Actuarial and Insurance Consultants

15 September 2017

Mr Bayne Carpenter
Head of Finance
The Hollard Insurance Company
Level 12, 465 Victoria Avenue
CHATSWOOD NSW 2067

Dear Bayne

Actuarial Report on Scheme Transfer – Supplementary Letter

1 Introduction

I previously prepared a report dated 8 June 2017 (Actuarial Report) in relation to the proposed Insurance Scheme to transfer assets and liabilities for the Australian insurance business of Progressive Direct Insurance Company (PDIC US), written through its Australian Branch (PDIC Aus), to The Hollard Insurance Company Pty Limited (Hollard).

The Actuarial Report set out my opinion that the interests of the policyholders of PDIC Aus and Hollard would not be adversely affected in a material way as a consequence of the Insurance Scheme.

I have been advised by Hollard that its actual capital position at 30 June 2017 differs to a significant extent from the position on which my opinion was based. Hence I have been asked by Hollard to confirm that my opinion is unchanged.

This supplementary letter sets out the additional analysis that I have undertaken and provides my updated opinion on the Insurance Scheme. The letter is not intended to stand alone as a report on the scheme and should be considered in conjunction with the Actuarial Report.

While I have considered the updated capital position of Hollard, I have made no allowance to reflect any changes to the financial position of PDIC Aus. This is because the Insurance Scheme does not involve any capital being transferred from PDIC Aus to Hollard. As such the updated capital position of PDIC Aus is not relevant to the post-transfer financial position.

Structure of this Letter

In Section 2 I set out the change to Hollard's capital position since the Actuarial Report was prepared. At 30 June 2017, Hollard's APRA Prescribed Capital Amount (PCA) and capital base both differ to a significant extent from the positions shown in the Actuarial Report. Hence both of these movements are shown.

Sydney
Tel +61 2 8252 3300
Level 7, 68 Harrington Street
The Rocks, NSW 2000

Melbourne
Tel +61 3 8080 0900
Level 3, 30 Collins Street
Melbourne, VIC 3000

Auckland
Tel +64 9 306 7700
Level 5, 79 Queen Street
Auckland 1010

Finity Consulting Pty Limited ABN 89 111 470 270

finity.com.au / finityconsulting.co.nz

The 'actual' position at 30 June 2017 is based on figures from the June 2017 annual APRA Return. I have also shown the actual position on an adjusted basis that includes allowance for an additional $10 million of capital provided by Hollard's parent after 30 June (called "June 2017 plus $10 million capital").

Having summarised the differences in the capital position I set out my conclusions in Section 3, including my revised opinion on the Insurance Scheme.

New Data Provided

I was provided with the following data for the purpose of this letter:

- Hollard's Capital Calculations dated 28 August 2017. This was an updated version of the information provided for the Actuarial Report, now including analysis of the movements in the capital position between December 2016 and June 2017.
- Hollard's APRA Return as at June 2017.

I received all data that I requested for the preparation of my analysis.

I also had the benefit of discussions with officers of Hollard including the Chief Financial Officer and Appointed Actuary.

2 Change to Capital Position

This section of the letter sets out the changes to Hollard's capital position since the Actuarial Report was prepared.

APRA Prescribed Capital Amount

Table 1 compares the Hollard PCA included in the Actuarial Report with the actual PCA at 30 June 2017 and the adjusted figures including the $10 million of additional capital.

Table 1 – APRA Prescribed Capital Amount – Hollard ($ million)

	Actuarial Report[1]	Actual June 2017	June 2017 plus $10 million Capital
Insurance Risk Charge	27.4	32.5	32.5
Insurance Concentration Risk Charge	4.2	4.1	4.1
Asset Risk Charge	28.3	26.6	26.8
Asset Concentration Risk Charge	-	-	-
Operational Risk Charge	19.5	22.8	22.8
Aggregation Benefit	(13.4)	(13.8)	(13.8)
Prescribed Capital Amount (PCA)	**65.9**	**72.1**	**72.3**

1 PCA of $65.9 million from Table 5.4 of the Actuarial Report.

The key differences to the figures shown in the Actuarial Report are:

- The Insurance Risk Charge is $5.1 million higher than in the Actuarial Report, driven by the high outstanding claims from the Sydney Hail and Cyclone Debbie events in the March 2017 quarter and the inwards reinsurance of the PDIC Aus business. While some allowance had been made for these factors in the Actuarial Report, the actual impact was higher than had been assumed.
- The Operational Risk Charge has increased by $3.2 million, reflecting growth in premium volumes, including the inwards reinsurance of the PDIC Aus business.
- The 'June 2017 plus $10 million Capital' column includes a small amount for additional Asset Risk Charges on the investment of the $10 million.

