



**OBE INSURANCE GROUP**  
ANNUAL REPORT DECEMBER 2005



**Cover:**  
“Morning, Yarragon siding”  
1983-84, private collection



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## OUR VISION

To be internationally recognised as:

- a highly successful general insurance and reinsurance group
- a builder of shareholders' wealth
- a developer of "can do" people
- an organisation that excels in the continuous delivery of new and proven quality products and services

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## OUR VALUES

- increasing the long term wealth of shareholders
- customer satisfaction and retention
- employee motivation
- integrity

## The year in review

# 2005

### PROFIT AND DIVIDEND PAYOUT

		2005	2004 <sup>(1)</sup>	% CHANGE
Net profit after income tax	\$M	1,091	857	27
Profit before income tax	\$M	1,523	1,115	37
Basic earnings per share <sup>(2)</sup>	cents	142.5	123.1	16
Diluted earnings per share <sup>(3)</sup>	cents	130.8	109.1	20
Dividend per share	cents	71.0	54.0	31
Shareholders' funds	\$M	5,093	4,032	26

### GROUP OPERATING PERFORMANCE

		2005	2004 <sup>(1)</sup>	% CHANGE
Gross written premium	\$M	9,408	8,766	7
Gross earned premium	\$M	9,171	8,571	7
Net earned premium	\$M	7,386	6,781	9
Combined operating ratio	%	89.1	91.2	
Insurance profit	\$M	1,288	928	39
Insurance profit to net earned premium	%	17.4	13.7	
Cash flow from operations	\$M	1,987	2,110	(6)

### DIVISIONAL OPERATING PERFORMANCE

			2005	2004 <sup>(1)</sup>	% CHANGE
Australia	Gross earned premium	\$M	2,405	2,114	14
	Combined operating ratio	%	83.6	89.7	
Pacific Asia Central Europe	Gross earned premium	\$M	688	684	1
	Combined operating ratio	%	82.3	86.4	
QBE Insurance (Europe)	Gross earned premium	\$M	2,370	2,154	10
	Combined operating ratio	%	90.0	95.6	
Lloyd's division	Gross earned premium	\$M	2,273	2,265	–
	Combined operating ratio	%	94.5	91.6	
the Americas	Gross earned premium	\$M	1,435	1,354	6
	Combined operating ratio	%	92.9	93.5	
Equator Re <sup>(4)</sup>	Gross earned premium	\$M	347	254	37
	Combined operating ratio	%	89.8	68.8	
Investment income	Gross	\$M	843	637	32
	Net of finance costs and investment expenses	\$M	718	519	38

(1) 2004 information has been restated for the impact of Australian equivalents to International Financial Reporting Standards ("AIFRS"). Refer to note 2 to the financial statements.

(2) Reflects shares notified to the Australian Stock Exchange. Refer to note 25(A) to the financial statements.

(3) Assumes that all hybrid securities are fully dilutive.

(4) Equator Re is the Group's captive reinsurance company based in Bermuda.

**ALL AMOUNTS IN THIS REPORT ARE DENOMINATED IN AUSTRALIAN DOLLARS UNLESS OTHERWISE SPECIFIED**



**John Cloney**  
Chairman

# Chairman's report

The 2005 financial year has produced an outstanding result for shareholders with net profit after tax up 27% to \$1,091 million and a record insurance profit, despite a year of significant catastrophes and large losses. Buoyant equity markets during the year assisted the result. The result has been prepared in accordance with Australian equivalents to International Financial Reporting Standards ("AIFRS").

The strong profit performance has again delivered an exceptional return on average shareholders' funds of 23.9% compared with 24.5% in 2004. Diluted earnings per share increased by 20% from 109.1 cents to 130.8 cents per share.

In recognition of the substantial increase in profit, and as a sign of our confidence in future earnings, the directors have declared a final dividend of 38.0 cents per share, up 27% on the final dividend of 30.0 cents per share for 2004. The final dividend will be 50% franked. Whilst the Dividend Reinvestment and the Dividend Election Plans continue, the reinvestment discount of 2.5% has been suspended as announced in August 2005.

QBE shares outperformed the Australian All Ordinaries accumulation index and inflation with a growth rate of 27.7% in 2005 and a compound average annual growth of 14.9% over the last five years and 17.4% over the last ten years. QBE's market capitalisation increased by 36% in the year to \$15.6 billion at 31 December 2005.

Shareholders' funds increased by 26% to \$5,093 million reflecting the increased profit, the strong support of the dividend reinvestment plans and the conversion of hybrid securities during the year. The number of issued shares notified to the Australian Stock Exchange increased by 49 million during the year to 794 million.

## SHAREHOLDERS' HIGHLIGHTS

FOR THE YEAR ENDED 31 DECEMBER		2005	2004 <sup>(1)</sup>
Net profit after income tax	\$M	1,091	857
Basic earnings per share <sup>(2)</sup>	cents	142.5	123.1
Diluted earnings per share <sup>(3)</sup>	cents	130.8	109.1
Dividend payout	\$M	556	392
Dividend per share <sup>(2)</sup>	cents	71.0	54.0
Net tangible assets per share <sup>(2)</sup>	\$	4.76	4.10
Cash flows from operations	\$M	1,987	2,110
Total investments and cash <sup>(4,5)</sup>	\$M	17,597	14,975
Total assets	\$M	29,665	25,036
Return on average shareholders' funds <sup>(6,7)</sup>	%	23.9	24.5
Shareholders' funds	\$M	5,093	4,032
Interest bearing liabilities to shareholders' funds <sup>(8)</sup>	%	41.8	44.8
Capital adequacy multiple		1.9	1.8

(1) 2004 information has been restated for the impact of AIFRS. Refer to note 2 to the financial statements.

(2) Reflects shares notified to the Australian Stock Exchange. Refer to note 25(A) to the financial statements.

(3) Assumes that all hybrid securities are fully dilutive.

(4) Excludes ABC financial assets pledged for funds at Lloyd's.

(5) Includes financial assets, cash and investment properties.

(6) 2004 comparatives are calculated with reference to the AIFRS adjusted shareholders' funds of \$2,951 million at 1 January 2004.

(7) Includes the equity portion of hybrid securities issued in 2002 and 2004.

(8) Excludes ABC securities for funds at Lloyd's.



"Reflected arrows" 1974, private collection

The QBE board oversees the Group's strategic direction, operational performance and corporate governance.

The increase in shares notified was the result of 28 million shares from the conversion of hybrid securities with the balance from the reinvestment of dividends, the issue of employee shares and the exercise of employee options.

Shareholders' funds at 31 December 2004 have been restated following the application of AIFRS. The financial impact of AIFRS was to reduce shareholders' funds at that date by \$388 million. We do not expect any future material financial impacts from the application of

existing AIFRS although there may be some ongoing volatility in the income statement and balance sheet due to fair value movements in assets and liabilities. Details are outlined on pages 16 and 17 of this report.

QBE's balance sheet and key ratios have strengthened during 2005. We completed a number of acquisitions during the year with no major capital raising or funding activity other than a \$400 million increase in short term borrowings. The ratio of borrowings to closing shareholders'

funds was 41.8% and, based on the estimated capital requirement for Australian regulated insurance companies, our capital adequacy multiple at 31 December 2005 was 1.9 times the minimum requirement. We have made a number of assumptions in applying APRA's risk-based capital approach for Australian insurers to the Group noting that APRA has not yet finalised prudential standards for calculating consolidated capital adequacy requirements for non-operating holding companies.

The assessment of QBE's financial strength by the rating agencies has been reaffirmed at various times during the year, with Standard & Poor's confirming our A+ financial strength rating for our main operating entities and equivalent ratings confirmed by AM Best, Fitch and Moody's. It is the intention of the directors to ensure the financial strength of all QBE's operating entities is maintained at levels adequate to meet the requirements of our business counterparties, regulatory authorities and rating agencies.

In accordance with increased reporting requirements, the annual report includes extensive detail on the Group's remuneration practices including at risk pay through incentives for senior staff members. There is considerable evidence to indicate that the increased level of reporting in recent years has been the major contributor to escalating executive remuneration and professional costs. The QBE staff incentive schemes are based upon pre-agreed financial targets, primarily return on equity, closely aligning them with the interests and expectations of our shareholders, both in the short and long term. QBE has a strong focus on staff development, succession planning and the provision of adequate incentives to retain our quality people. The long term incentives for our senior executives incorporate deferred share and option allocations for achieving financial performance hurdles and are structured to encourage long term commitment to QBE. The majority of our incentive schemes are based on achieving a targeted return on opening shareholders' funds using the seven year spread basis of accounting, which allocates realised and unrealised gains on equities and properties evenly over a period of seven years. Net profit after tax for 2005 using the seven year spread basis of

accounting was \$1,033 million compared with \$801 million last year. Return on opening shareholders' funds adjusted for dividends and share capital issued during the year was 25.9% compared with 22.8% last year. Details of the incentive arrangements and senior management remuneration are set out in notes 27 and 28 to the financial statements, and in the remuneration report which forms part of the directors' report.

As in previous years, the annual report includes a number of statements on the robust corporate governance structure and risk management framework we have in place throughout the QBE Group. There has been a great deal of focus on risk management and governance practices, particularly for companies operating in the financial sector. This has resulted in a monumental increase in compliance costs with our board and management spending an ever-increasing and disproportionate amount of their time attending to the requests of regulators, corporate governance bodies and rating agencies. Over many years, QBE has demonstrated that it has effective risk management, a clear focus on the key profit drivers and a strong culture of encouraging business acumen and leadership. The Group's corporate governance statement is set out on pages 40 to 45 of this report.

QBE has in place efficient and effective budget and planning processes, clearly focused on minimising risk relating to our insurance and investment operations and to protect the interests of all our stakeholders. The directors have again approved plans to reduce insurance risk for both aggregate exposures and claims frequency supported by extensive reinsurance protections and a low risk investment strategy for policyholders' and shareholders' funds.

Our prospects for the future have and will continue to be influenced by changes in global economic and environmental conditions. While economic conditions for the majority of international markets are stable at present, there is concern that the apparent global warming may result in a continuation of the increased frequency and intensity of natural disasters. Your directors and management will maintain a careful watch on this and other issues which may impact the Group and will closely monitor markets and conditions and adjust our strategies and plans if appropriate.

We aim to continue the proven and successful strategy of growth through acquisition and product and geographic diversification. We are confident that the current levels of capital, together with expected profits and the structure of our debt securities are sufficient to finance our normal level of acquisition activity.

On behalf of my directors, I acknowledge the significant achievements and hard work of our staff all around the world. In particular the board congratulates and compliments the CEO, Frank O'Halloran, and his management team for this historic result and for their outstanding contribution, and their dedication and commitment to increasing the long term wealth of shareholders, customer satisfaction, employee motivation and integrity.

I acknowledge the support and commitment of my fellow directors and the benefit of their experience. I take this opportunity to welcome our recently appointed director Isabel Hudson who joined us late in the year.

**John Cloney**  
Chairman

## 10 year history

FOR THE YEAR ENDED 31 DECEMBER		2005	2004 <sup>(1)</sup>	2003	2002	2001	2000	1999	1998	1997	1996
Gross written premium	\$M	9,408	8,766	8,350	7,723	6,793	4,406	2,877	2,409	2,054	1,561
Gross earned premium	\$M	9,171	8,571	7,816	7,197	6,298	4,399	2,692	2,266	1,902	1,479
Net earned premium	\$M	7,386	6,781	6,036	5,642	4,634	3,456	2,204	1,914	1,609	1,204
Claims ratio	%	59.9	61.3	63.3	67.6	76.6	71.2	70.1	68.1	68.6	67.0
Commission ratio	%	16.9	17.5	18.2	17.7	20.2	18.3	19.9	18.3	17.1	17.3
Expense ratio	%	12.3	12.4	12.3	12.4	12.8	13.0	13.9	13.9	13.8	15.0
Combined operating ratio	%	89.1	91.2	93.8	97.7	109.6	102.5	103.9	100.3	99.5	99.3
Investment income <sup>(2)</sup>											
before net fair value gains/losses	\$M	502	431	303	340	336	250	189	161	143	129
after net fair value gains/losses	\$M	718	519	413	189	349	310	243	164	163	182
Insurance profit (loss)	\$M	1,288	928	627	406	(119)	186	56	147	116	101
Insurance profit (loss) to net earned premium	%	17.4	13.7	10.4	7.2	(2.6)	5.4	2.5	7.7	7.2	8.4
Profit (loss)											
before income tax	\$M	1,523	1,115	765	311	(99)	220	156	157	170	189
after income tax and minority interest	\$M	1,091	857	572	279	(25)	179	132	141	131	150
Number of shares on issue <sup>(3)</sup>	millions	794	745	672	615	585	429	395	383	374	288
Shareholders' funds	\$M	5,093	4,032	3,313	2,954	2,620	1,709	1,135	1,057	968	875
Total assets	\$M	29,665	25,036	20,443	20,567	18,611	13,948	8,559	5,964	5,065	4,113
Net tangible assets per share <sup>(3)</sup>	\$M	4.76	4.10	4.17	3.96	3.67	3.13	2.57	2.56	2.40	2.74
Interest bearing liabilities to shareholders' funds <sup>(4)</sup>	%	41.8	44.8	40.3	49.3	32.0	53.5	22.7	24.9	22.8	20.9
Basic earnings per share <sup>(3)</sup>	cents	142.5	123.1	86.5	42.7	(10.5)	42.6	33.8	37.3	35.6	42.2
Diluted earnings per share <sup>(3,5)</sup>	cents	130.8	109.1	77.5	43.4	(4.9)	40.7	33.8	37.3	35.6	42.2
Return on average shareholders' funds <sup>(6,7)</sup>	%	23.9	24.5	18.3	10.0	(1.1)	12.6	12.0	13.9	14.2	18.4
Dividend per share	cents	71.0	54.0	42.0	35.0	30.0	31.0	32.5	26.5	24.0	20.8
Dividend payout	\$M	556	392	281	213	155	132	130	101	88	74
Cash flow from operations	\$M	1,987	2,110	2,089	1,511	280	173	242	289	350	248
Total investments and cash <sup>(8,9)</sup>	\$M	17,597	14,975	11,823	11,504	9,183	7,334	5,232	3,600	3,238	2,736

(1) 2004 information has been restated for the impact of AIFRS. Refer to note 2 to the financial statements.

(2) Excludes amortisation and impairment of goodwill/intangibles.

(3) Reflects shares notified to the Australian Stock Exchange. Refer to note 25(A) to the financial statements.

(4) Excludes ABC securities for funds at Lloyd's.

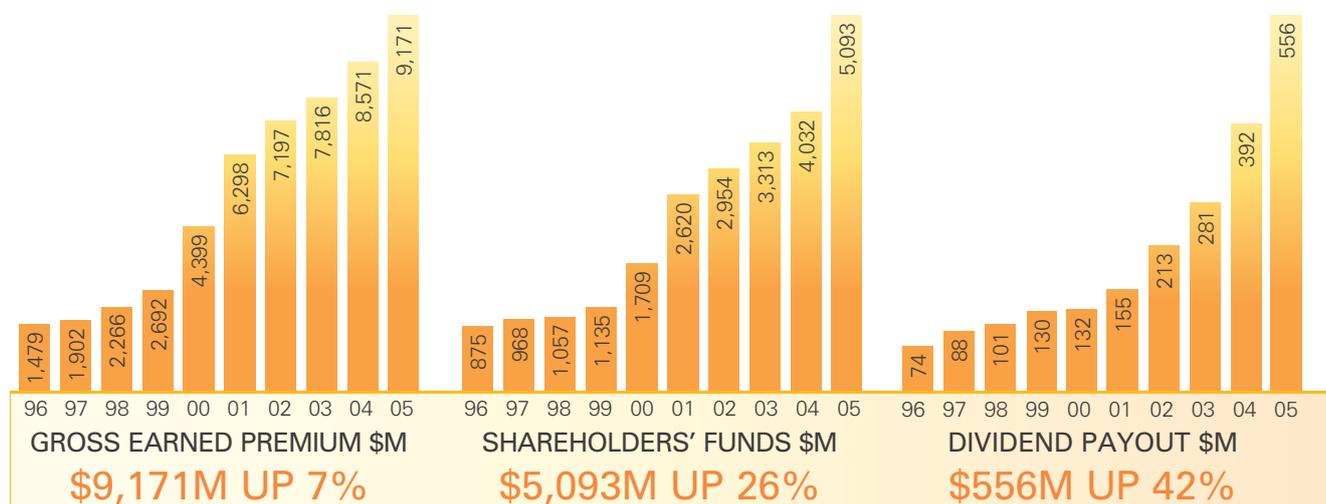
(5) Assumes that all hybrid securities are fully dilutive.

(6) 2004 comparatives are calculated with reference to the AIFRS adjusted shareholders' funds of \$2,951 million at 1 January 2004.

(7) Includes convertible preference shares from 2000 to 2003 and the equity portion of hybrid securities issued in 2002 and 2004.

(8) Excludes ABC financial assets pledged for funds at Lloyd's.

(9) Includes financial assets, cash and investment properties.





**Frank O'Halloran**  
Chief executive officer

# Chief executive officer's report

## GROUP KEY RATIOS

		HALF YEAR TO 30 JUN 2005	HALF YEAR TO 31 DEC 2005	FULL YEAR TO 31 DEC 2005	HALF YEAR TO 30 JUN 2004	HALF YEAR TO 31 DEC 2004	FULL YEAR TO 31 DEC 2004
Gross written premium	\$M	5,123	4,285	9,408	4,763	4,003	8,766
Gross earned premium	\$M	4,331	4,840	9,171	3,982	4,589	8,571
Net earned premium	\$M	3,506	3,880	7,386	3,114	3,667	6,781
Claims ratio	%	61.0	58.9	59.9	61.6	61.0	61.3
Commission ratio	%	17.0	16.8	16.9	16.8	18.1	17.5
Expense ratio	%	12.3	12.3	12.3	12.1	12.7	12.4
Combined operating ratio	%	90.3	88.0	89.1	90.5	91.8	91.2
Insurance profit to net earned premium	%	16.7	18.1	17.4	14.1	13.3	13.7

I am pleased to report that QBE has exceeded its 2005 profit targets with a 27% increase in net profit after tax to \$1,091 million and a 39% increase in insurance profit before tax to \$1,288 million.

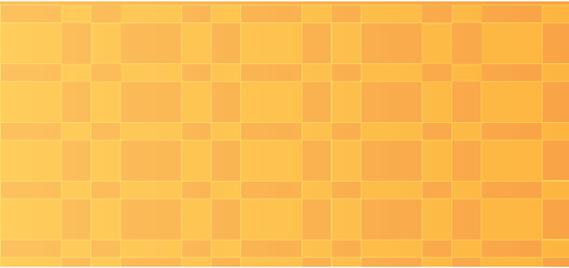
It is very satisfying that in 2005 we produced the highest insurance profit margin since the listing of QBE in 1973, despite significant claims from the worst catastrophe year on record for our industry. Insurance profit was 17.4% of net earned premium compared with 13.7% last year. The strength of QBE's risk management, product and geographic diversification and conservative reinsurance purchasing were key factors that enabled the Group to produce this excellent insurance profit.

Net claims from large catastrophes during 2005 were \$515 million compared with \$320 million last year. Large catastrophes included the European storm Erwin (January), Hurricane Katrina (August), Mumbai floods (August), European floods (September), Hurricane Rita (September) and Hurricane Wilma (October).

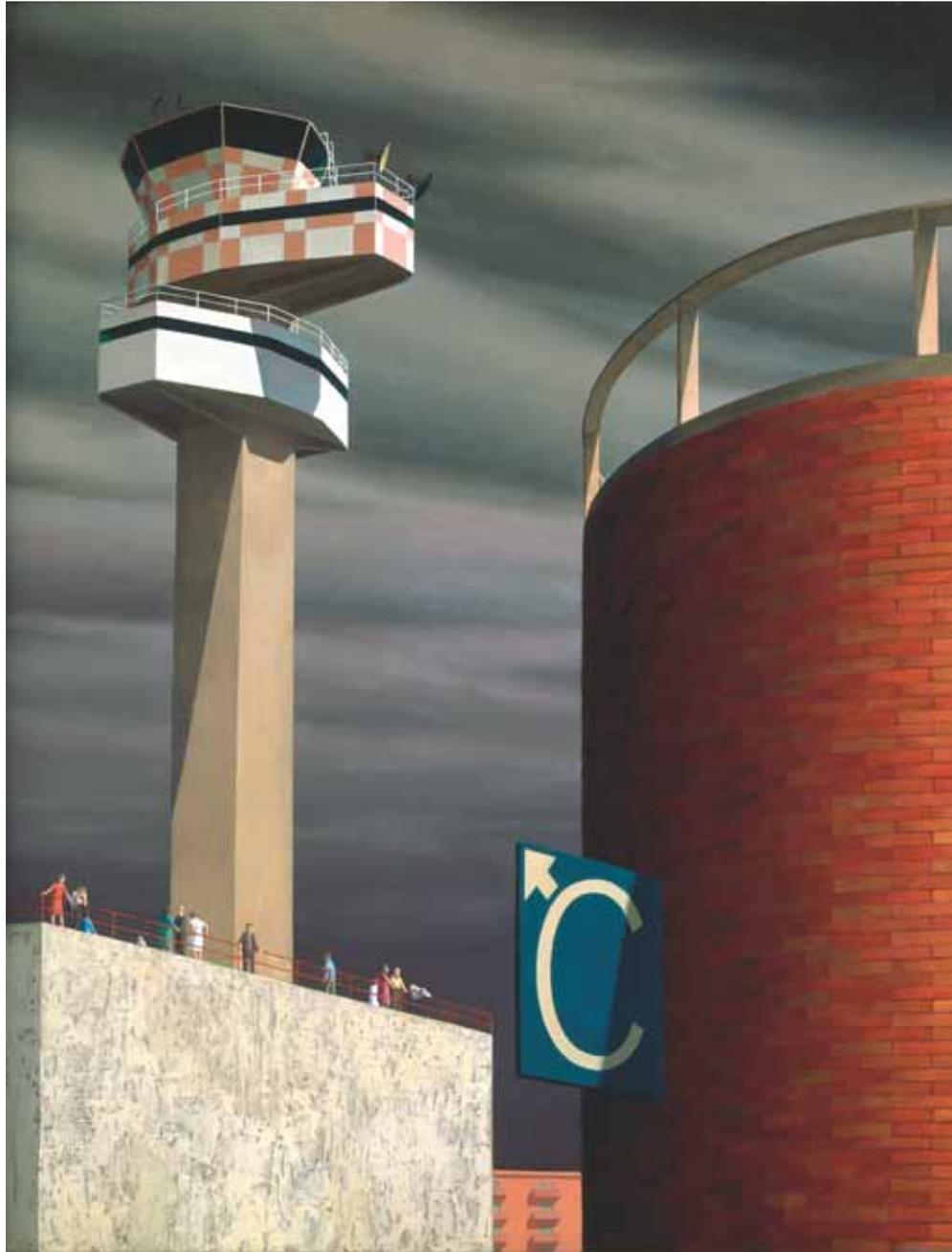
In 2005, our overall premium rates declined slightly, reflecting the significant improvement in underwriting profitability achieved by QBE and the industry over the past four years. In 2006, whilst competition will continue, we expect to achieve overall premium rate increases to cover the increased reinsurance costs following the 2005 catastrophes and to improve the reward for the significant catastrophe risks that we underwrite throughout the world. We also expect further strengthening of policy terms and conditions for many of our products exposed to catastrophes.

Cash flow from operations was again very strong at \$1,987 million compared with \$2,110 million last year. The slight reduction in cash flow is due to the payment of claims from the catastrophes in late 2004 and the slight overall decrease in premium rates in 2005.

Income tax expense increased from 23% of profit before tax last year to 28%. This is due to higher profits in Australia, the US and the UK.



The delivery of QBE's core values is achieved through a strong control environment based on robust risk management and planning frameworks.



"Control tower" 1969, Art Gallery of South Australia

Once again, we finalised a number of acquisitions during the year to increase profit and premium going forward. In particular, we:

- acquired Central de Seguros in Colombia with an expected gross written premium of \$95 million in 2006;
- acquired National Farmers Union Property and Casualty in the US with expected gross written premium of \$240 million in 2006;
- acquired Greenhill underwriting agency operations in France, Germany and Spain with expected gross written premium of \$50 million in 2006;
- acquired MiniBus Plus underwriting agency in the UK which is expected to increase our commercial motor gross written premium by \$100 million in 2006;
- acquired British Marine Holdings, a specialist small tonnage marine underwriter with expected gross written premium of \$180 million in 2006;
- commenced writing builders' warranty and medical malpractice insurance in Australia following much needed changes by governments to improve claims experience for insurers and affordability of insurance for consumers;
- acquired the wholly owned business of Allianz in Vietnam;
- acquired National Credit Insurance Brokers in Australia and New Zealand and Austral Mercantile Collections in Australia to support our trade credit operations; and
- consolidated our management teams in the UK and Australia, Pacific, Asia and Central Europe to achieve an estimated additional \$80 million of annual synergies by the end of 2007.

## Chief executive officer's report continued

These acquisitions and other initiatives will add more than \$600 million of gross written premium in 2006 together with the profit that will flow from this business.

We also sold Garwyn, our non-core loss adjusting business in the UK and Ireland, our 50% share of the QBE-BIDV joint venture in Vietnam and our small life business in Slovakia.

### Insurance profitability

The Group's insurance profit increased from \$928 million last year to \$1,288 million. Insurance profit comprises the underwriting result plus investment income on investments set aside to meet our liabilities to policyholders. The improvement in the insurance profit was after a significant increase in catastrophe claims and an increase in the dollar amount of prudential margins to maintain the probability of adequacy of the outstanding claims provision at 94%.

The Group's combined operating ratio (the total of claims, commission and expenses as a percentage of net earned premium) was 89.1% compared with 91.2% last year. All insurance divisions produced strong underwriting profits and most of our products around the world were again profitable. As a percentage of average shareholders' funds, insurance profit increased from 26.6% last year to 28.2%.

Net invested funds set aside to meet insurance liabilities increased from \$13.2 billion to \$15.5 billion assisted by acquisitions and the considerable cash flow from operations.

Gross written premium increased 7% to \$9,408 million, mainly from the acquisitions made in 2004 and a higher retention of business. Premium growth was affected by the slight overall reduction in premium rates during the year and increased competition. Organic growth was less than expected in some classes because of competition and our unwillingness to write the business at premium rates that did not meet our profit targets. QBE's offshore businesses now contribute 74% to the Group's gross written premium and the general insurance/reinsurance mix is now 77%:23%. Net earned premium increased 9% to \$7,386 million.

Our reinsurance operations have been a significant contributor to profit over a number of years. Property reinsurance, which now represents the largest part of our reinsurance business, has produced an average combined operating ratio of around 87% over the five years from 2001 (including the loss from the terrorist attack on the USA on 11 September 2001) to 2005. In 2001 and 2002, we made a number of changes to improve our returns from the catastrophe risks that we write and we have made further changes for the 2006 underwriting year. We do not intend to increase our exposures in our reinsurance operations, even though we expect overall premium rate increases will be significant for business renewed in the next 12 months.

The Group's cost of reinsurance protection as a percentage of gross earned premium decreased from 21% to 19% as expected, even though we incurred additional costs during the year to reinstate some of our protections. The cost of reinsurance is made up of 43% proportional reinsurance, mainly for programme business in the US, and 57% catastrophe and other excess of loss reinsurance. QBE's net exposure to major catastrophes continues to decrease with the 2005 maximum retention from the largest realistic disaster scenario being 4.0% of net earned premium compared with 4.3% for 2004.

Gross claims incurred as a percentage of gross earned premium increased from 62.2% to 73.5%. The increase in the gross claims ratio reflects the higher catastrophe claims partly offset by the continuation of low claims frequency on most of our portfolios. Gross and net claims from large catastrophes in 2005 were \$2,080 million and \$515 million respectively compared with \$835 million and \$320 million for 2004. The net cost of catastrophes in 2005 was within the catastrophe allowance included in our business plans. The net claims ratio, which includes the net costs of catastrophes, decreased from 61.3% to 59.9%. This reflects the benefit of QBE's reinsurance protections in 2005.

The commission ratio reduced from 17.5% to 16.9%, reflecting a change in the mix of business during the year

and the benefits from the acquisition of underwriting agencies in Australia in 2004. The Group's expense ratio decreased from 12.4% to 12.3%. The expense ratio reflects further synergies from acquisitions and other restructures, partly offset by higher staff incentives for improved results, further increases in costs related to corporate governance and regulatory compliance and one-off expenses relating to the restructure of our European and Australian businesses.

### Investment income

Investment income, net of borrowing costs and investment expenses, increased from \$519 million to \$718 million. The higher interest rates in the US, strong cash flow from operations, strong equity markets and active management of our investment portfolio benefited investment income during the year. Gross investment income was \$843 million compared with \$637 million last year. The gross investment yield was 5.2% compared with 4.8%. These yields reflect our focus on achieving absolute returns, which requires a low risk investment strategy.

We continue to maintain a policy of short duration on cash and fixed interest investments in anticipation of further interest rate rises. The average maturity of our cash and fixed interest securities at the end of 2005 was 0.6 years, although we expect the duration to increase in 2006 as interest rates peak.

We also continued our policy of investing in highly rated fixed interest securities and value equities. Our weighting in listed equities decreased from 8.9% of total investments and cash at 31 December 2004 to 3.7% at 31 December 2005 reflecting the realisation of capital gains and the use of derivatives to secure our investment returns.

## WORLDWIDE PORTFOLIO MIX

### GROSS EARNED PREMIUM

FOR THE YEAR ENDED 31 DECEMBER

	2005	2004
Marine and aviation	6.3%	6.6%
Accident and health	6.2%	6.1%
Property	28.7%	29.9%
Motor and motor casualty	13.7%	12.3%
Financial and credit	2.5%	2.4%
Liability	21.9%	21.8%
Professional indemnity	9.1%	9.5%
Workers' compensation	8.9%	9.6%
Other	2.7%	1.8%

## CONTRIBUTIONS BY REGION

FOR THE YEAR ENDED 31 DECEMBER	GROSS WRITTEN PREMIUM		NET EARNED PREMIUM		NET PROFIT AFTER TAX		COMBINED OPERATING RATIO	
	2005 \$M	2004 \$M	2005 \$M	2004 \$M	2005 \$M	2004 \$M	2005 %	2004 %
Australia	2,431	2,102	2,015	1,763	360	254	83.6	89.7
Pacific Asia Central Europe	691	672	536	514	103	62	82.3	86.4
QBE Insurance (Europe)	2,558	2,301	1,954	1,787	314	183	90.0	95.6
Lloyd's division	2,236	2,309	1,743	1,720	213	239	94.5	91.6
the Americas	1,492	1,382	843	766	62	44	92.9	93.5
Equator Re	353	278	295	231	39	75	89.8	68.8
Elimination – internal reinsurance	(353)	(278)	–	–	–	–	–	–
Group	9,408	8,766	7,386	6,781	1,091	857	89.1	91.2
General insurance	7,291	6,715	5,774	5,184	981	719	85.5	89.4
Inward reinsurance	2,117	2,051	1,612	1,597	110	138	101.9	97.1
Group	9,408	8,766	7,386	6,781	1,091	857	89.1	91.2

## OTHER INSURANCE RATIOS

FOR THE YEAR ENDED 31 DECEMBER

	2005 %	2004 %	2003 %	2002 %	2001 %
Premium growth					
gross written	7.3	5.0	8.1	13.7	54.2
net earned	8.9	12.3	7.0	21.8	34.1
Reinsurance ceded to gross written premium	19.0	20.3	21.7	21.1	26.8
Net written premium to gross written premium	81.0	79.7	78.3	78.9	73.2
Insurance profit to average shareholders' funds <sup>(1)</sup>	28.2	26.6	20.0	14.6	(5.5)

(1) 2004 comparatives are calculated with reference to the AIFRS adjusted shareholders' funds of \$2,951 million at 1 January 2004.

## IMPACT OF EXCHANGE RATE MOVEMENTS

	2005 ACTUAL \$M	2005 AT 2004 EXCHANGE RATES \$M	EXCHANGE RATE IMPACT %
Gross earned premium	9,171	9,362	(2)
Net earned premium	7,386	7,534	(2)
Net investment income	718	732	(2)
Net profit after income tax	1,091	1,121	(3)
Total investments and cash	17,597	17,755	(1)
Total assets	29,665	30,077	(1)
Gross outstanding claims	15,083	15,325	(2)
Total liabilities	24,506	25,167	(3)

### Impact of exchange rate movements

Currency fluctuation impacts the translation of income statement and balance sheet items because of our significant offshore operations, particularly in the UK and US. The Group translates income and expense items using the cumulative average rate of exchange whilst balance sheet items are translated at the closing rate of exchange. The impact of exchange rate movements is included in the table on page 9.

### Reinsurance recoveries

Reinsurance recoveries on outstanding claims increased from \$3,143 million at 31 December 2004 to \$4,213 million due to significant recoveries expected from current year catastrophe claims. Reinsurance recoveries on incurred but not reported claims included in this amount were \$1,627 million compared with \$1,415 million last year. We continue to maintain strict controls over our exposures to reinsurance counterparties which is evidenced by our consistently low level of bad debt write-offs over many years. However, due to the increased level of reinsurance recoveries and the lower ratings of some reinsurers, we have decided to take the opportunity to increase the general provision for doubtful recoveries by \$76 million to \$239 million.

### Claims development tables

Note 20 in the annual report includes an undiscounted net claims development table for accident years 2001 to 2005 to comply with AIFRS. Claims incurred and other claims statistics are maintained on either an accident or underwriting year basis for each product, business unit and operating entity. For our overseas operations, they are converted into Australian dollars using exchange rates at the end of the current financial year. With operations in 41 countries, hundreds of different products, various reinsurance arrangements and with the Group's risk tolerance managed on a net basis, it is not considered meaningful or practicable to provide claims information other than on a consolidated net accident year basis. Further information is provided on page 16 of the annual report.

In previous annual reports, QBE reported that it had upgraded US long tail casualty claims for 2001 and prior years mainly from our Limit operation, which was acquired in August 2000, and our US operations. We ceased underwriting the business that caused the deterioration in 2002. The US casualty development primarily relates to the Enron, Worldcom and financial laddering claims (written in the UK) and the casualty facultative portfolio (written in the US). Since 2001, we have experienced improved market conditions. In addition, we have cancelled segments of our business to improve overall returns. These factors have resulted in a lower claims frequency. The positive runoff of the 2002, 2003 and 2004 accident years reflects our conservative claims provisioning which results in the release of prudential margins as the claims are settled below central estimates.

### Captive reinsurer

Included in note 38 to the financial statements are the results of our captive reinsurer, Equator Reinsurances Limited ("Equator Re"). Equator Re provides excess of loss protection below the retentions deemed appropriate for the Group for most of QBE's subsidiaries around the world. Equator Re also participates on a number of the Group's excess of loss and proportional reinsurance protections placed with external reinsurers. The exposures written by Equator Re are included in the Group's maximum event retention, which is the Group's estimated net loss from its largest single realistic disaster scenario.

Equator Re has generated significant prudential margins for the Group as well as producing an underwriting profit in each year since 2002. The underwriting profit for 2005 was \$30 million compared with \$72 million last year. The lower profit reflects the increased incidence of catastrophe losses in 2005 and the increase in prudential margins in outstanding claims. Gross written premium was up 27% to \$353 million and net earned premium increased 28% to \$295 million. Equator Re purchased additional excess of loss reinsurance protection for 2005 as well as industry loss warranty covers. The operating divisions' reinsurance costs include the

amounts reinsured to Equator Re and these amounts are eliminated in the overall Group results.

For 2006, we expect that Equator Re will write additional gross written premium from proportional reinsurance from the divisions. Its net exposures are expected to remain substantially unchanged.

### Outlook

The acquisitions made in 2005 and expected overall premium rate increases of around 4% to cover higher reinsurance costs from recent catastrophes will benefit gross written premium in 2006. At current exchange rates, we expect to grow gross written premium by approximately 10% in 2006 to \$10.3 billion and net earned premium by 12.5% to \$8.3 billion. We expect our growth in 2006 to be supported by an increase in retention of customers. We also expect organic growth to be slightly in excess of lapsed business as policyholders look for better security. We were slightly ahead of expectation for premium rates and new business at the major renewal date of 1 January 2006. Our target for growth in net earned premium beyond 2006 is 10% per annum. This will largely depend on acquisitions and the value of the Australian dollar.

The reinsurance expense ratio is expected to reduce to around 17% of gross earned premium, assuming a normal level of catastrophes. We have placed our 2006 reinsurance protections and the increased costs of those protections is likely to be substantially exceeded by the overall increase in premium income on our direct and inward reinsurance business.

The risk profile of our insurance and reinsurance operations will continue to be amended to improve the reward for the significant catastrophe risks that we underwrite. We have decided to reduce our exposures to some risks in the Gulf of Mexico. We continue to monitor all portfolios in each country where we carry on business and to improve the management of exposures in various catastrophe zones around the world. Our 2006 net retention from our largest realistic disaster scenario as a percentage of net earned premium will be slightly lower than 2005.

Our analysis of the Group's claims ratio between attritional losses, large losses and catastrophes indicates that the 2006 business plan allowances for large losses and catastrophes substantially exceed the amounts incurred in each of the past seven years, including 1999 and 2005 which are recognised as the worst years on record for frequency and severity of insured catastrophe losses. These allowances are more than four times the net retention from our largest realistic disaster scenario.

The combined commission and expense ratio is targeted to decrease slightly in 2006 with further reductions in 2007 and 2008 from the synergies from acquisitions and the previously advised restructures in the UK and Australia.

The gross investment yield is targeted to be slightly in excess of 5.0% for 2006. We do not expect stock markets to improve at the same rate as the past two years and we have assumed a 5% capital appreciation on equities. The increase in interest rates on our substantial US investment portfolio in 2005 will assist our expectations for yields. Using current exchange rates, net invested funds are expected to be around \$18 billion by 31 December 2006 as a result of strong cash flow and acquisitions.

The income tax expense is expected to be around 27% of pre-tax profit for 2006.

The Group's probability of adequacy on outstanding claims is at the high end of our internal target range of 85% to 94%. In addition, our provision for unearned premium includes a significant allowance for large losses and catastrophes in 2006. These factors, together with the current premium rate environment, give us confidence that we will achieve an insurance profit of between 16.0% and 17.0% and increase net profit after tax by more than 10% in 2006. The achievement of these targets is subject to:

- no material movement in current exchange rates;
- large losses and catastrophes not exceeding the significant allowance in our business plan; and
- no significant fall in equity markets or interest rates.

### Summary

QBE's results for the past 12 months are very pleasing considering that 2005 was the worst year on record for catastrophe losses for the insurance and reinsurance industry. QBE is well positioned to participate in the substantial increase in premium rates for many of our property, marine and energy portfolios in the US, Latin America and the UK. Further, pricing continues to be strong for most of the classes of business that QBE underwrites.

QBE has completed 2005 with a probability of adequacy on outstanding claims at the high end of our internal target range of 85% to 94%. The increase in prudential margins in recent years is largely a result of the increase in the Group's exposure to non-US long tail classes of business. The probability of adequacy of the Group's outstanding claims provision will vary from time to time depending on the mix of short, medium and long tail business and economic and industry conditions such as latency claims, claims inflation and foreign currency movements. QBE has not decreased its provisions for its relatively limited exposures to asbestos-related claims even though the claims incurred and reported during 2004 and 2005 were much less than expected.

The Group's survival ratio for asbestos-related claims, measured as the ratio of net provisions held to the average of the past three years net claims paid, is now approximately 50 times.

We have again been very successful with our acquisition activity in 2005, which we expect will have a positive impact on profitability going forward. We will continue to pursue our strategy of growth by acquisition using our established criteria. We have converted over 90 acquisitions in the past 20 years.

In the past four years of a positive insurance cycle, QBE has been able to grow its business and profitability, and prospects for 2006 and beyond are very encouraging. QBE has sufficient shareholders' funds to achieve its targeted premium growth for 2006 including a normal level of acquisition activity.

QBE has a well diversified spread of business, both geographically and by product. This, together with our comprehensive approach to risk management, has enabled us to achieve substantially improved insurance profitability in 2005 despite the high level of catastrophe losses. We continue to lead terms and conditions on most business in the countries in which we operate. The major renewal season of 1 January 2006 was slightly better than expected in terms of business written and pricing. We have successfully integrated the acquisitions made during 2004 and 2005 and we are on track to achieve the previously announced synergies from the restructure of our UK and Australia Pacific Asia Central Europe operations.

We have a low turnover of senior staff and many quality employees capable of filling more senior roles as they arise within the Group. We also have a very strong focus on increasing wealth for our shareholders from our many excellent businesses around the world that operate within the parameters of measurable and approved business plans. These factors give us confidence about our future performance.

Gayle Tollifson, QBE's chief risk officer, will retire in early July 2006. She has been a major contributor to QBE's strategies, risk management and its success. George Thwaites, Group general manager corporate will be appointed chief risk officer on Gayle's retirement.

The strong 2005 result and our positive outlook have been achieved through the disciplined and professional approach of our more than 7,800 staff worldwide. I extend my sincere appreciation to all my fellow employees for their loyalty and significant contribution over the past year and to our directors for the support they have provided on the many initiatives that we have undertaken. I look forward to working with the QBE team to achieve our financial targets for 2006 and to build an even stronger QBE going forward.

**Frank O'Halloran**

Chief executive officer

# 05

## Group financial targets and performance goals

### FINANCIAL PERFORMANCE 2005

FINANCIAL TARGETS*	ACTUAL
• Achieve an insurance profit margin of 12.5% to 13.5%	• Insurance profit margin of 17.4%
• Increase profit after income tax and diluted earnings per share by more than 10%	• Profit after income tax increased 27% and diluted earnings per share increased 20%
• Achieve a return on average shareholders' funds of more than 18%	• Return on average shareholders' funds of 23.9%
• Gross written premium growth of 10%	• Gross written premium increased 7%
• Net earned premium growth of 12.5%	• Net earned premium increased 9%
• Reinsurance expense ratio of 19%	• Reinsurance expense ratio of 19%
• Maintain expense ratio of 12.3% or less	• Expense ratio of 12.3%
• Tax rate of 26%	• Tax rate of 28%
• Maintain Group capital adequacy multiple of more than 1.5 times APRA's minimum requirement for Australian licensed insurers	• Capital adequacy multiple of 1.9 times the minimum requirement
• Gross investment yield of 4.5%	• Gross investment yield of 5.2%

### OPERATIONAL PERFORMANCE 2005

PERFORMANCE GOALS	ACTUAL
• Achieve overall premium rate increases at least equal to claims inflation	• Slight reduction in overall premium rates
• Further increase customer retention	• Retention ratios increased for the majority of portfolios
• Further reduce risk profile of insurance business	• Maximum event retention reduced
• Achieve gross investment yield target with a low risk investment strategy	• Internal benchmarks exceeded
• Continue promotion of QBE manager programme	• Programme run in a number of countries

\* Targets assume no material movement in current exchange rates; large losses and catastrophes not exceeding the significant allowance in our business plans; and no major fall in equity markets or interest rates.

# 06

## Strategy and planning

### FINANCIAL PERFORMANCE 2006

#### FINANCIAL TARGETS\*

- Achieve an insurance profit margin of 16.0% to 17.0%
- Increase profit after income tax by more than 10% and diluted earnings per share by more than 10%
- Achieve a return on average shareholders' funds of more than 20%
- Gross written premium growth of 10%
- Net earned premium growth of 12.5%
- Reinsurance expense ratio of 17% or less
- Achieve expense ratio of 12.0% or less
- Tax rate of around 27%
- Maintain Group capital adequacy multiple of more than 1.5 times APRA's minimum requirement for Australian licensed insurers
- Gross investment yield slightly in excess of 5.0%

### OPERATIONAL PERFORMANCE 2006

#### PERFORMANCE GOALS

- Maintain overall premium rates at levels sufficient to achieve targeted attritional loss ratios
- Maintain existing terms, conditions and deductibles
- Further reduce risk profile of insurance business
- Achieve gross investment yield target with a low risk investment strategy
- Continue high retention of key staff and managers
- Continue promotion of QBE's culture and essential behaviours
- Continue to effectively manage the impact of foreign exchange volatility

QBE has developed a business planning framework which ensures that there is a systematic and disciplined approach to planning throughout the Group.

The framework helps to:

- establish a clear direction for each operating division;
- build confidence in our ability to execute our corporate strategies and deliver against our business plans;
- more accurately project profitability and financial performance;
- improve alignment of internal resources with external opportunities;
- generate greater accountability and transparency in decision making; and
- target the reduction of uncertainty and volatility, thereby reducing the likelihood and impact of events that could threaten our ability to meet our business objectives.

The QBE board of directors approves the Group's strategy and detailed business plans prepared by management and reviews actual performance against the plans. The strategy is consistent with shareholder expectations, our corporate financial profile, our organisational culture and our capacity to effectively manage risks. The strategy and plans form the basis for our risk tolerance within the Group.

Business plans are developed for all classes of insurance business, for our investment portfolios and for all support functions. The plans clearly document our strategy for achieving financial targets and performance goals within the limits set. Annual budgets included in the business plans form the basis for delegating authorities to all managers and staff with specific responsibilities, including underwriters, investment managers and claims managers.

Business plans are subject to detailed review by local and Group senior management. They are prepared annually and actual results are monitored regularly to identify adverse trends so that remedial action can be taken at an early stage. Regular reporting to both local and Group boards on performance against the business plans, including action plans to correct adverse variances, is a fundamental control within the Group.

# Risk management

QBE has established internal controls to manage risk in the key areas of exposure relevant to its business. The Group has a risk management framework to identify the significant areas of business risk and to manage these risks. Risk management is a continuous process and an integral part of quality business management. QBE's approach is to integrate risk management into the broader management processes throughout the organisation.

The QBE manager programme is designed to promote and maintain a common culture throughout our many businesses around the world. The QBE manager programme defines nine essential behaviours that all employees need to practise in order to be successful QBE managers. Risk management is embedded in the QBE essential behaviours and it is QBE's policy that all its employees adopt a rigorous approach to managing risk. The board's commitment to risk management is documented in QBE's risk management policy statement.

Throughout the Group a culture of utmost integrity prevails. This requires open and honest dealings with our employees, customers, shareholders, legislative bodies and the community at large.

Some of the key elements of QBE's risk management policy are:

- avoiding unwelcome surprises by reducing uncertainty and volatility through the identification and management of risks such as by controlling aggregate exposures and maintaining sound reinsurance arrangements;
- achieving competitive advantage by better understanding the risk environments in which we operate; and
- optimising risk and more effectively allocating capital and resources by assessing the balance of risk and reward.



"Plastic tube" 1980, private collection

QBE's risk management is a continuous process and an integral part of our quality business management practices.

This policy is supported by a risk management strategy identifying our key risks and our approach to the management of these risks. The strategy clearly documents the practical application of our risk management framework throughout the business management cycle, including the business and strategic planning process.

The risk management framework implemented by QBE is principles based, providing the flexibility and efficiency required to maintain high standards in an ever-changing regulatory and business environment. Robust systems and processes are fundamental to the supervision and management of a diverse international group. This framework is established around a suitably qualified and dedicated team which is focused on managing with integrity.

Through the risk management framework, QBE manages its risks within the following categories.

- Insurance - including underwriting, claims and actuarial risk factors.
- Operational - including areas such as human resources, valuation of assets, corporate security and outsourcing, regulatory risks and the adequacy of processes and systems.
- Acquisition - including due diligence and integration processes.
- Funds management and treasury - including operational, cash flow, trading and security risks.

Diversification is used as a tool to reduce the Group's overall insurance risk profile by spreading exposures geographically and by product, thereby reducing the volatility of results. Product diversification

is achieved through a strategy of developing strong underwriting skills in a wide variety of classes of insurance business. A combination of core and specialty products allows QBE to be a lead underwriter in many of the markets in which we operate. Geographic diversification is achieved by operating in 41 countries.

QBE continues to be committed to sound, practical risk management in order to protect shareholders' and policyholders' interests.

# Australian equivalents to International Financial Reporting Standards

QBE Group has now successfully completed its transition to AIFRS. A summary of the key standards impacting the Group is set out on page 17. Phase I of the AIFRS changes for insurance companies, whilst adding a significant compliance burden, has had no fundamental impact on the underlying economics of our business and the adjustments to restate opening balances have not affected our ability to pay dividends. The major financial effects on shareholders' funds are generally non-recurring transitional adjustments to restate opening balances under AIFRS. Retained profits at 31 December 2005 on an AIFRS basis are \$1.8 billion (2004 \$1.2 billion). There may also be some ongoing volatility in the income statement and balance sheet due to fair value movements in assets and liabilities as noted on page 17.

The Group issued its first AIFRS compliant financial statements for the half year ended 30 June 2005. At that time, we noted that the overall financial impact of AIFRS was to reduce equity as at 31 December 2004 by \$380 million. Since the half year report was issued, there has been a clarification within the Lloyd's market of the interpretation of AASB 121: The effects of changes in foreign exchange rates, as it applies to companies operating in the Lloyd's market. This has resulted in a further \$8 million reduction in retained earnings as at 31 December 2004. Details are provided in note 2 to the financial statements.

