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Actuarial Report on Scheme Transfer

The Hollard Insurance Company
Progressive Direct Insurance Company

June 2017

Actuarial and Insurance Consultants

8 June 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

I am pleased to enclose my actuarial report relating to the transfer of the Australian portfolio of Progressive Direct Insurance Company to The Hollard Insurance Company.

Please do not hesitate to contact me if you have any questions.

Yours sincerely

Tim Andrews
Fellow of the Institute of Actuaries of Australia

Actuarial Report on Scheme Transfer

Part I Report

1 Introduction

1.1 Purpose of Report

This report has been prepared at the request of The Hollard Insurance Company Pty Limited (Hollard). Hollard is a Level 1 general insurer authorised by the Australian Prudential Regulation Authority (APRA). The report covers the proposed transfer of assets and liabilities relating to the Australian insurance business of Progressive Direct Insurance Company (PDIC US), written through its Australian Branch (PDIC Aus), to Hollard.

The proposed transfer will take place in accordance with a scheme prepared under Part III Division 3A of the Insurance Act 1973 (referred to in this report as the 'Insurance Scheme').

This report provides my opinion on aspects of the scheme that the independent actuary would be required to assess, and specifically whether the interests of policyholders would be materially adversely impacted by the scheme having particular regard to its nature. This includes the impact of the scheme on the capital position of the relevant entities.

In relation to my opinion, I note the following:

- I have only preliminary information on the expected post-transfer finances, including the post-transfer balance sheet.
- It has been prepared largely on the basis of financial information at 31 December 2016.

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

Readers of this report should note the reliances and limitations detailed in Section 7.

1.2 Compliance

1.2.1 Prudential Standard GPS 410

APRA's Prudential Standard GPS 410 sets out the procedural requirements for insurers transferring or amalgamating insurance business, which includes a requirement for an actuarial report on which the scheme is founded.

While GPS 410 provides no specific guidance on the content of actuarial reports on which insurance business transfers are based, in my experience it is usual for such actuarial reports to provide an opinion as to whether or not the interests of policyholders are materially adversely affected by the proposed scheme.

1.2.2 Federal Court Practice Note

I acknowledge that I have read, understood and complied with the Federal Court of Australia's Expert Evidence Practice Note (GPN-EXPT).

1.3 Authorship of Report

This report has been prepared by Tim Andrews of Finity Consulting, who has been appointed by Hollard as the Independent Actuary for the purpose of Division 3A of Part III of the Insurance Act.

1.4 Policyholder Interests

I consider that policyholder interests relate to the payment of claims when they fall due, both now and in future, with such payments being made reasonably promptly and efficiently once liability and quantum have been established. In forming a view on policyholder interests, I have considered:

- The contractual rights of existing policyholders
- The continuity of claim management procedures
- The nature of the risks faced by policyholders before and after the transaction
- The capital position of the insurance entities before and after the transaction.

This report deals with the interests of policyholders of PDIC Aus and Hollard as broad groups.

1.5 Approach

Our approach involved the following steps:

- Review and understand the scheme documents and transaction documents.
- Review the nature and valuation of the liabilities to be transferred.
- Review the nature of the business written by PDIC Aus and Hollard, focussing on the financial position of the two insurers and any areas of particular risk which may be of relevance to our financial assessment of the impacts of the Insurance Scheme on policyholders of both organisations.
- Assess the capital adequacy position pre- and post-transfer. This step included consideration of the latest APRA balance sheets and Prescribed Capital Amounts (PCA) calculations available at the time of preparing our report, and considering the expected impacts up to and after the proposed transfer. I also considered the capital management approaches of both PDIC Aus and Hollard, and the potential for capital support from parent entities.
- Assess the impact of the Insurance Scheme on policyholders of PDIC Aus and Hollard. This included consideration of the terms and conditions applying to policyholders and the claims handling procedures to be adopted.

1.6 Information

In preparing this report, I have liaised with, and received assistance from, management of both PDIC Aus and Hollard, as well as their advisers. I have found all parties to be open in their dealings with me, and all material requested has been made available to me. Both PDIC Aus and Hollard have reviewed my report, and I understand that neither has any objections to the information as presented.

The information used in preparing this report is set out in Appendix B.

2 Conclusions

The main interest of policyholders is to have their valid claims paid when due. I have also examined a range of other likely outcomes of the proposed transfer, from the perspective of PDIC Aus and Hollard policyholders. This section summarises my findings and conclusions.

2.1 Nature of the Business to be Transferred

The PDIC Aus portfolio represents around $30 million of domestic motor business. The portfolio is small in the context of the Hollard business, representing around 5% of Hollard premium levels.

Domestic motor business tends to be 'short tailed', which means that claims are paid out relatively quickly after they occur. This is relevant in the context of the scheme as it means that there are low levels of uncertainty attaching to the claims liabilities.

From 31 March 2017 the PDIC Aus portfolio has been 100% reinsured by Hollard for all premiums earned from that date. The extra risk being transferred to Hollard as a result of the scheme relates to claims that occurred prior to 31 March 2017 but which still remain to be paid on the scheme date. Given that more than eight months will have elapsed by the time of the scheme, the unpaid claims and hence the extra risk being transferred to Hollard as a result of the scheme is expected to be small.

2.2 Policy Terms and Premium Rates

There will be no changes to the terms and conditions of current and prior policies issued by PDIC Aus as a result of the scheme.

In the event that Hollard changes the terms and conditions for new contracts in future, this will not impact current PDIC Aus policyholders for the remaining term of their contracts. Similarly, while premiums rates for some policyholders will change for future periods of insurance, such changes are part of normal insurer operations.

In this context, PDIC Aus's policyholders will be in the same position as before the scheme.

2.3 Claims Handling

The claims will be managed by the same claims team before and after the transfer using a claims management philosophy and guidelines that are initially broadly unchanged. While changes to the guidelines are possible or even likely, this could also have happened if the scheme did not occur. As such there is no reason to believe that policyholder and claimant expectations in relation to claims handling would be materially affected by the scheme.

