

**ADDRESS BY INSURANCE AUSTRALIA GROUP
CHIEF EXECUTIVE OFFICER, MR MICHAEL HAWKER**

“MYOPIA: SHORT-TERMISM AS A BARRIER TO CORPORATE SUSTAINABILITY”

AN EVENT COORIDINATED BY GREEN CAPITAL 28 JUNE 2006

Good morning ladies and Gentlemen.

I would like to do three things this morning. Firstly, I want to say a few words about the term ‘corporate sustainability’; secondly, I want to talk about insurance; and thirdly, I want to give you an example of a dilemma facing the insurance industry which explains why short-termism is a problem.

Firstly, in my view the term ‘corporate sustainability’ is a dirty word. It has all sorts of connotations. People think it is nice and friendly and has nothing to do with shareholder value. I think that is absolutely bizarre, because I don’t know how you generate shareholder value unless you have a very good understanding of your corporate social responsibility.

It is impossible to generate long-term returns for your shareholders if you can’t survive in the long-term, if you don’t understand what your customers want, if you don’t understand what the value of your business is to the community, and if you don’t understand what government is going to allow you to do.

You must have a very good understanding of your company’s corporate social responsibility to drive sustainability in the long-term.

The challenge for everyone in business is how to monetise what sustainability is in today’s terms. The biggest problem is that people talk about long-term changes but they can not put a financial value on them today. We have to be able to monetise future costs in today’s terms.

This is where I think a lot of NGO’s need to shift their thinking. It is not only about identifying the issues, but also about putting a monetary value on the issues in today’s terms. When that is done, businesses have to take notice.

Let me now say something about insurance, because insurance is a fascinating business.

Insurance is one of those rare businesses where we sell our product before we know the cost of it. We get all the money in today, and then we watch our costs manifest themselves in the future.

Those costs are driven by climate, by crime rates, by change in Government policy and by community behaviours - all elements outside of our control.

It is our job to estimate those future costs. Hence we have a great interest in what is going on around us, because changes to those elements change the nature of our costs.

When I first took on my job as the Chief Executive of IAG I went to dinner with some friends of mine and they asked me, “What do you do? What value do you add to society?”

I thought, “I have no idea!”

It’s a very hard question to answer, but it’s a very important question to be able answer when you’re running a business. I think the value-add of insurance companies is four things.

Firstly, we have to **pay claims**.

That is absolutely logical. We have to make sure that our customers are getting paid what they expect to be paid when they make a claim.

That is quite a challenging thing for us to do as we need to ensure our customers understand what they are covered for in the event of a claim - or more importantly what they are not covered for – and that all our processes line up exactly to ensure no confusion for our customers.

When you think about all the possible events that might incur a claim, this alignment is not a trivial process.

The second thing we should do is be expert at **pricing risk**.

We can't underprice risk, because if we do we will go the way of HIH, which is bankrupt. You can't overprice risk because if we do then customers say, I am being ripped off and why do I have to pay more money for something which seems to be a necessary purchase.

But how do we price the risk of, for example, asbestos when asbestos claims are going to happen over the next forty years. How do we price the risk that mobile phones may be bad for your health today, when it might only become known that they were, in thirty or forty years time.

It's quite a significant challenge, so we have a real interest in long term trends and what is happening in the market place.

The third thing we have to do is **manage costs**.

When we think about it, there is money coming in from all of our customers, and we want to use as much of that as we can to pay out claims. Anything that is kept in the middle is essentially forcing premiums up.

So you start thinking about what are all those costs in the middle?

I remember when I was at university, an acquaintance thought he would get a financial advantage from getting his car stolen. So he parked his Nissan 180B at Newtown, left his keys in it and put two dozen beers in the back seat. When he came back the next morning, the two dozen beers were gone but the car was still there.

If the car had been stolen we would have had to pay for that insurance claim and that raises the cost of insurance for everyone else. So fraud is a big cost for us.