We continue to monitor the International Accounting Standards Board's ("IASB") and Australian Accounting Standards Board's ("AASB") ongoing IFRS projects, particularly phase II of the IASB's insurance contracts project which is intended to implement a common international basis for the recognition and measurement of insurance contracts with particular reference to discounting, the determination of risk margins and the estimation of future cash flows. The IASB has indicated that it plans to issue a discussion paper in the second half of 2006 and a final standard is currently not expected until at least 2009.

The financial statements for the year ended 31 December 2005 contain significant new disclosures which are required under AIFRS. The new disclosures in respect of insurance contracts and financial instruments are particularly wide-ranging and include:

- details of the process used to determine assumptions, critical estimates and judgments which impact amounts recognised in the financial statements, and sensitivity analysis thereon;
- risk management policies and practices relating to insurance contracts; and
- enhanced disclosure of financial risk management strategy including controls over hedging arrangements, interest rate, credit and liquidity risks.

Insurers are also required, for the first time, to quantify the central estimate and risk margin in the outstanding claims provision and the benchmark risk margin used in applying the new liability adequacy test to unearned premium liabilities. The quantification of the central estimate and risk margin held in the outstanding claims provision has not previously been required under Australian accounting standards and QBE Group has therefore not published such information in previous consolidated financial statements. QBE Group has a long held policy of maintaining risk margins in the outstanding claims provision and has developed a rigorous approach to the valuation of insurance assets and liabilities. The probability of adequacy of the outstanding claims provision was substantially unchanged by AIFRS. The central estimate and risk margin are based on highly complex actuarial calculations which are likely to vary considerably from one insurer to another depending on the diversity of operations, risk management strategy and other variables. Whilst this information can be used to establish trends in a particular insurer's accounts year on year, comparison between entities is likely to be less meaningful.

Finally, the financial statements must include a claims development table commencing with five years of development, building to 10 years in

future reporting periods. The production of the historical data has been extremely onerous for the QBE Group requiring the collation of accident year data across multiple jurisdictions, lines of business and foreign currencies, and incorporating the numerous acquisitions which have been made over the period.

Whilst AIFRS prescribes the general form of the disclosures, each reporting entity must determine the level and extent of disclosure that is appropriate having regard to the circumstances in each case and which will enable the production of financial statements which are understandable, relevant, reliable and comparable. QBE Group has operations in 41 countries and differs significantly from other Australian based insurers due to the international diversity of its insurance business. Whilst the insurance business is managed at a local and divisional level, the overall management of risk is undertaken within the framework of a large, sophisticated consolidated group structure. The structure of the Group, its strategy, balance sheet, investments, appetite for risk and the measurement of the risk margin in insurance liabilities are determined and managed at a consolidated Group level, within the constraints of local regulatory requirements. Having regard to the product and geographic diversification of the QBE Group, the complexity of the Group's reinsurance arrangements and the fact that the Group's risk tolerance is managed on a net basis, we have prepared the insurance disclosures, including a net claims development table, at the consolidated level. This provides a level of analysis which satisfies AIFRS requirements and gives the reader information which is meaningful yet succinct. We consider that disclosure below consolidated level would not provide meaningful information given the complex interrelationships between the variables underpinning the consolidated entity's operations, and could compromise comparability with our international peers.

## KEY ACCOUNTING STANDARDS IMPACTING QBE GROUP

ACCOUNTING STANDARD	CHANGE	IMPACT
AASB 119: Employee benefits	Deficits and surpluses on defined benefit superannuation plans to be included on the balance sheet.	Total equity reduced by \$142 million after tax at 31 December 2004.
AASB 2: Share-based payment	Employee loans and related shares issued are no longer included on the balance sheet.	Share capital reduced by \$90 million at 31 December 2004, which will be reinstated when loans are repaid.
	Expensing of share options on employee incentive arrangements through the income statement.	Total impact on equity was minimal at 31 December 2004. Ongoing annual charge to the income statement.
AASB 3: Business combinations AASB 136: Impairment of assets	Reclassification of goodwill and intangibles. Amortisation of goodwill replaced by impairment testing.	Total equity reduced by \$49 million after tax at 31 December 2004 for impairment.
AASB 1023: General insurance contracts	Claims provision to be discounted at risk free rate.	Total equity reduced by \$64 million after tax at 31 December 2004.
	Significant increases in disclosure.	Significant increase in time and cost of compliance.
AASB 139: Financial instruments: recognition and measurement	Hedge effectiveness testing.	Potential volatility in income statement if a hedge fails the effectiveness test or if a component of a hedge is ineffective.
AASB 121: The effects of changes in foreign exchange rates	A Lloyd's corporate vehicle is now treated as a single entity with one functional currency. Non-monetary assets and liabilities, including unearned premium and deferred insurance costs, are carried on the balance sheet at the rates of exchange at the transaction dates.	Total equity reduced by \$8 million after tax at 31 December 2004.



## QBE people

QBE's people are critical to successfully delivering the Group's business strategy. Employee numbers have grown to more than 7,800 in 2005, up from 7,320 in 2004, due to acquisitions and growth within the business. The Group has a strong management team, reflecting the focus on QBE's essential behaviours for business acumen and leadership, together with the Group's performance measurement, succession management and staff development processes.

The capability of the QBE senior management team is key to sustaining the Group's track record of increasing the wealth of our shareholders. QBE strongly believes in developing its own talent and has committed effort and resources to this with a focus on developing the management and technical teams, ensuring that careers are carefully nurtured and monitored. The Group executive team, chief executive officer and the board regularly devote time to the issues of succession planning and staff development, and have set objectives against which they can assess outcomes and measure success.

Succession planning and staff development activities are an important part of the Group's human resource management processes, impacting staff at all levels of the business. The principal objective is to ensure that the best people occupy the key positions and that we have robust succession plans in place in all areas of the business. Annual performance and development reviews provide the forum for measuring performance and setting





"Factory at Erewyna" 1972, National Gallery of Victoria

QBE is committed to the development of "can do" people who are focused on the Group's vision and values.

objectives. Most staff members are assessed against QBE's nine essential behaviours, which form the basis of QBE's business and leadership culture. Additionally, most staff prepare a personal development plan with their line manager to support their own personal career development.

QBE's people are selected for their ability, experience and their "can do" approach to achieving corporate objectives. Our aim is to ensure that the interests of our shareholders and staff are aligned. In order to encourage high levels of performance and to achieve our vision of increasing shareholders' wealth, at risk incentive arrangements are in place for most staff worldwide through participation in Short Term

Incentive ("STI") arrangements. These arrangements reward staff when they achieve or exceed financial targets and meet personal performance objectives. Also central to our incentive arrangements is the Employee Share and Option Plan ("the Plan") which has been in place since 1981. Over 6,300 of our employees at all levels of the organisation now hold shares in QBE through the Plan, providing a further motivation for them to achieve the Group's vision of increasing wealth for our shareholders.

The Group's senior management also participate in a Long Term Incentive ("LTI") scheme. Senior managers are only entitled to participate in the LTI if they have already qualified for the

STI by achieving their financial targets. Details of the Plan and the LTI are set out in note 27 to the financial statements. In 2006, the LTI will be extended to include selected staff below senior management level.

QBE is committed to providing a safe and flexible working environment, recognising that employees may have different needs at different points in their working lives. QBE is also committed to a culture which is aligned with its vision and values, including employee motivation.

## Group and divisional executives

### **Gayle Tollifson**

FCA, FAICD, FCIS, AGE 51

Ms Tollifson is currently the Group's chief risk officer. She joined QBE in 1994 as Group financial controller and subsequent to that held the position of Group general manager, financial and business risks for two years. Prior to joining QBE, Ms Tollifson worked with Coopers and Lybrand in Australia and Bermuda, having qualified as a chartered accountant in Canada in 1981.

### **Tim Kenny**

NDBS, MICM, AGE 45

Mr Kenny is currently president and chief executive officer of QBE the Americas. He has over 23 years experience in the insurance industry including 16 years with QBE Group during which he has served as senior vice president, chief financial officer and treasurer in the Americas.

### **Steven Burns**

FCA, AGE 47

Mr Burns is currently chief executive officer of QBE European operations. He is a chartered accountant and was finance director of the Janson Green managing agency at Lloyd's from 1987, prior to it being acquired by Limit in 1998. Mr Burns became CEO of the Limit Group in August 2000. In September 2004 he was appointed CEO of European operations as part of the restructure of our European company operations and Lloyd's division.

### **Peter Grove**

AGE 56

Mr Grove is currently chief underwriting officer for QBE European operations and the reinsurance adviser to the Group's chief executive officer. He joined QBE in 2000 as a result of the acquisition of Limit and was formerly underwriting director at Bankside managing agency from 1996, prior to it being acquired by

Gayle Tollifson, Tim Kenny, Steven Burns, Peter Grove, Jenni Smith, Neil Drabsch, Frank O'Halloran, Vince McLenaghan, Duncan Ramsay, Mark ten Hove and Raymond Jones





Limit in 1998. Mr Grove has 39 years experience in the London market and has been a lead underwriter of reinsurance and retrocession business at Lloyd's for 23 years.

**Jenni Smith**

MBA, AGE 43

Ms Smith joined QBE in 2003 and is currently the Group general manager, human resources. She was formerly general manager HR, international at Telstra Corporation Ltd., based in Sydney with specific Asia-Pacific responsibilities. Before relocating to Australia in 1999, Ms Smith had extensive business and human resources experience in London in the advertising and television industries.

**Neil Drabsch**

FCA, FAICD, FCIS, AGE 57

Mr Drabsch was appointed chief financial officer of QBE Insurance Group in 1994 and acts as deputy company secretary of QBE Insurance Group Limited. He joined QBE in 1991 and was the Group company secretary from 1992 to 2001. Mr Drabsch has over 39 years experience in insurance and reinsurance management, finance and accounting, including 24 years as a practising chartered accountant.

**Frank O'Halloran**

FCA, AGE 59

Mr O'Halloran was appointed chief executive officer in January 1998. He joined QBE in 1976 as Group financial controller. He was appointed chief financial officer in 1982, joined the board as director of finance from 1987 to 1994 and was director of operations from 1994 to 1997. Mr O'Halloran is a chartered accountant and has had extensive experience in professional accountancy for 14 years and insurance management for over 29 years.

**Vince McLenaghan**

FANZIIF, AGE 46

Mr McLenaghan is currently chief executive officer of Australia Pacific Asia Central Europe ("APACE"). Mr McLenaghan has been in the insurance industry for 29 years. During his 23 years with QBE, he has served in a number of general management roles, including as managing director, within our Asia-Pacific operations prior to assuming his current role in 2005.

**Duncan Ramsay**

LLB, LLM, FANZIIF, FCIS, AGE 44

Mr Ramsay joined QBE as general counsel in 1993. Since May 2001 he has acted as general counsel and Group company

secretary. Prior to joining QBE, Mr Ramsay spent seven years working for Freehills, an Australian law firm, in the general commercial and litigation area.

**Mark ten Hove**

MBA, LLM, AGE 48

Mr ten Hove joined QBE in 1999 as Group investment manager, having previously been chief investment officer at OCBC Asset Management Limited in Singapore. He has over 20 years experience in funds management including previous roles with Bankers Trust in Hong Kong and Singapore and Thornton Investment Management (Dresdner Bank Group) in Hong Kong.

**Raymond Jones**

AGE 54

Mr Jones is currently Group general manager, business development. He joined QBE as managing director of Australian operations in 1994 after several years in Asia as a regional vice president for the American International Group. He was previously general manager at Citicorp Insurance and has 19 years experience in the general insurance market.



# Operations overview

## KEY ACTIVITIES

### Australia Pacific Asia Central Europe

#### Australia

- General insurance operations throughout Australia
- Provides all major lines of insurance cover for personal and commercial risks

#### Pacific Asia Central Europe

- General insurance in Asia, Pacific and Central Europe
- Ongoing operations in 24 countries
- Provides personal, commercial and specialist insurance covers, including professional and general liability, marine, corporate property and trade credit

## MAJOR EVENTS

- No major catastrophes in the year
- Integrated the Australian, QBE Mercantile Mutual and Asia-Pacific and Central European management structures in May 2005
- Introduced builders' warranty product in Australia
- Entered into a joint venture to market a limited medical malpractice product
- Acquired National Credit Insurance Brokers and Austral Mercantile Collections to enhance trade credit distribution and services
- Acquired the wholly owned business of Allianz in Vietnam and sold our share of the QBE-BIDV joint venture

### European operations

#### QBE Insurance (Europe)

- Reinsurance business in the UK and Ireland
- Insurance business in the UK, France, Spain and Germany
- Includes Ensign motor business acquired in April 2004

#### Lloyd's division (trading as Limit)

- Commercial insurance and reinsurance business operating in the Lloyd's market
- Market leading positions in all lines of business written
- Second largest managing agent at Lloyd's with approximately 6.8% share of total market capacity for the 2006 underwriting year
- Manages four ongoing syndicates

- Acquired Greenhill underwriting agency and Minibus Plus
- Fully integrated the European operations management structure
- Successfully merged former company reinsurance operations into syndicates 566 and 2000
- Experienced above average frequency and severity of catastrophe and risk losses, including significant US hurricane activity
- Merged syndicates 2724 and 1036 for the 2005 underwriting year
- Sold Garwyn, our non-core loss adjusting business

### the Americas

- General insurance and reinsurance business in the Americas
- Headquarters in New York with operations in North, Central and South America and Bermuda

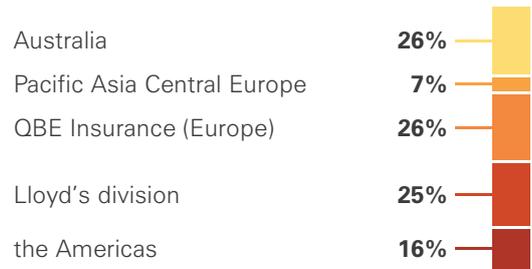
- Acquired Colorado based National Farmers Union Property and Casualty Company
- Experienced above average frequency and severity of US catastrophe losses
- Further diversified our Latin American portfolio with the acquisition of Compania Central de Seguros in Colombia

### Investments

- Management of the Group's investment funds
- Funds are predominantly managed in-house

- US federal reserve bank raised interest rates eight times from 2.25% to 4.25%
- Oil prices rose from US\$43 to US\$60 per barrel
- Core price inflation increased albeit slowly
- US and Euro two year yields rose strongly
- Apparent stability in the Japanese economy for the first time in 10 years
- Strong Australian and European equity markets

**Percentage of Group's gross earned premium**



**ACHIEVEMENTS**

- Achieved record combined operating ratio and insurance profit
- Achieved planned synergies for 2005 from integration of head office operations
- Developed a shared services model to enhance efficiency and consistency across information technology, human resources, risk management, finance and internal audit
- Developed our product distribution capability
- Commenced projects to consolidate information technology platforms in Australia with plans for new platforms in Asia and Pacific regions

**KEY STATISTICS**

- Gross written premium \$3,122M
- Gross earned premium \$3,093M
- Net earned premium \$2,551M
- Combined operating ratio 83.3%
- Staff numbers 5,302

- Maintained core focus on the underwriting of a predominantly non-US casualty account
- In difficult market conditions broadly maintained price and achieved stability in terms and conditions
- Successfully reorganised our business to create a more focused and transparent underwriting business model
- Successfully integrated the acquisitions
- Mitigated impact of catastrophe activity through the purchase of effective and cost efficient reinsurance programmes
- Successfully relocated the majority of staff into two new offices
- Increased share of syndicate 386 to 69.2% for 2006 underwriting year

- Gross written premium \$4,794M
- Gross earned premium \$4,643M
- Net earned premium \$3,697M
- Combined operating ratio 92.1%
- Staff numbers 1,651

- Despite increased catastrophe claims, maintained strong underwriting profitability across all major product classes
- Upgraded management information systems
- Achieved premium rate increases for most reinsurance and insurance classes of business with continued product and geographic diversification
- Benefited from opportunities presented by market dislocation across the Americas

- Gross written premium \$1,492M
- Gross earned premium \$1,435M
- Net earned premium \$843M
- Combined operating ratio 92.9%
- Staff numbers 729

- Fixed income and equity returns exceeded internal benchmarks
- Higher investment income driven by strong mid-year rally in equity markets
- Continuation of low risk investment strategy and the short duration fixed income strategy was successful
- Ongoing enhancements to funds management and treasury systems
- Used derivatives to secure equity gains for the year

- Gross investment income \$843M
- Net investment income \$718M
- Fair value gains – equities \$129M
- Staff numbers 41

# Australia Pacific Asia Central Europe

## KEY RATIOS

FOR THE YEAR ENDED 31 DECEMBER		AUSTRALIA		PACE		TOTAL APACE	
		2005	2004	2005	2004	2005	2004
Gross written premium	\$M	2,431	2,102	691	672	3,122	2,774
Gross earned premium	\$M	2,405	2,114	688	684	3,093	2,798
Net earned premium	\$M	2,015	1,763	536	514	2,551	2,277
Claims ratio	%	56.1	61.4	40.8	43.6	52.9	57.4
Commission ratio	%	12.7	13.8	18.7	18.1	14.0	14.8
Expense ratio	%	14.8	14.5	22.8	24.7	16.4	16.8
Combined operating ratio	%	83.6	89.7	82.3	86.4	83.3	89.0
Insurance profit to net earned premium	%	24.2	16.1	22.2	17.9	23.8	16.5

Australia Pacific Asia Central Europe ("APACE") produced an outstanding underwriting result with a combined operating ratio of 83.3% compared with 89.0% last year.

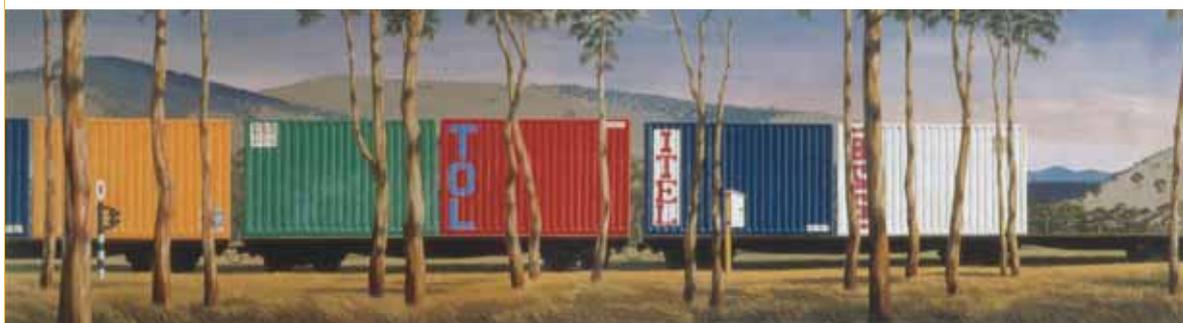
The merger of Australian operations and Pacific Asia Central Europe was announced in May 2005. The merged division brought together operations in 25 countries with much in common in terms of product range, distribution channels and methods of transacting business.

Gross earned premium for the year increased 11% to \$3,093 million. Net earned premium was up 12% to \$2,551 million. Premium growth was mainly due to acquisitions made in the second half of 2004, partly offset by the impact of a stronger Australian dollar. Net earned premium also benefited from savings through the restructure of reinsurance programmes following the acquisitions in 2004.

## Australia

## PORTFOLIO MIX

	GROSS EARNED PREMIUM FOR THE YEAR ENDED 31 DECEMBER	
	2005	2004
Professional indemnity	5.2%	6.2%
Credit and surety	4.7%	5.2%
Accident and health	7.3%	5.8%
Property	16.6%	15.7%
Motor vehicle	9.3%	8.9%
Travel	1.8%	1.9%
Householders	10.6%	9.8%
Compulsory third party ("CTP")	7.4%	9.0%
General liability	18.7%	18.2%
Workers' compensation	8.2%	9.2%
Marine and aviation	4.6%	4.6%
Other	5.6%	5.5%



Australian operations continues to produce excellent underwriting results with a combined operating ratio of 83.6% compared with 89.7% last year. A continuation of the low frequency of claims, savings on prior year outstanding claims provisions and improved customer retention have assisted the strong underwriting profitability.

QBE continues to be a market leader for most of the commercial products that we underwrite in Australia. All portfolios produced underwriting results ahead of plan. Premium rates for public and professional liability and CTP insurance have decreased to reflect the improved claims experience, particularly from recent tort reforms introduced by various state governments with the support of the federal government.

Gross earned premium increased 14% to \$2,405 million due to the acquisition of ING's 50% share in the QBE Mercantile Mutual joint venture underwriting agency on 30 June 2004. Overall premium rates were down slightly on 2004 reflecting the lower frequency of claims and increased competition. Net earned premium increased 14% to \$2,015 million.

The successful integration of the QBE Mercantile Mutual joint venture into QBE's Australian operations has enabled us to achieve synergies of \$40 million. It also enabled us to restructure our Australian operations into seven core units and still maintain our focus on product profitability. The new units are:

- specialist risk;
- intermediary distribution;
- third party distribution;
- credit and surety;
- statutory classes;
- aviation; and
- direct distribution.

Australian operations won the National Insurance Brokers' General Insurer of the Year award for the fourth successive year. This, together with other initiatives designed to make QBE easier to do business with, has enabled us to increase customer retention. We continue to remove duplicated processes and reduce manual intervention in our dealings with our intermediaries.

The continuation of a low frequency of claims has resulted in the net claims ratio decreasing from 61.4% to 56.1%. The commission ratio decreased from 13.8% to 12.7%, mainly due to benefits from the acquisition of underwriting agencies and the change in mix of business.

The expense ratio was 14.8% compared with 14.5% last year, with the increase due to one-off expenses relating to the restructure and higher information technology costs, statutory charges and compliance costs.

Many of our products improved underwriting profitability, including aviation, professional liability, workers' compensation, general liability, property, credit and surety, commercial packages, CTP and our direct underwriting unit, Western QBE.

In 2005, we commenced writing builders' warranty and medical malpractice insurance in Australia. This follows changes made by various state governments to improve the claims experience and affordability of these classes of insurance.

Overall premium rates were slightly down for the renewal of 1 January 2006 business with no major adverse changes to terms and conditions. We are satisfied that the current market conditions allow us to meet our profit requirements for each product. We expect the combined operating ratio going forward to be slightly higher than the excellent result achieved in 2005 due to the lower premium rates over the past two years.

**QBE intermediary distribution is a leader in the highly competitive commercial insurance market with a comprehensive range of corporate, commercial, rural and domestic insurance products. This was recognised during the year when QBE won the prestigious NIBA General Insurer of the Year award for the fourth consecutive year.**



"Container train in landscape" 1983-84, Victorian Arts Centre

## Pacific Asia Central Europe

### PORTFOLIO MIX

<b>GROSS EARNED PREMIUM FOR THE YEAR ENDED 31 DECEMBER</b>		<b>2005</b>	<b>2004</b>
Professional indemnity		10.4%	9.4%
Marine		11.1%	10.0%
Workers' compensation		6.0%	4.8%
Motor and motor casualty		18.8%	18.8%
Property		24.8%	25.3%
Accident and health		7.5%	8.1%
Liability		7.5%	7.8%
Engineering		3.2%	2.9%
Travel		3.0%	3.8%
Householders		3.5%	2.8%
Other		4.2%	6.3%

Our Pacific Asia Central Europe ("PACE") operations produced another outstanding underwriting result with a combined operating ratio of 82.3% compared with 86.4% last year. 21 of the 24 operations produced an underwriting profit in 2005. The improved underwriting profit was driven by the continued focus on portfolio profitability and a lower frequency of catastrophe losses.

Gross earned premium increased 1% to \$688 million. Premium growth was affected by the stronger Australian dollar, a slight reduction in overall premium rates and increased competition. Net earned premium increased 4% to \$536 million.

The claims ratio was 40.8% compared with 43.6% last year. The frequency of claims continues to be at an historically low level reflecting the higher premium rates of recent years, improved terms and conditions and the focus on underwriting profitability. The commission ratio was 18.7% compared with 18.1% last year with the increase due to the change in geographic mix. The expense ratio decreased from 24.7% to 22.8%, mainly due to the elimination of a number of duplicate processes in key operations.

We continue to increase business retention and grow our specialist product lines through international and local insurance brokers. We are considering a number of acquisitions that are capable of being bolted on to existing operations. We are targeting businesses where we can obtain management and shareholder control. We will not enter into any arrangements where QBE is not in control of its own destiny.

PACE business is conducted in 24 countries where we have shareholder and management control and a strong distribution base of over 11,000 agents and longstanding business relationships with key insurance brokers. We have excellent relationships with our joint venture partners in Asia and Central Europe.

Strong underwriting profits were achieved in Bulgaria, Fiji, French Polynesia, Hong Kong, Hungary, Indonesia, Macau, Malaysia, New Caledonia, New Zealand, Papua New Guinea, Philippines, Singapore, Slovakia, Solomon Islands, Thailand, Ukraine and Vanuatu. Macedonia, Moldova and the Vietnam joint venture produced small underwriting losses from general insurance. Satisfactory results were achieved in all other countries.

## Summary

The merger of APACE operations will bring further synergies to the division. We have exceeded our expected synergies for 2005 and we expect to achieve a further \$30 million of synergies by the end of 2007. We have already started to make better use of our diverse professional skills to meet our clients' requirements in the many countries in which we operate.

The 2005 underwriting profit was an outstanding achievement with most of our operations and products producing improved underwriting profits. We will continue to focus on building our businesses in each of the countries in which we operate, including acquisitions that add value, and on exceeding the Group's profit requirements.



“The guiding spheres II” 1979-80, private collection

Through operations in 71 offices in 24 countries, and a geographically diverse network of insurance agencies, brokers and other intermediaries, PACE offers a number of highly specialised products including policies which provide coverage for cargo in transit by sea, land and air.

Our key objectives for 2006 are to:

- complete the integration of divisional resources to deliver synergies and improved customer focus;
- drive further cost reductions by improving processes and cooperation across operating entities;
- launch a new initiative to improve the distribution of new products and capabilities to the Australian and Asia-Pacific markets;
- begin roll out of new information technology platforms across Asia, Central Europe and New Zealand;
- finalise the consolidation of the Australian information technology environment to improve business to business capability, sales and customer retention; and
- target and convert acquisitions that meet our criteria for profit and premium growth.

We expect 2006 underwriting profitability to be strong but with a slightly higher combined operating ratio than 2005. We have a strong team of professionals and management. I extend my appreciation to the team for their loyalty, hard work and dedication during 2005. I also thank our joint venture partners and our intermediaries for their support and assistance throughout the year.

**Vince McLenaghan**

# European operations

## KEY RATIOS

FOR THE YEAR ENDED 31 DECEMBER		QBE INSURANCE (EUROPE)		LIMIT		EUROPEAN OPERATIONS	
		2005	2004	2005	2004	2005	2004
Gross written premium	\$M	2,558	2,301	2,236	2,309	4,794	4,610
Gross earned premium	\$M	2,370	2,154	2,273	2,265	4,643	4,419
Net earned premium	\$M	1,954	1,787	1,743	1,720	3,697	3,507
Claims ratio	%	62.3	67.3	63.6	59.3	62.9	63.4
Commission ratio	%	15.3	15.5	20.3	21.0	17.7	18.2
Expense ratio	%	12.4	12.8	10.6	11.3	11.5	12.1
Combined operating ratio	%	90.0	95.6	94.5	91.6	92.1	93.7
Insurance profit to net earned premium	%	16.8	9.6	12.4	13.9	14.7	11.7

QBE's European operations comprise QBE Insurance (Europe) (formerly European company operations) and the Lloyd's division, trading as Limit.

The combined operating ratio for European operations was 92.1% compared with 93.7% last year. This is an excellent result considering the level of catastrophe claims we experienced during 2005 from Limit and QBE Insurance (Europe), both of which write marine, energy and property reinsurance and insurance risks around the world including the US. The combined operating ratio benefited from our product and geographic diversification, as well as the low frequency of claims on our non-catastrophe exposed businesses.

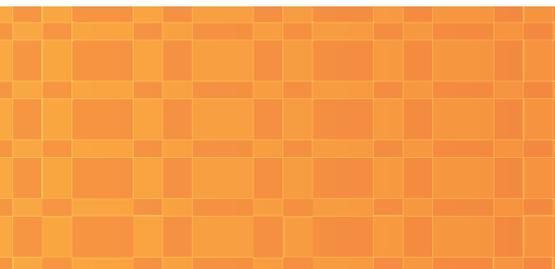
Gross earned premium increased by 5% to \$4,643 million, primarily due to acquisitions during the year and reinstatement premiums from reinstating covers after the catastrophes. Net earned premium increased 5% to \$3,697 million.

In 2005, we completed: the acquisition of the MiniBus Plus underwriting agency and its commercial motor business; the acquisition of the Greenhill underwriting agency with offices in France, Spain and Germany; the acquisition by the Group of British Marine and its specialist small tonnage marine underwriting business; and the sale of Garwyn, the non-core loss adjusting business.

## QBE Insurance (Europe)

## PORTFOLIO MIX

GROSS EARNED PREMIUM FOR THE YEAR ENDED 31 DECEMBER		2005	2004
	Professional indemnity	14.2%	13.0%
	Financial and credit	2.8%	4.6%
	Marine and aviation	4.6%	4.2%
	Accident and health	3.3%	4.8%
	Bloodstock	2.3%	2.1%
	Property treaty	5.5%	6.2%
	Property facultative and direct	9.6%	11.7%
	Employers' liability	13.7%	16.8%
	Motor vehicle	18.1%	8.1%
	Casualty	4.3%	5.1%
	Public and product liability	18.8%	21.2%
	Other	2.8%	2.2%



QBE Insurance (Europe) writes reinsurance business in Ireland and the UK and insurance business in the UK, France, Spain and Germany.

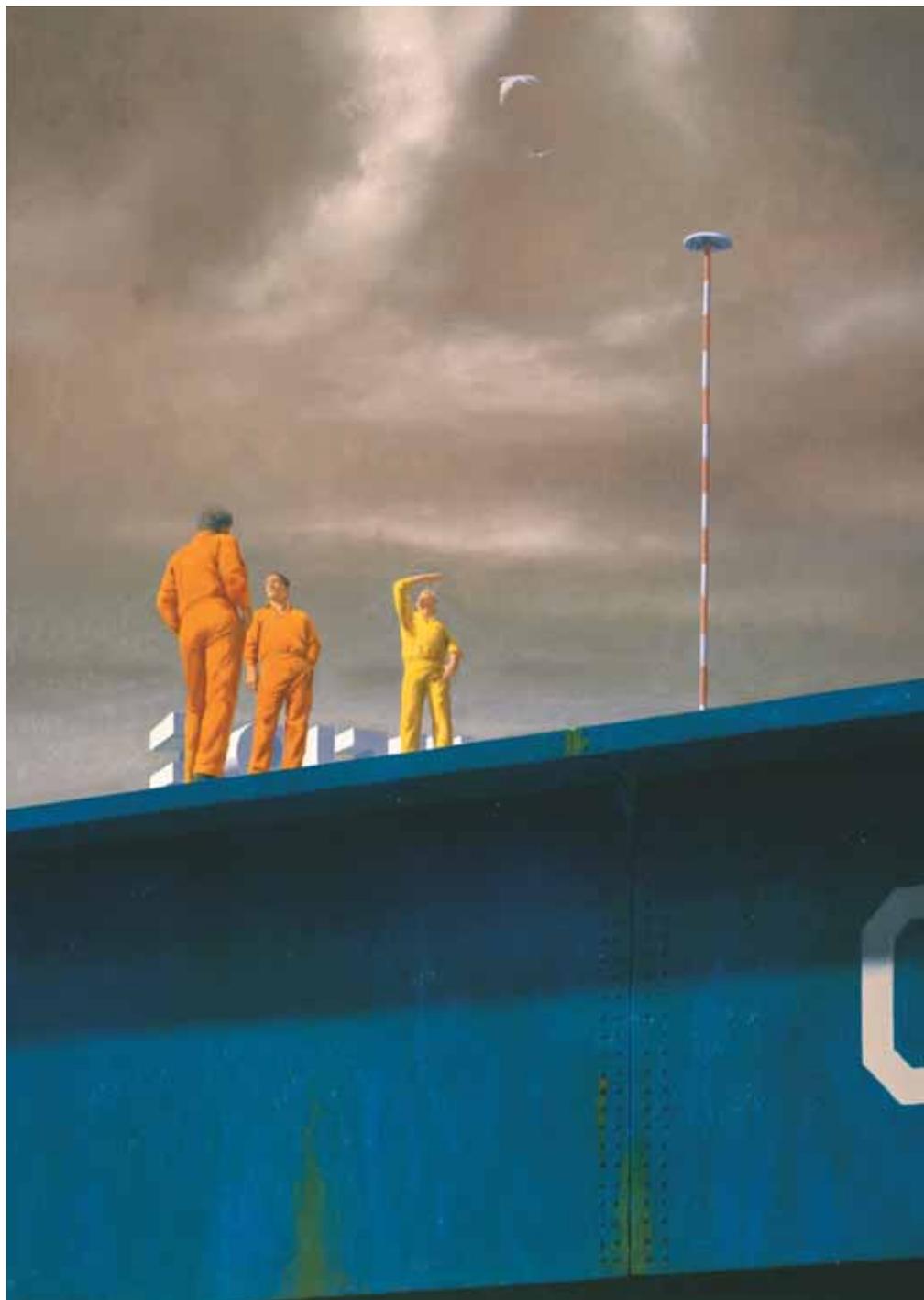
This division produced an excellent combined operating ratio of 90.0% compared with 95.6% last year. The division had a relatively small net exposure to the US hurricanes through its direct and facultative property and marine excess of loss portfolios. The combined operating ratio benefited from a low frequency of claims on the majority of portfolios not exposed to catastrophes, particularly on the UK and international (non-US) casualty accounts.

Gross earned premium increased 10% to \$2,370 million, primarily due to the inclusion of the Ensign motor business previously written in the Lloyd's division, the increased participation on that business for 2005, and acquisitions. Premium growth was also assisted by a strong increase in our business retention and a number of new business and distribution initiatives.

The claims ratio decreased from 67.3% to 62.3%. This improvement reflects the low claims frequency as well as the absence of upgrades for 2001 and prior years on US casualty and motor excess of loss claims which affected results in 2004.

The commission ratio was 15.3% compared with 15.5% for 2004. The slight decrease is due to the change in mix of business. The expense ratio decreased from 12.8% to 12.4%. This reflects the synergies from the restructure announced in September 2004, partly offset by provisions made for dilapidation and other costs incurred to achieve synergies by consolidating premises in the UK.

The general insurance operations produced a combined operating ratio of 84.5% compared with 89.1% last year. The improvement reflects the strong



"The bridge builders" 1990, private collection

**QBE Insurance (Europe) provides innovative commercial insurance and reinsurance solutions, focusing on specialist risk business in selected markets. QBE is a market leader in the areas of public and product liability, employers' liability and professional indemnity, including cover for architects and engineers.**

focus on portfolio performance and improved market conditions over the past four years. The UK and international (non-US) casualty portfolios produced excellent results, as did the more niche

bloodstock, leisure and sport and crisis management accounts. Our Ensign motor business produced an acceptable return in a more challenging market.

The combined operating ratio from inward reinsurance operations was 109.6% compared with 113.6% last year reflecting the higher level of catastrophes in both years. The improvement in 2005 is largely due to the absence of prior year upgrades which affected 2004.

For the 2006 underwriting year, most of the reinsurance business written by the London office of QBE Insurance (Europe) has been transferred to Limit. The transfer of this reinsurance business will be more than offset by the MiniBus Plus, Greenhill and British Marine acquisitions made in 2005, together with other new business initiatives on the existing portfolios.

## Limit

### PORTFOLIO MIX

<b>GROSS EARNED PREMIUM FOR THE YEAR ENDED 31 DECEMBER</b>	<b>2005</b>	<b>2004</b>
Professional indemnity	13.4%	13.6%
Marine and aviation	9.9%	12.3%
Property	36.0%	36.8%
Casualty	30.2%	31.8%
Other	10.5%	5.5%

In the 2005 underwriting year, Limit was the largest manager and second largest provider of capacity at Lloyd's. QBE provided 100% of capacity for syndicates 566, 2000 and 1036 and 68% of capacity for syndicate 386.

Limit's results for 2005 were materially affected by catastrophe claims. However, the diversification of our business, including an exceptional contribution from the non-US casualty portfolios in syndicate 386, has enabled us to produce a very creditable combined operating ratio of 94.5% compared with 91.6% last year. Limit's net claims from large catastrophes were \$285 million compared with \$140 million last year.

Gross earned premium was only marginally up on last year at \$2,273 million due to the transfer of the Ensign motor business to QBE Insurance (Europe). Premium growth was also affected by slightly lower premium rates and increased competition, particularly for casualty business. Net earned premium increased by 1% to \$1,743 million, reflecting synergies achieved by combining reinsurance protections for the reinsurance and marine and energy syndicates.

The claims ratio increased from 59.3% to 63.6%. The increase is due to higher net claims from catastrophes, partly offset by a lower frequency of claims on non-catastrophe exposed classes of business, in particular syndicate 386.

The commission ratio decreased from 21.0% to 20.3%, primarily from a change in mix of business. The expense ratio decreased from 11.3% to 10.6%. Higher incentives for increased profits from syndicate 386 and additional property costs associated with the restructure in 2004 were more than offset by the increased profit commission from external capital providers to syndicate 386.

The combined operating ratio from the general insurance business was 90.2% compared with 91.4%. This excellent result reflects the lower frequency of claims on non-catastrophe exposed business, particularly casualty classes written principally by syndicate 386. The inward reinsurance combined operating ratio was 100.8% compared with 91.9% last year. The increase is due to net claims from catastrophes during 2005.

The transfer of the inward reinsurance business from QBE Insurance (Europe), higher premium rates for property, marine and energy classes and new opportunities will assist premium growth in 2006.

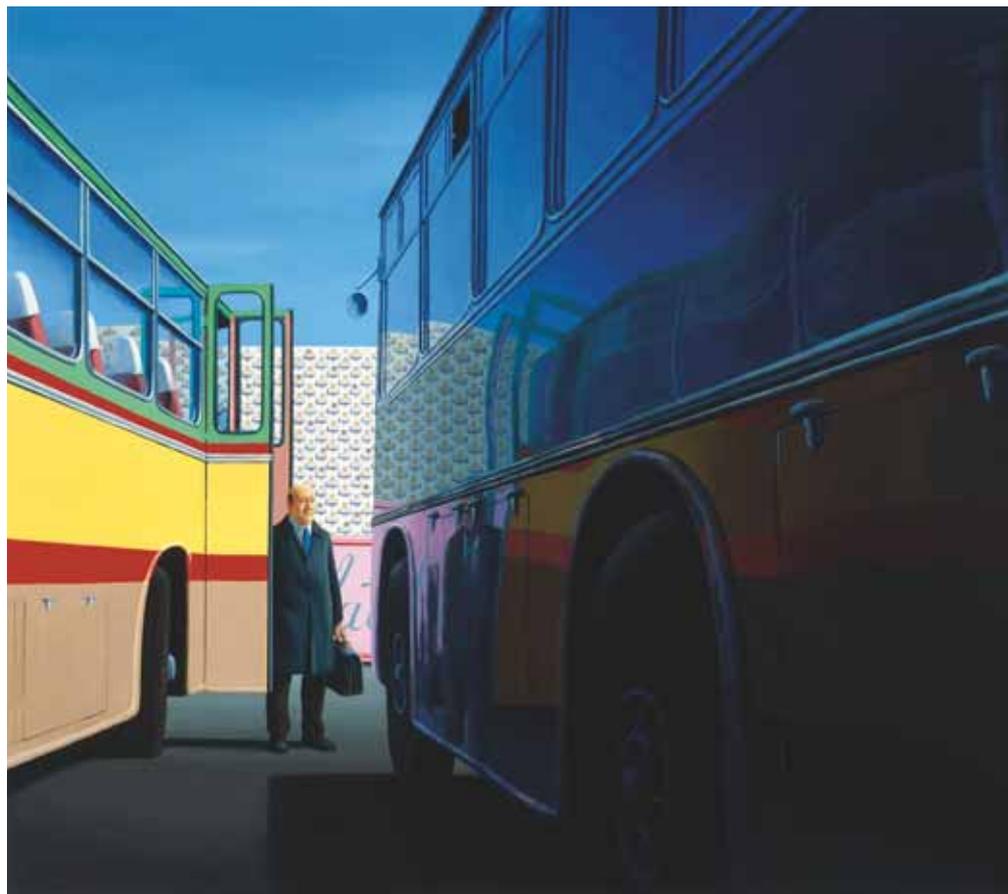
## Summary

The major renewal season of 1 January 2006 gives us confidence that an overall increase of around 5% in premium rates can be achieved in 2006 for European operations. The net increase contains significant increases on direct and reinsurance business exposed to catastrophes, particularly in the US, offset by some rate pressures on casualty and non-catastrophe portfolios. The positive impact of the overall premium rate increases will be partly offset by the higher cost of reinsurance.

We have reviewed the impact of the 2005 hurricanes on our business and made further changes to our risk profile to improve the reward for our shareholders. Our exposure to windstorms will be reduced on the east coast of the US and Gulf of Mexico for property and offshore energy business. We have also significantly reduced the capacity provided to US nationwide property insurers.

The expected overall increase in premium rates together with the MiniBus Plus and Greenhill acquisitions and the Group's acquisition of British Marine will assist gross written premium growth in 2006. We are looking at opportunities to further diversify our products and our continental European operations. We have exceeded our initial targets for synergies from the restructure of European operations in September 2004 and we expect to achieve the previously announced synergies during 2006 and 2007.

Our extensive risk management and conservative reinsurance purchasing have enabled us to achieve a very acceptable underwriting result for 2005. This, together with the overall premium rate increases, further changes to our portfolios and expense synergies, gives us confidence regarding our performance for 2006.



"The traveller" 1973, Queensland Art Gallery

**QBE's European operations is recognised as a leader in providing insurance cover in the UK for commercial motor risks, specialising in insurance protection for bus and minibus transport.**

Our key objectives for 2006 are to:

- deploy our specialist products to a wider client base through our enhanced distribution channels from 2005 acquisitions;
- deliver previously announced back office integration synergies by 31 December 2006 one year ahead of plan and develop a second phase, incremental cost saving plan;
- seek acquisition opportunities that meet QBE criteria and address local priorities of diversifying product mix and geographic spread;
- work with regulators and market associations to achieve local industry priorities e.g. contract certainty; and
- continue to refine risk management processes and techniques that protected the result and balance sheet so effectively in 2005 including aggregate exposure management and a conservative reinsurance strategy.

The past 15 months have seen significant changes in our European operations as a result of the restructure and our determination to improve returns for our shareholders. I am extremely pleased that we have been able to make these changes with little turnover of our key staff. I appreciate the enormous support that I have received from my team. I thank them for their focus, hard work and their contribution to the strong 2005 result.

**Steven Burns**



# the Americas

## KEY RATIOS

FOR THE YEAR ENDED 31 DECEMBER		2005	2004
Gross written premium	\$M	1,492	1,382
Gross earned premium	\$M	1,435	1,354
Net earned premium	\$M	843	766
Claims ratio	%	60.0	59.3
Commission ratio	%	25.5	27.0
Expense ratio	%	7.4	7.2
Combined operating ratio	%	92.9	93.5
Insurance profit to net earned premium	%	10.3	7.0

## PORTFOLIO MIX



GROSS EARNED PREMIUM FOR THE YEAR ENDED 31 DECEMBER		2005	2004
Property		37.4%	36.7%
Casualty		25.0%	25.1%
Motor and motor casualty		13.3%	17.4%
Accident and health		15.5%	17.4%
Workers' compensation		2.8%	1.4%
Other		6.0%	2.0%

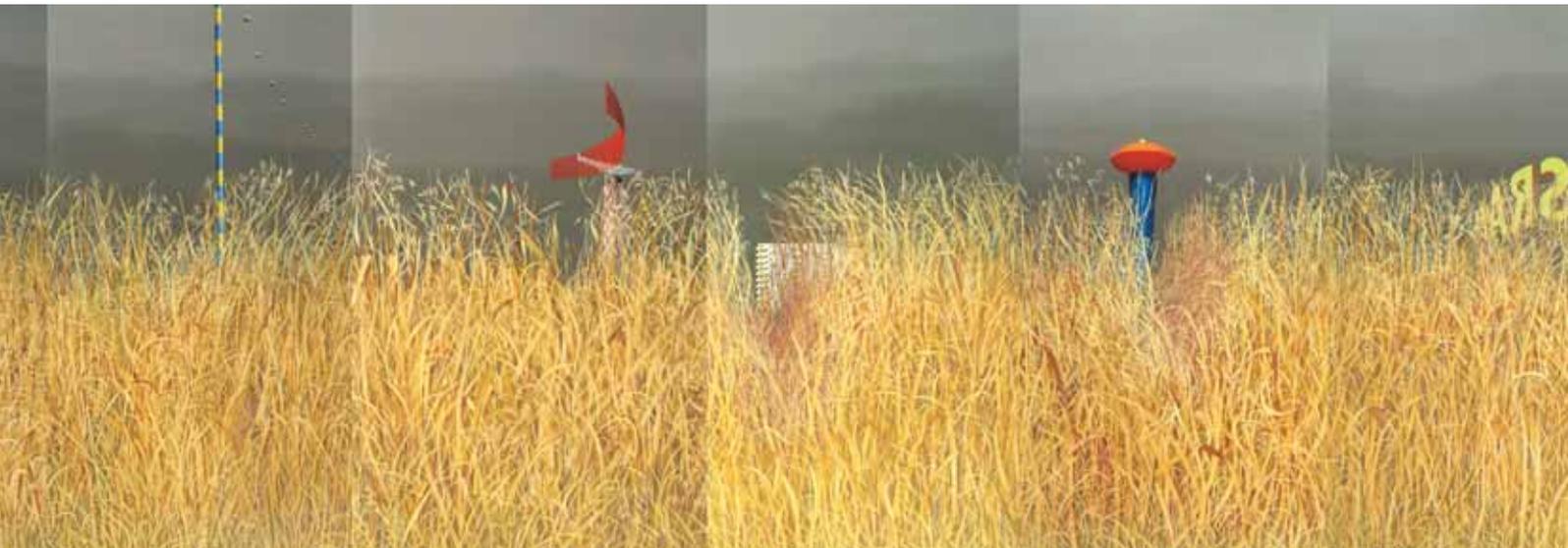
QBE the Americas comprises general insurance and reinsurance businesses in the United States and Colombia, reinsurance businesses in Panama, Mexico and Peru and general insurance businesses in Argentina and Brazil.

QBE the Americas has again increased its underwriting profit despite the worst year on record for catastrophes. The combined operating ratio was an excellent 92.9% compared with 93.5% last year.

Gross earned premium increased 6% to \$1,435 million. This follows a slight overall increase in premium rates, higher retention of business and the acquisition of general insurance businesses in Bogota, Colombia (June 2005) and Colorado, USA (September 2005).

Net earned premium increased 10% to \$843 million. Business ceded to highly rated reinsurers includes a substantial amount of proportional reinsurance on general insurance programme business. This generates overriding commissions and profit commissions for QBE. Of the total reinsurance cost of \$592 million, 71% related to proportional reinsurance. QBE's reinsurance captive, Equator Re, participates on a number of these proportional reinsurance programmes.

The net claims ratio was 60.0% compared with 59.3% last year. Our continued low claims ratio is due to our focus on portfolio profitability, extensive reinsurance protections, the general improvements in policy terms and conditions in recent years and our very low exposure to long tail US casualty business.



“City landscape” 1969-70, Art Gallery of NSW

During 2005 QBE acquired the Colorado based National Farmers Union Property and Casualty Company which writes personal and commercial business in nine mid-west states, including an exclusive agency with the National Farmers Union, and is also a leading national underwriter of rural telecommunications business.

The commission ratio was 25.5% compared with 27.0% last year, with the reduction mainly due to profit and overriding commissions from the proportional reinsurance protections. The expense ratio increased slightly from 7.2% to 7.4%, primarily from the higher expense ratio on acquisitions made during the year, increased staff incentives from improved insurance profitability and increased costs of information technology, compliance and risk management.

General insurance business now represents 71% of total gross written premium compared with 67% last year. This increase reflects our strategy of focusing on general insurance programme business and general insurance acquisitions and, where possible, converting reinsurance relationships into primary insurance. The combined operating ratio from our general insurance business was 93.0% compared with 94.7% last year. Our reinsurance business, which is primarily US regional and Latin American business, produced a combined operating ratio of 92.6% compared with 92.0% last year. The result was impacted by net claims from catastrophes.

All products produced satisfactory underwriting results, as did the acquisitions made during the year. Our focus on selected regional portfolios in the US means that we are not as exposed to major catastrophes as others who write nationwide accounts and large risks. We generally do not write long tail US casualty or US workers' compensation business.

We continue to build on our relationships with our existing client base, pursue acquisitions that meet our criteria and add new general insurance programme businesses with profitable track records. We are a leader in the market segments in which we operate.

