Macquarie
Equities Research

Agenda paper 2A

IASB Working Group
User Perspectives

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US analysts are highly skeptical

US analysts still not too focused on this project—analysts live in a world of quarterly earnings-- not what's going to affect me in three years.

- **The three biggest concerns are:**
  - **Asset/liability mismatches**
    - Insurers will have rate sensitive liabilities but not sure how assets will be recorded
  - **Volatility**
    - Presumption is that reported results will be more volatile
  - **Presentation**
    - See margin approach as not very informative
    - View premiums as revenues

US Property-Casualty Analysts

Basic view is—Our model isn't broken, why do we need these drastic changes?

- **Concerns**
  - Discounting
  - Risk adjustments
  - Presentation
- **Generally like**
  - Probability distributions rather than single point estimates
- **Suggestions**
  - Discounting and risk adjustment information in footnotes

US Life Analysts

Recognize the life model is not effective, but

Almost never look at consolidated financial statements since combines two USGAAPs

- **Concerns**
  - Discounting at risk free rather than portfolio rate
  - Risk adjustment
  - Opinions mixed on DAC
- **Generally like**
  - Current values rather than lock in
- **Suggestions**
  - Do interest rate changes have to go through income?

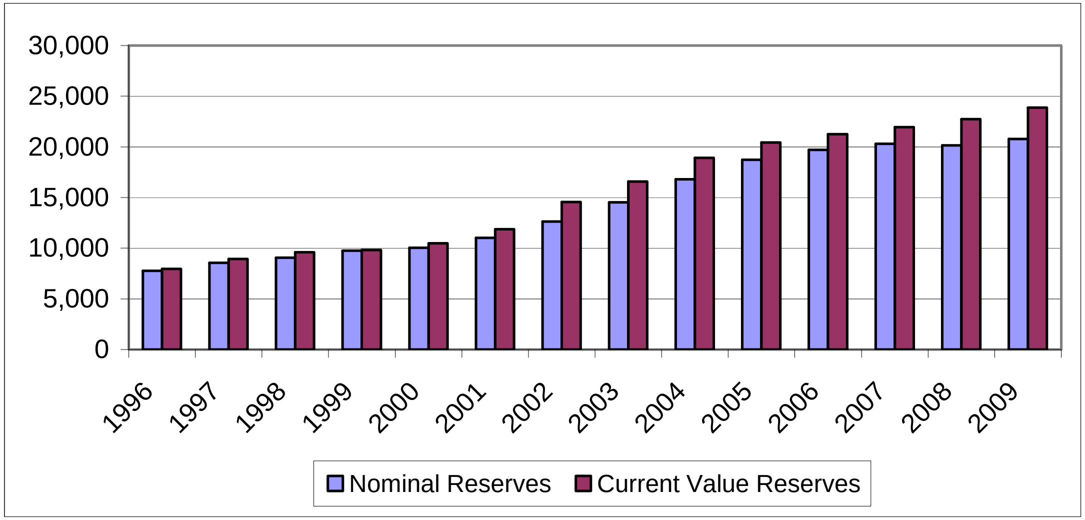
US analysts have not focused on

- **Transitions**
  - What will future profits look like?
- **Reinsurance**
  - Day one gains on outward reinsurance
- Benefits of having a single global standard
  - US analysts very domestic focused

Property-casualty model shows that current value reserves would exceed nominal reserves

Nominal vs Current Value Reserves

Proprietary model based on major US property-casualty company.

