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Calliden Group Limited
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Calliden Group Limited yesterday reported net profit of \$2.4 million for the first half ended June 2009, down from \$3.6 million for the previous corresponding period. Underwriting profit was \$2.9 million, down from \$3.8 million, partly reflecting an increase in gross claims expense to \$97.1 million from \$43.2 million. Can you comment on the claims environment and the impact of “unusual” events such as the Victorian bushfires in February?

CEO Nick Kirk

In the first six months of 2009 we had three “notifiable” catastrophes, the total cost of which was \$32.3 million gross of reinsurance. As well as the notifiable catastrophes, we also saw an increased incidence of smaller storm and weather related losses. In contrast, our gross claims were relatively low in the first half of 2008 reflecting the write-back of gross estimates relating to storm events in the second half of 2007.

On a gross basis the cost of the catastrophes in the first half was equivalent to a 53 percent loss ratio on our short-tail book. That’s the largest amount of catastrophe claims we’ve paid and compares with 5 percent in the second half of 2008, 2 percent in the first half of 2008 and 16 percent in the second half 2007. The catastrophes added \$3.75 million to our net claims costs before stop loss in the first half.

Our claims performance has been in line with the market: the number of storms and natural catastrophes in the last three years, and particularly the first half of 2009, has been very high compared with the last 10 years.

It's worth noting that in spite of the claims environment, our combined operating ratio improved to 97 percent in the first half, down from 101 percent in the second half of 2008.

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To what extent has the relatively poor first-half result set you back in terms of your target of achieving ROE of 12.5 to 20 percent by 2011 and your longer term strategy?

CEO Nick Kirk

In the circumstances, the first half result was very creditable: our combined operating ratio improved and we maintained our insurance margin at 6 percent. Our first half insurance margin compares very favourably with our much larger peers.

We'll be reviewing our ROE targets when we go through our budgeting process later this year. But our fundamental strategy is unchanged: we continue to simplify the business and improve efficiency; we've improved the profitability of our portfolios; we're focused on profitable growth in both our underwriting and agency businesses; and we're well positioned to benefit from an increasingly hardening premium environment and an improving interest rate outlook.

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You strengthened your reinsurance programme in the first half. How might your future reinsurance costs be impacted by the relatively large reinsurance claims in the first half?

CEO Nick Kirk

We expect reinsurance costs will increase, particularly for catastrophe reinsurance. We took the decision to strengthen our reinsurance and experience in the first half has validated that position. Having said that, reinsurance rate increases for 1 July renewals appear to have increased only moderately.

We have some flexibility to review how and the extent to which we reinsure, but we'd need to be very careful about reducing our catastrophe reinsurance. Our reinsurance renewal is 31 December and we're already working on our reinsurance strategy for 2010 and beyond.

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How might your reinsurance strategy change as the business matures? What benchmarks would the business have to meet before you sought to lower your relatively high level of reinsurance cover and consider increasing your risk retention?

CEO Nick Kirk

Our intention has always been to reduce the percentage of reinsurance we use as the portfolio develops and matures and as we build a track record of profitability. Any decision to reduce our cover would be based on our assessment of the true cost of reinsurance: the difference between the net cost of retaining a risk and using reinsurance. Our judgement will also be tempered by ensuring we're protecting our capital.

We're building this business for the long term, and the first half of 2009 has shown that being conservative has paid off for us even though we may have reduced the potential upside for a period of time.

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Has the claims experience in the first half caused you to reassess your portfolio exposures, particularly in regional and rural property?

CEO Nick Kirk

There's been no fundamental change in our level of comfort with our portfolios but we continue to do a lot of analysis of our claims experience over time, and particularly the impact on our portfolio of the recent natural catastrophes. It's about risk assessment and pricing, and our view is that we can get both of these right in the regional and rural sector. Clearly there's a need to make sure our pricing takes into account the sector's vulnerability to weather.

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Gross written premium (GWP) was \$104.4 million in the first half, up 7 percent from the previous corresponding period. Earlier in the year you expected to achieve GWP growth of over 10 percent. How did trading conditions vary from your expectations and does this level of GWP growth remain achievable in the current environment?

CEO Nick Kirk

We expected a more rational pricing environment, with more rapid premium increases in the face of the various weather events and the reduction in investment returns. Our new business growth has also slowed in 2009 with three large natural catastrophe events, and the conversion of our commercial package system.