We expect gross written premium to grow by more than 15% in 2006 as a result of the acquisitions completed in 2005 and higher overall premium rates. The cost of our reinsurance has increased but this will be substantially exceeded by the premium rate increases on the majority of business renewed and written during the year. We are reviewing a number of acquisitions and new opportunities, some of which we expect will be converted in 2006.

The QBE team in the Americas is proud of its performance in recent years. We have absorbed 2001 and prior year upgrades of claims from business no longer written and still met the Group's profit requirements. Our focus is on further increasing the profits for our shareholders and building on our excellent businesses throughout the Americas. We will continue to analyse market conditions and look for further opportunities for profitable growth. We remain committed to pricing adequacy, underwriting integrity and a counter-cyclical approach to insurance and reinsurance for property, casualty and health business using our admitted and non-admitted licences. The recent acquisition of National Farmers Union

Property and Casualty introduces us to regional US personal lines insurance which is consistent with our strategy of “focused diversification”.

Our key objectives for 2006 are to:

- fully integrate our newly acquired businesses in the US and Latin America;
- achieve portfolio profitability targets in our approved business plans;
- continue to pursue acquisition opportunities consistent with QBE's criteria and objectives;
- further enhance product development in trade credit and other specialist classes; and
- reduce the expense ratio through information technology and infrastructure improvements and synergies.

I express my sincere appreciation for the enormous support and loyalty that I have received from our team in the Americas and for their contribution to the strong insurance profit for 2005.

**Tim Kenny**

# Investments

## INVESTMENT INCOME

FOR THE YEAR ENDED 31 DECEMBER	2005 \$M	2004 \$M
Dividends	41	52
Interest	567	483
Realised gain on the sale of controlled entities	11	–
Other income	8	14
	627	549
Realised gains (losses) on fixed interest securities	61	(31)
Realised gains on equities	94	54
Unrealised gains on fixed interest securities	26	18
Unrealised gains on equities	35	47
Net fair value gains on financial assets	216	88
Gross investment income	843	637

Investment income for 2005 was well ahead of budget and our internal investment benchmarks. This outperformance was due to our active investment management and strong equity markets in Australia and Europe. The results for the year were achieved on our low risk investment strategy with targets based on achieving absolute returns. Our investment team has outperformed the absolute return targets in six out of the past seven years.

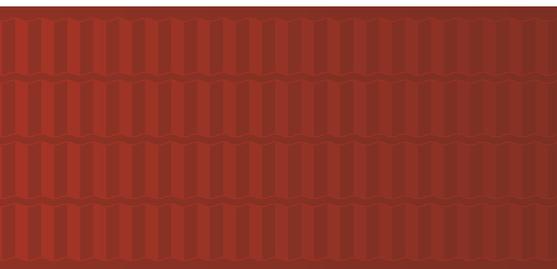
Gross investment income was \$843 million compared with \$637 million last year. The Group's gross investment yield on cash and fixed interest securities increased from 3.9% to 4.3% and the overall gross yield including equities was 5.2% compared with 4.8% last year. Net investment income including borrowing costs, foreign exchange gains and losses and investment expenses increased from \$519 million to \$718 million. The gross and net investment income included realised and unrealised gains on equities of \$129 million before tax compared with gains of \$101 million before tax last year. Due to our concerns about the high level of equity markets, we locked in a substantial portion of our equity gains in August and September through the use of derivatives.

At 31 December 2005 we held listed equities at 3.7% of total investments and cash. Our equity portfolio, which was substantially protected by derivatives, was invested 54% in Australia, 37% in the UK, 2% in the US and 7% in portfolios in other countries. Our cash and fixed interest portfolios have an average maturity of 0.6 years with only one small portfolio in a recent acquisition having an investment maturity over three years. We expect the duration to increase in 2006 as interest rate cycles reach their peak.

The strong cash flow and recent acquisitions have resulted in a 17% increase in net invested funds from \$13.2 billion at 31 December 2004 to \$15.5 billion at 31 December 2005. We continue to maintain a policy of matching liabilities with assets of the same currency where practical and matching all "tradable" overseas shareholders' funds back into Australian dollars. The nature of our business is such that we will have slight mismatches from time to time which, for 2005, has resulted in a small exchange gain of \$3 million compared with a gain of \$51 million last year. The gain in 2004 arose principally due to adjustments on transition to AIFRS, which are explained in note 2 to the financial statements.

Our low risk absolute return strategy remains in place. In the current environment this means a relatively short duration fixed income portfolio and for equities, which are held mainly to support our shareholders' funds, gradually rebuilding our portfolio on a selective basis.

The rise in US interest rates over the past 12 months, the substantial increase in investment funds in 2005 and our expectation of continued strong cash flow create a positive outlook



Approximately 99% of investments held by the Group are highly liquid.



"The Reservoir Centennial Park" 1988-89, Queensland Art Gallery

for investment income in 2006. We expect interest rates to increase slightly in the US and there are reasonable indications that some equity markets will continue to rise, albeit at a much lower rate than 2005. Our comprehensive investment model, which enables us to review the implications of numerous investment scenarios and asset allocations, has been a valuable tool for actively managing our investment portfolio.

Our key objectives for 2006 are to:

- achieve or outperform our absolute return targets for 2006;
- maintain tight control over the risk profile of our investment portfolio;
- continue investing in our people and our systems; and
- contain costs as a percentage of funds under management to internationally competitive levels.

Our investment team has excelled in 2005 with a substantial outperformance on financial targets and internal benchmarks. I appreciate the enormous support that I received from my team during the past year.

**Mark ten Hove**

## TOTAL INVESTMENTS AND CASH

AS AT	31 DECEMBER 2005		31 DECEMBER 2004	
	\$M	%	\$M	%
Cash	1,061	6.0	1,121	7.5
Short term money	8,292	47.1	5,482	36.6
Fixed interest securities and other	7,537	42.9	6,957	46.5
Equities	674	3.8	1,383	9.2
Investment properties	33	0.2	32	0.2
<b>Total investments and cash</b>	<b>17,597</b>	<b>100.0</b>	<b>14,975</b>	<b>100.0</b>

## CURRENCY MIX

MARKET VALUE OF EQUITIES	2005 %	2004 %	MARKET VALUE OF TOTAL INVESTMENTS AND CASH	2005 %	2004 %
Australian dollar	53.8	36.7	Australian dollar	30.2	28.0
US dollar	2.2	22.8	US dollar	23.3	25.5
Sterling	37.1	28.2	Sterling	33.8	34.1
Other	6.9	12.3	Other	12.7	12.4

## Shareholder information

QBE is incorporated in Australia, is listed on the Australian Stock Exchange ("ASX") and trades under the code "QBE".

### Annual General Meeting ("AGM")

11:00am Friday, 7 April 2006  
The Westin Hotel, 1 Martin Place  
Sydney NSW Australia

### Voting rights of ordinary shares

The constitution provides for votes to be cast:

- on a show of hands, one vote for each shareholder; and
- on a poll, one vote for each fully paid ordinary share.

### Shareholder information and enquiries

Most enquiries and correspondence regarding shareholdings can be directed to QBE's share registrar:

Link Market Services Limited  
(formerly ASX Perpetual Registrars Limited)  
Locked Bag A14  
Sydney South NSW 1235 Australia

Level 12, 680 George Street  
Sydney NSW 2000 Australia

Telephone: +61 2 8280 7158  
Facsimile: +61 2 9287 0303  
Internet: [www.linkmarketservices.com.au](http://www.linkmarketservices.com.au)  
Email: [registrars@linkmarketservices.com.au](mailto:registrars@linkmarketservices.com.au)

Please quote your Securityholder Reference Number ("SRN") and provide details of your previous address for security purposes.

If you are broker sponsored, queries relating to incorrect registrations and changes to name and/or address can only be processed by your stockbroker. Link Market Services ("Link") cannot assist you with these changes. Please quote your Holder Identification Number ("HIN").

### Relevant interests register

Orient Capital Pty Limited of 20 Bridge Street, Sydney NSW 2000, Australia maintains QBE's register of information about relevant interests. The register contains any responses from custodians on and after 1 January 2005 to searches relating to the beneficial ownership of QBE's shares. Shareholders and other parties can telephone Orient Capital on +61 2 9251 2700 or facsimile on +61 2 9251 1299 if they wish to inspect this register.

### Shareholding details online

View your shareholdings and update your details online at the Link investor service centre website. You will be asked to provide either your SRN or HIN, your surname and postcode.

You may receive dividend statements, notices of meetings, annual reports and major company announcements electronically by registering your email address at the Link investor service centre website.

Online proxy voting is available through the Link investor service centre website.

### Removal from annual report mailing list

If you do not wish to receive a copy of the annual report, please notify Link in writing or visit the Link investor service centre website.

The half yearly results summary to 30 June 2006 will be mailed with the interim dividend. The next annual report for the year ending 31 December 2006 will be distributed in March 2007. QBE does not produce a concise financial report.

### Tax File Number ("TFN"), Australian Business Number ("ABN") or exemption

You can confirm whether you have lodged your TFN, ABN or exemption by visiting the Link investor service centre website. If you choose not to lodge these details, QBE is obliged to deduct tax at the highest marginal rate (plus the Medicare levy) from the unfranked portion of dividends paid. Australian shareholders living abroad should advise Link of their resident status as limited exemptions to tax deductions may apply. TFN forms are available from Link or can be downloaded from either the QBE or Link websites.

### Dividends

QBE revised the terms of its Dividend Reinvestment Plan ("DRP") and Dividend Election Plan ("DEP") in January 2004. In particular, the revised terms:

- require a minimum shareholding of 100 shares for participation; and
- round the dividend amount up or down to the nearest whole cent and round the number of shares allocated up or down to the nearest whole share, rather than the previous practice of rounding up.

The DRP enables you to apply to subscribe for additional shares. The DEP is a bonus share plan whereby the dividend entitlement is forgone for bonus shares in lieu of the dividend.

Participants may change their election to participate in the DRP and DEP at any time. DRP/DEP election cutoff dates and application forms are available from QBE's website.

QBE encourages shareholders to have cash dividends credited directly to a bank, building society or credit union account in Australia, to eliminate delays in funds clearance and to significantly reduce the risk of loss or theft. A dividend advice confirming the deposit details is either mailed to you or is available online on the payment date.

### Unpresented cheques/unclaimed monies

Under the *Unclaimed Moneys Act 1962*, unclaimed dividends must be given to the state treasury. It is very important that shareholders bank outstanding dividend cheques promptly and advise Link immediately of changes of address or bank account details.

### Privacy legislation

Chapter 2C of the *Corporations Act 2001* requires information about you as a security holder (including your name, address and details of the securities you hold) to be included in QBE's share register. These details must continue to be included in the public register even if you cease to be a security holder. A copy of the privacy policy is available on Link's website.

### Registered office

QBE Insurance Group Limited  
Level 2, 82 Pitt Street  
Sydney NSW 2000 Australia

Telephone: +61 2 9375 4444  
Facsimile: +61 2 9235 3166  
Internet: [www.qbe.com](http://www.qbe.com)

### QBE website

QBE's website provides investors with information about QBE including annual reports, half yearly reports and announcements to the ASX. The website also offers regular QBE share price updates, a calendar of events, a brief history of QBE's dividends, access to standard forms (change of address, direct credit advice and more) and the ability to verify shareholding details.

## RECENT QBE DIVIDENDS

DATE PAID	TYPE	RECORD DATE	CENTS PER SHARE	FRANKING %
1 April 1998	interim	11 March 1998	8.0	50
2 October 1998	final	15 September 1998	18.0	50
26 March 1999	interim	5 March 1999	8.5	50
1 October 1999	final	10 September 1999	18.5	50
31 March 2000	interim	10 March 2000	14.0	10
29 September 2000	final	11 September 2000	15.0	35
12 April 2001	final	26 March 2001	16.0	30
28 September 2001	interim	7 September 2001	16.5	25
12 April 2002	final	25 March 2002	13.5	15
3 October 2002	interim	13 September 2002	16.5	12
11 April 2003	final	19 March 2003	18.5	12
25 September 2003	interim	1 September 2003	20.0	15
25 March 2004	final	9 March 2004	22.0	30
20 September 2004	interim	30 August 2004	24.0	50
23 March 2005	final	7 March 2005	30.0	50
16 September 2005	interim	29 August 2005	33.0	50

## TOP TWENTY SHAREHOLDERS AS AT 31 JANUARY 2006

NAME OF REGISTERED SHAREHOLDER	NUMBER OF SHARES	% OF TOTAL
JP Morgan Nominees Australia Limited	186,273,193	23.45
Westpac Custodian Nominees Limited	140,798,739	17.73
National Nominees Limited	115,624,018	14.56
ANZ Nominees Limited	64,062,596	8.07
Citicorp Nominees Pty Limited	44,115,317	5.56
Cogent Nominees Pty Limited	22,058,546	2.78
Queensland Investment Corporation (c/- National Nominees Limited)	15,994,253	2.01
HSBC Custody Nominees (Australia) Limited	9,997,765	1.26
AMP Life Limited	9,834,781	1.24
Westpac Financial Services Limited	7,306,872	0.92
UBS Nominees Pty Ltd	3,979,243	0.50
RBC Dexia Investor Services Australia Nominees Pty Limited	3,475,564	0.44
Victorian WorkCover Authority (c/- National Nominees Limited)	3,401,763	0.43
IAG Nominees Pty Limited	3,032,504	0.38
Suncorp Custodian Services Pty Limited	2,869,268	0.36
Australian Foundation Investment Company Limited	2,459,487	0.31
Perpetual Trustee Company Limited	2,284,048	0.29
Transport Accident Commission (c/- National Nominees Limited)	1,898,105	0.24
Choiseul Investments Limited	1,636,235	0.21
UBS Wealth Management Australia Nominees Pty Limited	1,487,588	0.19
<b>TOTAL</b>	<b>642,589,885</b>	<b>80.93</b>

## QBE SUBSTANTIAL SHAREHOLDERS AS AT 31 JANUARY 2006

NAME	NUMBER OF SHARES <sup>(1)</sup>	% OF TOTAL <sup>(1)</sup>	DATE OF NOTICE
UBS Nominees Pty Ltd and its related bodies corporate	71,138,018	9.15	21 December 2005
The Capital Group Companies Inc	61,499,274	7.91	22 December 2005
AXA Asia Pacific Holdings Limited	40,795,608	5.25	9 December 2005
Barclays Global Investors Australia Limited	38,779,454	5.04	27 July 2005

(1) % of total at date of notice.

## DISTRIBUTION OF SHAREHOLDERS AND SHAREHOLDINGS AS AT 31 JANUARY 2006

SIZE OF HOLDING	NUMBER OF SHAREHOLDERS	%	NUMBER OF SHARES	%
1-1,000	19,927	47.79	10,380,803	1.31
1,001-5,000	17,747	42.56	39,398,029	4.96
5,001-10,000	2,352	5.64	16,537,855	2.08
10,001-100,000	1,499	3.60	36,010,464	4.54
100,001 or more	171	0.41	691,684,543	87.11
<b>TOTAL</b>	<b>41,696</b>	<b>100.00</b>	<b>794,011,694</b>	<b>100.00</b>

## SHAREHOLDINGS OF LESS THAN A MARKETABLE PARCEL AS AT 31 JANUARY 2006

	NUMBER OF SHAREHOLDERS	%	NUMBER OF SHARES	%
Holdings of 26 or less shares	614	1.47	7,843	0.00

## Financial calendar and ASX announcements

### FINANCIAL CALENDAR

#### 2006

23 February	Profit and dividend announcement for the year ended 31 December 2005 Annual report available on website
6 March	Shares begin trading ex-dividend
7 March	Annual report posted to shareholders with notice of AGM and proxy form
10 March	Record date for determining shareholders' entitlement to 2005 final dividend payment
29 March	2005 final dividend paid
7 April	Annual General Meeting
30 June	Half year end
16 August*	Profit and dividend announcement for the half year ending 30 June 2006
23 August*	Shares begin trading ex-dividend
29 August*	Record date for determining shareholders' entitlement to 2006 interim dividend payment
14 September*	2006 interim dividend paid
31 December	Year end

\* Dates to be confirmed

### QBE ANNOUNCEMENTS TO THE ASX

#### 2005

Announced further exercise of options on achievement of performance hurdles in respect of a 2004 acquisition	21 December
Announced appointment of Isabel Hudson to QBE's board of directors	4 November
Announced acquisition of specialist marine insurer, British Marine Holdings Limited	27 September
Confirmed that QBE's exposure to Hurricane Katrina is within the Group's substantial allowance for large losses and catastrophes	6 September
Announced record half year profit and interim dividend	17 August
Announced acquisition of the UK underwriting agency, MiniBus Plus	16 August
Announced acquisition of US insurance company, National Farmers Union Property and Casualty Company	28 July
Issued statement in response to London terrorist attacks	8 July
Announced changes to structure of senior executive team	2 May
2005 AGM	8 April
Announced acquisitions in Latin America and Europe	1 March
Announced a record 2004 profit and increased dividend	24 February
Announced further conversion of QBE LYONs securities into ordinary shares of the company. Subsequent conversions announced 16 February, 18 February, 25 February, 23 March, 24 March, 3 May, 23 June, 20 July, 19 September and 23 December	4 February
Announced exercise of options issued to a third party as part of the consideration for the acquisition of insurance agency distribution businesses in Australia	14 January

## Board of directors



John Cloney, Len Bleasel AM, The Hon Nick Greiner AC, Isabel Hudson, Belinda Hutchinson, Charles Irby, Irene Lee and Frank O'Halloran

### John Cloney

ANZIIF, FAIM, FAICD, AGE 65  
CHAIRMAN

Mr Cloney joined QBE as managing director in 1981. He retired in January 1998, at which time he became a non-executive director. He was appointed deputy chairman in April 1998 and chairman in October 1998. He is chairman of the chairman's and funding committees, and a member of the investment and remuneration committees. Mr Cloney is a director of Boral Limited, Maple-Brown Abbott Limited and Patrick Corporation Limited. He is chairman of the Create Foundation, a member of the ABN AMRO advisory council and a trustee of the Sydney Cricket & Sports Ground Trust.

### Len Bleasel AM

FAIM, FAICD, AGE 63

Mr Bleasel was appointed an independent non-executive director of QBE in January 2001. He is chairman of the remuneration committee and a member of the audit committee. Mr Bleasel is chairman of Scopenergy Limited. He is also chairman of the Zoological Parks Board of NSW, a member of the ABN AMRO advisory council and is on the advisory boards of various charities.

### The Hon Nick Greiner AC

BEc, MBA, AGE 58

Mr Greiner was appointed an independent non-executive director of QBE in September 1992. He is a member of the audit, chairman's, funding and remuneration committees. He is chairman of Bradken Limited and Bilfinger Berger

Australia, deputy chairman of Stockland Trust Group and a director of McGuigan Simeon Wines Limited. He is a trustee of the Sydney Theatre Company and a director of South Sydney Rugby League Club.

### Isabel Hudson

MA, FCII, AGE 46

Ms Hudson is based in the UK and was appointed an independent non-executive director of QBE in November 2005. She is a member of the audit and remuneration committees. Ms Hudson is a non-executive director of Fineos Corporation Limited. She is a member of the committee of Scope, a UK charity.

### Belinda Hutchinson

BEc, FCA, AGE 52

Ms Hutchinson was appointed an independent non-executive director of QBE in September 1997. She is chairman of the investment committee and a member of the audit and funding committees. She is president of the State Library of NSW Council and a director of Coles Myer Ltd, St Vincent's & Mater Health Sydney Limited and Telstra Corporation Limited. Ms Hutchinson is a consultant to Macquarie Bank.

### Charles Irby

FCA (ENGLAND & WALES), AGE 60

Mr Irby is based in the UK and was appointed an independent non-executive director of QBE in June 2001. He is a member of the investment committee and chairman of the European operations' audit committee. He is chairman of

Aberdeen Asset Management plc and a director of Great Portland Estates plc and North Atlantic Smaller Companies Investment Trust plc. Mr Irby is also a trustee and governor of King Edward VII's Hospital Sister Agnes.

### Irene Lee

BA, BARRISTER-AT-LAW, AGE 52

Ms Lee was appointed an independent non-executive director of QBE in May 2002. She is chairman of the audit committee and a member of the funding and investment committees. Ms Lee is a director of Mariner Financial Limited, Record Investments Limited, Ten Network Holdings Limited and ING Bank (Australia) Limited. She is a member of the Takeovers Panel, the advisory council of JP Morgan Australia and the executive council of the UTS Faculty of Business. Ms Lee is also a trustee of the Art Gallery of New South Wales.

### Frank O'Halloran

FCA, AGE 59

CHIEF EXECUTIVE OFFICER

Mr O'Halloran was appointed chief executive officer in January 1998 and is a member of the chairman's, funding and investment committees. He joined QBE in 1976 as Group financial controller. He was appointed chief financial officer in 1982, joined the board as director of finance from 1987 to 1994 and was director of operations from 1994 to 1997. He has had extensive experience in professional accountancy for 14 years and insurance management for over 29 years.

# Corporate governance statement

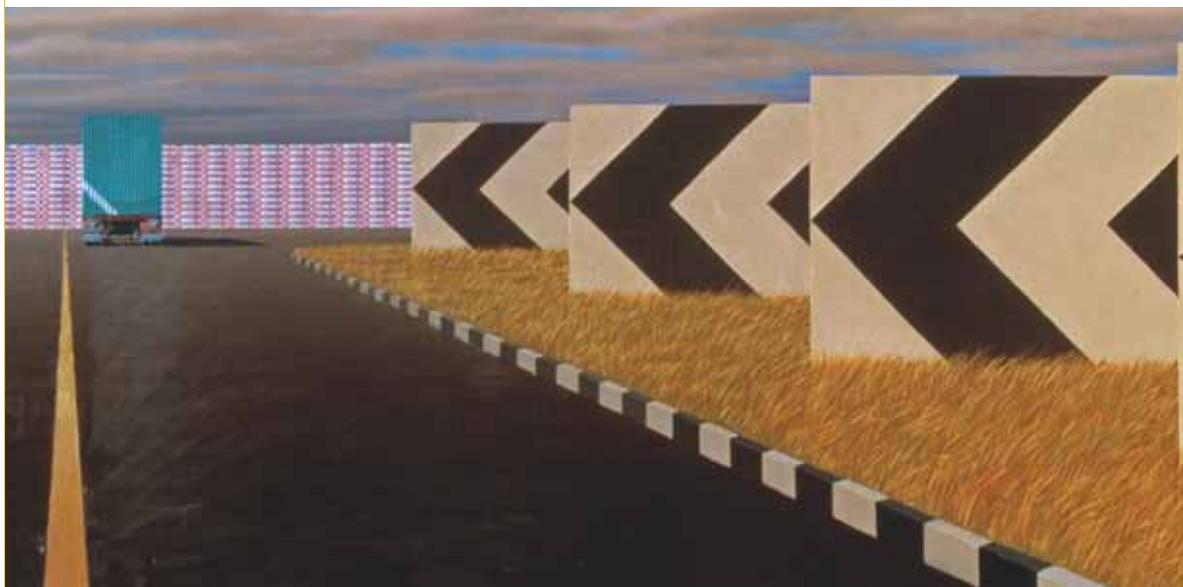
This statement aims to disclose as clearly and objectively as possible QBE's corporate governance standards and practices so that they can be readily understood by our shareholders, policyholders and other stakeholders. QBE also continues to focus on other equally important issues such as the strength of its outstanding claims provision, the quality of its reinsurers and the depth of its culture of honesty, integrity and business acumen.

## BOARD OF DIRECTORS

Directors are selected to achieve a broad range of skills, experience and expertise complementary to the Group's activities. These details for individual directors are included on page 39 and can also be found on the QBE website. The board comprises eight directors being the chairman, the chief executive officer and six independent non-executive directors, using the "independence" definition of the ASX Corporate Governance Council. Applying this definition, the board has determined that a non-executive director's relationship with QBE as a professional adviser, consultant, supplier, customer or otherwise is not material unless amounts paid under that relationship exceed 1% of the Group's revenue or expenses.

A majority of the board is independent, being six out of eight directors. The roles of chairman and chief executive are not exercised by the same individual.

As a general guide, the board has agreed that a non-executive director's term should be approximately 10 years. The board considers that a mandatory limit on tenure would deprive the Group of valuable and relevant corporate experience in the complex world of international general insurance and reinsurance. Although The Hon NF Greiner AC has been a non-executive director for more than 10 years, the other directors believe that he remains independent of management and continues to demonstrate independent judgment in decision making.



The chairman has 50 years involvement in the insurance industry, including over 16 years as managing director of QBE until he retired in January 1998. He became chairman in October 1998. The chairman's former executive capacity with QBE has been fully disclosed to shareholders, who re-elected him as a director by an overwhelming majority at the 2003 AGM. QBE's other directors consider that the chairman exercises independent judgment. Further, they believe it is in shareholders' and policyholders' interests to retain his wealth of experience and have resolved that he should continue in that role. However, the chairman is not considered to be an "independent" director as recommended by the ASX Corporate Governance Council because there was less than a three year period between him acting as managing director and being appointed chairman.

The chairman oversees the performance of the board, its committees and each director. The board review procedure

involves a periodic assessment of the entire board, with the review of each director comprising a combination of written questions and answers covering areas concerned and interviews with each director. The chairman reports the overall result to the board as a whole and it is discussed by all directors. This review procedure is a precursor to other directors determining whether to support, via the notice of meeting, a non-executive director for re-election at an AGM.

QBE's constitution provides that no director except the chief executive officer shall hold office for a continuous period in excess of three years or past the third annual general meeting following a director's appointment, whichever is the longer, without submission for re-election at the next AGM. Under QBE's constitution, there is no maximum fixed term or retirement age for non-executive directors.

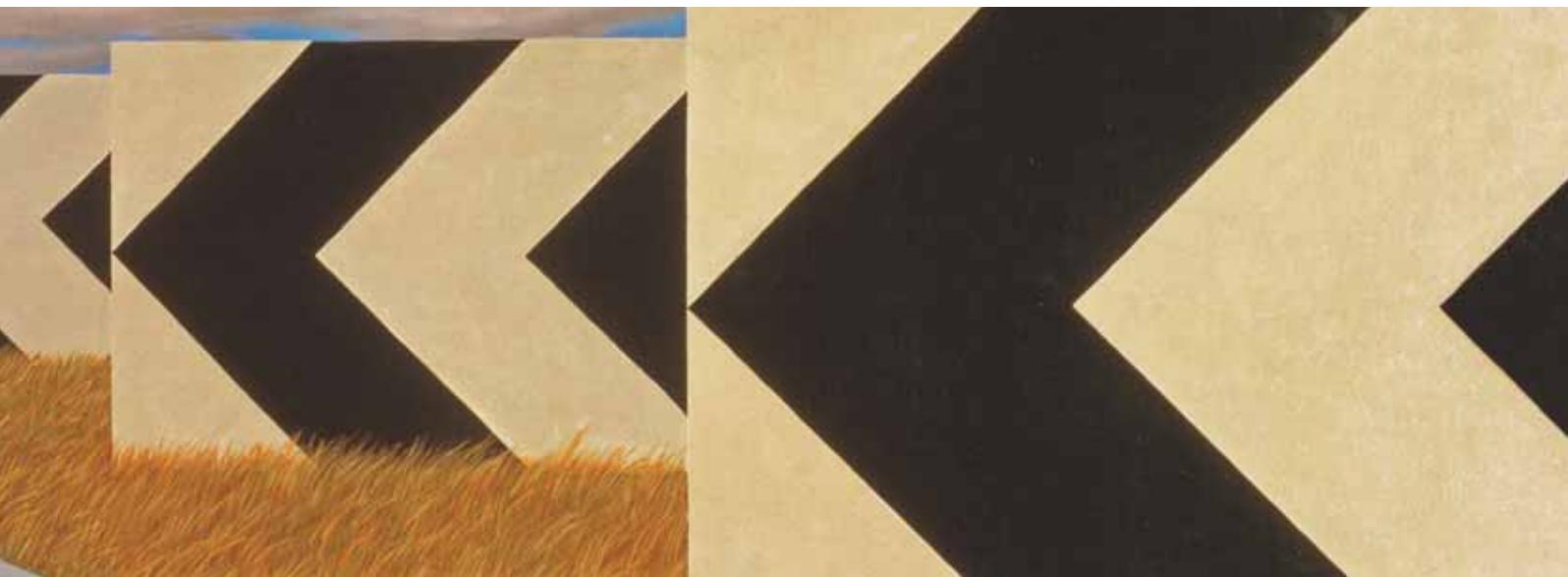
Directors advise the board on an ongoing basis of any interest they have that they

believe could conflict with QBE's interests. If a potential conflict does arise, either the director concerned may choose not to, or the board may decide he or she should not, receive documents or take part in board discussions whilst the matter is being considered.

Under QBE's constitution, management of the Group is vested in the board. In particular, the board:

- oversees corporate governance;
- selects and supervises the chief executive officer;
- provides direction to management;
- approves the strategies and major policies of the Group;
- monitors the achievement of strategies and policies;
- monitors performance against plan;
- considers regulatory compliance; and
- reviews human resources (including succession planning), information technology and other resources.

"The directors" 1977, Art Gallery of Western Australia



## Corporate governance statement continued

The board ensures it has the information it requires to be effective including, where necessary, external professional advice. A non-executive director may seek such advice at the company's cost with the consent of the chairman. All directors would receive a copy of such advice. Non-executive directors may attend relevant external training courses at QBE's cost with the consent of the chairman.

Strategic issues and management's detailed budgets and three year business plans are reviewed at least annually by the board. The board receives updated forecasts during the year. Visits by non-executive directors to the Group's offices in key locations are encouraged. To help the board to maintain its understanding of the business and to effectively assess management, directors have regular presentations by the divisional chief executive officers and other senior managers of the various divisions on topics including budgets, three year business plans and operating performance, and have contact with senior employees at numerous times and in various forums during the year. The board meets regularly in Australia and at least once a year overseas. Each meeting normally considers reports from the chief executive officer and chief financial officer together with other relevant reports. The board regularly meets in the absence of management. The chairman and chief executive officer in particular, and board members in general, have substantial contact outside board and committee meetings.

### COMMITTEES

The board is supported by several committees which meet regularly to consider the audit process, investments, remuneration and other matters. The main committees of the board are the audit committee, the investment committee and the remuneration committee. These committees operate under a written charter approved by the board. Any non-executive director may attend a committee meeting. The committees have direct and unlimited access to QBE's senior managers during their meetings and may consult external advisers when necessary at QBE's cost, including requiring their attendance at committee meetings. Committee membership is reviewed regularly.

In addition, the board has established a chairman's committee, comprising the chairman, a non-executive director, currently The Hon NF Greiner AC, and the chief executive officer, and a funding committee, comprising the chairman, The Hon NF Greiner AC, Ms BJ Hutchinson, Ms IYL Lee and the chief executive officer. These committees meet as required, including to deal with such matters as are referred by the board from time to time.

The board regularly discusses its composition and is involved in the selection of new members. All directors are members of the nomination committee. External consultants may be engaged where necessary to search for prospective board members. The board has adopted non-executive director nomination guidelines. As a relatively small board of eight directors (including the chief executive officer), the directors believe that this is an efficient mechanism for dealing with this issue.

Details of directors' attendance at board and committee meetings are outlined in the table of meeting attendance set out in the directors' report on page 49. A report on each committee's last meeting is provided to the next board meeting. The company secretary acts as secretary to all committees.

#### **Audit committee**

The membership of the audit committee may only comprise non-executive directors. The audit committee normally meets four times a year. The chairman must be a non-executive director who is not the chairman of the board. The current members are Ms IYL Lee (chairman), Mr LF Bleasel AM, The Hon NF Greiner AC, Ms IF Hudson and Ms BJ Hutchinson.

The role of the audit committee is to oversee the integrity of QBE's financial reporting process. This includes review of:

- the quality of financial reporting to the Australian Securities and Investments Commission ("ASIC"), ASX and shareholders;
- the consolidated entity's accounting policies, practices and disclosures; and
- the scope and outcome of external and internal audits.

The audit committee's responsibilities include the financial statements (including items such as the outstanding claims provision, reinsurance recoveries and income tax), external and internal audit, risk management, internal controls, compliance other than regulatory compliance and significant changes in accounting policies.

The chairman of the board, other non-executive directors and the Group actuary normally attend audit committee meetings which consider the 30 June and 31 December financial reports. Meetings of the audit committee normally include, by invitation, the chief executive officer, the chief financial officer, the chief risk officer, the Group internal audit manager and the external auditor. On occasion, other relevant senior managers also attend.

The audit committee has direct and unlimited access to the external auditor. The external auditor, the Group internal audit manager and the Group actuary have direct and unlimited access to the audit committee.

The chief executive officer and chief financial officer provide the board with certificates in relation to the financial reports and risk management as recommended by the ASX Corporate Governance Council and as required by the *Corporations Act 2001*.

#### **External auditor independence**

QBE firmly believes that the external auditor must be, and must be seen to be, independent. The external auditor confirms its independence in relation to the 30 June and 31 December financial reports and the audit committee confirms this by separate enquiry. The audit committee has contact with the external auditor in the absence of management in relation to the 30 June and 31 December financial reports and otherwise as required. The external auditor normally confers with the audit committee in the absence of management as part of each meeting.

QBE has issued an internal guideline on external auditor independence. Under this guideline, the external auditor is not allowed to provide the excluded services of preparing accounting records, financial reports or asset or liability valuations.

Furthermore, it cannot act in a management capacity, as a custodian of assets or as share registrar. The board believes some non-audit services are appropriate given the external auditor's knowledge of the Group. QBE may engage the external auditor for non-audit services other than excluded services subject to the general principle that fees for non-audit services should not exceed 30% of all fees paid to the external auditor in any one financial year. External tax services are generally provided by an accounting firm other than the external auditor.

The external auditor has been QBE's auditor for many years. As a diverse international group, QBE requires the services of one of a limited number of international accounting firms to act as auditor. It is the practice of QBE to review from time to time the role of the external auditor. The *Corporations Act 2001*, Australian professional auditing standards and the external auditor's own policy deal with rotation and require rotation of the lead engagement partner after five years. In accordance with such policy, the lead engagement partner of the external auditor rotated in 2004.

#### Investment committee

The membership of the investment committee comprises four non-executive directors and one executive director. The investment committee normally meets three times a year. The chairman must be a non-executive director who is not the chairman of the board. The current members are Ms BJ Hutchinson (chairman), Mr EJ Cloney, Mr CLA Irby, Ms IYL Lee and Mr FM O'Halloran. Meetings of the investment committee normally include, by invitation, the Group general manager, investments and the chief financial officer.

The role of the investment committee is to oversee QBE's investment activities. This includes review of:

- investment objectives and strategy;
- investment risk management;
- currency, equity and fixed interest exposure limits;
- credit exposure limits with financial counterparties; and
- Group treasury.

The investment committee's responsibilities include review of economic and investment conditions as they relate to QBE, approval of management's recommended investment strategy and review of investment performance, including the performance of QBE's defined benefit superannuation funds.

#### Remuneration committee

The membership of the remuneration committee may only comprise non-executive directors. The remuneration committee normally meets four times a year. The chairman must be a non-executive director who is not the chairman of the board. The current members are Mr LF Bleasel AM (chairman), Mr EJ Cloney, The Hon NF Greiner AC and Ms IF Hudson. Meetings of the remuneration committee normally include, by invitation, the chief executive officer and the Group general manager, human resources.

The role of the remuneration committee is to oversee QBE's general remuneration practices. The remuneration committee's responsibilities include:

- recommendation of the total remuneration cost ("TRC") of the chief executive officer and approval of the TRC of other members of the Group executive;
- review and approval of short and long term incentives such as equity based plans;
- review of superannuation;
- review of performance measurement criteria and other major human resource practices;
- review of personal development plans for the Group executive and other senior positions; and
- recommendations on non-executive director remuneration.

QBE has operations and staff in 41 countries with differing laws and customs. QBE's remuneration policy therefore needs to reflect the fact that QBE is a global organisation, whilst also taking into account local remuneration levels and practices.

#### Details of remuneration

Details of remuneration of employees and non-executive directors, including employee entitlements under the Employee Share and Option Plan and

Long Term Incentive ("LTI") arrangements are included in the remuneration report on pages 51 to 57 and in notes 27 and 28 to the financial statements.

## RISK MANAGEMENT

QBE's core business is the underwriting of risk. The Group's successful performance over many years clearly establishes its substantial risk management credentials.

Diversification is used as a tool to reduce the Group's overall insurance risk profile by spreading exposures, thereby reducing the volatility of results. QBE's approach is to diversify insurance risk, both by product and geographically. Product diversification is achieved through a strategy of developing strong underwriting skills in a wide variety of classes of business. A combination of core and specialty products under the control of proven employees skilled in such products allows QBE to lead underwrite in many of the markets in which we operate. Geographic diversification is achieved by operating in 41 countries.

QBE has a global risk management framework that defines the risks that QBE is in business to accept and those that we are not, together with the key risks that QBE needs to manage and the framework and standards of control that are needed to manage those risks.

The foundation of our risk management is the obligation and desire to manage our future and create wealth for our shareholders by maximising profitable opportunities through:

- adequate pricing of risk;
- avoiding unwelcome surprises by reducing uncertainty and volatility, such as by controlling aggregate exposures and maintaining sound reinsurance arrangements;
- optimising risk and more effectively allocating capital and resources by assessing the balance of risk and reward;
- achieving competitive advantage through better understanding of the risk environment in which we operate;
- complying with laws and internal procedures; and
- improving resilience to external events.

## Corporate governance statement continued

The Group has established internal controls to manage risk in the key areas of exposure relevant to its business. The broad risk categories are insurance risk, acquisition risk, operational risk and funds management and treasury risk. Internal controls and systems are designed to provide reasonable assurance that the assets of the Group are safeguarded, insurance and investment exposures are within desired limits, reinsurance protections are adequate, counterparties are subject to security assessment and foreign exchange exposures are within predetermined guidelines. The board approves annually a comprehensive risk management strategy ("RMS") and reinsurance management strategy ("REMS"), both of which are lodged with the Australian Prudential Regulation Authority ("APRA"). The RMS deals with all areas of significant business risk to the Group. The REMS covers topics such as the Group's risk tolerance and the Group's strategy in respect of the selection, approval and monitoring of all reinsurance arrangements. The Group security committee assesses reinsurer counterparty security. This management committee normally meets four times a year and holds special meetings as required.

While the RMS and REMS are approved by the board, QBE believes that managing risk is the responsibility of the business units and that all staff need to understand and actively manage risk. The business units are supported by compliance teams and by Group senior management. Information is provided on pages 14 and 15 of the annual report and in notes 4 and 5 to the financial statements.

### Internal audit

A global internal audit function is critical to the risk management process. QBE's internal audit function reports to senior management and the audit committee on the monitoring of the Group's worldwide operations. Internal audit provides independent assurance that the design and operation of the controls across the Group are effective. The internal audit function operates under a written charter from the audit committee. Other governing documents include a reporting

protocol, internal audit manual, internal audit rating system, internal audit opinion levels and internal audit timetables. A risk based internal audit approach is used so that higher risk activities are reviewed more frequently. The Group's internal audit teams work together with the external auditor to provide a wide audit scope.

### Delegated authorities

QBE has operated under an extensive written system of delegated authorities for many years. In particular, a written delegated authority with specified limits is approved by the board each year to enable the chief executive officer to conduct the Group's business in accordance with detailed budgets and business plans. This authority deals with topics such as underwriting, reinsurance protection, claims, investments, acquisitions and expenses. The chief executive officer delegates his authority to management throughout the Group on a selective basis taking into account expertise and past performance. Compliance with delegated authorities is closely monitored by management and adjusted as required for actual performance, market conditions and otherwise. Management and the Group's internal audit teams review compliance with delegated authorities and any breach can lead to disciplinary procedures, including dismissal in serious cases.

### Actuarial review

It is a longstanding practice of the directors to ensure that most of the Group's insurance liabilities are assessed by actuaries. The Group's outstanding claims provision is reviewed by experienced internal actuarial staff. The Group actuary is based in head office and there are over 90 actuarial staff who are involved in forming their own view, separate from management, of the central estimate and the probability of adequacy of the outstanding claims provision and premium liabilities, premium rates and related matters. Over 90% of QBE's outstanding claims provision is also reviewed by external actuaries at least annually. The external actuaries are from organisations which are not associated with the external auditor.

### Insurance and other regulation

General insurance and, to a lesser extent, reinsurance are heavily regulated industries. In addition to the Group's accounting, legal, tax and other professional teams, each division has compliance personnel and there is a Group risk and compliance manager based in head office. In Australia, regulators include ASIC, the Australian Competition and Consumer Commission, APRA, the Australian Privacy Commissioner and relevant state authorities for compulsory third party motor insurance and workers' compensation insurance. These regulatory bodies enforce laws which deal with a range of issues, including capital requirements and consumer protection. Similar local laws and regulations apply to the Group's operations outside Australia.

## COMMUNICATION AND GUIDELINES

### Continuous disclosure

ASX Listing Rule 3.1 requires QBE to inform the ASX immediately once QBE is or becomes aware of any information concerning it that a reasonable person would expect to have a material effect on the price or value of QBE's shares. Procedures are in place to ensure that items which potentially require announcement to the ASX are promptly notified to head office for assessment and released as required. The chief executive officer is responsible for authorising the release of market announcements. All market announcements are posted promptly to the Group's website.

QBE takes the spirit of its continuous disclosure obligations very seriously and issues frequent market announcements during the year to satisfy those obligations. A list of the material announcements made since 1 January 2005 is included on page 38.

### Communication with shareholders

QBE distributes an annual report to all shareholders except those who elect not to receive it. QBE also produces a half year report, with a summary sent to all shareholders except those who elect not to receive it. Both reports are available on the QBE website. The website also contains historical and other details on

the Group. Shareholders can discuss their shareholding with either the shareholder services department or the share registrar, both located in Sydney.

The AGM is held in Sydney each year, usually in April. Shareholders are encouraged to attend the AGM in person or by proxy. Most resolutions in the notice of meeting have explanatory notes. During the AGM, shareholders may ask questions of either the chairman or the external auditor.

#### **Communications with analysts, investors, media and others**

The chief executive officer, chief financial officer and chief risk officer generally deal with analysts, investors, media and others, taking account of regulatory guidelines including those issued by the ASX on continuous disclosure.

The presentations on the 30 June and 31 December results and other major presentations are sent to the ASX before the presentations commence and are available promptly on the Group's website. The 30 June and 31 December presentations are also generally webcast. The chief executive officers of QBE's operating divisions and other senior employees may have contact with analysts, investors, media and others as required.

#### **Share trading guidelines**

The company has guidelines for directors and senior Group executives relating to the purchase and sale of securities of the company. These are in addition to the insider trading provisions of the *Corporations Act 2001*. In particular, the guidelines state that directors and senior Group executives should:

- never actively trade the company's securities; and
- notify any intended transaction to nominated people within the Group.

The guidelines identify set periods during which directors or senior Group executives may buy or sell the company's securities, being three to 30 days after each of the release of the company's half year results, the release of the company's annual report and the date of the AGM, and also three days after the issue of any prospectus until the closing date. Any QBE share dealings by directors are promptly notified to the ASX.

#### **Other Group guidelines**

The Group has adopted a code of conduct for Australian operations, Group head office and Group investment division, which forms the basis for the manner in which these employees perform their work. The code of conduct requires that business be carried out in an open and honest manner with our customers, shareholders, employees, regulatory bodies, outside suppliers, intermediaries and the community at large. The code also deals with confidentiality, conflicts of interest and related matters. The non-executive directors have adopted a code of conduct for themselves which is substantially the same as the code above.

Other divisions have or are developing codes of conduct based on the Group code above, with some differences to allow for the requirements of the particular country or countries in which the division operates.

There are other Group policies covering anti-discrimination, employment, harassment, QBE essential behaviours, health and safety, privacy, whistle-blowing and many other business practices.

These policies are underpinned by the Group's vision and values statements. The vision and values statements form part of the induction information given to new employees. One of the core values of the Group is integrity.

QBE in Australia has adopted the general insurance code of practice, a self-regulated code developed by the Insurance Council of Australia ("ICA") relating to the provision of products and services to customers of the general insurance industry of Australia. A revised code commences in July 2006.

QBE in Australia is a member of the Insurance Ombudsman Service, an ASIC approved external dispute resolution body for insurance disputes between consumers and insurers. Similar insurance practice and privacy rules apply to the Group in certain other countries outside Australia.

Details of indemnification and insurance arrangements are included in the directors' report on page 48.

The following documents are available in the corporate governance area of QBE's website or on request from the company secretary:

- board charter;
- audit, investment and remuneration committee charters;
- non-executive director nomination guidelines;
- code of conduct for non-executive directors;
- code of conduct for Australian operations, Group head office and Group investment division;
- guidelines for dealing in securities of QBE Insurance Group Limited or other companies by directors and senior Group executives;
- continuous disclosure guidelines; and
- shareholder communication guidelines.

#### **Environmental issues**

QBE is a corporation involved in an industry that seeks to play an important role, in conjunction with governments, individuals and organisations, in managing and reducing environmental risk. In an initiative to collaborate with the United Nations environment programme, QBE, together with a number of other major international insurers, is a signatory to a statement of environmental commitment by the insurance industry.

# Directors' report

FOR THE YEAR ENDED 31 DECEMBER 2005

Your directors present their report on the consolidated entity consisting of QBE Insurance Group Limited and the entities it controlled at the end of or during the year ended 31 December 2005.

## DIRECTORS

The following directors held office during the whole of the financial year and up to the date of this report:

EJ Cloney (chairman)  
LF Bleasel AM  
The Hon NF Greiner AC  
BJ Hutchinson  
CLA Irby  
IYL Lee  
FM O'Halloran

Mr CP Curran AO retired on 8 April 2005. Ms IF Hudson was appointed as a director on 4 November 2005.

At the forthcoming AGM, Mr Cloney, Ms Hutchinson and Ms Lee will retire by rotation and offer themselves for re-election.

Ms Hudson retires in accordance with article 74 of the company's constitution and offers herself for re-election.

Details of the directors and their qualifications are provided on page 39.

## CONSOLIDATED RESULTS

	2005 \$M	2004 \$M
<b>Revenue</b>		
Premium revenue	9,171	8,571
Other revenue	2,946	1,771
Net fair value gains on financial assets	216	88
Realised gain on sale of controlled entities	11	–
Investment income – ABC financial assets pledged for funds at Lloyd's	84	40
	<b>12,428</b>	10,470
<b>Expenses</b>		
Outward reinsurance premium expense	1,785	1,790
Gross claims incurred	6,744	5,327
Other expenses	2,179	2,061
Expenses – ABC securities for funds at Lloyd's	101	83
Finance costs	96	94
<b>Profit before income tax</b>	<b>1,523</b>	1,115
Income tax expense	425	251
<b>Profit after income tax</b>	<b>1,098</b>	864
Net profit attributable to minority interest	7	7
<b>Net profit after income tax attributable to members of the company</b>	<b>1,091</b>	857

## AUSTRALIAN EQUIVALENTS TO INTERNATIONAL FINANCIAL REPORTING STANDARDS

Adjustments as a result of the adoption of Australian equivalents to International Financial Reporting Standards ("AIFRS") reduced shareholders' funds at 31 December 2004 by \$388 million to \$4,032 million. Adjustments as a result of the adoption of AIFRS increased 2004 net profit after income tax from \$820 million to \$857 million. Details are provided in note 2 to the financial statements.

## SHAREHOLDERS' FUNDS

Shareholders' funds increased during the year by 26% to \$5,093 million at 31 December 2005. The number of shares advised to the Australian Stock Exchange increased from 745 million to 794 million mainly due to the reinvestment of dividends and the conversion of hybrid securities.

## PROFIT

The directors are pleased to announce an increase of 27% in net profit after income tax to \$1,091 million for the year ended 31 December 2005 compared with \$857 million last year, despite significant net claims from large catastrophes. The significant increase in profit reflects the benefit of premium growth from acquisitions, the Group's geographic and product diversification, conservative reinsurance protections and improved investment yields.

## Directors' report continued

FOR THE YEAR ENDED 31 DECEMBER 2005

### DIVIDENDS

The directors are also pleased to announce a final dividend of 38.0 cents per share, 50% franked, for the year ended 31 December 2005. The total dividend for 2005 is 71.0 cents per share compared with 54.0 cents per share for the year ended 31 December 2004. The final dividend payout, including shares issued under the dividend reinvestment and election plans, will be \$302 million compared with \$228 million last year. The directors suspended the discount of 2.5% on the Dividend Reinvestment and Dividend Election Plans in August 2005. The franking account balance on a tax paid basis, after taking into account the final dividend franked at 50%, will be a surplus of \$148 million.

### ACTIVITIES

The principal activities of the company and its controlled entities during the year were underwriting general insurance and reinsurance risks, management of Lloyd's syndicates and investment management.

### REVIEW OF OPERATIONS

Gross earned premium was \$9,171 million, up 7% from last year. Premium growth has been assisted by the acquisitions made in the second half of 2004, primarily the acquisition on 30 June 2004 of ING's 50% interest in the QBE Mercantile Mutual joint venture, and a higher retention of business. Net earned premium increased 9% to \$7,386 million. Reinsurance costs decreased from 21% to 19% of gross earned premium primarily due to synergies from acquisitions and the restructure in the UK in 2004, partly offset by some additional cost to reinstate covers following the catastrophes.