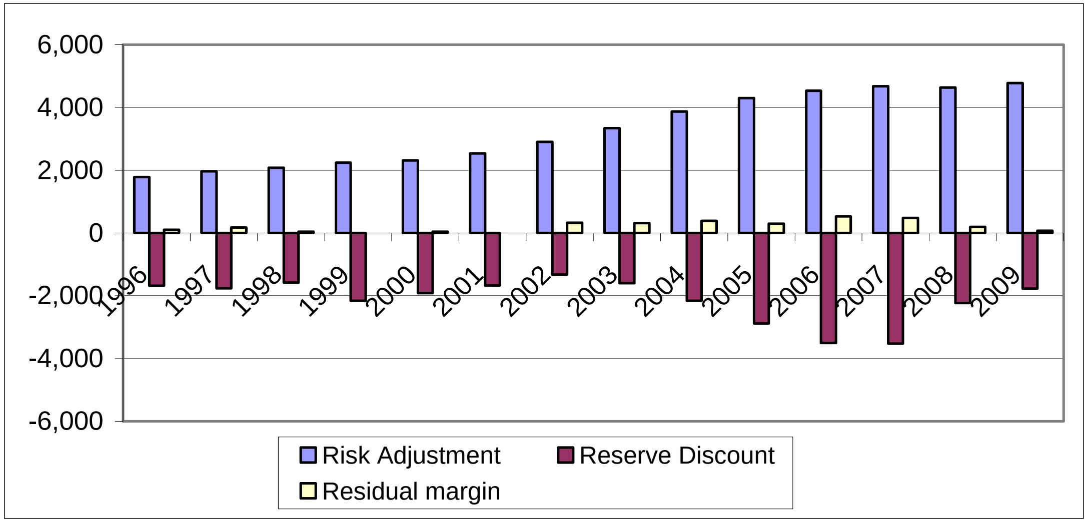


Source: Macquarie Capital (USA), November 2010

Because risk adjustment exceeds discount

Components of Reserve Changes

This is currently because of the low level of interest rates.

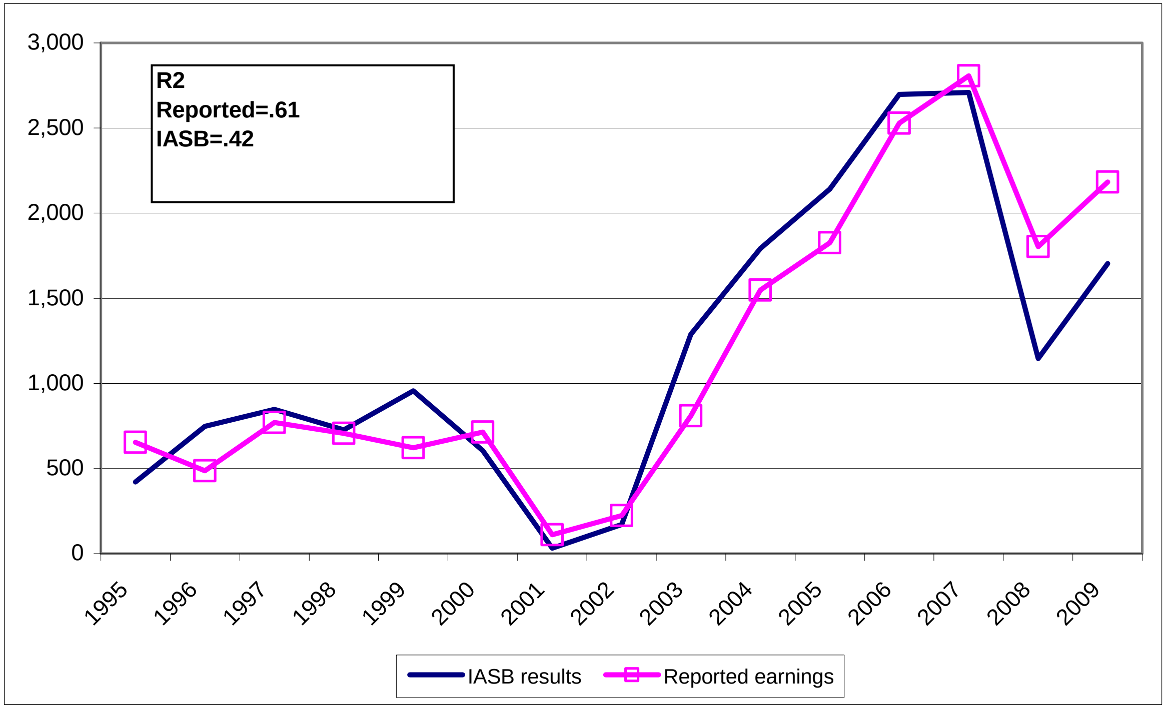


Source: Macquarie Capital (USA), November 2010

IASB results more volatile than USGAAP

Net Income Comparison: Reported Results vs IASB Proposal

Our property-casualty model shows that the proposed IASB model captures the same dynamics as current USGAAP but results are more volatile.

