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Market leader - where now for growth?

Company/ASX Code	Insurance Australia Group Limited/IAG
AGM date	Friday 26 October 2018
Time and location	9.30am Sofitel Sydney Wentworth, 61-101 Philip Street, Sydney
Registry	Computershare
Webcast	Yes
Poll or show of hands	Poll on all items
Monitor	Richard Wilkins assisted by Ian Graves
Pre AGM-Meeting?	Yes, with Chair Elizabeth Bryan and Investor Relations

	Receipt of financial statements and reports
ASA Vote	No vote required

Financial performance

IAG delivered another impressive result in FY18, surpassing the good results of FY17. The group's Underlying Insurance Margin (the most relevant measure of its core business) rose from 12.4% to 14.1%. The Australian Business segment continued to recover from its low profit margin of the second half of FY17; Australian Consumer and New Zealand both performed well. Rate increases offset rising claims inflation, and natural perils costs were below budget. NSW compulsory third party (CTP) law reform has caused a drop in premium but better profit. As usual, IAG was able to make higher reserves releases than budgeted, following conservative provisioning of prior year claims.

Cash Earnings rose 4.5% to $1034m; and Cash Return on Equity (ROE) rose to 15.6%. In common with standard practice in the banking and insurance sector, IAG emphasises cash earnings in its management and reporting statistics. The statutory (reported) profit of $923m was flat compared to FY17, reflecting a drop in investment income earned on shareholders' funds, $50m impairment charges (for Asia) and a higher average tax rate. Reinsurance costs have been favourable in recent years, but will rise in FY19. IAG's cost reduction plan was neutral in FY18, but IAG expects it to earn a net benefit of $100m in FY19m, and to finish FY19 with a run rate of $250m pa cost saving.

Cash earnings per share (EPS) rose by 5% to 43.8c; dividends increased to 34c fully franked, a 78% payout. In addition, IAG proposes a special dividend of 5.5c, along with a 19.5c capital return (Resolutions 7 and 8). These are welcome, but cannot be expected to be a regular feature. Because of these high payouts, future franking of dividends is likely to dip towards 70%+ from FY20 onwards. This is inevitable because the New Zealand profits do not generate franking credits.

IAG enjoys leading market shares in Australia and New Zealand, so future premium growth will be limited to about 3 to 5% pa, with organic improvements and attracting more SME business. (The Malaysian market has been subject to intense competition, but its Indian joint venture continues to grow very strongly). IAG's profit growth will need to come from continued refinement of products, predictive data usage and enhanced customer experience; the current optimisation program should deliver a savings boost equivalent to 2% of gross premium after FY19. IAG's guidance is for even stronger insurance results in FY19; this raises the question whether the peak of the insurance cycle has almost been reached. IAG's good results have been reflected in healthy dividends and a 57% share price rise in the two years to 30 June 2018.

Key events

In FY18, IAG sold or ceased two small product lines, and it ceased consumer credit insurance from 1 July 2018. In June, IAG announced the sale of its three Asian subsidiaries, in Thailand, Indonesia and Vietnam, for total proceeds of $525m. This appears to be a very attractive price. The vast majority of this was for the Thai business; that sale settled in August and will generate an after-tax profit of $200m, to be recorded in the FY19 results. The sales will improve the insurance margin of the group by 0.5% in FY19, and slightly increase IAG's regulatory capital. IAG retains its joint ventures in Malaysia and India, which have carrying values of $491m and $139m respectively, and the $60m investment in Bohai, a Chinese property insurer.

On 1 January, IAG entered a Quota Share Arrangement (QSA) with three major European reinsurers. It will receive streams of fee income for five years in exchange for ceding 12.5% of its group premium. IAG says this will be broadly neutral for earnings per share (EPS) and ROE, but *before* allowing for possible capital management plans. However, it has the certain twin benefits of reducing *volatility* of IAG's insurance profit and reducing its regulatory capital required by $435m, over a three-year period; $250m of that was realised by 30 June 2018. This QSA complements the 20% QSA made with Berkshire Hathaway (BH) in June 2015. There is another QSA with Munich Re for 30% of the CTP business. In total, 32.5% of IAG's group premiums (excluding CTP) and 62.5% of CTP premium have been ceded in exchange for predictable income streams and substantial capital support.

Capital

IAG has surplus regulatory capital, and proposes a share buy-back and special dividend, as discussed under Resolutions 7 and 8.

