North American Operations business review

A vastly improved result underpinned by a strong improvement in the attritional claims ratio and a turnaround in prior accident year claims development. Although greatly reduced relative to 2017, catastrophe experience was still above average.

Russ Johnston
Chief Executive Officer • North American Operations

Gross written premium (US$M)
4,711
↑ 3% from 2017

Net earned premium (US$M)
3,569
↑ 1% from 2017[1]

Underwriting result (US$M)
111
↑ $424M from 2017[1]

Insurance profit (US$M)
221
↑ $457M from 2017[1]

Combined operating ratio[2]
97.9%
2017 109.1%[1]

Insurance profit (loss) margin
6.2%
2017 (6.7)%[1]

2018 overview

North American Operations is an integrated specialist insurance and reinsurance franchise with four key business units: Property & Casualty (P&C), Specialty, Crop and QBE Re (a component of QBE Group's global reinsurance business).

Effective 1 January 2019 and with the sale of retail personal lines, the P&C and Specialty business units reorganised to Specialty & Commercial (retail agent and broker) and Alternative Markets (third-party distribution including programs) to better align with our go-to-market strategy.

The cell review process has been a major area of focus in 2018 and has enabled us to identify and respond faster to both positive and negative trends. This, coupled with the rollout of the Brilliant Basics program, contributed to a vastly improved underwriting result.

The following strategic initiatives were implemented during the year:

- We exited our underperforming retail personal lines business (the independent agent and Farmers Union Insurance businesses). This will enable material cost efficiencies through the eventual decommissioning of legacy systems and the downsizing of the regional office footprint.
- Crop delivered a strong result for the fourth consecutive year. We have further strengthened the Crop business through improved analytics supporting better risk selection and management of commodity price volatility.
- Notwithstanding above average catastrophe incidence, the program business delivered a solid result. We have bolstered our program partnerships with investments that support a more data driven approach to pricing. Having reduced our program footprint (P&C and Specialty programs combined) from around 100 to only 55 over the past several years, we now have a portfolio that is well positioned to deliver sustainable performance.
- We have de-risked parts of the commercial P&C business, particularly in excess & surplus lines (E&S) and legacy corporate exposures by refining underwriting guidelines and non-renewing risks that were outside of our revised underwriting appetite, including the run-off of the commercial agriculture portfolio.
- Within Specialty, the accident & health (A&H) business delivered positive rate increases with performance in line with expectations. The management liability and professional lines business continues to focus on risk selection with an emphasis on errors & omissions (E&O) over directors & officers (D&O) and private rather than public company exposures, while the Specialty program business has been restructured and refocused during 2018.

Our granular focus on performance management through cell reviews and enhanced pricing capability has seen us achieve an average premium rate increase of 4.1% compared with 0.7% in 2017. We achieved strong rate increases in both A&H and homebuilders as well as Specialty programs and E&S where stronger increases were achieved during the second half.

Operating and financial performance

Underwriting performance

To assist year-on-year comparability, the 2017 results in the table overleaf and the underwriting performance commentary hereafter are presented on an adjusted basis excluding the impact of the loss portfolio transfer (LPT) of discontinued programs.

North American Operations reported a combined operating ratio (COR) of 97.9%[2], down from 109.1%[1,2] in the prior year. The greatly improved underwriting performance was driven by a reduction in the attritional claims ratio of nearly 3% (excluding Crop), coupled with materially lower catastrophe incidence and modest positive prior accident year claims development relative to material adverse development in 2017.

The net cost of large individual risk and catastrophe claims fell to $309 million or 8.6% of net earned premium compared with $419 million or 11.8% in the prior year. This reflected reduced catastrophe claims costs which, although elevated by historical standards, were significantly lower than the extreme experience in 2017.

The underwriting result included a $36 million or 1.0% benefit related to an increase in risk-free rates used to discount net outstanding claims, compared with a $11 million or 0.3% benefit in 2017.

1 Excludes transaction to reinsure liabilities.
2 Excludes the impact of changes in risk-free rates used to discount net outstanding claims.

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Premium income

Gross written premium grew 3% to $4,711 million, underpinned by an average premium rate increase across the portfolio of 4.1% compared with only 0.7% in the prior year.

Specialty gross written premium grew 12% primarily reflecting a strong premium rate landscape and targeted new business growth in A&H offset by reductions in segments of D&O and trade credit and surety that no longer meet our underwriting criteria.

Crop gross written premium increased 5% to $1,474 million due to increased coverage and a modest increase in policy count. Net earned premium fell 2% to $828 million reflecting increased cessions under the MPCI scheme.

P&C gross written premium was flat compared with the prior year at $2,103 million. An increase in property catastrophe program income and the continued profitable transition of small commercial with Arrowhead was offset by the cancellation of poorly performing programs and our redefined risk appetite within commercial.