The ratio of claims, commissions and expenses to net earned premium (combined operating ratio) was 89.1% compared with 91.2% last year. The net claims ratio was 59.9% compared with 61.3% last year. The net claims ratio includes \$515 million of large catastrophe claims in 2005 (2004 \$320 million). The commission ratio decreased slightly from 17.5% to 16.9%, reflecting a change in the mix of business and the benefits from the acquisition of underwriting agencies in Australia in 2004. The expense ratio was 12.3%, down slightly from 12.4% last year. The reduction reflects further synergies from acquisitions and restructures, partly offset by higher staff incentives for improved results, increased costs of corporate governance and compliance and one-off restructure costs in the UK and Australia.

#### **Australia Pacific Asia Central Europe**

Australian general insurance combined operating ratio was 83.6% compared with 89.7% last year. The strong result was achieved from a continued low frequency of claims, savings on prior year outstanding claims provisions and improved customer retention. Net earned premium of \$2,015 million was up 14% from the last year, reflecting improved customer retention ratios and the impact of the acquisition of the remaining 50% of the QBE Mercantile Mutual joint venture in 2004. The claims ratio decreased from 61.4% to 56.1%. The commission ratio decreased from 13.8% to 12.7% mainly due to benefits from the acquisition of underwriting agencies in 2004 and the change in the mix of business. The expense ratio increased slightly from 14.5% last year to 14.8% due to one-off expenses relating to the restructure, higher information technology costs, statutory charges and compliance costs.

Pacific Asia Central Europe combined operating ratio was 82.3% compared with 86.4% last year, from the continuous focus on portfolio profitability and the lower frequency of catastrophe claims. Premium growth was affected by the stronger Australian dollar, a slight reduction in overall premium rates and increased competition. Net earned premium increased by 4% to \$536 million. The claims ratio decreased from 43.6% to 40.8% reflecting higher premium rates in recent years, improved terms and conditions, the continued focus on underwriting profitability and the lower frequency of claims. The commission ratio increased from 18.1% to 18.7% reflecting a change in the geographic mix of business, and the expense ratio decreased from 24.7% to 22.8%. Expenses benefited from the elimination of duplicate processes in key operations.

#### **European Operations**

QBE Insurance (Europe), which includes company operations in the UK, Ireland, France, Spain and Germany reported net earned premium growth of 9% to \$1,954 million, primarily due to the inclusion of the Ensign motor business, which was previously written in the Lloyd's division, and the increased participation on that business for 2005. The division produced a combined operating ratio of 90.0% compared with 95.6% last year. The excellent combined operating ratio reflects the low frequency of claims on the majority of portfolios and the relatively small net exposure to the US hurricanes. The net claims ratio was 62.3% compared with 67.3% last year reflecting the low claims frequency as well as the absence of the upgrades for 2001 and prior years that impacted the 2004 result. The commission ratio decreased from 15.5% to 15.3% from a change in the mix of business, and the expense ratio decreased from 12.8% last year to 12.4%. This reflects the synergies from the restructure announced in 2004, partly offset by an increase in the general provision for doubtful debts and provisions for dilapidation and other costs incurred to achieve synergies by consolidating the premises in the UK.

Lloyd's division combined operating ratio was 94.5% compared with 91.6% last year, reflecting the material impact of catastrophe losses during the year. Net earned premium increased 1% to \$1,743 million primarily due to the transfer of the Ensign business to QBE Insurance (Europe), slightly lower overall premium rates and increased competition. The claims ratio increased from 59.3% to 63.6% reflecting the impact of net claims from catastrophe losses partly offset by a lower claims frequency on non-catastrophe exposed classes, in particular syndicate 386. The commission ratio decreased from 21.0% to 20.3% due to a change in the mix of business. The expense ratio decreased from 11.3% last year to 10.6%. Higher incentive costs on increased profits from syndicate 386 and additional property costs associated with the restructure in 2004 were more than offset by increased profit commission from external capital providers to syndicate 386.

## Directors' report continued

FOR THE YEAR ENDED 31 DECEMBER 2005

### the Americas

This division reported net earned premium growth of 10% to \$843 million following a slight overall increase in premium rates, a higher retention of business and the impact of the acquisitions in the second half of the year. The combined operating ratio was 92.9% compared with 93.5% last year. The combined operating ratio improved despite 2005 being the worst year on record for catastrophe claims. The net claims ratio increased from 59.3% to 60.0%. The commission ratio decreased from 27.0% last year to 25.5% mainly due to profit and overriding commissions from the proportional reinsurance protections. The expense ratio increased slightly from 7.2% to 7.4% due to the higher expense ratio on acquisitions in the year, higher staff incentives from improved insurance profitability and increased costs of information technology, compliance and risk management.

The provision for **outstanding claims** is determined after consultation with internal and external actuaries. The outstanding claims assessment takes into account the statistical analysis of past claims, allowance for claims incurred but not reported, recoveries and future interest and inflation factors. As in previous years, the directors consider that substantial prudential margins are required in addition to actuarial central estimates to cover uncertainties such as latency claims, changes in interest rates and superimposed inflation. The APRA prudential standards provide that, for our Australian licensed insurers, outstanding claims must be set at a level that provides a probability of at least 75% that the provision for outstanding claims will be adequate to settle claims as they become payable in the future. The directors and management have set an internal target range of 85% to 94% and the directors have satisfied themselves that the probability of adequacy of the Group's outstanding claims provision is at the high end of this range.

**Net investment income** increased 38% to \$718 million, reflecting the higher US interest rates, continued strong cash flow from operations, stronger equity markets and active management of the investment portfolio. The result includes net fair value gains on equities of \$129 million (\$101 million gain last year) and foreign exchange gains of \$3 million (\$51 million gain last year principally due to the impact of transition to AIFRS). The gross investment yield before borrowing costs, exchange gains and losses and investment expenses was 5.2% compared with 4.8% last year.

**Income tax** expense for the period increased from 23% of profit before tax last year to 28%, primarily due to higher profits in Australia, the US and the UK.

### GROUP INDEMNITIES

Article 115 of the company's constitution provides that the company indemnifies past and present directors, secretaries or officers against any liability for serving in those capacities for the company or its controlled entities. This indemnity does not apply to any liability (excluding legal costs):

- owed to the company or its controlled entities (e.g. breach of directors' duties);
- for a pecuniary penalty or compensation order under the *Corporations Act 2001*; or
- which did not arise out of conduct in good faith.

The indemnity extends to legal costs other than where:

- an exclusion above applies;
- the person is subject to criminal penalties;
- the person is liable for civil remedies in proceedings brought by either ASIC or a liquidator; or
- the court does not grant relief after an application under the *Corporations Act 2001* that, in relation to civil proceedings, the person acted honestly and having regard to all the circumstances ought fairly to be excused for negligence, default, breach of trust or breach of duty in civil proceedings.

Article 115 was approved at the 2003 AGM.

### DIRECTORS' AND OFFICERS' INSURANCE

The consolidated entity pays a premium each year in respect of a contract insuring directors, secretaries, senior managers and employees of the consolidated entity together with any natural person who is a trustee of a superannuation plan established for the benefit of the consolidated entity's employees against liabilities past, present or future. The officers of the consolidated entity covered by the insurance contract include the directors listed on page 46, the secretary, DA Ramsay, and deputy secretaries, NG Drabsch and PE Barnes. Other officers covered by the insurance contract are directors and secretaries of controlled entities who are not also directors and secretaries of the ultimate parent and senior managers of the consolidated entity ("excluded officers").

The functions of the excluded officers are management of insurance related operations, finance, investment and corporate services. In accordance with normal commercial practice, disclosure of the total amount of premium payable under, and the nature of liabilities covered by, the insurance contract is prohibited by a confidentiality clause in the contract.

No such insurance cover has been provided for the benefit of any external auditor of the consolidated entity.

## Directors' report continued

FOR THE YEAR ENDED 31 DECEMBER 2005

### DECLARATIONS BY THE CHIEF EXECUTIVE OFFICER AND CHIEF FINANCIAL OFFICER

The chief executive officer and the chief financial officer have provided declarations to the directors stating that the financial records and annual financial statements are in compliance with the *Corporations Act 2001* and applicable accounting standards. Reference is included on page 126 of the financial report.

### SIGNIFICANT CHANGES

There were no significant changes in the state of affairs of the consolidated entity during the financial year.

### EVENTS SUBSEQUENT TO BALANCE DATE

There is, at the date of this report, no matter or circumstance that has arisen since 31 December 2005 that has significantly affected, or may significantly affect:

- the consolidated entity's operations in future financial years;
- the results of those operations in future financial years; or
- the consolidated entity's state of affairs in future financial years.

### LIKELY DEVELOPMENTS

Information on likely developments in the consolidated entity's operations in future financial years and the expected results of those operations has not been included in this report because disclosure of the information would be likely to result in unreasonable prejudice to the consolidated entity.

### MEETINGS OF DIRECTORS

	FULL MEETINGS OF DIRECTORS <sup>(1)</sup>	AUDIT	MEETINGS OF COMMITTEES		REMUNERATION
			CHAIRMAN'S	INVESTMENT	
Number of meetings held	8	4	2	3	4
<b>Number attended</b>					
LF Bleasel AM	8	4	–	–	4
EJ Cloney	8	–	2	2	4
CP Curran AO <sup>(2)</sup>	2	–	1	1	1
The Hon NF Greiner AC	8	4	–	–	4
IF Hudson <sup>(3)</sup>	1	–	–	–	–
BJ Hutchinson	8	3	1	3	–
CLA Irby	8	–	–	3	–
IYL Lee	8	4	–	3	–
FM O'Halloran	8	–	2	3	–

(1) Included a five day review meeting in London. In addition, directors attended quarterly meetings for each of the Australian regulated insurance companies.

(2) Mr Curran retired on 8 April 2005.

(3) Ms Hudson was appointed on 4 November 2005.

During the April, June, July, August and September 2005 board meetings, the board also met as the nomination committee to consider issues relevant to the appointment of non-executive directors. In addition, further meetings occurred during the year including meetings of the chairman and chief executive officer, meetings of the directors with management and regulators, and meetings of non-executive directors. From time to time, directors attend meetings of committees of which they are not currently members.

## Directors' report continued

FOR THE YEAR ENDED 31 DECEMBER 2005

### DIRECTORSHIPS OF LISTED COMPANIES HELD BY THE MEMBERS OF THE BOARD

From 1 January 2003 to 31 December 2005 the directors also served as directors of the following listed companies:

	POSITION	DATE APPOINTED	DATE CEASED
<b>LF Bleasel AM</b>			
Foodland Associated Limited	Chairman <sup>(1)</sup>	11 March 2004	24 November 2005
St George Bank Limited	Director	27 May 1993	16 December 2005
<b>EJ Cloney</b>			
Boral Limited	Director	3 March 1998	–
Patrick Corporation Limited	Director	1 May 2003	–
<b>The Hon NF Greiner AC</b>			
Bradken Limited	Chairman	13 April 2004	–
McGuigan Simeon Wines Limited	Director	11 September 1992	–
Stockland Trust Group	Deputy chairman	1 September 1992	–
<b>BJ Hutchinson</b>			
Coles Myer Ltd	Director	23 September 2005	–
Crane Group Limited	Director	1 September 1997	9 June 2004
TAB Limited	Director	11 July 1997	6 July 2004
Telstra Corporation Limited	Director	16 November 2001	–
<b>CLA Irby</b>			
Aberdeen Asset Management plc	Chairman	1 August 1999	–
Great Portland Estates plc	Director	1 April 2004	–
North Atlantic Smaller Companies Investment Trust plc	Director	10 December 2002	–
<b>IYL Lee</b>			
Beyond International Limited	Director	30 September 1986	25 November 2004
BioTech Capital Limited	Director	14 June 2000	1 July 2004
Mariner Financial Limited	Director	5 September 1985	–
Record Funds Management Limited	Director	14 May 2002	31 August 2005
Record Investments Limited	Director	16 January 2001	–
Ten Network Holdings Limited	Director	13 October 2000	–

(1) Mr Bleasel was appointed as a director of Foodland Associated Limited on 10 April 2002.

### QUALIFICATIONS AND EXPERIENCE OF COMPANY SECRETARIES

#### **DA Ramsay** LLB, LL.M., FANZIIF, FCIS

Mr Ramsay is general counsel and company secretary of QBE Insurance Group Limited. His legal career commenced in March 1986 with Freehills, where he worked in the general commercial and litigation area. In June 1993, he joined QBE as general counsel. Since May 2001 he has acted as general counsel and company secretary for the consolidated entity. He is also a director or secretary of a number of QBE controlled entities and acts as chairman and a trustee respectively of the QBE superannuation plans in Australia and New Zealand.

#### **NG Drabsch** FCA, FAICD, FCIS

Mr Drabsch was appointed chief financial officer in 1994 and acts as deputy company secretary of QBE Insurance Group Limited in addition to being a director of a number of QBE controlled entities. He joined QBE in 1991 and was the company secretary for the consolidated entity from 1992 to 2001. Mr Drabsch has over 39 years experience in insurance and reinsurance management, finance and accounting, including 24 years as a practising chartered accountant. He is a member of the Finance & Advisory Committee to the Insurance Council of Australia ("ICA"). He was previously a member of other representative committees for the ICA in relation to the development of Australian accounting standards for general insurance.

#### **PE Barnes** FCA

Mr Barnes is deputy company secretary of QBE Insurance Group Limited and company secretary of selected controlled entities in Australia. Mr Barnes has been company secretary of many of QBE's Australian companies since November 1991. He has been responsible for taxation matters in QBE's Australian operations for the past 17 years and was formerly accounting manager in QBE's international division. Prior to joining QBE 18 years ago, Mr Barnes was a manager in the chartered accounting firm Horwath and Horwath. He has for the past 12 years been chairman of the ICA's taxation committee.

## Directors' report continued

FOR THE YEAR ENDED 31 DECEMBER 2005

### DIRECTORS' INTERESTS AND BENEFITS

#### (A) Ordinary share capital

Directors' interests, including the interests of their personally related entities, in the ordinary share capital of the company at the date of this report are as follows:

DIRECTOR	2005 NUMBER	2004 NUMBER
LF Bleasel AM	43,403	42,768
EJ Cloney	734,917	720,410
The Hon NF Greiner AC <sup>(1)</sup>	55,505	53,716
IF Hudson	-	-
BJ Hutchinson	27,446	27,446
CLA Irby	15,000	15,000
IYL Lee	13,956	10,467
FM O'Halloran	1,079,602	1,160,741

(1) Includes 10,000 warrants to purchase ordinary shares.

#### (B) Conditional rights and options

At the date of this report, Mr O'Halloran had 138,038 (2004 89,033) conditional rights to ordinary shares of the company and 344,165 (2004 225,578) options over ordinary shares of the company under the Long Term Incentive ("LTI") scheme. Details of the LTI are provided in note 27 to the financial statements.

The names of all persons who currently hold options granted under the Employee Share and Option Plan ("the Plan") and conditional rights are entered in the registers kept by the company pursuant to section 173 of the *Corporations Act 2001* and the registers may be inspected free of charge.

#### (C) Share loans

At the date of this report, Mr O'Halloran had a non-recourse loan of \$4,335,692 (2004 \$4,335,692) for the purchase of shares in QBE Insurance Group Limited. Under AIFRS, non-recourse loans and the shares they purchased are derecognised and treated as options.

#### (D) Related entity interests

Details of directors' and executives' interests with related parties are provided in note 28(D) to the financial statements.

### REMUNERATION REPORT

Current regulatory requirements are incorporated into this annual report as set out below.

REQUIREMENT	
<b>Corporations Act 2001</b>	
Remuneration policy	Refer remuneration report
Elements of remuneration for each specified individual	Refer remuneration report
<b>AASB 1046: Director and Executive Disclosures by Disclosing Entities</b>	
Director and executive remuneration disclosures	Refer remuneration report
Director and executive equity instrument disclosures	Refer note 28 to the financial statements
<b>ASX Corporate Governance Council: Principle 9</b>	
Remunerate fairly and responsibly	Refer remuneration report

## Directors' report continued

FOR THE YEAR ENDED 31 DECEMBER 2005

### (A) Details of specified directors and specified executives

During the financial year the specified directors and the executives (other than the chief executive officer) with the greatest authority for strategic direction and management of the consolidated entity ("specified executives") were:

#### Non-executive directors

EJ Cloney (chairman)  
 LF Bleasel AM  
 CP Curran AO (retired 8 April 2005)  
 The Hon NF Greiner AC  
 IF Hudson (appointed 4 November 2005)  
 BJ Hutchinson  
 CLA Irby  
 IYL Lee

	POSITION	EMPLOYER	EMPLOYMENT START DATE
<b>Executive director</b>			
FM O'Halloran	Chief executive officer, QBE Insurance Group Limited	QBE Management Services Pty Limited	28 June 1976
<b>Executives<sup>(1)</sup></b>			
SP Burns <sup>(2)</sup>	Chief executive officer, European operations	QBE Management (UK) Limited	1 January 1987
NG Drabsch	Chief financial officer, QBE Insurance Group Limited	QBE Management Services Pty Limited	20 September 1991
PE Grove <sup>(2)</sup>	Chief underwriting officer, European operations	QBE Management (UK) Limited	1 August 1982
MD ten Hove <sup>(3)</sup>	Group general manager, investments, QBE Insurance Group Limited	QBE Management Services Pty Limited	1 March 1999
RL Jones <sup>(4)</sup>	Group general manager, business development, QBE Insurance Group Limited	QBE Management Services Pty Limited	1 April 1994
TM Kenny	President and chief executive officer, the Americas	QBE Reinsurance Corporation	28 November 1994
V McLenaghan	Chief executive officer, Australia Pacific Asia Central Europe	QBE Management Services Pty Limited	14 August 1995
EG Tollifson	Chief risk officer, QBE Insurance Group Limited	QBE Management Services Pty Limited	14 February 1994

(1) All of the above persons were also specified executives during the year ended 31 December 2004. Mr Glen, managing director, European company operations was also a specified executive in the year ended 31 December 2004 until his employment was terminated by way of redundancy on 30 September 2004.

(2) Messrs Burns and Grove were previously employed by Limit Underwriting Limited.

(3) Mr ten Hove was employed by QBE Management (UK) Limited in London from 1 March 2002 until 31 December 2004. With effect from 1 January 2005, he relocated to Australia and is employed by QBE Management Services Pty Limited.

(4) Mr Jones was managing director, Australian operations until 1 May 2005. At that date, the Australian operations and Pacific Asia Central Europe operations were brought together under the leadership of Mr McLenaghan.

The five highest paid executives of the consolidated entity are also specified executives of the consolidated entity. No executives are employed by the parent company.

### (B) Remuneration framework

The remuneration committee of the board oversees remuneration practices. The committee assesses the appropriateness of remuneration policies and practices in order to fairly and responsibly reward executives, ensuring rewards are commensurate with performance and delivered results, and that remuneration levels are market competitive in the various markets in which the consolidated entity operates.

#### (i) Non-executive directors

Non-executive director remuneration reflects the consolidated entity's desire to attract, motivate and retain high quality directors and to ensure their active participation in the consolidated entity's affairs for the purposes of corporate governance, regulatory compliance and other matters. The consolidated entity aims to provide a level of remuneration for non-executive directors comparable with its peers, which include multi-national financial institutions. The board seeks the advice of independent remuneration consultants to ensure that remuneration levels are appropriate.

## Directors' report continued

FOR THE YEAR ENDED 31 DECEMBER 2005

### (ii) Executives

#### REMUNERATION AND REWARD PHILOSOPHY

Remuneration practices vary in each of the markets within which the consolidated entity operates, and therefore the diversity of individual roles and the complexity of each operating environment is considered. The remuneration committee recognises that the consolidated entity operates in a competitive environment, where the key to achieving sustained performance is to generally align executive reward with increasing shareholder wealth.

The guiding principles applied in managing remuneration and reward for executives combine:

- linking individual performance objectives to achievement of financial targets and business strategies;
- the achievement of short term and long term financial business targets that deliver sustained growth in value for shareholders (e.g. return on equity, insurance profit, return on capacity for our Lloyd's business and investment performance); and
- using market data to set fixed annual remuneration levels.

The remuneration committee seeks the advice of independent remuneration consultants to ensure that remuneration and reward levels are appropriate and are in line with market conditions in the various markets in which the consolidated entity operates. The remuneration committee endeavours to have remuneration structures in place that encourage the achievement of a return for shareholders in terms of both dividends and growth in share price.

#### SHORT TERM INCENTIVE SCHEME

The Short Term Incentive ("STI") scheme is a short term incentive arrangement in the form of an annual cash bonus, designed to reward both executives and the majority of staff. The STI aims to recognise the contributions and achievements of individuals when business targets relating to the performance of the business unit, the division or the consolidated entity as appropriate are achieved or exceeded.

#### LONG TERM INCENTIVE SCHEME

Executives are also eligible to participate in an annual long term incentive arrangement under the LTI. The LTI aims to reward the achievement of excellent results in the financial year, retain key executives and increase shareholder value by motivating executives. It provides executives with the opportunity to acquire equity in the form of conditional rights to fully paid shares without payment by the executive, and options to subscribe for shares at market value at the grant date. Further details are provided in note 27 to the financial statements.

The remuneration committee reviews and approves the STI and the LTI rules annually, and approves the quantum of short term and long term incentives for executives based on the applicable audited results.

#### TOTAL REWARD MIX

Consistent with market practice, the mix of total remuneration is dependent on the level of seniority of the executive. Total reward mix assuming achievement of maximum incentives under the STI and the LTI is as follows:

	BASE SALARY/TRC <sup>(1)</sup>	AT RISK ELEMENT	
	%	STI %	LTI %
Chief executive officer	31	42	27
Chief financial officer	34	40	26
Other specified executives	31–39	37–42	24–27

(1) Total remuneration cost

## Directors' report continued

FOR THE YEAR ENDED 31 DECEMBER 2005

### (C) Director and executive remuneration disclosures

#### (i) Elements of non-executive director remuneration and reward structure

Remuneration packages contain the following key elements:

ELEMENT	
Fees	Annual cash remuneration. The aggregate amount approved by shareholders at the 2004 AGM was \$2,200,000 per annum. The amount paid to individual non-executive directors may vary according to specific responsibilities, including involvement on the committees of the board.
Other benefits	Non-executive directors do not receive any performance based remuneration such as cash bonuses or equity incentives. Under the company's constitution, non-executive directors are entitled to be paid all travel and related expenses properly incurred in connection with the business of the company.
Superannuation	Annual cost of superannuation or superannuation contributions. The consolidated entity pays superannuation of 9% to eligible non-executive directors. The portion representing the superannuation guarantee charge is excluded from the shareholder approved remuneration cap under the company's constitution.
Other retirement benefits	Non-executive directors previously received a retirement allowance based on their period of service. The allowance was limited to the aggregate of the director's fees in the last three years of service, subject to a minimum of 10 years service. Where service was less than 10 years, a pro-rata amount was paid. With effect from 31 December 2003, the board terminated the retirement allowance to non-executive directors. Directors' fees were increased by 30% as compensation. Accrued retirement benefits at 31 December 2003 are preserved until retirement and are subject to an annual increase equal to the average five year Australian government bond rate. Shareholders approved an increase in non-executive directors' remuneration and the company's constitution was amended at the 2004 AGM to recognise this change.

#### (ii) Elements of executive remuneration and reward structure

Remuneration packages contain the following key elements:

STRUCTURE	COMPONENT	DESCRIPTION
Total remuneration cost ("TRC")	Base salary	Annual gross cash salary.
	Other benefits	Benefits such as motor vehicles, long service leave, health insurance, life assurance and personal accident insurance, and the applicable taxes thereon.
	Superannuation	Annual cost of employer superannuation contributions.
At risk remuneration	Short term incentive	Annual cash award delivered under the STI terms based on the achievement of specific financial targets and individual performance objectives.
	Long term incentive	<p>Annual deferred equity award delivered under the LTI terms, granting conditional rights to fully paid shares and options to subscribe for shares at market value. The annual equity award is linked to STI.</p> <p>The LTI award quantum is restricted to the lesser of 66.67% of the STI award in that year or 100% of base salary or TRC as at 31 December in the financial year prior to the year in which the STI award is paid.</p> <p>The LTI award quantum is used to acquire conditional rights to fully paid shares and options respectively as follows:</p> <ul style="list-style-type: none"> <li>• conditional rights to shares to the value of 60% of the LTI award; and</li> <li>• options over ordinary shares to the value of 40% of the LTI award, with the resulting number multiplied by four in 2005, reducing to a multiplier of three in 2006.</li> </ul> <p>Conditional rights and options relating to the achievement of targets in a financial year are granted in March of the following year. Interest free personal recourse loans are available on terms permitted by the Plan to persons in the employment of the company who hold options under the LTI, to fund the exercise of the options.</p> <p>Conditional rights and options issued in 2004 and prior financial years are exercisable after three years. Options issued in 2005 and future financial years are exercisable after five years, with the exception of options for staff in the Group investment division, which continue to be exercisable after three years.</p>

## Directors' report continued

FOR THE YEAR ENDED 31 DECEMBER 2005

### (iii) Incentive structure – FM O'Halloran

Consistent with other executives, Mr O'Halloran is entitled to an annual cash incentive payment under the STI, calculated as a percentage of TRC, if specified targets are achieved. Mr O'Halloran's incentives are based on the achievement of the following range of target returns on opening shareholders' funds adjusted for dividends and increases in share capital ("return on equity") for the 2005 financial year, and are based on the consolidated entity's management basis of accounting which spreads realised and unrealised gains on equities and properties evenly over a period of seven years ("seven year spread basis").

The table below outlines the terms of Mr O'Halloran's STI scale:

	GROUP RETURN ON EQUITY %	STI AS A % OF TRC
Minimum target	13	15
Maximum target	20	134
Achieved	26	134

Subject to the approval by shareholders at the 2006 AGM, Mr O'Halloran, on a basis consistent with other specified executives, is also entitled to receive conditional rights to fully paid shares and options to subscribe for shares under the LTI in relation to 2005 performance. These will be exercisable in three and five years respectively, or on Mr O'Halloran's retirement, whichever is earlier.

### (iv) Incentive structure – specified executives

For each of the specified executives, the table below summarises the financial targets which are generally consistent with the targets in the table above, the result used for determining incentive payments and the maximum STI that can be earned for the 2005 financial year generally expressed as a percentage of base salary or TRC as appropriate.

	FINANCIAL TARGET	RESULT BASIS	MAXIMUM STI AS A % OF REMUNERATION <sup>(1)</sup>
SP Burns	European operations insurance profit %	Financial year result	133% x TRC
NG Drabsch	QBE Group return on equity	Financial year result (seven year spread basis)	117% x TRC
PE Grove	European operations insurance profit %	Financial year result	75% x TRC
	Limit syndicate 566	Underwriting year result	Between 1.5% and 2.5% of syndicate 566 profits
MD ten Hove	Investment income as a % of budget income and actual performance as a % of Group investment division benchmark including individual performance measures	Financial year result	125% x base salary
RL Jones	Australian operations return on equity	Financial year result	100% x TRC
TM Kenny	the Americas insurance profit %	Financial year result	133% x base salary
V McLenaghan	Australia Pacific Asia Central Europe operations return on equity	Financial year result	100% x TRC
EG Tollifson	QBE Group return on equity	Financial year result (seven year spread basis)	94% x TRC

(1) Payable based on base salary or TRC at the end of the financial year.

### (D) Employment agreements

The executive director and specified executives are employed by various controlled entities within the consolidated entity on a permanent full time basis with an open ended contract. Upon termination of employment, the executive director and specified executives receive their statutory entitlements of accrued annual and long service leave (where applicable), together with any superannuation benefits. Written notice is usually required in the event of termination of employment. In the case of a voluntary termination prior to retirement age, specified executives forfeit all conditional rights to ordinary shares not yet vested and unexercised options under the LTI.

## Directors' report continued

FOR THE YEAR ENDED 31 DECEMBER 2005

In the event that the contract of employment is terminated through redundancy, retirement through ill health or age, or death and no disciplinary procedure is pending, the specified executive is entitled to the outstanding STI and LTI awards for previous years plus a pro rata share of the STI and LTI awards for the current financial year.

For certain specified executives, the controlled entities have entered into employment agreements that provide for payment of benefits in the event that the agreement is terminated by either the controlled entity or the specified executive. The agreements generally provide for the following.

- A notice period up to one year.
- Where the controlled entity terminates the agreement, a payment comprised of TRC or base salary as appropriate plus STI for the relevant period.
- In certain circumstances, where the controlled entity or the specified executive terminates the contract due to material diminution in role, a payment of up to one year's TRC or base salary as appropriate plus STI for the relevant period.

The exceptions to the general provisions are described below.

In the event of material diminution in role or responsibility, in certain circumstances Mr ten Hove is entitled to a payment equivalent to TRC from the date of termination to 1 January 2008 plus one year's STI based on the average payment in the preceding three years, plus the accelerated vesting of all conditional rights and options.

In the event of material diminution in role or responsibility, in certain circumstances Mr Kenny is entitled to a payment equivalent to two years' TRC plus the accelerated vesting of all conditional rights and options that would otherwise have vested in the two years following the termination date.

Subject to the achievement of financial hurdles, Mr Kenny will receive a contractually agreed bonus payment on 12 May 2011, being one year's base salary plus 100,000 future performance options to be granted in tranches of 20,000 over a five year period from 1 January 2006.

Subject the achievement of financial hurdles, Mr Burns will receive a contractually agreed bonus payment on 31 December 2010 being one year's TRC plus 100,000 future performance options to be granted in tranches of 20,000 over a five year period from 1 January 2006.

### (E) Remuneration details

The following tables provide details of the remuneration of the specified directors and specified executives for the financial year.

	YEAR	PRIMARY BENEFITS	POST EMPLOYMENT BENEFITS		TOTAL
		DIRECTORS' FEES <sup>(1)</sup> \$'000	SUPERANNUATION \$'000	RETIREMENT BENEFITS <sup>(2)</sup> \$'000	\$'000
<b>Non-executive directors</b>					
LF Bleasel AM	<b>2005</b>	<b>187</b>	<b>17</b>	<b>6</b>	<b>210</b>
	2004	182	17	5	204
EJ Cloney	<b>2005</b>	<b>494</b>	<b>44</b>	<b>26</b>	<b>564</b>
	2004	468	42	23	533
CP Curran AO <sup>(3)</sup>	<b>2005</b>	<b>53</b>	<b>5</b>	<b>5</b>	<b>63</b>
	2004	202	18	19	239
The Hon NF Greiner AC	<b>2005</b>	<b>194</b>	<b>17</b>	<b>20</b>	<b>231</b>
	2004	189	18	19	226
IF Hudson <sup>(4)</sup>	<b>2005</b>	<b>28</b>	<b>3</b>	–	<b>31</b>
	2004	–	–	–	–
BJ Hutchinson	<b>2005</b>	<b>189</b>	<b>17</b>	<b>13</b>	<b>219</b>
	2004	189	18	12	219
CLA Irby	<b>2005</b>	<b>206</b>	–	<b>5</b>	<b>211</b>
	2004	205	–	5	210
IYL Lee	<b>2005</b>	<b>187</b>	<b>17</b>	<b>4</b>	<b>208</b>
	2004	182	17	3	202
<b>Total</b>	<b>2005</b>	<b>1,538</b>	<b>120</b>	<b>79</b>	<b>1,737</b>
	2004	1,617	130	86	1,833

(1) Includes fees paid for services on board committees.

(2) Retirement benefits reflect the adjustment to the amounts preserved at 31 December 2003, being an annual increase equal to the five year Australian government bond rate.

(3) Mr Curran retired on 8 April 2005.

(4) Ms Hudson was appointed on 4 November 2005.

# Directors' report continued

FOR THE YEAR ENDED 31 DECEMBER 2005

YEAR	PRIMARY BENEFITS			POST EMPLOYMENT BENEFITS	LTI/ EQUITY COMPENSATION <sup>(2)</sup>		TERMINATION BENEFITS	TOTAL	
	BASE SALARY \$'000	OTHER <sup>(3)</sup> \$'000	STI <sup>(6)</sup> \$'000	SUPER- ANNUATION \$'000	CONDITIONAL RIGHTS \$'000	OPTIONS \$'000	\$'000	\$'000	
<b>Executive director</b>									
FM O'Halloran	<b>2005</b>	<b>1,115</b>	<b>203</b>	<b>1,816</b>	<b>167</b>	<b>496</b>	<b>201</b>	–	<b>3,998</b>
	2004	984	139	1,651	147	267	581	–	3,769
<b>Specified executives</b>									
SP Burns <sup>(1)</sup>	<b>2005</b>	<b>1,074</b>	<b>253</b>	<b>1,914</b>	<b>45</b>	<b>594</b>	<b>350</b>	–	<b>4,230</b>
	2004	963	40	1,484	131	286	189	–	3,093
NG Drabsch	<b>2005</b>	<b>668</b>	<b>93</b>	<b>967</b>	<b>98</b>	<b>300</b>	<b>261</b>	–	<b>2,387</b>
	2004	638	78	938	94	164	340	–	2,252
PE Glen <sup>(4)</sup>	<b>2005</b>	–	–	–	–	–	–	<b>317</b>	<b>317</b>
	2004	597	46	–	124	177	100	2,110	3,154
PE Grove <sup>(1)</sup>	<b>2005</b>	<b>907</b>	<b>973</b>	<b>2,512</b>	<b>272</b>	<b>530</b>	<b>295</b>	–	<b>5,489</b>
	2004	874	181	3,124	262	294	190	–	4,925
MD ten Hove <sup>(1,5)</sup>	<b>2005</b>	<b>697</b>	<b>154</b>	<b>897</b>	<b>137</b>	<b>117</b>	<b>53</b>	–	<b>2,055</b>
	2004	941	223	955	38	594	847	–	3,598
RL Jones	<b>2005</b>	<b>530</b>	<b>125</b>	<b>720</b>	<b>85</b>	<b>294</b>	<b>175</b>	–	<b>1,929</b>
	2004	499	80	700	81	230	436	–	2,026
TM Kenny <sup>(1)</sup>	<b>2005</b>	<b>971</b>	<b>1,151</b>	<b>1,291</b>	<b>35</b>	<b>460</b>	<b>289</b>	–	<b>4,197</b>
	2004	863	104	1,117	32	304	173	–	2,593
V McLenaghan	<b>2005</b>	<b>590</b>	<b>92</b>	<b>750</b>	<b>88</b>	<b>193</b>	<b>104</b>	–	<b>1,817</b>
	2004	530	100	675	79	114	279	–	1,777
EG Tollifson	<b>2005</b>	<b>479</b>	<b>23</b>	<b>517</b>	<b>71</b>	<b>157</b>	<b>111</b>	–	<b>1,358</b>
	2004	443	12	484	65	86	197	–	1,287
<b>Total specified executives</b>	<b>2005</b>	<b>5,916</b>	<b>2,864</b>	<b>9,568</b>	<b>831</b>	<b>2,645</b>	<b>1,638</b>	<b>317</b>	<b>23,779</b>
	2004	6,348	864	9,477	906	2,249	2,751	2,110	24,705

(1) Mr Kenny is located in New York and Messrs Burns and Grove are located in London. Mr ten Hove was located in London during 2004 and relocated to Sydney effective 1 January 2005. Their remuneration has been converted to Australian dollars using the cumulative average rates of exchange for the year.

(2) The fair value at grant date of options and conditional rights is calculated using a binomial model. The fair value of each option and conditional right is earned evenly over the period between grant and vesting. Details of grants of conditional rights and options are provided in note 28 to the financial statements.

(3) "Other" includes the deemed value of the provision of motor vehicles, long service leave, health insurance, life assurance and personal accident insurance and the applicable taxes thereon. Directors' and officers' liability insurance has not been included in other remuneration since it is not possible to determine an appropriate allocation basis.

(4) Mr Glen's employment was terminated through redundancy on 30 September 2004. Included in 2004 termination benefits is the cost attributable to the accelerated recognition of conditional rights and options, where the remuneration committee used its discretion to permit exercise of these instruments before the original exercise date. During 2005, Mr Glen became entitled to a further allocation of conditional rights to ordinary shares in QBE on the fulfilment of certain conditions in his redundancy arrangements.

(5) As part of Mr ten Hove's revised contractual arrangements effective 1 January 2005 following relocation from London to Sydney, the remuneration committee used its discretion to permit Mr ten Hove to receive his conditional rights and exercise his options before the original exercise date. The accelerated cost of these conditional rights and options is included as a 2004 benefit in the table above.

(6) STI is the accrued entitlement for the financial year.

(7) Comparatives have been restated to reflect the reclassification of non-recourse loans as options under AIFRS. Refer note 28(C) to the financial statements. In 2004, the notional interest of \$795,000 on non-recourse loans was included in "Other". This amount has now been reversed and replaced with a notional cost of options in the table above. The valuation of these loans as options has increased the 2004 option component of remuneration by \$1,829,000.

## Directors' report continued

FOR THE YEAR ENDED 31 DECEMBER 2005

### ENVIRONMENTAL REGULATION

The consolidated entity's operations are not subject to any significant environmental regulations under either Commonwealth or state legislation.

### AUDITOR

PricewaterhouseCoopers, Chartered Accountants, continues in office in accordance with section 327 of the *Corporations Act 2001*.

### NON-AUDIT SERVICES

During the year PricewaterhouseCoopers has performed certain other services in addition to its statutory duties.

The board of directors has considered the position and, in accordance with the advice received from the audit committee, is satisfied that the provision of the non-audit services is compatible with the general standard of independence for auditors imposed by the *Corporations Act 2001*. The directors are satisfied that the provision of non-audit services by the auditor, as provided in note 30 to the financial statements, did not compromise the auditor independence requirements of the *Corporations Act 2001* for the following reasons:

- all non-audit services have been reviewed by the audit committee to ensure that they do not impact the impartiality and objectivity of the auditor; and
- none of the services undermine the general principles relating to auditor independence as set out in Professional Statement F1, including reviewing or auditing the auditor's own work, acting in a management or a decision making capacity for the company, acting as advocate for the company or jointly sharing economic risk and rewards.

A copy of the auditor's independence declaration required under section 307C of the *Corporations Act 2001* is set out on page 59.

Details of amounts paid or payable to PricewaterhouseCoopers for audit and non-audit services are provided in note 30 to the financial statements.

### ROUNDING OF AMOUNTS

The company is of a kind referred to in the ASIC class order 98/0100 dated 10 July 1998 (as amended by class order 04/667 dated 15 July 2004) relating to the "rounding off" of amounts in the directors' report. Amounts have been rounded off in the directors' report to the nearest million dollars or, in certain cases, to the nearest thousand dollars in accordance with that class order.

Signed in SYDNEY this 23rd day of February 2006 in accordance with a resolution of the directors.



**EJ Cloney**  
Director



**FM O'Halloran**  
Director

## Directors' report continued

FOR THE YEAR ENDED 31 DECEMBER 2005

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### AUDITOR'S INDEPENDENCE DECLARATION FOR THE YEAR ENDED 31 DECEMBER 2005

As lead auditor of QBE Insurance Group Limited for the year ended 31 December 2005, I declare that, to the best of my knowledge and belief, there have been:

- (a) no contraventions of the auditor independence requirements of the *Corporations Act 2001* in relation to the audit; and
- (b) no contraventions of any applicable code of professional conduct in relation to the audit.

This declaration is in respect of QBE Insurance Group Limited and the entities it controlled during the period.



**RD Deutsch**

Partner

SYDNEY

23 February 2006



**PricewaterhouseCoopers**

Liability limited by a scheme approved under the Professional Standards Legislation.

# Income statements

FOR THE YEAR ENDED 31 DECEMBER 2005

	NOTE	THE COMPANY		CONSOLIDATED	
		2005 \$M	2004 \$M	2005 \$M	2004 \$M
<b>Revenue</b>					
Premium revenue		–	–	9,171	8,571
Other revenue		520	1,940	2,946	1,771
Net fair value gains on financial assets		–	–	216	88
Realised gain on sale of controlled entities		629	–	11	–
Investment income – ABC financial assets pledged for funds at Lloyd's		48	48	84	40
	6	1,197	1,988	12,428	10,470
<b>Expenses</b>					
Outward reinsurance premium expense		–	–	1,785	1,790
Gross claims incurred		–	–	6,744	5,327
Other expenses	7(C)	6	51	2,179	2,061
Expenses – ABC securities for funds at Lloyd's		45	45	101	83
Finance costs		93	76	96	94
<b>Profit before income tax</b>	7	1,053	1,816	1,523	1,115
Income tax (credit) expense	8	(7)	(18)	425	251
<b>Profit after income tax</b>		1,060	1,834	1,098	864
Net profit attributable to minority interest		–	–	7	7
<b>Net profit after income tax attributable to members of the company</b>		1,060	1,834	1,091	857

	NOTE	CONSOLIDATED	
		2005 CENTS	2004 CENTS
Basic earnings per share	37	144.3	123.4
Diluted earnings per share	37	134.4	109.9

The above income statements should be read in conjunction with the accompanying notes.

# Balance sheets

AS AT 31 DECEMBER 2005

	NOTE	THE COMPANY		CONSOLIDATED	
		2005 \$M	2004 \$M	2005 \$M	2004 \$M
<b>CURRENT ASSETS</b>					
Cash and cash equivalents	10	14	9	1,061	1,121
Receivables	11	1,928	3,443	3,607	3,146
Reinsurance and other recoveries on outstanding claims	20	–	–	1,357	805
Deferred insurance costs	12	–	–	1,446	1,358
Financial assets at fair value through the income statement	13	40	–	9,411	6,548
Derivative financial instruments	15	11	1	82	78
Current tax assets		–	–	–	2
Other current assets		–	–	4	2
<b>Total current assets</b>		<b>1,993</b>	3,453	<b>16,968</b>	13,060
<b>NON-CURRENT ASSETS</b>					
Reinsurance and other recoveries on outstanding claims	20	–	–	2,856	2,338
Shares in controlled entities		6,427	3,644	–	–
Financial assets at fair value through the income statement	13	–	–	7,092	7,274
Investment properties	14	–	–	33	32
ABC financial assets pledged for funds at Lloyd's	35	–	–	1,032	998
Property, plant and equipment	17	–	–	232	186
Intangible assets	18	–	–	1,382	1,039
Deferred tax assets	24	–	–	67	73
Retirement benefit surplus	29	–	–	2	2
Other non-current assets		56	47	1	34
<b>Total non-current assets</b>		<b>6,483</b>	3,691	<b>12,697</b>	11,976
<b>Total assets</b>		<b>8,476</b>	7,144	<b>29,665</b>	25,036
<b>CURRENT LIABILITIES</b>					
Trade and other payables	19	1,457	1,619	1,282	1,084
Outstanding claims	20	–	–	4,904	3,670
Unearned premium	21	–	–	4,287	3,948
Interest bearing liabilities	22	400	–	400	–
Derivative financial instruments	15	4	8	35	53
Current tax liabilities		144	84	162	73
Provisions		–	–	2	–
<b>Total current liabilities</b>		<b>2,005</b>	1,711	<b>11,072</b>	8,828
<b>NON-CURRENT LIABILITIES</b>					
Outstanding claims	20	–	–	10,179	8,935
Interest bearing liabilities	22	745	742	1,730	1,805
Swaps relating to ABC securities	35	5	5	29	30
ABC securities for funds at Lloyd's	35	–	–	1,015	968
Deferred tax liabilities	24	10	27	251	122
Provisions	23	13	27	62	54
Retirement benefit obligations	29	–	–	168	202
<b>Total non-current liabilities</b>		<b>773</b>	801	<b>13,434</b>	12,116
<b>Total liabilities</b>		<b>2,778</b>	2,512	<b>24,506</b>	20,944
<b>Net assets</b>		<b>5,698</b>	4,632	<b>5,159</b>	4,092
<b>EQUITY</b>					
Share capital	25(A)	3,195	2,780	3,195	2,780
Equity component of hybrid securities	25(B)	108	108	108	108
Reserves	26(A)	33	15	(20)	(29)
Retained profits	26(B)	2,362	1,729	1,810	1,173
<b>Shareholders' funds</b>		<b>5,698</b>	4,632	<b>5,093</b>	4,032
Minority interest	16	–	–	66	60
<b>Total equity</b>		<b>5,698</b>	4,632	<b>5,159</b>	4,092

The above balance sheets should be read in conjunction with the accompanying notes.

# Statements of recognised income and expense

FOR THE YEAR ENDED 31 DECEMBER 2005

	NOTE	THE COMPANY		CONSOLIDATED	
		2005 \$M	2004 \$M	2005 \$M	2004 \$M
<b>Amounts recognised in equity</b>					
Net decrease in foreign currency translation reserve	26(A)	–	–	(24)	(48)
Actuarial losses on defined benefit superannuation plans, net of tax	26(B)	–	–	(27)	(25)
Cash flow hedges, net of tax	26(A)	(5)	–	(5)	(2)
Gains (losses) on revaluation of owner occupied properties, net of tax	26(A)	–	–	2	(1)
Employee share options, net of tax	26(A)	23	11	36	15
Net income (expense) recognised directly in equity		18	11	(18)	(61)
<b>Amounts recognised in income statement</b>					
Net profit after income tax		1,060	1,834	1,098	864
<b>Total recognised income and expense for the year</b>		<b>1,078</b>	<b>1,845</b>	<b>1,080</b>	<b>803</b>
Attributable to:					
Equity holders		1,078	1,845	1,073	796
Minority interest		–	–	7	7
		<b>1,078</b>	<b>1,845</b>	<b>1,080</b>	<b>803</b>

The above statements of recognised income and expense should be read in conjunction with the accompanying notes.

# Statements of cash flows

FOR THE YEAR ENDED 31 DECEMBER 2005

	NOTE	THE COMPANY		CONSOLIDATED	
		2005 \$M	2004 \$M	2005 \$M	2004 \$M
<b>OPERATING ACTIVITIES</b>					
Premium received		–	–	<b>8,756</b>	8,598
Reinsurance and other recoveries received		–	–	<b>1,309</b>	907
Outward reinsurance paid		–	–	<b>(1,479)</b>	(1,664)
Claims paid		–	–	<b>(4,620)</b>	(4,006)
Insurance costs paid		–	–	<b>(1,748)</b>	(1,629)
Other underwriting costs		–	–	<b>(343)</b>	(374)
Interest received		<b>3</b>	–	<b>562</b>	471
Dividends received		<b>262</b>	435	<b>44</b>	50
Other operating income		–	–	–	18
Other operating payments		<b>(23)</b>	(15)	<b>(208)</b>	(16)
Interest paid		<b>(49)</b>	(33)	<b>(115)</b>	(103)
Income taxes paid		<b>(6)</b>	(39)	<b>(171)</b>	(142)
<b>Net cash flows from operating activities</b>	39	<b>187</b>	348	<b>1,987</b>	2,110
<b>INVESTING ACTIVITIES</b>					
Proceeds on sale of equity investments		–	–	<b>1,403</b>	1,526
Proceeds on sale of investment property		–	–	<b>1</b>	9
Proceeds on sale of property, plant and equipment		–	–	<b>2</b>	4
Payments for purchase of equity investments		–	–	<b>(589)</b>	(1,498)
Proceeds from foreign exchange transactions		–	–	<b>188</b>	30
Payments for purchase of other financial assets		<b>(40)</b>	–	<b>(2,755)</b>	(1,620)
Payments for purchase of ABC financial assets		–	–	–	(295)
Payments for purchase of controlled entities and business acquired <sup>(1)</sup>		<b>(54)</b>	(795)	<b>(402)</b>	(877)
Proceeds on disposal of controlled entities		–	–	<b>35</b>	–
Payments for purchase of investment property		–	–	<b>(4)</b>	–
Payments for purchase of property, plant and equipment		–	–	<b>(82)</b>	(38)
<b>Net cash flows from investing activities</b>		<b>(94)</b>	(795)	<b>(2,203)</b>	(2,759)
<b>FINANCING ACTIVITIES</b>					
Payments to controlled entities		<b>(417)</b>	(234)	–	–
Proceeds from issue of shares		<b>154</b>	390	–	3
Share issue expenses		<b>(2)</b>	–	<b>(4)</b>	–
Proceeds from settlement of staff share loans		–	–	<b>34</b>	33
Proceeds from interest bearing liabilities		<b>400</b>	1,240	<b>400</b>	1,796
Proceeds from issue of ABC securities		–	–	–	294
Repayment of interest bearing liabilities		–	(800)	<b>(45)</b>	(932)
Dividends paid		<b>(224)</b>	(141)	<b>(224)</b>	(141)
<b>Net cash flows from financing activities</b>		<b>(89)</b>	455	<b>161</b>	1,053
<b>NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS HELD</b>					
Cash and cash equivalents at the beginning of the financial year		<b>9</b>	1	<b>1,121</b>	717
Effect of exchange rate changes on opening cash and cash equivalents		<b>1</b>	–	<b>(5)</b>	–
<b>Cash and cash equivalents at the end of the financial year</b>		<b>14</b>	9	<b>1,061</b>	1,121

(1) Consolidated is net of cash acquired.

