FIRST INTERVIEW

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Level 7, 100 Arthur Street
North Sydney NSW 2060, Australia
www.calliden.com.au

Calliden Group CEO - The Outlook for 2013

FIRST Interview with CEO Nick Kirk

Topics of discussion

- *Operating Environment in 2013*
- *Overview of the FY12 profit result reported in February 2013*
- *Earnings Outlook for FY13, consolidating the MGA model*

Operating Environment in 2013

FIRST Interview

The equity markets have been signaling their confidence in the outlook for General Insurance companies in 2013 since at least the middle of 2012 - Calliden and two of the three major Australian insurance stocks have risen on average over 50%. Since January 2013 all 4 listed insurers have posted increases ranging between 14% and 26% against a market increase of 5%. *What do you think has changed in the industry over the past 12 months, apart from a relatively 'uneventful' 2012 in relation to catastrophic weather events, to support the market's confidence?*

CEO Nick Kirk

I don't think you can ignore the uneventful 2012 in terms of catastrophic weather events entirely. It is not unusual for the insurance industry to out-perform after a period of catastrophe activity. The losses act as a catalyst for increased premiums and improved underwriting which in turn helps to boost future profits. I also think that there is an understandable tendency by investors to over react to catastrophe events and then correct over time.

FIRST Interview

In January this year the east coast of Australia bore the brunt of another season of bush fires in Victoria, Tasmania and NSW with Queensland and NSW going close to experiencing a repeat of the floods in 2011 as a result of ex-tropical cyclone Oswald. You recently reported that the estimated net cost to Calliden of these incidents to date is well within its annual expectation. *How much of an influence was the move to place up to 50% of Calliden's underwriting risk with third party insurers on that outcome, or was it related to a much more conservative approach to policy writing?*

CEO Nick Kirk

It did have more to do with a more conservative approach to underwriting. Those risks that had been transferred over to the agency arrangement did reduce the overall loss burden but if we look at all the claims that we had from those events then it appears that our overall share, both agency and insurer, is significantly less than it has been in past events. A proportion of the claims that we've had from those events relate to portfolios that are being transferred to an agency basis from 1 January 2013 so the vast majority of those risks were still being written by CIL at the time these events happened. In total more than 50% of the claims that have come through relate to portfolios that have been or are in the process of being progressively transferred to an agency basis during 2013. The biggest change was the number and cost of flood claims which does appear to have been driven by a much better approach to the underwriting of risks that are particularly prone to flood.

FIRST Interview
Now that most insurers appear to have finished recapitalising their balance sheets, cutting costs and increasing premiums to reflect the revised view of risk in the global insurance market*, how do you see competition in the market unfolding over the next 12-18 months, particularly in some of the niche markets in which Calliden operates?*

CEO Nick Kirk
I still see it as being different based on different portfolios. If we look at ex-tropical cyclone Oswald and the various different bushfires, I am of the view that for property risk (particularly home and classes like strata) we will continue to see upwards pressure on rates. That trend will be driven by the step change in catastrophe reinsurance costs which will then be reflected in original rates. I believe that will continue to flow through for a period yet. In other areas of the market it's remained quite competitive - business pack, for example - and that will continue for the rest of calendar 2013.

We're seeing steady and rational pricing in the areas of motor that we are involved in – but not the large increases we have seen in home insurance and some of the other areas.

Overview of the FY12 Profit Result reported in February 2013

FIRST Interview
Calliden has reported a profit, at the low end of the guidance range of $1-3m it provided to the market at the half year results in August 2012. Given that 2012 was positioned as a year of transition as Calliden progressively moved its business to that of a Managing General Agent, *how much of this result was impacted by restructuring costs, and do you expect further costs to be incurred in 2013?*

CEO Nick Kirk
During 2012 there were two principal sources of restructuring costs that arose from the transition. First, $1m of costs related to changes to the computer system and documentation arising from portfolios moving to an agency basis. In addition to that we have been reducing our expenses in relation to introducing the agency model, so they include some staff redundancy costs.

There is also $1.3m of transitional costs which relate to provisions against agency revenues for future administration and claims handling. Whilst that amount won't reverse, the creation of that provision will level off as GWP levels off i.e. it's not something we will have to top up continually. In 2013 as farm insurance moves across to an agency basis we will create a provision against agency revenue for that so, from that perspective we will to some extent have a repeat of 2012.

There will be some minor additional costs during 2013 but they are of the order of $0.1-0.3m on top of the provisions that will be required.