Governance and culture

IAG has a very strong emphasis on corporate culture and good governance, and in recent years placed more explicit focus on being customer-centred. To date IAG has been relatively unscathed by the Royal Commission, except for the poor value "add-on" insurance sold under its Swann brand, which was self-reported to ASIC. Total compensation required for that is $39m, of which over half has been paid to date. The annual report refers to improvements in risk governance in FY18, with more to come: we will ask IAG to elaborate on this at the AGM.

Board and Senior Management changes

Alison Deans retired as a director on 20 October 2017. Sheila McGregor and Michelle Tredenick were appointed as Directors of IAG on 13 March 2018. Mr Twyman will retire from the Board at the close of this year's AGM.

Under the new IAG Australian operating model, effective 19 July 2017, Mark Milliner became CEO, Australia. From this date, Ben Bessell (CEO, Australian Business Division) reported to Mr Milliner and no longer met the criteria of a KMP (Key Management Personnel). Anthony Justice (CEO, Australian Consumer) remained a KMP until he left IAG on 18 November 2017. Tim Clark was appointed Acting Chief Risk Officer from 27 February 2018, following Clayton Whipp's retirement on 1 December 2017.

Summary

(As at 30 June)	**2018**	**2017**	**2016**	**2015**
Statutory NPAT ($m)	923	929	625	728
UPAT ($m) Cash Earnings	1,034	990	867	987
Cash EPS (cents)	43.8	41.6	35.8	42.3
Dividend (cents) fully franked	34	33	36	29
Underlying Insurance Margin	14.1%	12.4%	14.0%	13.1%
Cash Return on Equity (ROE)	15.6%	15.2%	13.0%	15.3%
Share price ($)	8.53	6.78	5.45	5.58
TSR (%)	+30.8	+30.5	+6.6	+0.5
CEO total pay, actual ($m)	4.502	3.841	4.174	4.046

For FY18, the CEO's total actual remuneration of $4.5m was 52.5 times the Australian Full time Adult Average Total Earnings of $85,831 (May 2018 data from the Australian Bureau of Statistics).

IAG's FY19 outlook

IAG does not provide guidance for future earnings or dividends; however, it states that "FY19 guidance is for premium growth of 2% to 4%, and a 16.0% to 18.0% *reported* insurance margin; that reflects further improvement in underlying performance." It expects FY19 *underlying* results in each of its three main segments- Australian Business, Consumer and New Zealand- to be at least as strong as in FY18. This allows for more favourable premium pricing and a $100m pre-tax benefit from the optimisation program, partly offset by a higher perils allowance and higher underlying reinsurance expense.

Resolution 1	**Adoption of Remuneration Report**
ASA Vote	**Against**

Summary of ASA Position

We discussed the matters below with the Chair in general terms rather than specifics. Her main observation is that there are likely to be significant changes to remuneration practices throughout the banking and

insurance industry, when the Royal Commission's reports have been published and digested. It would be wise to await this and to change future IAG's pay practices wholesale - if needed - rather than try to respond to requests for changes in a piecemeal way. We accept that that this is reasonable.

IAG's remuneration report is again very well written, and provides clear and comprehensive disclosures. All relevant key management personnel (KMP) met (or exceeded) their minimum shareholding requirements. We welcome prospective changes to making both parts of long-term incentive (LTI) subject to 4 year terms, and increasing the deferred part of the short-term incentives (STI) to 50%. ASA's dislikes are similar to previous years'. Almost everything we said in last year's voting intentions is equally applicable to the 2018 report.

Annual report P21: there was no change from 2017 to the structure of KMP pay, so the CEO can earn up to 4.0x fixed annual remuneration (FAR) (base pay), and other KMP up to 3.45x FAR. In fact, IAG will *increase* some of these components from FY19: the maximum STI of the CFO and the CEO Australia will rise from 120% to 130% of FAR; their LTIs will increase from 125% to 140% of FAR; the LTI of the group CEO will increase from 150% to 165% of FAR. It is hard to believe that such high multiples of FAR can motivate commensurate extraordinary value in executive performance, especially in senior roles paying FAR of $700,000 or more.

As in many previous years, the 2018 STIs were at very high levels, with several KMP receiving close to 100% of their FAR and two were above 100%. We concede of course that the 2018 results were generally very good, and the 2017 results were also good. We believe that target and maximum STIs should be much lower (for executives at this pay level): only modest STIs should be awarded for achieving "target" results, and even excellent results should get smaller STIs - we suggest no more than 80% of FAR. The achievement of STIs should be much more stringent - to achieve more than say half of the maximum possible STI should require extraordinary and sustained achievement, and ought to be seen only rarely. If IAG feels that executives must be offered <u>total</u> pay packages of this size, we would rather see bigger LTI - or if necessary larger FAR. The STI structure is not doing its job when large STIs have become predictable. It is not a useful measure or motivator of outstanding performance, either for executives or shareholders.

