Equator Re business review

Despite another challenging catastrophe year, Equator Re generated an underwriting profit whilst providing effective reinsurance protection to our divisions. We have successfully redesigned and placed the Group's 2019 external reinsurance program with world leading reinsurers.

Jim Fiore
Group Chief Reinsurance Officer & President • Equator Re

Gross written premium (US$M)
1,486
↓ 6% from 2017

Net earned premium (US$M)
664
↓ 22% from 2017 [1]

Underwriting result (US$M)
58
↑ $408M from 2017 [1]

Insurance profit (US$M)
85
↑ $408M from 2017 [1]

Combined operating ratio[2]
91.4%
2017 140.9%[1]

Insurance profit (loss) margin
12.8%
2017 (38.1)%[1]

2018 overview

Equator Re is instrumental in managing the Group's exposure and reinsurance risk appetites and plays a pivotal role in optimising capital across the Group. In doing so, Equator Re works closely with the divisions to bridge the gap between their risk appetites and that of the Group.

Despite 2017 being widely regarded as the costliest year on record for insured natural catastrophes, the global reinsurance market maintained strong levels of capital which limited reinsurance premium rate increases in 2018. QBE did not incur any increase in reinsurance costs during 2018 as the Group's reinsurance program had been placed for two years from 1 January 2017.

As Equator Re prices its products to compete with third party reinsurers, catastrophe excess of loss covers provided to the divisions saw an overall rate increase of around 5%, with more pronounced increases levied on divisions with loss-affected reinsurance layers. Pricing on loss-free treaties and/or layers was largely unchanged on a risk-adjusted basis. On non-catastrophe business, the same industry capital surplus ensured that downward pricing pressure on renewal rates remained, with price increases limited to loss-affected portfolios in most instances.

In December 2017, the Base Erosion Anti-Abuse Tax (BEAT) was introduced as part of the US Tax Reform Act which introduced a tax of 10% on payments made from US tax paying entities to non-US affiliated companies (effectively a tax of 10% on premium ceded to Equator Re).

In response, QBE created a new Bermudian domiciled captive, Blue Ocean Re, which now owns Equator Re. Blue Ocean Re in turn is owned by North American Operations and will be taxed as a US domestic taxpayer. This corporate restructure required no additional capital to be deployed and mitigated the impact of BEAT, with taxable profits of Blue Ocean Re and Equator Re now taxed at the US corporate rate of 21%. The US taxable income of Blue Ocean Re and Equator Re can be offset against existing tax losses in North American Operations.

For the 2019 outwards reinsurance renewal, the reinsurance market remained well capitalised and the Group was able to place its external program in line with our plans. Commencing negotiations early proved beneficial as the market began to see displacement of capacity that resulted in slightly higher premium rates later in the renewal season.

The transition away from a Group program structured around a combined individual risk and catastrophe aggregate reinsurance contract required a significant reduction in the attachment point on both the per risk and catastrophe programs, reducing the Group's net exposure to a single event or risk. In addition to lower retentions, Equator Re received additional support for its external quota share protection (from 40% to 50%) reflecting market confidence in our underwriting improvement plans. For 2019, our assumed divisional 'per risk' covers renewed largely with expiring retentions, whereas divisional catastrophe retentions were lowered, consistent with the changes to the Group's external program.

As part of the Group's focus on simplification of our business, we will also simplify the way we communicate our divisional results to the market. Effective from 1 January 2019, we will no longer separately identify Equator Re as a standalone entity; the captive's results will instead be eliminated into the relevant divisional results to provide a more holistic view of performance in each of the operating divisions – Australia Pacific, International and North America.

Operating and financial performance

Underwriting performance

Equator Re reported an underwriting profit of $58 million with a combined operating ratio of 91.4%[2]. This compares with an underwriting loss of $350 million[1] and combined operating ratio of 140.9%[1,2] in 2017. Adjusting for large individual risk and catastrophe claims retained by Equator Re in excess of the Group's aggregate reinsurance protections, the 2017 underlying COR would have been around 89%.

During 2018, Equator Re saw a reduction in premium income due to changes in divisional appetite following portfolio remediation coupled with implementation of the Brilliant Basics program that resulted

1 Excludes LPT transactions with North American Operations.
2 Excludes the impact of changes in risk-free rates used to discount net outstanding claims.