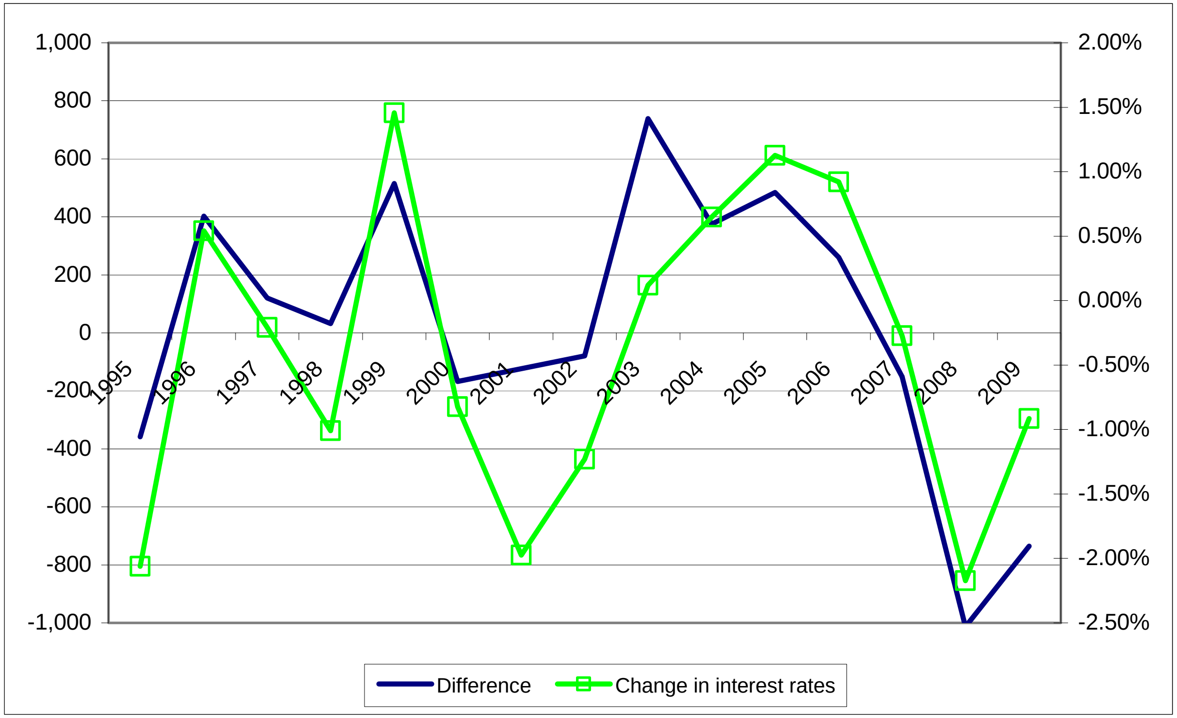


Source: Macquarie Capital (USA), November 2010

Much of the volatility comes from interest rate fluctuations

When interest rates are declining IASB underwriting income is below reported income.

