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## Insurance Australia Group Limited

**ABN: 60 090 739 923**

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#### **Stock Exchange Listings**

Australian Stock Exchange Limited

ASX code for ordinary shares: **IAG**

ASX codes for reset preference shares: **IAGPA** (Listed June 2002) and **IAGPB** (Listed June 2003)

#### **Investor Information/Administration**

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### Key dates for shareholders - proposed

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#### **Interim dividend – ordinary shares**

- Ex-dividend date 11 March 2004

- Record date 17 March 2004

- Payment date 19 April 2004

**Half-yearly reset preference shares dividends due** 15 June 2004

**Announcement of annual results to 30 June 2004** 19 August 2004

#### **Final dividend – ordinary shares**

- Ex-dividend date 14 September 2004

- Record date 20 September 2004

- Payment date 18 October 2004

**Annual General Meeting** 10 November 2004

**Half-yearly reset preference shares dividend due** 15 December 2004

**Announcement of half year results - 31 December 2004** 24 February 2005

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## Introduction

- The six months to 31 December 2003 ('1H04') marked the completion of the refocus on the Group's core general insurance business. During this period, the Group completed the sale of its health insurance underwriting business and entered into an agreement to sell its financial services business, ClearView Retirement Solutions ('ClearView'), both to MBF Australia Limited. The ClearView sale was completed in January 2004. The Group is now wholly focused on its general insurance operations.
- At an operational level, the Group has been progressing the integration of the CGU and NZI businesses, (acquired in January 2003). It is pleasing to report that a year into the 18-month integration programme, the acquisition is delivering results that have exceeded initial expectations. The overall progress is tracking ahead of target and is EPS positive (pre-goodwill) six months ahead of the original target.
- The Group's stability and strength have been maintained during this period of significant challenge, as evidenced by the delivery in line with the Group's operating margin target.
- During the period, the Group also continued to progress its customer focus programme, which is intrinsically linked with overall improvement in the business processes. These efforts have contributed to the maintenance of high customer retention levels in key business lines.
- The execution of key strategies has steered the Group towards a path of profitable growth over the medium term. With its scale, the Group has potential to extract further sustained margin capacity by effectively utilising its underwriting processes and systems to support its focus on delivering consistent quality results from the insurance business.

The following points should be noted when reviewing this report:

- The profit on the sale of ClearView is not included in this period's result as the sale was completed in January 2004. The Group's expectation is that the profit on sale to be reported in 2H04 will be finalised in the range announced on 11 December 2003, ie. \$42-45m (pre-tax \$60-65m).
- Integration expenses of \$25m (\$45m in 2H03) have been included in the pre-tax result. They have been allocated between claims and underwriting expenses within the relevant business segments.
- With the acquisition of the CGU and NZI businesses on 2 January 2003, the Group added approximately \$2.5bn in annual premium. This should be borne in mind when comparing 1H04 with 1H03.
- When the CGU and NZI businesses were acquired, the change in business mix to include nearly 50% distributed through intermediaries or under third party brands (previously less than 15%) generated an increase in commissions paid with an appropriately corresponding increase in premiums. In relative terms, there is a higher denominator with a lower loss ratio and higher expense ratio on the acquired business.

## Financial results

- The Group generated a profit for shareholders of \$302m for the half-year ended 31 December 2003 compared to the previous corresponding period profit of \$62m. The return on equity for ordinary shares was the equivalent of 18.4% per annum.
- The key components of the 1H04 result were:
  - Sustained improvement in underwriting profit to \$277m for the period, an increase of \$149m on 2H03 reflecting both the growth in the business and underlying profitability;
  - The strength of the underwriting result produced an insurance margin of 11.8%, within the Group target range of 9 –12% for FY04;
  - At the Group level, the combined ratio (COR) of 90.5% was better than the target range 93 – 96% and was also an improvement on 95.5% in 2H03 and 96.0% in 1H03. The 1H04 result includes a 3.3% benefit from the increase in discount rates applied to claims reserves;
  - After two years of negative returns, the recovery in the global equity markets delivered a positive contribution to the Group's result. The total pre-tax return on shareholders' funds was \$204m, compared with a loss of \$129m in the previous corresponding period.
- The strength of the Group's result is a reflection of the realisation of the benefits from business improvement across the integrated Group and the benefits of diversification.

## Overview of financial position

- As at 31 December 2003 the MCR multiple for the Group was 1.90x, which is substantially more than the Group's current requirements. It is also in line with the pro-forma multiple of 1.90x at 31 October 2003 announced at the time of the agreement to sell ClearView.
- The continued strong business performance and higher returns from the equity market since 30 June 2003 have been the predominant factors behind the strength of the Group's capital position, together with the sale of ClearView. The offsetting factors which affected the MCR multiple in November and December 2003 include:
  - Factoring in an increase in the Group's catastrophe retention effective 1 January 2004;
  - The continued strengthening of the Australian dollar, which reduced the value of the hedge on the Group's US dollar denominated sub-debt with consequent regulatory capital implications;
  - The business and investment results in the period; and
  - Payment of the \$15m half yearly dividend on the reset preference shares.
- In line with the Group's capital management philosophy and taking into account changes in the Group's earnings profile since listing, the Group has:
  - Resolved to change its dividend policy, which has led to an increase in the interim dividend to 8.0 cents per ordinary share; and
  - Announced that it intends to undertake a buy-back in the order of \$350m.

## Progress of CGU & NZI integration

- The Group has completed 12 months of an 18-month integration programme for CGU and NZI, which were acquired in January 2003.
- Integration of these businesses has continued to run marginally ahead of schedule and, at 31 December 2003, annualised benefits totalling \$117m had been “locked in”. This compares with the target for this date of \$111m announced in August 2003.
- The target of \$160m of annualised benefits (including \$20m in New Zealand) is expected to be fully achieved marginally ahead of the 30 June 2004 target.
- One off integration costs are running according to budget, with final costs expected to fall slightly below the \$145m target previously announced.
- \$42m has been delivered to the pre-tax profits as a result of the integration synergies since the programme’s inception, including \$33m in 1H04. Financial progress of the integration is reflected in the following table:

| Synergy realisation schedule           | 2H03<br>Actual | 1H04<br>Target | 1H04<br>Actual | 2H04<br>Estimated |
|--|----------------|----------------|----------------|-------------------|
| All amounts are pre-tax                | A\$m           | A\$m           | A\$m           | A\$m              |
| <b>Cumulative run-rate per annum</b>   |                |                |                |                   |
| Personal lines                         | 15             | 49             | 41             | 80                |
| Commercial                             | 14             | 20             | 27             | 27                |
| IT, shared services & overheads        | 13             | 25             | 33             | 33                |
| <b>Australia sub-total</b>             | <b>42</b>      | <b>94</b>      | <b>101</b>     | <b>140</b>        |
| <b>International - New Zealand</b>     | <b>12</b>      | <b>17</b>      | <b>16</b>      | <b>20</b>         |
| <b>Total synergies in run-rate</b>     | <b>54</b>      | <b>111</b>     | <b>117</b>     | <b>160</b>        |
| <b>Reported income statement</b>       |                |                |                |                   |
| Synergy benefits collected             | 9              | 38             | 33             | 76                |
| Costs of implementation expensed       | (45)           | (40)           | (25)           | (25)              |
| <b>Net impact on profit for period</b> | <b>(36)</b>    | <b>(2)</b>     | <b>8</b>       | <b>51</b>         |

- During 1H04, the Group successfully integrated its Australian remuneration practices. Key steps in this process were:
  - The migration of all CGU group employees to the IAG/NRMA Superannuation Plan; and
  - The adoption of one Enterprise Agreement for the Australian business, replacing three separate agreements for NRMA Insurance, IMA and CGU.
- Due to strong underlying performance by the CGU and NZI businesses, together with integration benefits achieved ahead of target, this acquisition has been assessed as shareholder value accretive as at 31 December 2003. Achieving this earnings per share positive status within a year of acquisition is six months ahead of the initially announced target. This is measured on a pre-goodwill or cash earnings basis.

## Outlook

### A. Growth

- The Group's large market shares in Australia and New Zealand mean that the focus is on organic growth in these markets. Whilst they are mature markets, ongoing growth from a combination of policies in force and premium inflation (sums insured, rates, extension of coverage, etc.) is expected to run at about two times nominal GDP growth.

### B. Operating margins

- In operating terms, the Group expects the integration of the acquisition of CGU and NZI to deliver an additional \$43m of benefits to the Group's pre-tax profits during 2H04. On the other hand, there have already been a number of quite significant storms on the east coast of Australia and in New Zealand in January and February 2004. Over the next couple of years, there are also expectations that the commercial market will "soften", although the extent of this cannot be predicted, and the Group expects to gain further benefits from its ongoing efforts to improve the efficiency of its operations.
- In the context of all of these matters – and the variations that may arise in future – the Group continues to consider that it can generate an insurance margin of 9 – 12% throughout the cycle. There may be periods in which conditions align to deliver a margin above this range, but this is not regarded as sustainable for prolonged periods. The Group believes its positioning in terms of scale and diversity in its markets is such that an insurance margin below the range is quite unlikely.
- The Group's view of target combined ratios is affected by the interest rate environment which drives the returns on the fixed interest exposure of the technical reserves and can change the tolerable combined ratio in individual periods. However, the Group's business mix should enable the combined ratio to remain under 100%.

### C. ROE

- An annualised return of 16.8% (pre-tax) on the Group's shareholders funds portfolios was above the normal expected level of return from the markets and a very significant turnaround from the negative return of 6.5% (pre-tax) for FY03. Market expectations – and those of the Group – are that positive returns of this order will not be sustained. If the returns from the shareholders funds are assumed to be 9.5% per annum, being more akin to a normal return based on equity market premiums and current market interest rates, the ROE would have been 14.4%.
- The Group continues to regard its sustainable range of return on ordinary equity as 13 – 15% over the cycle, measured after amortisation. The range is based on what is seen as a reasonable return for shareholders balanced with maintaining the provision of insurance at fair rates for customers. It is set in the context of the current mix of business, the Group's desire to maintain an 'AA' category rating and relativities with international peer organisations.
- The current Australian requirement to mark to market shareholders funds portfolios through the income statement results in volatility from period to period. It is for this reason that the Group discloses a normalised ROE. It also means that the reported ROE can exceed – as it has in 1H04 – the range and, indeed, fall below the range as it did in the last three years when equity market performance was significantly below long-term averages.

## Half year results

| Consolidated Financial Results                             | Half year ended Dec-02 | Half year ended June-03 | Half year ended Dec-03 | Variance from Jun-03 |
|--|------------------------|-------------------------|------------------------|----------------------|
|  | A\$m                   | A\$m                    | A\$m                   | A\$m                 |
| <b>Gross written premium</b>                               | <b>1,886</b>           | <b>3,264</b>            | <b>3,142</b>           | <b>(121)</b>         |
| <b>Gross earned premium</b>                                | <b>1,868</b>           | <b>3,017</b>            | <b>3,116</b>           | <b>99</b>            |
| Reinsurance expense  | (69)                   | (180)                   | (204)                  | (24)                 |
| <b>Net premium revenue</b>                                 | <b>1,799</b>           | <b>2,837</b>            | <b>2,912</b>           | <b>75</b>            |
| Net claims expense   | (1,382)                | (1,981)                 | (1,909)                | 72                   |
| Underwriting expense                                       | (346)                  | (728)                   | (726)                  | 3                    |
| <b>Underwriting profit/(loss)</b>                          | <b>71</b>              | <b>128</b>              | <b>277</b>             | <b>150</b>           |
| Investment income on technical reserves                    | 219                    | 153                     | 67                     | (86)                 |
| <b>Insurance profit</b>                                    | <b>290</b>             | <b>281</b>              | <b>344</b>             | <b>63</b>            |
| Financial services   | 2                      | 1                       | 15                     | 17                   |
| Net corporate expenses                                     | (14)                   | (25)                    | (14)                   | 11                   |
| Amortisation   | (27)                   | (54)                    | (54)                   | -                    |
| Interest   | (12)                   | (35)                    | (29)                   | 9                    |
| Profit/(loss) from fee based businesses                    | 2                      | 8                       | 20                     | 9                    |
| Investment income/(loss) on shareholders' funds            | (129)                  | 9                       | 204                    | 195                  |
| Investment income/(loss) on external funds                 | 12                     | 8                       | 8                      | (0)                  |
| NSW Insurance Protection Tax                               | (9)                    | (11)                    | (10)                   | 1                    |
| <b>Profit before income tax</b>                            | <b>115</b>             | <b>182</b>              | <b>484</b>             | <b>302</b>           |
| Income tax (expense)/benefit                               | (18)                   | (62)                    | (136)                  | (74)                 |
| <b>Profit after income tax</b>                             | <b>97</b>              | <b>120</b>              | <b>348</b>             | <b>228</b>           |
| Outside equity interests                                   | (35)                   | (29)                    | (46)                   | (17)                 |
| <b>Profit/(loss) attributable to all shareholders</b>      | <b>62</b>              | <b>91</b>               | <b>302</b>             | <b>212</b>           |
| Dividends paid to reset preference shares                  | (11)                   | (10)                    | (14)                   | (5)                  |
| <b>Profit/(loss) attributable to ordinary shareholders</b> | <b>51</b>              | <b>81</b>               | <b>288</b>             | <b>206</b>           |

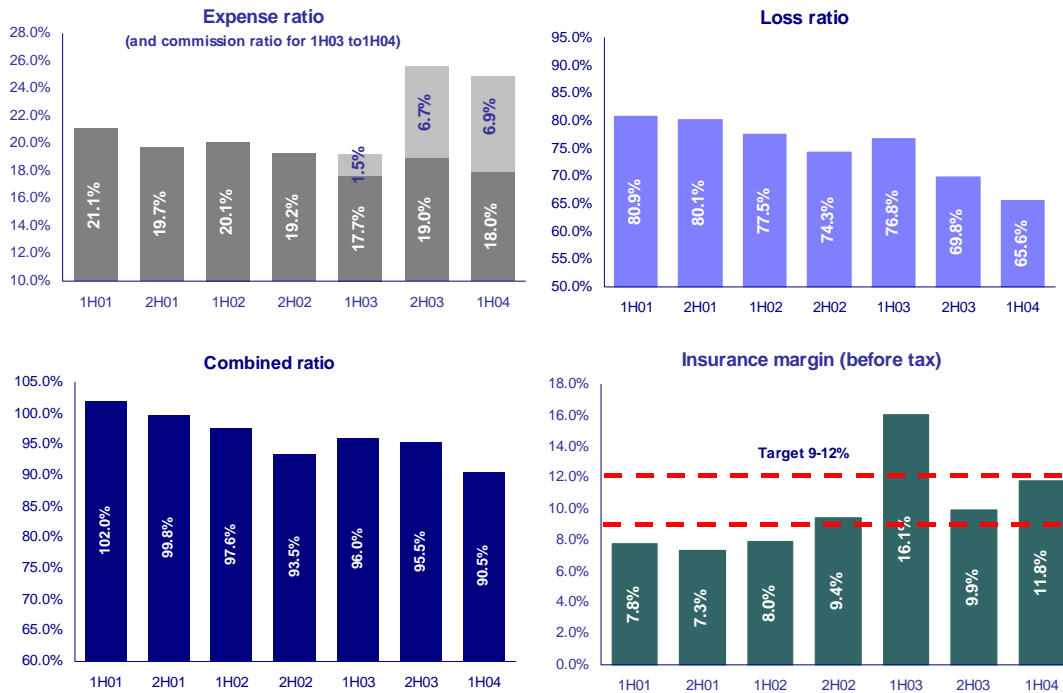
| Financial Results/Ratios  | Half year ended Dec-02 | Half year ended Jun-03 | Half year ended Dec-03 |
|---|------------------------|------------------------|------------------------|
| <b>GWP (A\$m)</b>   | <b>\$1,886</b>         | <b>\$3,264</b>         | <b>\$3,142</b>         |
| Profit attributable to shareholders (A\$m)                      | \$62                   | \$91                   | \$302                  |
| ROE % (Average Equity) to ordinary shareholders pa              | 4.0%                   | 5.4%                   | 18.4%                  |
| Net cash flow from operations (A\$m)                            | \$293                  | \$532                  | \$694                  |
| Basic EPS (cents)   | 3.64                   | 5.01                   | 17.07                  |
| Diluted EPS (cents)   | 3.62                   | 4.99                   | 17.01                  |
| DPS (cents)   | 4.50                   | 7.00                   | 8.0                    |
| <b>Group insurance ratios</b>                                   |                        |                        |                        |
| Loss ratio  | 76.8%                  | 69.8%                  | 65.6%                  |
| Expense ratio   | 19.2%                  | 25.7%                  | 24.9%                  |
| Administration expense  | 17.7%                  | 19.0%                  | 18.0%                  |
| Commissions ratio   | 1.5%                   | 6.7%                   | 6.9%                   |
| Combined ratio  | 96.0%                  | 95.5%                  | 90.5%                  |
| Insurance margin (before tax)                                   | 16.1%                  | 9.9%                   | 11.8%                  |
| Probability of sufficiency of general insurance claims reserves | >90%                   | >90%                   | >90%                   |
| MCR multiple - Australian licensed entities                     | -                      | 2.03x                  | 2.21x                  |
| MCR multiple - Group  | 2.29x                  | 1.62x                  | 1.90x                  |

## A. Key elements of results

- The Group has delivered a net profit after tax of \$302m, substantially more than the 2H03 result of \$91m. This outcome has been driven by the combination of a number of factors:
  - Strong general insurance margins reflecting both the current environment for the Group's major portfolios and the Group's positioning;
  - Continued good results from the CGU and NZI acquired businesses, including the effect of more appropriate premium rates for risks assumed, particularly in commercial liability classes; and
  - Recovery in equity markets since 30 June 2003.
- The gross written premium (GWP) of \$3.1bn is two-thirds higher than the 1H03 total, primarily due to the inclusion of the CGU and NZI businesses since their acquisition in January 2003.
- The 1H03 and 2H03 GWP included \$79m and \$93m, respectively, of health insurance premium. This business was sold in July 2003.
- When compared with 2H03, which includes CGU and NZI, the GWP remained unchanged for the period. Other than the loss of the health business, the other key point is the seasonal effect of commercial business in the CGU and NZI operations where most renewals occur in the second half of the financial year and therefore those portfolios characteristically have higher GWP in that period.
- Gross earned premium grew marginally to \$3.1bn from \$3.0bn relative to 2H03. This growth is affected by the loss of the health premium following the sale of that business.
- Reinsurance expense, relative to gross earned premium, grew by a tenth to 6.6% from the 6% experienced in 2H03. This level of reinsurance expense is in line with expectations. It is not comparable with 1H03 due to the different reinsurance profile for the acquired commercial businesses.
- The underwriting result of \$277m is more than double the 2H03 underwriting result of \$128m, and more than three times 1H03 result of \$71m. Excluding the benefit of \$96m in discount rate adjustments in 1H04, the underwriting result of \$181m, is still a 41% increase on 2H03. The 1H04 result also includes \$105m in respect of large storms in Sydney (August), Queensland (October) and Melbourne (December).
- The delivery of underwriting profits for six consecutive halves is confirmation that the Group is being successful in its ongoing efforts to improve the scale, diversity and fundamentals of its general insurance operations.
- The domestic short-tail operations comprised 70% (approx.) of the Group's business over the period and delivered a COR of 93.4%, a further improvement from 94.5% in 2H03. This is in line with the FY04 target of 92 – 94%. The structural improvement in the portfolio over the past few years is continuing to support the consistent growth in margins. The combination of the rollout of further improvements in rating and claims management, and a reduction in the incidence of theft loss in the motor portfolio contributed to producing the short-tail insurance margin of 8.6%, after integration costs.