Another cost is our suppliers. How many times have you been to a supplier and they say, "is this an insurance pay-out or are you paying for this yourself?" - If it's an insurance payout you're charged more.

That is a real problem for us. We have to ensure that our suppliers are not using us for financial advantage.

The Government is another cost. We are the single largest provider of state Government taxes, through the collection of stamp duties and the fire services levy in each state.

The fourth one, and the one which I think is the most intriguing, is **reducing risk**.

We have all this wonderful information about risk in the community and one of the real things that we can do is help our customers and help the community reduce risk before an accident happens.

No one wants to have to make a claim. No one wants to have a car stolen. No one wants to have their house burnt down. So how do we help reduce the chance of those things happening. It is in this area that we have real 'social responsibility' and an opportunity to add real value to the community.

There are four areas that we focus on when we are working to reduce risk.

Firstly, *climate change*.

Climate change is increasing the frequency and ferocity of storms in this country and right around the world. As a result the cost of owning homes is going up because the likelihood of homes being damaged by larger hail stones, higher wind speeds, greater rain fall or greater flooding is increasing.

One of the most significant risks and concerns we have is that we have a demographic shift, with people moving north to Queensland as they retire. At the same time the warmer climates are becoming more turbulent in terms of frequency and ferocity of storms.

So you are getting the demographic shift of people moving into higher risk areas and the risk going up simultaneously.

One area we do have particular concern for is the Gold Coast. If we had a cyclone with a similar intensity to that of Cyclone Larry come down the coast, there is the possibility of a significant storm surge on the Gold Coast and that would create significant damage.

Fortunately we haven't had a major storm surge across the coast of Queensland for a hundred years. But in 1899, Cyclone Mahina sent a 10 metre storm surge across the coast line.

I would hate to see that happen today in the Gold Coast. It is a significant risk.

The second area we focus on is *road safety*.

Road safety is the second largest area of claims costs in the community. So how can we help reduce and improve road safety. We do a huge amount of work in terms of managing how roads are built and how we can improve road design to reduce accidents.

One key example is when you have on-ramps on express ways that are too short, you get a concertina effect of cars because they don't have the speed to merge easily onto the express way.

We also do a huge amount of work identifying and publicising black spots right around the country to help governments focus on road design issues.

The third area where costs are significantly high is in *crime rates*.

A couple of years ago, according to our statistics, the three top crime areas in NSW were Shellharbour, South Sydney and Dubbo.

In Shellharbour you have high youth unemployment rate. You also have one of the highest rates of car theft because there is little public transport. Teenagers steal cars for transport and have a tendency to burn them when they no longer need them.

As a car insurer, we have to pay for those burnt motor cars. So there is an opportunity to help the community reduce this risk and cost. How can we provide ways of improving public transport in those areas, allowing people to get around.

The fourth area is *workplace safety*.

I won't spend much time going through workplace safety as I am very limited for time.

So, why do I mention these areas of interest? From my point of view the real challenge in a business is to align what is an interest of a community and what is an interest of your organisation.

Aligning those areas of interest will substantially improve the perception and the reality of the value of your company within the community.

When you think about some of the valuable contributions the insurance industry has made to the community there are a number of them.

Fire brigades for instance, were designed by the insurance industry. Years ago when your house was burning down, no one put it out. If you were insured with an insurance company you had a plaque that you would put on the wall. If your house was burning down and you belonged to an insurance company that had their own fire brigade and you had the plaque displayed, the fire brigade would put it out for you. If you didn't have the plaque displayed they would go straight past your front door.

Today the fire brigade has become a community service - it was designed by the insurance industry.

Another area where benefits have been introduced by insurance companies is seatbelts.

People in the insurance industry were trying to figure out how they could reduce the number of injuries in motor vehicle accidents and seatbelts were designed.

There is a whole series of community benefits which reduce risk in the community that have come out of an industry which is by nature concerned with long-term sustainability.