FIRST Interview
Interest rates were cut by 50 basis points in the final quarter of 2012 which would normally be expected to put some pressure on your investment returns and, more significantly, the valuation of insurance liabilities. *To what extent was your profit in the second half impacted by this and if so what were the offsetting factors that enabled you to deliver within guidance?*

CEO Nick Kirk
As you say there are two impacts on insurers from interest rate movements – one is on the discount rate which flows through to the valuation on our insurance liabilities and the other is on our investment returns. So far as the former is concerned we were fortunate in the second half to actually record a net positive movement of $0.3m. The reason for that was the average duration of our claims had lengthened slightly as the short tail claims dropped away with the movement of business pack across to GLA. That changed where we sat

on the yield curve and so, instead of getting a negative out of the interest rate drop, at that point on the yield curve we got a slight benefit.

In terms of the impact on our investment returns it really didn't have much impact at all – prior to interest rates starting to fall we had put a portion of our investment portfolio into longer term deposits which are still earning pre-interest rate drop returns. That will continue to soften the impact of falling interest rates into 2013 as well.

FIRST Interview
The increased cost of reinsurance combined with the decision to take out additional reinsurance to strengthen the capital base in 2012 clearly impacted your bottom line. *It could be said that Calliden paid away any opportunity it might have had to deliver a decent profit for shareholders in 2012 – is that fair and if so do you think you got value for money?*

CEO Nick Kirk
I don't think that is a fair comment. The fact is, we had to rebuild the regulatory capital ratios following the unprecedented catastrophe activity in 2011 and also to prepare for the new LAGIC capital standard that APRA was introducing on 1 January 2013. The reinsurance that we bought did its job and enabled us to lift those ratios back up to what they are today, allowing us to make the transition to LAGIC smoothly and to prepare us to take advantage of our portfolio management actions by reducing our reliance on reinsurance going forward.

That the loss experience on the underlying portfolio was that much better meant that the reinsurance cost us more money, but it was a fair premium to pay at the time the contracts were settled and I have no doubt at all that we got value for money from those transactions.

FIRST Interview
Calliden's NTA increased from 17.9cps at the end of 2011 to 20.0cps largely due to a $3.6m reduction in intangible assets which largely reflects systems development costs. *Firstly*, c*an you provide some background around this item and whether it is realistic to expect that similar reductions are likely in future*?

CEO Nick Kirk
The amortisation is made up of two items – software costs and customer relationships from past purchases. They are both related – the acquisitions that we made, culminating in our purchase of Australian Unity's general insurance business in 2007, meant that we inherited three legacy mainframe systems which had to be converted onto our one modern platform. The cost of creating that platform together with the conversion required in order to have all of that business on the one IT system was significant, although we were always sure we would get value for that investment in the future. That system cost is being amortised over a 5 year period commencing as each of the three businesses was converted. In 2012 we were amortising more than we were putting into capital expenditure which led to the increase in net tangible assets. We expect the reduction in intangibles to continue in 2013.

As we'll discuss later, we are investing in developing IT connectivity to market platforms so we are not going to reach a point where we have no systems costs being added. However in the longer term we would we expect to bring that overall cost down to perhaps half of the amortised cost that we had in 2012. But we have at least another two years of relatively high amortisation to go which will also provide some underpinning of further growth in NTA over that period.

Earnings Outlook for FY13 – Consolidating the MGA model

FIRST Interview
Calliden has set itself a target $10m profit in its first full year of operation as an MGA. This implies an ROE of around 10% which would be viewed as about average for the industry. Do you see that $10m being more weighted to the second half in 2013 and w*hat is your assessment of an acceptable target ROE for Calliden over the medium term (3-5 years)?*

CEO Nick Kirk
It is important for the market to view 2013 as the final phase of the transition process with the full impact of the move to the MGA model really only starting to come through in the second half. So it is likely that the

weighting of our reported profit for the year will be along the lines of 20% in the first half and 80% in the second half. This is largely due to the continued building of the provision on agency, the phasing in of fees, the reduction in proportional reinsurance having a larger impact in the second half and the effect on investment income due to reinsurance premiums being paid in the first half. In 2014, our business will become simpler to understand after all of the transitional elements work their way through the books, but in the meantime, there is still some unavoidable complexity as there are a lot of moving parts.

In terms of a target ROE, I think the first priority for Calliden is to get to the point where we can deliver 10% ROE in a relatively non-volatile way, then we would look to grow that return over a period of time. While there will continue to be variation in the insurance margin year on year due to the nature of catastrophes and individual losses, the financial results delivered by the insurance portfolio are now balanced by a more predictable earnings profile from the agency business. We talked earlier about amortisation and our expectation of a more normalized amortisation of intangibles going forward. With that in mind I don't see any reason why we shouldn't deliver a 12-12.5% ROE in say three years' time – it's definitely what we've got to aim for but my goal this year is to get the 10% underlying return under our belt.