- The long-tail portfolio continues to experience stable trends in the major personal injury portfolios and has achieved rates for the commercial liability business that more appropriately reflect the risks assumed. These combined to produce a solid underwriting result with a COR of 73.6% and an insurance margin of 29.6%. The COR is 17.0% lower than would have been the case if discount rates applicable to the claims reserves had not risen during 1H04. Removing the effect of changes in discount rates, the immunised combined ratio of 90.6% compares with an FY04 target of 100 – 105%. This benefit from increased discount rates is essentially offset by capital losses on fixed interest securities of \$98m.
- Due to seasonality in the New Zealand business and the storm losses of \$25m retained in the Captive, the international segment fell short of delivering COR within the FY04 target range 91 – 93%.
- Whilst the improvement in the Group insurance margin to 11.8% (2H03: 9.9%) was mainly due to a strong performance by the underlying businesses, it also benefited from the progress of integration entering a phase of synergy realisation.
- Consistent with 2H03, the \$25m of integration costs have been allocated to the underwriting result (2H03: \$45m). These costs were allocated between claims and underwriting expenses. These expenses were offset by realised synergy benefits of \$33m (2H03: \$9m).
- The recovery of equity markets during the period provided a substantial boost to the Group's earnings with shareholders' funds delivering the highest half-year returns since listing. The 1H04 shareholders' fund return was \$204m compared to \$9m in 2H03.
- As returns from wealth management businesses are closely aligned with the equity market performance, the recovery in equity markets was the main factor influencing the financial services profit of \$15m pre-tax compared with negligible profit over the past two years, during which the business bore the impact of poor equity markets and investment in relaunching the business in February 2002. This business was sold effective 21 January 2004.
- Despite the growth of the business, Group corporate expenses for 1H04 remain unchanged since 1H03 and represent a reduction of almost 50% relative to 2H03. The 2H03 expenses included some expenses relating to the CGU and NZI acquisition.
- The increase in amortisation and interest expense since 1H03 is a function of the CGU/NZI acquisition.
- The tax expense of \$136m includes a \$22m non-recurring benefit arising on the adoption of tax consolidation. This reduced the effective tax rate by 4.5% to 28.1%. On cash earnings, that is, before charges for amortisation of \$54m, the effective tax rate is 25.3% – or 29.4% excluding the non-recurring benefit on adoption of tax consolidation.

## Group insurance ratios



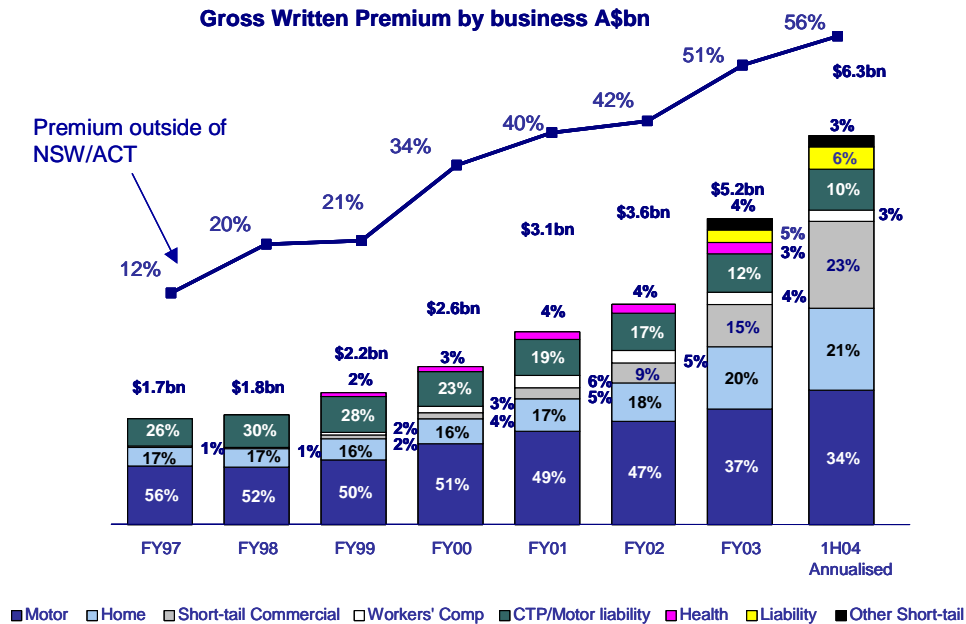
\* Commission ratio negligible in prior periods.

- These graphs demonstrate the continued improvement in the Group's expense and loss ratio. This is largely attributable to:
  - A combination of improved scale and diversification of the business, which enables the Group result to remain relatively stable in spite of inevitable fluctuations in individual portfolios or regions; and
  - Ongoing focus on improving the quality and efficiency of risks assumed and operations.
- However, the impact of changes in the discount rates applicable to claims reserves must also be considered. For example, in recent periods the impact of changes in the discount rates have had the following impact on the Group loss and combined ratios:
  - 1H04: Reduction of 3.3%
  - 2H03: Increase of 0.1%
  - 1H03: Increase of 4.4%
  - 2H02: Reduction of 0.6%
  - 1H02: Increase of 1.7%.
- The impact of changes in discount rates is largely negated in the insurance margin by the offsetting mark to market adjustment of the interest bearing securities held to back technical reserves. In 1H04 and 1H03 there were movements of close to 1% in the relevant interest rates within six-month periods. The net impact on insurance margins was a decrease of 0.1% in 1H04 and an increase of 0.7% in 1H03.
- The Group's insurance margin is the clearest measure of improvement in the Group's operations over time.

- A year into the CGU/NZI integration, the synergy benefits are beginning to show through to the Group's underwriting result by way of lower loss and expense ratios (excluding commission).
- The integration expenses for 1H04 were \$25m, of which \$9m was allocated to claims expenses and the remaining \$16m to underwriting expenses. The integration expenses of \$45m in 2H03 were similarly incurred, with \$15m in claims expense and \$30m in underwriting expenses. The impact on the combined ratio for 1H04 was 0.9% compared with 1.6% in 2H03.
- Since the acquisition of the predominately indirectly distributed general insurance businesses of CGU and NZI, the commission ratio has become a larger component of the combined ratio.
- The consistent reduction in the administration ratio reflects the Group's ongoing commitment to operating efficiently, including greater automation of underwriting processes over the past few years.
- The lower expense ratio during 1H04 is also a testament of the ability of the Group to generate significant expense efficiencies from the CGU and NZI businesses and from the additional scale they provided to the Group's operations.
- The Group's increased scale positions it well to extract further benefits from the business through its commitment to maintain its efficient cost structure and continuous improvement in its claims management processes.
- The administration ratio would fall by 1.9% to 16.1%, which is in the range of world's best practice, if the fire brigades charges expense of \$55m for 1H04 was excluded from premium and expenses.
- The Group's ongoing commitment to improve the efficiency of its operations, together with the scale and diversity of its Australian and New Zealand businesses, provides a solid platform for ongoing delivery of results at these levels.

# Analysis of group results

## A. PREMIUM GROWTH AND DIVERSIFICATION



**Notes:**

1. Includes GWP of all businesses except Inwards Reinsurance, which is in run-off.
2. The health insurance business was sold in July 2003.
3. Other short-tail primarily consists of other accident, extended warranty and consumer credit businesses.

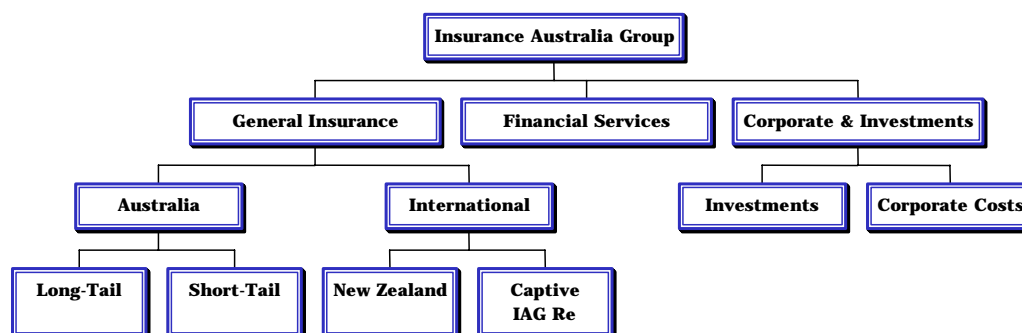
- The acquisition of CGU and NZI has been the major accelerator in the Group annual premium revenue growing from under \$4bn to in excess of \$6bn during the past calendar year.
- More importantly, the consolidated Group has sustained high retention levels and increases in business volumes. Policies/risks in force grew by 1.8% during 1H04. This is a reflection of the focused efforts over the past year to continue organic growth while integrating the acquired businesses.
- The Group's major presence in the general insurance market segments of personal lines, commercial lines and personal injury classes means its performance is consequently influenced by the conditions in each of these three areas. The Group's view of the current position and expectations for each of these are as follows:
  - Personal lines (c 55% of premium): A decade of consolidation, privatisations and improved focus on appropriate risk management for products, which are largely directly distributed, has delivered a stable market. This is expected to continue with competitive efforts focused on service. Premium rates are expected to be driven by claims inflation.

- Commercial lines (c30% of premium): The global capacity for insurance and reinsurance will continue to influence the Australian and New Zealand commercial markets. However, the impact reduces broadly in line with the scale of the insured's operations (related to access to international sourcing of insurance cover by larger operations). Due to the Group's weighting towards medium and small commercial operations, the cyclical impacts are modified somewhat. In the last few years, due to global factors and local factors (eg. removal of capacity and insufficient pricing practices of HIH), commercial premiums have experienced significant hardening. The Group's expectation is that rate increases will return to be closer to the level of inflation, subject to no major changes in claims experience.
- Personal injury (c 15% of premium): There has been significant tort reform and reform of statutory schemes in recent years following unsustainable increases in claims experience. While there remain some inconsistencies between State and Scheme legislation, there are encouraging signs of harmonisation. In the largest scheme in which the Group participates (NSW compulsory third party motor liability), where significant scheme reform was implemented in October 1999, the benchmark premium (the Sydney best Metro rate) has risen by \$6.55 to \$336.60, including GST, as at February 2004. This 2% decrease compares with an increase in the CPI of over 15% in the same period.

This line of business tends to operate on long cycles with periods of stability followed by some deterioration until legislative action is taken to rebalance the scheme. Currently the Group's significant exposures are to schemes which are operating quite stably.

- The Group is continuing to pursue opportunities for organic growth in Australia and New Zealand. To this end, the Group has focused on instituting various system and process initiatives already developed in the personal lines business to deliver the same improvements in the commercial business, and to thus under-pin ongoing earnings growth.
- A year into ownership of CGU and NZI there has been no notable loss of business apart from the joint venture underwriting agency with Zurich, Associated Marine, which does not have a material impact on the Group. During 2003 Zurich exercised its right under the joint venture agreement to purchase the Group's 50% interest in the business under a change of ownership clause invoked following the Group's acquisition of CGU. Until termination of the joint venture on 31 December 2003, CGU and Zurich each referred relevant commercial marine business from their Australian clients to the joint venture, which generated annual premium in the order of \$65m for the Group. The business was co-insured 50:50 by the joint venturers. As part of transition, the Group retains its interest in the business in force at 31 December 2003 and a 25% quota share on the Associated Marine business for two years from 1 January 2004. With the cessation of the joint venture, the Group has started its own commercial marine insurance underwriting operation in Australia. Consequently, no significant change is anticipated in marine insurance's contribution to the Group in the medium term.

## B. RESULTS BY BUSINESS AREA



| Insurance Australia Group Limited                          | Short-tail   | Long-tail  | Financial Services | International | Corp & Inv't | 1H04         | 1H03         |
|--|--------------|------------|--------------------|---------------|--------------|--------------|--------------|
|  | A\$m         | A\$m       | A\$m               | A\$m          | A\$m         | A\$m         | A\$m         |
| <b>Gross written premium</b>                               | <b>2,084</b> | <b>604</b> | -                  | (454)         | -            | <b>3,142</b> | <b>1,886</b> |
| Gross earned premium                                       | 2,067        | 599        | -                  | 450           | -            | 3,116        | 1,868        |
| Reinsurance  | (160)        | (34)       | -                  | (10)          | -            | (204)        | (69)         |
| <b>Net premium revenue</b>                                 | <b>1,907</b> | <b>565</b> | -                  | <b>440</b>    | -            | <b>2,912</b> | <b>1,799</b> |
| Net claims expense   | (1,276)      | (318)      | -                  | (315)         | -            | (1,909)      | (1,382)      |
| Underwriting expense                                       | (505)        | (98)       | -                  | (123)         | -            | (726)        | (346)        |
| <b>Underwriting profit/(loss)</b>                          | <b>126</b>   | <b>149</b> | -                  | <b>2</b>      | -            | <b>277</b>   | <b>71</b>    |
| Investment income on technical reserves                    | 38           | 18         | -                  | 11            | -            | 67           | 219          |
| <b>Insurance profit</b>                                    | <b>164</b>   | <b>167</b> | -                  | <b>13</b>     | -            | <b>344</b>   | <b>290</b>   |
| Financial services   | -            | -          | 15                 | -             | -            | 15           | 2            |
| Net corporate expenses                                     | -            | -          | -                  | -             | (14)         | (14)         | (14)         |
| Amortisation   | -            | -          | -                  | -             | (54)         | (54)         | (27)         |
| Interest   | -            | -          | -                  | -             | (29)         | (29)         | (12)         |
| Profit from fee based businesses                           | 3            | 17         | -                  | -             | -            | 20           | 2            |
| Investment income/(loss) on internal funds                 | -            | -          | -                  | -             | 204          | 204          | (129)        |
| Investment income/(loss) on external funds                 | -            | -          | -                  | -             | 8            | 8            | 12           |
| NSW Insurance Protection Tax 1                             | -            | -          | -                  | -             | (10)         | (10)         | (9)          |
| <b>Profit before income tax</b>                            | <b>167</b>   | <b>184</b> | <b>15</b>          | <b>13</b>     | <b>105</b>   | <b>484</b>   | <b>115</b>   |
| Income tax (expense)/benefit                               | -            | -          | -                  | -             | -            | (136)        | (18)         |
| <b>Profit after income tax</b>                             | -            | -          | -                  | -             | -            | <b>348</b>   | <b>97</b>    |
| OEI: External funds  | -            | -          | -                  | -             | -            | (8)          | (12)         |
| OEI: Insurance Manufacturers of Australia                  | -            | -          | -                  | -             | -            | (38)         | (22)         |
| <b>Profit/(loss) attributable to shareholders</b>          | -            | -          | -                  | -             | -            | <b>302</b>   | <b>62</b>    |
| Dividends on reset preference shares                       | -            | -          | -                  | -             | -            | (14)         | (11)         |
| <b>Profit/(loss) attributable to ordinary shareholders</b> | -            | -          | -                  | -             | -            | <b>288</b>   | <b>51</b>    |
| <b>Basic earnings per share (cents)</b>                    | -            | -          | -                  | -             | -            | <b>17.07</b> | <b>3.64</b>  |
| <b>Diluted earnings per share (cents)</b>                  | -            | -          | -                  | -             | -            | <b>17.01</b> | <b>3.62</b>  |

## Domestic short-tail analysis

| Domestic short-tail                     | Half year ended Dec-02 | Half year ended June-03 | Half year ended Dec-03 | Variance from Jun-03 |
|---|------------------------|-------------------------|------------------------|----------------------|
|   | A\$m                   | A\$m                    | A\$m                   | A\$m                 |
| <b>Gross written premium</b>            | <b>1,252</b>           | <b>2,163</b>            | <b>2,084</b>           | <b>(79)</b>          |
| <b>Gross earned premium</b>             | <b>1,216</b>           | <b>2,006</b>            | <b>2,067</b>           | <b>61</b>            |
| Reinsurance expense                     | (53)                   | (138)                   | (160)                  | (22)                 |
| <b>Net premium revenue</b>              | <b>1,163</b>           | <b>1,868</b>            | <b>1,907</b>           | <b>39</b>            |
| Net claims expense                      | (834)                  | (1,248)                 | (1,276)                | (29)                 |
| Underwriting expense                    | (240)                  | (517)                   | (505)                  | 12                   |
| <b>Underwriting profit</b>              | <b>89</b>              | <b>103</b>              | <b>126</b>             | <b>23</b>            |
| Investment income on technical reserves | 46                     | 42                      | 38                     | (4)                  |
| <b>Insurance profit</b>                 | <b>135</b>             | <b>145</b>              | <b>164</b>             | <b>18</b>            |
| Profit from fee based businesses        | -                      | -                       | 3                      | 3                    |
| <b>Total short-tail result</b>          | <b>135</b>             | <b>145</b>              | <b>167</b>             | <b>21</b>            |
| <b>Insurance ratios</b>                 |                        |                         |                        |                      |
| Loss ratio                              | 71.7%                  | 66.8%                   | 66.9%                  | 0.1%                 |
| Expense ratio                           | 20.6%                  | 27.7%                   | 26.5%                  | (1.2%)               |
| Administration ratio                    | 20.0%                  | 21.4%                   | 19.6%                  | (1.8%)               |
| Commission ratio                        | 0.6%                   | 6.3%                    | 6.9%                   | 0.6%                 |
| Combined ratio                          | 92.3%                  | 94.5%                   | 93.4%                  | (1.1%)               |
| Insurance margin (before tax)           | 11.6%                  | 7.8%                    | 8.6%                   | 0.8%                 |