The above statements of cash flows should be read in conjunction with the accompanying notes.

# Notes to the financial statements

FOR THE YEAR ENDED 31 DECEMBER 2005

## 1

### SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The principal accounting policies adopted in the preparation of the financial report are set out below. These policies have been consistently applied to all the years presented, unless otherwise stated.

The financial report includes separate financial statements for QBE Insurance Group Limited ("the company") as an individual entity and the consolidated entity consisting of QBE Insurance Group Limited and its controlled entities.

#### (A) Basis of preparation

This general purpose financial report has been prepared in accordance with accounting standards, other authoritative pronouncements of the Australian Accounting Standards Board ("AASB"), Urgent Issues Group interpretations corresponding to the interpretations approved by the International Accounting Standards Board ("IASB") and the *Corporations Act 2001*.

Until 31 December 2004, financial statements of the consolidated entity were prepared in accordance with previous Australian Generally Accepted Accounting Principles ("AGAAP"). From 1 January 2005, the financial statements have been prepared in accordance with current AGAAP which includes the Australian equivalents to International Financial Reporting Standards ("AIFRS"). For the consolidated entity the date of adoption of AIFRS was 1 January 2004, which is the start of the comparative period.

This is the first annual report to be prepared by the consolidated entity in accordance with AIFRS. AASB 1: First Time Adoption of Australian Equivalents to International Financial Reporting Standards ("AASB 1") has been applied in preparing these financial statements. When preparing this annual report, management has amended certain accounting and valuation methods applied in the previous AGAAP financial statements to comply with AIFRS and the comparative figures have been restated to reflect these adjustments. The half year report of the consolidated entity, for the period to 30 June 2005, was prepared in accordance with AIFRS.

The consolidated entity has taken the exemption available under AASB 1 to apply AASB 3: Business Combinations ("AASB 3") from 1 January 2004. The consolidated entity has also taken the exemption under AASB 1 to apply

AASB 2: Share-based Payment ("AASB 2") to options and conditional rights issued after 7 November 2002 and vesting after 1 January 2005. Accordingly, no expense is recognised in respect of instruments granted before 7 November 2002 and/or vested before 1 January 2005.

The consolidated entity has elected to apply AASB 119: Employee Benefits ("AASB 119"), issued December 2004, to reporting periods beginning on or after 1 January 2005. This includes applying AASB 119 to the comparatives in accordance with AASB 108: Accounting Policies, Changes in Accounting Estimates and Errors. In addition, the consolidated entity has elected to apply AASB 124: Related Party Disclosures to reporting periods beginning on or after 1 January 2005.

The consolidated entity has not taken the exemptions available under AASB 1 in respect of the restatement of comparative figures on application of:

- AASB 132: Financial Instruments: Disclosure and Presentation ("AASB 132");
- AASB 139: Financial Instruments: Recognition and Measurement ("AASB 139");
- AASB 4: Insurance Contracts ("AASB 4"); and
- AASB 1023: General Insurance Contracts ("AASB 1023").

Consequently, comparative figures have been restated.

Reconciliations and descriptions of the effect of transition from previous AGAAP to AIFRS on the consolidated entity's equity and net profit after income tax are provided in note 2.

These financial statements have been prepared under the historical cost convention, as modified by the revaluation of:

- financial assets and liabilities (including derivative instruments) at fair value through the income statement;
- certain classes of property, plant and equipment; and
- investment property.

#### (B) Principles of consolidation

The consolidated financial statements incorporate the assets and liabilities of all entities controlled by the company as at 31 December 2005 and the results of all controlled entities for the financial year then ended. The company and

its controlled entities together are referred to in this financial report as the "consolidated entity". The effects of all transactions between entities in the consolidated entity are eliminated in full. Minority interest in the results and equity of controlled entities is shown separately in the consolidated income statement and balance sheet.

Where control of an entity commences during a financial year, its results are included in the consolidated income statement from the date on which the control commences. Where control of an entity ceases during a financial year, its results are included for that part of the year during which the control existed.

The purchase method of accounting is used to account for the acquisition of controlled entities by the consolidated entity. The cost of an acquisition is measured as the fair value of the assets acquired, equity instruments issued and liabilities incurred or assumed at the date of exchange, plus costs directly attributable to the acquisition. Identifiable assets acquired and liabilities and contingent liabilities assumed in a business combination are measured initially at their fair values at the acquisition date, irrespective of the extent of any minority interest. The excess of the cost of acquisition over the fair value of the consolidated entity's share of the identifiable net assets acquired is recorded as goodwill. If the cost of acquisition is less than the fair value of the net assets of the controlled entity acquired, the difference is recognised directly in the income statement.

#### (C) Premium revenue

Direct and inward reinsurance premium comprises amounts charged to policyholders, excluding taxes collected on behalf of third parties. The earned portion of premium received and receivable, including unclosed business, is recognised as revenue. Premium on unclosed business is brought to account based upon the pattern of booking of renewals and new business.

#### (D) Unearned premium

Unearned premium is calculated based on the term of the risk which closely approximates the pattern of risks underwritten using either the daily pro rata method or the 24ths method.

At each balance date, the adequacy of the unearned premium liability is assessed on a net of reinsurance

# Notes to the financial statements continued

FOR THE YEAR ENDED 31 DECEMBER 2005

## 1

### SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES CONTINUED

basis against the present value of the expected future cash flows relating to potential future claims in respect of the relevant insurance contracts, plus an additional risk margin to reflect the inherent uncertainty of the central estimate. The assessment is carried out at the divisional business segment level, being a portfolio of contracts that are broadly similar and managed together as a single portfolio. If the unearned premium liability, less related intangible assets and deferred acquisition costs, is deficient, then the resulting deficiency is recognised in the income statement of the consolidated entity.

#### **(E) Outward reinsurance**

Premium ceded to reinsurers is recognised as an expense in accordance with the pattern of reinsurance service received. Accordingly, a portion of outward reinsurance premium is treated as a prepayment at the balance date.

#### **(F) Claims**

The provision for outstanding claims is measured as the central estimate of the present value of expected future claims payments plus a risk margin. The expected future payments include those in relation to claims reported but not yet paid; claims incurred but not reported ("IBNR"); claims incurred but not enough reported ("IBNER"); and estimated claims handling costs.

The expected future payments are discounted to present value using a risk free rate.

A risk margin is applied to the central estimate, net of reinsurance and other recoveries, to reflect the inherent uncertainty in the central estimate. This risk margin increases the probability that the net liability is adequate to a minimum of 85%.

#### **(G) Reinsurance and other recoveries**

Reinsurance and other recoveries on paid claims, reported claims not yet paid, IBNR and IBNER are recognised as revenue.

Amounts recoverable are assessed in a manner similar to the assessment of outstanding claims. Recoveries are measured as the present value of the expected future receipts, calculated on the same basis as the provision for outstanding claims.

#### **(H) Acquisition costs**

A portion of acquisition costs relating to unearned premium is deferred in recognition that it represents a future benefit. Deferred acquisition costs are measured at the lower of cost and recoverable amount. Deferred acquisition costs are amortised over the financial years expected to benefit from the expenditure.

#### **(I) Investment income**

Interest income is recognised on an accruals basis. Dividends are recognised when due. Investment income includes realised and unrealised gains or losses on financial assets which are reported on a combined basis as fair value gains or losses on financial assets.

Investment income on ABC financial assets pledged for funds at Lloyd's and expenses from ABC securities for funds at Lloyd's, both of which are separately identified, include fair value gains and losses on the ABC swaps.

#### **(J) Taxation**

The income tax expense for the period is the tax payable on the current period's taxable income based on the notional income tax rate for each jurisdiction, adjusted by changes in deferred tax assets and liabilities attributable to temporary differences between the tax bases of assets and liabilities and their carrying amounts in the financial statements.

Deferred tax assets and liabilities are recognised for temporary differences at the tax rate expected to apply when the assets are recovered or liabilities are settled, based on those tax rates which are enacted or substantively enacted for each jurisdiction. The relevant tax rates are applied to the cumulative amounts of deductible and taxable temporary differences to measure the deferred tax asset or liability. An exception is made for certain temporary differences arising from the initial recognition of an asset or liability. No deferred tax asset or liability is recognised in relation to these temporary differences if they arose in a transaction, other than a business combination, that at the time of the transaction did not affect accounting profit or loss.

Deferred tax assets are recognised for deductible temporary differences and unused tax losses only if it is probable that future taxable amounts will be available to utilise those temporary differences and losses.

Deferred tax liabilities and assets are not recognised for temporary differences between the carrying amount and tax bases of investments in controlled entities where the parent entity is able to control the timing of the reversal of the temporary differences and it is probable that the differences will not reverse in the near future.

Current and deferred tax balances attributable to amounts recognised directly in equity are also recognised directly in equity.

The company and all of its Australian wholly owned controlled entities have implemented the tax consolidation legislation.

#### **(K) Cash and cash equivalents**

Cash and cash equivalents includes cash at bank and on hand and deposits at call which are readily convertible to cash on hand and which are used in the cash management function on a day to day basis, net of bank overdrafts.

#### **(L) Financial assets**

##### **(i) Classification of policyholders' and shareholders' funds**

Policyholders' funds are those financial assets which are held to fund the insurance provisions of the consolidated entity. The remaining financial assets, including equities, and investment properties (refer note 1M) represent shareholders' funds. Insurance profit is derived by adding investment income on policyholders' funds to the underwriting result.

##### **(ii) Policyholders' funds**

In accordance with AASB 1023, the consolidated entity is required to measure financial assets held to fund insurance provisions at fair value through the income statement.

##### **(iii) Shareholders' funds**

AASB 139 has an option to measure all financial assets at fair value through the income statement. Shareholders' funds constitutes a group of financial assets which are managed, and their performance evaluated, on a fair value basis in accordance with the consolidated entity's documented investment strategy. Information prepared on this basis is provided to the consolidated entity's senior management. The consolidated entity has therefore elected to measure all financial assets that do not fund insurance provisions at fair value through

# Notes to the financial statements continued

FOR THE YEAR ENDED 31 DECEMBER 2005

## 1

### SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES CONTINUED

the income statement upon initial recognition and at the date of transition to AIFRS.

#### (iv) Basis of valuation

Fair value for each type of financial asset is determined as follows:

*Listed investments* – by reference to the closing bid price of the instrument at the balance date.

*Unlisted investments* – the fair value of financial assets not traded on an active market is determined using valuation techniques including reference to:

- the fair value of recent arm's length transactions involving the same instrument or instruments that are substantially the same;
- discounted cash flow analysis; and
- option pricing models.

All purchases and sales of financial assets that require delivery of the asset within the time frame established by regulation or market convention ("regular way" transactions) are recognised at trade date, being the date on which the consolidated entity commits to buy or sell the asset.

Financial assets are derecognised when the right to receive future cash flows from the assets has expired, or has been transferred, and the consolidated entity has transferred substantially all the risks and rewards of ownership.

#### (M) Investment properties

Investment properties are valued by reference to external market valuation at fair value through the income statement.

#### (N) Derivative financial instruments

The consolidated entity is subject to currency, cash flow, interest rate, price, credit and liquidity risks. Derivative financial instruments ("derivatives") are used to manage these risks. The consolidated entity does not enter into, issue or hold derivatives for speculative trading purposes.

Derivatives are initially recognised at fair value on the date a derivative contract is entered into and are subsequently remeasured to their fair value. The method of recognising the resulting gain or loss depends on whether the derivative is designated as a hedging

instrument and the nature of the item being hedged. Derivatives which are not part of a hedging relationship are valued at fair value through the income statement. Derivatives which are part of a hedging relationship are accounted for as provided in note 1(O). The fair value of forward exchange contracts is determined using forward exchange rates at the balance date.

#### (O) Hedging transactions

Derivatives held for risk management purposes which meet the criteria specified in AASB 139 are accounted for by the consolidated entity using fair value hedge accounting, cash flow hedge accounting or hedging of a net investment in a foreign operation as appropriate to the risks being hedged.

When a financial instrument is designated as a hedge, the consolidated entity formally documents the relationship between the hedging instrument and hedged item as well as its risk management objectives and its strategy for undertaking the various hedging transactions. The consolidated entity also documents its assessment, both at hedge inception and on an ongoing basis, of whether the derivatives that are used for hedging are highly effective in offsetting changes in fair values or cash flows of hedged items.

Hedge accounting is discontinued when:

- it is determined that a derivative is not, or has ceased to be, highly effective as a hedge;
- the derivative expires, or is sold, terminated or exercised; or
- the hedged item matures, is sold or repaid.

#### (i) Fair value hedge accounting

Changes in the fair value of derivatives that qualify and are designated as fair value hedges are recorded in the income statement, together with changes in the fair value of the hedged asset or liability that are attributable to the hedged risk. If the hedge no longer meets the criteria for hedge accounting, the fair value hedging adjustment cumulatively made to the carrying value of the hedged item is, for items carried at amortised cost, amortised over the period to maturity of the previously designated hedge relationship using the effective interest method. If the hedged item is sold or repaid, the unamortised fair value adjustment is recognised immediately in the income statement.

#### (ii) Cash flow hedge accounting

For qualifying cash flow hedges, the fair value gain or loss associated with the effective portion of the cash flow hedge is recognised initially directly in shareholders' equity and recycled to the income statement in the periods when the hedged item will affect profit or loss. The gain or loss on any ineffective portion of the hedging instrument is recognised in the income statement immediately. When a hedging instrument expires or is sold, or when a hedge no longer meets the criteria for hedge accounting, any cumulative gain or loss existing in equity at that time remains in equity and is recognised when the hedged item affects the income statement. When a transaction is no longer expected to occur, the cumulative gain or loss that was recognised in equity is immediately transferred to the income statement.

#### (iii) Hedges of net investments in foreign operations

Hedges of net investments in foreign operations, including monetary items that are accounted for as part of the net investment, are accounted for in a manner similar to cash flow hedges. The gain or loss on the effective portion of the hedging instrument is recognised directly in equity and the gain or loss on the ineffective portion is recognised immediately in the income statement. The cumulative gain or loss previously recognised in equity is recognised in the income statement on the disposal or partial disposal of the foreign operation.

#### (P) Receivables

Receivables are measured at fair value through the income statement and form part of policyholders' funds.

#### (Q) Property, plant and equipment

Owner occupied properties are measured at fair value by reference to external market valuations. When a revaluation increases the carrying value of a property, the increase is credited to the revaluation reserve in equity. To the extent that the increase reverses a decrease previously recognised in the income statement, the increase is first recognised in the income statement. When an asset's carrying amount is decreased as a result of a revaluation, the decrease is recognised in the income statement. To the extent that the decrease reverses an increase previously recognised in equity, the decrease is first recognised in equity.

# Notes to the financial statements continued

FOR THE YEAR ENDED 31 DECEMBER 2005

## 1

### SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES CONTINUED

All other property, plant and equipment is stated at historical cost less depreciation.

Leasehold improvements, office equipment, fixtures and fittings and motor vehicles are depreciated using the straight line method over the estimated useful life to the consolidated entity of each class of asset. Estimated useful lives are between three and 10 years.

An asset's carrying amount is written down to its recoverable amount if the asset's carrying amount is greater than its estimated recoverable amount. Refer note 1(S).

#### **(R) Intangible assets**

##### **(i) Goodwill**

Goodwill represents the excess of the cost of an acquisition over the fair value of the consolidated entity's share of the net identifiable assets acquired. Goodwill acquired in a business combination is tested for impairment and is not subject to amortisation.

##### **(ii) Intangible assets**

Intangible assets are measured at cost. Those with a finite useful life are amortised using the straight line method over the estimated useful life. Intangible assets are tested for impairment annually or more often if there is an indication of impairment.

#### **(S) Impairment of assets**

Assets, including goodwill and intangibles, that have an indefinite useful life are tested annually for impairment or more frequently when changes in circumstances indicate that the carrying amount may not be recoverable. Assets that are subject to amortisation are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. An impairment loss is recognised as the amount by which the asset's carrying amount exceeds its recoverable amount. The recoverable amount is the higher of an asset's fair value less costs to sell and its value in use. For the purposes of assessing impairment, assets are grouped in cash generating units which are the lowest levels for which there are separately identifiable cash flows.

#### **(T) Financial liabilities**

Financial liabilities are initially measured at fair value and are subsequently measured at amortised cost. Any

difference between the proceeds and the redemption amount is recognised in the income statement over the period of the financial liability using the effective interest method.

On issue of hybrid securities, the fair value of the liability component, being the obligation to make future payments of principal and interest to investors, is calculated using a market interest rate for an equivalent non-convertible note. The residual amount, representing the fair value of the conversion option, is included in equity with no recognition of any change in the value of the option in subsequent periods. The liability is included in financial liabilities and carried on an amortised cost basis with interest on the securities recognised as financing costs on an effective interest method until the liability is extinguished on conversion or maturity of the securities.

Financial liabilities are classified as current liabilities unless the consolidated entity has an unconditional right to defer settlement of the liability for at least 12 months after the balance date.

#### **(U) Foreign currency translation**

**(i) Functional and presentation currency**  
Items included in the financial statements of controlled entities are measured using the currency of the primary economic environment in which the entity operates ("the functional currency"). The consolidated entity's financial statements are presented in Australian dollars, being the functional and presentation currency of the company.

##### **(ii) Transactions and balances**

Foreign currency transactions are translated into functional currencies at the rates of exchange at the dates of the transactions. At the balance date, amounts payable and receivable in foreign currencies are translated at the rates of exchange prevailing at that date. Exchange gains and losses on operational foreign currency transactions and the translation of amounts receivable and payable in foreign currencies are included in the income statement.

The results and financial position of all overseas controlled entities that have a functional currency different from the presentation currency are translated into the presentation currency as follows:

- assets and liabilities are translated at the closing balance date rates of exchange;

- income and expenses are translated at cumulative average rates of exchange; and

- all resulting exchange differences are recognised as a separate component of equity.

On consolidation, exchange differences arising from the translation of the net investment in overseas controlled entities, and of financial liabilities and other instruments designated as hedges of such investments, are taken to shareholders' equity. When an overseas controlled entity is sold, these exchange differences are recognised in the income statement as part of the gain or loss on sale.

#### **(V) Equity**

Ordinary shares are classified as equity. Incremental costs directly attributable to the issue of new shares or options are shown in equity as a deduction from the proceeds, net of tax. Incremental costs directly attributable to the issue of new shares or options, or for the acquisition of a business, are included in the cost of acquisition as part of the purchase consideration.

The equity component of hybrid securities is calculated and disclosed as provided in note 1(T).

#### **(W) Earnings per share**

##### **(i) Basic earnings per share**

Basic earnings per share is determined by dividing net profit after income tax attributable to members of the company, adjusted for the cost of servicing equity other than ordinary shares, by the weighted average number of ordinary shares outstanding during the financial year, adjusted for bonus elements in ordinary shares issued during the year.

##### **(ii) Diluted earnings per share**

Diluted earnings per share adjusts the earnings figure used in the determination of basic earnings per share to exclude the after income tax effect of interest and other financing costs associated with potential dilutive ordinary shares and the weighted average number of shares assumed to have been issued for no consideration. It also adjusts the weighted average number of shares to include potential dilutive ordinary shares and instruments with a mandatory conversion feature.

# Notes to the financial statements continued

FOR THE YEAR ENDED 31 DECEMBER 2005

# 1

## SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES CONTINUED

### (X) Dividends

Dividends are recognised when declared or determined. No provision is made for a proposed dividend.

### (Y) Employee benefits

#### (i) Superannuation

The consolidated entity participates in a number of superannuation plans and contributes to these plans in accordance with plan rules and actuarial recommendations, which are designed to ensure that each plan's funding provides sufficient assets to meet its liabilities.

#### DEFINED CONTRIBUTION PLANS

For defined contribution plans, contributions are expensed as incurred.

#### DEFINED BENEFIT PLANS

The liability recognised in the balance sheet in respect of defined benefit superannuation plans is the present value of the defined benefit obligation at the balance date less the fair value of plan assets, adjusted for any unrecognised past service costs. The defined benefit obligation is calculated annually by independent actuaries using the projected unit credit method. The present value of the defined benefit obligation is determined by discounting the estimated future cash outflows using interest rates of high quality corporate or government bonds that are denominated in the currency in which the benefits will be paid, and that have a term to maturity approximating the term of the related superannuation liability. Actuarial gains and losses arising from experience adjustments and changes in actuarial assumptions are recognised directly in

equity. Past service costs are recognised immediately in income, unless the changes to the superannuation plan are conditional on the employees remaining in service for a specified period of time (the vesting period) in which case the past service costs are amortised on a straight line basis over the vesting period.

#### (ii) Share based compensation

The consolidated entity operates an equity settled, share based compensation plan. The fair value of the employee services received in exchange for the grant of the options and conditional rights is recognised as an expense. The total amount to be expensed over the vesting period is determined by reference to the fair value of the instruments granted, excluding the impact of any non-market vesting conditions. The fair value at grant date of the options and conditional rights is calculated using a binomial model. The fair value of each instrument is earned evenly over the period between grant and vesting dates. Non-market vesting conditions are included in assumptions about the number of instruments that are expected to become exercisable. At each balance date, the entity revises its estimates of the number of options that are expected to become exercisable.

It recognises the impact of the revision of original estimates, if any, in the income statement, with a corresponding adjustment to equity.

#### (iii) Profit-sharing and bonus plans

The consolidated entity recognises a liability and an expense for bonuses and profit-sharing, based on a formula that takes into consideration the profit attributable to the company's shareholders after certain adjustments.

#### (iv) Termination benefits

Termination benefits are payable when employment is terminated before the normal retirement date or when an employee accepts voluntary redundancy in exchange for these benefits.

The consolidated entity recognises termination benefits when it has demonstrably committed to either:

- terminating the employment of current employees according to a detailed formal plan without possibility of withdrawal; or
- providing termination benefits as a result of an offer made to encourage voluntary redundancy.

Benefits falling due more than 12 months after the balance date are discounted to present value.

#### (Z) Leases

Leases in which a significant portion of the risks and rewards of ownership are retained by the lessor are classified as operating leases. Payments made under operating leases (net of any incentives received from the lessor) are charged to the income statement on a straight line basis over the period of the lease.

#### (AA) Rounding of amounts

The company is of a kind referred to in the ASIC class order 98/0100 dated 10 July 1998 (as amended by class order 04/667 dated 15 July 2004) relating to the "rounding off" of amounts in the financial statements. Amounts have been rounded off in the financial statements to the nearest million dollars or, in certain cases, to the nearest thousand dollars in accordance with that class order.

### (AB) Australian Accounting Standards issued but not yet effective

TITLE	OPERATIVE DATE
2005-1 Amendments to Australian Accounting Standard (AASB 139)	1 January 2006
2005-5 Amendments to Australian Accounting Standards (AASB 1 and AASB 139)	1 January 2006
2005-6 Amendments to Australian Accounting Standard (AASB 3)	1 January 2006
2005-7 Amendments to Australian Accounting Standard (AASB 134)	30 June 2005
2005-9 Amendments to Australian Accounting Standards (AASB 4, AASB 1023, AASB 139 and AASB 132)	1 January 2006
2005-10 Amendments to Australian Accounting Standards (AASB 132, AASB 101, AASB 114, AASB 117, AASB 133, AASB 139, AASB 1, AASB 4, AASB 1023 and AASB 1038)	1 January 2007
AASB 7 Financial Instruments: Disclosures	1 January 2007

These amendments are not effective for the year ended 31 December 2005 and have not been applied in preparing the consolidated entity's financial statements. The impact of the application of these standards is disclosure only. The consolidated entity will apply these standards for the annual reporting periods beginning on or after the operative dates set out above.

## Notes to the financial statements continued

FOR THE YEAR ENDED 31 DECEMBER 2005

# 2

### IMPACT OF THE ADOPTION OF AIFRS

In preparing the opening AIFRS compliant balance sheet, a number of adjustments have been made to the figures previously reported in the 31 December 2004 financial report. The impacts of the adoption of AIFRS on total equity brought forward and 2004 profit after income tax reported under previous AGAAP are illustrated below. All amounts have been tax effected in accordance with AASB 112: Income Taxes.

#### (A) Reconciliation of total equity under previous AGAAP to that under AIFRS:

	THE COMPANY		CONSOLIDATED	
	31 DEC 2004 \$M	1 JAN 2004 \$M	31 DEC 2004 \$M	1 JAN 2004 \$M
<b>Brought forward equity under previous AGAAP</b>	4,711	2,513	4,480	3,368
Defined benefit superannuation plan obligations <sup>(1)</sup>	–	–	(142)	(117)
Shares issued under the Employee Share and Option Plan derecognised <sup>(2)</sup>	(90)	(76)	(90)	(76)
Impairment <sup>(3)</sup>	–	–	(49)	(62)
Risk free rate adjustment <sup>(4)</sup>	–	–	(64)	(70)
Non-monetary assets/liabilities adjustment <sup>(5)</sup>	–	–	(8)	(19)
Cash flow hedges <sup>(6)</sup>	–	–	(17)	(15)
Swaps relating to ABC securities <sup>(7)</sup>	(3)	2	(20)	(2)
Fair value of financial assets <sup>(8)</sup>	–	–	(4)	(2)
Share based payments <sup>(9)</sup>	15	4	7	1
Amortisation of financing costs using effective interest rate method <sup>(10)</sup>	(1)	–	(1)	–
	(79)	(70)	(388)	(362)
<b>Brought forward equity under AIFRS</b>	4,632	2,443	4,092	3,006

The consolidated entity has elected to apply an exemption in AASB 1 which permits the cumulative translation differences in respect of all foreign operations represented in the foreign currency translation reserve to be deemed to be zero at the date of adoption of AIFRS. At 1 January 2004, the \$130 million debit balance in the foreign currency translation reserve was reduced to zero with an equivalent adjustment to retained profits.

Under previous AGAAP, the company recognised current and deferred tax amounts relating to transactions and balances of the Australian tax-consolidated group. Under AIFRS, the company only recognises the current tax payable and deferred tax assets arising from unused tax losses assumed from controlled entities in the tax-consolidated group. There is no impact on the consolidated entity. For the company, deferred tax liabilities decreased by \$643 million with an equivalent adjustment to intercompany balances.

#### (B) Reconciliation of net profit after tax for the year ended 31 December 2004 under previous AGAAP to that under AIFRS:

	THE COMPANY 2004 \$M	CONSOLIDATED 2004 \$M
<b>Net profit after income tax under previous AGAAP</b>	1,840	820
Defined benefit superannuation plan obligations <sup>(1)</sup>	–	3
Reversal of goodwill amortisation <sup>(3)</sup>	–	13
Risk free rate adjustment <sup>(4)</sup>	–	6
Non-monetary assets/liabilities adjustment <sup>(5)</sup>	–	11
Swaps relating to ABC securities <sup>(7)</sup>	(5)	(18)
Fair value of financial assets <sup>(8)</sup>	–	(2)
Share based payments <sup>(9)</sup>	–	(9)
Amortisation of financing costs using effective interest rate method <sup>(10)</sup>	(1)	(1)
Interest component of forward contracts used for hedging <sup>(11)</sup>	–	34
	(6)	37
<b>Net profit after income tax under AIFRS</b>	1,834	857

# Notes to the financial statements continued

FOR THE YEAR ENDED 31 DECEMBER 2005

## 2

### IMPACT OF THE ADOPTION OF AIFRS CONTINUED

#### (C) Impact of AIFRS on cash flows

There are no material differences to the statement of cash flows presented under AIFRS from that presented under previous AGAAP.

#### Notes

- (1) Under AIFRS, the net deficit or surplus on defined benefit superannuation plan obligations must be recognised on the balance sheet. Under previous AGAAP, deficits or surpluses were not recognised. An asset or liability, as determined by reference to external valuations, has been recognised where the present value of the employees' accrued benefits is less than or exceeds the net market value of the superannuation plans' assets.
- (2) A non-recourse loan issued under the Plan is treated as an option under AASB 2. As a result, the employee loans and related shares issued to date are derecognised under AIFRS. The share capital will be reinstated onto the balance sheet when the loans are repaid by employees. Consequently, the issued share capital on the balance sheet of the consolidated entity differs from issued share capital as notified to the Australian Stock Exchange.
- (3) Under previous AGAAP, goodwill was amortised over its estimated useful life whilst intangible assets were subject to ongoing impairment review. Under AIFRS, goodwill and intangible assets with an indefinite life must be tested for impairment and are no longer amortised. Intangible assets with a finite life are reviewed periodically for impairment and amortised over the estimated useful life. The process for impairment testing under AIFRS is more prescriptive than under previous AGAAP resulting in an impairment to goodwill.
- (4) Under AIFRS, the outstanding claims provision must be discounted at a risk free rate. Under previous AGAAP, the consolidated entity discounted the outstanding claims provision with reference to market risk related returns.
- (5) AASB 121: The Effects of Changes in Foreign Exchange Rates requires non-monetary assets, liabilities and transactions measured in terms of historical cost to be translated to the functional currency using the rates of exchange prevailing at the transaction date. This is a change from previous market practice at Lloyd's.
- (6) The consolidated entity has designated certain derivatives as cash flow hedges. These instruments are initially recognised at fair value on the date the contract is entered into and are subsequently remeasured at fair value at each balance date. The derivatives have qualified for hedge accounting and therefore the portion of the instrument determined to be an effective hedge has been recognised directly in equity. Such instruments were previously accounted for on an accruals basis.
- (7) The interest rate and cross-currency interest rate swaps in relation to the ABC securities are initially valued at fair value and are subsequently remeasured at fair value through the income statement.
- (8) The fair value of quoted financial assets is based on closing bid prices. Under previous AGAAP, the consolidated entity used trade price as the basis of valuation.
- (9) Under AASB 2, the consolidated entity is required to recognise an expense for those options and conditional rights to shares that were issued to employees under share based compensation plans after 7 November 2002 and that had not vested by 1 January 2005.
- (10) Interest bearing liabilities are valued at amortised cost using the effective interest rate method. Under previous AGAAP, interest bearing liabilities were carried at their principal amount and financing costs were expensed on a straight line basis over the period of the financial liabilities.
- (11) As permitted under AASB 139, the spot component of a forward contract is designated as a hedge in the consolidated entity's hedging of net investments in foreign operations. The interest component of the forward contract is included in the income statement. The effective portion of the spot component of the forward contract is transferred to equity.

## 3

### CRITICAL ACCOUNTING ESTIMATES AND JUDGMENTS

The consolidated entity is an international general insurance and reinsurance group underwriting most major commercial and personal lines classes of business through operations in 41 countries. The class of business mix and an analysis of the consolidated entity's gross written and net earned premium from insurance and reinsurance business is shown on page 9. The head office function is located in Australia and exists to support the activities of divisional operations as follows:

- Australia Pacific Asia Central Europe ("APACE"), which comprises general insurance operations in 25 countries under a single management structure;
- European operations, which comprises reinsurance business written in the UK and Ireland, general insurance business written in the UK, France, Spain and Germany and both general insurance and reinsurance business written through Lloyd's of London; and
- QBE the Americas, which comprises general insurance and reinsurance operations in the US and a number of Latin American countries.

In view of this geographic and product diversity, the consolidated entity has developed a strong, centralised risk management and policy framework designed to ensure consistency of approach across a number of operational activities, subject to the specific requirements of local markets, legislation and regulation. Such operational activities include underwriting, claims management, actuarial assessment of the claims provision and investment management. In addition, the assessment of the risk margin undertaken at a divisional level is subject to detailed head office review and the consolidated entity's probability of adequacy is determined by the Group actuary.

Given the centralised approach to many of its activities and the product and geographical diversification, sensitivity analyses in respect of critical accounting estimates and judgments are presented at the consolidated entity level in order to provide a level of analysis which is meaningful, relevant, reliable and comparable year on year. It is considered that disclosure at business segment or product level would not provide a meaningful overview given the complex interrelationships between the variables underpinning the consolidated entity's operations.

# Notes to the financial statements continued

FOR THE YEAR ENDED 31 DECEMBER 2005

## 3

### CRITICAL ACCOUNTING ESTIMATES AND JUDGMENTS CONTINUED

The consolidated entity makes estimates in respect of certain key assets and liabilities. Such estimates are determined by qualified and experienced employees with reference to historical data and reasoned expectations of future events. The key areas in which critical estimates and judgments are applied are described below.

#### **(A) Ultimate liability arising from claims made under insurance contracts**

Provision is made for the estimated cost of claims incurred but not settled at the balance date. The estimated cost of claims includes direct expenses that are expected to be incurred in settling those claims.

The estimation of IBNR is generally subject to a greater degree of uncertainty than the estimation of the cost of settling claims already notified to the consolidated entity, where more information about the claims is generally available. Liability and other long tail classes of business, where claims settlement may not happen for many years after the event giving rise to the claim, typically display greater variability between initial estimates and final settlement due to delays in reporting claims, uncertainty in respect of court awards and future claims inflation. Claims in respect of property and other short tail classes are typically reported and settled sooner after the claim event, giving rise to more certainty. The estimation techniques and assumptions used in determining the outstanding claims provision and the associated reinsurance and other recoveries are described below.

#### **(i) Insurance risk assumptions**

The consolidated entity's process for establishing the outstanding claims provision involves extensive consultation with internal and external actuaries, claims managers, underwriters and other senior management. This process includes quarterly internal claims review meetings attended by senior divisional management and one or both of the chief risk officer and Group actuary, and detailed review by external actuaries at least annually. The risk management procedures related to the actuarial function are explained further in note 4.

The determination of the amounts that the consolidated entity will ultimately pay for claims arising under insurance and reinsurance contracts involves a number of critical assumptions. Some of the uncertainties impacting these assumptions are as follows:

- changes in patterns of claims incidence, reporting and payment;
- volatility in the estimation of future costs for long tail insurance classes due to the longer period of time that elapses before a definitive determination of the ultimate claims cost can be made;
- incidence of catastrophic events close to the balance date;
- changes in the legal environment, including the interpretation of liability laws and the quantum of damages; and
- social and economic trends, for example price and wage inflation and interest rates.

The potential impact of changes in key assumptions on the consolidated entity's income statement and balance sheet are summarised in note 3(A)(vii).

#### **(ii) Central estimates**

The outstanding claims provision comprises the central estimate and a risk margin which is added to the central estimate to achieve a desired probability of adequacy. The outstanding claims provision is discounted at risk free rates of return to reflect the time value of money.

A central estimate is an estimate of the level of claims provision that is intended to contain no intentional under or over estimation. In simple terms, the central estimate is equally likely to be too high (more than adequate) or too low (inadequate) and is commonly described as providing a 50% probability of adequacy. As the consolidated entity requires a higher probability that estimates will be adequate over time, a risk margin is added to the central estimate of outstanding claims.

Central estimates for each class of business are determined by reference to a variety of estimation techniques, generally based on a statistical analysis of historical experience which assumes an underlying pattern of claims development and payment. The final selected central estimates are based on a judgmental consideration of the results of each method and qualitative information, for example, the class of business, the maturity of the portfolio and the expected term to settlement of the class. Projections are based on both historical experience and external benchmarks where relevant.

Central estimates are calculated gross of any reinsurance recoveries. A separate estimate is made of the amounts recoverable from reinsurers based on the gross outstanding claims provision.

#### **(iii) Risk margin**

The determination of the appropriate level of risk margin takes into account the uncertainty or variability of each class of business and the diversification benefits achieved by writing a number of classes of business in a number of geographic locations.

The measurement of variability by class of business uses techniques similar to those used in determining the central estimate. These techniques determine a range of possible outcomes of ultimate payments and assign a likelihood to outcomes at different levels. The use of a range of outcomes allows a determination of the risk margin required to provide an estimate at a given probability of adequacy, e.g. nine times in 10 (a 90% probability of adequacy). These techniques use standard statistical distributions, and the measure of variability is referred to as the standard deviation or the coefficient of variation.

## Notes to the financial statements continued

FOR THE YEAR ENDED 31 DECEMBER 2005

### 3

#### CRITICAL ACCOUNTING ESTIMATES AND JUDGMENTS CONTINUED

The risk margin required to provide a given probability of adequacy for two or more classes of business or for two or more geographic locations combined is likely to be less than the sum of the risk margins for the individual classes. This reflects the benefit of diversification in general insurance. The statistical measure used to determine diversification is called the correlation or covariance. The higher the correlation between two classes of business, the more likely it is that a negative outcome in one class will correspond to a negative outcome in the other class. For example, high correlation exists in classes of business affected by court cases involving bodily injury claims such as motor third party liability (CTP), workers' compensation and public liability.

Whilst there are estimation techniques for determining correlations, they are difficult to apply. The correlations adopted by the consolidated entity are normally derived from industry analysis, the consolidated entity's historical experience and the judgment of experienced and qualified actuaries.

The risk margin for the consolidated entity is determined by analysing the variability of each class of business and the correlation between classes of business and divisions. Correlations are determined for aggregations of classes of business, where appropriate, at the divisional level. Applying correlations between divisions results in a further diversification benefit to the consolidated entity with a consequent impact on the consolidated entity's risk margin.

The potential impact of changes in the coefficient of variation assumptions on the consolidated entity's income statement and balance sheet is summarised in note 3(A)(vii).

#### (iv) Assets arising from contracts with reinsurers

Assets arising from contracts with the consolidated entity's reinsurers are determined using the same methods described above. In addition, the recoverability of these assets is assessed at each balance date to ensure that the balances properly reflect the amounts that will ultimately be received, taking into account counterparty and credit risk.

#### (v) Expected present value of future cash flows for future claims

The expected present value of future cash flows for future claims and risk margin used in the liability adequacy test are determined using the same methods described above.

#### (vi) Financial assumptions used to determine outstanding claims provisions

The outstanding claims provision is discounted to net present value using a risk free rate of return. Details of risk free rates applied are as follows:

	2005 %		2004 %	
	SUCCEEDING YEAR	SUBSEQUENT YEARS	SUCCEEDING YEAR	SUBSEQUENT YEARS
Australia Pacific Asia Central Europe	2.70–13.40	2.70–13.40	0.60–7.85	1.66–10.35
European operations	4.30–4.40	4.30–4.40	3.00–4.50	3.00–4.50
the Americas	4.40	4.40	3.00	3.00
Equator Re	4.30–5.53	4.30–5.38	3.00–5.22	3.00–5.49

The potential impact of a change in discount rates on the consolidated entity's income statement and balance sheet is summarised in note 3(A)(vii).

The weighted average terms to settlement of net outstanding claims at the balance date are as follows:

	2005 YEARS	2004 YEARS
Australia Pacific Asia Central Europe	2.8	3.1
European operations	3.0	3.1
the Americas	2.2	2.3
Equator Re	1.9	1.8
Consolidated entity	2.9	3.0

The potential impact of a change in the weighted average term to settlement on the consolidated entity's income statement and balance sheet is summarised in note 3(A)(vii).

The sensitivity of the consolidated entity's exposure to interest rate risk in respect of financial assets is also considered in note 5(A)(ii).

## Notes to the financial statements continued

FOR THE YEAR ENDED 31 DECEMBER 2005

### 3

#### CRITICAL ACCOUNTING ESTIMATES AND JUDGMENTS CONTINUED

##### (vii) Impact of changes in key variables on the outstanding claims provision

The impact of changes in key outstanding claims variables are summarised below. Each change has been calculated in isolation of the other changes and each change shows the after tax impact on profit and equity assuming that there is no change to:

- Any of the other variables – This is considered unlikely as, for example, an increase in interest rates is normally accompanied by an increase in the rate of inflation. As can be seen from the table below, the impact of a change in discount rates is largely offset by the impact of a change in the rate of inflation. The impact of a change in interest rates on financial assets is shown in note 5(D).
- The probability of adequacy – The directors and management have set an internal target range of 85% to 94% for the probability of adequacy of the outstanding claims provision. It is likely that if, for example, the central estimate was to increase by 5%, at least part of the increase would result in a decrease in the probability of adequacy, which is currently estimated to be 94%. Likewise, if the coefficient of variation were to increase by 1%, it is likely that the probability of adequacy would reduce from its current level and that the change would therefore impact the amount of risk margins held rather than net profit after tax or equity.

	MOVEMENT IN VARIABLE %	FINANCIAL IMPACT <sup>(1)</sup>	
		PROFIT (LOSS) \$M	EQUITY \$M
Central estimate	+5	(337)	(337)
	-5	337	337
Inflation rate	+1	(211)	(211)
	-1	200	200
Discount rate	+1	180	180
	-1	(193)	(193)
Coefficient of variation	+1	(113)	(113)
	-1	112	112
Weighted average term to settlement	+10	99	99
	-10	(101)	(101)

(1) Determined at the consolidated entity level net of reinsurance and taxation at the prima facie rate of 30%.

##### (B) Superannuation plan obligations

The present value of the obligations arising from the consolidated entity's defined benefit superannuation plans is determined by external actuaries based on discount rate, mortality, salary growth and investment return assumptions. Key assumptions are set out in note 29.

The discount rate applied to the various plans is the interest rate on high quality corporate bonds (where there is a sufficiently deep market) or the appropriate government bond rate. The surplus or deficit at each balance date varies to reflect changes in interest rates.

Mortality assumptions are affected by experience which indicates increasing longevity, particularly for certain age groups of the population. The consolidated entity has considered the consensus of professional opinions from a number of external actuaries in respect of the appropriateness of the mortality tables selected for use in the valuation of the superannuation obligations for each of the consolidated entity's plans.

The potential impact of a change in the most sensitive assumption on the consolidated entity's income statement and balance sheet is summarised below.

	MOVEMENT IN VARIABLE %	FINANCIAL IMPACT <sup>(1)</sup>	
		PROFIT (LOSS) \$M	EQUITY \$M
Discount rate	-1	-	(108)

(1) Determined at the consolidated entity level net of taxation at the prima facie rate relevant to the superannuation plan.

##### (C) Intangible assets

Goodwill and intangible assets with an indefinite useful life are tested annually for impairment, or more frequently when changes in circumstances indicate that the carrying amount may not be recoverable. Intangible assets subject to amortisation are reviewed for impairment whenever events or changes in circumstances indicate that the carrying value may not be recoverable. The impairment review is based on the net present value of estimated future cash flows of the relevant cash generating unit, which is determined by reference to, amongst other factors, the estimated combined operating ratio in the business plan.

If the combined operating ratio applied in these calculations was increased by one per cent over management's estimates at 31 December 2005, the consolidated entity would have no requirement to reflect an impairment write down.

## 4

### INSURANCE CONTRACTS – RISK MANAGEMENT POLICIES AND PROCEDURES

An overview of the consolidated entity's risk management framework is provided in the risk management statement on pages 14 and 15 and in the risk management section of the corporate governance statement on pages 43 to 44. The consolidated entity's risk management objectives are to:

- avoid unwelcome surprises by reducing uncertainty and volatility;
- achieve competitive advantage through better understanding the risk environment in which the consolidated entity operates; and
- optimise risk and more effectively allocate capital and resources by assessing the balance of risk and reward.

A fundamental part of the consolidated entity's overall risk management strategy is the effective governance and management of the risks that impact the amount, timing and uncertainty of cash flows arising from insurance contracts. These risks include insurance and reinsurance risks, financial risks and other risks such as regulatory and capital risks.

One of the cornerstones of the consolidated entity's risk management framework is the recruitment and retention of high quality people who are entrusted with appropriate levels of autonomy within the parameters of disciplined risk management practices. The consolidated entity operates a system of delegated authorities based on expertise and proven performance, and compliance is closely monitored.

#### **(A) Insurance and reinsurance risks**

The consolidated entity has established protocols to manage its insurance risks across the underwriting, claims and actuarial disciplines.

##### **(i) Underwriting risks**

###### SELECTION AND PRICING OF RISKS

Underwriting authority is delegated to experienced underwriters for the forthcoming year following a detailed retrospective and prospective analysis of each class of business as part of the consolidated entity's annual business planning process. Delegated authorities reflect the level of risk which the consolidated entity is prepared to take. The authorities include reference to some combination of:

- gross written premium;
- premium per contract;
- sum insured per contract;
- aggregate exposures per zone;
- probable maximum loss and realistic disaster scenarios ("RDSs");
- levels and quality of reinsurance protection;
- geographic exposures; and/or
- classes of business and types of product that may be written.

Limits in respect of each of the above are set at a portfolio, divisional and consolidated entity level and are included within business plans for individual classes of business. They are adjusted at a local level to reflect a risk factor in respect of each controlled entity depending on previous underwriting results, the economic environment and other potential drivers of volatility.

Insurance and reinsurance policies are written in accordance with local management practices and regulations within each jurisdiction taking into account the consolidated entity's risk tolerance and underwriting standards. Non-standard and long term policies may only be written if expressly included in the delegated authorities. No individual long term or non-standard policy is material to the consolidated entity.

Pricing of risks is controlled by use of in-house pricing models relevant to the specific portfolio and markets in which the consolidated entity operates. Experienced underwriters and actuaries maintain historical pricing and claims analysis for each portfolio and this is combined with a detailed knowledge of the current developments in the respective markets and classes of business.

###### CONCENTRATION RISK

The consolidated entity's exposure to concentrations of insurance risk is mitigated by a portfolio diversified across 41 countries and hundreds of classes of business. Product diversification is achieved through a strategy of developing strong underwriting skills in a wide variety of classes of business. A combination of core and specialty products under the control of proven employees skilled in underwriting such products allows the consolidated entity to lead underwrite in many of the markets in which it operates.

The consolidated entity has potential exposure to catastrophe losses that may impact more than one operating division. Each year, the consolidated entity sets its tolerance to concentration risk. RDSs, using industry standard and QBE determined probable maximum losses and various catastrophe models, are calculated for each portfolio during the business planning process. These RDSs are aggregated across all portfolios and divisions to determine the consolidated entity's maximum event retention ("MER") which is the estimated maximum net loss from major natural catastrophes with an approximate return period of 250 years. The MER must be less than the consolidated entity's concentration risk tolerance; otherwise, steps such as the purchase of additional reinsurance are taken to limit the exposure.

# Notes to the financial statements continued

FOR THE YEAR ENDED 31 DECEMBER 2005

## 4

### INSURANCE CONTRACTS – RISK MANAGEMENT POLICIES AND PROCEDURES CONTINUED

In 2005, the net cost of large catastrophes, being catastrophes with an individual net cost of more than \$10 million to the consolidated entity, was \$515 million before tax (2004 \$320 million).

#### REINSURANCE RISK

The consolidated entity's strategy in respect of the selection, approval and monitoring of reinsurance arrangements is addressed by the following protocols.

- Treaty or facultative reinsurance is placed in accordance with the requirements of the consolidated entity's reinsurance management strategy and Group security committee guidelines.
- Reinsurance arrangements are regularly reassessed to determine their effectiveness based on current exposures, historic losses and potential future losses based on RDSs and the consolidated entity's MER.

The consolidated entity's exposure to reinsurance counterparties and the credit quality of those counterparties is actively monitored.

#### (ii) Claims management and claims provisioning risks

The consolidated entity's approach to determining the outstanding claims provision and the related sensitivities are set out in note 3.

The consolidated entity seeks to ensure the adequacy of its outstanding claims provision by reference to the following controls.

- Experienced claims managers work with underwriters on coverage issues and operate within the levels of authority delegated to them in respect of the settlement of claims.
- Processes exist to ensure that all claims advices are captured and updated on a timely basis and with a realistic assessment of the ultimate claims cost.
- Initial IBNR estimates are set by experienced internal actuaries in conjunction with the local product managers and underwriters for each class of business in each business unit.
- The aggregate outstanding claims provision for each controlled entity is assessed in a series of quarterly internal claims review meetings, which are attended by senior divisional management and one or both of the chief risk officer and Group actuary in order to ensure consistency of provisioning practices across all divisions.
- Over 90% of the consolidated entity's outstanding claims provision is reviewed by external actuaries at least annually.

Despite the rigour involved in the establishment and review of the outstanding claims provision, the provision is subject to significant uncertainty for the reasons set out in note 3.

#### (B) Financial risks arising from insurance contracts

The consolidated entity is exposed to the risk that interest rate movements may materially impact the value of the outstanding claims provision. Historically, there has been a high correlation between changes in discount rates and the movement in claims inflation. The financial impact of changing interest rates on outstanding claims is therefore expected to be offset in the longer term by similar changes in claims inflation.

#### (C) Other risks arising from insurance contracts

The consolidated entity is exposed to a number of other risks arising from insurance contracts.

##### (i) Capital and regulatory risks

Australian and overseas controlled entities are subject to extensive prudential regulation in the jurisdictions in which they conduct business. Prudential regulation is generally designed to protect policyholders. Regulation covers a number of areas including solvency, change in control and capital movement limitations. The regulatory environment in Australia and overseas continues to evolve in response to economic, political and industry developments. The consolidated entity works closely with regulators and monitors regulatory developments across its global operations to assess their potential impact on its ability to meet solvency and other requirements.

##### (ii) Acquisition risks

The consolidated entity's strategy of growth by acquisition exposes it to additional risks. Acquisition risks are principally managed by the consolidated entity's controls over the due diligence and subsequent integration processes. The consolidated entity has experienced due diligence teams in each of the divisions and has documented minimum requirements for carrying out due diligence.