2.4 Risk Profile

Many of the risks currently faced by the two insurers are similar. To the extent that there are some additional risks for PDIC Aus policyholders, these are offset by the benefits of the proposed transfer in terms of a more diversified spread of risk and greater scale in the Australian business.

Overall I am satisfied that any changes in the risk profile as a result of the scheme do not materially adversely affect the interests of policyholders of either PDIC Aus or Hollard.

2.5 Financial Security

2.5.1 PDIC Aus Policyholders

PDIC Aus has been making substantial underwriting losses. As such the protection provided to the policyholders has been dependent on the branch holding additional capital in Australia to reflect a level of projected losses as well as regular injections of capital from the parent. The parent is a large well rated (S&P AA) US company with a book value of US$8 billion. The potential level of protection provided to policyholders is thus substantial currently.

On transfer to Hollard the policyholders will be subject to a wider range of risks than they were previously, reflecting the more complex nature of the Hollard business. However, in my opinion the financial security for the PDIC Aus policyholders will not be adversely affected to a material extent post-scheme for the following reasons:

- Firstly, as a result of the short tailed nature of the 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.
- Post-scheme, Hollard's capital adequacy multiple is estimated to be 1.63 times APRA's minimum requirements. This represents a substantial level of capital in its own right. The capital level will be within Hollard's normal operating range. The Hollard operating range for capital is higher than the equivalent figures for PDIC Aus.
- Certain of the Hollard assets which are inadmissible for APRA purposes can be seen as having some value – i.e. in effect the capital adequacy is better than the capital adequacy multiple of 1.63 shows.
- In Australia the Hollard portfolio is larger, more profitable and more diversified than the PDIC Aus business. This reduces the likelihood of capital being needed to support payments to policyholders.
- Like PDIC Aus currently, Hollard is supported by a parent company. Furthermore Hollard's dependence on the parent is lower than PDIC Aus's, noting the better profitability of Hollard. While the Hollard shareholders may ultimately not have the same financial resources as PDIC US, I note that they have demonstrated a preparedness to make capital injections into the business where needed in the past.
- Hollard has significant reinsurance protection which limits the volatility of performance and is used by the company to provide capital relief. In addition this reinsurance will apply to the PDIC Aus portfolio, limiting the volatility being added as a result of liabilities transferred under the scheme.

2.5.2 Hollard Policyholders

The capital adequacy provided to the Hollard policyholders is reduced post-scheme. This reflects that the liabilities of PDIC Aus but no capital are being transferred. Furthermore the PDIC Aus profitability has historically been poor, which has the potential to impact on future capital adequacy levels.

However in my opinion the financial security for the Hollard policyholders will not be materially lower post-scheme for the following reasons:

- The liabilities being transferred are small in the context of Hollard's size.

- The performance of the PDIC Aus portfolio has already improved relative to the 2014-2016 period, reflecting both claims management and pricing initiatives that have recently been undertaken and further improvement is likely.
- The terms of the agency agreement, which caps commission levels if the experience is adverse, and Hollard's involvement in the business mean that the risk of the PDIC Aus portfolio making underwriting losses for Hollard is reduced.
- The PDIC Aus portfolio is small relative to the Hollard business. Furthermore as Hollard's reinsurance is applied to the PDIC Aus portfolio, the volatility is reduced.
- The support of Hollard's parent continues to be available, if needed.

2.6 Conclusion

My opinion is 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.

The more detailed analysis supporting my conclusion is set out in the remainder of the report.

2.7 Declaration as Expert Witness

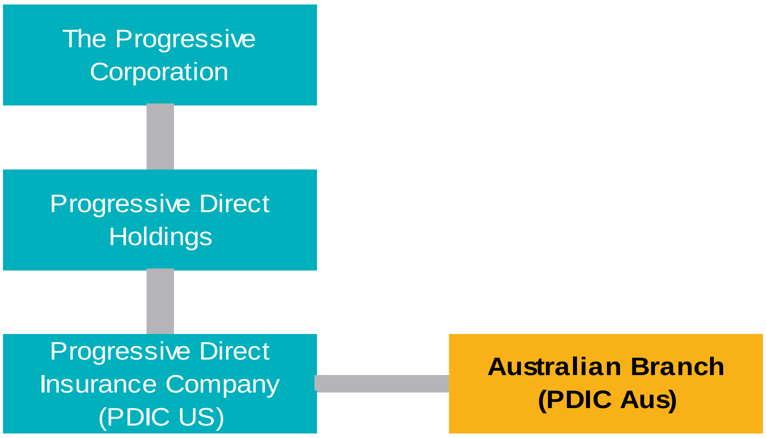
I declare that I have made all the enquiries that I believe are desirable and appropriate and that no matters of significance that I regard as relevant have, to our knowledge, been withheld from my report.

3 Proposed Scheme

3.1 Business to be Transferred

'PDIC Aus' is the Australian branch of Progressive Direct Insurance Company (PDIC US), whose ultimate parent is The Progressive Corporation, a publicly listed general insurer based in Ohio, USA. Figure 3.1 shows the simplified corporate structure of PDIC Aus as at 31 December 2016.

Figure 3.1 – Simplified Corporate Structure of PDIC Aus



PDIC Aus sells domestic motor insurance primarily online.

PDIC US is exiting the Australian market and is seeking to be relieved of its obligations under the Insurance Act and to have its APRA authorisation revoked. As part of this process, PDIC US is seeking to transfer the insurance business written through PDIC Aus to The Hollard Insurance Company Pty Limited (Hollard); that proposed transfer is the subject of this report.