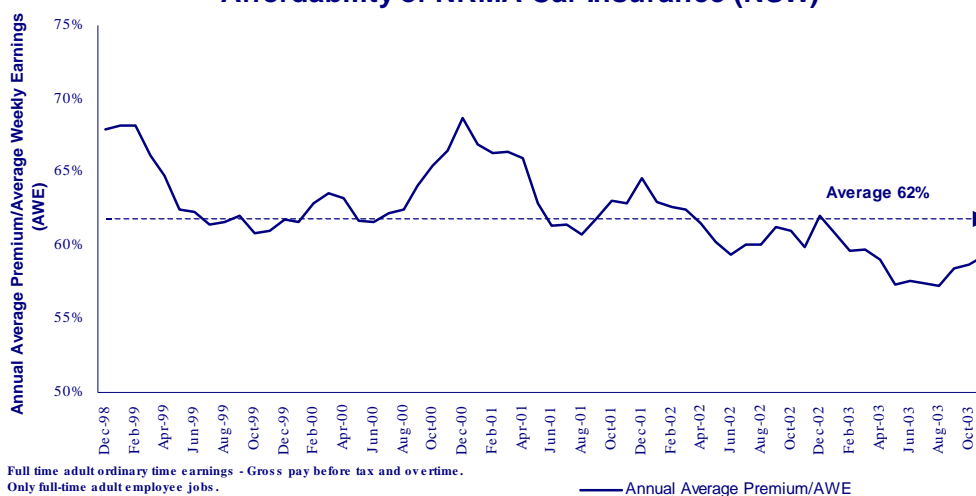
## A. OPERATING RESULTS

- The Group's domestic short-tail portfolio insurance margin for 1H04 of 8.6% and its constituent elements are within the Group's targeted range for FY04, in particular a COR range of 92 – 94%.
- Relative to 2H03, gross written premium reduced by \$79m in 1H04. This is wholly accounted for by the sale of the health business in July 2003 – it contributed \$93m to the 2H03 GWP. The seasonality of commercial premium, whereby the written premium is weighted to the second half of the financial year, and the fact that the main commercial business (CGU) was not purchased until January 2003, make comparisons difficult. The Group continues to experience high retention rates and policies/risks in force grew by 2.8% during 1H04.
- Gross earned premium has also been affected by the sale of the health business. If this business is excluded from the 2H03 earned premium, underlying growth of about 8% would have been reported.
- The Group's increased scale and diversity has enabled the domestic short-tail portfolio to bear integration expenses of \$20m and major storm costs of \$80m and still deliver a combined ratio of 93.4%. The continued strong performance of the CGU-led commercial portfolio and dry weather in other months and regions were off-setting favourable contributors.
- The combined ratio has now been in the range of 92 – 94% for four consecutive financial half-years. This relatively narrow operating range – which shows a step change down from prior periods – reflects both the Group's increased scale and diversity and the Group's continued focus on underwriting and expense management.
- The Group's administration expense ratio continued to improve to 19.6%, relative to 20.0% for 1H03. The 1H04 ratio includes 0.7% in respect of the \$14m of integration costs expensed in this category (1.4% in 2H03).
- If the expense for fire brigades charges was excluded from both premium and administration expenses, the administration ratio would be 16.6%. The Group had a net release of fire brigade expense in the period following a significant restatement of costs notified by the NSW authorities in December 2003. This reduced the expense ratio by approximately 1%.
- The insurance margin in 1H03 reflected a higher yield on technical reserves than was experienced during either 2H03 or 1H04.

## B. PREMIUMS

- The Group is committed to ensuring that its customers share in the benefits of improvements in the cost efficiency of its operations. This should mean that premiums do not need to rise as fast as the market trends in the input costs.
- The capacity of efficiencies and other claims savings to provide more affordable premiums can be demonstrated in the following chart which shows the trend in the cost of NSW motor car premiums for the Group's direct business relative to average weekly earnings. The NSW motor car insurance annual premium has become 4% cheaper than two years ago, relative to average weekly earnings.

## Affordability of NRMA Car Insurance (NSW)



Note: On Average, 62% of the Average Weekly Earnings covers a 12 months Insurance Policy

- Average premiums in the Group's largest personal lines portfolios, ie. the NSW and Victoria business branded NRMA Insurance and RACV, rose by less than 2% for motor and 3.5% for home relative to December 2002. The movement in home premiums includes the effect of a growing proportion of customers choosing to include optional extra covers in their policies, as well as the ongoing impact of the increasing building and contents values.
- While the commercial portfolio increased its GWP relative to the prior comparative period (prior to acquisition of CGU by the Group), the portfolio is starting to experience a flattening in premium rates for commercial property. Pricing remains in line with the Group's statistical risk rating.

### C. OPERATIONAL IMPROVEMENTS, INCLUDING CLAIMS

- The fundamentals of supply chain management and automation of processes underlying the Preferred Supplier Schemes have led to the development of a number of initiatives such as the 'Preferred Accident Towing Programme', 'Home Procurement Model' and 'National Salvage Model'. Whilst these models and programmes improve efficiencies and reduce costs, as importantly, the Group has scalable procurement arrangements in place which deliver quality service to customers even in times of major catastrophe.
- These systems allow the Group to manage every step of the claims process from the perspective of cost management and customer service, which are important elements of ensuring profitable and sustainable underwriting operations.
- These processes have also delivered greater customer satisfaction in the form of faster claims processing and payments. Results from the latest external survey conducted by Woolcott Research shows that the Group continues to maintain high customer satisfaction rates of over 85% for claims on both motor and home insurance sold directly.

- Work undertaken during 1H04 included the integration of claims management for the majority of personal lines products, regardless of distribution channel. This migration was the major component of the \$6m of integration expenses included in total claims expense for the period. The centralisation of claims management facilitated efficiencies in administration and enables the CGU claims to leverage the benefits of the Group's procurement arrangements, including Preferred Smash Repairer ('PSR') and Online Repair Management ('ORM') for motor claims. Benefits from these changes to the CGU claims – which also includes access to 24 x 7 claims lodgement for majority of lines of business – will emerge during 2H04.
- Current statistics on the use of these models in the personal lines business are as follows:
  - National roll-out of the PSR programmes was fully implemented as at December 2003;
  - In NSW, the Group's largest market, over 75% of motor repair work was allocated to PSRs. In Victoria, over 60% repair work was allocated to PSRs and other states averaged around 80%;
  - The adoption of the automated process for claims management via the Group's ORM system has led to 94% of all NSW motor assessments being completed on-line. Also, the ORM auto-payment function continues to be a success with 95% of PSR payments being automatically validated and paid, enabling earlier repairer payments. In Victoria more than 200 repairers are operating on ORM, with greater than 45% of all work completed through this system; and
  - The Repair Management Centres – a model used in the States where the Group's penetration of the motor market is lower – were handling over 90% of the relevant claims for Queensland and South Australia by December 2003. The penetration in Western Australia was under 50% but expected to rise significantly following the opening of the last scheduled site in January 2004.
- An incorporated association of smash repairers, the Australian Automotive Repairers Association ('AARA'), has taken legal action against the Group claiming that the Group's PSR model constitutes "third line forcing", which is prohibited under the Trade Practices Act. The Group denies this claim on a number of grounds and considers that, in the unlikely event of success by AARA in its action, the Group would still be able to sustain the model. In this context, it should be noted that the Australian Competition and Consumer Commission, which regulates the Trade Practices Act, has previously reviewed the model and not found any breach of the legislation.
- The Group also continues to work to generate efficiencies through the use of e-business solutions in its commercial business. Premium passed through these systems grew 24% relative to a year ago and now comprises 20% of the total.
- The intermediated area of the business experienced considerable change during 1H04 including:
  - System changes to align the underwriting, pricing and risk acceptance approach between the ex-CGU and ex-IAG business;
  - Substantial progress in conversion of all intermediary sourced IAG SME commercial business to CGU products and systems; and
  - Completion of training and documentation for the Financial Services Reform changes prior to the March 2004 deadline.

- The Group continues to expand its product offering by developing new products including:
  - Marine insurance products following the cessation of the joint venture with Associated Marine; and
  - The expected launch of homeowners warranty insurance in NSW, Victoria and the ACT in 2H04.

### **C. SPOTLIGHT ON MOTOR VEHICLE THEFT**

- The ongoing improvements in car security design and application of security intelligence and policing has seen a noticeable decline in the rate of theft of vehicles. Theft is the second most expensive element of car claims after collision repair costs.
- Over the period, lower theft rates were a contributing factor to the strong short tail result. According to industry data (Source: National Motor Vehicle Theft Reduction Council Annual Report 2003), Australia recorded a drop of 19% in theft numbers in 2003, compared with a drop of 11% in the prior year. All States and Territories, with the exclusion of ACT (up 4%) saw a significant drop in theft rates during 2003. NSW and Victoria saw the strongest reduction, at 24%.
- At the industry level, the National Motor Vehicle Theft Reduction Council is the key body charged with developing and implementing initiatives to drive down thefts. IAG has also taken a proactive stance to devise its own theft reduction strategy to maintain this downward trend in theft rates.
- The combined effect of these improvements has been a reduction in the allowance for theft frequency in the Group's premium rating models for the relevant vehicle types and areas.

### **D. MARKET SHARES & CUSTOMERS**

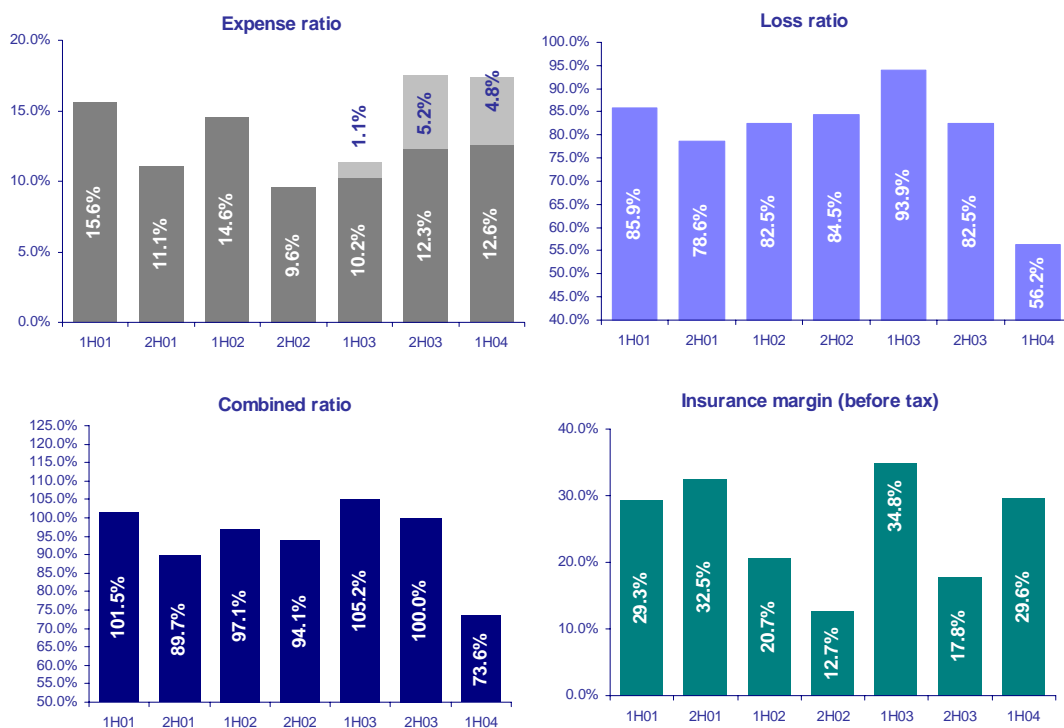
- The Group's market share of personal lines business has remained quite static overall during the period, based on the latest available data from Roy Morgan Research. There are variations by State and product but the overall results are heavily weighted by the large size of the NSW and Victorian populations and portfolios. The most obvious growth in market shares have been in Queensland (motor and home) and South Australia and Western Australia (home).
- During the period, the customer service indicators show that the Group has been effective in reducing customer complaint levels and maintaining high customer satisfaction rates. Customer satisfaction is measured on key attributes, including price, convenience, clarity, recognition and value for money.
- The trends in complaint levels continue to decline, with complaints as a percentage of risk in-force running at 0.05% per annum of personal lines policies in force for the calendar year to 31 December 2003.
- As affirmation of the indirect business progress from the customer perspective, the JP Morgan Broker Survey 2003 released in early December, ranked CGU as the leading underwriter overall (based on votes by class), by both the top-20 broker group and the middle market broker group. In the survey, brokers were asked to nominate the underwriter they considered the best in each of the major classes of business.

### **E. FEE BASED BUSINESS - PREMIUM FUNDING**

- The profit for premium funding was \$3m compared to a breakeven result in 2H03 due to improved funding terms.
- The volume of loans funded and number of loans increased by 11.8% relative to 2H03.

## Domestic long-tail analysis

| Domestic long-tail                      | Half year ended Dec-02 | Half year ended June-03 | Half year ended Dec-03 | Variance from Jun-03 |
|---|------------------------|-------------------------|------------------------|----------------------|
|   | A\$m                   | A\$m                    | A\$m                   | A\$m                 |
| <b>Gross written premium</b>            | <b>410</b>             | <b>639</b>              | <b>604</b>             | <b>(35)</b>          |
| <b>Gross earned premium</b>             | <b>439</b>             | <b>580</b>              | <b>599</b>             | <b>18</b>            |
| Reinsurance expense                     | (16)                   | (21)                    | (34)                   | (13)                 |
| <b>Net premium revenue</b>              | <b>423</b>             | <b>559</b>              | <b>565</b>             | <b>5</b>             |
| Net claims expense                      | (397)                  | (461)                   | (318)                  | 143                  |
| Underwriting expense                    | (48)                   | (98)                    | (98)                   | (0)                  |
| <b>Underwriting profit</b>              | <b>(22)</b>            | <b>-</b>                | <b>149</b>             | <b>149</b>           |
| Investment income on technical reserves | 169                    | 100                     | 18                     | (82)                 |
| <b>Insurance profit</b>                 | <b>147</b>             | <b>100</b>              | <b>167</b>             | <b>68</b>            |
| Profit from fee based businesses        | 3                      | 2                       | 17                     | 15                   |
| <b>Total long-tail result</b>           | <b>150</b>             | <b>102</b>              | <b>184</b>             | <b>82</b>            |
| <b>Insurance ratios</b>                 |                        |                         |                        |                      |
| Loss ratio                              | 93.9%                  | 82.5%                   | 56.2%                  | (26.3%)              |
| Expense ratio                           | 11.3%                  | 17.5%                   | 17.4%                  | (0.1%)               |
| Administration expense ratio            | 10.2%                  | 12.3%                   | 12.6%                  | 0.3%                 |
| Commission ratio                        | 1.1%                   | 5.2%                    | 4.8%                   | (0.4%)               |
| Combined ratio                          | 105.2%                 | 100.0%                  | 73.6%                  | (26.3%)              |
| Insurance margin (before tax)           | 34.8%                  | 17.8%                   | 29.6%                  | 11.8%                |



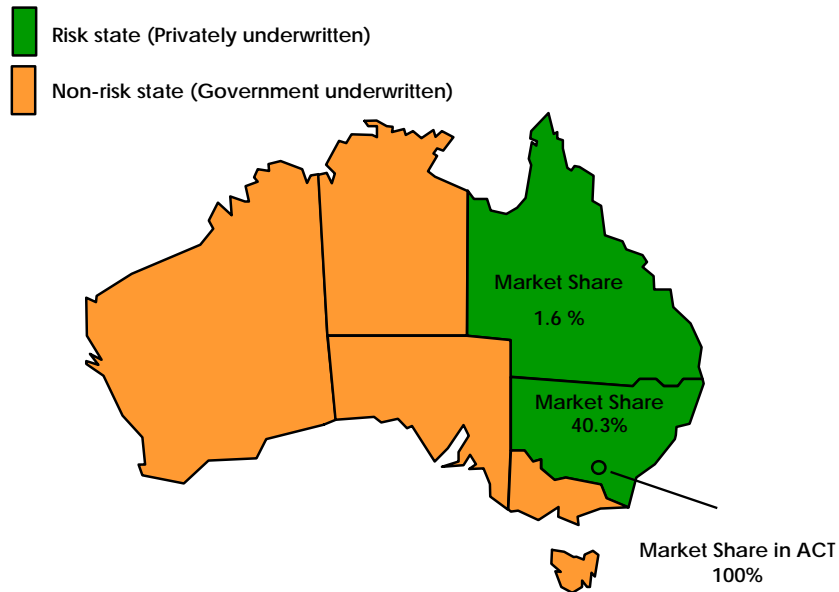
## A. OPERATING RESULTS

- The long-tail portfolio comprises less than 20% of the Group's business and is split approximately 70:30 between personal injury and commercial business.
- The strong long-tail result is reflective of the positive contribution made by both segments of the portfolio. These were driven by stability of the key personal injury schemes and profitable results from the commercial business. Profitability has been reached as premiums are now more closely matched to the exposures being assumed following a number of years of premium inadequacy.
- The marginal reduction in GWP over the period again reflects the seasonality of renewals of commercial business and workers' compensation, which primarily occur in the second half of the financial year.
- The combined ratio includes the effect of a reduced net claims expense from a discount adjustment of \$96m, which improved the loss ratio by 17.0%. Therefore, the combined ratio excluding this impact would be 90.6%.
- Similarly the reported loss ratio of 56.2% would be 73.2%, immunised for the effect of the change in discount rates.
- Aside from the distortion caused by the change in discount rates, the Group's performance is ahead of the FY04 target. This is largely due to increased confidence about the effectiveness of tort and scheme reforms implemented in recent years. The Group has a conservative provisioning policy which effectively means that, in long-tail classes, the Group includes allowances in its claims reserves for the adverse claims development beyond that which the claims reported models record. If this adverse development does not eventuate, these allowances can be reversed to profit. This is done with the intention of ensuring there is a very high degree of probability that sufficient funds are set aside for future claims settlements. In 1H04, the net experience was less adverse than the allowances originally made.
- During 1H04, the actuarial models were adjusted to recognise a downward trend in injury frequency in NSW CTP. This was the most significant change in claims assumptions in the long-tail portfolio during the period. It also influenced the price reduction announced in late January 2004.
- The increase in the expense ratio since 1H03 is due to a larger expense ratio, including commissions, incurred in distributing via intermediaries. There has been little change in the expense ratio in 1H04 relative to 2H03 as both six-month periods include the CGU business.
- Whilst the insurance margin of 29.6% for the period includes the positive impact of \$96m adjustment for discount rates at the underwriting result level, this was offset by a corresponding adverse impact of \$98m on investment income on technical reserves reflecting the fall in bond valuations from increasing interest rates.
- Profit from fee based businesses increased to \$17m from \$3m and \$2m in 1H03 and 2H03, respectively. This reflects:
  - The increase in the scale of operations since CGU was acquired;
  - The fact that the 2H03 profits were reduced by provisions required on cessation of the management contract for the South Australian CTP management contract; and
  - Incentive fees received for FY03, which are usually notified in the following financial year.