Underwriting Income Difference vs Change in Interest Rates

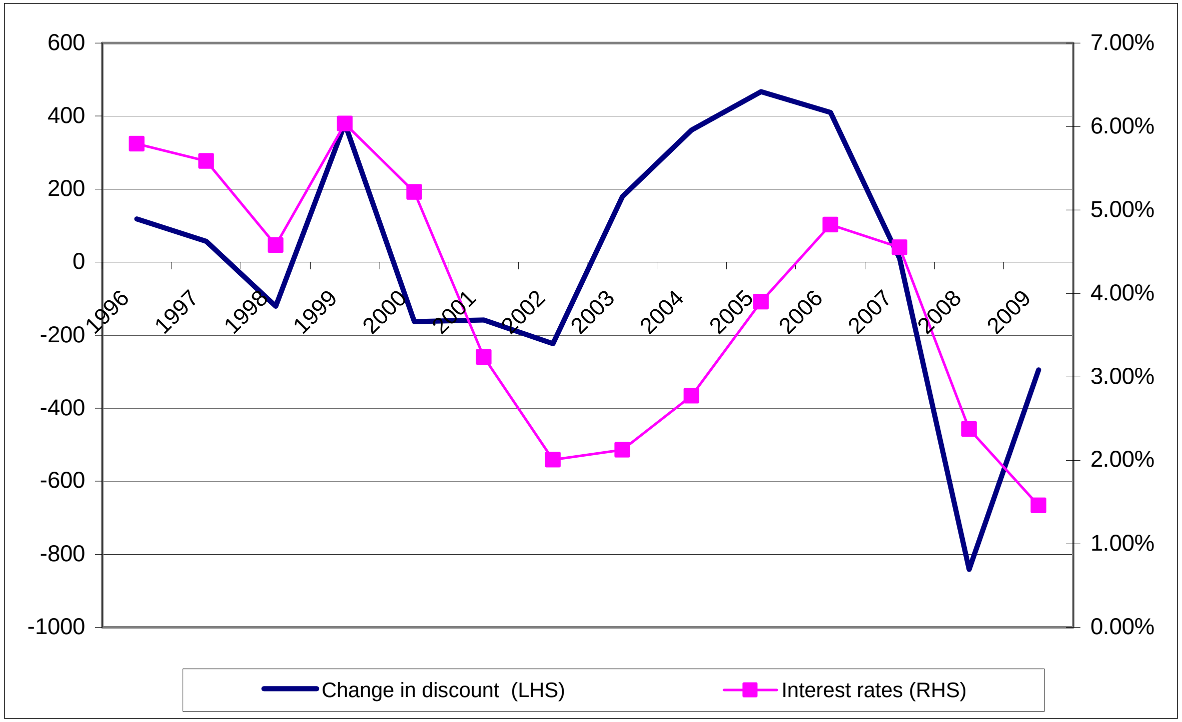


Source: Macquarie Capital (USA), November, 2010

Because interest rate fluctuations affect the reserve discount

When interest rates decline the reserve discount also declines, thus affecting earnings.

Change in Discount vs Interest rates



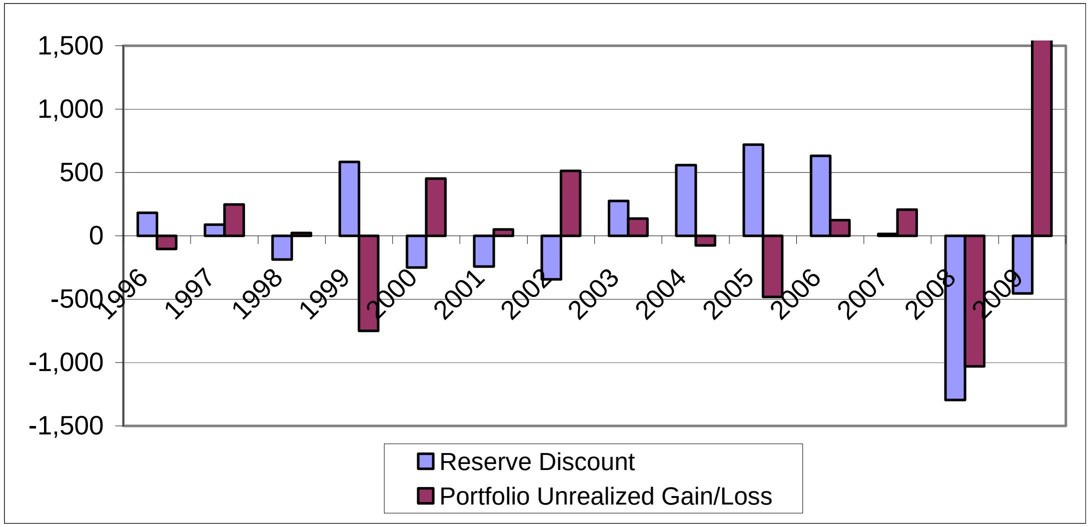
Source: Macquarie Capital (USA), November 2010

There are natural offsets between reserve discounts and changes in the investment portfolio

Change in Reserve Discount vs Unrealized Portfolio Gains/Losses (Pretax)

But the magnitudes are far different.