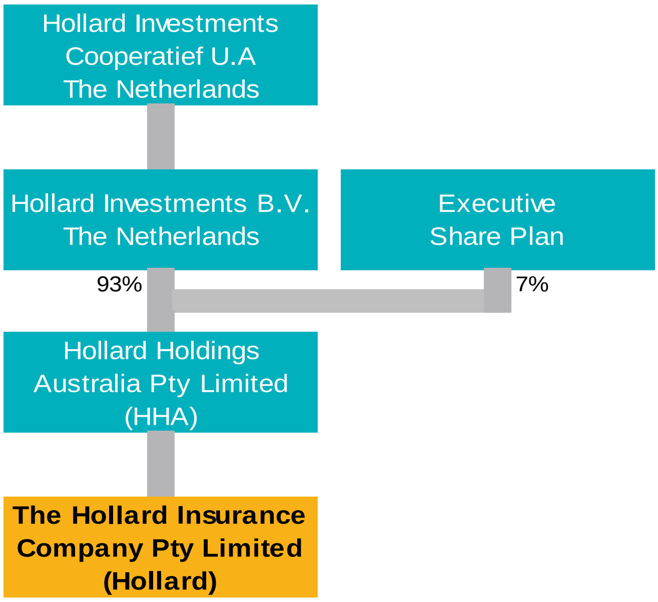
The following arrangements between the two companies, which apply separate to the Insurance Scheme, were put in place with effect from 31 March 2017:

- The insurance business written through PDIC Aus is being administered by PD Insurance Agency Pty Ltd (PDIA). PDIA is part owned by Hollard. PDIA's role is set out in an Intermediary Agreement with PDIC US.
- Hollard reinsures business written through PDIC Aus, including unearned business at that date, on a 100% basis.

As such, key elements of the post-scheme position are already in place – i.e. the administration of the policies and claims is being undertaken by PDIA and the risk is, in effect, underwritten by Hollard (albeit with PDIC Aus having ultimate responsibility for the risk as the direct insurer).

Figure 3.2 shows the simplified corporate structure of Hollard.

Figure 3.2 – Simplified Corporate Structure of Hollard



Hollard is a Level 1 Insurer. Its immediate parent, Hollard Holdings Australia Pty Limited (HHA), is authorised as a Level 2 Insurance Group. Throughout this report, I have shown figures for the Level 1 insurer (i.e. Hollard). The APRA capital adequacy is higher for the Level 2 Insurance Group[1].

3.2 Nature of the Scheme

The scheme will involve the following actions on the scheme transfer date:

Directly related to the scheme:

- All insurance contracts, rights and obligations and insurance liabilities of PDIC Aus will be transferred to Hollard.
- A payment for the business being transferred will be made by PDIC Aus to Hollard, referred to in the scheme documents as the "Supporting Asset Payment". This will primarily reflect the value of the outstanding claims on business earned prior to 31 March 2017. For the purposes of this payment, the liabilities will be calculated at a 75% probability of sufficiency. None of the capital of PDIC Aus will be transferred to Hollard. The Supporting Asset Payment is currently estimated to be $0.5 million.

Coincident with the scheme:

- An Intermediary Arrangement will be put in place between PDIA and Hollard such that PDIA will continue to administer the portfolio beyond the scheme transfer date.
- Hollard's 100% reinsurance of the PDIC Aus portfolio will be removed as the underlying liabilities will have been transferred to Hollard. In effect, there will be no requirement for Hollard's reinsurance of PDIC Aus as the latter will no longer have any insurance liabilities.

After the transfer, PDIC US intends to apply to APRA for revocation of its APRA authorisation.

[1] The difference arises due to the consolidation of intercompany balances between Hollard and Petsure (which is owned by HHA). On consolidation, the deferred profit share commission is eliminated from HHA's deferred acquisition costs, materially increasing its premium liability surplus and, therefore, its APRA Capital Base.

3.3 Timing

The proposed scheme transfer date is 4 November 2017, assuming confirmation by the Federal Court.

I have been provided with the latest annual balance date (audited) information at 31 December 2016 for PDIC Aus and 30 June 2016 for Hollard. In addition, I have been provided with Hollard's quarterly APRA return[2] as at 31 December 2016.

At the time of writing, I am not aware of any significant events in relation to PDIC Aus that have occurred since 31 December 2016, besides the quota share reinsurance by Hollard, that need to be considered in reaching my conclusions.

I have however been made aware by both insurers that their capital positions have changed since 31 December 2016, primarily reflecting the impact of the Sydney Hailstorm in February, cyclone Debbie and the 100% quota share of PDIC Aus by Hollard. I have made explicit adjustments to the December 2016 APRA returns to reflect these changed positions and the planned Hollard response. These adjustments are documented in Sections 5.1 and 5.2.

[2] Not subject to audit.

4 Description of Business

This section is essentially background and describes key elements of the business of both companies that are relevant to my consideration of the impact of the scheme in Sections 2 and 5.

4.1 Nature of Business

Table 4.1 summarises the gross earned premium for PDIC Aus (12 months to December 2016) and Hollard (12 months to June 2016).

Table 4.1 – Gross Earned Premium ($ million)

	PDIC Aus Year to Dec16	Hollard Year to Jun16
Direct Business		
Personal Lines	27.3	406.3
Commercial Lines	-	58.5
Other	-	7.6
Subtotal	27.3	472.4
Reinsurance Business		
Proportional RI	-	12.8
Total	27.3	485.2

4.1.1 PDIC Aus

PDIC Aus wrote $27 million of domestic motor business in 2016. My review of the figures by class showed that PDIC Aus's domestic motor premium volume is around a quarter of Hollard's domestic motor book, and just over 5% of Hollard's total premium volumes.

4.1.2 Hollard

Hollard is a multi-line insurer, although dominated by personal lines, and wrote $485 million of premium in the 12 months to June 2016. The domestic motor portfolio accounts for almost a quarter of total premiums.

4.2 Summary of Financial Performance

4.2.1 PDIC Aus

Table 4.2 summarises PDIC Aus's profitability for the three years to December 2016.