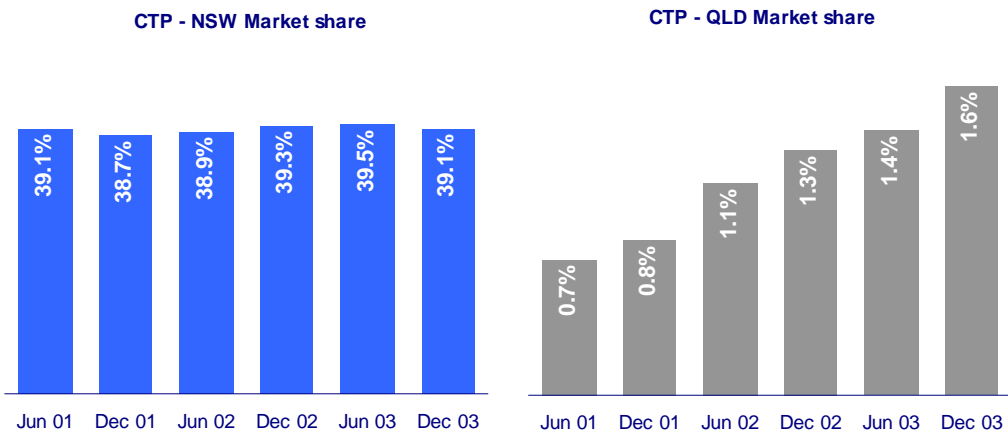
## B. PERSONAL INJURY

### B.1.1 Personal Injury - Compulsory Third Party

#### CTP market participation



### B.1 CTP market shares



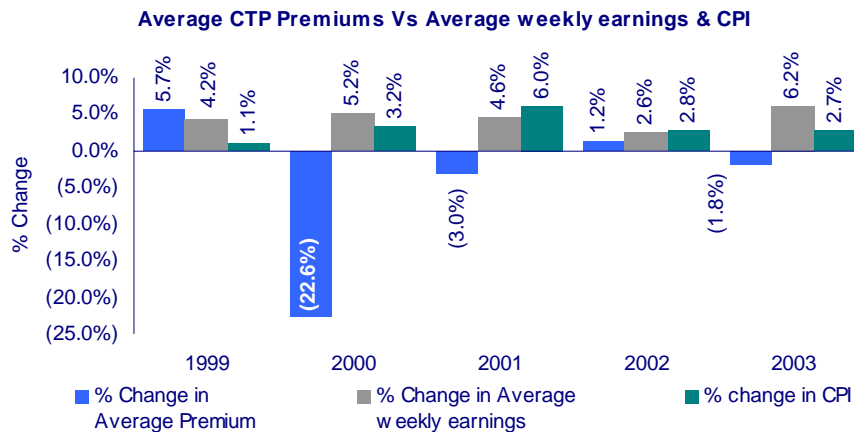
Sources: NSW CTP market share: Motor Accident Authority (MAA)

QLD CTP market share: Motor Accident Insurance Commission (MAIC)

- Notes:
1. QLD market share for June 2003 has been restated from 1.6% to 1.4% to correct an inconsistency in the basis of determination.
  2. Market shares are based on 12 month rolling averages.

### B.1.1.1 CTP – New South Wales

- The Group has retained its market leading position in NSW with its market share remaining relatively stable at 39.1% compared with 39.5% in June 2003 and 39.3% in December 2002. The Group remains satisfied with the risk profile of the portfolio, due to preferred risk groups being successfully targeted.
- Penetration into the Group's NSW motor portfolio remains high. The penetration into the motor portfolio at December 2003 was 78.2%, up from 76.9% at December 2002.
- As a result of the October 1999 reforms, claims costs within the NSW Motor Accidents Scheme remain lower than originally anticipated. Reported claim frequencies for the scheme have been trending downwards since the introduction of the reforms. Settlement costs are also falling as a lower proportion of claimants are accessing non-economic loss benefits and legal costs have reduced significantly. Claim finalisation rates continue to accelerate across accident years, particularly for smaller claims. The conversion rate of Accident Notification Forms ('ANFs') to claims has been stable.
- The success of the NSW CTP scheme is highlighted by the following graph, showing that average weekly earnings and CPI growth have exceeded changes in the average CTP premium rates, which have actually decreased since 1999 (net of GST).



- Some key statistics that illustrate the Group's effective management of its portion of the scheme include:
  - The Company has finalised 54% of claims under the Motor Accidents Compensation Act, compared with an industry average of 52%;
  - The Group's average incurred cost per claim was 6% lower than industry average, compared with 4% lower than industry average achieved at June 2003; and
  - The average payments on finalised claims were also 23% lower than the scheme average. Finalisation rates for claims lodged under the 1988 Act are also higher for the Group at 98.8%, when compared with the scheme average of 97.6% with the average incurred cost for claims lodged under the 1988 Act 1.5% lower for the Group than the industry average.

- The outcomes from the medical assessment and dispute resolution systems established for the scheme are being tested to evaluate their effectiveness. The early signs are encouraging and suggest that these systems are functioning effectively.
- The leveraging of Swann Insurance's relationships within the motor dealer industry has led to the finalisation of agreements with a number of dealerships to sell NRMA Insurance CTP policies. The Group has also entered into an agreement with Toyota Financial Services, which now offers NRMA Insurance CTP policies to its car finance customers. The motor dealer segment is an area in which NRMA Insurance has not traditionally participated and represents a growth opportunity.

#### **B.1.1.2 CTP – Australian Capital Territory**

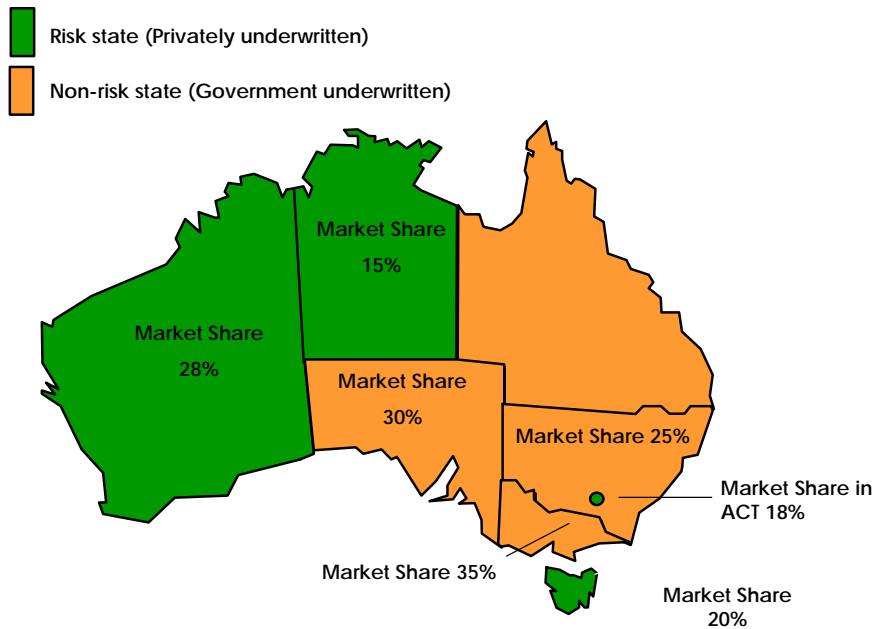
- The Group continues to be the sole provider of CTP in the ACT. The scheme is currently performing well as a result of lower notifications and a general reduction in the number of large claims incurred. Claims estimates have also been developing favourably.
- Civil Liability Reform legislation was introduced in the ACT during the last year. The changes were introduced to produce claims cost savings for the ACT personal injury schemes, including CTP, and thereby either reverse or curtail premium increases. The regulations underpinning this legislation have yet to be released, making it difficult to assess its potential impact on scheme costs and premiums.

#### **B.1.1.3 CTP - Queensland**

- The market share in Queensland, as measured by premium on a rolling 12 month basis, has risen to 1.61% for the year to December 2003 (source: Motor Accident Insurance Commission), up from 1.27% in December 2002 and 0.78% in December 2001. The increase in market share has been achieved without adversely affecting the risk profile of the portfolio as marketing efforts have been focused on more profitable segments, eg rural areas.
- The recent Civil Liability Reforms, designed to effect claims cost reductions – and consequently premium reductions in real terms – within the Queensland Personal Injury schemes, including CTP, are being monitored closely to measure their effectiveness. The main impact upon CTP will be the introduction of the Injury Scale Value, in association with the Australian Medical Association No. 5 guidelines. It is anticipated that these two tools will ensure more objectivity in impairment assessment and provide greater certainty in determining the level of damages payable for injuries. It will take some time before there is sufficient experience to quantify the scheme savings as a result of these reforms. Insurers are adopting a cautious approach to these reforms and insurers continue to file at the MAIC ceiling (ie. premium rates at the maximum permitted by the regulator).

## B.2 Personal Injury - Workers' Compensation

### Workers' compensation market participation



- The workers' compensation business in Australia comprises of a mix of privately and government-underwritten insurance with differences in the schemes in each State and Territory. Queensland is the only State where the government both underwrites and manages all the premiums and claims.
- Whilst the Group had a strong presence across Australia prior to 2003, the CGU acquisition accelerated the growth of the business in all the available States and Territories whether as underwriter or manager of the government-underwritten schemes. This, combined with continued extensive efforts undertaken to refine the Group's service delivery model and also to expand its safety services to improve product offerings, has been key in maintaining the Group's position as the leading Australian workers' compensation insurer.
- As part of integration of the CGU businesses with the Group's pre-existing workers' compensation portfolios (which were previously branded NRMA Insurance and SGIO), a single brand and underwriter was established. From July 2003, Insurance Australia Limited has used the CGU Workers' Compensation brand to underwrite all new business and renewals processed in the privately underwritten states. Premium renewal retention is tracking at 88.5% for 1H04, which is an indication of the market's acceptance of the combined operations.
- Market conditions for workers' compensation in WA and the ACT remain relatively satisfactory. In WA, the recommended premium rates were reduced by 5% in 2003-04, due largely to the success of the 1999 scheme reforms in restricting access to common law. Scheme changes anticipated next year are causing some uncertainty about the future pricing and scheme performance, but it is expected that, if the proposed reforms are implemented, they will lead to an increase in both claims costs and premiums. The Group is cautiously awaiting the outcome of the proposals, and is well prepared to respond accordingly.

- The Group is preparing for a restructure of the NSW scheme, following the passing of the NSW Workers' Compensation Amendment (Insurance Reform) Act. These legislative amendments provide the NSW Government with the authority to alter the structure of the scheme to achieve better outcomes. The Group is in a strong position to participate in the restructured NSW scheme, due to the competitive advantages it has developed through leveraging innovations across the personal injury insurance classes of workers' compensation and CTP.
- The recent proposals by the Productivity Commission to open the Comcare scheme (which provides workers' compensation to Federal government operations) to a wider range of self-insuring employers represents a potential opportunity for the Group to expand its workers' compensation business. The Group has been steadily developing its self-insurance capabilities over the last couple of years, and is in a good position to capitalise on any widening of access to the Comcare scheme should it eventuate.
- The risk states continue to experience strong competitive pressure which has kept GWP growth relatively flat over the past six months, particularly in Tasmania and Western Australia. After adjusting for the CGU acquisition, GWP for 1H04 was 0.5% higher than 1H03.
- The consolidation of legacy systems inherited through acquisitions is continuing as part of the Group's IT Transformation and should be completed by the end of the calendar year.

### **B.3 Fee based businesses/managed schemes**

- Fee based income for 1H04 is derived from management of government underwritten workers' compensation schemes in NSW, South Australia and Victoria.
- The strong results during the period were achieved by attaining high levels of performance in key measures that dictate the Group's share of net profit from these schemes. The incentive fees receivable for this performance are generally verified in the following financial year.
- The Group's strong safety capability and claims management model were instrumental in achieving the performance hurdles established by the various regulators.
- The fee based business profit of \$17m for 1H04 was a significant improvement on 2H03, which included provisions necessary following the loss of the contract to manage the South Australian government underwritten CTP scheme.
- The workers' compensation operations are working to increase their fee for service offerings, which leverage the Group's core competencies in terms of risk management, claims management, pricing of risk and OH&S knowledge. Three product lines have been targeted: self insurance, risk management consulting and OH&S training.

### **C. LONG-TAIL – COMMERCIAL**

- The commercial long-tail business has returned to profitability following a few years of strain due to inadequate premiums for the claims experience and issues such as asbestos. As this portfolio was essentially acquired as part of the CGU acquisition, most of these issues and the corrective actions were undertaken prior to ownership by the Group.
- The Group is hopeful that the actions taken in the portfolio (eg. ceasing to write certain types of business or improving terms and conditions) and the various legislative amendments supporting tort reform will deliver a period of relative stability in pricing and profits in this portfolio.

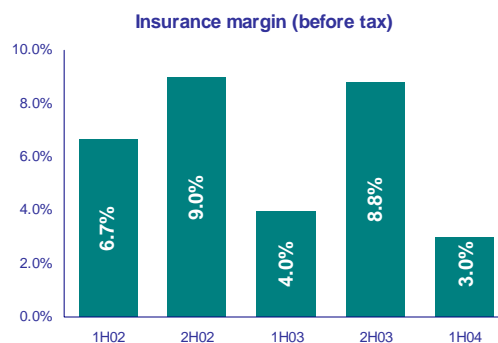
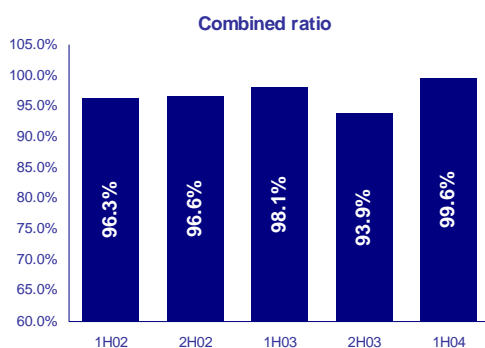
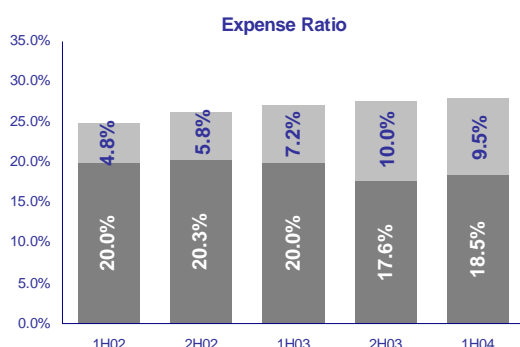
#### **D. DISCONTINUED BUSINESS - INWARDS REINSURANCE RUN-OFF**

- The commutation strategy for the inwards reinsurance run-off portfolio continues to be executed with an additional ten contracts commuted during 1H04, resulting in a net savings position for the Group.
- As at 31 December 2003, 50% of the remaining contracts are subject to discussions on possible commutations.
- The net provision for outstanding claims on this portfolio is now approximately \$130m, a reduction of 47% on the balance at 31 December 2001.

# International general insurance

## A. INTERNATIONAL

| International operations                | Half year ended Dec-02 | Half year ended June-03 | Half year ended Dec-03 | Variance from Jun-03 |
|---|------------------------|-------------------------|------------------------|----------------------|
|   | A\$m                   | A\$m                    | A\$m                   | A\$m                 |
| <b>Gross written premium</b>            | 224                    | 461                     | 454                    | (7)                  |
| <b>Gross earned premium</b>             | 213                    | 431                     | 450                    | 19                   |
| Reinsurance expense                     | -                      | (21)                    | (10)                   | 10                   |
| <b>Net premium revenue</b>              | 213                    | 410                     | 440                    | 30                   |
| Net claims expense                      | (151)                  | (272)                   | (315)                  | (43)                 |
| Underwriting expense                    | (58)                   | (113)                   | (123)                  | (10)                 |
| <b>Underwriting profit/(loss)</b>       | 4                      | 25                      | 2                      | (23)                 |
| Investment income on technical reserves | 4                      | 11                      | 11                     | -                    |
| <b>Insurance profit/(loss)</b>          | 8                      | 36                      | 13                     | (23)                 |
| <b>Insurance ratios</b>                 |                        |                         |                        |                      |
| Loss ratio                              | 70.9%                  | 66.3%                   | 71.6%                  | 5.3%                 |
| Expense ratio                           | 27.2%                  | 27.6%                   | 28.0%                  | 0.4%                 |
| Administration ratio                    | 20.0%                  | 17.6%                   | 18.5%                  | 0.9%                 |
| Commission ratio                        | 7.2%                   | 10.0%                   | 9.5%                   | (0.5%)               |
| Combined ratio                          | 98.1%                  | 93.9%                   | 99.6%                  | 5.7%                 |
| Insurance margin (before tax)           | 4.0%                   | 8.8%                    | 3.0%                   | (5.8%)               |



- The international business result is mainly comprised of the New Zealand operations and the Captive operations. The Group also has a subsidiary in China.
- The acquisition of NZI in January 2003 has been the predominant factor driving the 102% growth in GWP over the prior comparative period. Exchange rate movements account for the marginal decline in GWP relative to 2H03. There is also a seasonality impact from commercial renewals. However, the 4.4% growth in GEP in the same period is more indicative of the underlying organic growth.
- The latest available data, as at September 2003, shows the Group's New Zealand operations continue to lead the market in terms of written premium with a 38% market share, unchanged from December 2002. (Source: Insurance Council of New Zealand.)
- In reviewing the performance of the international operation for 1H04, the following should be noted:
  - There is considerable seasonality in the New Zealand business due to weather, which traditionally results in less profitable results in the first half of the financial year, which includes the worst of winter;
  - The Captive absorbed \$25m of the claims costs incurred from the major storms in Sydney and Melbourne in 1H04. This generated a deterioration of 5.7% in the COR for the international business. Excluding this impact, the COR for the international business would be unchanged from 2H03 at 93.9%;
  - Integration costs for the period remained relatively unchanged at \$4m against \$5m in 2H03; and
  - Investment returns on technical reserves were suppressed due to lower bond yields. As the New Zealand operations are about 95% short-tail, there is little offsetting benefit in the COR from increased discount rates on claims reserves.
- The total expense ratio increased marginally during the period to 28.0% from 27.6%. This includes the costs of re-launching both the State and NZI brands. The costs included additional advertising and trade sponsorship. They also include migrating the Circle business to the NZI processes and systems.
- Similar to the Group's experience in Australia, the New Zealand commercial market rate environment – which includes no personal injury exposure due to the government underwritten no fault scheme that operates - is starting to flatten.
- The Group expects the international business to generate its FY04 combined ratio target range of 91 – 93%, subject to any impact on the business, including the Captive, from any large events in 2H04. In addition to the normal seasonal fluctuations, this improvement will be facilitated by more NZI integration synergies being realised during 2H04. The ability to reach the FY04 target has been impacted by the February storms in New Zealand.
- Consistent with the Group-wide integration programme, the New Zealand integration programme remains on track, having achieved all major milestones due in 1H04. These milestones and related matters include:
  - Moving all the business into a single insurance entity;
  - On-track with the process of migrating the Circle business to the NZI brand, systems and procedures on policy renewal. This is being achieved with no notable interruption to the business and ongoing strong results from the broker channel;

- Entering into a four-year contract for the supply of a single integrated voice and data network for the merged operations. This will generate savings in the future periods; and
  - Continuing the development and testing of the new insurance system for the New Zealand operations. This will be delivered during 2004. The development costs have been expensed as incurred.
- The emphasis for the remainder of the programme will be extracting the balance of the planned synergy benefits now that the infrastructure to support the new business model for the combined business is largely in place.

