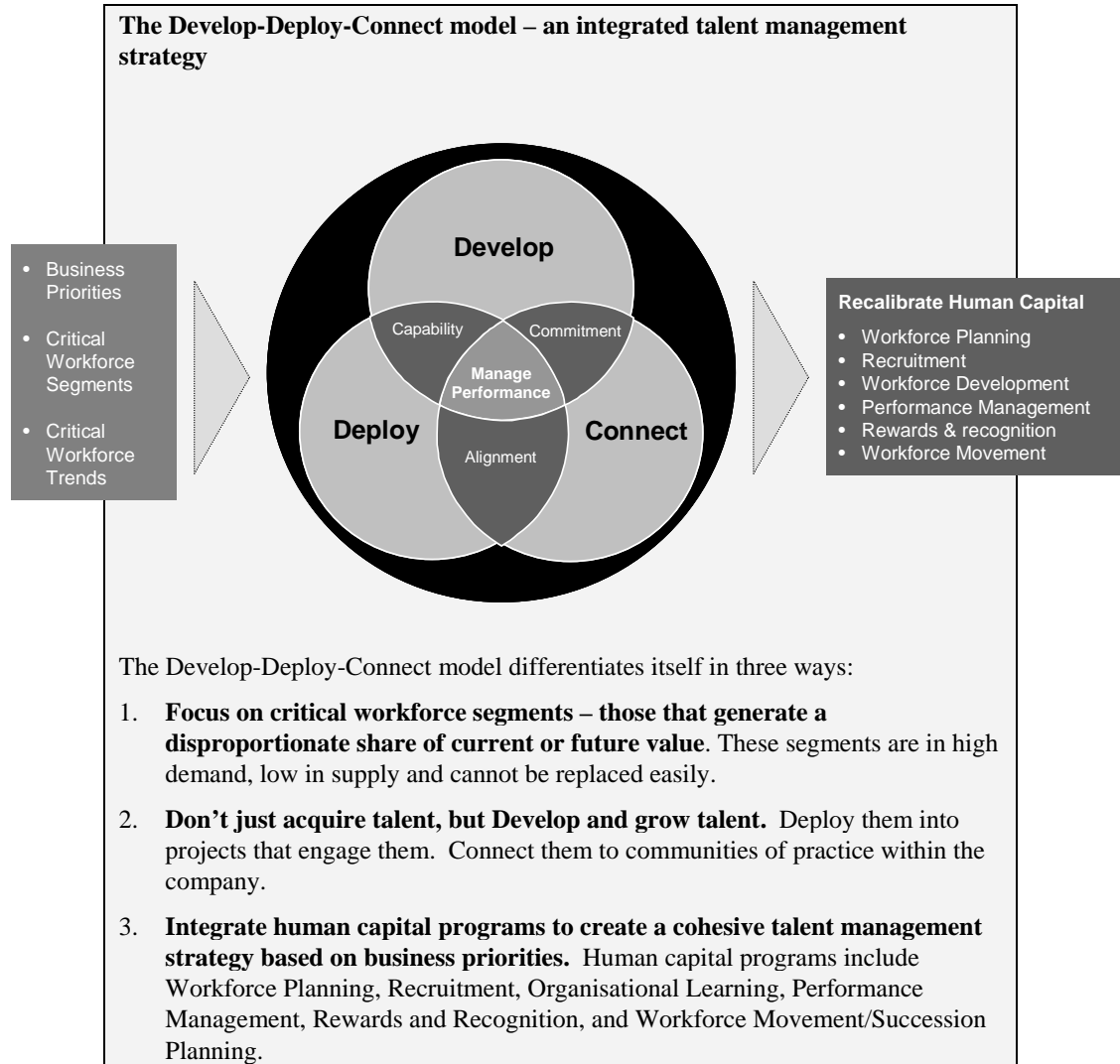
Source: Deloitte

The way forward: the Develop-Deploy-Connect model

As the competition for critical talent heats up, organisations must rethink the way they manage their people.

- They must identify the segments of the workforce that drive their current and future growth
- Rather than focus on acquisition and retention, they must concentrate on the things that employees care about the most such as:
 - developing in ways that stretch their capabilities
 - being in work that engages their heads and hearts
 - connecting to the people who will help them achieve their objectives.

By focusing on these things, attraction and retention largely take care of themselves.



Source: Deloitte

What does it mean to Develop, Deploy and Connect?

Develop means providing the real-life learning employees need to master a job. It isn't just about providing traditional classroom or online education. More important are the 'trial-by-fire' experiences that stretch capabilities and the lessons learned from peers, mentors and others.

In particular, the new generation of underwriters and claims professionals generally don't learn well in classroom settings. Their development will be better managed through new methods of learning and skill building, such as:

- on-the-job training
- 'stretch' assignments, and

- formal and informal mentoring relationships.