Table 4.2 – PDIC Aus Income Statements ($ million)

	2014	2015	2016
Gross Earned Premium	18.9	21.2	27.3
Reinsurance Premium	-	-	-
Net Earned Premium	18.9	21.2	27.3
Net Claims	(16.6)	(19.7)	(23.8)
Underwriting Expenses	(8.8)	(9.2)	(8.5)
Other Insurance Income	-	-	-
Other Income & Expenses	(3.2)	(4.0)	(4.0)
Underwriting Result	**(9.7)**	**(11.7)**	**(9.0)**
Investment Income	0.5	0.5	0.6
Profit before Tax	(9.3)	(11.2)	(8.4)
Tax	-	-	-
Profit after Tax	**(9.3)**	**(11.2)**	**(8.4)**
Loss Ratio	87%	93%	87%
Total Expense Ratio	64%	62%	46%
Combined Operating Ratio	151%	155%	133%

The PDIC Aus business has been loss making. Over the last three years the claims costs and expenses have averaged close to 150% of the premiums collected. To some extent, this outcome can be expected for a developing portfolio, with a significant amount needing to be invested to acquire new business. It is also normal for the loss ratio to improve as the business matures.

The historical losses have been significant in the context of the capital in the business and the APRA capital requirements, necessitating regular injections of capital from the parent to maintain adequate solvency coverage.

From my discussions with PDIC Aus it is recognised that the company experienced some challenges with claims reserving and claims management in 2014 and 2015 that impacted the business adversely. I understand that since that time, improvements have been made to these processes and significant premium increases have been achieved. There is some evidence of improving claims ratios since mid-2016 in reports that I have seen. The company expects to introduce additional initiatives to reduce claims leakage which would be expected to drive further improvement in the claims ratio. Hence I expect the claims ratio will be lower in 2017 and beyond than the figures shown in Table 4.2.

4.2.2 Hollard

Table 4.3 summarises Hollard's profitability for the three years to June 2016.

Table 4.3 – Hollard Income Statements ($ million)

	2013/14	2014/15	2015/16
Gross Earned Premium	316.6	373.0	485.2
Reinsurance Premium	(70.1)	(89.9)	(143.0)
Net Earned Premium	246.5	283.0	342.2
Net Claims	(133.8)	(162.6)	(201.9)
Underwriting Expenses	(97.1)	(106.8)	(143.2)
Other Insurance Income	23.2	18.1	41.8
Other Income & Expenses	(35.3)	(50.1)	(58.2)
Underwriting Result	**3.6**	**(18.4)**	**(19.4)**
Investment Income	13.9	19.3	32.2
Profit before Tax	17.6	1.0	12.8
Tax	(4.8)	0.2	(4.9)
Profit after Tax	**12.8**	**1.2**	**7.9**
Loss Ratio	54%	57%	59%
Total Expense Ratio	44%	49%	47%
Combined Operating Ratio	99%	106%	106%

Hollard has been making modest profits. Assessing the underlying profitability is complex due to the investments in strategic partners, which are reflected in "Other Income & Expenses" and noting that the investment income can include changes in the value of those investments. The profitability is lower than Hollard would be targeting in the longer term.

The business plan is projecting an improvement in profitability, with the Combined Operating Ratio falling from its recent level of 106% to 97% by June 2019. The reasons for this improvement appear reasonable.

4.3 Reinsurance Arrangements

4.3.1 PDIC Aus

Before the 100% reinsurance arrangement with Hollard, PDIC Aus did not purchase reinsurance to cover its Australian insurance portfolio. In effect, PDIC Aus had no reinsurance in place in relation to its Australian portfolio for business earned to 30 March 2017. From 31 March 2017, business earned is covered by the 100% quota share reinsurance cession to Hollard. As noted in Section 3.2, the quota share will be removed coincident with the transfer occurring.

4.3.2 Hollard

Hollard makes extensive use of reinsurance. Of the $485 million of gross premium earned during 2015/16 (see Table 4.3), 30% was ceded to reinsurers. Hollard's key reinsurers are well rated by independent rating agencies (on average A- or better), and include companies such as Peak Re, Swiss Re, Gen Re and XL Catlin. There is no reinsurance with companies in the Hollard group.

There are significant quota shares in place for motor (50% quota share) and home (75% quota share). The catastrophe retention is $4 million, reducing to $3 million, $1 million and $1 million for the second, third and fourth events in the year. The maximum retained cost from a single claim is $1 million[3].

The extensive reinsurance programme provides capital relief and significantly dampens the volatility of claims costs.

4.4 Insurance Liabilities and Uncertainty

4.4.1 PDIC Aus

Table 4.4 summarises PDIC Aus's insurance liabilities as at 31 December 2016.

Table 4.4 – PDIC Aus Insurance Liabilities at 31 December 2016 ($ million)

	Outstanding Claims	Premium Liabilities
Central Estimate	6.1	13.0
Claims Handling Expenses[1]	0.5	-
Policy Administration Expenses	n/a	0.0
Risk Margin	0.5	1.3
Total	7.1	14.3
CHE %	7.9%	-
PAE %	n/a	0.3%
RM %	7.7%	10.2%

1 For the Premium Liabilities, the CHE allowance is included in the central estimate.

The PDIC Aus liabilities are determined by PDIC US actuaries based in the US. The analysis is set out, and documented in brief, in Excel spreadsheets. I received copies of these spreadsheets. While I undertook a high level reasonableness assessment of the work of the US actuaries, I have not independently estimated the liabilities. My high level review included consideration of the methods adopted and the key assumptions selected. I was comfortable that these were reasonable. I also note that the liability estimates have been considered by PwC as part of the annual audit and no concerns were raised in that review with respect to the level of the liabilities.

Being short tailed in nature (i.e. the claims normally develop to their ultimate cost over 3-6 months) and given relatively homogeneous claim types, the estimation of insurance liabilities for motor insurance tends to be more reliable than for some other classes of insurance. The uncertainty is reflected in the risk margins applied.