Chief Risk Officer: this role, as for Internal Audit and the Chief Actuary, should not be subject to incentives by business results, except in risk performance. We commend that the STI and LTI for this role were reduced in FY18, but surprisingly to favour short term over long term incentives. We would prefer a still lower STI for the CRO, with risk being the sole determinant, rebalanced if necessary by higher LTI or FAR. We welcome the board's stated decision to apply greater rigour in risk management, but we are concerned at the implication that it was not entirely satisfactory before.

The behaviour gateway is redundant, at least at senior levels. Any senior person not meeting that should be removed. IAG acknowledges this: the gateway is mainly to convey a message to the several hundred less senior people who are covered by this regime.

STI Balanced Scorecard. We have some concerns about parts of it. Individual components of the Scorecard may be rescaled to exceed their apparent maximum—e.g. in 2017. Although the financial measures account for 60% of the STIs, there appear to be some overlaps and some difficulties of interpretation. Financial targets are referred to, but not quantified, so shareholders cannot tell how rigorous they were. It's unclear how targets can be "partially met" or "partially exceeded".

Customer advocacy has a 20% weighting in the scorecard. This uses net promoter scores relative to peer companies, and the figures are determined externally. Given the importance of IAG's focus on customer-

centred culture, this is good. In contrast, the 10% weight applied to risk appetite seems surprisingly low, for an insurance company: as IAG rightly says “due to the importance of risk management to IAG, it is included as an explicit measure on the scorecard”.

The Chair explained that the balanced scorecard regime is applied with much rigour throughout IAG, but the variations and nuances for different staffing levels and different job roles are complex, and can’t all be summarised in one or two pages for this report. There are Group level targets, then the business units have their own targets and there are also individual targets. A blend of these is taken into account for each person, as appropriate.

Once again, the (unchanged) ROE metrics are shown to be unsatisfactory. Both the starting point and 100% vesting occur at too low a level. IAG’s justification is that its long term weighted average cost of capital (WACC) and cost of equity are 10% and 15% respectively. We respectfully disagree: its own figures in recent years show that they have been about 7.6%, and 8.6%. This means that LTI vesting now starts at ROE of about only 9.1% (which is only 0.5% above the recent cost of equity) and fully vests at about 12.1% which is only 3.5% above cost of equity. Both the start point and the end point are far too easy to achieve. We have said this for many years. The ROE tranche has vested in full for at least 6 years (including at June 2018), and is likely do so again in FY19- probably also in 2020. We like the metric, just not the thresholds.

The relative total shareholder return (RTSR) tranche has worked better: it had 100% vesting in four periods up to Sept 2014; then 88% vesting including two retests to Sept 15/6/7; it was NIL for year to Sept 17. It remains to be seen whether IAG met the 50th percentile of its peer group’s market returns to 30 Sept 18, which would enable vesting of 50%+.

We would like the board to add an LTI tranche based on 4 or 5 year cash eps growth. One of IAG’s major financial targets is for long-term average eps growth of 10% pa. This is welcome, and ambitious; it’s an important and objective measure, which aligns best of all with the creation of shareholder value. Moreover, it is entirely within management control; in contrast, although RTSR is ostensibly aligned with shareholders’ experience, it is passive and dependent on market vagaries, both for IAG’s share price and those of the peer group.

Overall, despite the qualities of the FY18 report and some prospective improvements for FY19, we believe that the size and the structure of the KMP pay packages are still not desirable for shareholders. We will therefore vote proxies against this resolution, as we have done for many years. However, we believe that the Royal Commission, and public opinion, may bring about sweeping changes to pay arrangements throughout the financial sector; we are hopeful that this will lead us to being able to make a favourable recommendation at IAG in future years.

Resolution 2	**Allocation of share rights to Peter Harmer, CEO/Managing Director**
ASA Vote	**Against**

Summary of ASA Position

Mr Harmer’s (maximum) salary package at 30 June 2018 was split 25% fixed pay; 25% cash STI, 12.5% deferred STI; and 37.5% LTI, based on the maximum incentive opportunity. His fixed salary *then* was $1.7m, so the maximum total pay for FY18 was $1.7m/25% = $6.8m. However, two changes were made in the

August 2018 remuneration review, which modify this. His fixed salary was increased from $1.7m to $1.9m, and his LTI increased from 1.5x fixed salary to 1.65x IAG always *grants* the maximum LTI, which is then subject to performance testing over the next 3 or 4 years; the actual proportion of the LTI vesting could (ultimately) be as low as nil, or as high as 100%. In contrast, STI is awarded for the financial year just completed and so the size and value of the STI award are certain now.