Net earned premium increased 1% to $3,569 million, reflecting reduced reinsurance spend (despite significant Crop cessions due to the large MPCI gain in 2017). Excluding this Crop impact, net earned premium increased 2%.

Claims expense

In 2018, we focused on rolling out and embedding the Brilliant Basics program to provide a consistent level of excellence in pricing, risk selection and claims management. The cell review discipline coupled with early benefits from the Brilliant Basics program contributed to the improvement in the net claims ratio which fell to 66.0% from 77.7% in the prior year.

Excluding Crop, the attritional claims ratio improved materially to 50.4% from 53.2% in the prior year driven mainly by underwriting and pricing initiatives in our corporate, affiliated, D&O and trade credit & surety portfolios. This improvement is despite an increased contribution from Specialty which operates at a higher attritional claims ratio relative to the rest of the portfolio. The improvement also gathered momentum as the year progressed with the attritional claims ratio falling to 48.7% in the second half of 2018 from 52.1% in the first half.

The net cost of large individual risk and catastrophe claims fell to $309 million from $419 million in the prior year, contributing 8.6% to the net claims ratio compared with 11.8% in 2017. Individual risk claims increased relative to the prior year due to a business mix shift to longer-tail and professional liability business as well as an increase in frequency in our P&C property portfolio. Although down from the extreme experience of 2017, catastrophe claims were above average reflecting Hurricanes Florence and Michael as well as the Californian wildfires.

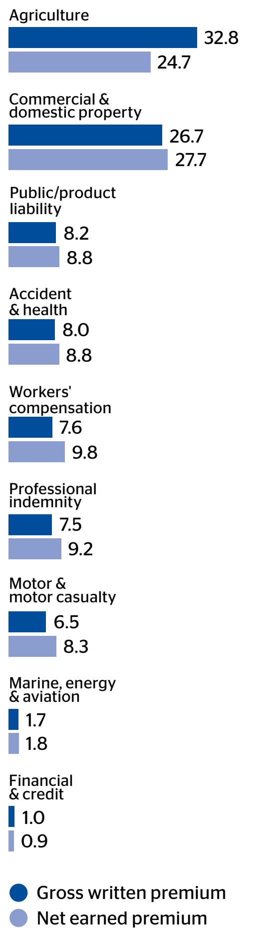
Net underwriting income was also impacted by $11 million or 0.3% of positive prior accident year claims development compared with net unfavourable development of $149 million or 4.2% in the prior period. Favourable development in Crop (that was not matched by additional premium cessions under the MPCI scheme) was partly offset by adverse development in assumed multi-line, commercial corporate, D&O and Specialty programs.

Commission and expenses

The net commission ratio was broadly stable at 15.7%. A shift in mix to business with lower commission rates was offset by the impact of the Arrowhead outsourcing arrangement, reduced exchange commissions associated with the change in reinsurance protection for Specialty and the impact of increased Crop cessions to the MPCI.

The expense ratio improved to 15.2% from 15.5% in the prior year, primarily reflecting strict cost control and tighter discipline in the division's operating model.

Gross written premium and net earned premium by class of business (%)



Underwriting result

FOR THE YEAR ENDED 31 DECEMBER		2018	2017	2017 ADJUSTED[1]	2016	2016 ADJUSTED[1]	2015[2]	2014[2]
Gross written premium	US$M	**4,711**	4,556	4,556	4,647	4,647	4,961	5,310
Gross earned premium	US$M	**4,612**	4,622	4,622	4,657	4,657	4,930	5,457
Net earned premium	US$M	**3,569**	3,241	3,541	2,731	3,318	3,666	4,471
Net incurred claims	US$M	**2,356**	2,439	2,750	1,528	2,131	2,323	3,023
Net commission	US$M	**559**	556	556	564	564	635	698
Expenses	US$M	**543**	550	548	556	551	678	788
Underwriting result	US$M	**111**	(304)	(313)	83	72	30	(38)
Net claims ratio	%	**66.0**	75.3	77.7	56.0	64.2	63.4	67.6
Net commission ratio	%	**15.7**	17.1	15.6	20.7	17.0	17.3	15.6
Expense ratio	%	**15.2**	17.0	15.5	20.4	16.6	18.5	17.6
Combined operating ratio	%	**96.9**	109.4	108.8	97.0	97.8	99.2	100.8
Adjusted combined operating ratio[3]	%	**97.9**	109.7	109.1	97.7	98.5	99.8	100.4
Insurance profit margin	%	**6.2**	(7.0)	(6.7)	6.1	4.7	2.5	0.2

1 Excludes transactions to reinsure liabilities.
2 Comparability of prior period data is reduced due to the sale of M&LS.
3 Excludes the impact of changes in risk-free rates used to discount net outstanding claims.