# Notes to the financial statements continued

FOR THE YEAR ENDED 31 DECEMBER 2005

## 5

### FINANCIAL RISK MANAGEMENT

The activities of the consolidated entity expose it to financial risks such as market risk (including currency risk, cash flow and fair value interest rate risk and price risk), credit risk and liquidity risk. The consolidated entity's risk management framework recognises the unpredictability of financial markets and seeks to minimise potential adverse effects on the financial performance of the Group.

The key objectives of the consolidated entity's asset and liability management strategy are to ensure sufficient liquidity is maintained at all times to meet the consolidated entity's obligations, including its settlement of insurance liabilities and, within these parameters, to optimise investment returns for policyholders and shareholders.

#### **(A) Market risk**

##### **(i) Currency risk**

The consolidated entity is exposed to foreign currency risk in respect of its net foreign currency exposures. This risk is managed as follows.

- Each controlled entity manages the volatility arising from changes in foreign exchange rates by matching liabilities with assets of the same currency, thus ensuring that any exposures to overseas currencies are minimised.
- Forward foreign exchange contracts are used to protect residual currency positions. These forward foreign exchange contracts are accounted for in accordance with the derivatives accounting policy set out in note 1(N).
- The consolidated entity manages the foreign currency exposures arising from the revaluation of net investments in foreign operations to Australian dollars using either foreign currency interest bearing liabilities designated as hedging instruments or forward foreign exchange contracts designated as hedging instruments.

Those arrangements which meet the hedging criteria set out under AASB 139 are accounted for in accordance with the accounting policy provided in note 1(O). The effectiveness of the currency management processes and the related use of derivatives is actively monitored by the Group treasurer and Group chief financial officer.

The risk management process covering forward foreign exchange contracts and hedges involves close senior management scrutiny, including regular board and other management reporting. All forward foreign exchange contracts and hedge transactions are subject to delegated authority levels provided to management, and the levels of exposure are reviewed on an ongoing basis.

All instruments that are designated as hedges are tested for effectiveness on both a prospective and retrospective basis. These tests are performed at least quarterly.

##### **(ii) Cash flow and fair value interest rate risk**

The consolidated entity is exposed to interest rate risk arising on interest bearing assets. Assets with floating rate interest expose the consolidated entity to cash flow interest rate risk. Fixed interest rate assets expose the consolidated entity to fair value interest rate risk. The consolidated entity's strategy is to invest in high quality, liquid fixed interest securities and cash and to actively manage duration. The investment portfolios are actively managed to achieve a balance between cash flow interest rate risk and fair value interest rate risk bearing in mind the need to meet the liquidity requirements of the insurance business.

The consolidated entity is also exposed to interest rate risk arising from long term interest bearing liabilities.

Eurobonds issued at variable interest rates expose the consolidated entity to cash flow interest rate and foreign currency risk. The consolidated entity manages this cash flow interest rate risk by using floating to fixed cross currency interest rate swaps, details of which are set out in note 22.

The consolidated entity is exposed to fair value interest rate and currency risk in respect of ABC securities and exposed to cash flow interest rate risk on the ABC financial assets pledged. The consolidated entity manages these risks by using floating to fixed interest rate swaps and floating to fixed cross currency interest rate swaps, details of which are set out in note 35.

All other long term interest bearing liabilities are generally fixed interest rate borrowings valued at amortised cost and therefore do not expose the entity to cash flow or fair value interest rate risk.

The consolidated entity's exposure to interest rate risk and the effective weighted average interest rate for each significant class of interest bearing financial asset and liability is provided on the opposite page.

# Notes to the financial statements continued

FOR THE YEAR ENDED 31 DECEMBER 2005

## 5

### FINANCIAL RISK MANAGEMENT CONTINUED

2005	FLOATING INTEREST RATE	FIXED INTEREST RATE MATURING IN							TOTAL
		1 YEAR OR LESS	1 TO 2 YEARS	2 TO 3 YEARS	3 TO 4 YEARS	4 TO 5 YEARS	OVER 5 YEARS		
<b>(i) Net interest bearing financial assets (excluding ABC financial assets and ABC securities)</b>									
Interest bearing securities	\$M	3,100	9,376	1,803	526	217	360	447	15,829
Weighted average interest rate	%	4.3	4.7	4.8	5.0	5.4	5.5	5.8	4.7
Financial liabilities	\$M	(400)	–	–	–	(404)	(344)	(982)	(2,130)
Weighted average interest rate	%	5.8	–	–	–	5.7	8.8	3.4	5.2
<b>Net interest bearing financial assets</b>	\$M	2,700	9,376	1,803	526	(187)	16	(535)	13,699
<b>(ii) ABC financial assets and ABC securities</b>									
ABC financial assets pledged for funds at Lloyd's <sup>(1)</sup>	\$M	–	–	–	750	282	–	–	1,032
Weighted average interest rate	%	–	–	–	3.5	3.2	–	–	3.4
ABC securities for funds at Lloyd's	\$M	–	–	–	(720)	(295)	–	–	(1,015)
Weighted average interest rate	%	–	–	–	4.8	4.7	–	–	4.8
<b>Net ABC financial assets and ABC securities</b>	\$M	–	–	–	30	(13)	–	–	17

(1) Weighted average interest rate is net of swap income.

2004	FLOATING INTEREST RATE	FIXED INTEREST RATE MATURING IN							TOTAL
		1 YEAR OR LESS	1 TO 2 YEARS	2 TO 3 YEARS	3 TO 4 YEARS	4 TO 5 YEARS	OVER 5 YEARS		
<b>(i) Net interest bearing financial assets (excluding ABC financial assets and ABC securities)</b>									
Interest bearing securities	\$M	2,542	6,055	1,792	1,035	181	180	654	12,439
Weighted average interest rate	%	3.8	4.4	4.7	5.0	5.0	4.6	4.8	4.4
Financial liabilities	\$M	–	–	–	–	–	(427)	(1,378)	(1,805)
Weighted average interest rate	%	–	–	–	–	–	5.6	4.7	4.9
<b>Net interest bearing financial assets</b>	\$M	2,542	6,055	1,792	1,035	181	(247)	(724)	10,634
<b>(ii) ABC financial assets and ABC securities</b>									
ABC financial assets pledged for funds at Lloyd's <sup>(1)</sup>	\$M	–	–	–	–	703	295	–	998
Weighted average interest rate	%	–	–	–	–	3.5	3.2	–	3.4
ABC securities for funds at Lloyd's	\$M	–	–	–	–	(691)	(277)	–	(968)
Weighted average interest rate	%	–	–	–	–	4.8	4.7	–	4.8
<b>Net ABC financial assets and ABC securities</b>	\$M	–	–	–	–	12	18	–	30

(1) Weighted average interest rate is net of swap income.

# Notes to the financial statements continued

FOR THE YEAR ENDED 31 DECEMBER 2005

## 5

### FINANCIAL RISK MANAGEMENT CONTINUED

	2005 \$M	2004 \$M
<b>(iii) Reconciliation of net financial assets to net assets</b>		
Net financial assets		
Interest bearing	13,699	10,634
ABC financial assets pledged for funds at Lloyd's	1,032	998
ABC securities for funds at Lloyd's	(1,015)	(968)
Non-interest bearing and other	1,401	2,136
Net insurance liabilities	(11,267)	(9,854)
Net non-financial assets	1,309	1,146
<b>Net assets</b>	<b>5,159</b>	<b>4,092</b>

The potential impact of movements in interest rates on the consolidated entity's income statement and balance sheet in relation to the valuation of financial assets is summarised in note 5(D).

#### (iii) Price risk

The consolidated entity is exposed to price or market value risk on its investment in equities and fixed interest securities and uses forward contracts and options to manage this exposure. The risk management processes over these forward contracts and options are the same as those explained in note 5(A)(i) in respect of forward foreign currency contracts.

Equities are held mainly against shareholders' funds. At 31 December 2005, 3.7% (2004 8.9%) of the consolidated entity's financial assets were held in listed equities. The potential impact of movements in the market value of equities on the consolidated entity's income statement and balance sheet was therefore immaterial as shown in note 5(D).

#### (B) Credit risk

Credit risk exposures are calculated regularly and compared with authorised credit limits before further transactions are undertaken with each counterparty.

77% (2004 74%) of total financial assets and cash is with counterparties having a Moody's rating of Aa3 or better. The consolidated entity does not expect any investment counterparties to fail to meet their obligations given their strong credit ratings and therefore does not require collateral or other security to support derivatives. The consolidated entity only uses derivatives in highly liquid markets.

#### (C) Liquidity risk

In addition to treasury cash held for working capital requirements, a minimum percentage of the consolidated entity's total financial assets is held in liquid, short term money market securities to ensure there are sufficient liquid funds available to meet obligations. Details of the consolidated entity's financial assets are provided in note 13. At 31 December 2005, the mean term of cash and fixed interest investments was 0.6 years (2004 0.6 years).

The consolidated entity limits the risk of liquidity shortfalls resulting from a mismatch in the timing of claims payments and receipt of claims recoveries by negotiating cash call clauses in reinsurance contracts and seeking accelerated settlements for large claims.

#### (D) Impact of changes in key variables

	MOVEMENT IN VARIABLE %	FINANCIAL IMPACT <sup>(1)</sup>	
		PROFIT (LOSS) \$M	EQUITY \$M
Interest rate movement – impact on fair value of fixed interest securities	+1	(66)	(66)
	-1	66	66
Market value of equities	+1	5	5
	-1	(5)	(5)

(1) Determined at the consolidated entity level net of taxation at the prima facie rate of 30%.

## Notes to the financial statements continued

FOR THE YEAR ENDED 31 DECEMBER 2005

### 6

#### REVENUE

	THE COMPANY		CONSOLIDATED	
	2005 \$M	2004 \$M	2005 \$M	2004 \$M
<b>Premium revenue</b>				
Direct	–	–	7,076	6,583
Inward reinsurance	–	–	2,095	1,988
	–	–	9,171	8,571
<b>Other revenue</b>				
Reinsurance and other recoveries	–	–	2,327	1,171
Interest and dividend income	520	1,940	616	549
Foreign exchange gains	–	–	3	51
	520	1,940	2,946	1,771
Net fair value gains on financial assets <sup>(1)</sup>	–	–	216	88
Realised gain on sale of controlled entities	629	–	11	–
Investment income – ABC financial assets pledged for funds at Lloyd's	48	48	84	40
<b>Revenue</b>	<b>1,197</b>	<b>1,988</b>	<b>12,428</b>	<b>10,470</b>

(1) Consolidated includes realised gains of \$155 million (2004 \$23 million).

### 7

#### PROFIT BEFORE INCOME TAX

##### (A) Profit before income tax (consolidated)

	NOTE	2005 \$M	2004 \$M
Gross written premium		9,408	8,766
Unearned premium movement		(237)	(195)
Gross earned premium		9,171	8,571
Outward reinsurance premium		(1,785)	(1,781)
Deferred reinsurance premium movement		–	(9)
Outward reinsurance premium expense		(1,785)	(1,790)
Net earned premium		7,386	6,781
Gross claims incurred		(6,744)	(5,327)
Reinsurance and other recoveries		2,327	1,171
Net claims incurred	9	(4,417)	(4,156)
Net commission		(1,251)	(1,184)
Other acquisition costs		(428)	(439)
Underwriting and other expenses		(482)	(405)
		(6,578)	(6,184)
<b>Underwriting profit</b>		<b>808</b>	<b>597</b>
Investment income on policyholders' funds		480	331
<b>Insurance profit</b>		<b>1,288</b>	<b>928</b>
Investment income on shareholders' funds		238	188
Amortisation of intangibles and impairment of goodwill/intangibles		(3)	(1)
<b>Profit before income tax</b>		<b>1,523</b>	<b>1,115</b>

# Notes to the financial statements continued

FOR THE YEAR ENDED 31 DECEMBER 2005

## 7

### PROFIT BEFORE INCOME TAX CONTINUED

#### (B) Net investment and other income

	THE COMPANY		CONSOLIDATED	
	2005 \$M	2004 \$M	2005 \$M	2004 \$M
Dividends from controlled entities	445	1,867	–	–
Dividends from non-related entities	–	–	41	52
Interest received or receivable from controlled entities	65	58	–	–
Interest received or receivable from non-related entities	1	1	567	483
Other investment income	9	14	8	14
<b>Interest and dividend income</b>	<b>520</b>	<b>1,940</b>	<b>616</b>	<b>549</b>
Investment income - ABC financial assets pledged for funds at Lloyd's	48	48	84	40
Realised gains - equities	–	–	94	54
Realised gains (losses) - fixed interest and other	–	–	61	(31)
Unrealised gains - equities	–	–	35	47
Unrealised gains - fixed interest and other	–	–	26	18
Realised gains on sale of controlled entity	629	–	11	–
Foreign exchange gains	–	–	3	51
<b>Investment and other income</b>	<b>1,197</b>	<b>1,988</b>	<b>930</b>	<b>728</b>
Expenses - ABC securities for funds at Lloyd's	(45)	(45)	(101)	(83)
Finance costs paid or payable to controlled entities	(49)	(39)	–	–
Finance costs paid or payable to non-related entities	(44)	(37)	(96)	(94)
Investment expenses	(1)	(4)	(15)	(32)
Foreign exchange losses	(5)	(47)	–	–
<b>Net investment and other income</b>	<b>1,053</b>	<b>1,816</b>	<b>718</b>	<b>519</b>
Investment income on policyholders' funds			480	331
Investment income on shareholders' funds			238	188
<b>Net investment and other income</b>			<b>718</b>	<b>519</b>

#### (C) Other expenses

	THE COMPANY		CONSOLIDATED	
	2005 \$M	2004 \$M	2005 \$M	2004 \$M
Net commission	–	–	1,251	1,184
Other acquisition costs	–	–	428	439
Underwriting and other expenses	–	–	482	405
Investment expenses	1	4	15	32
Amortisation of intangibles	–	–	3	1
Foreign exchange losses	5	47	–	–
<b>Other expenses</b>	<b>6</b>	<b>51</b>	<b>2,179</b>	<b>2,061</b>

#### (D) Specific items

	THE COMPANY		CONSOLIDATED	
	2005 \$M	2004 \$M	2005 \$M	2004 \$M
Defined contribution superannuation plan expense	–	–	24	24
Payments on operating leases	–	–	31	23
Depreciation of assets	–	–	40	53

## Notes to the financial statements continued

FOR THE YEAR ENDED 31 DECEMBER 2005

# 8

### INCOME TAX

#### (A) Reconciliation of prima facie tax to income tax expense

	THE COMPANY		CONSOLIDATED	
	2005 \$M	2004 \$M	2005 \$M	2004 \$M
Profit before income tax	1,053	1,816	1,523	1,115
Prima facie tax payable at 30%	316	545	457	335
Tax effect of permanent differences:				
Untaxed dividends	(335)	(563)	(11)	(15)
Differences in tax rates	15	9	(1)	(11)
Other, including non-allowable expenses and non-taxable income	(2)	(8)	(20)	(31)
Prima facie tax adjusted for permanent differences	(6)	(17)	425	278
Overprovision in prior years	(1)	(1)	–	(27)
<b>Income tax (credit) expense</b>	<b>(7)</b>	<b>(18)</b>	<b>425</b>	<b>251</b>
Analysed as follows:				
Current tax	(15)	(12)	486	153
Deferred tax	9	(5)	(61)	125
Overprovision in prior years <sup>(1)</sup>	(1)	(1)	–	(27)
	<b>(7)</b>	<b>(18)</b>	<b>425</b>	<b>251</b>

(1) Overprovision in prior years includes current and deferred tax components.

#### (B) Tax consolidation

Effective 1 January 2003, the company became the head entity in a tax-consolidated group comprising the company and all of its Australian wholly owned controlled entities ("Australian entities") and the requirements of the relevant accounting standards have been applied.

The directors of the company and its Australian entities have entered into a tax sharing and tax funding agreement that requires the Australian entities to make contributions to the company for current tax liabilities and deferred tax balances in respect of tax losses arising from external transactions occurring after the implementation of tax consolidation. The contributions are allocated by reference to the notional taxable income of each Australian entity.

The company has formally notified the Australian Taxation Office that the tax consolidation regime has been adopted by the Australian entities.

Details of franking credits available to shareholders are shown in note 25(D).

## Notes to the financial statements continued

FOR THE YEAR ENDED 31 DECEMBER 2005

# 9

### CLAIMS INCURRED (CONSOLIDATED)

#### (A) Claims analysis

	2005 \$M	2004 \$M
<b>Gross claims incurred and related expenses</b>		
Direct	4,384	3,962
Inward reinsurance	2,360	1,365
	<b>6,744</b>	5,327
<b>Reinsurance and other recoveries</b>		
Direct	1,125	843
Inward reinsurance	1,202	328
	<b>2,327</b>	1,171
<b>Net claims incurred</b>	<b>4,417</b>	4,156

#### (B) Claims development

Current year claims relate to risks borne in the current reporting year. Prior year claims relate to a reassessment of the risks borne in all previous reporting years.

	CURRENT YEAR \$M	2005 PRIOR YEARS \$M	TOTAL \$M	CURRENT YEAR \$M	2004 PRIOR YEARS \$M	TOTAL \$M
<b>Gross claims incurred and related expenses</b>						
Undiscounted	7,533	(651)	6,882	5,808	(205)	5,603
Discount	(659)	521	(138)	(541)	265	(276)
	<b>6,874</b>	<b>(130)</b>	<b>6,744</b>	5,267	60	5,327
<b>Reinsurance and other recoveries</b>						
Undiscounted	2,458	(33)	2,425	1,322	(65)	1,257
Discount	(233)	135	(98)	(153)	67	(86)
	<b>2,225</b>	<b>102</b>	<b>2,327</b>	1,169	2	1,171
<b>Net claims incurred</b>						
Undiscounted	5,075	(618)	4,457	4,486	(140)	4,346
Discount	(426)	386	(40)	(388)	198	(190)
	<b>4,649</b>	<b>(232)</b>	<b>4,417</b>	4,098	58	4,156

The development of net undiscounted outstanding claims for the five most recent accident years is shown in note 20.

## Notes to the financial statements continued

FOR THE YEAR ENDED 31 DECEMBER 2005

# 10

### CASH AND CASH EQUIVALENTS

	THE COMPANY		CONSOLIDATED	
	2005 \$M	2004 \$M	2005 \$M	2004 \$M
Cash at bank and in hand	12	4	317	349
Overnight money	2	5	162	253
Cash management trusts	-	-	129	252
Term deposits	-	-	416	224
Commercial paper	-	-	37	43
	14	9	1,061	1,121

Included in cash and cash equivalents are amounts totalling \$31 million (2004 \$107 million) not available for use by the consolidated entity which are held within Lloyd's syndicates as funds at Lloyd's.

# 11

### RECEIVABLES – CURRENT

	THE COMPANY		CONSOLIDATED	
	2005 \$M	2004 \$M	2005 \$M	2004 \$M
<b>Trade debtors</b>				
Premium <sup>(1)</sup>	-	-	917	736
Reinsurance and other recoveries <sup>(2)</sup>	-	-	547	565
Unclosed premium	-	-	1,412	1,273
	-	-	2,876	2,574
Other debtors	-	1	505	404
Treasury receivables	27	46	2	2
Investment receivables	10	5	224	166
Amounts due from controlled entities	1,891	3,391	-	-
	1,928	3,443	3,607	3,146

(1) Premium receivable is net of a provision for impairment of \$52 million (2004 \$37 million).

(2) Reinsurance and other recoveries are net of a provision for impairment of \$87 million (2004 \$75 million).

(3) A provision for impairment of reinsurance and other recoveries on outstanding claims of \$152 million (2004 \$88 million) is included in note 20.

## Notes to the financial statements continued

FOR THE YEAR ENDED 31 DECEMBER 2005

# 12

### DEFERRED INSURANCE COSTS (CONSOLIDATED)

	2005 \$M	2004 \$M
Deferred reinsurance premium	582	566
Deferred net commission	653	586
Deferred acquisition costs	211	206
	<b>1,446</b>	1,358

	DEFERRED NET COMMISSION \$M	DEFERRED ACQUISITION COSTS \$M
<b>Deferred costs at 1 January 2004</b>	463	170
Acquisitions	70	15
Costs deferred in financial year	507	182
Amortisation of costs deferred in previous financial years	(456)	(159)
Foreign exchange	2	(2)
<b>Deferred costs at 31 December 2004</b>	586	206
Acquisitions	25	–
Costs deferred in financial year	570	182
Amortisation of costs deferred in previous financial years	(528)	(174)
Foreign exchange	–	(3)
<b>Deferred costs at 31 December 2005</b>	653	211

# 13

### FINANCIAL ASSETS

#### (A) Financial assets at fair value through the income statement

	THE COMPANY		CONSOLIDATED	
	2005 \$M	2004 \$M	2005 \$M	2004 \$M
Short term money	40	–	8,292	5,482
Government bonds	–	–	3,866	2,848
Corporate bonds	–	–	1,919	2,396
Floating rate notes and other	–	–	1,634	1,698
Fixed interest trusts	–	–	68	5
Mortgages	–	–	50	10
	<b>40</b>	–	<b>15,829</b>	12,439
<b>Equities</b>				
Listed	–	–	654	1,333
Unlisted	–	–	33	50
Equity derivatives (forward contracts)	–	–	(13)	–
	–	–	<b>674</b>	1,383
	<b>40</b>	–	<b>16,503</b>	13,822
Current	40	–	9,411	6,548
Non-current	–	–	7,092	7,274
	<b>40</b>	–	<b>16,503</b>	13,822

ABC financial assets pledged for funds at Lloyd's are not included in this analysis. Details of ABCs are included in note 35(C).

## Notes to the financial statements continued

FOR THE YEAR ENDED 31 DECEMBER 2005

# 13

### FINANCIAL ASSETS CONTINUED

#### (B) Unlisted equities

The fair value movement in unlisted equities was a gain of \$4.3 million (2004 \$nil).

#### (C) Investments maturing within 12 months

Non-current investments include amounts maturing within 12 months of \$1,722 million (2004 \$1,408 million) which, in the normal course of business, will be reinvested and not used for working capital.

#### (D) Charges over investments and other assets

A controlled entity has given fixed and floating charges over certain of its investments and other assets in order to secure the obligations of the consolidated entity's corporate members at Lloyd's of London as described in note 31. Details of the fixed and floating charges over ABC financial assets pledged for funds at Lloyd's are provided in note 35(C).

# 14

### INVESTMENT PROPERTIES (CONSOLIDATED)

	2005 \$M	2004 \$M
<b>At 1 January</b>	<b>32</b>	38
Additions	4	–
Disposals	(2)	(8)
Fair value (losses) gains	(1)	2
<b>At 31 December</b>	<b>33</b>	32

The principal investment properties are valued by the directors based on the independent valuation of various qualified employees of Knight Frank (Australia) Pty Limited. Minor investment properties are included at the independent valuation of other licensed valuers.

All investment properties were valued on the basis of capitalisation of net market rentals allowing for costs of reletting, having regard to comparable on-market sales and discounted future cash flows.

# 15

### DERIVATIVE FINANCIAL INSTRUMENTS

#### (A) Derivative financial instruments – fair value

	THE COMPANY		CONSOLIDATED	
	2005 \$M	2004 \$M	2005 \$M	2004 \$M
<b>Current assets</b>				
Forward foreign exchange contracts	11	1	69	66
Eurobonds swaps	–	–	13	12
	<b>11</b>	1	<b>82</b>	78
<b>Current liabilities</b>				
Forward foreign exchange contracts	(4)	(8)	(35)	(53)
	<b>7</b>	(7)	<b>47</b>	25

Swaps relating to ABC securities are included in note 35(C).

# Notes to the financial statements continued

FOR THE YEAR ENDED 31 DECEMBER 2005

## 15

### DERIVATIVE FINANCIAL INSTRUMENTS CONTINUED

#### (i) Foreign currency risk

Foreign currency risk arises from the translation of net investments in foreign operations to Australian dollars, being both the presentation currency for the consolidated entity and the functional currency of the parent entity. The consolidated entity uses foreign currency interest bearing liabilities and forward foreign exchange contracts to mitigate this risk.

The consolidated entity is also exposed to foreign currency risk on its net position in foreign currencies arising from foreign currency transactions. The consolidated entity uses derivatives to help manage this exposure by entering into forward foreign exchange contracts, some of which involve the exchange of two foreign currencies according to the needs of controlled foreign entities.

Contractual amounts for foreign exchange derivatives outstanding at the balance date include forward foreign exchange contracts to purchase \$6,778 million (2004 \$5,162 million).

The maturity profile of these derivatives is as follows:

	2005 \$M	2004 \$M
Less than one year	6,766	4,962
More than one but less than five years	–	–
More than five years	12	200
	<b>6,778</b>	5,162

#### (ii) Market risk

The consolidated entity is exposed to market risk on its investment in equities and fixed interest securities and uses forward contracts and options to help manage this exposure. All derivative positions entered into by the consolidated entity are for economic hedging purposes but do not, in all cases, meet the criteria for hedge accounting. Contractual amounts for written options outstanding at the balance date were \$nil (2004 \$nil). There were no amounts outstanding for purchased options (2004 \$12 million).

The derivative risk management process is subject to regular internal audit and close senior management scrutiny, including regular board and other management reporting. All derivative transactions are subject to authority levels provided to management and the levels of exposure are reviewed on an ongoing basis.

#### (B) Hedging arrangements

The consolidated entity has designated the following derivatives as hedges:

TYPE OF HEDGE	DESCRIPTION OF INSTRUMENT	NATURE OF RISKS	FAIR VALUE	
			2005 \$M	2004 \$M
Fair value	Interest rate swaps – ABC securities (due 2008)	Changes in fair value of financial liability due to interest rate risk	(28)	–
Cash flow	Cross currency interest rate swaps – Eurobonds	Variability of functional currency cash flows due to interest rate and foreign currency risk	13	12
Cash flow	Cross currency interest rate swaps – ABC securities (due 2009)	Variability of functional currency cash flows due to interest rate and foreign currency risk	(1)	–
Net investments in foreign operations	Forward foreign exchange contracts – spot component	Currency risk	(21)	117

At the balance date, \$nil (2004 \$908 million) non-derivative interest bearing liabilities were designated as hedges of net investments in foreign operations. During 2005, these hedging instruments were replaced as hedges by forward foreign exchange contracts.

# 16

## INVESTMENTS IN CONTROLLED ENTITIES

	COUNTRY OF INCORPORATION/FORMATION	EQUITY HOLDING	
		2005 %	2004 %
<b>(A) Parent entity</b>			
QBE Insurance Group Limited	Australia		
<b>(B) Controlled entities</b>			
AIS Green Slip Group Pty Limited	Australia	100.00	100.00
Atlasz Real Estate and Management Company Limited	Hungary	100.00	100.00
Atlasz Utasbiztosítási Egyes Ügynöki Kft	Hungary	100.00	100.00
Australian Aviation Underwriting Pool Pty Limited	Australia	100.00	100.00
Bankside Insurance Holdings Limited (in liquidation)	UK	100.00	100.00
Bankside Underwriting Agencies Limited (in liquidation)	UK	100.00	100.00
BIDV – QBE Insurance Company Limited <sup>(1)</sup>	Vietnam	50.00	50.00
British Marine Holdings Limited	UK	100.00	–
British Marine Holdings SA	Luxembourg	100.00	–
British Marine Holdings II SA	Luxembourg	100.00	–
British Marine Luxembourg SA	Luxembourg	100.00	–
British Marine Managers Limited	UK	100.00	–
CHU Underwriting Agencies Pty Ltd	Australia	100.00	100.00
Concord Accident and Health Underwriting Agencies Pty Limited <sup>(1)</sup>	Australia	49.90	49.90
Concord Accident and Health Underwriting Agencies (SA) Pty Limited <sup>(1)</sup>	Australia	49.90	49.90
Concord Sports Insurance Agencies Pty Limited <sup>(1)</sup>	Australia	49.90	49.90
Concord Underwriting Agencies (NSW) Pty Limited <sup>(1)</sup>	Australia	49.90	49.90
Concord Underwriting Agencies (SA) Pty Limited <sup>(1)</sup>	Australia	49.90	49.90
Concord Underwriting Agencies Pty Limited <sup>(1)</sup>	Australia	49.90	49.90
Compania Central de Seguros SA	Colombia	97.00	–
Compania Internationale de Asigurari QBE ASITO SA	Moldova	72.60	72.60
Corporate Underwriting Agencies Pty Ltd	Australia	100.00	100.00
DA Constable Syndicate (Ireland) Limited	Ireland	100.00	100.00
DA Constable Syndicate Limited	UK	100.00	100.00
DA Constable Syndicate Pty Limited	Australia	100.00	100.00
Energy Insurance Services Limited	UK	100.00	100.00
Ensign Dedicated 1 Limited	UK	100.00	100.00
Ensign Holdings Limited	UK	100.00	100.00
Ensign Plus Insurance Services Limited (in liquidation)	UK	100.00	100.00
Equator Investments Pty Limited	Australia	100.00	100.00
Equator Reinsurances Limited	Bermuda	100.00	100.00
European Claims Organisation Limited (in liquidation)	UK	100.00	100.00
FAI Insurances (Fiji) Limited	Fiji	100.00	100.00
Greenhill Baia Underwriting GmbH	Germany	100.00	–
Greenhill International Insurance Holdings Limited	UK	100.00	–
Greenhill Sturge Underwriting Limited	UK	100.00	–
Greenhill Underwriting Espana Limited	UK	100.00	–
Hyfield Company Limited <sup>(1)</sup>	Thailand	49.00	49.00
Icon Schemes Limited	UK	100.00	100.00
Insurance Consult SRL	Moldova	100.00	100.00
Invivo Medical Pty Ltd	Australia	50.00	–
Iron Trades Management Services Ltd	UK	100.00	100.00
Limit (Insurance and Reinsurance) Services Limited (in liquidation)	UK	100.00	100.00
Limit Corporate Members Limited	UK	100.00	100.00
Limit Holdings Limited	UK	100.00	100.00

# Notes to the financial statements continued

FOR THE YEAR ENDED 31 DECEMBER 2005

## 16

### INVESTMENTS IN CONTROLLED ENTITIES CONTINUED

	COUNTRY OF INCORPORATION/FORMATION	EQUITY HOLDING	
		2005 %	2004 %
Limit No 1 Limited	UK	100.00	100.00
Limit No 2 Limited	UK	100.00	100.00
Limit No 3 Limited	UK	100.00	100.00
Limit No 4 Limited	UK	100.00	100.00
Limit No 5 Limited	UK	100.00	100.00
Limit No 6 Limited	UK	100.00	100.00
Limit No 7 Limited	UK	100.00	100.00
Limit No 10 Limited	UK	100.00	100.00
Limit plc	UK	100.00	100.00
Limit Properties Limited	UK	100.00	100.00
Limit Technology and Commercial Underwriting Limited	UK	100.00	100.00
Limit Underwriting Limited	UK	100.00	100.00
Mantis Reef Limited <sup>(2)</sup>	Cayman Is	–	–
Mantis Reef Pledge Limited <sup>(2)</sup>	Cayman Is	–	–
Mantis Reef II Limited <sup>(2)</sup>	Cayman Is	–	–
Mantis Reef II Pledge Limited <sup>(2)</sup>	Cayman Is	–	–
MBP Holdings Limited	UK	100.00	–
MiniBus Plus Limited	UK	100.00	–
Minster Court Asset Management Limited	UK	100.00	100.00
MMIA Pty Limited	Australia	100.00	100.00
MMNSW Pty Limited	Australia	100.00	100.00
MMWC Pty Limited	Australia	100.00	100.00
National Credit Insurance (Brokers) NZ Limited	NZ	100.00	–
National Credit Insurance (Brokers) Pty Ltd	Australia	100.00	–
National Farmers Union Property and Casualty Company	US	100.00	–
Pitt Nominees Pty Limited	Australia	100.00	100.00
PT Asuransi QBE Pool Indonesia	Indonesia	60.00	60.00
QBE (PNG) Pty Limited	PNG	100.00	100.00
QBE (Singapore) Pte Ltd	Singapore	100.00	100.00
QBE Aseguradora de Riesgos del Trabajo SA	Argentina	83.00	83.00
QBE Atlasz Biztosító zrt	Hungary	100.00	100.00
QBE Australia Pty Limited	Australia	100.00	100.00
QBE Brasil Seguros SA	Brazil	100.00	100.00
QBE Corporate Capital Holdings plc	UK	100.00	100.00
QBE Corporate Holdings Ltd	UK	100.00	100.00
QBE Corporate Limited	UK	100.00	100.00
QBE Employee Share Trust <sup>(2)</sup>	Australia	–	–
QBE Equities Pty Limited	Australia	100.00	100.00
QBE Finance Pty Limited	Australia	100.00	100.00
QBE Funding Limited	Jersey	100.00	100.00
QBE Funding II Limited	Jersey	100.00	100.00
QBE Funding III Limited	Jersey	100.00	100.00
QBE Funding Trust <sup>(2)</sup>	US	–	–
QBE Funding Trust II <sup>(2)</sup>	US	–	–
QBE Funding Trust III <sup>(2)</sup>	US	–	–
QBE Holdings (UK) Limited	UK	100.00	100.00
QBE Holdings Inc	US	100.00	100.00
QBE Hongkong & Shanghai Insurance Limited	Hong Kong	74.47	74.47

# Notes to the financial statements continued

FOR THE YEAR ENDED 31 DECEMBER 2005

## 16

### INVESTMENTS IN CONTROLLED ENTITIES CONTINUED

	COUNTRY OF INCORPORATION/FORMATION	EQUITY HOLDING	
		2005 %	2004 %
QBE Insurance (Australia) Limited	Australia	100.00	100.00
QBE Insurance (Europe) Limited	UK	100.00	100.00
QBE Insurance (Fiji) Limited	Fiji	100.00	100.00
QBE Insurance (Hong Kong) Limited (in liquidation)	Hong Kong	100.00	100.00
QBE Insurance (International) Limited	Australia	100.00	100.00
QBE Insurance (Malaysia) Berhad	Malaysia	51.00	51.00
QBE Insurance (Philippines) Inc	Philippines	59.00	59.00
QBE Insurance (PNG) Limited	PNG	100.00	100.00
QBE Insurance (Thailand) Co Ltd <sup>(1)</sup>	Thailand		
Thai resident entities		23.67	23.67
Non-Thai resident entities		24.87	24.87
QBE Insurance (Vanuatu) Limited	Vanuatu	100.00	100.00
QBE Insurance Company (UK) Limited	UK	100.00	100.00
QBE Insurance Corporation	US	100.00	100.00
QBE International (Investments) Pty Limited	Australia	100.00	100.00
QBE International Holdings (UK) plc	UK	100.00	100.00
QBE International Holdings Limited	Hong Kong	100.00	100.00
QBE Investments (North America) Inc	US	100.00	100.00
QBE Investments Pty Limited	Australia	100.00	100.00
QBE Irish Share Incentive Plan <sup>(2)</sup>	Ireland	–	–
QBE IT Services Pty Limited	Australia	100.00	100.00
QBE Kindlustuse Eesti AS	Estonia	100.00	–
QBE Makedonija <sup>(3)</sup>	Macedonia	65.25	65.25
QBE Management Company (Bermuda) Limited	Bermuda	100.00	100.00
QBE Management (UK) Limited	UK	100.00	100.00
QBE Management Inc	US	100.00	100.00
QBE Management Services Pty Ltd	Australia	100.00	100.00
QBE Marine Underwriting Agency Pte Limited	Singapore	70.00	70.00
QBE Nominees (PNG) Limited	PNG	100.00	100.00
QBE Nominees Pty Limited	Australia	100.00	100.00
QBE Pacific Insurance Limited	PNG	100.00	100.00
QBE Poistovna AS	Slovakia	100.00	100.00
QBE Re Services Pty Limited	Australia	100.00	100.00
QBE Reinsurance (Bermuda) Limited	Bermuda	100.00	100.00
QBE Reinsurance (Europe) Limited	Ireland	100.00	100.00
QBE Reinsurance (UK) Limited	UK	100.00	100.00
QBE Reinsurance Administration Pty Ltd	Australia	100.00	100.00
QBE Reinsurance Corporation	US	100.00	100.00
QBE Specialty Insurance Company	US	100.00	100.00
QBE UK Finance I Limited	UK	100.00	100.00
QBE UK Finance II Limited	UK	100.00	–
QBE UK Share Incentive Plan <sup>(2)</sup>	UK	–	–
QBE WorkAble Limited	NZ	100.00	100.00
QBE Workers Compensation (NSW) Limited	Australia	100.00	100.00
QBE Workers Compensation (SA) Limited	Australia	100.00	100.00
QBE Workers Compensation (VIC) Limited	Australia	100.00	100.00
QBEMM Pty Limited	Australia	100.00	100.00
QBE-UGPB Insurance <sup>(1)</sup>	Ukraine	50.00	50.00

# Notes to the financial statements continued

FOR THE YEAR ENDED 31 DECEMBER 2005

## 16

### INVESTMENTS IN CONTROLLED ENTITIES CONTINUED

	COUNTRY OF INCORPORATION/FORMATION	EQUITY HOLDING	
		2005 %	2004 %
Queensland Insurance (Australia) Pty Limited	Australia	100.00	100.00
Queensland Insurance (Investments) Limited	Fiji	100.00	100.00
Ridgwell Fox & Partners (Underwriting Management) Limited	UK	100.00	100.00
Sinkaonamahasarn Company Limited <sup>(1)</sup>	Thailand	49.00	49.00
SRL Underwriting Limited	UK	100.00	100.00
Star Trust <sup>(2)</sup>	Cayman Is	–	–
Strakh-Consult	Ukraine	100.00	100.00
Sukhothai Re Consultants Limited	Thailand	100.00	100.00
The MiniBus & Coach Club Limited	UK	100.00	–
Torch Dedicated Corporate Member Limited	UK	100.00	100.00
Torch Insurance Services Limited (in liquidation)	UK	100.00	100.00
Travelon Pty Limited	Australia	100.00	100.00
Underwriting Marketing Services Pty Limited <sup>(1)</sup>	Australia	49.90	49.90
United Security Insurance Company	US	100.00	–
Universal Management Limited	Ireland	100.00	100.00
Visionex 2000 Limited	UK	100.00	–

(1) The following special conditions exist with respect to the consolidated entity's equity holdings.

- For accounting purposes, the consolidated entity has effective control of QBE Insurance (Thailand) Co Ltd, QBE-UGPB Insurance, BIDV-QBE Insurance Company Limited and the Concord group of companies.
- The issued share capital of Hyfield Company Limited and Sinkaonamahasarn Company Limited owned by the consolidated entity is held by various controlled entities. Other controlled entities have the right to acquire the remaining share capital.

(2) In accordance with the requirements of UIG 112: Consolidation – Special Purpose Entities, Mantis Reef Limited, Mantis Reef II Limited, Mantis Reef Pledge Limited, Mantis Reef II Pledge Limited, QBE Employee Share Trust, QBE Irish Share Incentive Plan, QBE UK Share Incentive Plan, Star Trust and the QBE Funding Trusts have been included in the consolidated financial statements.

(3) The shareholding in QBE Makedonija equates to 73.50% (2004 73.50%) of the voting rights.

#### (C) Change of name

CONTROLLED ENTITY	FORMER NAME
MMIA Pty Limited	Mercantile Mutual Insurance (Australia) Limited
MMNSW Pty Limited	Mercantile Mutual Insurance (NSW Workers Compensation) Pty Limited
MMWC Pty Limited	Mercantile Mutual Insurance (Workers Compensation) Limited
QBE Atlasz Biztosító zrt	QBE Atlasz Biztosító Rt
QBE Equities Pty Limited	Mercantile Equities Pty Limited
QBE Insurance (Europe) Limited	QBE International Insurance Limited
QBE UK Finance I Limited	Sandsale Limited
QBE Workers Compensation (SA) Limited	Mercantile Mutual Insurance (SA Workers Compensation) Limited
QBE Workers Compensation (VIC) Limited	Mercantile Mutual Worksure Limited
QBEMM Pty Limited	QBE Mercantile Mutual Limited
QBE (Singapore) Pte Ltd	QBE Insurance (Singapore) Pte Ltd

# Notes to the financial statements continued

FOR THE YEAR ENDED 31 DECEMBER 2005

## 16

### INVESTMENTS IN CONTROLLED ENTITIES CONTINUED

#### (D) Minority interest in controlled entities (consolidated)

	2005 \$M	2004 \$M
Ordinary share capital	57	57
Reserves	(6)	(15)
Retained profits	15	18
	66	60

#### (E) Equity

All equity in controlled entities is held in the form of shares or through contractual arrangements.

#### (F) Acquisitions

The following entities were acquired during the financial year:

- On 8 April 2005, a wholly owned entity acquired QBE Kindlustuse Eesti AS (formerly Nordicum Kindlustuse Eesti AS), a general insurance business in Estonia.
- On 29 April 2005, a wholly owned entity acquired an underwriting agency, Greenhill Underwriting Group, which operates in France, Germany and Spain producing property and liability insurance for the London market.
- On 31 May 2005, a wholly owned entity acquired Compania Central de Seguros SA, a general insurance business in Colombia.
- On 16 August 2005, a wholly owned entity acquired MBP Holdings Limited, the holding company of a UK underwriting agency, MiniBus Plus.
- On 30 September 2005, a wholly owned entity acquired National Farmers Union Property and Casualty Company, a general insurance business in the US.
- On 23 November 2005, a wholly owned entity acquired a specialist marine insurer, British Marine Holdings Limited. The purchase price was US\$199 million for net tangible assets of US\$108 million.
- On 23 December 2005, a wholly owned entity acquired National Credit Insurance (Brokers) Pty Ltd.

#### (G) Fair value of net assets of controlled entities acquired

	2005 \$M	2004 \$M
Cash and current financial assets	271	1,311
Receivables	113	321
Deferred insurance costs	36	129
Non-current financial assets	439	–
Property, plant and equipment	15	10
Trade and other payables	(181)	(187)
Net outstanding claims	(255)	(710)
Unearned premium	(166)	(412)
Provision for income tax	(3)	(9)
Net deferred income tax	5	9
Other provisions	(15)	(6)
	259	456
Intangible assets	307	550
Cost of acquisitions	566	1,006
The net cash flow relating to acquisitions was as follows:		
Cash consideration	536	953
Cash and current financial assets acquired	(136)	(123)
Net cash paid	400	830

The net contribution to the consolidated net profit after income tax for current year acquisitions is \$11 million (2004 \$42 million).

# Notes to the financial statements continued

FOR THE YEAR ENDED 31 DECEMBER 2005

## 17

### PROPERTY, PLANT AND EQUIPMENT (CONSOLIDATED)

2005	FREEHOLD BUILDINGS \$M	LEASEHOLD IMPROVEMENTS \$M	OFFICE EQUIPMENT/ FIXTURES & FITTINGS \$M	MOTOR VEHICLES \$M	TOTAL \$M
<b>Cost or valuation</b>					
At 1 January 2005	86	69	235	14	404
Acquisitions	7	1	7	–	15
Additions	–	53	25	3	81
Revaluations	(1)	–	–	–	(1)
Disposals	(1)	(9)	(55)	(3)	(68)
Foreign exchange	–	(1)	(2)	–	(3)
At 31 December 2005	91	113	210	14	428
<b>Accumulated depreciation and impairment losses</b>					
At 1 January 2005	–	40	171	7	218
Disposals	–	(8)	(50)	(2)	(60)
Depreciation charge for the year	–	7	31	2	40
Foreign exchange	–	–	(2)	–	(2)
At 31 December 2005	–	39	150	7	196
<b>Carrying amount</b>					
At 1 January 2005	86	29	64	7	186
At 31 December 2005	91	74	60	7	232

Principal owner occupied properties are valued by the directors based on the independent valuation of various qualified employees of Knight Frank (Australia) Pty Limited. Minor owner occupied properties are included at the independent valuation of other licensed valuers.

All owner occupied properties were valued on the basis of capitalisation of net market rentals allowing for costs of reletting, having regard to comparable on-market sales and discounted future cash flows.

2004	FREEHOLD BUILDINGS \$M	LEASEHOLD IMPROVEMENTS \$M	OFFICE EQUIPMENT/ FIXTURES & FITTINGS \$M	MOTOR VEHICLES \$M	TOTAL \$M
<b>Cost or valuation</b>					
At 1 January 2004	81	65	219	13	378
Acquisitions	–	–	9	1	10
Additions	5	5	24	4	38
Revaluations	(1)	–	–	–	(1)
Disposals	–	(1)	(20)	(4)	(25)
Foreign exchange	1	–	3	–	4
At 31 December 2004	86	69	235	14	404
<b>Accumulated depreciation and impairment losses</b>					
At 1 January 2004	–	34	145	7	186
Disposals	–	(1)	(19)	(3)	(23)
Depreciation charge for the year	–	7	43	3	53
Foreign exchange	–	–	2	–	2
At 31 December 2004	–	40	171	7	218
<b>Carrying amount</b>					
At 1 January 2004	81	31	74	6	192
At 31 December 2004	86	29	64	7	186

# 18

## INTANGIBLE ASSETS (CONSOLIDATED)

2005	GOODWILL	IDENTIFIABLE INTANGIBLES		TOTAL
	\$M	PURCHASED CAPACITY COSTS \$M	OTHER \$M	\$M
<b>Cost</b>				
At 1 January 2005	894	135	11	1,040
Acquisitions	265	–	42	307
Additions	43	3	–	46
Foreign exchange	(1)	(6)	(1)	(8)
At 31 December 2005	1,201	132	52	1,385
<b>Amortisation and impairment losses</b>				
At 1 January 2005	–	–	1	1
Amortisation for the year	–	–	2	2
At 31 December 2005	–	–	3	3
<b>Carrying amount</b>				
At 1 January 2005	894	135	10	1,039
At 31 December 2005	1,201	132	49	1,382

2004	GOODWILL	IDENTIFIABLE INTANGIBLES		TOTAL
	\$M	PURCHASED CAPACITY COSTS \$M	OTHER \$M	\$M
<b>Cost</b>				
At 1 January 2004	356	91	–	447
Acquisitions	539	–	11	550
Additions	–	41	–	41
Foreign exchange	(1)	3	–	2
At 31 December 2004	894	135	11	1,040
<b>Amortisation and impairment losses</b>				
At 1 January 2004	–	–	–	–
Amortisation for the year	–	–	1	1
At 31 December 2004	–	–	1	1
<b>Carrying amount</b>				
At 1 January 2004	356	91	–	447
At 31 December 2004	894	135	10	1,039

## Notes to the financial statements continued

FOR THE YEAR ENDED 31 DECEMBER 2005

# 18

### INTANGIBLE ASSETS (CONSOLIDATED) CONTINUED

#### (A) Identifiable intangibles

Purchased capacity costs, the most significant component of identifiable intangibles, relate to the acquisition of syndicate capacity at Lloyd's of London. Syndicate capacity is considered to have an indefinite useful life due to the planned long term commitment to, and increasing size of, the consolidated entity's operations in the Lloyd's market. The relevant cash generating unit ("CGU") is Lloyd's operating division. The recoverable amount of the purchased capacity costs is determined by reference to a value in use calculation using cash flow projections for the next five years based on the latest business plan. Purchased capacity costs have an indefinite useful life and therefore no amortisation is charged. The value in use over such a period is sufficient to validate the carrying value of the purchased capacity costs.

Other identifiable intangible assets include:

- rights to manage the Ensign business in the UK, which are being amortised over 11 years from the date of acquisition in February 2004;
- renewal rights in respect of the acquisition of Icon Schemes Limited in April 2004, which are being amortised over three years;
- insurance licences on the acquisition of National Farmers Union Property and Casualty Company in September 2005, which were deemed to have an indefinite useful life are therefore not amortised; and
- renewal rights on the acquisition of the National Farmers Union Property and Casualty Company in September 2005, which are being amortised over 20 years.

None of these is individually significant.

#### (B) Goodwill

The recoverable amount of all goodwill is determined by a value in use calculation using cash flow projections for the next five years based on the latest business plan. The most significant CGUs are:

- Australian operations, which includes the acquisition of the remaining 50% of the QBE Mercantile Mutual joint venture on 30 June 2004;
- QBE Insurance (Europe), which includes the acquisitions of QBE Insurance Company (UK) Limited (formerly Iron Trades) in 1999, MiniBus Plus in August 2005 and British Marine Holdings Limited in November 2005; and
- Limit, which comprises mainly the acquisition of the consolidated entity's operations at Lloyd's of London in 2000.

#### (C) Key assumptions

Key assumptions used in the determination of the value in use are as follows.

- Combined operating ratios from business plans are used.
- Risk adjusted discount rates are applied.
- Taxation is assumed at the relevant prima facie rate.