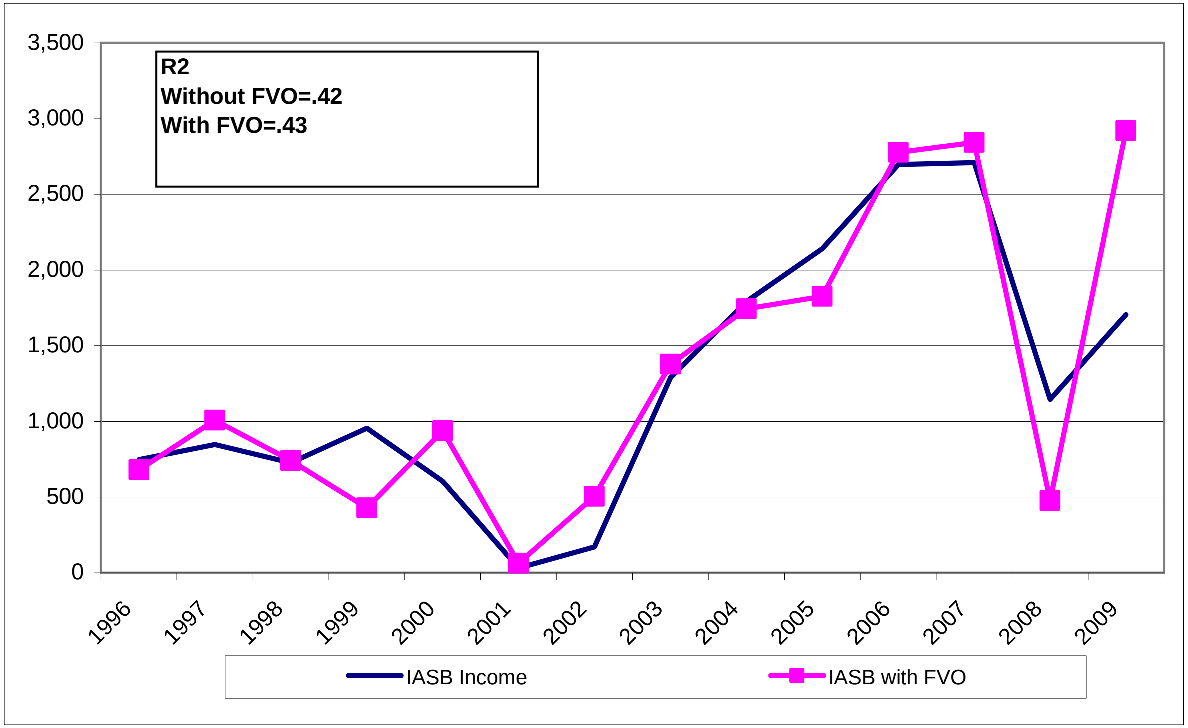
2008 was a highly unusual year—perfect storm of risk free rates declining while risk spreads widened.



Source: Macquarie Capital (USA), November, 2010

So the fair value option doesn't make results more stable

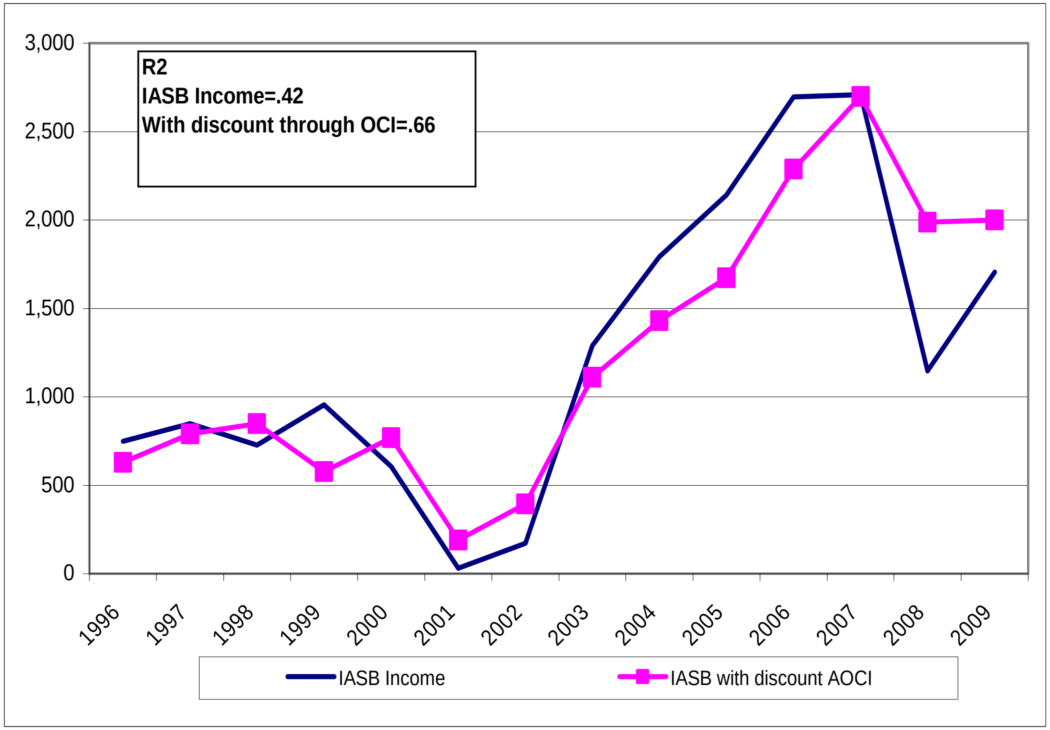
IASB Income: With and Without FVO



Source: Macquarie Capital (USA), November, 2010

But putting reserve discount changes through OCI does make results more stable

IASB Income with Reserve Discount Changes Through OCI



Source: Macquarie Capital (USA), November. 2010

Risk adjustment contains much useful information

Note how the risk adjustments—determined by confidence intervals--vary by type of company.