In the context of the Insurance Scheme, the important insurance liabilities will be the remaining outstanding claims at the scheme transfer date in respect of accidents occurring prior to 31 March 2017. This amount is currently estimated to be $0.5 million but will be confirmed in our update report. By the scheme transfer date, all of the other insurance liabilities of PDIC Aus will have been transferred already by the operation of the quota share reinsurance with Hollard that is currently in place.

4.4.2 Hollard

Table 4.5 summarises Hollard's insurance liabilities as at 30 June 2016.

[3] For Cyber Risk, the maximum retained cost is $1 million. For all other classes, the maximum retained cost is $0.5 million or lower.

Table 4.5 – Hollard Insurance Liabilities at 30 June 2016 ($ million)

	Outstanding Claims	Premium Liabilities
Central Estimate	62.3	99.0
Claims Handling Expenses	3.7	6.7
Policy Administration Expenses	n/a	5.6
Risk Margin	9.3	7.9
Total	75.3	119.3
CHE % (of Central Estimate)	6.0%	6.8%
PAE % (of Unearned Premium)	n/a	2.0%
RM % (of Total before Risk Margin)	14.1%	7.1%

The Hollard liabilities were determined by the company's Appointed Actuary and were documented in the Insurance Liability Valuation Report (ILVR) dated 19 September 2016. While I undertook a high level review of the ILVR, I have not independently estimated the liabilities.

The Appointed Actuary has also undertaken analysis to test the adequacy of the historical outstanding claims reserves. This analysis shows that averaged over the last three years, the reserves were deficient by around $0.2 million per annum, equivalent to 0.3% of the reserves. This is a good outcome and gives some comfort that the valuation methodology is producing acceptable results.

The premium liabilities reflect a future projected loss ratio of 55% (as a proportion of unearned premium at the balance date). This appears reasonable having regard to the recent experience as shown in Table 4.3, which shows an average loss ratio over the last three years of 57%.

Like PDIC Aus, most of the business is short tailed in nature. Hollard's extensive use of reinsurance reduces the volatility of the portfolio. The Risk Margins appear reasonable having regard to the nature of the underlying risks.

4.5 Capital Management

4.5.1 PDIC Aus

PDIC Aus's capital management approach is set out in its Internal Capital Adequacy Assessment Process (ICAAP) report. The November 2016 ICAAP states that APRA requires PDIC Aus's Prudential Capital Requirement (PCR) to be calculated as shown below:

Prudential Capital Requirement (PCR) = (**Prescribed Capital Amount (PCA)** x **125%**) + **Six months of forward losses**

The target capital level is between 1.20 and 1.49 times the PCR.

Given the losses being made by PDIC Aus, the branch has been dependent on the support of the parent to make regular capital injections, which it has done. The ultimate parent company, the Progressive Corporation, has an S&P AA rating and a book value of US$8 billion.

4.5.2 Hollard

Hollard's capital management approach is set out in its ICAAP report.

The September 2016 ICAAP Summary Statement shows the company's normal operating range for capital. This range has been determined with respect to Hollard's risk appetite. The target capital levels are intended to give the following probabilities of capital falling below the PCA.

Capital level	Probability of falling below PCA
Target level	Less than 2%
Bottom of operating range	Less than 5%

Hollard has significant assets deemed inadmissible in the context of the APRA capital base. At 31 December 2016, these assets totalled $98 million, 65% of which related to strategic investment assets (net of tax impacts). Notwithstanding the APRA rules, it is reasonable to view these investments as having some value. In this regard, I was provided with evidence showing that Hollard has a recent track record of selling strategic investments for amounts above the carried book value[4].

In addition to the capital held in the insurer, Hollard manages its capital by:

- Extensive use of reinsurance to provide capital relief. The significant quota share reinsurances in place for the home and motor portfolios are evidence of this.
- Access to capital from the parent. As part of a private group it is difficult to know the level of resources that ultimately backs the insurer. However I note that Hollard has a history of accessing capital from its parent, as evidenced by injections of $44 million in 2015/16 and $8 million the previous year. Given the value built up in the business it is difficult to see support not being provided in future, if it is needed.

[4] Hollard provided me with information relating to the sale of four strategic investments over 2014 and 2015. $11.2 million of investments were sold, realising gains of $5.8 million.

5 Financial Security

This section considers the impact of the proposed scheme on the capital positions of the entities involved. I am relying on Hollard's calculations of regulatory capital requirements and capital base, both before and after the proposed transfer. I have reviewed these calculations for reasonableness.

5.1 Financial Security Pre-Transfer

5.1.1 Balance Sheet

Table 5.1 summarises the reported assets and liabilities of PDIC Aus and Hollard as at December 2016. Because the December position is not audited for Hollard (as it has a June balance date), Table 5.1 also shows Hollard's (audited) June 2016 position for comparison.

Table 5.1 – Balance Sheets ($ million)

	PDIC Aus	Hollard	
	31 Dec 16	31 Dec 16	30 Jun 16
Assets			
Cash	2.0	61.2	132.7
Investments	35.8	254.9	179.5
Premium and Other Receivables	10.2	318.3	275.1
Reinsurance Assets	-	214.5	165.9
Deferred Assets	0.4	81.3	77.2
Plant and Equipment	0.0	3.7	3.9
Prepayments	0.1	1.3	1.4
Intangibles	-	27.8	28.1
Current Tax Assets	-	-	-
Total Assets	48.5	963.1	863.8
Liabilities			
Creditors and Accruals	3.1	130.5	135.5
Claims Liabilities	8.4	147.7	128.4
Unearned Premium	14.7	308.5	291.9
Amounts Due to Reinsurers	-	154.6	98.0
Provisions	-	40.8	36.9
Income Tax Liability	-	6.1	5.7
Other Liabilities	0.1	-	-
Total Liabilities	26.3	788.1	696.3
Net Assets	22.2	175.0	167.5

The PDIC Aus balance sheet is relatively simple and shows net assets of $22 million. PDIC Aus has advised me that the claims from the Sydney hailstorm event in February have exceeded $2 million, such that the current net asset position is closer to $20 million.