# 19

### TRADE AND OTHER PAYABLES

	THE COMPANY		CONSOLIDATED	
	2005 \$M	2004 \$M	2005 \$M	2004 \$M
Trade payables	–	–	838	652
Amounts due to controlled entities	1,431	1,597	–	–
Other payables and accrued expenses	12	12	413	394
Treasury payables	8	6	13	11
Investment payables	6	4	18	27
	1,457	1,619	1,282	1,084

## Notes to the financial statements continued

FOR THE YEAR ENDED 31 DECEMBER 2005

# 20

### OUTSTANDING CLAIMS (CONSOLIDATED)

#### (A) Net outstanding claims

	2005 \$M	2004 \$M
Gross outstanding claims	16,694	14,172
Claims settlement costs	365	260
	17,059	14,432
Discount to present value	(1,976)	(1,827)
Gross outstanding claims provision	15,083	12,605
Current	4,904	3,670
Non-current	10,179	8,935
Gross outstanding claims provision	15,083	12,605
Reinsurance and other recoveries on outstanding claims <sup>(1)</sup>	4,769	3,582
Discount to present value	(556)	(439)
Reinsurance and other recoveries on outstanding claims	4,213	3,143
Current	1,357	805
Non-current	2,856	2,338
Reinsurance and other recoveries on outstanding claims	4,213	3,143
Net outstanding claims	10,870	9,462
Central estimate	9,627	8,404
Risk margin	1,243	1,058
Net outstanding claims	10,870	9,462

(1) Reinsurance and other recoveries on outstanding claims are shown net of a provision for impairment of \$152 million (2004 \$88 million).

#### (B) Risk margin

The process used to determine the risk margin is explained in note 3(A)(iii). The probability of adequacy at 31 December 2005 is 94% (2004 94%) which is at the high end of our internal target range of 85% to 94%.

The risk margin included in net outstanding claims is 12.9% of the central estimate (2004 12.6%).

#### (C) Reconciliation of movement in discounted outstanding claims provision

	GROSS \$M	2005 REINSURANCE \$M	NET \$M	2004 NET \$M
<b>At 1 January</b>	12,605	(3,143)	9,462	7,695
Increase in net claims incurred in current accident year	6,874	(2,225)	4,649	4,098
Movement in prior year claims provision	(130)	(102)	(232)	58
Incurred claims recognised in the income statement	6,744	(2,327)	4,417	4,156
Acquisitions/disposals	387	(76)	311	759
Net claim payments	(4,620)	1,309	(3,311)	(3,099)
Foreign exchange	(33)	24	(9)	(49)
<b>At 31 December</b>	15,083	(4,213)	10,870	9,462

## Notes to the financial statements continued

FOR THE YEAR ENDED 31 DECEMBER 2005

# 20

### OUTSTANDING CLAIMS (CONSOLIDATED) CONTINUED

#### (D) Claims development

##### (i) Net undiscounted outstanding claims for the five most recent accident years

	2001 \$M	2002 \$M	2003 \$M	2004 \$M	2005 \$M	TOTAL \$M
Estimate of net ultimate claims cost:						
At end of accident year	3,522	3,201	3,413	4,490	5,189	
One year later	3,496	3,084	3,154	4,120	–	
Two years later	3,599	3,004	2,921	–	–	
Three years later	3,737	2,965	–	–	–	
Four years later	3,753	–	–	–	–	
<b>Current estimate of net cumulative claims cost</b>	<b>3,753</b>	<b>2,965</b>	<b>2,921</b>	<b>4,120</b>	<b>5,189</b>	
Cumulative net payments	(2,883)	(1,975)	(1,474)	(1,566)	(873)	
<b>Net undiscounted outstanding claims for the five most recent accident years</b>	<b>870</b>	<b>990</b>	<b>1,447</b>	<b>2,554</b>	<b>4,316</b>	<b>10,177</b>

The estimates of net ultimate claims cost and cumulative claims payments for the five most recent accident years have been translated to Australian dollars using the closing rate of exchange at 31 December 2005.

##### (ii) Reconciliation of net undiscounted outstanding claims for the five most recent accident years to net outstanding claims

	TOTAL \$M
Net undiscounted outstanding claims for the five most recent accident years	10,177
Outstanding claims – accident years 2000 and prior	1,734
Foreign exchange	(164)
Discount on outstanding claims	(1,420)
Claims settlement costs	365
Other	178
<b>Net outstanding claims</b>	<b>10,870</b>

##### (iii) Commentary

The claims development table is presented net of reinsurance. With operations in 41 countries, hundreds of products, various reinsurance arrangements and with the consolidated entity's risk tolerance managed on a consolidated net basis, it is not considered meaningful or practicable to provide this information other than on a consolidated net accident year basis.

Outstanding claims in respect of acquisitions are included in the estimate of net ultimate claims cost in the accident year in which the acquisition was made. The exception is increased participation in Lloyd's syndicates, where the increased share of the outstanding claims provision is allocated to the original accident year. The 2005 estimate of net ultimate claims cost includes \$224 million from acquisitions in 2005.

2001 accident year deterioration was mainly the result of upgrades for US casualty risks, primarily relating to Enron, Worldcom and financial laddering claims written in European operations, and the casualty facultative portfolio written in the Americas. We ceased underwriting this business in 2002.

Favourable development of claims provisions for the 2002, 2003 and 2004 accident years was the result of our conservative claims provisioning which gave rise to the release of risk margins, and in some cases excess central estimates, as the ultimate claims costs were settled or became more certain.

## Notes to the financial statements continued

FOR THE YEAR ENDED 31 DECEMBER 2005

# 21

### UNEARNED PREMIUM (CONSOLIDATED)

#### (A) Unearned premium

	2005 M	2004 \$M
<b>At 1 January</b>	<b>3,948</b>	3,342
Acquisitions/disposals	166	412
Deferral of premium on contracts written in the period	3,849	3,555
Earning of premium written in previous periods	(3,667)	(3,301)
Foreign exchange	(9)	(60)
<b>At 31 December</b>	<b>4,287</b>	3,948

#### (B) Net premium liabilities

	NOTE	2005 \$M	2004 \$M
Unearned premium		4,287	3,948
Deferred insurance costs	12	(1,446)	(1,358)
<b>Net premium liabilities</b>		<b>2,841</b>	2,590

#### (C) Expected present value of future cash flows for future claims including risk margin

	2005 \$M	2004 \$M
Undiscounted central estimate	2,348	2,232
Risk margin	113	103
	2,461	2,335
Discount to present value	(280)	(263)
<b>Expected present value of future cash flows for future claims including risk margin</b>	<b>2,181</b>	2,072

#### (D) Liability adequacy test

The probability of adequacy applied in the liability adequacy test differs from the probability of adequacy adopted in determining the outstanding claims provision. The reason for the difference is that the former is a benchmark used only to test the sufficiency of net premium liabilities whereas the latter is a measure of the adequacy of the outstanding claims provision actually carried by the consolidated entity.

AASB 1023 requires the inclusion of a risk margin in insurance liabilities, but does not prescribe a minimum level of margin. Whilst there is established practice in the calculation of the probability of adequacy of the claims provision, no such guidance exists in respect of the level of risk margin to be used in determining the adequacy of net premium liabilities. The consolidated entity has adopted a risk margin for the purposes of the liability adequacy test to produce a 75% probability of adequacy in respect of total insurance liabilities. The 75% basis is a recognised industry benchmark in Australia, being the minimum probability of adequacy required for Australian licensed insurers by APRA.

The application of the liability adequacy test in respect of the net premium liabilities identified a surplus at 31 December 2005 and 2004.

#### (E) Risk margin

The process used to determine the risk margin is explained in note 3(A)(iii).

The risk margin in expected future cash flows for future claims as a percentage of the central estimate is 5.5% (2004 5.2%). This is the risk margin required to give a probability of adequacy of 75% for total insurance liabilities.

# Notes to the financial statements continued

FOR THE YEAR ENDED 31 DECEMBER 2005

## 22

### INTEREST BEARING LIABILITIES

#### (A) Analysis of interest bearing liabilities

	THE COMPANY		CONSOLIDATED	
	2005 \$M	2004 \$M	2005 \$M	2004 \$M
Repayable as follows:				
<b>Bank loans</b>				
27 February 2006	A\$400 million	400	–	400
<b>Senior debt</b>				
28 September 2009	£175 million	409	427	409
<b>Eurobonds</b>				
2 August 2010	A\$150 million/£58 million	–	–	149
2 August 2010	A\$20 million/£8 million	–	–	20
2 August 2010	€115 million/£70 million	–	–	185
		–	–	354
<b>Hybrid securities<sup>(1)</sup></b>				
15 April 2022	US\$201 million (2004 US\$399 million)	–	–	165
21 September 2024	US\$558 million	–	–	466
		–	–	631
<b>Subordinated debt</b>				
1 July 2023	US\$250 million	336	315	336
<b>Total interest bearing liabilities<sup>(2)</sup></b>		<b>1,145</b>	<b>742</b>	<b>2,130</b>
Current		400	–	400
Non-current		745	742	1,730
<b>Total interest bearing liabilities<sup>(2)</sup></b>		<b>1,145</b>	<b>742</b>	<b>2,130</b>

(1) Hybrid securities are shown net of the fair value of the equity conversion option. The US dollar principal amounts shown are the outstanding amounts payable at the end of the 20 year term.

(2) ABC securities for funds at Lloyd's are not included in this analysis. Details of ABCs are included in note 35(C).

#### (B) Finance costs

No finance costs have been capitalised in the year (2004 \$18 million).

#### (C) Security and facility arrangements

In the normal course of business, bank loans are made to controlled entities and secured by guarantees or letters of comfort given by the company.

The Eurobonds were issued by a controlled entity and secured by guarantees given by the company and another controlled entity. The US\$250 million subordinated debt was issued by the company. The claims of bondholders pursuant to both of these interest bearing liabilities will be subordinated in right of payment to the claims of all senior creditors, including policyholders, of the relevant controlled entity.

#### (D) Eurobonds

A controlled entity is exposed to interest rate and currency risk in respect of its three Eurobond financing arrangements. Accordingly, the consolidated entity has entered into swap agreements which result in the consolidated entity's financial liabilities being fixed at sterling amounts until 2010, at which point the consolidated entity will be liable for the original Australian dollar and Euro amounts in the underlying financing arrangements. The facility can be extended for a further 10 years to 2020. Under the swap agreements, the variable interest rates of between 1.8% and 2.0% above the wholesale interbank rate are swapped to fixed rates of between 8.4% and 8.6% payable quarterly until 2010. The timing of the payments under the swap agreements matches the dates on which interest is payable on the underlying debt. The contracts are settled on a net basis.

The underlying financial liabilities are measured at amortised cost in original currency and translated to Australian dollars at the closing rate of exchange. The swaps are measured at fair value. The swaps are designated as cash flow hedges and have satisfied the relevant hedge effectiveness tests throughout the year and at the balance date. The gain or loss on the cash flow hedges is recognised directly in equity. Any ineffectiveness in the cash flow hedges is recognised directly in the income statement. Each financial year end, until the close out of the swap agreements in 2010, an amount is transferred from equity to the income statement to offset:

- the differential between the fixed and variable interest payments; and
- the movement in the spot rate on the financial liabilities.

During the year, a gain of \$1 million (2004 loss of \$5 million) was recognised in equity relating to the movements in the fair value of the swaps. During the year, a gain of \$1 million (2004 loss of \$3 million) was removed from equity and included in the income statement.

## Notes to the financial statements continued

FOR THE YEAR ENDED 31 DECEMBER 2005

# 22

### INTEREST BEARING LIABILITIES CONTINUED

#### (E) Hybrid securities

The hybrid securities are guaranteed by the company and a controlled entity. The claims of investors under these guarantees in general will rank equally with all existing and future unsecured and unsubordinated indebtedness of the company and the controlled entity. The liability component of the securities, being the obligation to make future payments of principal and interest to investors, is included in interest bearing liabilities, and the fair value of the equity conversion option is included in equity.

#### (i) Hybrid securities due 2024

In 2004, a controlled entity issued US\$375 million of 20 year hybrid securities. Investors have the option to convert the security if:

- the company calls for their redemption;
- the market value of the security is less than the market value of the underlying shares in the company for five consecutive trading days; or
- certain corporate transactions occur (e.g. change in control).

In the event of conversion, up to 29 million shares will be issued.

#### (ii) Hybrid securities due 2022

In 2002, two controlled entities issued US\$471 million of 20 year hybrid securities. Investors have the option to convert the security if:

- the company calls for their redemption;
- the market value of the security is less than the market value of the underlying shares in the company for two consecutive trading days; or
- certain corporate transactions occur (e.g. change in control).

In 2005, 28 million shares (2004 54 million) were issued as a result of the conversion of 24% (2004 51%) of the hybrid securities due 2022. In the event of conversion of the remaining securities, up to 31 million shares will be issued.

#### (F) Fair value of interest bearing liabilities

	THE COMPANY		CONSOLIDATED	
	2005 \$M	2004 \$M	2005 \$M	2004 \$M
Bank loans	400	–	400	–
Senior debt	423	438	423	438
Eurobonds	–	–	358	372
Hybrid securities	–	–	1,105	1,258
Subordinated debt	350	336	350	336
	<b>1,173</b>	774	<b>2,636</b>	2,404

There has been no active trading of interest bearing liabilities during 2005. The fair value has been estimated using valuation techniques based on market available data for similar debt instruments.

Hybrid securities have been valued using a convertible bond pricing model that takes into account credit spread, share price volatility, interest rates, dividends and financing costs. The ability to convert the hybrid securities is restricted by the terms and conditions included in note 22(E).

# 23

### PROVISIONS – NON-CURRENT

	THE COMPANY		CONSOLIDATED	
	2005 \$M	2004 \$M	2005 \$M	2004 \$M
Long service leave	–	–	18	16
Amounts payable under acquisition agreements	13	27	31	28
Other provisions	–	–	13	10
	<b>13</b>	27	<b>62</b>	54

## Notes to the financial statements continued

FOR THE YEAR ENDED 31 DECEMBER 2005

# 24

### DEFERRED INCOME TAX

	THE COMPANY		CONSOLIDATED	
	2005 \$M	2004 \$M	2005 \$M	2004 \$M
Deferred tax assets	–	–	67	73
Deferred tax liabilities	(10)	(27)	(251)	(122)
<b>Net</b>	<b>(10)</b>	<b>(27)</b>	<b>(184)</b>	<b>(49)</b>

#### (A) Deferred tax assets – non-current

(i) The balance comprises temporary differences attributable to:

	THE COMPANY		CONSOLIDATED	
	2005 \$M	2004 \$M	2005 \$M	2004 \$M
<b>Amounts recognised in the income statement</b>				
Doubtful debts provision	–	–	12	11
Employee benefits	–	–	39	26
Defined benefit superannuation plans	–	–	29	47
Depreciation	–	–	–	6
Insurance provisions	–	–	115	68
Deferred tax losses recognised	11	5	13	11
Other	3	6	15	10
	<b>14</b>	<b>11</b>	<b>223</b>	<b>179</b>
<b>Amounts recognised directly in equity</b>				
Cash flow hedges	–	–	7	7
Capitalised expenses	1	1	1	1
Defined benefit superannuation plans	–	–	19	10
Employee share options	–	–	17	4
	<b>1</b>	<b>1</b>	<b>44</b>	<b>22</b>
	<b>15</b>	<b>12</b>	<b>267</b>	<b>201</b>
Set-off of deferred tax liabilities	(15)	(12)	(200)	(128)
	–	–	67	73

(ii) Movements:

	THE COMPANY		CONSOLIDATED	
	2005 \$M	2004 \$M	2005 \$M	2004 \$M
<b>Balance at 1 January</b>	<b>12</b>	<b>23</b>	<b>201</b>	<b>171</b>
Credited (charged) to the income statement	3	(11)	39	3
Credited to equity	1	–	23	15
Acquisitions	–	–	5	12
Reclassification	(1)	–	(1)	–
<b>Balance at 31 December</b>	<b>15</b>	<b>12</b>	<b>267</b>	<b>201</b>

#### (B) Tax losses

The consolidated entity has not brought to account \$1 million of tax losses (2004 \$4 million), which includes the benefit arising from tax losses in overseas countries. This benefit will only be brought to account when the directors believe it is probable that it will be realised. This benefit of tax losses will only be obtained if:

- the consolidated entity derives future assessable income of a nature and an amount sufficient to enable the benefit from the deductions for the losses to be realised;
- the consolidated entity continues to comply with the conditions for deductibility imposed by tax legislation; and
- no changes in tax legislation adversely affect the consolidated entity in realising the benefit from the deductions for the losses.

Included in deferred tax assets is \$13 million (2004 \$11 million) relating to tax losses which the directors believe will probably be realised.

## Notes to the financial statements continued

FOR THE YEAR ENDED 31 DECEMBER 2005

# 24

### DEFERRED INCOME TAX CONTINUED

#### (C) Deferred tax liabilities – non-current

(i) The balance comprises temporary differences attributable to:

	THE COMPANY		CONSOLIDATED	
	2005 \$M	2004 \$M	2005 \$M	2004 \$M
<b>Amounts recognised in the income statement</b>				
Insurance provisions	–	–	(373)	(215)
Foreign currency monetary items	(24)	(4)	(26)	(11)
Financial assets – fair value movements	–	(2)	(41)	(21)
Other provisions	–	(33)	–	–
Other items	(1)	–	(11)	(3)
	(25)	(39)	(451)	(250)
Set-off of deferred tax assets	15	12	200	128
	(10)	(27)	(251)	(122)

(ii) Movements:

	THE COMPANY		CONSOLIDATED	
	2005 \$M	2004 \$M	2005 \$M	2004 \$M
<b>Balance at 1 January</b>	(39)	(41)	(250)	(77)
Charged to the income statement	14	2	(201)	(170)
Acquisitions	–	–	–	(3)
<b>Balance at 31 December</b>	(25)	(39)	(451)	(250)

# 25

### CONTRIBUTED EQUITY

#### (A) Share capital (company and consolidated)

	2005 \$M	2004 \$M
Issued ordinary shares, fully paid	3,195	2,780
	<b>NUMBER OF SHARES</b>	<b>\$M</b>
	000	
<b>Issued and fully paid at 1 January 2004</b>	661,371	2,268
Shares issued under the Plan	4,030	33
Vendor options exercised	150	2
Shares issued under Dividend Reinvestment Plan	11,708	135
Shares issued under Dividend Election Plan	3,098	–
Shares issued to holders of hybrid securities	53,983	342
Shares issued under the LTI on vesting of conditional rights	269	–
<b>Issued and fully paid at 31 December 2004</b>	734,609	2,780
Shares issued under the Plan	3,701	30
Employee options exercised	319	4
Vendor options exercised	1,591	28
Shares issued under Dividend Reinvestment Plan	13,051	203
Shares issued under Dividend Election Plan	3,437	–
Shares issued to holders of hybrid securities	28,113	153
Shares issued under the LTI on vesting of conditional rights	472	–
Share issue expenses	–	(3)
Bonus shares	1	–
<b>Issued and fully paid at 31 December 2005</b>	785,294	3,195
<b>Shares notified to the Australian Stock Exchange</b>	793,510	3,263
Less: Plan shares subject to non-recourse loans, derecognised under AIFRS	(8,216)	(68)
<b>Issued and fully paid at 31 December 2005</b>	785,294	3,195

## Notes to the financial statements continued

FOR THE YEAR ENDED 31 DECEMBER 2005

# 25

### CONTRIBUTED EQUITY CONTINUED

Ordinary shares in the company have no par value and entitle the holder to participate in dividends and the proceeds on winding up of the company in proportion to the number of shares held. Ordinary shareholders rank after all creditors and are entitled to any residual proceeds.

#### (B) Equity component of hybrid securities

	THE COMPANY		CONSOLIDATED	
	2005 \$M	2004 \$M	2005 \$M	2004 \$M
<b>At 1 January</b>	<b>108</b>	–	<b>108</b>	59
Movement during the period	–	108	–	49
<b>At 31 December</b>	<b>108</b>	108	<b>108</b>	108

#### (C) Dividend Reinvestment and Dividend Election Plans

The company operates a Dividend Reinvestment Plan ("DRP") and a Dividend Election Plan ("DEP"). The directors suspended the 2.5% discount on shares issued under these plans in August 2005.

The last date for receipt of election notices applicable to the final dividend is 7 March 2006 for the DRP and 22 February 2006 for the DEP.

#### (D) Dividends (company and consolidated)

	2005 \$M	2004 \$M
Previous year final dividend paid on ordinary shares		
Franked at 50% – 15.0 cents (2004 6.6 cents)	<b>114</b>	44
Unfranked – 15.0 cents (2004 15.4 cents)	<b>114</b>	104
	<b>228</b>	148
Interim dividend paid on ordinary shares		
Franked at 50% – 16.5 cents (2004 12.0 cents)	<b>127</b>	82
Unfranked – 16.5 cents (2004 12.0 cents)	<b>127</b>	82
	<b>254</b>	164
Dividend reinvested under the Dividend Election Plan	<b>(55)</b>	(36)
<b>Total dividend paid</b>	<b>427</b>	276

The interim dividend of \$254 million was paid on 16 September 2005. On 23 February 2006, the directors declared a 50% franked final dividend of 38.0 cents per share (2004 30.0 cents per share, 50% franked). The final dividend payout is \$302 million (2004 \$228 million).

The franking account balance on a tax paid basis as at the balance date was a surplus of \$213 million (2004 \$113 million). After taking into account the final dividend, the franking account balance will be a surplus of \$148 million.

#### (E) Options issued to third parties

The consolidated entity has issued options to third parties in respect of acquisitions. These options are subject to performance hurdles. Details of the movements in respect of such options during the year are as follows:

GRANT DATE	EXERCISE PRICE	BALANCE AT 1 JAN 2005	EXERCISED IN THE YEAR	BALANCE AT 31 DEC 2005	EXPIRY DATE
1 December 2004	\$0.00	5,000,000	2,000,000	3,000,000	30 November 2007
22 December 2004	\$0.00	2,750,000	–	2,750,000	31 July 2006
		7,750,000	2,000,000	5,750,000	

The market value of the options outstanding at the balance date is \$113 million (2004 \$119 million), calculated by reference to the quoted market value of the underlying shares at that date. During the financial year, two million (2004 nil) options were exercised, resulting in the issue of 1,591,000 (2004 nil) shares.

# Notes to the financial statements continued

FOR THE YEAR ENDED 31 DECEMBER 2005

## 26

### OTHER RESERVES

#### (A) Reserves

	THE COMPANY		CONSOLIDATED	
	2005 \$M	2004 \$M	2005 \$M	2004 \$M
<b>Owner occupied property revaluation reserve<sup>(1)</sup></b>				
At 1 January	–	–	6	7
Reversal of previous valuation increase	–	–	–	(1)
Valuation increase	–	–	2	–
At 31 December	–	–	8	6
<b>Cash flow hedges reserve<sup>(2)</sup></b>				
At 1 January	–	–	(17)	(15)
Other increase	(5)	–	(5)	(3)
Deferred tax	–	–	–	1
At 31 December	(5)	–	(22)	(17)
<b>Foreign currency translation reserve<sup>(3)</sup></b>				
At 1 January	–	–	(48)	–
Losses on translation	–	–	(48)	(15)
Gains (losses) on forward foreign exchange contracts	–	–	26	(85)
Other (decrease) increase	–	–	(2)	52
At 31 December	–	–	(72)	(48)
<b>Options reserve<sup>(4)</sup></b>				
At 1 January	15	4	19	4
Options expense	23	11	23	11
Deferred tax	–	–	13	4
At 31 December	38	15	55	19
<b>General reserve<sup>(5)</sup></b>				
At 1 January	–	–	5	5
Movement in the year	–	–	–	–
At 31 December	–	–	5	5
<b>Realised capital profits reserve<sup>(6)</sup></b>				
At 1 January	–	–	6	6
Movement in the year	–	–	–	–
At 31 December	–	–	6	6
<b>Total reserves at 31 December</b>	<b>33</b>	<b>15</b>	<b>(20)</b>	<b>(29)</b>

(1) Used to recognise fair value movements in the carrying value of owner occupied property. Refer note 1(Q).

(2) Used to record gains or losses on a hedging instrument in a cash flow hedge that are recognised directly in equity. Refer note 1(O)(ii).

(3) Exchange gains and losses arising on translation of a foreign controlled entity and related hedging instruments are taken to the foreign currency translation reserve. Refer note 1(U). In the event of the disposal of a relevant net investment, the movement in the reserve is recognised in the income statement.

(4) Used to recognise the fair value of instruments issued as share based payments.

(5) Established prior to 1989 for general purposes.

(6) Realised capital profits arising prior to the introduction of capital gains tax in Australia.

#### (B) Retained profits

NOTE	THE COMPANY		CONSOLIDATED	
	2005 \$M	2004 \$M	2005 \$M	2004 \$M
<b>Retained profits at 1 January</b>	<b>1,729</b>	171	<b>1,173</b>	617
Net profit after income tax attributable to members of the company	<b>1,060</b>	1,834	<b>1,091</b>	857
Actuarial losses on defined benefit superannuation plans, net of tax	29(C) –	–	(27)	(25)
Total available for appropriation	<b>2,789</b>	2,005	<b>2,237</b>	1,449
Dividends paid	(427)	(276)	(427)	(276)
<b>Retained profits at 31 December</b>	<b>2,362</b>	1,729	<b>1,810</b>	1,173

### SHARE BASED PAYMENTS

#### **(A) Share based remuneration plans**

The company, at its 1981 AGM, approved the issue of shares from time to time under an Employee Share and Option Plan ("the Plan"), up to 5% of the issued ordinary shares in the capital of the company. Any full-time or part-time employee of the consolidated entity or equally owned joint ventures who is offered shares or options pursuant to the offer document of the Plan is eligible to participate in the Plan.

Under the Plan, ordinary shares of the company are offered at the weighted average market price during the five trading days up to the date of the offer. Likewise, the exercise price for options offered under the Plan is the weighted average market price during the five trading days up to the date of the offer.

In accordance with the terms of the Plan, interest free loans are granted to employees to subscribe for shares issued under the Plan. Prior to 20 June 2005, the terms of the loans were either personal recourse or non-recourse. With effect from 20 June 2005, only personal recourse loans are granted to employees to subscribe for shares under the Plan. The loans are repayable in certain circumstances as set out in the Plan, such as termination of employment or breach of condition.

Generally, all full-time or part-time employees of the consolidated entity with a minimum of one year's service are invited to participate in the Share Incentive Plan ("the SIP"). Under the SIP, directors can provide shares to employees without payment being made by employees. The allocation of shares is based on the period of service. The shares are purchased on market and held in trust for the employee for a minimum of three years or until cessation of employment, whichever is earlier. Further details are provided in note 27(D).

Senior management are invited to participate in the LTI scheme. Under the LTI, the directors can issue conditional rights to shares and grant options to senior management who have already achieved predetermined performance criteria. The terms of the LTI may vary to take into account the requirements and market conditions of the locations of senior management, but the general terms of the LTI conditional rights and options are set out below.

- The conditional rights entitle relevant employees to receive shares on the third anniversary of the grant of the rights. Further shares are issued in relation to the conditional rights to reflect dividends paid on ordinary shares of the company in the period commencing from the date of the grant of the conditional rights. The shares issued pursuant to the conditional rights are issued without payment being made by senior management (i.e. at a nil exercise price).
- The options are subject to the terms and conditions of the Plan. Options issued in 2004 and prior can be exercised after three years, whilst any options issued in 2005 and thereafter will generally be exercisable after five years. They must be exercised within a 12 month period of vesting. Interest free personal recourse loans are granted on the terms permitted by the Plan as described above to persons who hold options to fund the exercise of options.

The shares issued pursuant to the conditional rights and options will only be issued if the individual has remained in the company's service throughout this period (unless they leave due to redundancy, retirement through ill health or age, or death) and is not subject to disciplinary proceedings on that date.

Shareholder approval of the LTI was given in 2003 for the purpose of ASX Listing Rule 7.2.

## Notes to the financial statements continued

FOR THE YEAR ENDED 31 DECEMBER 2005

# 27

### SHARE BASED PAYMENTS CONTINUED

#### (B) Employee options

During the year, the company granted to 340 (2004 478) qualifying employees options to subscribe for 3,747,896 (2004 3,918,197) ordinary shares with a total market value of \$55 million (2004 \$44 million) being the quoted market price at the date the options were granted.

At 31 December 2005, 10,738,590 (2004 8,952,849) options were outstanding with an exercise price of \$118 million (2004 \$83 million). The market value of the options outstanding at balance date is \$210 million (2004 \$137 million), calculated by reference to the quoted market value of the underlying shares at that date. During the financial year, 1,517,237 (2004 1,710,906) options were exercised, resulting in the issue of 1,517,237 (2004 1,710,906) shares. Details of the number of employee options granted, exercised and forfeited or cancelled during the year, including those issued under the LTI, are as follows:

GRANT DATE	EXERCISE PRICE	BALANCE AT 1 JAN 2005	GRANTED IN THE YEAR	EXERCISED IN THE YEAR	CANCELLED/ FORFEITED IN THE YEAR <sup>(1)</sup>	BALANCE AT 31 DEC 2005 <sup>(2)</sup>
1 June 2000	\$6.53	10,000	–	(10,000)	–	–
1 July 2000	\$7.62	10,000	–	(10,000)	–	–
1 October 2000	\$8.63	45,730	–	(44,730)	(1,000)	–
1 November 2000	\$8.90	50,000	–	(50,000)	–	–
1 January 2001	\$9.76	5,000	–	(5,000)	–	–
2 April 2001	\$10.72	67,728	–	(36,814)	(2,900)	28,014
25 May 2001	\$10.65	335,000	–	(17,500)	–	317,500
1 June 2001	\$10.69	155,000	–	–	–	155,000
10 December 2001	\$7.27	965,000	–	(130,000)	(25,000)	810,000
18 March 2002	\$7.49	745,070	–	(707,649)	(10,784)	26,637
14 November 2002	\$7.37	100,000	–	–	–	100,000
13 March 2003	\$8.04	2,755,728	1,094	(280,733)	(75,371)	2,400,718
10 April 2003	\$8.04	110,884	–	–	–	110,884
3 November 2003	\$10.14	10,000	–	–	–	10,000
3 March 2004	\$11.08	3,263,378	–	(149,586)	(127,457)	2,986,335
3 March 2004	\$8.04	209,637	–	–	–	209,637
2 April 2004	\$11.08	114,694	–	–	–	114,694
3 March 2005	\$14.85	–	2,960,740	(75,225)	(67,156)	2,818,359
3 March 2005	\$11.08	–	207,182	–	–	207,182
3 March 2005	\$8.04	–	225,043	–	–	225,043
15 March 2005	\$15.13	–	135,250	–	(135,250)	–
8 April 2005	\$14.85	–	118,587	–	–	118,587
12 May 2005	\$14.81	–	100,000	–	–	100,000
		8,952,849	3,747,896	(1,517,237)	(444,918)	10,738,590
Weighted average exercise price		\$9.22	\$14.24	\$8.49	\$12.06	\$10.96

(1) 135,250 options were issued on 15 March 2005 and were subsequently cancelled. All other options were forfeited.

(2) At 31 December 2005, 100,000 future performance options have vested and are exercisable from 27 February 2006 until 13 March 2006 at \$7.37 and 26,637 LTI options have vested and are exercisable immediately at \$7.49. No other options are vested and exercisable.

The weighted average share price at the date of exercise of options during the year was \$15.67 (2004 \$12.59). The weighted average remaining contractual life of total options outstanding at 31 December 2005 was 2.79 years (2004 2.57 years).

## Notes to the financial statements continued

FOR THE YEAR ENDED 31 DECEMBER 2005

# 27

### SHARE BASED PAYMENTS CONTINUED

Employee options outstanding at 31 December 2005 are as follows:

YEAR OF EXPIRY	FUTURE PERFORMANCE	REGULAR	LTI/STI	TOTAL OPTIONS
2006	582,500	28,014	26,637	637,151
2007	810,000	–	2,603,262	3,413,262
2008	–	–	3,147,756	3,147,756
2009	100,000	–	116,992	216,992
2010	–	–	126,175	126,175
2011	–	–	3,126,004	3,126,004
2024	–	71,250	–	71,250
	1,492,500	99,264	9,146,826	10,738,590

The future performance options have been issued subject to the achievement of specific performance criteria. Examples of such criteria are provided in the directors' report.

Regular options issued under the Plan based on the achievement of past performance are exercisable at 20% per annum. If an employee is entitled to exercise options in a particular year but does not, then the employee may exercise the options in the following year. These options expire if not exercised within five years from the date of issue.

The assessed fair value at grant date of options issued during the year is in the range of \$3.04 to \$6.90 (2004 \$1.96 to \$3.61) per option. The fair value of options is determined using a binomial model. The fair value of each option is earned evenly over the period between grant and vesting.

Details of the number of options granted, exercised and forfeited or cancelled during 2004, including those issued under the LTI, are as follows:

GRANT DATE	EXERCISE PRICE	BALANCE AT 1 JAN 2004	GRANTED IN THE YEAR	EXERCISED IN THE YEAR	CANCELLED/ FORFEITED IN THE YEAR	BALANCE AT 31 DEC 2004
1 October 1999	\$5.84	196,100	–	(196,100)	–	–
1 June 2000	\$6.53	20,000	–	(10,000)	–	10,000
1 July 2000	\$7.62	40,000	–	(30,000)	–	10,000
1 October 2000	\$8.63	101,860	–	(55,730)	(400)	45,730
1 November 2000	\$8.90	50,000	–	–	–	50,000
1 January 2001	\$9.76	10,000	–	(5,000)	–	5,000
2 April 2001	\$10.72	121,842	–	(54,114)	–	67,728
19 April 2001	\$11.45	200,000	–	(200,000)	–	–
25 May 2001	\$10.65	655,000	–	(320,000)	–	335,000
1 June 2001	\$10.69	155,000	–	–	–	155,000
30 June 2001	\$11.50	150,000	–	(150,000)	–	–
6 July 2001	\$11.20	30,000	–	(30,000)	–	–
10 December 2001	\$7.27	965,000	–	–	–	965,000
28 February 2002	\$7.79	24,000	–	(24,000)	–	–
18 March 2002	\$7.49	804,949	–	(37,053)	(22,826)	745,070
14 November 2002	\$7.37	100,000	–	–	–	100,000
13 March 2003	\$8.04	3,066,865	–	(276,634)	(34,503)	2,755,728
10 April 2003	\$8.04	110,884	–	–	–	110,884
3 November 2003	\$10.14	10,000	–	–	–	10,000
3 March 2004	\$11.08	–	3,593,866	(322,275)	(8,213)	3,263,378
3 March 2004	\$8.04	–	209,637	–	–	209,637
2 April 2004	\$11.08	–	114,694	–	–	114,694
		6,811,500	3,918,197	(1,710,906)	(65,942)	8,952,849
Weighted average exercise price		\$8.36	\$10.92	\$9.68	\$8.23	\$9.22

## Notes to the financial statements continued

FOR THE YEAR ENDED 31 DECEMBER 2005

# 27

### SHARE BASED PAYMENTS CONTINUED

Employee options outstanding at 31 December 2004 were as follows:

YEAR OF EXPIRY	FUTURE PERFORMANCE	REGULAR	LTI/STI	TOTAL OPTIONS
2005	295,000	115,730	–	410,730
2006	600,000	67,728	455,070	1,122,798
2007	965,000	167,082	2,751,697	3,883,779
2008	–	114,915	3,322,627	3,437,542
2024	–	98,000	–	98,000
	1,860,000	563,455	6,529,394	8,952,849

#### (C) Conditional rights

Details of the number of employee entitlements to conditional rights to ordinary shares under the LTI granted, vested and transferred to employees during the year, are as follows:

GRANT DATE	DATE EXERCISABLE	VALUE PER RIGHT AT GRANT DATE	BALANCE AT 1 JAN 2005	GRANTED IN THE YEAR	DIVIDENDS ATTACHING IN THE YEAR	VESTED AND TRANSFERRED TO EMPLOYEE IN THE YEAR	CANCELLED IN THE YEAR	BALANCE AT 31 DEC 2005
18 March 2002	17 March 2005	\$8.40	193,441	–	3,537	(194,858)	(2,120)	–
13 March 2003	13 March 2006	\$9.16	250,212	445	9,915	(10,774)	(7,964)	241,834
13 March 2003	13 March 2006	\$9.71	145,229	–	5,901	(2,226)	(2,182)	146,722
13 March 2003	13 March 2006	\$9.56	664,341	–	24,266	(93,368)	(12,802)	582,437
10 April 2003	10 April 2006	\$9.16	45,177	–	1,849	–	–	47,026
3 March 2004	2 March 2007	\$11.65	81,763	–	3,346	–	–	85,109
3 March 2004	2 March 2007	\$12.49	325,267	–	12,845	(14,103)	(9,204)	314,805
3 March 2004	2 March 2007	\$13.24	101,372	–	4,107	(2,927)	(2,243)	100,309
3 March 2004	2 March 2007	\$12.96	732,536	–	29,021	(53,152)	(18,074)	690,331
2 April 2004	1 April 2007	\$12.49	43,856	–	1,795	–	–	45,651
3 March 2005	2 March 2008	\$16.94	–	305,675	12,444	(9,246)	(980)	307,893
3 March 2005	2 March 2008	\$17.81	–	106,760	4,323	–	(2,538)	108,545
3 March 2005	2 March 2008	\$17.51	–	717,906	27,662	(91,304)	(19,802)	634,462
3 March 2005	2 March 2008	\$15.30	–	84,393	3,454	–	–	87,847
3 March 2005	2 March 2008	\$15.86	–	77,695	3,182	–	–	80,877
8 April 2005	7 April 2008	\$16.94	–	44,470	891	–	–	45,361
			2,583,194	1,337,344	148,538	(471,958)	(77,909)	3,519,209

The weighted average share price at the date of vesting of conditional rights during the year ended 31 December 2005 was \$15.87 (2004 \$13.40).

The assessed fair value at grant date of conditional rights granted during the year is in the range of \$15.15 to \$17.81 (2004 \$11.65 to \$13.24) per conditional right. The fair value of conditional rights is determined using a binomial model. The fair value of each conditional right is earned evenly over the period between grant and vesting.

#### (D) Share Incentive Plan

The SIP was introduced during 2005 and is a global reward scheme available to eligible permanent employees who have met minimum service conditions at the annual grant date. Under the SIP, eligible employees may be offered up to \$1,000 of fully paid ordinary shares in the company annually for no cash consideration. The market value of shares issued under the SIP is expensed in the period in which the shares are granted. The total number of shares issued under the SIP to participating employees in the year was 235,450 (2004 nil). The weighted average market price on the issue date was \$17.09.

## Notes to the financial statements continued

FOR THE YEAR ENDED 31 DECEMBER 2005

# 27

### SHARE BASED PAYMENTS CONTINUED

#### (E) Share based payment expenses

Total expenses arising from share based payment transactions during the year included in underwriting expenses were as follows:

	CONSOLIDATED	
	2005 \$M	2004 \$M
Options issued under the LTI	6	3
Conditional rights issued under the LTI	16	8
Shares issued under the SIP	4	–
	26	11

# 28

### DIRECTORS' AND EXECUTIVES' DISCLOSURES (COMPANY AND CONSOLIDATED)

This note discloses equity compensation for the executive director and specified executives. Disclosure of specified director and specified executive remuneration is provided in the directors' report on pages 51 to 57.

#### (A) Equity compensation

Details of the consolidated entity's share based remuneration plans are provided in note 27.

Set out below are the holdings of equity benefits granted as remuneration to the executive director and specified executives in the year. No equity compensation was provided to the non-executive directors.

#### (i) Conditional rights to ordinary shares under the LTI

The conditional rights entitle the executive director and specified executives to receive fully paid shares on the third anniversary of the grant of the rights. Notional dividends on the conditional rights accrue during the three year period. These dividends will be paid in ordinary shares in the company.

Details of conditional rights granted under the LTI during the year are:

	NUMBER OF RIGHTS GRANTED IN THE YEAR	GRANT DATE	DATE EXERCISABLE	VALUE PER RIGHT AT GRANT DATE <sup>(3)</sup>
<b>Executive director</b>				
FM O'Halloran	44,470	8 April 2005	7 April 2008	\$16.94
<b>Specified executives</b>				
SP Burns <sup>(1)</sup>	17,517	3 March 2005	2 March 2008	\$17.51
SP Burns <sup>(1)</sup>	23,263	3 March 2005	2 March 2008	\$15.30
SP Burns <sup>(1)</sup>	20,541	3 March 2005	2 March 2008	\$15.86
NG Drabsch	25,256	3 March 2005	2 March 2008	\$16.94
PE Glen <sup>(2)</sup>	21,340	3 March 2005	12 April 2005	\$15.15
PE Grove <sup>(1)</sup>	23,741	3 March 2005	2 March 2008	\$17.51
PE Grove <sup>(1)</sup>	11,755	3 March 2005	2 March 2008	\$15.30
PE Grove <sup>(1)</sup>	10,620	3 March 2005	2 March 2008	\$15.86
MD ten Hove	25,015	3 March 2005	2 March 2008	\$16.94
RL Jones	18,856	3 March 2005	2 March 2008	\$16.94
TM Kenny	28,406	3 March 2005	2 March 2008	\$17.81
V McLenaghan	18,183	3 March 2005	2 March 2008	\$16.94
EG Tollifson	13,027	3 March 2005	2 March 2008	\$16.94

(1) Under the terms of Limit's LTI, Mr Burns and Mr Grove are eligible to receive a portion of their long term incentive award based on the earning of prior underwriting year results. The value of the conditional rights at grant date is based on the share price in the relevant prior underwriting year.

(2) Mr Glen's employment was terminated through redundancy on 30 September 2004. Under the terms of the redundancy agreement, these conditional rights were granted on 3 March 2005 and vested on 12 April 2005.

(3) The fair value at grant date of conditional rights is calculated using a binomial model. The fair value of each conditional right is earned evenly over the three year period between grant and vesting.

# Notes to the financial statements continued

FOR THE YEAR ENDED 31 DECEMBER 2005

## 28

### DIRECTORS' AND EXECUTIVES' DISCLOSURES (COMPANY AND CONSOLIDATED) CONTINUED

Details of movements in the conditional rights to ordinary shares in the company provided as remuneration under the LTI to the executive director and specified executives are provided below:

NUMBER OF RIGHTS	BALANCE AT 1 JAN 2005	GRANTED IN THE YEAR	DIVIDENDS ATTACHING IN THE YEAR	VESTED AND TRANSFERRED IN THE YEAR	BALANCE AT 31 DEC 2005
<b>Executive director</b>					
FM O'Halloran	89,033	44,470	4,535	–	138,038
<b>Specified executives</b>					
SP Burns	89,601	61,321	6,179	–	157,101
NG Drabsch	52,094	25,256	3,165	–	80,515
PE Glen <sup>(1)</sup>	–	21,340	437	(21,777)	–
PE Grove	90,342	46,116	5,585	–	142,043
MD ten Hove	–	25,015	1,024	–	26,039
RL Jones	76,332	18,856	3,548	(17,388)	81,348
TM Kenny	92,990	28,406	4,970	–	126,366
V McLenaghan	36,922	18,183	2,083	(8,586)	48,602
EG Tollifson	27,530	13,027	1,660	–	42,217

(1) Mr Glen's employment was terminated through redundancy on 30 September 2004. Under the terms of the redundancy agreement, these conditional rights were granted and vested on 12 April 2005.

#### (ii) LTI options

Details of options granted under the LTI during the year are:

	NUMBER OF OPTIONS GRANTED IN THE YEAR	GRANT DATE	DATE EXERCISABLE	EXPIRY DATE	EXERCISE PRICE	VALUE PER OPTION AT GRANT DATE <sup>(2)</sup>
<b>Executive director</b>						
FM O'Halloran	118,587	8 April 2005	8 April 2010	7 April 2011	\$14.85	\$3.60
<b>Specified executives</b>						
SP Burns <sup>(1)</sup>	46,711	3 March 2005	3 March 2010	2 March 2011	\$14.85	\$3.60
SP Burns <sup>(1)</sup>	62,035	3 March 2005	3 March 2010	2 March 2011	\$8.04	\$6.90
SP Burns <sup>(1)</sup>	54,776	3 March 2005	3 March 2010	2 March 2011	\$11.08	\$5.17
NG Drabsch	67,350	3 March 2005	3 March 2010	2 March 2011	\$14.85	\$3.60
PE Grove <sup>(1)</sup>	63,304	3 March 2005	3 March 2010	2 March 2011	\$14.85	\$3.60
PE Grove <sup>(1)</sup>	31,345	3 March 2005	3 March 2010	2 March 2011	\$8.04	\$6.90
PE Grove <sup>(1)</sup>	28,320	3 March 2005	3 March 2010	2 March 2011	\$11.08	\$5.17
MD ten Hove	66,707	3 March 2005	3 March 2008	2 March 2009	\$14.85	\$3.04
RL Jones	50,283	3 March 2005	3 March 2010	2 March 2011	\$14.85	\$3.60
TM Kenny	75,750	3 March 2005	3 March 2010	2 March 2011	\$14.85	\$3.46
V McLenaghan	48,487	3 March 2005	3 March 2010	2 March 2011	\$14.85	\$3.60
EG Tollifson	34,740	3 March 2005	3 March 2010	2 March 2011	\$14.85	\$3.60

(1) Under the terms of Limit's LTI, Mr Burns and Mr Grove are eligible to receive a portion of their long term incentive award based on the earning of prior underwriting year results. The value of the option at grant date is based on the share price in the relevant prior underwriting year.

(2) The fair value at grant date of options is calculated using a binomial model. The fair value of each option is earned evenly over the period between grant and vesting.

## Notes to the financial statements continued

FOR THE YEAR ENDED 31 DECEMBER 2005

# 28

### DIRECTORS' AND EXECUTIVES' DISCLOSURES (COMPANY AND CONSOLIDATED) CONTINUED

Details of the movements in options over ordinary shares in the company provided as remuneration under the LTI to the executive director and specified executives are provided below:

NUMBER OF OPTIONS	BALANCE AT 1 JAN 2005	GRANTED IN THE YEAR	EXERCISED IN THE YEAR	FORFEITED/ CANCELLED IN THE YEAR	BALANCE AT 31 DEC 2005 <sup>(1)</sup>
<b>Executive director</b>					
FM O'Halloran	225,578	118,587	–	–	344,165
<b>Specified executives</b>					
SP Burns	226,244	163,522	–	–	389,766
NG Drabsch	130,780	67,350	–	–	198,130
PE Grove	226,569	122,969	–	–	349,538
MD ten Hove	–	66,707	–	–	66,707
RL Jones	188,351	50,283	(40,087)	–	198,547
TM Kenny	231,965	75,750	–	–	307,715
V McLenaghan	91,891	48,487	(19,794)	–	120,584
EG Tollifson	69,073	34,740	–	–	103,813

(1) None of the options are vested and exercisable at 31 December 2005.

#### (iii) Future performance options

The executive director, Mr O'Halloran, has no future performance options at the balance date (2004 nil). The terms and conditions of each grant of future performance options that affect remuneration of the specified executives in this or future reporting periods are as follows:

	NUMBER OF OPTIONS GRANTED	GRANT DATE	DATE EXERCISABLE	PERFORMANCE CRITERIA
SP Burns	35,000	25 May 2001	24 May 2006	Limit to achieve an average 5% return on capacity for five years from the 2001 underwriting year.
	80,000	10 December 2001	31 March 2007	Limit to achieve an average 5% return on capacity for five years from and including the 2002 underwriting year.
NG Drabsch	100,000 <sup>(1)</sup>	18 March 2002	31 March 2005	QBE Group to achieve an average annual 12.5% increase in earnings per share over three years to 31 December 2004.
PE Glen	50,000 <sup>(2)</sup>	10 December 2001	31 March 2007	European company operations to achieve an average 5% insurance profit for five years from and including the 2002 underwriting year.
PE Grove	35,000	25 May 2001	24 May 2006	Limit to achieve an average 5% return on capacity for five years from the 2001 underwriting year.
	60,000	10 December 2001	31 March 2007	Limit to achieve an average 5% return on capacity for five years from and including the 2002 underwriting year.
	100,000 <sup>(3)</sup>	14 November 2002	31 December 2005	Limit managed syndicates to achieve an average return on capacity of 7% or more over the years ending 2002 to 2005.
TM Kenny	30,000	1 June 2001	31 May 2006	QBE the Americas to achieve an average insurance profit of 6% for underwriting years 2001 to 2005.
	100,000	10 December 2001	31 March 2007	QBE the Americas to achieve an average insurance profit of 5% for underwriting years 2002 to 2006.
	100,000	12 May 2005	20% by December each year until 31 December 2009	QBE the Americas to achieve an average insurance profit of 7% of net earned premium for the five underwriting years commencing 1 January 2001.
EG Tollifson	100,000 <sup>(1)</sup>	18 March 2002	31 March 2005	QBE Group to achieve an average annual 12.5% increase in earnings per share over three years to 31 December 2004.

(1) These options were exercised during the financial year following the achievement of the relevant performance criteria.

(2) Mr Glen's employment was terminated through redundancy on 30 September 2004. Under the terms of the redundancy agreement, he was eligible to exercise these options in March 2005.

(3) These options vested on 31 December 2005 but will only be exercisable from 27 February 2006 until 13 March 2006.