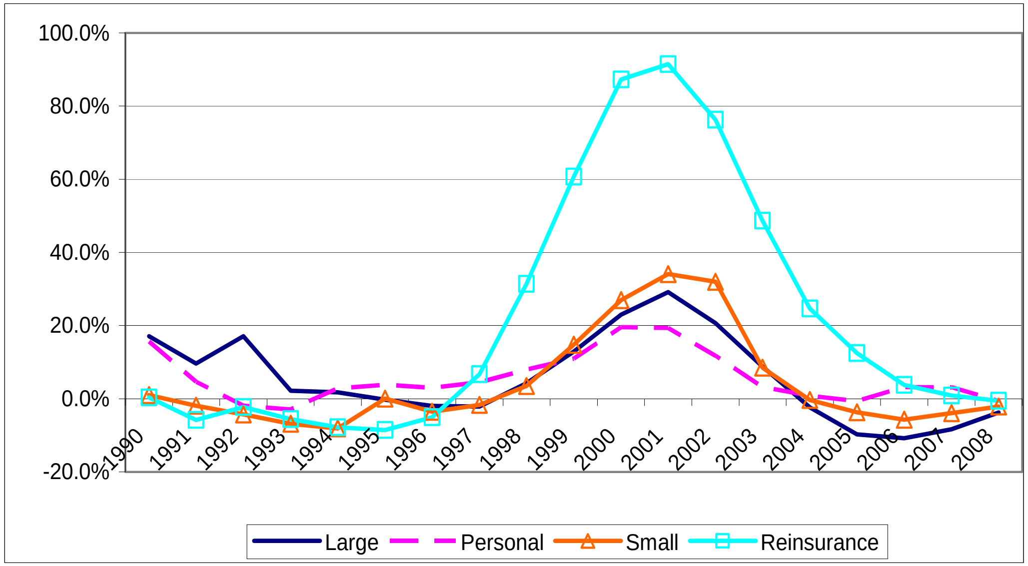
Percentage Change in Reserves
From Initial Report through Development

Yearend	Personal Lines	Large Diversified	Small Diversified	Reinsurance	Years of Development
1990	15.6%	17.1%	1.0%	0.3%	10
1991	4.6%	9.6%	-1.9%	-5.8%	10
1992	-1.9%	17.1%	-4.3%	-2.3%	10
1993	-3.0%	2.2%	-6.8%	-5.6%	10
1994	2.8%	1.8%	-8.1%	-7.8%	10
1995	3.9%	-0.2%	0.1%	-8.5%	10
1996	3.0%	-2.0%	-3.5%	-5.0%	10
1997	4.5%	-2.1%	-1.6%	6.7%	10
1998	8.0%	4.2%	3.5%	31.4%	10
1999	11.0%	12.9%	14.8%	60.7%	10
2000	19.6%	23.0%	27.0%	87.3%	9
2001	19.3%	29.1%	34.1%	91.5%	8
2002	11.7%	20.7%	32.0%	76.3%	7
2003	3.2%	8.8%	8.5%	48.7%	6
2004	0.8%	-2.4%	-0.3%	24.7%	5
2005	-0.7%	-9.8%	-3.7%	12.5%	4
2006	3.2%	-10.8%	-5.7%	3.8%	3
2007	3.1%	-8.4%	-3.9%	0.9%	2
2008	-0.7%	-3.8%	-2.1%	-0.5%	1
Mean	5.7%	5.6%	4.1%	21.5%	
Standard Deviation	6.8%	11.7%	13.1%	34.2%	
Risk adjustment					
Percentage increase to bring reserves to higher confidence level					
90% confidence level	14.4%	20.6%	21.0%	65.4%	
75% confidence level	10.3%	13.5%	13.0%	44.6%	

Risk adjustments would vary over time

A roll-forward of the risk adjustment would provide useful insights.