Capital Adequacy at 30 June 2017

Table 2 compares the Hollard capital base, PCA, and resultant Capital Adequacy Multiple (CAM) from the Actuarial Report with the actual 30 June 2017 positions, and the adjusted position including the $10 million of additional capital.

Table 2 – APRA Capital Adequacy at 30 June 2017 – Hollard ($ million)

	Actuarial Report[1]	Actual June 2017	June 2017 plus $10 million Capital
APRA Capital Base	106.8	93.8	103.8
Prescribed Capital Amount (PCA)	65.9	72.1	72.3
Capital Adequacy Multiple (CAM)	**1.62**	**1.30**	**1.44**

1 CAM of 1.62 from Table 5.4 of the Actuarial Report.

For the Actuarial Report I anticipated that Hollard's capital base would be $106.8 million. This was based on the actual position at 31 December 2016 with adjustments for the impact of the March 2017 quarter experience and planned capital actions, and allowing for the 100% reinsurance of PDIC Aus (as shown in Table 5.4 of the Actuarial Report). The actual capital base at June 2017 is $13.0 million lower, at $93.8 million.

Based on my discussions with the company I understand that the reasons for the lower than expected capital base include:

- Elements that I would consider to be normal variability, such as variations in the claims costs, and
- One-off elements, the two largest of which are:
  - An adjustment relating to an investment in a recently acquired subsidiary. The increase in the value of the investment asset is not admissible for APRA capital purposes and consequently the extra amount that needed to be paid for the investment is a reduction to APRA capital of $6.5 million.

- An investment, previously admissible for capital purposes, changed classification to an associate and became non-admissible for APRA capital purposes. This investment had a value of $2.3 million.

In response to the lower than expected capital base, $10 million of capital was transferred to Hollard on 30 August 2017.

To some extent the movement in the capital position is indicative of the inherent variability in insurer balance sheets. I would not expect Hollard's capital position to regularly vary by such a large amount in a six month period, which reflects the one-off nature of some of the movements in the PCA and capital base.

Capital Adequacy Post-Transfer

The lower Hollard capital position at 30 June 2017 means that the estimated post-transfer capital position differs to that included in the Actuarial Report.

Table 3 – Estimated Post-Transfer APRA Capital Adequacy at June 2017($ million)[1]

	Actuarial Report	June 2017 plus $10 million Capital
Net Assets	191.1	212.3
Adjustments:		
Insurance Liability Surplus	15.2	14.1
Intangibles and Other Adjustments	(98.5)	(121.4)
APRA Capital Base	107.9	104.9
Prescribed Capital Amount (PCA)	66.3	72.7
Capital Adequacy Multiple (CAM)	**1.63**	**1.44**

1 Figures shown are post-transfer (whereas figures in Table 2 are pre-transfer).

Given a lower capital base and higher PCA than assumed in the Actuarial Report, the estimated post-transfer CAM is **1.44** which compares to the **1.63** shown in the Actuarial Report and on which my opinion was based.

The CAM of 1.44 is within Hollard's target range for operating capital, albeit at the lower end of that range whereas it was previously at the upper end of the range.

3 Conclusion

The main interest of policyholders is to have their valid claims paid when due. Hence I have relied heavily on the capital position of Hollard post-transfer in forming my opinion on the Insurance Scheme. My revised comments in relation to financial security and the impact on PDIC Aus policyholders are set out below. There is no change to the impact of the Insurance Scheme on Hollard policyholders, noting that there was no capital being transferred from PDIC US to Hollard in any case.

I have previously also examined a range of other likely outcomes of the proposed transfer, including the impact it could have on risk profile, premium rates, policy terms and the claims handling approach. I have not updated my assessment of these other outcomes. My comments in relation to these matters are set out in the Actuarial Report.