The Hollard financial structure is more complicated than PDIC Aus's. The company has a number of investments in strategic partners. There are also significant assets and liabilities relating to reinsurance, reflecting the extensive reinsurance programme. The Hollard net assets at December 2016 are $175 million.

Hollard has advised me that the net assets have reduced since 31 December 2016, primarily as a result of the Sydney Hailstorm in February, cyclone Debbie and an unusually high level of weather claims in the March quarter. I understand that the net assets are around $5 million lower (after tax). Hollard has also advised me that as a result, the company plans to raise an additional $20 million of capital. This will be by way of $10 million of new equity and the replacement of $10 million of a convertible note with equity. Both of these are expected in the June 2017 quarter. For the purposes of the capital adequacy calculation shown in the remainder of this report, I have allowed for this extra $20 million of capital. I will verify that these transactions occur as part of my update report closer to the actual scheme transfer date.

5.1.2 APRA Capital Adequacy

Table 5.2 shows the APRA Prescribed Capital Amount (PCA) for the two insurers at 31 December 2016.

Table 5.2 – APRA Prescribed Capital Amount at December 2016 ($ million)

	PDIC Aus	Hollard
Insurance Risk Charge	2.6	26.1
Insurance Concentration Risk Charge	9.2	4.2
Asset Risk Charge	0.6	27.0
Asset Concentration Risk Charge	-	-
Operational Risk Charge	1.0	18.8
Aggregation Benefit	(0.5)	(12.9)
Prescribed Capital Amount (PCA)	**12.9**	**63.2**

Table 5.3 summarises the calculation of the APRA Capital Base, starting with the net assets from Table 5.1. This is then compared to the PCA from Table 5.2 to determine the Capital Adequacy Multiple (CAM) for the two insurers at 31 December 2016. In each case, allowance has been made for the impact of the adverse March quarter experience and planned capital actions.

I have not adjusted the pre-transfer capital positions for the impact of the 100% quota share placed with Hollard, which impacts the PCA for PDIC Aus in particular. This reflects that my assessment is based on the capital position of Hollard as the continuing insurer more so than PDIC Aus. The impact of the quota share on Hollard is reflected in the post-transfer position shown later in Table 5.4.

Table 5.3 – APRA Capital Adequacy at December 2016 ($ million)

	PDIC Aus	Hollard
Net Assets at December 2016	22.2	175.0
Impact of March Quarter Experience	(2.2)	(5.0)
Planned Capital Actions	-	20.0
Adjusted Net Assets	20.0	190.0
APRA Basis Adjustments:		
Insurance Liability Surplus	0.1	14.6
Intangibles and Other Adjustments	-	(98.2)
APRA Capital Base	**20.1**	**106.4**
Prescribed Capital Amount (PCA)	**12.9**	**63.2**
Capital Adequacy Multiple (CAM)	**1.55**	**1.68**

The PDIC Aus APRA capital base is close to the net asset position of $20 million. The 1.55 coverage of the PCA is equivalent to 1.24 times the PCR, consistent with the entity's targets (refer Section 4.5.1).

The Hollard APRA capital base of $106 million is $84 million lower that the net asset position. This is primarily due to the significant amount of Hollard assets being excluded from the capital base as identified in Section 4.5.2. The 1.68 coverage of the PCA is within the normal operating range for the company as set out in the ICAAP.

5.2 Financial Security Post-Transfer

5.2.1 APRA Capital Adequacy

Table 5.4 shows the estimated post-transfer capital adequacy position, with the pre-transfer positions included for comparison. The post-transfer position was calculated by Hollard and I have reviewed it for reasonableness.

The post-transfer position was estimated by:

- Starting with the pre-transfer positions as at 31 December 2016
- Adjusting to allow for the impact of Hollard 100% reinsuring PDIC Aus's business from 31 March 2017
- Unwinding the impact of the 100% reinsurance of PDIC Aus's business immediately following the scheme
- Transferring the gross amount of PDIC Aus's remaining outstanding claims to Hollard on the scheme transfer date, and an equivalent amount of assets – assumed to be $0.5 million
- Applying the Hollard reinsurance arrangements, and in particular the quota share arrangements, to the transferred business.

Other than as described above (including Section 5.1), no allowance has been made for changes occurring after 31 December 2016 (e.g. estimated insurance liabilities, investment income etc.)

Table 5.4 – Estimated Post-Transfer APRA Capital Adequacy at December 2016 ($ million)

	PDIC Aus	Hollard		
	Pre-Scheme Transfer	Pre-Scheme Transfer	Allowing for 100% RI of PDIC Aus (Effective 31Mar17)	Post-Scheme Transfer
Net Assets	20.0	190.0	190.0	191.1
Adjustments:				
Insurance Liability Surplus	0.1	14.6	15.3	15.2
Intangibles and Other Adjustments	-	(98.2)	(98.5)	(98.5)
APRA Capital Base	20.1	106.4	106.8	107.9
Prescribed Capital Amount (PCA)	12.9	63.2	65.9	66.3
Capital Adequacy Multiple (CAM)	**1.55**	**1.68**	**1.62**	**1.63**

In accordance with the terms of the scheme, there is no transfer of any of the PDIC Aus capital to Hollard. Hence, given the higher insurance liabilities post-transfer, Hollard's capital requirements increase also, leading to a reduction in the CAM.

The projected CAM post-transfer of 1.63 remains within the company's target operating range.

6 Impacts of Proposed Scheme

This section considers the impacts of the proposed scheme in areas other than financial security (which was discussed in Section 5). My formal findings and conclusions are set out in Section 2.

6.1 Policies and Claims

Policies

There will be no changes to the terms and conditions of current and prior policies issued by PDIC Aus as a result of the transfer, apart from Hollard being substituted for PDIC Aus as the insurer.