The value for the industry, is that there are fewer claims, therefore there are fewer claims costs, therefore it improves the profit of the insurance company, and they can bring premiums down, making insurance more affordable.

So if you think as an insurance company about how you want to manage your business, putting premiums up would be a very short-term value proposition. Bringing claims costs down and therefore being able to keep insurance premiums cost effective is a far more sustainable way to run your business.

How do you do that in your own business?

I think it's critical to ask 'what is the core purpose that your business is offering to the community?'

We think our core purpose is paying claims, pricing risk, managing costs and reducing risk in the community. We drive everything in our organisation along those lines.

Let me finish by outlining a short-term dilemma that the insurance industry is facing.

We are now in a situation in the market place where we have new entrants coming in from offshore, writing insurance in the commercial property insurance lines. These new entrants are significantly reducing premiums, and in our view are reducing premiums below what are sustainable levels.

That is, they are writing premiums at a loss. The challenge we have is that we have a share market telling us that growth is really critical, so how do you grow the business?

Mathematically, to be a top quartile performer in the Australia share market and to be a top quartile performer in the insurance sector globally over a ten year period, you need to grow your bottom line profit by 15% per annum.

Effectively you have to double your profit every five years. You have to double the size of your company every five years. Assuming the margin is the same, that is a serious growth target to give yourself.

So how do you grow a business where you are doubling the size of your company every five years when you have got competitors in the market place pricing the risk which is below the market?

Do you chase the growth for growth sake? Which would be a short-term way of thinking, and get the growth for shareholders, or do you sit back and give growth away and retain your capital base and stay there for longer-term?

It is a really interesting dilemma and that is where the Australian insurance industry finds itself today in a number of its businesses.

I can tell you the right decision is to not grow and retain your capital. It requires a hell of a lot of courage by the company executives and the company boards to be able to articulate that position.

If you look at Warren Buffet's Berkshire Hathaway insurance business over a period of time you see periods where they significantly reduce their growth over a number of years and then re-drive it. So I can tell you it is a fascinating business when you are running an insurance company where you are slowing up growth when growth is your critical issue.

In addition, in the Australian market place today we have many of our brokers saying, we want you to broaden your terms, drop your price and we want bigger commissions. This is not a sustainable proposition.

One solution is to find acquisitions and try and find growth in other markets not experiencing such pressures and that is exactly what IAG is doing.

I think one of the very interesting questions for Australian companies, is should companies go offshore or not?

I can tell you when AMP went offshore, as it did in the 1980's because it got to the size it had in its insurance business in Australia, it needed to because it had no more growth potential at the growth rate required in Australia.

The Australian market place (on average) is growing at 5% to 6% a year. If you have already got 35% to 40% of the market place, how are you going to grow at more than 5% or 6% a year?

It is quite a challenge unless you are focussing on other markets, and if you have to grow at 15% a year that means 10% growth has to come from somewhere else. Either from new businesses in Australia or taking your skill sets offshore.

As a company we have decided to go offshore. We are looking to further diversify our risks and bring income back into the Australian economy.

I have tried to give you a couple of different perspectives today on what is a very complex concept.

So I will leave you with a couple of messages.

Firstly we need to monetise long term issues into today's terms. We must be able to bring long-term changes into current and present value terms so they can be assessed along with all the short-term financial drivers.

The second, is to align your business with your core purpose and truly understand your core purpose.

When the New Zealanders first won the America's Cup, they had a core purpose, a tag line that said 'make the boat go faster'. Everyone knew what they had to do - make the boat go faster. So how do you create a core purpose in your organisation which is sustainable.

In our core purpose - pay claims, we will always have to do that. We will always have to be experts in pricing risk. We will always have to be good at reducing costs and we will always have to help our community reduce risk. That will never change. It is the core purpose of what we do.

The third, is to understand the value proposition of your business and be able to articulate it without allowing short term pressures of the share market drive short-term decision making which might be beneficial in the first two or three years, but is going to be disastrous in the medium-term.

Thank you.