## Notes to the financial statements continued

FOR THE YEAR ENDED 31 DECEMBER 2005

# 28

### DIRECTORS' AND EXECUTIVES' DISCLOSURES (COMPANY AND CONSOLIDATED) CONTINUED

Details of the movements in future performance options over ordinary shares in the company provided as remuneration to the executive director and specified executives are provided below:

NUMBER OF OPTIONS	BALANCE AT 1 JAN 2005	GRANTED IN THE YEAR	EXERCISED IN THE YEAR	FORFEITED/ CANCELLED IN THE YEAR	BALANCE AT 31 DEC 2005	VESTED AT 31 DEC 2005
<b>Specified executives</b>						
SP Burns	115,000	–	–	–	115,000	–
NG Drabsch	100,000	–	(100,000)	–	–	–
PE Glen <sup>(1)</sup>	50,000	–	(50,000)	–	–	–
PE Grove	195,000	–	–	–	195,000	100,000 <sup>(3)</sup>
TM Kenny <sup>(2)</sup>	130,000	100,000	–	–	230,000	20,000 <sup>(4)</sup>
EG Tollifson	100,000	–	(100,000)	–	–	–

(1) Mr Glen's employment was terminated through redundancy on 30 September 2004. Under the terms of the redundancy agreement, he was eligible to exercise these options in March 2005.

(2) 100,000 future performance options were granted to Mr Kenny on 12 May 2005 under the terms of an agreement entered into on 12 May 2000. The fair value of these options at grant date was \$2.32. The exercise price is \$14.81.

(3) These options are exercisable from 27 February 2006 until 13 March 2006.

(4) These options were exercised on 31 January 2006. The shares issued as a result of this exercise have not been sold.

#### (iv) Regular options

Regular options issued under the Plan are based on the achievement of past performance hurdles and are exercisable at 20% per annum. If the specified executive is entitled to exercise options in a particular year but does not, then he or she may exercise the options in the following year. These options expire if not exercised within five years from the date of issue.

Regular options have been phased out and replaced with the long term incentive arrangement under the LTI.

Details of the movements in regular options that affect remuneration in this or future reporting periods are as follows:

NUMBER OF OPTIONS	BALANCE AT 1 JAN 2005	EXERCISED IN THE YEAR	FORFEITED/ CANCELLED IN THE YEAR	BALANCE AT 31 DEC 2005 <sup>(2)</sup>
<b>Specified executives</b>				
PE Glen <sup>(1)</sup>	60,000	(60,000)	–	–
RL Jones	6,000	(4,500)	–	1,500
TM Kenny	10,000	(10,000)	–	–
V McLenaghan	3,000	(2,250)	–	750
EG Tollifson	4,000	(3,000)	–	1,000

(1) Mr Glen's employment was terminated through redundancy on 30 September 2004. Under the terms of the redundancy agreement, he was eligible to exercise his remaining options in March 2005.

(2) None of the options are vested and exercisable at 31 December 2005.

# Notes to the financial statements continued

FOR THE YEAR ENDED 31 DECEMBER 2005

## 28

### DIRECTORS' AND EXECUTIVES' DISCLOSURES (COMPANY AND CONSOLIDATED) CONTINUED

#### (B) Equity holdings and transactions

The movement during the year in the number of ordinary shares in the company held by each specified director and specified executive, including their personally related entities, is provided below:

NUMBER OF SHARES	INTEREST IN SHARES AT 1 JAN 2005	CONDITIONAL RIGHTS VESTED	OPTIONS EXERCISED	PURCHASED (SOLD)	DIVIDENDS REINVESTED IN THE YEAR	INTEREST IN SHARES AT 31 DEC 2005	INTEREST IN SHARES AT 31 DEC 2005 SUBJECT TO NON-RECOURSE LOANS <sup>(3)</sup>
<b>Non-executive directors</b>							
LF Bleasel AM	42,768	–	–	–	635	43,403	–
EJ Cloney	720,410	–	–	(14,485)	28,992	734,917	–
CP Curran AO	356,751	–	–	–	1,162	357,913 <sup>(1)</sup>	–
The Hon NF Greiner AC	53,716	–	–	–	1,789	55,505 <sup>(2)</sup>	–
IF Hudson	–	–	–	–	–	–	–
BJ Hutchinson	27,446	–	–	–	–	27,446	–
CLA Irby	15,000	–	–	–	–	15,000	–
IYL Lee	10,467	–	–	3,000	489	13,956	–
<b>Executive director</b>							
FM O'Halloran	1,160,741	–	–	(124,000)	42,861	1,079,602	965,580
<b>Specified executives</b>							
SP Burns	3,083	–	–	–	124	3,207	2,970
NG Drabsch	256,067	–	100,000	(75,000)	12,352	293,419	287,371
PE Grove	2,854	–	–	–	116	2,970	2,970
MD ten Hove	376,296	–	–	(60,000)	14,198	330,494	328,833
RL Jones	228,076	17,388	44,587	–	10,515	300,566	282,830
TM Kenny	150,749	–	10,000	(150,749)	3,022	13,022	13,022
V McLenaghan	198,116	8,586	22,044	–	–	228,746	207,609
EG Tollifson	165,104	–	103,000	(60,000)	7,579	215,683	194,682

(1) Balance of ordinary shares held at 8 April 2005.

(2) Includes 10,000 warrants to purchase ordinary shares.

(3) Prior to 20 June 2005, non-recourse loans were provided by the consolidated entity to the executive director and specified executives on the exercise of their options for the purchase of shares in the company. Under AIFRS, non-recourse loans and the related shares are derecognised and are instead treated as options.

# Notes to the financial statements continued

FOR THE YEAR ENDED 31 DECEMBER 2005

## 28

### DIRECTORS' AND EXECUTIVES' DISCLOSURES (COMPANY AND CONSOLIDATED) CONTINUED

#### (C) Share loans to specified directors and specified executives

All share loans to the executive director and specified executives are secured over the relevant issued shares in the company. In accordance with the terms of the Plan, which were approved at the 1981 AGM, share loans to employees do not accrue interest. The amount shown for interest not charged in the table below is calculated using the fringe benefits tax benchmark interest rate for loans.

Details regarding the share loans made by the consolidated entity to the executive director and specified executives are as follows:

#### (i) Non-recourse share loans

	BALANCE AT 1 JAN 2005 \$'000	LOANS MADE IN THE YEAR \$'000	REPAYMENTS \$'000	BALANCE AT 31 DEC 2005 \$'000	INTEREST NOT CHARGED \$'000	HIGHEST BALANCE IN PERIOD \$'000
<b>Executive director</b>						
FM O'Halloran	4,336	–	–	4,336	306	4,336
<b>Specified executives</b>						
SP Burns	22	–	–	22	2	22
NG Drabsch	1,817	749	(128)	2,438	165	2,566
PE Grove	22	–	–	22	2	22
MD ten Hove	3,465	–	(98)	3,367	241	3,465
RL Jones	2,010	316	–	2,326	159	2,326
TM Kenny	947	65	(951)	61	15	947
V McLenaghan	1,326	156	(60)	1,422	100	1,474
EG Tollifson	977	760	(106)	1,631	106	1,737
<b>Total specified executives</b>	10,586	2,046	(1,343)	11,289	790	

Prior to 20 June 2005, non-recourse loans were provided by the consolidated entity to the executive director and specified executives for the purchase of shares in the company. Under AIFRS, non-recourse loans and the related shares are derecognised and are instead treated as options.

#### (ii) Personal recourse share loans

Since 20 June 2005, total personal recourse loans of \$56,000 (2004 \$nil) have been provided to three specified executives. Interest not charged amounted to \$1,000 (2004 \$nil). The amount outstanding at the balance date was \$56,000 (2004 \$nil).

#### (D) Other transactions with directors, executives and personally related entities

##### CP Curran AO – related entities

Mr Curran AO retired as a director of QBE Insurance Group Limited on 8 April 2005. During his directorship of the company he was also non-executive chairman of Perpetual Trustees Australia Ltd, an entity whose controlled entity was used during the year, on an arm's length basis, for share registration purposes. During 2005, a controlled entity paid \$738,000 (2004 \$658,000) for these services.

##### MD ten Hove – apartment purchase arrangement

Mr ten Hove joined QBE in March 1999 as Group general manager, investments. He entered into a contractual arrangement with a controlled entity at that time which provided him with an option to purchase an apartment in the Sydney CBD, already owned by the consolidated entity, if he remained with QBE and decided to apply for permanent residence in Australia. The option agreement enabled purchase of the apartment for \$533,736, being the original purchase price to the controlled entity plus stamp duty and improvements. Mr ten Hove paid market rent during his occupancy of the property until purchase. In January 2005, he returned to Sydney from London, achieved permanent residence and subsequently purchased the apartment on 22 June 2005 for \$610,000. The most recent market valuation of the property was \$610,000 in November 2004. Mr ten Hove was subsequently reimbursed \$76,264, being the difference between the market value at the date of purchase and the value of the original option agreement.

##### FM O'Halloran – retirement benefits

Mr O'Halloran joined QBE in June 1976. Eight of his years with the consolidated entity have been in the position of chief executive officer, with four years as director of operations, seven years as director of finance, five years as chief financial officer and the remainder as Group financial controller. On 1 January 1998, a controlled entity entered into a retirement benefit arrangement with Mr O'Halloran, which is in addition to his entitlement under the Group staff superannuation plan. As Mr O'Halloran was employed by the consolidated entity in May 2004, he will receive a lump sum payment of 150% of his total remuneration cost being his annual base salary plus STI for the year prior to the date of his retirement. As a condition of this arrangement, Mr O'Halloran has entered into a non-compete agreement for three years from the date of his retirement.

## Notes to the financial statements continued

FOR THE YEAR ENDED 31 DECEMBER 2005

# 29

### RETIREMENT BENEFITS

Entities in the consolidated entity participate in a number of superannuation plans which have been established and are sponsored by those entities. A number of these plans provide defined benefits to employees on retirement, disability or death. The benefits are based on years of service and an average salary calculation.

Contributions are made to the plans by both employees and controlled entities, typically as a percentage of salary and within the rules of the plans, and are based on funding schedules prepared by independent actuaries on the dates specified below. In addition, the consolidated entity continues to meet applicable statutory minimum funding requirements set out by legislation in the UK. The contribution rate in respect of defined benefit plans is agreed between the relevant controlled entity and the plans' trustees and actuaries. The consolidated entity has no immediate legal obligation to settle the liability.

Independent actuarial assessments of all significant plans are completed at least once every three years. The main plans were assessed by various qualified employees of Russell Employee Benefits, AON Consulting, Watson Wyatt Worldwide and Mercer's. All valuations have been updated for information available at 31 December 2005.

#### (A) Balance sheet amounts

The amounts recognised in the balance sheet for defined benefit superannuation plans are as follows:

	DATE OF LAST ACTUARIAL VALUATION	FAIR VALUE OF PLAN ASSETS		PRESENT VALUE OF PLAN OBLIGATIONS		NET SURPLUS (DEFICIT)	
		2005 \$M	2004 \$M	2005 \$M	2004 \$M	2005 \$M	2004 \$M
<b>Non-current assets – superannuation plan surplus</b>							
New Zealand superannuation plan	31 Dec 05	7	6	(5)	(4)	2	2
<b>Non-current liabilities – superannuation plan obligations</b>							
QBE Group staff superannuation plan – closed	31 Dec 04	–	125	–	(145)	–	(20)
QBE defined benefit plan	31 Dec 05	63	–	(71)	–	(8)	–
Iron Trades insurance staff trust	31 Dec 05	279	233	(349)	(319)	(70)	(86)
European staff retirement benefit plan	31 Dec 05	13	10	(21)	(16)	(8)	(6)
Janson Green final salary superannuation scheme	31 Dec 05	162	120	(237)	(208)	(75)	(88)
National Farmers Union	31 Dec 05	31	–	(34)	–	(3)	–
Other plans		5	4	(9)	(6)	(4)	(2)
		553	492	(721)	(694)	(168)	(202)
<b>Net liability recognised in the balance sheet</b>		<b>560</b>	<b>498</b>	<b>(726)</b>	<b>(698)</b>	<b>(166)</b>	<b>(200)</b>

On 28 October 2005, the consolidated entity announced the closure of the QBE Group staff superannuation plan. Members of the plan were offered the option of either transferring to a new defined benefit plan with no pension entitlements or to a defined contribution plan. The relevant controlled entity provided an incentive to those transferring to the defined contribution plan. The consolidated entity has no further obligation in respect of the closed plan, but has an obligation in respect of those members transferring to the new defined benefit plan. In order to determine the consolidated entity's superannuation plan obligation at the balance date, the number of members expected to transfer to the defined contribution plan was estimated by management and independent actuaries as this information will not be finalised until 28 February 2006.

## Notes to the financial statements continued

FOR THE YEAR ENDED 31 DECEMBER 2005

# 29

### RETIREMENT BENEFITS CONTINUED

#### (B) Reconciliation

	2005 \$M	2004 \$M
<b>Wholly funded defined benefit obligation at 1 January</b>	<b>698</b>	615
Current service cost	16	15
Interest cost	35	33
Experience losses on plan liabilities	75	42
Benefits and expenses paid	(32)	(23)
Past service cost	1	–
Contributions by plan participants	1	1
Transfer of defined benefit obligation from closed fund	(80)	–
Curtailments and settlements	1	–
Acquisitions	34	–
Foreign exchange	(23)	15
<b>Wholly funded defined benefit obligation at 31 December</b>	<b>726</b>	698
<b>Fair value of plan assets at 1 January</b>	<b>498</b>	449
Expected return on plan assets	30	31
Actuarial gains on plan assets	39	7
Employer contributions	87	23
Contributions by plan participants	1	1
Benefits and expenses paid	(32)	(23)
Transfer of assets from closed fund	(80)	–
Curtailments and settlements	3	–
Acquisitions	30	–
Foreign exchange	(16)	10
<b>Fair value of plan assets at 31 December</b>	<b>560</b>	498
<b>Net liability recognised in the balance sheet at 31 December</b>	<b>166</b>	200

	2005 \$M	2004 \$M
<b>Net liability recognised in the balance sheet at 1 January</b>	<b>200</b>	166
<b>Amounts recognised in the income statement</b>		
Current service cost	16	15
Interest cost	35	33
Past service cost	1	–
Expected return on plan assets	(30)	(31)
Curtailments and settlements	(2)	–
	20	17
Actuarial losses included in the statement of recognised income and expense	36	35
Employer contributions	(87)	(23)
Acquisitions	4	–
Foreign exchange	(7)	5
<b>Net liability recognised in the balance sheet at 31 December</b>	<b>166</b>	200

The amount recognised in the income statement in the year of \$20 million (2004 \$17 million) has been included within underwriting expenses. The actual return on plan assets was \$69 million (2004 \$38 million).

## Notes to the financial statements continued

FOR THE YEAR ENDED 31 DECEMBER 2005

# 29

### RETIREMENT BENEFITS CONTINUED

#### (C) Amounts included in the statement of recognised income and expense

Cumulative actuarial gains and losses included in the statement of recognised income and expense are as follows:

	2005 \$M	2004 \$M
<b>Actuarial losses at 1 January</b>	<b>35</b>	–
Actuarial losses recognised in year	<b>36</b>	35
<b>Actuarial losses at 31 December</b>	<b>71</b>	35
<b>Deferred taxation on actuarial losses at 1 January</b>	<b>(10)</b>	–
Deferred taxation credit on actuarial losses recognised in year	<b>(9)</b>	(10)
<b>Deferred taxation on actuarial losses at 31 December</b>	<b>(19)</b>	(10)
<b>Net actuarial losses at 31 December</b>	<b>52</b>	25

#### (D) Principal actuarial assumptions

	2005 %	2004 %
Discount rate	<b>3.9 – 6.1</b>	4.0 – 6.6
Expected return on plan assets	<b>5.2 – 8.0</b>	5.5 – 8.0
Future salary increases	<b>3.5 – 6.0</b>	3.5 – 6.0
Future pension increases	<b>0.0 – 2.8</b>	0 – 2.8

The expected return on plan assets is based on historical and future expectations of returns for each of the major asset classes as well as the expected and actual allocation of plan assets to these major classes.

#### (E) Analysis of plan assets

	2005 \$M	2004 \$M
Equities	<b>195</b>	229
Bonds	<b>319</b>	203
Property	<b>1</b>	1
Other	<b>45</b>	65
	<b>560</b>	498

#### (F) Historical summary

	2005 \$M	2004 \$M
Experience losses arising on plan liabilities	<b>75</b>	42
Experience gains arising on plan assets	<b>69</b>	38

#### (G) Funding

Employer contributions to the defined benefit superannuation plans are based on recommendations by the plans' actuaries. The objective of the consolidated entity's funding schedules is to ensure that benefit entitlements are fully funded at the time they become payable. The key economic assumptions applied by the actuaries are shown in note 29(D).

## Notes to the financial statements continued

FOR THE YEAR ENDED 31 DECEMBER 2005

### 30

#### REMUNERATION OF AUDITORS

	2005 \$'000	2004 \$'000
<b>PricewaterhouseCoopers – Australian firm<sup>(1)</sup></b>		
Audit or review of financial reports of the parent entity	754	665
Audit of financial reports of controlled entities	2,251	1,865
Audit of statutory returns	442	515
Other audit assurance services	430	499
Taxation services	233	46
Advisory services (including business continuity management assistance)	151	–
	<b>4,261</b>	<b>3,590</b>
<b>Related practices of PricewaterhouseCoopers – Australian firm<sup>(1)</sup></b> (including overseas PricewaterhouseCoopers firms)		
Audit of financial reports of controlled entities	5,235	3,081
Audit of statutory returns	1,882	1,367
Other audit assurance services	15	123
Taxation services	427	327
Advisory services (including due diligence services)	1,001	66
Actuarial services	–	15
Legal services	–	897
	<b>8,560</b>	<b>5,876</b>
	<b>12,821</b>	<b>9,466</b>
Audit and assurance services	<b>11,009</b>	<b>8,115</b>
Other services	<b>1,812</b>	<b>1,351</b>
	<b>12,821</b>	<b>9,466</b>
<b>Other auditors</b>		
Audit of financial reports of controlled entities	410	866

(1) From 1 January 2003, the consolidated entity may engage PricewaterhouseCoopers for non-audit services, subject to the general principle that fees for non-audit services should not exceed 30% of the total of all fees in any one year. Consistent with prior periods, PricewaterhouseCoopers cannot provide the excluded services of preparing accounting records or financial reports, asset or liability valuations, acting in a management capacity, acting as a custodian of assets or acting as share registrar.

### 31

#### CONTINGENT LIABILITIES

The company and the consolidated entity had the following contingent liabilities:

	THE COMPANY		CONSOLIDATED	
	2005 \$M	2004 \$M	2005 \$M	2004 \$M
Guarantees of interest bearing liabilities in controlled entities	427	453	–	–
Letters of credit issued in support of the consolidated entity's participation in Lloyd's of London	352	245	352	294
Letters of credit issued in support of insurance provisions of controlled entities	237	233	–	–
Guarantees to investors in hybrid securities	701	796	–	–
Guarantees to investors in ABC securities for funds at Lloyd's (due 2008)	750	703	–	–
Guarantees to investors in ABC securities for funds at Lloyd's (due 2009)	300	281	–	–

A controlled entity has entered into a number of deeds of covenant in respect of its controlled entities to meet part of their obligations to Lloyd's of London. The total guarantee given under these deeds of covenant amounts to \$316 million (2004 \$398 million). The obligations under the deeds of covenant are secured by a fixed and floating charge over certain investments and other assets in favour of Lloyd's of London. Refer note 13(D).

Details of the guarantees to investors in Eurobonds and hybrid securities and security arrangements in respect of interest bearing liabilities are provided in note 22.

Details of contingent liabilities in respect of ABC securities for funds at Lloyd's are included in note 35(C).

## Notes to the financial statements continued

FOR THE YEAR ENDED 31 DECEMBER 2005

### 32

#### CAPITAL EXPENDITURE COMMITMENTS

	THE COMPANY		CONSOLIDATED	
	2005 \$M	2004 \$M	2005 \$M	2004 \$M
Capital expenditure commitments contracted but not provided for in the financial statements (not later than one year)	-	-	14	3

### 33

#### OPERATING LEASE COMMITMENTS

	THE COMPANY		CONSOLIDATED	
	2005 \$M	2004 \$M	2005 \$M	2004 \$M
Payable:				
Not later than one year	-	-	27	33
Later than one year but not later than five years	-	-	80	86
Later than five years	-	-	166	80
<b>Aggregate amounts contracted but not provided for in the financial statements</b>	-	-	273	199

### 34

#### NEW SOUTH WALES WORKERS' COMPENSATION MANAGED FUNDS (CONSOLIDATED)

A controlled entity is a licensed insurer under the *New South Wales Compensation Act 1987*. In 2005, WorkCover New South Wales issued a new licence to the controlled entity including new terms and conditions that do not require the controlled entity to establish or maintain statutory funds. Prior to the issue of the new licence, in accordance with the requirements of the previous licence, the controlled entity established and maintained statutory funds in respect of the issue and renewal of policies of insurance.

	2005 \$M	2004 \$M
<b>Statutory fund balance sheet</b>		
<b>Current assets</b>		
Cash and short term deposits	-	1,079
Debtors	-	184
<b>Non-current assets</b>		
Financial assets – market value	-	445
<b>Total assets</b>	-	1,708
<b>Current liabilities</b>		
Creditors	-	18
Unearned premium	-	247
Statutory funds to meet outstanding claims and statutory transfers	-	1,443
<b>Total liabilities and statutory funds</b>	-	1,708

## Notes to the financial statements continued

FOR THE YEAR ENDED 31 DECEMBER 2005

# 35

### LLOYD'S DIVISION

#### (A) Non-aligned syndicates

A controlled entity acquired Limit plc and its controlled entities ("Limit") in August 2000. From 1994 to 2000, Limit participated in the results of a number of syndicates managed by other managing agents at Lloyd's (non-aligned syndicates). In 2000, Limit sold its right to participate in the results of these syndicates after 31 December 2000. In 2001, Limit sold the rights to manage syndicate 318, previously managed by its controlled managing agency, to another managing agency at Lloyd's but retained participation in the syndicate until December 2004. The result of Limit's participation on this syndicate has also been included as non-aligned. Lloyd's operates on a three year accounting basis and at the end of the third year the underwriting account is normally closed by reinsurance into the following year of account. The runoff of these syndicates is expected to complete by 31 March 2007. The consolidated entity is expected to have to fund its share of the net outstanding claims of these operations, as shown below, and therefore the assets and liabilities are included on a net basis in outstanding claims in the balance sheet.

	2005 \$M	2004 \$M
<b>Assets</b>		
Financial assets – market value	120	122
Other assets	115	119
	<b>235</b>	241
<b>Liabilities</b>		
Outstanding claims net of reinsurance recoveries	277	263
Other liabilities	13	17
	<b>290</b>	280
<b>Net liabilities</b>	<b>55</b>	39

#### (B) Reinsurance to close

Since acquiring Limit in August 2000, the consolidated entity has purchased additional capacity in the syndicates managed by Limit, taking its ownership share for all syndicates from 55% in 2000 to 90% for the 2006 underwriting year. These purchases of additional capacity create an obligation for the consolidated entity to accept the additional share of insurance provisions in exchange for an equal amount of investments and other assets. The amounts will be determined when the reinsurance to close is calculated on 31 December 2006 or subsequent dates. It is currently estimated that the amount of the net insurance provisions and matching assets will exceed \$557 million, which will be recognised in the years in which the reinsurance to close is expected to be finalised.

# Notes to the financial statements continued

FOR THE YEAR ENDED 31 DECEMBER 2005

## 35

### LLOYD'S DIVISION CONTINUED

#### (C) Funds at Lloyd's

##### (i) ABC securities (due 2009)

In October 2004, the company entered into an arrangement with Mantis Reef II Limited ("MR(II)L") to issue US\$220 million of ABC (asset backed capital) securities to support funds at Lloyd's ("FAL") pursuant to Lloyd's collateral requirements. This arrangement substantially replaced bank letters of credit and assisted in meeting new FAL requirements. MR(II)L is a special purpose entity incorporated with limited liability under the laws of the Cayman Islands. The consolidated entity has no ownership interest in MR(II)L.

Proceeds from the sale of the ABC securities to investors have been swapped to sterling and then used to purchase shares in a wholly owned controlled entity of MR(II)L, Mantis Reef II Pledge Limited ("MR(II)PL"). MR(II)PL is another special purpose entity incorporated with limited liability under the laws of the Cayman Islands. The proceeds from the sale of shares in MR(II)PL have been used to purchase eligible investments over which security interests, in the form of a fixed and floating charge, have been granted to Lloyd's in support of FAL requirements of some of the company's controlled entities. Details of the eligible investments included in the asset portfolio are shown below as ABC financial assets pledged for funds at Lloyd's.

Under its arrangement with MR(II)L and MR(II)PL, the company makes fixed payments to MR(II)L and in return receives the benefit of the earnings from the investment portfolio. As part of its agreement with MR(II)L and MR(II)PL the company can, if the need arises, call on MR(II)PL to provide up to £120 million by the sale or transfer of its investment portfolio to meet certain controlled entities' cash call requirements from Lloyd's, and at that time the company would assume a loan obligation including servicing of interest payments and repayment of the principal. To achieve this, the company would issue debt securities to MR(II)L with similar terms to the ABC securities. The company has entered into a fixed for floating cross currency interest rate swap with a third party to service its fixed interest rate obligations.

##### (ii) ABC securities (due 2008)

In October 2003, the company entered into an arrangement with Mantis Reef Limited ("MRL") to issue US\$550 million of ABC securities to support FAL pursuant to Lloyd's collateral requirements. This arrangement substantially replaced bank letters of credit. MRL is a special purpose entity incorporated with limited liability under the laws of the Cayman Islands. The consolidated entity has no ownership interest in MRL.

Proceeds from the sale of the ABC securities to investors have been used to purchase shares in a wholly owned controlled entity of MRL, Mantis Reef Pledge Limited ("MRPL"). MRPL is another special purpose entity incorporated with limited liability under the laws of the Cayman Islands. The proceeds from the sale of shares in MRPL have been used to purchase eligible investments over which security interests, in the form of a fixed and floating charge, have been granted to Lloyd's in support of FAL requirements. Details of the eligible investments included in the asset portfolio are shown below as ABC financial assets pledged for funds at Lloyd's.

Under its arrangement with MRL and MRPL, the company makes fixed payments to MRL and in return receives the benefit of the earnings from the investment portfolio. As part of its agreement with MRL and MRPL the company can, if the need arises, call on MRPL to provide up to US\$550 million by the sale or transfer of its investment portfolio to meet certain controlled entities' cash call requirements from Lloyd's, and at that time the company would assume a loan obligation including servicing of interest payments and repayment of the principal. To achieve this, the company would issue debt securities to MRL with similar terms to the ABC securities. The company has entered into a fixed for floating interest rate swap with a third party to service its fixed interest rate obligations.

##### (iii) Swaps relating to ABC securities

The consolidated entity is exposed to interest rate and currency risk in respect of the ABC securities and has therefore entered into two swap agreements, being an interest rate swap agreement with a financial institution under which it is obliged to pay interest at a variable rate and receive interest at a fixed rate and a cross currency interest rate swap agreement under which it is obliged to pay variable rate interest on a sterling asset portfolio and receive a fixed amount of US dollar interest.

ABC securities (due 2009) are measured at amortised cost in original currency and translated to Australian dollars at the closing rate of exchange. Under the swap agreement, the consolidated entity pays a margin of 1.7% above the wholesale interbank rate monthly on £120 million and receives a fixed rate of 3.2% on US\$220 million every six months to match the interest payment to investors. The swap agreement currently comprises three swaps which are measured at fair value. Two of the swaps are designated as cash flow hedges and have satisfied the effectiveness tests throughout the period from inception and at the balance date. The movement in the fair value of the cash flow hedges is taken to equity. Any ineffectiveness in the cash flow hedges is recognised directly in the income statement. An amount is transferred from equity and taken to the income statement to offset:

- the differential between the fixed and variable interest payments; and
- the foreign exchange gain or loss on translation of the financial liabilities.

During the year, a loss of \$1 million (2004 \$nil) was recognised in equity relating to the fair value movements on the cash flow hedges. During the year, a gain of \$4 million (2004 \$nil) was transferred from equity to the income statement.

ABC securities (due 2008) are measured at amortised cost in original currency and translated to Australian dollars at the closing rate of exchange. Under the swap agreement, the consolidated entity pays interest at the wholesale interbank rate and receives a fixed rate of 3.5% on US\$550 million every six months to match the interest payment to investors.

## Notes to the financial statements continued

FOR THE YEAR ENDED 31 DECEMBER 2005

# 35

### LLOYD'S DIVISION CONTINUED

The swap agreement comprises two swaps which are measured at fair value. The swaps are designated as fair value hedges and have satisfied the relevant hedge effectiveness tests throughout the period and at the balance date. The fair value movement on the swaps is recognised in the income statement. Any change in the value of the financial liabilities as a result of the hedged risk adjusts the carrying amount of the hedged item and impacts the income statement.

			THE COMPANY		CONSOLIDATED	
			2005	2004	2005	2004
			\$M	\$M	\$M	\$M
<b>ABC financial assets pledged for funds at Lloyd's<sup>(1)</sup></b>						
Due 2008	Interest bearing short term money	US\$550 million	–	–	750	703
Due 2009	Interest bearing short term money	£120 million	–	–	282	295
			–	–	1,032	998
<b>ABC securities for funds at Lloyd's</b>						
Due 2008		US\$550 million	–	–	720	691
Due 2009		US\$220 million	–	–	295	277
			–	–	1,015	968
Swaps relating to ABC securities			5	5	29	30
			5	5	1,044	998

(1) Under the terms of the ABC securities arrangements, all interest bearing short term money will be reinvested and it is therefore included in non-current assets.

			2005	2004
			\$M	\$M
<b>Fair value of ABC securities for funds at Lloyd's</b>				
Due 2008		US\$550 million	724	693
Due 2009		US\$220 million	288	278
			1,012	971

# 36

### RELATED PARTIES (COMPANY AND CONSOLIDATED)

AASB 124: Related Party Disclosures ("AASB 124") defines key management personnel as a collective term for the specified directors and the specified executives of an entity. All material information required to be disclosed under AASB 124 has been included in the financial statements as follows:

#### Reference

Dividends from controlled entities	Note 7(B)
Amounts due from controlled entities	Note 11
Investments in controlled entities	Note 16
Amounts due to controlled entities	Note 19
Tax sharing agreement	Note 8(B)
Remuneration of key management personnel	Directors' report and note 28
Retirement allowances of key management personnel	Directors' report
Shares and options held by key management personnel	Note 28
Related party transactions with key management personnel	Note 28
Retirement benefits	Note 29
Guarantees in respect of related parties	Note 31

In the ordinary course of business, various controlled entities receive dividends and purchase and sell investments in public entities in which directors of the company are directors and shareholders.

## Notes to the financial statements continued

FOR THE YEAR ENDED 31 DECEMBER 2005

# 37

### EARNINGS PER SHARE (CONSOLIDATED)

	2005 CENTS	2004 CENTS
Basic earnings per share	144.3	123.4
Diluted earnings per share <sup>(1)</sup>	134.4	109.9
	\$M	\$M
<b>Reconciliation of earnings used in calculating earnings per share</b>		
Net profit after income tax attributable to members of the company, used in calculating basic earnings per share	1,091	857
Add: finance costs of hybrid securities	6	13
Earnings used in calculating diluted earnings per share	1,097	870
	MILLIONS	MILLIONS
Weighted average number of ordinary shares used as the denominator in calculating <sup>(2)</sup> :		
Basic earnings per share	757	695
Diluted earnings per share	817	791

(1) Hybrid securities have been treated as dilutive if the contingent conversion conditions are met at the balance date. If all hybrid securities had been considered dilutive at 31 December 2005, diluted earnings per share would have been 130.8 cents (2004 109.1 cents).

(2) Weighted average number of ordinary shares reflects shares adjusted to derecognise shares issued under the Plan. Basic earnings per share calculated with reference to issued share capital notified to the ASX would have been 142.5 cents (2004 123.1 cents). Refer to note 25(A).

# 38

### SEGMENT INFORMATION

#### (A) Business segments

2005	AUSTRALIA PACIFIC ASIA CENTRAL EUROPE \$M	EUROPEAN OPERATIONS \$M	THE AMERICAS \$M	EQUATOR RE \$M	ELIMINATION \$M	TOTAL \$M
Total assets	8,056	18,412	3,107	956	(866)	29,665
Total liabilities	6,060	15,835	2,717	760	(866)	24,506
Acquisition of property, plant and equipment, intangibles and other non-current segment assets	81	306	61	–	–	448
Depreciation expense	16	21	3	–	–	40
Other non-cash expenses	1	2	–	–	–	3
Total revenue	3,372	6,944	2,086	373	(347)	12,428
Gross written premium	3,122	4,794	1,492	353	(353)	9,408
Gross earned premium	3,093	4,643	1,435	347	(347)	9,171
Outward reinsurance premium expense	(542)	(946)	(592)	(52)	347	(1,785)
Net earned premium	2,551	3,697	843	295	–	7,386
Net claims incurred	(1,349)	(2,326)	(506)	(236)	–	(4,417)
Net commission	(356)	(651)	(215)	(29)	–	(1,251)
Underwriting and other expenses	(420)	(428)	(62)	–	–	(910)
Underwriting result	426	292	60	30	–	808
Investment income on policyholders' funds	181	253	27	19	–	480
Insurance profit	607	545	87	49	–	1,288
Investment income on shareholders' funds	50	171	10	7	–	238
Amortisation of intangibles	(1)	(2)	–	–	–	(3)
Profit before income tax	656	714	97	56	–	1,523
Income tax expense	(187)	(187)	(34)	(17)	–	(425)
Profit after income tax	469	527	63	39	–	1,098
Net profit attributable to minority interest	(6)	–	(1)	–	–	(7)
Net profit after income tax attributable to members of the company	463	527	62	39	–	1,091

Intersegment transactions are priced on an arm's length basis and are eliminated on consolidation.

# Notes to the financial statements continued

FOR THE YEAR ENDED 31 DECEMBER 2005

## 38

### SEGMENT INFORMATION CONTINUED

2004	AUSTRALIA PACIFIC ASIA CENTRAL EUROPE \$M	EUROPEAN OPERATIONS \$M	THE AMERICAS \$M	EQUATOR RE \$M	ELIMINATION \$M	TOTAL \$M
Total assets	7,269	15,445	2,156	596	(430)	25,036
Total liabilities	5,760	13,318	1,827	469	(430)	20,944
Acquisition of property, plant and equipment, intangibles and other non-current segment assets	540	95	4	–	–	639
Depreciation expense	18	33	2	–	–	53
Other non-cash expenses	–	1	–	–	–	1
Total revenue	3,233	5,381	1,833	277	(254)	10,470
Gross written premium	2,774	4,610	1,382	278	(278)	8,766
Gross earned premium	2,798	4,419	1,354	254	(254)	8,571
Outward reinsurance premium expense	(521)	(912)	(588)	(23)	254	(1,790)
Net earned premium	2,277	3,507	766	231	–	6,781
Net claims incurred	(1,306)	(2,222)	(454)	(174)	–	(4,156)
Net commission	(337)	(640)	(207)	–	–	(1,184)
Underwriting and other expenses	(382)	(422)	(55)	15	–	(844)
Underwriting result	252	223	50	72	–	597
Investment income on policyholders' funds	123	188	4	16	–	331
Insurance profit	375	411	54	88	–	928
Investment income on shareholders' funds	32	141	10	5	–	188
Amortisation of intangibles	–	(1)	–	–	–	(1)
Profit before income tax	407	551	64	93	–	1,115
Income tax expense	(84)	(129)	(20)	(18)	–	(251)
Profit after income tax	323	422	44	75	–	864
Net profit attributable to minority interest	(7)	–	–	–	–	(7)
Net profit after income tax attributable to members of the company	316	422	44	75	–	857

# Notes to the financial statements continued

FOR THE YEAR ENDED 31 DECEMBER 2005

## 38

### SEGMENT INFORMATION CONTINUED

#### (B) External product segments

	GENERAL INSURANCE		INWARD REINSURANCE		TOTAL	
	2005 \$M	2004 \$M	2005 \$M	2004 \$M	2005 \$M	2004 \$M
Total revenue	<b>8,882</b>	7,966	<b>3,546</b>	2,504	<b>12,428</b>	10,470
Net profit after income tax attributable to members of the company	<b>981</b>	719	<b>110</b>	138	<b>1,091</b>	857
Total assets	<b>21,637</b>	18,303	<b>8,028</b>	6,733	<b>29,665</b>	25,036
Acquisition of property, plant and equipment, intangibles and other non-current segment assets	<b>328</b>	466	<b>120</b>	173	<b>448</b>	639

#### (C) Geographical analysis

		AUSTRALIA	ASIA-PACIFIC	EUROPE	THE AMERICAS	OTHER	TOTAL
		\$M	\$M	\$M	\$M	\$M	\$M
Total revenue	<b>2005</b>	<b>3,632</b>	<b>922</b>	<b>3,278</b>	<b>3,632</b>	<b>964</b>	<b>12,428</b>
	2004	2,728	836	3,077	3,313	516	10,470
Net profit after income tax attributable to members of the company	<b>2005</b>	<b>404</b>	<b>140</b>	<b>418</b>	<b>68</b>	<b>61</b>	<b>1,091</b>
	2004	243	94	181	280	59	857
Total assets	<b>2005</b>	<b>10,677</b>	<b>1,975</b>	<b>8,243</b>	<b>7,730</b>	<b>1,040</b>	<b>29,665</b>
	2004	7,923	1,779	8,634	5,783	917	25,036
Acquisition of property, plant and equipment, intangibles and other non-current segment assets	<b>2005</b>	<b>81</b>	–	<b>170</b>	<b>197</b>	–	<b>448</b>
	2004	540	–	95	4	–	639

## Notes to the financial statements continued

FOR THE YEAR ENDED 31 DECEMBER 2005

# 39

### RECONCILIATION OF CASH FLOWS FROM OPERATING ACTIVITIES TO NET PROFIT AFTER INCOME TAX ATTRIBUTABLE TO MEMBERS OF THE COMPANY

	THE COMPANY		CONSOLIDATED	
	2005 \$M	2004 \$M	2005 \$M	2004 \$M
Cash flows from operating activities	<b>187</b>	348	<b>1,987</b>	2,110
Depreciation of assets	-	-	<b>(40)</b>	(53)
Amortisation of intangibles	-	-	<b>(3)</b>	(1)
Amortisation of premium/discount on fixed interest securities	-	-	<b>(9)</b>	(14)
Profit on sale of controlled entities	<b>629</b>	-	<b>11</b>	-
Loss on sale of plant and equipment	-	-	<b>(5)</b>	(1)
Net foreign exchange (losses) gains	<b>(5)</b>	(47)	<b>3</b>	51
Other gains on financial assets	-	-	<b>219</b>	89
Increase in net outstanding claims	-	-	<b>(836)</b>	(1,091)
Increase in unearned premium	-	-	<b>(236)</b>	(161)
Increase in deferred insurance costs	-	-	<b>62</b>	77
Increase in net amounts receivable from controlled entities	<b>267</b>	1,299	-	-
Increase in trade debtors	-	-	<b>350</b>	149
Increase (decrease) in other operating assets	<b>26</b>	229	<b>17</b>	(283)
Increase in trade and other payables	-	-	<b>(263)</b>	(172)
(Increase) decrease in current tax liabilities	<b>(60)</b>	5	<b>(85)</b>	41
Increase (decrease) in deferred tax liabilities	<b>16</b>	5	<b>(139)</b>	(121)
(Increase) decrease in provisions	-	(5)	<b>65</b>	244
Minority interest	-	-	<b>(7)</b>	(7)
<b>Net profit after income tax attributable to members of the company</b>	<b>1,060</b>	1,834	<b>1,091</b>	857

## Directors' declaration

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The directors declare that the financial statements and notes set out on pages 60 to 125:

- (a) comply with accounting standards, the Corporations Regulations 2001 and other mandatory professional reporting requirements; and
- (b) give a true and fair view of the company's and consolidated entity's financial position as at 31 December 2005 and of their performance, as represented by the results of their operations and their cash flows, for the financial year ended on that date.

In the directors' opinion, the financial statements are in accordance with the *Corporations Act 2001* and there are reasonable grounds to believe that the company will be able to pay its debts as and when they become due and payable.

The directors have been given the declarations by the chief executive officer and chief financial officer required by section 295A of the *Corporations Act 2001* for the financial year ended 31 December 2005.

Signed in SYDNEY this 23rd day of February 2006 in accordance with a resolution of the directors.



**EJ Cloney**  
Director



**FM O'Halloran**  
Director

# Independent audit report

TO THE MEMBERS OF QBE INSURANCE GROUP LIMITED

## Matters relating to the electronic presentation of the audited financial report

This audit report relates to the financial report and remuneration disclosures of QBE Insurance Group Limited (the company) and the QBE Insurance Group (defined below) for the financial year ended 31 December 2005 included on QBE Insurance Group Limited's web site. The company's directors are responsible for the integrity of the QBE Insurance Group Limited web site. We have not been engaged to report on the integrity of this web site. The audit report refers only to the financial report and remuneration disclosures identified below. It does not provide an opinion on any other information which may have been hyperlinked to/from the financial report or the remuneration disclosures. If users of this report are concerned with the inherent risks arising from electronic data communications they are advised to refer to the hard copy of the audited financial report and remuneration disclosures to confirm the information included in the audited financial report and remuneration disclosures presented on this web site.

## Audit opinion

In our opinion:

1. the financial report of QBE Insurance Group Limited:
  - gives a true and fair view, as required by the *Corporations Act 2001* in Australia, of the financial position of QBE Insurance Group Limited and the QBE Insurance Group (defined below) as at 31 December 2005, and of their performance for the year ended on that date; and
  - is presented in accordance with the *Corporations Act 2001*, Accounting Standards and other mandatory financial reporting requirements in Australia, and the Corporations Regulations 2001; and
2. the remunerations disclosures that are contained in pages 51 to 57 of the directors' report comply with Accounting Standard AASB 124 *Related Party Disclosures* (AASB 124) and class order 06/50 issued by the Australian Securities and Investments Commission.

This opinion must be read in conjunction with the rest of our audit report.

## Scope

### The financial report, remuneration disclosures and directors' responsibility

The financial report comprises the balance sheet, income statement, cash flow statement, statement of changes in equity, accompanying notes to the financial statements and the directors' declaration for both QBE Insurance Group Limited (the company) and the QBE Insurance Group (the consolidated entity), for the year ended 31 December 2005. The consolidated entity comprises both the company and the entities it controlled during that year.

The company has disclosed information about the remuneration of directors and executives (remuneration disclosures) as required by AASB 124, under the heading "remuneration report" on pages 51 to 57 of the directors' report, as permitted by class order 06/50.

The directors of the company are responsible for the preparation and true and fair presentation of the financial report in accordance with the *Corporations Act 2001*. This includes responsibility for the maintenance of adequate accounting records and internal controls that are designed to prevent and detect fraud and error, and for the accounting policies and accounting estimates inherent in the financial report. The directors are also responsible for the remuneration disclosures contained in the directors' report.

## Audit approach

We conducted an independent audit in order to express an opinion to the members of the company. Our audit was conducted in accordance with Australian Auditing Standards, in order to provide reasonable assurance as to whether the financial report is free of material misstatement and the remuneration disclosures comply with AASB 124 and class order 06/50. The nature of an audit is influenced by factors such as the use of professional judgment, selective testing, the inherent limitations of internal control and the availability of persuasive rather than conclusive evidence. Therefore, an audit cannot guarantee that all material misstatements have been detected. For further explanation of an audit, visit our website <http://www.pwc.com/au/financialstatementaudit>.

We performed procedures to assess whether in all material respects the financial report presents fairly, in accordance with the *Corporations Act 2001*, Accounting Standards and other mandatory financial reporting requirements in Australia, a view which is consistent with our understanding of the company's and the consolidated entity's financial position, and of their performance as represented by the results of their operations, changes in equity and cash flows. We also performed procedures to assess whether the remuneration disclosures comply with AASB 124 and class order 06/50.

We formed our audit opinion on the basis of these procedures, which included:

- examining, on a test basis information to provide evidence supporting the amounts and disclosures in the financial report and remuneration disclosures; and
- assessing the appropriateness of the accounting policies and disclosures used and the reasonableness of significant accounting estimates made by the directors.

Our procedures include reading the other information in the annual report to determine whether it contains any material inconsistencies with the financial report.

Whilst we considered the effectiveness of management's internal controls over financial reporting when determining the nature and extent of our procedures, our audit was not designed to provide assurance on internal controls.

Our audit did not involve an analysis of the prudence of business decisions made by directors or management.

## Independence

In conducting our audit, we followed applicable independence requirements of Australian professional ethical pronouncements and the *Corporations Act 2001*.



**RD Deutsch**

Partner

Sydney

23 February 2006



**PricewaterhouseCoopers**



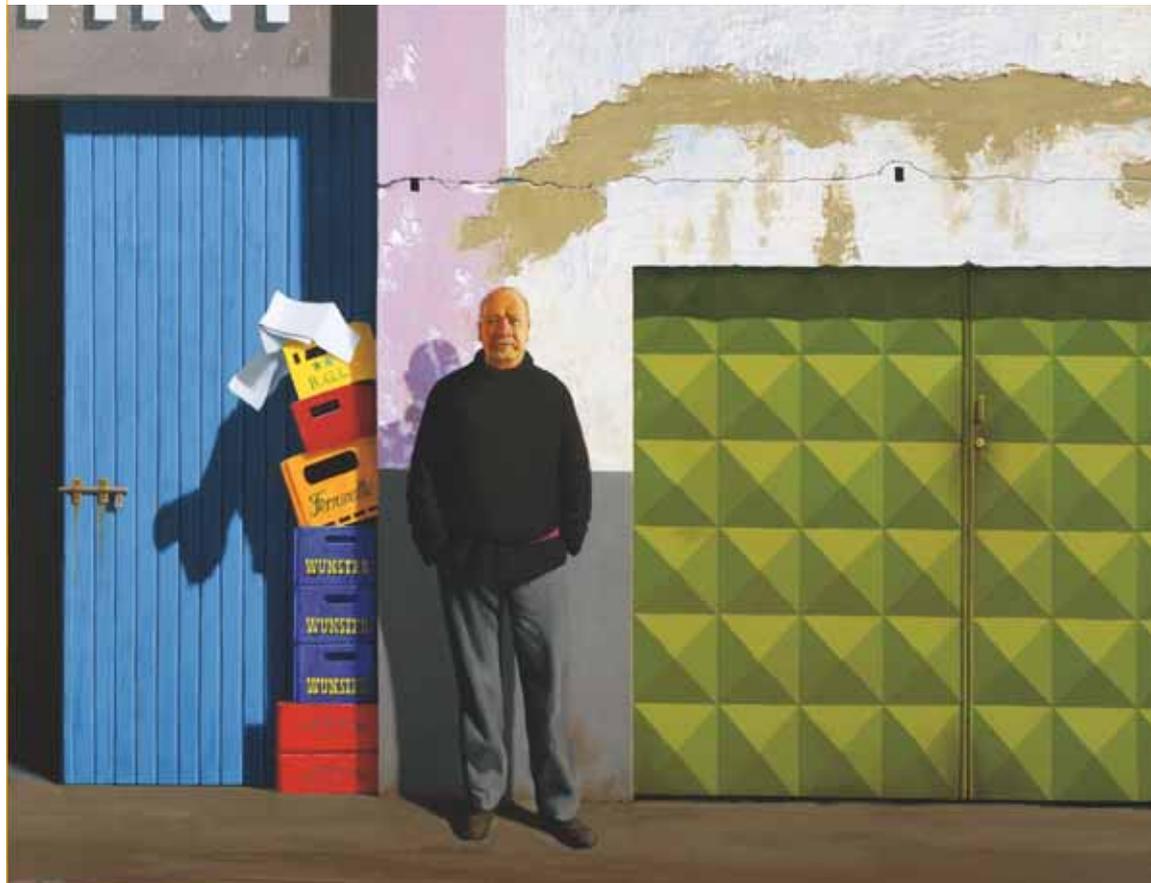
For further information please refer  
to our website [www.qbe.com](http://www.qbe.com)

## JEFFREY SMART

The 2005 QBE Group annual report celebrates the work of internationally renowned Australian artist Jeffrey Smart. An Australian icon in the art world, Jeffrey Smart was born and grew up in Adelaide but has lived most of his life in Italy. Aside from the aesthetic qualities of his work, we were struck by the parallel between the artist as a successful expatriate Australian artist with a strong international reputation and QBE as a leading Australian company which operates in 41 countries including the major insurance markets.

Technically complex and elegantly constructed, Jeffrey Smart's paintings investigate profoundly commonplace situations such as buildings, highways, car parks and heavy vehicles with human figures included to provide emphasis or to counterpoint some part of the pattern. The artist portrays these familiar images of the contemporary world as precise geometric compositions of pattern, shape, colour and design to achieve a feeling of innate balance and beauty. What makes the works so compelling is the skilful juggling of colour and form and the subtle inclusion of an ambiguous figure or surreal image leaving the meaning of the paintings open to interpretation depending upon the temperament of the observer.

The design concept for this annual report has been developed to complement Jeffrey Smart's paintings in keeping with his demonstrated aesthetic values and in recognition of his considerable contribution as an Australian artist. We would like to thank Mr Smart for the opportunity to feature the works selected as well as Australian Galleries who represent his works for their assistance in producing this report.



"Self portrait at Papini's" 1984-85, private collection



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