Mr Harmer's maximum potential STI for FY18 was 150% of his fixed pay. He was awarded 74% of his maximum for FY18, which equates to 111% of his fixed pay. Two thirds of that is paid in cash; the other third is paid as share rights (deferred award rights or DARs) which will vest in one and two years, subject to any clawback on his leaving IAG. Because the STI is backward looking, it is based on his fixed pay rate in FY18, which was then $1.7m. Thus his FY18 cash STI is 2/3 x 111% of $1.7m fixed pay = $1.258m; the deferred (equity) STI is a further 50% of that i.e. $629,000, which is granted as 75,700 DARs (rounded up) at a face value of $8.32 each. These will vest on 1 September 2019 and 2020, in two equal parts. The value of $8.32 was the market average of IAG's share price traded in the 30 days to 30 June 2018.

As noted under the previous resolution, we consider that the potential and actual STIs awarded to all IAG's executives, including Mr Harmer, are far too high. We have said this for several years, and hold the same opinion regarding FY18, even though we readily concede that the financial results were impressive.

For FY19, Mr Harmer's LTI was increased to 1.65x fixed pay, which itself was increased to $1.9m. The LTI is granted as executive performance rights (EPRs), also at $8.32 each, hence 1.65x $1.9m /$8.32 = 377,000 (rounded up) EPRs worth $3.14m. That is split into two equal tranches: one is assessed over 4 years to 30 Sept 2022 on IAG's total shareholder return (TSR) relative to a listed market peer group; the other is based on IAG's average cash ROE measured against a sliding scale, over 4 years to 30 June 2022. (The second tranche had previously been measured over 3 years; we welcome IAG's change to the 4 year performance assessment.)

As noted above, the second 50% of the LTI award begins to vest if ROE achieves only 1.2X WACC. That is too low. We also seek a higher threshold at which 100% vesting would occur: 2X WACC would be more appropriate than 1.6x. We consider that the current ROE scale is not a "stretch target"; as in previous years the bar is set too low and perversely weakens the desired motivating factor. The extension to a four year term is good, but the scale is not tough enough.

Although we would like elements of the RTSR measure to be more demanding, we concede that IAG uses terms that are common in the market.

The form of this resolution is similar to those in recent years: the increase to 4 years for ROE is welcome, but we have always expressed objections to the undemanding sliding scale for the ROE vesting, and this has not changed. Moreover, the component for the LTI has increased so the total package is now 4.15x fixed salary, and Mr Harmer's fixed salary itself rose by nearly 12% in August.

For these reasons, and for similar beliefs about the STI size, we will vote undirected proxies against this resolution, as in previous years. This is not a reflection on Mr Harmer: he is the only person named in the resolution because he is a director. Our objections apply to the incentive structure, not his individual performance.

Resolution 3	Re-election of Elizabeth Bryan as a Director
ASA Vote	For

Summary of ASA Position

INTRODUCTION

Board composition Other than the CEO all IAG's directors are considered to be independent. Four of the ten directors are female. IAG's Corporate Governance statement (see website) is informative and contains a good "Board Skills Matrix". IAG has a strong Board. It meets ASA's tenure guidelines; the two longstanding directors, Mr Fletcher and Mr Twyman, will retire by the end of their current terms. We queried the fact that IAG has not had an Asian-based director since Mr. Lim retired; the Chair feels that, given the recent sale of the Asian subsidiaries, this is not critical.

We expressed some concern that the two new directors, and Mr. Nicholson, have extensive commitments outside IAG. The Chair has assured ASA that many of these roles were not time-consuming, and that all the directors standing at the AGM had met their obligations to IAG more than adequately. However, it is concerning that they appear to have heavier workloads than desirable in order to discharge their duties to IAG fully if, for example, one or more those roles suddenly became more demanding

The directors must hold IAG shares worth one year's board fee, within 3 years of appointment (the same as ASA's policy). All relevant directors met this requirement at June 2018. Senior Executives must hold IAG shares worth at least one year's base salary, within four years of appointment, and 2 years' base salary for the CEO. We commend this, which is more demanding than ASA's equity policy; it was met by all relevant executives at June 2018.