Claims

Under the existing Intermediary Agreement between PDIA and PDIC Aus, PDIA is managing all claims according to guidelines provided by PDIC Aus. I understand however, from discussions with PDIA, that Hollard is already influencing the claims processes via its part ownership of the agency. PDIA has recruited new expertise into the claims management area and has indicated to me that it expects to introduce a range of initiatives to reduce claims leakage during 2017.

Following the scheme, claims will continue to be managed by PDIA as per the Intermediary Agreement between PDIA and Hollard. The claims will be managed according to guidelines specified by Hollard.

Based on my discussions with PDIA staff, I understand that the Hollard guidelines for managing claims are not expected to differ to the claims management process in effect currently to a material extent. In particular no changes are expected to the claims management philosophy, and the agency has indicated that it intends to introduce initiatives that deliver a better customer experience.

It is likely that at some stage PDIA and Hollard will introduce further claims management initiatives via the guidelines that impact on PDIC Aus policyholders. However it is important to recognise that the processes for managing motor claims are fluid and that changes can be expected in the normal course of trading.

6.2 Risk Exposures

I considered the two organisations' risk profiles. For many of the risks faced by the insurers, APRA specifies minimum capital requirements intended to deliver a 99.5% probability of policyholder liabilities being met in full. I therefore focussed on risks which are not covered by capital requirements, and on the changes in risk profile resulting from the Insurance Scheme.

I have not identified any material additional risks that the Hollard policyholders would be exposed to as a result of the scheme. The PDIC Aus portfolio is similar to existing portfolios that are already written by Hollard and is relatively small (representing only 5% of total Hollard premiums).

The PDIC Aus policyholders will become insured by a more complicated entity that is subject to a wider range of risks. Offsetting the extra risks, the insurer is more profitable, has a more diversified spread of risk, and greater scale. Overall I am satisfied that any changes in the risk profile of PDIC Aus policyholders' insurer are offset by benefits.

The proposed scheme could increase the operational risk for both sets of policyholders in the short term. However these risks are not considered to be material, and the fact that the PDIA agency will have been in operation for around eight months by the time of the scheme provides opportunities to resolve any issues that the new structure creates.

6.3 Profitability

Historically the PDIC Aus business has been loss making (refer Section 4.2). The average annual loss in the last three years has been $9 million. In the same period the Hollard business has made average profits of $7 million.

Hence, on the face of it bringing the PDIC Aus business into Hollard would materially affect the Hollard profitability. Potentially this could adversely impact Hollard policyholders, as it would reduce the buffer against poor experience provided by the Hollard profits. Hence I have considered this issue further. I have formed the view that the PDIC Aus business is not likely to materially impact on the level of Hollard profits for the following reasons:

- The PDIC Aus losses are partly driven by the high expense ratio (averaging more than 50% of premium in the last three years). Under the terms of the Intermediary Agreement, Hollard's expenses for the portfolio appear likely to be less than 25% (commission of 15%, plus licence fee of 5% and some reimbursable expenses). The only exception to this would be if the portfolio performs very well, in which case profit commissions are payable, but by definition this would be a good outcome for Hollard.
- The PDIC Aus loss ratio has been well above market levels. The portfolio can be expected to benefit from newly recruited expertise to the business and by leveraging Hollard's claims management and pricing expertise. From discussions with PDIA, I am aware that a number of pricing and claims management changes have already been made and these are delivering better performance than the financial accounts for 2014-2016 show. I have seen evidence of this in internal profitability reports.

In summary, while I assess that the short to medium term impact on Hollard's profits will probably be adverse, the impact is not expected to be material in the context of Hollard's overall performance.

6.4 Capital Management

No changes are expected to Hollard's capital management approach as a result of the scheme. Given the size and nature of the PDIC Aus portfolio and its impact on profitability as described in Section 6.3, the risk profile of Hollard will be similar pre- and post-scheme. Hence, given an unchanged risk appetite, no changes would be expected to Hollard's capital targets.

6.5 Reinsurance Arrangements

PDIC Aus has not historically purchased reinsurance. This simplifies the scheme with no reinsurance needing to be novated or otherwise transferred. The current quota share with Hollard is removed immediately following the scheme and hence is of no relevance to the scheme.

With effect from 31 March 2017, new claims from the PDIC Aus portfolio are subject to Hollard's reinsurance. This includes a 35% quota share purchased by Hollard, protection against individual large losses and catastrophe protection. As such the net risk of the PDIC Aus portfolio is materially lower than it was prior to the arrangements with Hollard. Of the approximately $30 million of premium expected in the first year, the net premium retained by Hollard will be less than $20 million – as such, the volatility of the performance of this portfolio will be lower than it was as part of PDIC Aus.

The only liabilities that transfer from PDIC Aus that do not have reinsurance protection will be the outstanding claims at the date of the scheme in respect of claims that occurred prior to 31 March 2017. Given the short tail nature of motor insurance, the likelihood that any of these claims could deteriorate in a manner that would have triggered excess of loss reinsurance is extremely remote. In this regard, the risk taken by Hollard by not having reinsurance for these liabilities is very small.

7 Reliances and Limitations

7.1 Reliances on Information

In preparing this report, I have relied extensively on the accuracy and completeness of the information provided by Hollard and PDIC US (both qualitative and quantitative). In particular, reliance was placed on the APRA returns and insurance liability valuations of the entities as at 31 December 2016.

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 report. The reader of this report is relying on Hollard and PDIC Aus, 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 report amended accordingly.

I note that my report has been prepared based on draft scheme documents. While my understanding is that there are not expected to be any material changes between the draft and final documents, if any material changes are made, my analysis, conclusions and findings may need to be updated accordingly.

7.2 Uncertainty

Future financial security is subject to many external factors that are impossible to predict, including legislative, social and economic forces. In this report, 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.