Deploy means working with key individuals to:

- identify their deep-rooted skills, interests and knowledge,
- help them find their best fit in the company, and
- craft the job design and conditions that help them to perform.

An example of a deployment strategy could be the introduction of programs that encourage critical retirement-age insurance professionals to stay on in a part-time capacity.

Connect means providing critical employees with the tools and guidance they need to:

- build networks that enhance individual and company performance
- improve the quality of their interactions with others within the company, and
- ultimately feel more connected to the company.

Making newly hired employees, such as underwriters and actuaries, feel connected to the company could involve fostering 'communities of practice' where insurance professionals dealing with similar issues can network and learn from one another. Or create knowledge management and mentoring programs that enable more experienced practitioners to share their knowledge with up-and-coming talent.

Flexibility and Choice – a key aspect in an effective talent management strategy

In today's talent marketplace, the best workers want more flexibility and more choice. Many organisations have introduced formal flexible work arrangements, but informal flexibility is at least as important in helping people navigate their myriad of responsibilities.

Flexibility takes on many forms: it can be applied to work schedules, work setting, job design and career planning.

Flexibility has become a key aspect of an effective talent management strategy due to the following facts:

- Now many workers have no 'stay-at-home partner' to handle personal matters while they are at work
- Dual income creates options and consequently employers do not have the leverage they previously had over workers. At least for the time of a reasonable job search, one partner in a two-income family can feasibly quit an unsatisfying job without manageable financial consequences
- A greater proportion of workers have either a primary focus on family, or

they divide their focus between work and family so employers have to be flexible in how they define the work day and the workplace

- The number of females with professional skills is increasing and women more often want flexible schedules and will choose a business that deals effectively with the issue.

Innovation in talent strategies and solutions should have the potential to span the needs of multiple segments of your organisation's workforce. Your company may very well be a great place to start a career and raise a family, but is it also a great place to finish a career? If your organisation can find a way to be all three, it will be in good shape when it comes to attracting and keeping the best talent.

Critical talent - a key factor in maintaining a competitive edge

In the coming years, many insurance companies will have no choice but to seriously rethink approaches to talent management strategies. However, shifting demographics should not be the only reason.

Improving the performance of critical employees directly improves company performance. Furthermore, focusing on critical workforce segments is relatively new territory for most insurance companies and, thus, offers new ways to compete. Compared to more popular investments in customer, technological and financial strategies (which have been refined over decades), a well-designed talent strategy could truly differentiate a company.

Rather than fight a futile war for talent, insurance leaders should look within for the critical skills and knowledge required to execute the company's most important jobs.

By developing, deploying and connecting these people the right way, leaders will see increased retention of critical workforce talent and watch as this talent raises its own performance – and the performance of the entire company – to a whole new level.

Part 2: Survey Participants

Survey Participants

We list here the participants in this year's survey. Where an international organisation is shown, the response is from its Australian-based subsidiary or branch.

Underwriters

| | |
|---------------------------|------------------------------------|
| AIG Australia | IAG |
| Allianz Australia | Liberty International Underwriters |
| Ansvar Insurance | Lumley General Insurance |
| Calliden Group | NTI |
| Catholic Church Insurance | RACQ |
| Chubb Insurance | Sompo Japan Insurance |
| CommInsure | SRS |
| Dexta Corporation | TIO |
| Guild Insurance | Wesfarmers Federation Insurance |
| Hollard Insurance | Zurich |

Brokers

| | |
|-------------------------------------|-------------------------|
| Annis Parisi | Jardine Lloyd Thompson |
| Aon Risk Services Australia | Macey Insurance Brokers |
| Fitzpatrick & Co. Insurance Brokers | Marsh |
| Guy Carpenter | OAMPS |
| Horsell International | Philp, Newby & Owen |
| Insurance Advisernet Australia | Willis Australia |

Reinsurers

| | |
|---------------------|-------------------------|
| SCOR Asia Pacific | Swiss Re |
| General Reinsurance | The New India Assurance |
| Hannover Re | |

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Stuart Alexander, Partner, Assurance and Advisory, Deloitte has over 15 years experience managing engagements for a wide range of clients specialising in assurance and advisory services to financial institutions. He has worked with Deloitte in New Zealand, United States and Scotland and is an Approved Auditor for a number of authorised general insurers. Stuart also provides clients with financial due diligence, internal audit services and process improvement advice.

Raffe Margossian is responsible for Insurance Consulting in Deloitte. He has worked throughout Australia, Asia and Europe solving complex problems for some of the world's leading insurance organisations in the areas of strategy, operational improvement and component technology solutions. Raffe is considered as an expert in general insurance where he has developed strategies and been engaged in

numerous organisational transformation programs in both mature and emerging markets.

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