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Calliden Group CEO on Strategic Alliance with GLA

FIRST Interview with CEO Nick Kirk

Topics of discussion

- Strategic alliance with Great Lakes Australia (GLA) signals a shift in operating focus towards that of a Managing General Agent
- Sale of Calliden's 50% interest in CSA affirms company's earlier decision to bring commercial claims processing in-house
- Organisational restructure underway to reduce expense base by 10-15% over the next year
- 2012 to be a transition year as Calliden moves to becoming a focused insurer supported by more stable commission revenue from its alliance with GLA

Strategic Alliance with Great Lakes Australia (GLA)

FIRST Interview

Calliden announced on 8 December that it had entered into a strategic alliance with GLA whereby Calliden will in future underwrite its commercial package portfolio as an agent on behalf of GLA. Calliden's commercial package book represents around 25% of its total underwriting portfolio. Is this a one-off or the first stage of a more fundamental shift in Calliden's business model?

CEO Nick Kirk

Given our growth projections and the capital needs for future growth, moving more of our portfolios to an agency basis makes sense. We've decided to move to a model where we act as a Managing General Agent¹ (MGA), whether we use our own insurance company or source capacity from elsewhere. In this way we can continue to grow and develop while at the same time becoming less capital intensive and reducing the profit volatility we've had over the past two years.

Calliden has operated both as an insurer and a MGA for some time. It has for example been a cover holder for Lloyds of London for its Mansions business since it bought that portfolio in 2007. We do a similar role for the Home Warranty business on behalf of the State Government of NSW. This combination of insurer and MGA in the same group makes us quite unique. We can offer access to the SME and personal lines markets through our modern infrastructure with the assurance that they are dealing with a company which is an insurer in its own right and has skin in the game.

¹ A Managing General Agent may perform one of many tasks normally performed by an insurer. These include but are not limited to: marketing, distribution via broker and agents for placement of business, relationship management, negotiating commissions, handling claims, issuing policies, processing endorsements, collecting policy premiums, risk assessment and pricing.

Over the next 12-18 months we will form a view on each of our portfolios as to whether it is best to back them with our own insurance company and our own capital or whether we feel, on balance, that the portfolio would be better supported in tandem with another partner or source of capital. This process is already under way. We considered the commercial package portfolio to be an ideal candidate for the new business model given all the changes occurring in that market and the opportunities we see this giving rise to.

FIRST Interview

Why was the commercial package chosen over other parts of your business? Has this been a segment of Calliden's portfolio where, perhaps because of lack of scale, it has been difficult to make an acceptable return?

CEO Nick Kirk

Choosing the commercial package was all about the opportunity that presented itself, rather than any perceived weakness. This particular part of the market is going through quite a considerable change - more and more of it is being placed electronically and there is also the introduction of something called "contestable platforms" by the major broker groups. These electronic platforms comprise panels of competing insurers. As they become more of a feature of the market it is important that we position ourselves to compete effectively on these platforms.

There is a tremendous opportunity here for those that don't currently have a major market share. It is that opportunity that both Calliden and Great Lakes are looking to maximise.

I believe our IT infrastructure is as good as, if not better than, most of the majors in the market. Creating an alliance with Great Lakes, where we are able to access their capital backing which is rated by S&P as AA- very strong, means we can actively compete in that segment and really get some scale and good profitable growth.

FIRST Interview

Calliden and GLA have an existing relationship through Munich Re's role as Calliden's primary reinsurer. Was there any other reason that you chose GLA as underwriter for Calliden's commercial business? Were others considered, for example, and what process was followed in making this selection? What benefits does this alliance provide for Calliden and its customers?

CEO Nick Kirk

Munich Re has been a reinsurance partner for us since we started in 2005 so there has always been a close relationship between the two companies and that developed into a relationship with their insurance subsidiary, Great Lakes Australia. In terms of this alliance they seemed to us the absolutely logical choice. We knew them, they knew us. We had the infrastructure, they had the capital. So we really didn't need to look beyond them in our search for a trusted partner.

The important point to be made here is that when we operate as an agent on behalf of another insurer, we are committing their capital to risk. And so the absolutely essential ingredient in a relationship like that is trust. Now if you have had a relationship for six years and particularly when it is a "proportional" relationship i.e. they take a percentage of every piece of business we write, then that trust develops. That's an enormous advantage for both companies entering a relationship like this. We have to trust that they're not going to suddenly change their risk appetite overnight and they have to trust that we're a responsible underwriter who looks after their capital appropriately and who will underwrite a profit. You can't manufacture a relationship like that overnight.

In terms of the benefits it brings to Calliden's business customers, the alliance provides everything they currently receive with Calliden - the Callibrate system, our Retail Underwriting Centre and of course the same day-to-day relationship management, support and claims handling that our customers expect of us. However in addition to this our commercial customers now get access to AA-rated paper.