7.3 Limitations on Use

This report has been prepared for the sole use of Hollard and PDIC Aus, for the purpose stated in Section 1. I understand that the report 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 full report will be available for public inspection online. No other use of, or reference to, this report may be made without the prior written consent of Finity, nor should the whole or part of the report be disclosed to any unauthorised person.

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

This report 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 report, Finity accepts no responsibility for any action which may be taken based on its contents.

Part II Appendices

A Key Terms Used in the Report

Capital Adequacy Multiple (CAM): The insurer's capital base, calculated according to APRA's standards, expressed as a multiple of the PCA.

Financial Condition Report (FCR): The Appointed Actuary of an APRA-authorised general insurance company is required to provide an annual report to the directors of the company which assesses its financial condition, including recent performance and prospects. 'Financial condition' refers to the sustainability of the business – its continued ability to achieve financial objectives and meet long term business aspirations.

Insurance Concentration Risk Charge (ICRC): Element of the PCA which represents the net cost of the insurer's 1-in-200 year claim event. The ICRC is the highest of:

1. The Natural Perils Vertical Requirement (NPVR), representing the net cost of the 1-in-200 year property catastrophe event
2. The Natural Perils Horizontal Requirement (NPHR), which is the greater of the net cost of four 1-in-6 year events, and the net cost of three 1-in-10 year events (in each case, adjusted for the allowance for the cost of events in the premium liabilities)
3. The Other Accumulations Vertical Requirement (OAVR), which is the net cost of the 1-in-200 year event relating to risks other than property catastrophes.

Insurance Liabilities: At least once a year, the Appointed Actuary of an APRA-authorised general insurance company is required to estimate the company's insurance liabilities – the outstanding claims liabilities (future payments on claims which have already occurred) and the premium liabilities (anticipated losses on unexpired risk). The liabilities include claim payments, associated expenses, and a risk margin which is intended to provide for the liability estimate to be sufficient three years in four. The valuation is summarised in the *Insurance Liability Valuation Report*.

Internal Capital Adequacy Assessment Process (ICAAP): The insurer's framework for managing capital and ensuring adequate solvency, consistent with risk appetite. The ICAAP is described in the *ICAAP Summary Statement*. The insurer's annual *ICAAP Report* summarises the ICAAP outcomes for the year, and capital projections.

Level 1 Insurer: For the purposes of APRA's prudential requirements, this is an individual insurer that is authorised under the Insurance Act 1973, and may be part of a Level 2 Insurance Group.

Level 2 Insurance Group: A group of companies comprising an insurer and one or more controlled entities or parent companies. For the purposes of prudential supervision of insurance groups at Level 2, all entities conducting insurance business within the group are consolidated.

Natural perils: Natural events which cause losses giving rise to insurance claims – storm, earthquake, flood, bushfire etc.

Prescribed Capital Amount (PCA): The minimum capital requirement defined under APRA's risk based capital requirements. Insurers hold capital in excess of the PCA in order to withstand fluctuations in capital levels.

Prudential Capital Requirement (PCR): The PCR is the sum of the insurer's PCA and any Supervisory Adjustment. APRA may make a Supervisory Adjustment to an insurer's capital requirement if it believes the PCA is not sufficient.

Reinsurance covers: An insurer may buy different types of reinsurance to protect against the impacts of more extreme risks and events. The types of reinsurance referred to in this report are:

- *Catastrophe cover* – Covers an insurer for the accumulation of claims arising from a single event. The reinsurer pays claims in excess of a specified retention, up to a specified limit.
- *Quota share cover* – The insurer pays a percentage of its premium to the reinsurer, and the reinsurer pays the same percentage of the insurer's claims.

Short tail: Insurance business where claims are generally reported and settled quickly – usually covering physical property.

B Information Received

This appendix sets out the information received to prepare this report.

Information for Hollard

- APRA Returns as at June 2014, June 2015, June 2016 and December 2016.
- Insurance Liability Valuation Report as at 30 June 2016, dated 19 September 2016.
- Valuation update presentation to the Board, dated 15 March 2017.
- Financial Condition Report as at 30 June 2016, dated 19 September 2016.
- ICAAP Summary Statement, dated 14 September 2016.
- ICAAP Report, dated 14 September 2016.
- Reinsurance Arrangements Statement, dated 28 February 2017.
- External reinsurance arrangements diagrams as at 30 June 2016 and 1 December 2016.
- Corporate structure diagrams.

Information for PDIC Aus

- APRA Returns as at December 2014, December 2015 and December 2016.
- Valuation spreadsheet summaries.
- ICAAP Report, dated 16 November 2016.
- PCR calculations at December 2016 and information on APRA's Supervisory Adjustment.
- Analysis of Profitability to January 2017.
- PwC audit reports to the Senior Officer Outside Australia, dated 31 December 2015 and 29 March 2016.
- Pricing and Underwriting Policy, dated November 2016.
- Insurance Risk Strategy Overview, dated February 2017.
- Motor Vehicle Insurance Product Disclosure Statement.
- Corporate structure diagrams.

Scheme Documents

- Transfer Scheme Document, draft dated 10 May 2017.
- Transfer Agreement, draft dated 10 May 2017.

Other Information

- Implementation Deed between Hollard, PDIC US, PDIA and others, dated 8 March 2017.
- Intermediary Agreement between PDIC US and PDIA.
- Intermediary Agreement between Hollard and PDIA.

- Hollard PDIC US Private Motor Reinsurance Summary, dated February 2017.
- Hollard PDIC Private Motor Reinsurance Treaty.
- 'Flow of Funds' Summary, dated 23 February 2017.
- Hollard's Investment Proposal for Equity Investment in PDIA, dated December 2016.
- Hollard's Capital Calculations, showing the estimated impacts of the scheme transfer on capital adequacy, using 31 December 2016 capital positions.

I also liaised with, and received assistance from, representatives from Hollard, PDIC US and PDIA.