FIRST Interview

With Calliden now restructured into two divisions to reflect its new operating model - Calliden Insurance and Calliden Agency Services - *can you provide some detail on the likely profile of revenue/GWP and earnings over the next couple of years for each division?*

CEO Nick Kirk

As far as CIL is concerned you will see its top line income dropping from around $160m to $110m. However the net revenue, which is the income we have to run the business after we have paid our reinsurances, is going to increase. So by 2014 we will have more net earned premium in CIL than we had in 2011 (which was $126m). That is simply because as the proportional reinsurance reduces, the net earned premium flows through.

Simply put, if we were to write $110m of premium in 2013 on 25% quota share, then our net premium is going to be $80-85m which is virtually the same as writing $220m on 60% quota share (or $85-90m), which is what we did in 2012.

The story is the other way round in the case of Agency where the income will increase from around $56m to $170m which makes it a very sizable agency business. We would be looking to grow GWP by about 7% in 2013 without having to access more capital to do so. Beyond 2013 we have a target growth rate of 5-7% pa plus we are putting policy and administration fees on top of that. That will increase our revenue in addition to the commission on those lines that are being transferred to the agency business.

FIRST Interview

Can you provide some visibility on Calliden's dividend policy for 2013 and would it be reasonable to infer from the dividend just declared, a much higher payout ratio than in the past?

CEO Nick Kirk

The dividend we have just paid was an important statement to our shareholders, acknowledging that 2011 was a very difficult year and we felt it was the right thing to do to reward our shareholders. The capital ratios in the insurer had got to the point where we didn't need more capital in CIL and it seemed the correct thing to do to pay that out to shareholders as a fully franked dividend.

We haven't created a dividend policy as yet. In the past one of the reasons for not doing so was that any policy dividend was deducted from our regulatory capital – that has now changed, which makes it much more straight forward to set a dividend policy. It is something the board will look at between now and the end of the year, but it is still early days in terms of landing on a fixed percentage payout that investors can take as a future indication of dividend.

Nevertheless the whole reason for the strategy we have been implementing over the past year was to get to a point where we could fully frank the dividend, given the bank of franking credits that the company has. The board has been extremely aware of that and it was a large part of the rationale for the strategy that we are now following.

FIRST Interview
Would you describe 2013 as a consolidation year, ensuring that the benefits of the restructure are delivered to shareholders or are you now looking for opportunities, like your investment in new IT infrastructure mentioned earlier, to actively grow the agency business?

CEO Nick Kirk
2013 is a year where we have to show the value of the new model and that is the aim. We will be looking to grow the agency business but it is important to bear in mind that the portfolios that we exited during 2012 were transitioned at different periods during the year and we still have some flow through to come. Therefore to keep the income more or less the same as the agency/insurer income produced in 2012, does entail a degree of growth and that is what we will be looking to achieve.

To that end, the board have agreed to proceed with the investment in building the necessary IT infrastructure to link to broker platforms. It is our aim to take part in the Steadfast platform as an agent for Great Lakes Australia for business pack policies. We think this is a great opportunity for us to grow our business pack portfolio. It is also a good fit with our strategy to provide our broker customers with the products they want, delivered in the way that makes sense to them backed by excellent security. For our carrier it is an example of how our systems and distribution footprint provide opportunities for them to access wider markets in a risk managed way at a variable cost. The cost of the development will still enable us to reduce our intangibles over time.

There are other strategies for growth that we will be pursuing. In the agency business for example we will be introducing new products and initiatives, like the middle market offering that we'll be launching in the second quarter. That is what I call vertical growth i.e. increased premiums through higher sums insured and bigger risks than we would have been comfortable putting onto our own capital. We will also be looking for add-on or bolt-on products that would improve the range of products that our agency business can sell to our intermediary brokers. That is more along the lines of horizontal growth i.e. adding product to the same base.

I think we offer now a very good platform for insurers who do not have the infrastructure to reach the number of brokers throughout the country that we do. Our systems are robust and, being an APRA regulated entity, our risk management and governance processes are very strong. I truly believe that we are a much better alternative to an insurer entering the market entirely on their own steam i.e. we offer good systems, good governance, good market knowledge and a really excellent distribution footprint. So I think it will be mix of product opportunities that we see, or become aware of from listening to our customers, and it is more than possible that a number of insurers will look for ways of distributing products that they want to get to a wider intermediary base than they are currently able to access.

FIRST Interview
Finally, you recently announced the appointment of a new CFO to take over from Tony Thomas at the completion of his contract this month.

CEO Nick Kirk
Tony Thomas joined us as CFO in April 2012 on a 12 month contract. He has made a very strong contribution and ensured that, in our year of transition, our finance, governance and reinsurance teams were very focused on that process. Tony is moving onto a new opportunity at the end of his contract and we have appointed an internal candidate, Anthony Dijanosic who is currently our Risk and Capital Manager. Anthony is a Chartered Accountant and has 17 years' industry experience and I have no doubt he will be an excellent CFO.

We wish Tony well with his exciting opportunity outside the Group and thank him for the part he has played in delivering a positive result for 2012.