Percentage Change in Reserves
By Accident Year



Source: Macquarie Capital (USA), November 2010

The margin approach income statement seems limited

Comparative Income Statements

($ Mil.)	IASB	Current GAAP
Premiums earned		11,331
Incurred losses		6,268
Expenses		3,437
Projected cash flows	610	
Risk adjustment	1,170	
Discount	-751	
Residual margin	-191	
Initial liability	0	
Release of risk adjustment	1,025	
Release of residual margin	308	
Amortization of discount	-1,205	
Experience and estimate adjustments	762	
Non incremental expenses	0	
Net underwriting income	890	1,626
Tax rate (%)	35%	35%
Tax	-312	-569
After tax underwriting	579	1,057
Investment income	1,408	1,408
All other	-282	-282
Net income	1,705	2,183

Source: Macquarie Capital (USA), November 2010

But showing the roll-forward of the components is useful

Reserve discount	
Opening discount	2,230
New discount	751
Release	-1,205
Closing discount	1,776
Risk adjustment	
Opening risk adjustment	-4,636
New risk adjustment	-1,170
Release	1,025
Closing risk adjustment	-4,781
Residual margin	
Opening residual margin	-190
New	-191
Release	317
Accretion charge for interest (5%)	-10
Net release	308
Closing residual margin	-73

Source: Macquarie Capital (USA), November 2010

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Important disclosures:

Recommendation definitions

Macquarie - Australia/New Zealand

Outperform – return >5% in excess of benchmark return (>2.5% in excess for listed property trusts)
Neutral – return within 5% of benchmark return (within 2.5% for listed property trusts)
Underperform – return >5% below benchmark return (>2.5% below for listed property trusts)

Macquarie - Asia

Outperform – expected return >+10%
Neutral – expected return from -10% to +10%
Underperform – expected <-10%

Macquarie First South - South Africa

Outperform – return > 10% in excess of benchmark return
Neutral – return within 10% of benchmark return
Underperform – return > 10% below benchmark return

Macquarie - Canada

Outperform – return > 5% in excess of benchmark return
Neutral – return within 5% of benchmark return
Underperform – return > 5% below benchmark return

Macquarie - USA

Outperform (Buy) – return > 5% in excess of benchmark return
Neutral (Hold) – return within 5% of benchmark return
Underperform (Sell) – return > 5% below benchmark return

Recommendation – 12 months

Note: Quant recommendations may differ from Fundamental Analyst recommendations

Volatility index definition*
This is calculated from the volatility of historic price movements.

Very high–highest risk – Stock should be expected to move up or down 60-100% in a year – investors should be aware this stock is highly speculative.

High – stock should be expected to move up or down at least 40-60% in a year – investors should be aware this stock could be speculative.

Medium – stock should be expected to move up or down at least 30-40% in a year.

Low–medium – stock should be expected to move up or down at least 25-30% in a year.

Low – stock should be expected to move up or down at least 15-25% in a year.

* Applicable to Australian/NZ stocks only

Financial definitions

All "Adjusted" data items have had the following adjustments made:

Added back: goodwill amortisation, provision for catastrophe reserves, IFRS derivatives & hedging, IFRS impairments & IFRS interest expense
Excluded: non recurring items, asset revals, property revals, appraisal value uplift, preference dividends & minority interests

EPS = adjusted net profit /efpowa*
ROA = adjusted ebit / average total assets
ROA Banks/Insurance = adjusted net profit /average total assets
ROE = adjusted net profit / average shareholders funds
Gross cashflow = adjusted net profit + depreciation
*equivalent fully paid ordinary weighted average number of shares

All Reported numbers for Australian/NZ listed stocks are modelled under IFRS (International Financial Reporting Standards).

Recommendation proportions – For quarter ending 31 December 2009 ------UPDATE IF EXTERNAL

	AU/NZ	Asia	RSA	USA	CA	EUR	
Outperform	47.94%	60.52%	37.50%	43.42%	65.26%	41.60%	(for US coverage by MCUSA, 3.76% of stocks followed are investment banking clients)
Neutral	35.58%	18.70%	53.13%	49.06%	29.11%	36.80%	(for US coverage by MCUSA, 4.51% of stocks followed are investment banking clients)
Underperform	16.48%	20.79%	9.38%	7.52%	5.63%	21.60%	(for US coverage by MCUSA, 0.0% of stocks followed are investment banking clients)

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