## **B. INTERNATIONAL – ASIAN OPERATIONS**

- The Group has continuing interests in two operations in Asia, specifically a 20% ownership stake in Thailand's Safety Insurance and 100% ownership of China Automobile Association, a company providing road service in Beijing.
- Over the years, these operations have provided a view of the expanding Asian market and provided an avenue for active research and development into the dynamics of the general insurance market in this region.
- Both operations are profitable. The Thailand operation has started to pay dividends for the first time since the Group's investment in 1997.
- IAG acquired the final 1% of the China operation in December 2003, and is now considering options to expand the business outside Beijing.

## Financial Services

- The Group's financial services operation, ClearView Retirement Solutions, was sold in January 2004 for approximately \$220m plus an additional \$50m earn-out, subject to business performance. The sale, to MBF Australia Limited, was announced on 11 December 2003.

| Profit before income tax              | Half year ended Dec-02 | Half year ended June-03 | Half year ended Dec-03 | Variance from Jun-03 |
|---------------------------------------|------------------------|-------------------------|------------------------|----------------------|
|                                       | A\$m                   | A\$m                    | A\$m                   | A\$m                 |
| NRMA Life Limited                     | 9                      | 7                       | 18                     | 11                   |
| NRMA Financial Management Limited     | (7)                    | (7)                     | (3)                    | 4                    |
| <b>ClearView Retirement Solutions</b> | <b>2</b>               | <b>-</b>                | <b>15</b>              | <b>15</b>            |

| ClearView Retirement Solutions                               | Half Year ended Dec-02 | Half Year ended June-03 | Half Year ended Dec-03 | Variance from Jun-03 |
|--|------------------------|-------------------------|------------------------|----------------------|
|  | A\$m                   | A\$m                    | A\$m                   | A\$m                 |
| Managed investments <sup>(1)</sup>                           | 2                      | 3                       | 4                      | 2                    |
| Risk products  | 9                      | 6                       | 7                      | -                    |
| Shareholders Fund investment income                          | -                      | (1)                     | 1                      | 2                    |
| Retirement Solutions development                             | (2)                    | (2)                     | (1)                    | 1                    |
| Distribution channel   | (7)                    | (7)                     | (3)                    | 4                    |
| <b>Net profit after statutory fund but before income tax</b> | <b>2</b>               | <b>(1)</b>              | <b>8</b>               | <b>9</b>             |
| Statutory Fund Tax <sup>(2)</sup>                            | -                      | 1                       | 7                      | 6                    |
| <b>Net profit before statutory fund and income tax</b>       | <b>2</b>               | <b>-</b>                | <b>15</b>              | <b>15</b>            |
| Funds under management                                       | 1,192                  | 1,182                   | 1,236                  | 54                   |
| Life embedded value  | 225                    | 200                     | 198                    | (2)                  |

1 Includes all single premium business including retail unit trusts

2 Statutory fund tax charged is included in the results from managed investments and risk products, it being an integral part of the result of the life operations. It is added back to reconcile to the pre-tax figures reported by the Group.

3 The embedded value at 30 June 2003 is net of the payment of a \$30m dividend in March 2003.

- The improved results in 1H04 were due to the improved investment market sentiment and performance and continued focus on cost control.
- The movement in embedded value essentially reflects increased discount rates used.
- The CGU premium funding business did not form part of the ClearView sale and is now reported as part of the domestic short-tail insurance segment.

# Investments

## A. INVESTMENT RETURNS

| Investment returns              | Actual return<br>1H03 | Benchmark return<br>1H03 | Actual return<br>2H03 | Benchmark return<br>2H03 | Actual return<br>1H04 | Benchmark return<br>1H04 | Notes    |
|---------------------------------|-----------------------|--------------------------|-----------------------|--------------------------|-----------------------|--------------------------|----------|
|                                 | %                     | %                        | %                     | %                        | %                     | %                        |          |
| Australian equities             | (5.8)                 | (4.5)                    | 3.4                   | 2.6                      | 12.8                  | 11.3                     | a        |
| International equities          | (8.3)                 | (12.5)                   | (6.8)                 | (6.9)                    | 5.6                   | 6.6                      | b        |
| New Zealand equities            | -                     | -                        | 11.9                  | 13.3                     | 4.8                   | 3.2                      | c        |
| Fixed interest                  | 5.7                   | 5.6                      | 2.8                   | 2.7                      | 0.9                   | 0.5                      | d        |
| Cash                            | 2.6                   | 2.6                      | 2.4                   | 2.4                      | 1.6                   | 1.6                      | e        |
| <b>Total</b>                    | <b>0.5</b>            | <b>0.6</b>               | <b>1.9</b>            | <b>1.6</b>               | <b>3.6</b>            | <b>3.0</b>               |          |
| Asset overlay                   | 1.0                   | 0.9                      | 0.5                   | 0.5                      | -                     | -                        | f        |
| <b>Total with overlay</b>       | <b>1.5</b>            | <b>1.5</b>               | <b>2.4</b>            | <b>2.1</b>               | <b>3.6</b>            | <b>3.0</b>               |          |
| Tactical option programme       | 0.1                   | -                        | (0.9)                 | n/a                      | (0.4)                 | n/a                      | f,g      |
| <b>Total (incl derivatives)</b> | <b>1.6</b>            | <b>1.5</b>               | <b>1.5</b>            | <b>n/a</b>               | <b>3.2</b>            | <b>n/a</b>               | <b>g</b> |

### Notes:

- Combination of S&P/ASX200 Accumulation Index (IAG ex CGU/NZI) and S&P/ASX100 Accumulation Index (CGU/NZI Aust Equities benchmark).
- MSCI World Index (ex-Australia) Net Dividend Reinvested in Australian dollars.
- Combination of NZSE30 and NZSE40 Gross New Zealand equity indices in Australian dollars. (These assets were sold for international shares in December 2003.)
- Combination of internal benchmarks (for IAG ex CGU/NZI) that are marked to a benchmark of government securities constructed to reflect the target duration of the portfolio (matching insurance technical reserves) and a combination of standard market benchmarks (for CGU/NZI): UBS Composite Bond Index, UBS Bank Bill Index and 0-3 Maturity UBS NZ Government Bond Index.
- Combination of UBS Bank Bill index (Aust) and UBS Bank Bill index (NZ) in Australian dollars.
- Performance measure as contribution to total fund.
- The tactical option protection programme is outside the benchmark measures and therefore no benchmark return measures are applicable.

- The Group portfolio out-performed its benchmark by 0.58% for the six months ending 31 December 2003, before the 0.4% cost of the tactical option programme.

| Portfolio return (pre-tax)<br>and incl. Derivatives | 1H03      | 1H03                   | 2H03       | 2H03                   | 1H04       | 1H04                   |
|---|-----------|------------------------|------------|------------------------|------------|------------------------|
|   | A\$m      | Annualised<br>return % | A\$m       | Annualised<br>return % | A\$m       | Annualised<br>return % |
| Technical reserves                                  | 219       | 10.6                   | 153        | 5.2                    | 67         | 2.0                    |
| Shareholders' funds                                 | (129)     | (10.4)                 | 9          | (2.8)                  | 204        | 16.8                   |
| <b>Total investment income</b>                      | <b>90</b> | <b>3.2</b>             | <b>162</b> | <b>3.0</b>             | <b>271</b> | <b>6.4</b>             |

- The Group continued its long term exposure to equities in its shareholder funds. While proactively managing the market exposure, it has generated a total contribution of \$204m, net of protection costs.
- The Australian sharemarket produced a strong 11.3% return during 1H04. The six month period was marked by an increase in investors' risk appetite globally after a long period of negative sharemarket returns. This resulted in a strong market rally, particularly in resource companies. In addition to the generally positive outcome from the reporting season, many companies provided positive outlook statements and upbeat earnings guidance.

- World sharemarkets finished 2003 on a positive note, rising by 6.6% (in Australian dollar terms) over the six months to 31 December 2003. Financial markets were underpinned by improving global economic growth, led by the US.
- The rising Australian dollar during 1H04 reduced the returns from international shares by as much as 8.6%. The Australian dollar's movement has been most pronounced against the US Dollar, rising by 12.3% during 1H04.
- Investors' increasing appetite for risk and the improving global economic environment over the last six months had a negative impact on fixed interest prices putting upward pressure on fixed interest yields. Australian official cash rates also increased by 0.5% over the period.
- Technical reserves remained solely exposed to fixed interest and cash assets. The gain experienced on these assets contributed \$67m to the Group's insurance result. The return achieved on the technical reserve assets was 0.97% compared to the benchmark return of 0.53%. The active return of 0.44% was essentially achieved through active duration management. This duration management is undertaken within strict limits, reflecting the Group's default position of duration matching its technical reserves assets and liabilities.

## B. INTEGRATION OF CGU/NZI ASSETS

- Assets in the name of CGU and NZI, which were managed by external parties, were transitioned to IAG Asset Management in November 2003. As part of the transition all the assets of those companies were allocated between technical reserves and shareholder funds in line with other Group assets.

## C. INVESTMENT DERIVATIVE STRATEGIES

- The Group has an actively managed option protection programme over its Australian and international equity investment portfolios. This protection programme was initially implemented during FY03 to protect the capital base of the Group from periods of substantial equity market weakness.
- During 1H04 the Group reduced the level of option protection over its equity portfolios, as reported in the June 2003 investor report. This decision was made in the light of the substantial increase in the Group's capital strength; the completion of the CGU and NZI acquisition funding; the revival in equity market performance and sentiment; and to minimise the option protection programme costs. It is now at negligible levels.

## D. ASSET RETURN EXPOSURE

| Asset return exposure  | Technical Shareholders' Reserves |              | Technical Shareholders' Funds |              | Technical Shareholders' Reserves |              | Technical Shareholders' Funds |      |
|------------------------|----------------------------------|--------------|-------------------------------|--------------|----------------------------------|--------------|-------------------------------|------|
|                        | 1H03                             | 1H03         | 2H03                          | 2H03         | 1H04                             | 1H04         | 1H04                          | 1H04 |
|                        | %                                | %            | %                             | %            | %                                | %            | %                             | %    |
| Australian equities    | -                                | 62.6         | -                             | 44.4         | -                                | -            | 72.9                          |      |
| International equities | -                                | 26.8         | -                             | 19.6         | -                                | -            | 18.9                          |      |
| Fixed interest         | 95.8                             | 6.2          | 92.8                          | 4.0          | 100.0                            | -            | 3.7                           |      |
| Cash                   | 4.2                              | 4.4          | 7.2                           | 32.0         | -                                | -            | 4.5                           |      |
| <b>Total</b>           | <b>100.0</b>                     | <b>100.0</b> | <b>100.0</b>                  | <b>100.0</b> | <b>100.0</b>                     | <b>100.0</b> | <b>100.0</b>                  |      |

**Note:**

1. This table represents the Group's asset class exposure (net of derivatives).
2. New Zealand equities held by NZI were included under international equities.

## E. STRATEGIC ASSET ALLOCATION

### E.1 Shareholders' Funds

- The Group has reviewed its policy of investing shareholders' funds in equities. This work was undertaken to investigate opportunities to reduce investment volatility risk while minimising any associated reduction in expected returns.
- This resulted in a decision to increase diversification across markets and managers and the expected result is a reduction in downside risk by 30% with only a slight reduction in expected returns of \$2m per annum (after taxes, fees and capital charges).
- The increased diversification involves reducing the allocation to Australian equities, which will fund the introduction or increase in current holdings in hedge funds, absolute return funds; private equity; and Australian small cap stocks. In aggregate, these elements will constitute approximately 20% of the portfolio. Another 20% will remain in international equities, the management of which will continue to be out-sourced.
- The amended allocation will be implemented in coming months.
- A portion of the shareholders' funds will continue to be invested in cash. This proportion will vary over time depending on market conditions and timing, eg. it is likely to rise as the company moves close to completing corporate actions such as dividend payments.

### E.2 Technical Reserves Funds

- During 2002, IAG used bond swaps to enhance returns by retaining exposure to active equity returns and fully franked dividends in its technical reserves while having effective exposure to bonds/fixed interest securities that matched the expected duration of the liabilities. This practice was discontinued in 2003 as the Group preferred to concentrate its derivatives exposure on equity market protection rather than return enhancement. Now that the Group's capital position is relatively strong and market sentiment has improved, return enhancement is again a priority.
- This return enhancement practice is still deemed beneficial on a net basis and is being reinstated for approximately 12.5% of the portfolio (previously 20%).

## F. GROUP ASSETS UNDER MANAGEMENT

| Assets under management<br>As at period ended | 1H03        | FY03        | 1H04        |
|---|-------------|-------------|-------------|
|   | A\$bn       | A\$bn       | A\$bn       |
| Technical reserves                            | 4.2         | 6.3         | 6.5         |
| Financial Services – Life Company             | 1.0         | 1.0         | 1.1         |
| Outside equity interest - Unitholders' funds* | 0.3         | 0.3         | 0.4         |
| Shareholders' funds                           | 1.7         | 2.4         | 2.5         |
| Other   | 1.7         | 0.4         | 0.6         |
| <b>Total investments - on balance sheet</b>   | <b>8.9</b>  | <b>10.4</b> | <b>11.1</b> |
| ClearView Personal Investment Trusts          | 0.2         | 0.2         | 0.2         |
| External wholesale mandates*                  | 1.0         | 1.5         | 1.8         |
| <b>Total assets under management</b>          | <b>10.1</b> | <b>12.1</b> | <b>13.1</b> |

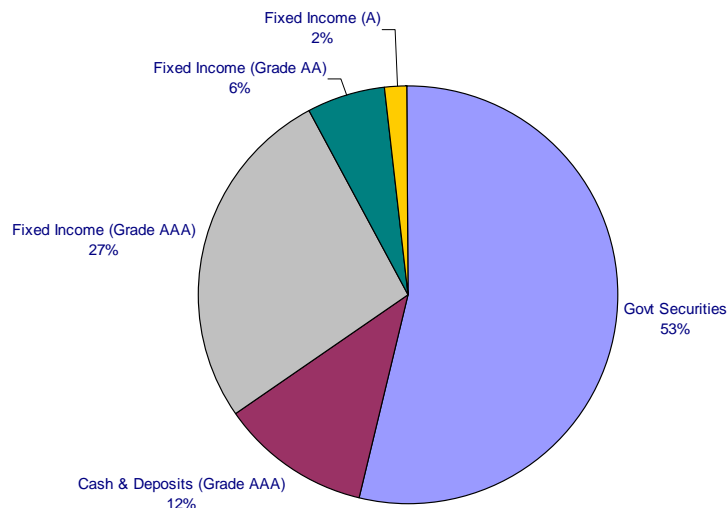
\* Total external mandates are \$2.2bn of which \$400m is held in IAG controlled entities and included in "on balance sheet" investments.

- The key factors attributable to the growth in the Group's assets under management are:
  - Market value gains in the shareholder funds offset by dividends paid of \$132m; and
  - The Group has merged the CGU staff superannuation funds with the IAG fund and, in doing so, just over \$300 million was brought under Group management (included in external mandates).
- Under the terms of sale of the ClearView business, the Group will continue as a fund manager for both funds of the Life Company and the ClearView Personal Investment Trusts on a contract basis.
- The technical reserves split between the three business segments as at 31 December was as follows:
  - Domestic short-tail – 28%;
  - Domestic long-tail – 68%; and
  - International – 4%.
- The technical reserves balance is stated net of GST on outstanding claims of \$0.2bn.
- The balance classified as 'Other' represents cash in corporate treasury rather than under investment management.

#### **F.1 Credit quality of assets under management**

- The credit quality of the Group's cash & fixed income portfolio (\$6.5bn as at 31 December 2003) is considered very strong, with 53% invested in government securities, and 27% in 'AAA' rated fixed income securities. The minimum acceptable credit quality is 'A' rated. The portfolio is comprised of predominantly highly liquid securities, and seeks to match the duration of the insurance liabilities.

**Cash & Fixed Income by Credit Quality as at 31 December 2003**



# Corporate

## A. CORPORATE

| Corporate                        | Half Year ended Dec-02 | Half Year ended June-03 | Half Year ended Dec-03 | Variance from Jun-03 |
|----------------------------------|------------------------|-------------------------|------------------------|----------------------|
|                                  | A\$m                   | A\$m                    | A\$m                   | A\$m                 |
| Head Office                      | 14                     | 25                      | 14                     | (11)                 |
| Fee based business profit/(loss) | 1                      | (6)                     | -                      | 6                    |
| Amortisation                     | 27                     | 54                      | 54                     | 0                    |
| Interest                         | 12                     | 35                      | 29                     | (6)                  |
| <b>Total corporate expenses</b>  | <b>54</b>              | <b>108</b>              | <b>97</b>              | <b>(12)</b>          |

- The main factors driving the increase of Group corporate segment over the equivalent halves are the additional amortisation and interest expenses as a result of the CGU and NZI integration.
- Head office expenses of \$14m for 1H04 are unchanged from 1H03. No significant change is anticipated in 2H04. The 2H03 expenses included one-off expenses relating to the CGU and NZI acquisition.
- The amortisation expense is consistent with the charges in 2H03. Adoption of international accounting standards is expected to affect the recognition of goodwill amortisation in 2005 and later periods.
- Interest expense relates primarily to the Group's term debt funding which has an average fixed rate of approximately 6.8%.
- Both RACV and NRMA Motoring & Services have reduced their reliance on the Group for the provision of IT services. Remaining fee based contracts in Corporate Services are negligible.