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in a reduction in the level of proportional business ceded by the divisions. The reduction in proportional business reduced Equator Re's exposure to attritional claims as well as benefiting commission costs and is better aligned with the Group's external reinsurance program which is designed to protect against large individual risk and catastrophe claims.

The mid-year commutation of cover provided to QBE's now sold Latin American countries contributed to the reduction in gross written premium. Equator Re also commuted a number of divisional treaties where the capital efficiencies to the Group were marginal. This balance sheet deleveraging has freed up capacity to expand the portfolio into more capital effective treaties in 2019.

Premium income

Changes to divisional reinsurance contributed to a 6% reduction in Equator Re's gross written premium in 2018, which fell to $1,486 million from $1,580 million in the prior year.

Increased confidence in the earnings trajectory of the North American Specialty book prompted a switch from quota share support to an excess of loss program that materially reduced premium income to Equator Re. The increased volume of Crop premium reflects a change in the cessions across the underlying portfolios. Australian & New Zealand Operations also elected not to renew a quota share treaty reflecting a change in that division's appetite for reinsurance spend following significant remediation over the past 18 months. During 2017 an aggregate stop loss protection was provided to European Operations in relation to prior accident year risk losses; this was a one-off contract and was not expected to renew in 2018.

Net earned premium fell 22% to $664 million from $847 million in the prior year, reflecting a reduction in gross earned premium with outwards reinsurance costs flat year on year. External reinsurance primarily protects against large individual risk and catastrophe claims. The non-renewed treaties had minimal current accident year large risk and catastrophe exposure and therefore their non-renewal did not impact the cost or extent of external reinsurance cover purchased.

Claims expense

Equator Re reported a significantly improved net claims ratio of 77.9% compared with 130.7%[1] in 2017, which was impacted by severe catastrophe experience including Cyclone Debbie in Australia and hurricanes Harvey, Irma and Maria in the Americas. Although still well above historical averages, catastrophe activity improved significantly relative to a particularly extreme 2017. The net claims ratio also benefitted from a lower frequency and severity of large individual risk claims, some of which can be attributed to improved underwriting practices within the operating divisions due to the Brilliant Basics program.

The net claims ratio includes 12.7% or $84 million of adverse prior accident year claims development compared with 11.5% or $97 million of adverse development in 2017. The adverse experience relates to attritional claims ceded through quota shares that are largely retained by Equator Re and deterioration of 2013 and prior year individual risk claims that in the aggregate exceeded the allowance for incurred but not reported claims.

Commission and expenses

The combined commission and expense ratio increased to 13.4% from 10.6% in 2017.

Although commission expense was stable, the net commission ratio increased to 11.1% from 8.7% in the prior year. This reflected an overall change in business mix and changes to the external quota share cession, partly offset by the reduced level of proportional business that typically attracts a far higher exchange commission relative to excess of loss business.

Underwriting and administration expenses remained relatively flat at $15 million, with the expense ratio increasing marginally due to lower premium income.

Underwriting result

FOR THE YEAR ENDED 31 DECEMBER		2018	2017	2017 ADJUSTED[1]	2016	2016 ADJUSTED[1]	2015	2014
Gross written premium	US$M	**1,486**	1,580	1,580	1,532	1,349	1,007	642
Gross earned premium	US$M	**1,443**	1,614	1,614	1,429	1,246	994	764
Net earned premium	US$M	**664**	732	847	651	468	367	525
Net incurred claims	US$M	**517**	982	1,107	453	268	297	389
Net commission	US$M	**74**	74	74	50	50	17	18
Expenses	US$M	**15**	16	16	13	13	13	13
Underwriting result	US$M	**58**	(340)	(350)	135	137	40	105
Net claims ratio	%	**77.9**	134.2	130.7	69.6	57.3	80.9	74.2
Net commission ratio	%	**11.1**	10.1	8.7	7.7	10.7	4.6	3.3
Expense ratio	%	**2.3**	2.2	1.9	2.0	2.8	3.5	2.4
Combined operating ratio	%	**91.3**	146.5	141.3	79.3	70.7	89.0	79.9
Adjusted combined operating ratio[2]	%	**91.4**	146.1	140.9	78.9	70.2	89.9	75.0
Insurance profit margin	%	**12.8**	(42.8)	(38.1)	24.9	35.0	28.1	27.7

1 Excludes LPT transactions with North American Operations.
2 Excludes the impact of changes in risk-free rates used to discount net outstanding claims.