Elizabeth has been Chairman of IAG since March 2016 and brings to the role her financial services experience as well as previous boards and Statutory Authorities. ASA supports the re-election of Ms Bryan and will vote undirected proxies accordingly.

Resolution 4	Re-election of Jonathan Nicholson as a Director
ASA Vote	For

Summary of ASA Position

Mr Nicholson was appointed a director in 2015. He is Chair of the People and Remuneration Committee and a member of both the Risk and the Nomination Committees. His career in banking and strategy make him well qualified for his director role at IAG.

Mr. Nicholson has extensive commitments outside IAG. He is a non-executive director of QuintessenceLabs. and has commitments with not for profit bodies, being non-executive Chair of the Westpac Foundation, a trustee of Westpac Bicentennial Foundation, and a non-executive Director of Cape York Partnerships. We understand that the last three roles above require relatively little time. Given this, we recommend voting in favour of his re-election.

Resolution 5	Election of Sheila McGregor as a Director
ASA Vote	Undecided

Ms McGregor was appointed to the IAG Board in March 2018. Although we welcome her addition to the Board, we are concerned about her demanding workload, especially as a partner of Gilbert & Tobin, heading its Technology & Digital Group; she is a member of its board and partner remuneration committee. She is also a non-executive director of wealth manager Crestone Holdings Limited.

We note that Ms McGregor resigned from the Seven West Media board last year after only 19 months on it. To obtain shareholder support, there must be an expectation that a director will serve out her full three year term. ASA intends to ask Ms McGregor about this principle and her workload; depending on her response, we will vote undirected proxies accordingly.

Resolution 6	Election of Michelle Tredenick as a Director
ASA Vote	For

Ms Tredenick was appointed to the IAG Board in March 2018. She is a member of the People and Remuneration Committee and the Nominations Committee. She is also a director of Bank of Queensland, a director of Cricket Australia and Urbis Pty Ltd, a member of the Ethics Centre Board and of the Senate of University of Queensland. Her executive career included several senior roles in banking, insurance and technology. She is well qualified to be a director of IAG. ASA's sole concern is her apparently very demanding commitments outside IAG.

ASA intends to ask Ms Tredenick about that workload and confirm the roles above require relatively little time.

Resolution 7	Equal reduction of capital
ASA Vote	For

Summary of ASA Position

Resolutions 7 and 8 are conditional and interdependent upon each other.

The Corporations Act requires a return of capital and a share consolidation to be approved by an ordinary resolution of shareholders. IAG proposes to make a capital return of 19.5c per ordinary share and a 5.5c special dividend, making 25c per ordinary share. (This proposal does not apply to or affect IAG's other classes of securities). The payment of the special dividend does not require shareholder approval, but will occur only if the two resolutions are passed. IAG has for some years maintained equity capital comfortably above its own targets and APRA regulatory requirements. This has arisen from the retention of earnings, enhanced by the quota share reinsurance transactions with BH in June 2015 and three other major reinsurers from 1/1/2018. The recent sale of the Asian subsidiaries for $525m also adds modestly to its

regulatory capital base. The board says “in the absence of significant operational demands on [IAG’s] capital, this initiative proposes to return a portion of the surplus capital to shareholders to ensure that IAG maintains an efficient capital structure”. Since the time of the BH transaction, ASA has encouraged IAG to return some surplus capital to shareholders, and we applaud this proposal. IAG’s capital base will still be very strong after the capital return and special dividend, but more efficient as profitability will not suffer the dilutive effect of holding too much cash.

One consequence of paying the special dividend is that IAG’s franking balance will be largely consumed, and from late 2019 the franking of future dividends is likely to drop from 100% towards 70%. This is a disadvantage, but on balance the payment of the 5.5c special dividend now should prove beneficial to shareholders. Again please note, shareholders are not voting on the special dividend, just the 19.5c capital return.

Resolution 8	Consolidation of share capital
ASA Vote	**For**

Summary of ASA Position

If resolution 7 is approved, the equity base will reduced by 25c. The purpose of Resolution 8 is to consolidate IAG’s remaining share capital so that every 100 shares become 97.6. This is solely to enable comparability of future earnings per share calculations; it has no cash effect and does not change the total value of each shareholder’s investment. Nor does it affect IAG’s other securities. It is not essential but is a sensible proposal. NB however, that the 25c payments under Resolution 7 will only be made if Resolution 8 is approved. We therefore recommend voting in favour of Resolution 8.

An individual involved in the preparation of this voting intention has a shareholding in this company.

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