## B. CHANGES IN FINANCIAL LEGISLATIVE REQUIREMENTS

### B.1 International accounting standards

- For reporting periods beginning on or after 1 January 2005, the Group must comply with Australian equivalents to the International Financial Reporting Standards (IFRS) issued by the Australian Accounting Standards Board.
- The differences between the current Australian requirements ('Australian GAAP') and IFRS identified to date as potentially having a significant effect on the Group's financial performance and financial position are summarised below.
- Regulatory bodies that promulgate Australian GAAP and IFRS have a number of ongoing projects that could affect the differences described below between Australian GAAP and IFRS, and the impact of these differences on the Group's future financial reports. The potential impacts of the adoption of IFRS on the Group's financial performance and financial position, including system upgrades and other implementation costs which may be incurred, have not been quantified as the actual impact will depend on the particular circumstances prevailing on adoption of IFRS in the half-year commencing on 1 July 2005.
- It is important to understand that, while the IFRS accounting requirements will change the Group's reported results, this does not represent a change in the strength of the underlying business.

- The key potential implications of the conversion to IFRS to the consolidated entity are as follows:
  - Firstly, in respect of the Group's core insurance business, the changes to be effected in 2005 are expected to be quite minor. The International Accounting Standards Board's (IASB) suite of accounting standards does not currently include a standard on insurance. Having recognised that it was unable to conduct a comprehensive consultation process and produce a full standard in time for the 2005 start date set by a number of jurisdictions, the IASB split its insurance project into two phases. The IASB has issued an exposure draft as part of phase I that sets out interim measures to be applied until finalisation of the complete standard under phase II. There are a number of issues being considered in relation to the IASB exposure draft and the resulting standard is not expected until the end of the first quarter of 2004. The issue of an Australian equivalent to that standard is more involved because of the issues and recommendations arising from the HIH Royal Commission, and is not expected before May 2004. Due to Australia's current advanced accounting treatments for insurance (relative to the key tenets proposed by the IASB), combined with the Group's robust accounting policies, the new standard is expected to result in minimal change to current treatments. However, the release of phase II in a few years time may bring significant changes to the Group's accounting treatments.
  - The Group's reset preference shares will be reclassified as debt under IFRS. This will raise the Group's debt to equity ratio but is not expected to impact the securities' rating from Standard & Poor's. Distributions made on those instruments will be treated as interest rather than dividends.
  - As the revised standard on insurance has not yet been finalised, there remains uncertainty as to how general insurers will be required to account for financial assets. What is clear is that financial assets must be recognised in the statement of financial position and that all derivatives must be carried at fair value. It should be noted that the application of this new treatment has been delayed for a year beyond the application of other standards.
  - Equity-based compensation, in the form of shares and options, will be recognised as an expense in the period during which the employee provides related services. The Group has, during the last two years, simplified its approach to equity-based remuneration. Consequently, this new requirement will not have a major impact on the Group's performance, as the cost of shares acquired to fund future obligations for equity-based remuneration is expensed over the period from grant to first potential exercise.
  - Surpluses and deficits in defined benefit superannuation plans sponsored by entities within the Group will be recognised in the statement of financial position and the statement of financial performance. As at 30 June 2003, the relevant surplus in the defined benefit superannuation plans was estimated to be \$136m. Due to the surplus in these plans, contribution holidays are currently in place that, together with movements in investment markets, mean that the surplus in the plans upon the transition to IFRS may be significantly different to the current figure. Upon transition, the full amount of the surplus or deficit will pass through retained earnings, with the profit or loss impact in subsequent periods being only the movement in the surplus or deficit.

- Goodwill will not be amortised under IFRS but will be tested for impairment at least annually. Under AASB 1: First-time Adoption of Australian International Financial Reporting Pronouncements, it is likely that the carrying value of goodwill (being the original value less accumulated amortisation) at 30 June 2004 will be carried forward indefinitely subject to regular impairment testing. The Group currently has an annual goodwill amortisation expense of around \$92m. The elimination of this charge from the statement of financial performance will increase reported profits, subject to any impairment charge that may be required.
- The recognition of internally generated intangible assets will become very restrictive. It is likely that there will be no grandfathering of the recognition of intangible assets recognised under current Australian Standards. Other than goodwill, the Group holds only one intangible asset (the value of contractual rights entered into in 1999) with a value of \$34m as at 31 December 2003. The Group believes that this non-goodwill intangible asset will meet the new recognition criteria and so its accounting treatment, including amortisation, will remain unchanged. It will be subject to impairment testing.
- In certain circumstances, under the new accounting standards, development phase expenditure will be capitalised and so recognised as an internally generated intangible asset. Software development is the largest component of development expenditure for the Group. The Group is not currently carrying any amount in fixed assets for software development.
- Property, plant and equipment will be measured at either cost less accumulated depreciation or a revalued amount, being the fair value at the date of the revaluation less any subsequent accumulated depreciation. Under the fair value option, movements in fair value are recorded through equity. While the revised standard on insurance has yet to be finalised, it is likely that general insurers, will be required to use the fair value measurement option for those items of property, plant and equipment that are held to back insurance liabilities. Under current accounting treatments, all property, regardless of the purpose for which it is used, is designated as an investment and hence integral to general insurance activities and so measured at fair value. This forced designation will not continue under the new standards and property will be classified according to the purpose for which it is held.
- Income tax will be calculated based on the “balance sheet” approach, which may result in increased deferred tax assets and liabilities and, as tax effects follow the underlying transaction, some tax effects will be recognised in equity.

## **B.2 Tax consolidation**

- All Australian resident wholly owned companies in the Group have elected to be treated as a single entity for income tax purposes in line with legislation that has been enacted from 1 July 2002.
- The head entity, Insurance Australia Group Limited, will recognise all current and deferred tax assets and liabilities of the tax consolidated group.
- On formation of a tax consolidated group, the head entity has an option to bring the assets of each subsidiary member into the tax consolidated group by choosing between two alternative methods, the Allocable Cost Amount (‘ACA’) method or Transitional Method.

- As a result of recent announcements by the Government which are yet to be enacted, the tax cost setting rules will be modified so that the goodwill asset of a general insurance company that has demutualised will retain its existing tax value provided that the ownership of the company has not changed between the time of demutualisation and the time of joining a consolidated group. The Government has also announced that it intends extending the deadline for taxpayers to choose between the alternative methods until 31 December 2004. Given the recently announced change to the treatment of goodwill, the Group is currently reassessing whether its preliminary choices remain optimal.
- However, the Group is required to adopt the ACA method in respect of its acquisition of the CGU sub-group that took place on 2 January 2003. Under this method, the tax values of a subsidiary's assets are reset according to certain allocation rules, which consequently impacts future tax deductions and the deferred tax balances. A once-off benefit of \$22m included in the reported tax expense for 1H04 reflects the increase in future tax deductions arising from these reset tax values.

### **B.3 Licence consolidation**

- As part of the Group's strategy to eliminate unnecessary costs in its corporate structure, entities which are surplus to requirements are scheduled to be wound up. The key element of this is a significant reduction in the number of licensed general insurers for the Group's wholly owned Australian operations.
- There are no plans to change or remove any of the key brands. Rather, the legal entity conducting the underwriting would change and existing assets, liabilities and policies would be transferred to continuing companies.
- Five insurance licences have been targeted for cancellation. They are those held by:
  - SGIO Insurance Limited;
  - SGIC General Insurance Limited;
  - Swann Insurance (Aust) Pty Ltd;
  - NZI Insurance Australia Limited; and
  - CGU-VACC Insurance Limited.
- It is the Group's intention that this be achieved by a process of portfolio transfers and member schemes from the above insurers whose businesses are sold/transferred to either Insurance Australia Limited (IAL) or CGU Insurance Limited (CGU). These insurers would assume all the insurance obligations of the assigning insurers. The direct personal lines, workers' compensation and CTP portfolios would be transferred to IAL. The indirect personal lines and commercial business would be transferred to CGU. Both schemes require Federal Court approval under the Insurance Act for portfolio transfers and under Corporations Act for member schemes. The Group is currently in dialogue with the respective regulators to seek their approval and support for the proposal. The targeted effective date for this proposal is 31 December 2004.

#### **B.4 APRA Stage 2 reforms**

- On 20 November 2003, the Australian Prudential Regulation Authority (APRA) released a discussion paper on “Stage 2 Reforms” to the prudential supervision of general insurance.
- The discussion paper proposes significant changes to the general insurance industry's regulatory framework, particularly in the areas of corporate governance and intra-group transactions.
- It is not possible to assess what impact the final version of the Stage 2 Reforms will have on the Group given that the consultation period is still underway, and therefore substantial changes to the proposed reforms may still occur. In particular, the impact of the Stage 2 Reforms on the Group (and other general insurance conglomerates) is difficult to assess in the absence of APRA's yet to be released discussion paper on consolidated supervision. These conglomerate requirements are now not scheduled to be effective until 2006.
- The Group has prepared a submission on the proposed reforms and participated in the development of submissions by a number of interested parties, including the Insurance Council of Australia.

#### **C. INFORMATION SYSTEMS**

- The Group is part way through the process of a major technology transformation to address areas where the Group's technology had fallen behind the pace of development in the market and to build the technology foundations that will support Group-wide operations to optimise efficiencies and deliver improved products and customer service.
- The last six months marked the completion of the majority of the integration initiatives including:
  - CGU short-tail claims lodgement and processing transferred to IAG's existing system. This included the roll-out of the IAG procurement model for claims;
  - Establishment of six new assessing centres for motor vehicle claims across Australia;
  - Consolidation of the CGU and IAG superannuation systems;
  - Implementation of a document imaging system for Human Resources' centralised function. This is used, for example, to store the Group's personnel files;
  - Supporting the rationalisation to one workers' compensation licence for New South Wales;
  - Establishment of an on-line travel insurance product for the NRMA Insurance, SGIO and SGIC brands;
  - Various site relocations and office restacks affecting over 2,500 staff;
  - Consolidation of the Group General ledger and Accounts Payable to SAP;
  - Company wide Intranet implemented; and
  - Consolidation of the Group's HR (including payroll) and procurement systems.

- At the infrastructure level, the Group has completed phase one of in-sourcing services previously contracted to IBM GSA. The transition to the Group's technology services infrastructure team has been smooth, with minimal operational and financial impacts to the business.
- The main priorities over the next six months for technology services will be to complete the integration programme and in-sourcing.
- The refinement and transformation of the Group's technology system is integral to delivering future growth opportunities. As a leading player in the insurance market, the Group is in a key position to leverage its scale and extract benefits from its technology transformation programme.

#### **D. SUSTAINABILITY**

- The Group has made significant progress on developing and measuring the progress of its sustainability programme.
- The Group continues to drive internal culture change to support the achievement of sustainability targets.
- Some of the initiatives during the period were:
  - Development of a waste strategy for smash repair industry: The strategy proposed includes a combination of standardised waste pick-up and recycling processes, 'cleaner production' training for smash repairers and an 'on-the-ground' change management programme that will see suitable change agents working directly with smash repairers to improve waste management practices. The Group's Preferred Smash Repairers network has been overwhelmingly supportive of the strategy with 95% of PSRs surveyed (from a survey of 100 PSRs from various regions) showing support for the proposal;
  - Redesigning the home insurance sections of the NRMA website: The Group is currently working to re-design and re-launch information relating to homes and home insurance on the Group's internet sites to have a strong sustainability focus; and
  - 'Cool communities' is an Australian Government programme delivered in partnership with non-government environmental organisations from each State and Territory. By working with communities, industry and government, Cool Communities is aiming to cut greenhouse gas emissions, save money and improve lifestyles at the same time. The Group's Personal Insurance Division has been selected by the Australian Greenhouse Office to participate in Round 2 of the Cool Communities programme and, over the next six months, will be developing detailed plans to directly involve NSW staff in training and awareness programmes to reduce their personal impact on the environment.
- The Group's sustainability efforts have been recognised in the community with the Group receiving the 'Sustainable Company of the Year' award from Ethical Investor magazine. This award has been running for three years, with Bendigo Bank the winner for the previous two years.

## Financial position, dividends and capital

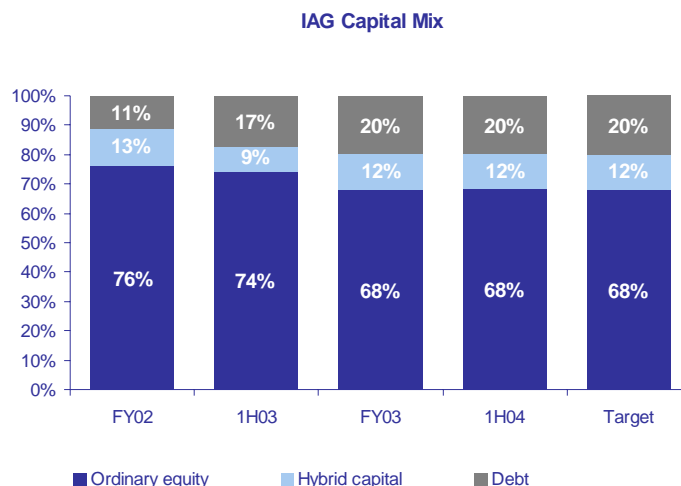
### A. STATEMENT OF FINANCIAL POSITION

| IAG Group Balance Sheet<br>As at        | 31-Dec-02     | 30-Jun-03     | 31-Dec-03     |
|---|---------------|---------------|---------------|
|   | A\$m          | A\$m          | A\$m          |
| <b>Assets</b>                           |               |               |               |
| Investments                             | 8,925         | 10,457        | 11,068        |
| Premium receivables                     | 719           | 1,505         | 1,487         |
| Reinsurance recoveries on claims        | 72            | 376           | 417           |
| Other recoveries on claims              | 341           | 373           | 447           |
| Deferred acquisition costs              | 239           | 513           | 503           |
| Goodwill and other intangibles          | 616           | 1,626         | 1,521         |
| Other assets                            | 918           | 1,542         | 1,441         |
| <b>Total assets</b>                     | <b>11,830</b> | <b>16,392</b> | <b>16,884</b> |
| <b>Liabilities</b>                      |               |               |               |
| Outstanding claims                      | 3,867         | 5,975         | 6,227         |
| Unearned premium                        | 1,877         | 3,301         | 3,316         |
| Interest bearing liabilities            | 694           | 925           | 913           |
| Gross life insurance policy liabilities | 909           | 910           | 958           |
| Other liabilities                       | 695           | 1,228         | 1,193         |
| <b>Total liabilities</b>                | <b>8,042</b>  | <b>12,339</b> | <b>12,607</b> |
| <b>Net assets</b>                       | <b>3,788</b>  | <b>4,053</b>  | <b>4,277</b>  |
| <b>Equity</b>                           |               |               |               |
| Equity attributable to shareholders     | 3,302         | 3,575         | 3,745         |
| Outside equity interests                | 486           | 478           | 532           |
| <b>Total equity</b>                     | <b>3,788</b>  | <b>4,053</b>  | <b>4,277</b>  |

- The main movements in the Group's financial position include:
  - Increase in investments mainly attributable to strong cashflows from operations and improved equity markets; and
  - The increase in recoveries is primarily attributable to increase in the provisions for outstanding claims.
- The total amount of outstanding reinsurance recoveries is \$417m at balance date.
- Cashflow generated from operations was \$694m for 1H04, relative to \$532m and \$293 for 2H03 and 1H03 respectively.

## B. CAPITAL MANAGEMENT

### B.1 Target capital mix



Ordinary equity = Total equity less hybrid equity less outside equity interests

### B.2 Total capitalisation and debt as at 31 December 2003

| Total Capitalisation  |              |
|---|--------------|
| As at 31 December 2003  | A\$m         |
| <b>Short-term debt</b>  | <b>124</b>   |
| <b>Long-term debt:</b>  |              |
| Senior  | 87           |
| Subordinated  | 620          |
| Cross currency swap payable <sup>1</sup>                              | 82           |
| <b>Total long-term debt</b>   | <b>789</b>   |
| <b>Total debt</b>   | <b>913</b>   |
| <br>  |              |
| <b>Shareholders' Equity</b>   |              |
| Equity attributable to ordinary shareholders                          | 3,434        |
| Retained Profits  | (226)        |
| Foreign currency translation reserve                                  | (2)          |
| Reset preference shares   | 539          |
| <b>Total shareholders equity (excl OEI)</b>                           | <b>3,745</b> |
| <b>Total capitalisation</b>   | <b>4,658</b> |
| Interest coverage & debt ratios                                       |              |
| Earnings before interest and tax (EBIT)                               | 513          |
| Earnings before interest, tax, depreciation and amortisation (EBITDA) | 587          |
| Market capitalisation at close of business day, 31 December 2003      |              |
| - Ordinary shares (\$4.25 per share)                                  | 7,152        |
| - Reset preference shares (IAGPA & IAGPB)                             | 555          |
| <b>Total market capitalisation</b>                                    | <b>7,707</b> |
| Total debt/(Total debt+shareholders equity excluding OEI)             | 19.6%        |
| Total debt/(Total debt+total market capitalisation)                   | 10.6%        |
| EBIT interest cover (times)   | 18x          |
| EBITDA interest cover (times)   | 20x          |

<sup>1</sup>Cross currency swaps have been entered into to hedge the currency exposure from US\$ denominated subordinated debt. The principal of the cross currency swaps is revalued to take into account movements in the US\$/A\$ exchange rate and disclosed separately from the underlying borrowings in the statement of financial position.

| Maturity profile of Group debt and Reset preference shares | Currency Principal Amount \$ millions | A\$ equivalent Principal Amount \$ millions | Yield (net of interest rate and cross currency swaps) | Interest rate & dividend repricing date |
|--|---------------------------------------|---|---|---|
| <b>Short-term debt</b>                                     | A\$124                                | 124   | 5.42%   | Q1 2004                                 |
| <b>Long-term debt<sup>1</sup>:</b>                         |                                       |   |   |   |
| NZ\$50m senior fixed rate notes                            | NZ\$50                                | 44  | 7.06%   | Aug-05                                  |
| NZ\$50m senior fixed rate notes                            | NZ\$50                                | 43  | 7.36%   | Aug-08                                  |
| A\$50m subordinated floating rate notes                    | A\$50                                 | 50  | 5.78%   | Nov-07                                  |
| A\$250m subordinated fixed rate notes                      | A\$249                                | 249   | 6.41%   | Nov-07                                  |
| US\$240m subordinated fixed rate notes <sup>2</sup>        | US\$240                               | 401   | 6.93%   | Apr-10                                  |
| A\$1.715m subordinated convertible loan <sup>3</sup>       | A\$2                                  | 2   | 6.67%   | Perpetual                               |
| <b>Total debt</b>  |                                       | <b>913</b>                                  |   |   |
| <b>Reset preference shares<sup>4</sup></b>                 |                                       |   |   |   |
| IAGPA  | A\$350                                | 350   | 5.80%   | Jun-07                                  |
| IAGPB  | A\$200                                | 200   | 4.51%   | Jun-08                                  |

<sup>1</sup> All long term debt has been issued as either fixed rate notes, or hedged to fixed rate with interest rate swaps. The yields shown are pre-tax.