We still expect to achieve growth in selected portfolios where it makes sense: our primary focus is to make sure we improve margin rather than just push for growth. That means different things for different portfolios: there's no doubt there's a need for higher premiums in regional and rural given the impact of the weather in the last couple of years, and that also applies in sectors like residential buildings cover. Other portfolios are growing strongly and profitably, for example specialised motor and our Mansions of Australia business.

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What is the outlook for premium rates going forward?

CEO Nick Kirk

We're getting price increases, although not as fast we'd targeted and part of that is attributable to the market not hardening as quickly as we thought it would. We're getting increases in our home and motor insurance portfolios and commercial short tail, albeit lower than required.

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You completed your first conversion of legacy systems to your new IT platform in the first half and the second conversion will be in the second half.

What's the expected cost of the conversion programme in the current year and will there be any immediate cost savings?

CEO Nick Kirk

The cash cost this year will run at \$3 million, consistent with our previous estimates.

We expect to complete the conversion project in 2010. The development and conversion programme has been capitalised and will be amortised over a four year period, and whilst the cash outlay will reduce in 2010, it's going to be a while before that flows through into savings. We expect annual savings of \$1 million to \$2 million when the conversion is complete. In the meantime, we're already seeing some degree of business simplification, making administration easier than it's been with the legacy systems we've inherited.

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Calliden's investment income was down in the first half, with income on assets backing insurance liabilities falling to \$1.6 million from \$2.3 million and income on shareholders' funds falling to \$0.6 from \$1.1 million. This reflected the impact of lower interest rates on your 100-percent cash and fixed interest investment portfolio. With equity markets having substantially recovered in recent months, are you looking to review your current investment strategy?

CEO Nick Kirk

We review our investment strategy on a regular basis. At present we're happy to err on the conservative side and take lower returns rather than introduce more volatility into our results. Also, it's not just the overall rate of return that's dropped, but also our investable funds have reduced. That's partly a function of our move to heavier reinsurance: our technical funds therefore are lower. One of the hidden costs of catastrophes like the bushfires is that we outlay cash on claims before we get the reinsurance recoveries, therefore reducing investable funds for a period.

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In early July Calliden acquired the 50 percent of IUA it did not already own for \$1.5 million. What was the rationale for this investment and how is your strategy evolving in the non-underwriting area?

CEO Nick Kirk

IUA is a business we really believe in and think has a great future. It's a specialist business interruption underwriter and we believe small business in particular is under-insured in this area. We felt that taking 100 percent ownership would allow us to direct the business and manage its growth better than remaining a JV partner. Full ownership also simplifies our structure.

We still believe it's strategically important to have some involvement in the underwriting agency side, whether we underwrite the risk or whether it's underwritten by other capital providers. Our JVs contributed an increased part of our profit during the first half of 2009 and the overall rate of return from the JVs has been the highest of all of our investments. It's an area we want to continue to grow.

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You've indicated that Calliden Insurance Limited was capitalised at more than 2.3 times its minimum capital requirement as at the end of June. Can you comment on the impact on your "excess capital" of the new Australian Prudential Regulation Authority (APRA) capital standards which were introduced in July?

CEO Nick Kirk

The new APRA standards place a minimum capital requirement on the Group in addition to the existing capital requirement for our insurance company. The Group has 2.0 times the minimum regulatory capital, representing capital in excess of the minimum of \$25 million. However it's worth noting that not all of the surplus capital could be returned to shareholders because APRA requires a buffer to be maintained over the regulatory minimum.

We previously had three licensed – and separately capitalised – insurance entities in the group, so we've progressively reduced our minimum capital requirement in recent periods.

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Calliden introduced a dividend last year, paying a final dividend of 1.25 cents per share. Can you provide any guidance regarding the outlook for dividends in the current year?

CEO Nick Kirk

As we've said previously, we'll review the amount of capital the business needs and the amount of retained earnings and make a decision at year end. As a group we have franking credits and tax losses and we're aware that's an attractive feature for investors. We'll bear that in mind when we decide on the level of dividend.

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Thank you Nick.

For more information about Calliden Group, please visit www.calliden.com.au or call General Counsel & Company Secretary Charles Whattam, on +61 (2) 9551 1143.

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