From Calliden's perspective, we have spent a lot of time and money building the company to the point it is today. We need to continue to grow Calliden in order to make the most out of that investment. This effectively provides us with capital to support the desired growth trajectory.

FIRST Interview

Is it possible to quantify the impact on Calliden's profit in 2012 of moving from an underwriting model to generating a return from a fixed commission margin for this part of the business, recognizing that there is also an indirect benefit from the reduction in capital requirements for the Group?

CEO Nick Kirk

2012 is going to be a year where Calliden makes the change to becoming a MGA. The outcomes of both the existing and new business models will be evident in the 2012 results – the risks we wrote as the insurer in 2011 and the risks from 2012 where a large part will have been written in our capacity as agent on behalf of GLA. There will also be some restructuring costs as we change models. It would be fair to say that as we move down this path there is a price to having a less volatile earnings profile. If, for example, we were to have no weather catastrophes next year and investment markets returned to “normal” then of course we would be better off being a pure insurer. But on balance I believe this new approach will deliver a better outcome in the long run - it trades off some upside for less risk and in doing so provides investors with more certainty.

Regardless of business model the key drivers of Calliden’s profit in 2012 will be the ability to continue writing profitable business, together with the gradual reduction in our expense base to a level befitting our new business model.

Sale of Calliden's 50% interest in the CSA joint venture**FIRST Interview**

Calliden also announced in the same week the sale of its 50% interest in the CSA joint venture to the Innovation Group in the UK for \$10m. Given Calliden’s focus on customer service the obvious question to ask is, why didn’t you simply buy out your JV partners and bring it all in-house?

CEO Nick Kirk

We believe CSA, as a specialist claims management company, has an important role to play. When we made our initial investment in CSA in 2006 we did so because it was an excellent opportunity to invest in a quality business that we understood. They had successfully demonstrated their expertise and we saw an opportunity for a mutually profitable partnership. We provided them with more scale in their claims management operation from which we benefitted as a customer and grew the value of the business.

More recently however we have come to realise that our presence as majority shareholder was holding CSA back from fulfilling its potential. By disposing of our shareholding we believe it will help CSA win more business with other Australian insurers. They will be able to provide additional scale and efficiency benefits to all their customers, including Calliden. CSA is now well-positioned to prosper as a dedicated claims management provider within The Innovation Group’s international business. This transaction has worked out very well for all concerned.

FIRST Interview

Calliden brought processing of all commercial claims in-house earlier this year and signed a 5 year agreement with CSA focused only on motor and domestic home insurance – was that essentially preparing the way for the GLA alliance and the sale of CSA?

CEO Nick Kirk

Earlier this year we gave much thought to our future claims handling requirements. At that time we decided to take our commercial claims in-house for the purpose of improving the overall commercial package offering. Calliden is very fortunate in having an outstanding in-house claims team with a deep understanding of the intricacies of commercial claims – key to this is a deep understanding of policy wording and the expertise around that particular class. When we made the judgment to bring our commercial short-tail claims in house last May, it was on the basis that we felt they would be better managed by ourselves.

As a secondary consideration we were also aware that one of our CSA joint venture partners with executive responsibilities at the Company was considering his future after a long and successful career. Taking commercial claims in house at that time was also a way of de-risking our exposure in this area.

I would also like to point out that, whilst we did take our commercial claims in house, we also decided to renew a long-term contract with CSA for motor, home and strata claims. CSA can provide a better service to our motor, home and strata customers if they continue to manage these claims because there are far more opportunities to realise scale benefits in these product lines as opposed to commercial lines. The new owners, The Innovation Group, add even more to this with their international scale and capability.

This transaction has played out in line with our strategy for this business. We maintain a relationship with an expert claims manager who can deliver further scale and expertise and at the same time we generated a very satisfying return on our initial investment based upon its current and future earnings. It is a win-win for all concerned.

FIRST Interview

The contribution from JVs to Calliden's earnings in 2010 was \$1.3m. The CSA joint venture was the only JV of any size left after the sale of Calliden's interest in Sports Underwriting Australia last year - can we assume that this is a good indication of the actual return Calliden was receiving from CSA?

CEO Nick Kirk

We do get a reasonable return from the other agencies. The largest contribution to that \$1.3m was definitely CSA but it doesn't represent all of it. Their annual profit would certainly be north of \$1m in the last few years.

FIRST Interview

Calliden has sold out of two joint ventures in the past 18 months and is reducing its exposure to risk – does this reflect a fundamental change in the Company's attitude to risk in the current environment and if so what is your view on the outlook for the insurance sector over the next 3 years?