<sup>2</sup> The A\$ equivalent is shown net of the related cross currency swaps.

<sup>3</sup> Fixed rate loan from the minority shareholder of Mutual Community General Insurance Pty Limited, a subsidiary of CGU Insurance Limited.

<sup>4</sup> The dividend yields shown on the reset preference yields are the cash yields excluding the value to investors of the attached franking credits.

### B.3 Capital adequacy/MCR

| Coverage of regulatory capital requirements | IAG Group 30-Jun-03 | Insurance Australia 30-Jun-03 | IAG Group 31-Dec-03 | Insurance Australia 31-Dec-03 |
|---|---------------------|-------------------------------|---------------------|-------------------------------|
|   | A\$m                | A\$m                          | A\$m                | A\$m                          |
| <b>Tier 1 capital</b>                       |                     |                               |                     |                               |
| Paid-up ordinary shares                     | 3,434               | 885                           | 3,434               | 1,286                         |
| Hybrid equity                               | 539                 | -                             | 539                 | -                             |
| Reserves                                    | (2)                 | -                             | (2)                 | -                             |
| Retained earnings (2)                       | (396)               | 2,555                         | (183)               | 2,443                         |
| Excess technical provisions (net of tax)    | 353                 | 327                           | 371                 | 336                           |
| Less: deductions                            | (1,838)             | (1,456)                       | (1,745)             | (1,403)                       |
|   | <b>2,090</b>        | <b>2,311</b>                  | <b>2,414</b>        | <b>2,662</b>                  |
| <b>Tier 2 capital</b>                       |                     |                               |                     |                               |
| Term subordinated notes                     | 657                 | 657                           | 618                 | 618                           |
| <b>Capital base</b>                         | <b>2,747</b>        | <b>2,968</b>                  | <b>3,032</b>        | <b>3,280</b>                  |
| <b>Minimum capital requirements (MCR):</b>  |                     |                               |                     |                               |
| Australian general insurance businesses     | 1,392               | 1,460                         | 1,456               | 1,486                         |
| International insurance businesses (1)      | 136                 | -                             | 142                 | -                             |
| Other businesses (2,3)                      | 165                 | -                             | -                   | -                             |
| Minimum capital requirements                | <b>1,693</b>        | <b>1,460</b>                  | <b>1,598</b>        | <b>1,486</b>                  |
| <b>MCR multiple</b>                         | <b>1.62x</b>        | <b>2.03x</b>                  | <b>1.90x</b>        | <b>2.21x</b>                  |

#### Notes:

- The MCR and Capital base for International insurance businesses is calculated on a similar basis to the Australian regulatory requirements and includes the Captive reinsurance business and the operations in New Zealand.
- The 30 June 2003 position excludes the capital requirement of NRMA Health Pty Limited as the Group sold this business in July 2003. Similarly, the 31 December 2003 position excludes the capital requirement of the ClearView business as this business was sold in January 2004. The retained earnings position at 31 December 2003 has been stated assuming \$43m of profit on sale of the ClearView business.
- Other businesses include the minimum capital requirement of NRMA Life Limited and an allocation of capital for the fee-based businesses. With the sale of the ClearView business and a review of the Group's capital, these have been excluded from the 31 December 2003 MCR calculation.

- The table above provides an analysis of the Group's regulatory capital position, summarising both the Group position (after adjusting for the sale of the ClearView business) and that of the Australian general insurance business ("Insurance Australia").
- The Group's practice is to determine economic capital requirements and relate those to a multiple of MCR where the MCR is determined by treating the consolidated operation as if it was one legal entity. APRA standards are used as the methodology for this calculation and are applied to both the Australian and international businesses.
- On this basis, the Group has set a target MCR multiple of 1.60 times the MCR using methodology from APRA Standards. As can be seen from the table above, the MCR multiple of 1.90 times at 31 December 2003 is well above the target. As such, the Group is proposing a buy-back of capital as outlined in Section B.4.

### **B.3.1 IAG Group MCR Position**

- The increase in the Group's regulatory capital base from \$2,747 million at 30 June 2003 to \$3,032 million at 31 December 2003 is attributable to:
  - Movement (increase) in retained earnings of \$213m attributable to the net profit for the period less dividends paid, and includes an estimated profit on the sale of ClearView of approximately \$43m;
  - An increase of \$18m in excess technical provisions (net of tax) which represents the excess of provisions in the Group's Statement of Financial Position compared to insurance liabilities as calculated in accordance with the APRA guidelines at a 75% probability of sufficiency;
  - Deductions have also reduced by \$93m, primarily due to the reduction in intangible assets (\$102m) and increase in net future income tax benefits (\$9m). The decrease in intangibles is due to amortisation charges of \$54m for the period together with the sale of the Health business in July 2003; and
  - In April 2003, the Group issued US\$240m of dated subordinated debt that qualifies as Lower Tier 2 APRA regulatory capital. The US\$240m of proceeds were originally exchanged into A\$401m under A\$/US\$ cross currency swaps that were entered into to hedge both the debt's US\$ principal and US\$ interest payment obligations. For regulatory purposes, the US\$ principal is translated to A\$ using the spot exchange rate applicable on each reporting date. During 1H04, the A\$ has continued to appreciate against the US\$. This has resulted in a decline in the A\$ equivalent value of the subordinated notes to A\$319m at 31 December 2003 (from A\$358m at 30 June 2003) and thus a reduction of some A\$39m in the Group's eligible Lower Tier 2 regulatory capital over the period.
- The reduction in the Group's MCR from \$1,693m to \$1,598m relates to:
  - A decrease in the charges for other businesses of \$165m following the disposal of ClearView, offset by a small increase in the capital requirements of the Australian business of \$64m, including a \$30m increase in the Concentration Risk Charge (now \$100m). The balance is primarily attributable to growth and a small seasonality impact on the Group's business; and
  - An increase of \$6 million in the MCR of the international insurance business due to an increase in insurance liabilities relating to storm losses borne by the captive in 1H04.

- The main components of the Group MCR at 31 December 2003 were:
  - Investment risk – \$1,007m;
  - Insurance risk – 491m; and
  - Concentration risk – \$100m.

### **B.3.2 Insurance Australia Limited MCR position**

- This capital position has been prepared on the aggregated financial position of Insurance Australia Limited and includes all the general insurance operations in Australia.
- The capital base is higher than the IAG Group due to funding raised through Insurance Australia Limited to cover the capital requirements of the NZ Group. However, the goodwill of the NZ Group is not deducted in this capital base calculation, therefore increasing the net position relative to the IAG Group.
- During 1H04, Insurance Australia Limited paid a \$401m dividend to its holding company, Insurance Australia Group Limited. The holding company reinvested the proceeds back into the subsidiary group in the form of ordinary shares, explaining the movement in paid-up ordinary shares.

### **B.4 Proposed buy-back**

- In view of the Group's very strong capital position and its current phase of consolidating the earnings capacity of its existing businesses, the Group has announced its intention to undertake an off-market buy-back in the order of \$350m of its ordinary shares. This is in accordance with the Group's stated principle of not carrying substantial surplus capital for any significant period of time on the basis that this is not an efficient use of shareholders' funds.
- The Group reserves the right to change the size of the buy-back or even choose not to proceed if a situation develops before finalisation whereby the Directors conclude that proceeding would not be in the best interests of the Group.

### **B.5 Reinsurance**

#### **B.5.1 Reinsurance protections**

- Most of the Group's reinsurance protections are now purchased on a calendar year basis – the main exception is the CTP portfolio for which protection continues to be purchased on a fiscal year basis. There were a number of changes made to the Group's programme on renewal effective 1 January 2004. Key changes are as follows:
  - An increase in the maximum event retention for a first event to \$100m from \$70m. This increase is well within the Group's current tolerable limit for income statement volatility from a single event, with the \$100m limit constituting less than 2% of net earned premium;
  - An increase in the upper limits of the programme. The Australian earthquake cover limit has increased to \$3bn (from \$2.5bn). The 'all perils' cover for Australia and New Zealand was increased to \$2bn (\$1.5bn at January 2003 and \$1.9bn by August 2003). Free reinstatements are in place for all covers above \$75m for a second event and \$50m for a third event, with the exception of the \$1bn xs \$2bn layer;
  - A change in the aggregate covers to make them more effective in covering attritional losses; and

- An increase in the capacity of the Group's key commercial surplus facility providing the business with increased capacity in this area with less reliance on facultative covers.
- In terms of total expected expenditure, the renewal increases the Group's spend by less than 5%. However, adjusted for the increased aggregates exposed to the contracts, the cost actually went down. Within this, there were significant savings on the property covers (which constitute the major portion of the total spend) while casualty rates rose.

### B.5.1 Reinsurance counter-party exposures

- The Group achieved a substantial increase in the rating of the counter-parties on the catastrophe programme for the January 2004 renewal. The following table tracks the security profile in recent years, which has been clearly impacted by the ratings down-grades experienced by a number of reinsurers since late 2001.

| Year   | Limit<br>A\$m | Excess<br>A\$m | Credit rating<br>AAA/AA | Credit rating<br>A |
|--------|---------------|----------------|-------------------------|--------------------|
| 2001/2 | 1,000         | 30             | 69%                     | 31%                |
| 2002/3 | 1,250         | 30             | 68%                     | 32%                |
| 2003   | 2,500         | 70             | 46%                     | 54%                |
| 2004   | 3,000         | 100            | 59%                     | 41%                |

- The Group continues to enhance its approach to managing reinsurance counter-party risk. During 1H04, a proprietary model was developed for measuring counter-party exposure tolerances factoring in existing recoveries and contingent recoveries. The measurement of tolerance for contingent recoveries – ie. the Group's exposure if there is a future claim against the reinsurer and the reinsurer then defaults – in the model takes into account factors such as:
  - The weighted rating agency views on the reinsurer, including outlook;
  - Event probability for the risks covered by the Group's treaties with the particular reinsurer; and
  - The impact of a failure of the reinsurer to pay on the Group (eg cover for attritional losses or short-tail risks is less of an issue than large lines on a major catastrophe).
- The Group will be using this model to monitor its own exposures and in future negotiations with reinsurers on the terms of their future participation on the Group's programme.

## C. DIVIDENDS

### C.1 Dividend policy and distributable earnings

- The Group has undertaken a review of its dividend policy during the period and has now resolved to amend the policy such that annual dividends on ordinary shares are targeted to be 50 – 70% of normalised profits before goodwill amortisation charges. Profits will be normalised to smooth the impacts of fluctuations in returns on shareholders' funds. The return on shareholders' funds will be determined based on a risk-free rate plus an equity risk premium. It is anticipated that the annual dividend will be paid in a 45:55 proportion between the interim and final dividends.
- Since listing in 2000, the policy was based on a payout ratio of 40 – 70% of normalised profits after goodwill amortisation, with returns from technical reserves subject to adjustment as well as those on shareholders funds. It was also based on a 40:60 mix of interim:final.
- The key drivers for the change were as follows:
  - The increased diversity and scale of the business that have resulted in a far less volatile profit stream from the core operations, providing more confidence that the business can generate the profits each period to support an increasing dividend.
  - The significant reduction in the size of the shareholders' funds relative to the core business operations – the Group was significantly over-capitalised and under-g geared when first listed;
  - The build up of a bank of distributable earnings; and
  - The desire to utilise more of the Group's franking credits, which is particularly important for the Group's large domestic shareholder base.
- The Group's franking capacity remains very high with the capacity to fully frank approximately \$1,150m of dividends as at 31 December 2003.
- The Group's distributable earnings have also increased as a result of the strong profit during 1H04 and some internal distributions. As at 31 December 2003, the distributable earnings in the parent entity were \$423m, with a further \$437m which could be accessed if required. This level of distributable earnings is not easily identifiable in the statutory financial statements due to transitional issues on demutualisation of the core operations in 2000.

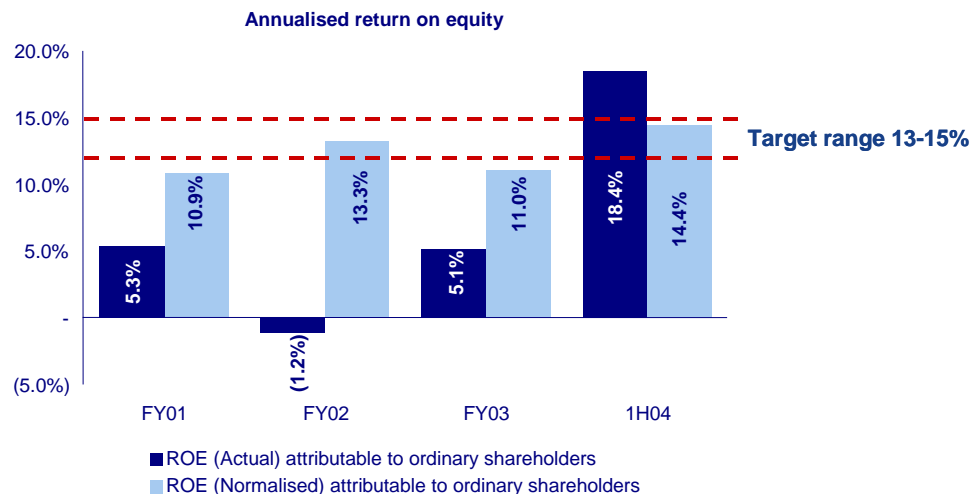
## C.2 Dividend on ordinary shares

| Period            | Dividend per share | Franking |
|-------------------|--------------------|----------|
|                   | cents              | %        |
| Interim – FY 2004 | 8.0                | 100      |
| Final - FY 2003   | 7.0                | 100      |
| Interim – FY 2003 | 4.5                | 100      |
| Final - FY 2002   | 6.0                | 100      |
| Interim - FY 2002 | 4.5                | 100      |
| Final - FY 2001   | 6.0                | 100      |
| Interim - FY 2001 | 4.0                | 100      |

The Group resolved to increase the interim dividend to 8.0 cents per ordinary share – an increase of 3.5 cents or 78% – to align with the new dividend policy.

All dividends remain fully franked.

## D. RETURN ON EQUITY



**Note:**

1. 2H02-2H03 normalised ROE uses 6% return on technical reserves & 7.4% on shareholders' funds, both pre-tax.
2. 1H04 normalised ROE uses 9.5% on shareholders' funds, pre-tax.

- The Group's ROE for ordinary shareholders in 1H04 was 18.4%. Normalising this by substituting a pre-tax return of 9.5% per annum on shareholders' funds into the actual results yields a normalised return of 14.4%. This is at the higher end of the Group's target of 13 – 15% ROE throughout any cycle.

## E. SENSITIVITY ANALYSIS

### E.1 Investment market sensitivities

- The following table indicates the impact of an immediate change in the market value of equities and changes in interest rates on the Group's net profit before tax at the specific dates.

| Sensitivity on net profit before tax | Change in assumption                       | 30-Jun-03 | 31-Dec-03 |
|--------------------------------------|--|-----------|-----------|
|                                      |  | A\$m      | A\$m      |
| <b>Investment sensitivities</b>      |  |           |           |
| <b>Equity market values:</b>         |  |           |           |
| Australian equities                  | +1%  | 11.2      | 18.5      |
| International equities               | +1%  | 3.9       | 4.8       |
| New Zealand equities                 | +1%  | 0.6       | -         |
| <b>Interest rates</b>                |  |           |           |
| Investment returns                   | +/-1% or 100 bpts change in interest rates | 141.7     | 148.6     |
| Outstanding claims                   | +/-1% Change in net discount rate          | 145.7     | 137.3     |

- As noted in the June 2003 investor report, there were anomalies in the June 2003 sensitivities due to the equity protection programme in place on the equities portfolio and some short-term duration positions in the technical reserves.
- The relationships between gross equities held and the equity market sensitivities are now proportional as the Group is not currently using hedges to protect its equity market exposure.
- The duration of the fixed interest portfolio was essentially duration matched as at 31 December 2003. The gap in sensitivities between interest rates and outstanding claims effectively reflects the accounting treatment of unearned premium as a cash liability while the Group generally invests on the basis of its ultimate expected economic duration.

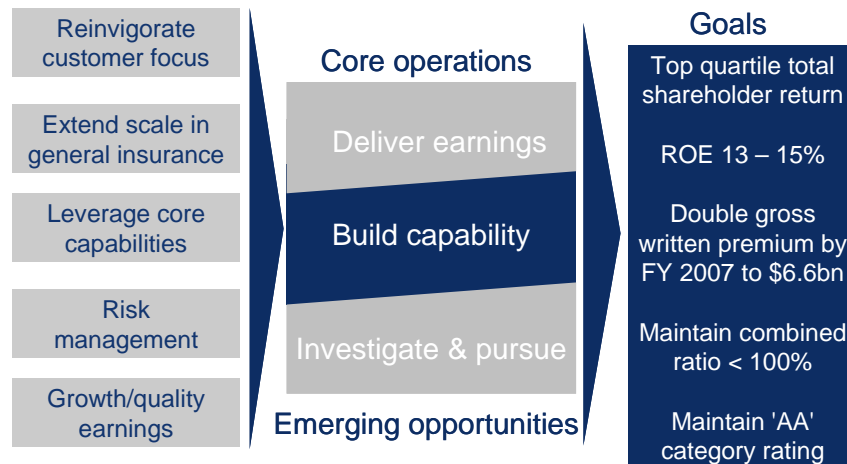
### E.2 Operational sensitivities

- This table indicates the effect of a 1% change in key elements of the insurance operational performance on the Group's annual profit before tax for the respective periods. The sensitivities provided are annualised for 31 December 2003 and the 30 June 2003 comparatives includes annualised figures for CGU and NZI which were acquired in January 2003.
- The operational sensitivity has remained relatively unchanged over the past six months.