Post-Transfer Financial Security of PDIC Aus Policyholders

My original opinion in the Actuarial Report was based on a post-transfer CAM of 1.63. The key issue is whether the opinion is still valid given Hollard's adverse experience in the second half of the financial year and the lower implied CAM of 1.44.

Factors that I have considered in forming my view are:

1. As a result of the short tailed nature of the PDIC Aus business, the period for which the transferring policyholders are exposed to any extra risk is short, noting they have the option at renewal to transfer to other insurers.
2. The CAM of 1.44 reflects a buffer of $32 million over the APRA PCA. To put this figure in perspective, the capital in the six months was $13 million lower than expected. Given the six month period included elements that were one-off in nature, the current buffer over the APRA PCA is significant.
3. Certain of the Hollard assets which are inadmissible for APRA purposes can be seen as having some value – in effect, the capital adequacy is better than the CAM of 1.44 shows.
4. Hollard is supported by a parent company and has access to further capital. The group has demonstrated a preparedness to make capital injections into the business where needed in the past. I have seen further evidence of the group support in the last six months, with a separate capital injection of $20 million on 31 May 2017 and a further $10 million on 30 August 2017. I am confident that further capital injections would be made by the parent, in the event that they were needed in the short to medium term.
5. I assess that the possibility of Hollard not being able to meet its obligations to the PDIC Aus policyholders to be remote, given the buffer and noting that the PCA represents a substantial amount of capital in its own right.

In short, I regard the risk to policyholders of PDIC Aus as a result of the Insurance Scheme to be short-lived. In the context of the short period, the capital buffer is sufficient, albeit lower than it previously was. Furthermore I am comfortable that further capital will be injected by the parent, if needed.

Opinion

Having undertaken the additional analysis set out in this letter, my opinion is unchanged: namely that the interests of the policyholders of PDIC Aus and Hollard will not be adversely affected in a material way as a consequence of the Insurance Scheme.

Future Update of this Advice

I will prepare a second update report closer to the effective date of the Insurance Scheme to verify that the findings shown in the Actuarial Report and in this letter report remain appropriate having regard to the actual financial position at that time.

4 Reliances and Limitations

Reliances on Information

In preparing this letter, I have relied extensively on the accuracy and completeness of the information provided by Hollard (both qualitative and quantitative). In particular, reliance was placed on the capital calculations (provided in a spreadsheet dated 28 August 2017).

While I have reviewed the information for reasonableness and consistency, I have not independently verified or audited the data. The accuracy of my findings is dependent on the accuracy of this information; therefore, any material discrepancies may change the conclusions I have made in this letter. The reader of this letter is relying on Hollard, and not Finity, for the accuracy and reliability of the data. If any of the data or other information provided is inaccurate or incomplete, my advice may need to be revised and the letter amended accordingly.

Uncertainty

Future financial security is subject to many external factors that are impossible to predict, including legislative, social and economic forces. In this letter, I consider only the impact of the proposed scheme.

It is not possible to be certain about the impact of the proposed scheme on the affected policyholders. While I believe my conclusions are reasonable based on known information, there may be adverse impacts in future that I have not identified or evaluated.

Limitations on Use

This letter has been prepared for the sole use of Hollard and PDIC Aus, for the purpose stated in the introduction. I understand that the letter will also be provided to:

- Hollard's legal advisers, mackenzie thomas
- PDIC US's legal advisers, Clayton Utz
- APRA
- The Federal Court of Australia.

Furthermore, I understand that a copy of the letter will be available for public inspection online. No other use of, or reference to, this letter may be made without the prior written consent of Finity, nor should the whole or part of the letter be disclosed to any unauthorised person.

Third parties, whether authorised or not to receive this letter, should recognise that the furnishing of this letter is not a substitute for their own due diligence and should place no reliance on this letter or the data contained herein which would result in the creation of any duty or liability by Finity to the third party.

This letter should be considered as a whole. Members of Finity staff are available to answer any queries, and the reader should seek that advice before drawing conclusions on any issue in doubt. While due care has been taken in the preparation of this letter, Finity accepts no responsibility for any action which may be taken based on its contents.

Yours sincerely

T. Andrews

Tim Andrews
Fellow of the Institute of Actuaries of Australia