CEO Nick Kirk

Selling out of the agency side of Sports Underwriting and then CSA is not an aversion to that type of risk as they were actually two fee-based, non-risk based businesses. And whilst it might be argued that putting money into the development of small entrepreneurial ventures in the first place might seem risky, our joint venture investments have been the best investments that we have made. I would be keen to invest in businesses like that again in the future. If we can find the right people, with the right business plan in an area connected to what we do, then that really makes sense. What we are really coming to realise is that in the current environment of ongoing uncertainty we must focus on our core business and our core competencies to deliver over the long term.

In terms of the risk environment, we've got a very volatile natural environment and that's led to a change in the reinsurance market, or certainly the reinsurers' perception of risk in Australasia. That's now flowing through, both in terms of increased reinsurance premiums as well as a pushing up of net retentions. In other words forcing insurers like ourselves to take a larger share of their own risks, particularly when it comes to catastrophe and weather perils, increases both capital requirements and potential volatility. Then there is the protracted uncertainty in the investment and economic environment globally. With none of these factors likely to disappear in the near future, I believe uncertainty is the new norm.

In the regulatory environment APRA's new capital standards will come into effect in 2013 which will undoubtedly increase the amount of capital needed for insurers, including Calliden.

So the path we are navigating for Calliden through these external challenges is looking to reduce volatility and capital intensity while allowing us to grow into the infrastructure we have created over the last five years.

Internal Restructure of Calliden**FIRST Interview**

You haven't mentioned the impact on employees arising from this alliance with GLA. Will there be redundancies and if so what is the likely level of costs incurred and which year will they be booked (2011 or 2012)?

CEO Nick Kirk

The arrangement with GLA is not in itself going to result in redundancies in Calliden.

Irrespective of this alliance we have to become a more cost-efficient organisation. The significant increase in reinsurance costs and the other challenges we have talked about make this efficiency drive non-negotiable. As a result of all of the work that has been done in systems conversions, integration and centralisation, Calliden today is a less complex business than it was three or four years ago. In response to this we have started a restructure process with the executive team. As a result three executives are leaving Calliden. All three have made significant contributions in the last five years and I would like to take this opportunity to thank them and wish them well in the future. The cost of this stage of the restructure will be taken in 2011.

FIRST Interview

Can you outline in practical terms how this restructure will actually work and how it will deliver better outcomes for customers, brokers, agents and shareholders?

CEO Nick Kirk

For me improved quality and consistency will be the key outcomes for our customers, brokers and agents. We have yet to achieve the level of consistency that I would like. This is a legacy of having grown through acquisition, resulting in a number of different brands operating across a range of different niches that you see today. Part of the restructure is to enable the total customer experience to be consistent across all brands and offerings.

From a capital provider point of view, including our own insurer Calliden Insurance Limited, the new structure with its focus on underwriting should drive a more consistent and lower gross loss ratio. This will be particularly evident as we see the benefit of some of the price rises that have been put through on household and personal insurance.

Finally from an investor's point of view, improved customer service, lower loss ratio and reduced expenses will lead to a better and more consistent bottom line.

So from that aspect the restructure is designed to work on all of those outcomes for our important stakeholders.

FIRST Interview

It would appear that lowering the overall cost structure is a particular focus - do you have a target in mind and if so what is your measurement of success and over what timeframe?

CEO Nick Kirk

During 2012 we are going to be more focused on costs than ever. Undoubtedly we will be looking to make savings and make the Company more efficient. Part of this will entail further tactical investment in IT to speed up some areas of the process and drive further efficiencies. We do intend reducing headcount but I hope most of this can be achieved through natural attrition.

I'm aiming to make something like a 10- 15% reduction in our inflation-adjusted expense base by the end of 2012. That's another reason why 2012 is going to have an element of transition to it in terms of where we are now, and where we need to get to.

Update on 2012 and Outlook**FIRST Interview**

Finally, we are only weeks away from the end of Calliden's financial year. Can you give an update on the second half and perhaps more importantly what you see the business looking like in 2-3 years?

CEO Nick Kirk

The first half of 2011 was very tough for the entire industry in terms of the unprecedented frequency and magnitude of natural catastrophes. On top of this Calliden has experienced a higher than expected frequency of large loss activity and indeed there has been some continuation of this into the second half of the year. There is no hiding from the fact that in relation to earnings, 2011 is going to be a tough year for Calliden.

I said earlier that this new direction will take time before it starts to deliver. We might be criticised for saying that it is going to take a year or eighteen months to get there, but I don't see a shortcut and the alternative looks far more challenging than moving in this direction. The Board undertook a strategic review earlier in the year, the outcome of which was for Calliden to become less capital-intensive and less volatile but continue to grow nonetheless. I believe the announcements of the last week take a significant step towards achieving that vision. The GLA deal in particular will result in a bigger business overall with much of our revenue being generated in the form of stable commission income. This will position us to pay fully franked dividends more consistently and carry out other capital management initiatives in the future and to reward the faith of our shareholders.