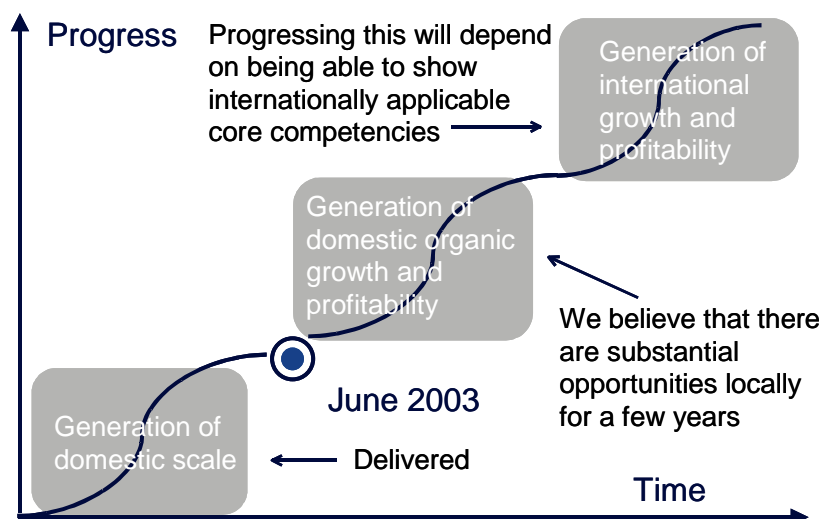
| Sensitivity on net profit before tax | Change in assumption | 30-Jun-03 | 31-Dec-03 |
|--------------------------------------|----------------------|-----------|-----------|
|                                      |                      | A\$m      | A\$m      |
| <b>Insurance sensitivities</b>       |                      |           |           |
| Loss ratio - short-tail              | -1%                  | 37.4      | 38.1      |
| Loss ratio - long-tail               | -1%                  | 11.2      | 11.3      |
| Underwriting expenses                | -1%                  | 13.9      | 14.5      |

## Appendix A – Strategy

- The Group's strategy is focused around managing the business to achieve top quartile shareholder return through sustainable quality growth. In May 2002, the Group identified the following strategic platforms to achieve its overall goal of top quartile total shareholder return.



- Since that time the Group has used the areas of focus on the left to deliver the goals on the right. Currently, the Group is delivering on each of these goals. Looking to the future, the Group is considering how best to sustain delivery on these goals. While considering itself very well placed to deliver double-digit earnings growth in the short to medium term from optimising its market leading position in the Australian and New Zealand markets, the focus for medium and long-term direction is how to sustain that double-digit earnings growth while also continuing to deliver the other goals.
- This future focus is encapsulated in the following chart:



## Appendix B – Corporate Governance

- The Group's corporate governance structure and supporting risk management framework provide a sustainable balance of the Group's core business function of paying claims and providing insurance at an affordable cost with its responsibility to provide fair and stable return to shareholders.
- The corporate governance structure stipulates guidelines on the following matters:
  - The role of the Board and management;
  - Ethical and responsible decision making;
  - Board composition;
  - How the Board operates;
  - Managing risks;
  - Board and executive performance; and
  - Compensation arrangements.
- For share based remuneration in the form of Performance Award Rights, the Group practice is to acquire the shares it anticipates will be needed to remunerate management and staff who may become entitled to exercise their Performance Award Rights. The costs of acquiring the shares are expensed over a three year vesting period. This accounting treatment is consistent with international accounting standards.
- The Group's corporate website: [www.iag.com.au](http://www.iag.com.au) contains more information on the Group's corporate governance policies, including copies of key charters and policies.

## Appendix C - Key ASX Releases

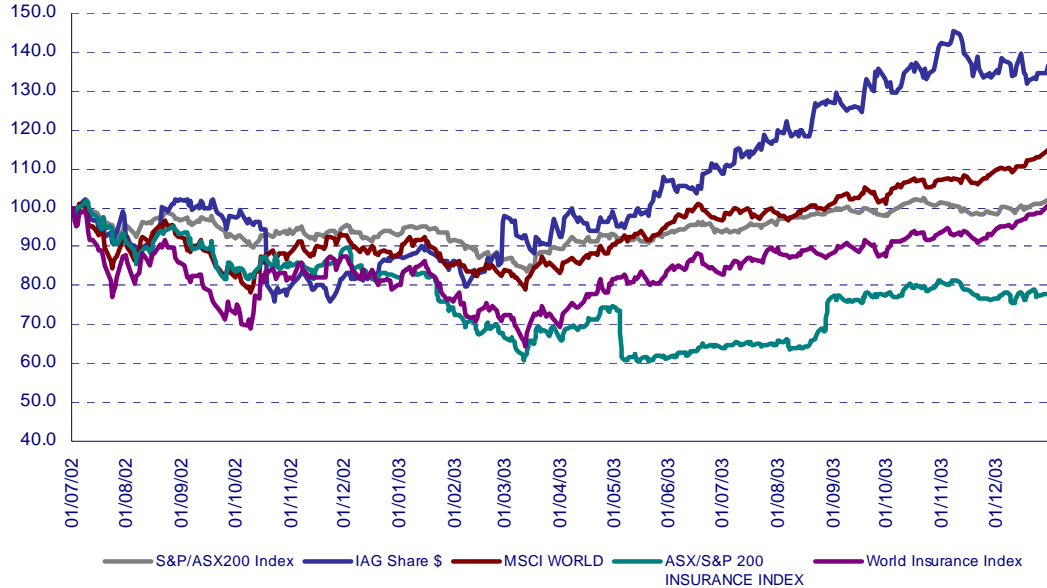
This schedule contains only a summary of the announcements made to the ASX since 1H03 commenced. It does not include announcements of changes in Directors' interests. Reference should be made to a full copy of the ASX announcements should further information be required. These are available on [www.iag.com.au](http://www.iag.com.au)

- 2 February 2004**      **IAG RPS1 (IAGPA) Class meeting**  
The meeting voted in favour of changing the terms of RPS1 (IAGPA) to align with RPS2 (IAGPB) in all relevant respects.
- 23 January 2004**      **IAG to relocate share register**  
IAG announced it would be relocating its share registers in April 2004 to Computershare Investor Services Pty Limited.
- 19 January 2004**      **CGU enters the marine insurance market**  
CGU announced it will enter the marine insurance market, establishing a business unit to offer specialised marine products. The marine insurance market in Australia generates approximately \$300m per annum in premiums.  
  
CGU previously offered marine products through a joint venture with Zurich, which ended in December 2003 following the Insurance Australia Group's acquisition of CGU.
- 11 December 2003**      **Agreement to sell ClearView businesses to MBF**  
IAG entered an agreement to sell its ClearView businesses to MBF for approximately \$220m plus an additional \$50m earn-out, subject to business performance.
- 12 November 2003**      **Annual general meeting**  
The chairman informed the shareholders that the Group was well positioned to deliver another solid performance in the full year 2004.  
  
The positive operating environment and solid performance of CGU/NZI acquisition are the main drivers of the improved performance for the year-ended 30 June 2003. All resolutions put to the meeting were passed in accordance with the Directors' recommendations.
- 11 November 2003**      **Dividends Payable for Reset Preference Shares RPS1 (IAGPA) and RPS2 (IAGPB)**  
IAG declared a fully franked preferred dividend on IAGPA (3.5m RPS) at a rate of 5.8% per annum and on IAGPB (2m RPS) at a rate of 4.51% per annum payable on 15 December 2003.
- 29 September 2003**      **Pricing of shares to be allocated under DRP**  
The ordinary shares allocated under the dividend reinvestment plan (DRP) as part of the final dividend for 2003 were priced at \$4.07 per share. The DRP price was based on an average market price for ten trading days from 15 September to 26 September 2003 inclusive.  
  
Under the DRP 9.1 million ordinary shares were allocated to participating shareholders.

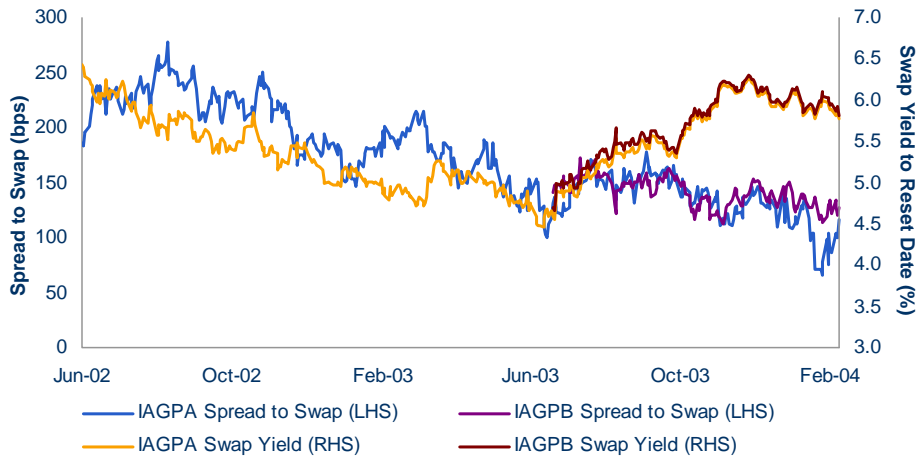
- 1 September 2003**     **IAG announces changes to Board processes and composition**  
The board approved a number of Board process and composition changes to ensure IAG governance practices remained in line with current developments.  
Referring the composition, the board numbers have reduced from ten to eight members following the retirement of Mrs Maree Callaghan and Mrs Mary Easson effective on 1 September 2003.
- 1 September 2003**     **Payment of retirement benefit to former director**  
IAG Board resolved to pay \$637,000 to former Chairman, Nicholas Whitlam, following the decision of the New South Wales Court of Appeal, in which Mr Whitlam was not found to have committed any breach of duties as a director of IAG.
- 21 August 2003**     **Announcement of annual results – 30 June 2003**
- 11 August 2003**     **Closing date for nominations for election of directors**  
IAG announced a closing date of 8 September 2003 for receipt of nominations for election of directors at the 2003 annual general meeting scheduled for 12 November 2003. The closing date was set pursuant to a waiver under ASX Listing Rule 14.3.
- 17 July 2003**     **Update of investment market sensitivities**  
As a result of the improvement in the Group's capital position, tranches of option protection expiring in June 2003 over Australian and international equities were not replaced.
- At 30 June 2003, after expiry of these options, protection remains over 70% of the Group's \$2.2bn equity exposure in face value terms (previously 95% at 31 March 2003). The effective exposure to equities, as a percentage of total investments for shareholders' funds and technical reserves, has risen from approximately 13% at 31 March 2003 to approximately 18% at 30 June 2003.
- The programme structure will continue to be assessed in the context of the Group's view of equity markets, its capital position and the costs of the programme.
- 1 July 2003**     **Sale of IAG's health arm to MBF incorporates innovative product marketing alliance**  
IAG and the Medical Benefits Fund of Australia Limited (MBF) announced that IAG had agreed to sell its health insurance underwriting and claims operations, NRMA Health, to MBF for A\$100 million.
- The purchase incorporates an exclusive six-year alliance in which IAG – operating as NRMA Insurance, SGIC and SGIO – will offer customers competitive health insurance products underwritten by MBF.

## Share price trends & top 20 registered holdings

### A. Ordinary Share price performance relative to the Australian All Ordinaries and Insurance Indices to 31 December 2003



### B. RESET PREFERENCE SHARES PRICE PERFORMANCE



- The first issue reset preference shares (IAGPA) listed on 5 June 2002. The shares are expected to pay a six-monthly fully franked dividend, currently fixed at 5.80% per annum.
- The second issue of reset preference shares listed on 23 June 2003. They are expected to pay a six-monthly fully franked dividend, currently fixed at 4.51% per annum.
- The performance of the IAGPA and IAGPB shares can be expected to be more directly influenced by the interest rate environment than the performance of IAG's business or the equity markets and the timing of payment of dividends.

**C. Ordinary Shareholders (IAG) as at 31 December 2003**

| <b>Rank</b> | <b>Investor</b>   | <b># Shares</b> | <b>% Issued Capital</b> |
|-------------|---|-----------------|-------------------------|
| 1           | JP Morgan Nominees Australia Limited                        | 218,630,507     | 12.99                   |
| 2           | National Nominees Limited                                   | 127,284,358     | 7.56                    |
| 3           | Westpac Custodian Nominees Limited                          | 121,052,690     | 7.19                    |
| 4           | Citicorp Nominees Pty Limited                               | 35,747,550      | 2.12                    |
| 5           | Queensland Investment Corporation                           | 25,202,228      | 1.50                    |
| 6           | AMP Life Limited  | 23,113,667      | 1.37                    |
| 7           | ANZ Nominees Limited  | 20,042,427      | 1.19                    |
| 8           | Citicorp Nominees Pty Limited (CFS WSLE Imputation FND A/C) | 18,907,186      | 1.12                    |
| 9           | Westpac Financial Services Limited                          | 17,271,368      | 1.03                    |
| 10          | Citicorp Nominees Pty Limited (CFS WSLE Aust Share FND A/C) | 12,141,766      | 0.72                    |
| 11          | Cogent Nominees Pty Limited                                 | 11,473,007      | 0.68                    |
| 12          | Citicorp Nominees Pty Limited (CFS Imputation FND A/C)      | 10,938,196      | 0.65                    |
| 13          | Citicorp Nominees Pty Limited (CFS WSLE Geared SHR FND A/C) | 10,842,594      | 0.64                    |
| 14          | Citicorp Nominees Pty Limited (CFS WSLE Industrial SHR A/C) | 9,034,930       | 0.54                    |
| 15          | Government Superannuation Office (State Super Fund A/C)     | 8,899,677       | 0.53                    |
| 16          | Cogent Nominees Pty Limited (SMP Accounts)                  | 6,959,157       | 0.41                    |
| 17          | Victorian Workcover Authority                               | 6,637,830       | 0.39                    |
| 18          | Transport Accident Commission                               | 5,586,405       | 0.33                    |
| 19          | HSBC Custody Nominees (Australia) Limited                   | 5,017,604       | 0.30                    |
| 20          | RBC Global Services Australia Nominees Pty Limited          | 4,976,869       | 0.30                    |

**D. Reset Preference (IAGPA) Shareholders as at 31 December 2003**

| <b>Rank</b> | <b>Investor</b>   | <b># Shares</b> | <b>% Issued Capital</b> |
|-------------|---|-----------------|-------------------------|
| 1           | Westpac Custodian Nominees                                      | 722,331         | 20.64                   |
| 2           | Citicorp Nominees Pty Limited                                   | 144,000         | 4.11                    |
| 3           | RBC Global Services Australia Nominees Pty Limited (JBENIP A/C) | 140,540         | 4.02                    |
| 4           | AMP Life Limited  | 132,387         | 3.78                    |
| 5           | Citibank Limited  | 115,000         | 3.29                    |
| 6           | JP Morgan Nominees Australia Limited                            | 101,980         | 2.91                    |
| 7           | Share Direct Nominees Pty Ltd                                   | 100,000         | 2.86                    |
| 8           | National Nominees Limited                                       | 99,460          | 2.84                    |
| 9           | RBC Global Services Australia Nominees Pty Limited (BKCUST A/C) | 70,200          | 2.01                    |
| 10          | Net Nominees Limited C/- Westpac Securities Limited             | 63,645          | 1.82                    |
| 11          | JB Were Capital Markets Limited                                 | 46,563          | 1.33                    |
| 12          | Perpetual Trustee Company Limited                               | 38,938          | 1.11                    |
| 13          | UBS Private Clients Australia Nominees Pty Ltd                  | 37,448          | 1.07                    |
| 14          | Cambooya Pty Limited  | 31,100          | 0.89                    |
| 15          | ARGO Investments Limited  | 30,800          | 0.88                    |
| 16          | Merrill Lynch (Australia) Nominees Pty Ltd                      | 30,290          | 0.87                    |
| 17          | Brencorp No 11 Pty Limited                                      | 22,500          | 0.64                    |
| 18          | RBC Global Services Australia Nominees Pty Limited              | 20,744          | 0.59                    |
| 19          | Citicorp Nominees Pty Limited                                   | 20,000          | 0.57                    |
| 19          | Equipart Nominees Pty Ltd                                       | 20,000          | 0.57                    |
| 20          | ANZ Executors and Trustee Company Limited                       | 19,117          | 0.55                    |

**E. Reset Preference (IAGPB) Shareholders as at 31 December 2003**

| <b>Rank</b> | <b>Investor</b>                                       | <b># Shares</b> | <b>% Issued Capital</b> |
|-------------|---|-----------------|-------------------------|
| 1           | Westpac Custodian Nominees Limited                    | 246,850         | 12.34                   |
| 2           | National Nominees Limited                             | 114,200         | 5.71                    |
| 3           | AMP Life Limited                                      | 97,114          | 4.86                    |
| 4           | Citicorp Nominees Pty Limited                         | 92,500          | 4.63                    |
| 5           | RBC Global Services Australia Nominees Pty Limited    | 87,110          | 4.36                    |
| 6           | JP Morgan Nominees Australia Limited                  | 86,212          | 4.31                    |
| 7           | Share Direct Nominees Pty Ltd (National Nominees A/C) | 86,000          | 4.30                    |
| 8           | Warnford Nominees Pty Limited (No. 1 Account)         | 62,787          | 3.14                    |
| 9           | Equipart Nominees Pty Ltd                             | 61,000          | 3.05                    |
| 10          | UBS Private Clients Australia                         | 59,420          | 2.97                    |
| 11          | Net Nominees Limited                                  | 53,250          | 2.66                    |
| 12          | Permanent Nominees (Aust) Limited                     | 50,000          | 2.50                    |
| 13          | JB Were Capital Markets Limited                       | 49,572          | 2.48                    |
| 14          | UBS Nominees Pty Ltd (Primate Broking A/C)            | 43,604          | 2.18                    |
| 15          | IOOF Investment Management Limited                    | 35,000          | 1.75                    |
| 16          | RBC Global Services Australia Nominees Pty Limited    | 29,458          | 1.47                    |
| 17          | Perpetual Trustee Company Limited                     | 29,353          | 1.47                    |
| 18          | Mrs. Fay Cleo Martin-Weber                            | 20,000          | 1.00                    |
| 19          | Permanent Trustee Australia Limited                   | 17,000          | 0.85                    |
| 20          | Cogent Nominees Pty Limited (SMP Accounts)            | 16,291          | 0.81                    |