

30 April 2014

Mr Peter Rose  
Chief Executive Officer  
Southern Response Earthquake Services Ltd  
6 Show Place  
Christchurch 8149  
NEW ZEALAND

Dear Peter

## Earthquake Claim Liabilities as at 31 March 2014

We have been asked by Southern Response Earthquake Services Limited ("SRES") to make an assessment of its insurance liabilities as at 31 March 2014. SRES is the Crown-owned entity which emerged from a transaction whereby, with effect from 5 April 2012, the ongoing business of AMI Insurance Limited ("AMI") was separated from the existing AMI entity and sold to Insurance Australia Group.

The purpose of this letter is to provide an estimate of the earthquake claim liabilities for Southern Response Earthquake Services Limited ("SRES") as at 31 March 2014. This valuation is predominantly based on a roll forward of our 31 December 2013 valuation with changes to valuation assumptions where emerging experience, or new information in respect of emerging issues, suggests changes are appropriate. We include commentary on the key changes to assumptions later in this letter.

We understand that this advice will be used by SRES in preparing its management accounts. This letter does not deal with the other non-earthquake retained events that were transferred from AMI Insurance Limited to SRES at the close of business on 5 April 2012.

## Summary of Results

Table 1 summarises our estimates of SRES' earthquake liabilities at 31 March 2014. The line below the table indicates our estimate of the total amount which will be ultimately paid once all claims are settled (including payments already made but excluding SRES CHE expenses). This represents our central estimate of the ultimate liability which is recoverable under SRES's reinsurance treaties. Our recommended provisions incorporate a risk margin which we believe to be consistent with the requirements to establish provisions which incorporate at least a 75% probability of sufficiency.



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Table 1 – Recommended EQ Provisions at 31 March 2014

Provisions for Outstanding Claims as at 31 Mar 2014	Cat 93	Cat 106	Cat 112	Total		
	4-Sep-10 \$m	22-Feb-11 \$m	13-Jun-11 \$m	Major \$m	Minor \$m	Overall \$m
<b>Gross Incurred Cost in 31 Mar \$ before EQC</b>	972.1	1,961.1	82.8	3,016.0	33.2	3,049.2
Expected EQC Share	-314.1	-511.8	-32.6	-858.4	-4.5	-862.9
<b>Gross Incurred Cost in 31 Mar \$ after EQC</b>	658.1	1,449.3	50.2	2,157.6	28.6	2,186.2
less paid to 31 Mar 2014	-381.4	-519.6	-14.2	-915.2	-14.1	-929.3
<b>Gross Outstanding Claims</b>						
In 31 Mar 2014 Values	276.7	929.7	36.1	1,242.5	14.5	1,257.0
Allowance for Future Inflation	28.4	76.1	3.5	108.0	0.8	108.9
Inflated Values	305.1	1,005.8	39.6	1,350.5	15.4	1,365.9
Discount to Present Value	-10.6	-34.0	-1.3	-45.9	-0.4	-46.3
<b>OSC Discounted to 31 Mar 2014</b>	<b>294.5</b>	<b>971.8</b>	<b>38.3</b>	<b>1,304.6</b>	<b>15.0</b>	<b>1,319.6</b>
Claims Handling	█	█	█	█	█	█
<b>Gross Central Estimate</b>						
Catastrophe R/I Recoveries	-214.3	-80.2	-38.3	-332.8	-9.5	-342.3
Aggregate R/I Recoveries	0.0	0.0	0.0	0.0	0.0	0.0
<b>Net Central Estimate</b>	<b>95.8</b>	<b>943.0</b>	<b>2.0</b>	<b>1,040.8</b>	<b>6.3</b>	<b>1,047.1</b>
Risk Margin	█	█	█	█	█	█
<b>Recommended provision</b>						
<b>Inflated Gross Central Estimate (Incl paid to date, excl CHE)</b>	<b>686</b>	<b>1,525</b>	<b>54</b>	<b>2,266</b>	<b>29</b>	<b>2,295</b>
<b>Change on 31 Dec 2013 Valuation</b>	<b>34</b>	<b>-2</b>	<b>-2</b>	<b>31</b>	<b>0</b>	<b>30</b>

Since 31 December 2013 there has been an increase of around \$30 million in the central estimate of the gross inflated ultimate cost. This is largely a result of more Multi-Unit Building (MUB) Over Cap claims expected to come through than previously expected, resulting in an increase in the expected cost of Over Cap claims. The expected ultimate cost of OOS only claims has also increased following an Insurance and Savings Ombudsman (ISO) ruling which means SRES will not be able to collect an excess on OOS only claims. There has also been an increase of \$█ million in the project management cost allowance.

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For comments on the movements between June and December the reader is referred to our 31 December and September 2013 valuation letters.

Table 2 shows the main components of cost underpinning our overall estimate of SRES' ultimate earthquake liabilities.

Table 2 – Estimated Ultimate EQ Liabilities at 31 March 2014

	30 Jun 13	31 Dec 13	31 Mar 14	Mov't from Dec 13	Mov't from Jun 13
	\$m	\$m	\$m	\$m	\$m
<b>Ultimate Outflows</b>					
Over Cap	2,558	2,547	2,578	31	21
Out of Scope	288	282	289	7	1
Other	147	148	146	-3	-2
Claims Cost (Excl PM Cost)	2,993	2,977	3,013	36	20
Project Management Costs	█	█	█	█	█
SRES Claims Handling	127	132	139	6	12
<b>Ultimate Inflows</b>					
EQC Contributions	872	864	874	10	1
Reinsurance Recoveries	1,274	1,243	1,242	0	-32
	2,146	2,107	2,116	9	-31
<b>Gross Outflow (net EQC, ex CHE)</b>	2,255	2,265	2,295	30	40
<b>Net Outflow (net of RI)</b>	█	█	█	█	█
<b>Cum. Paid Net of EQC (excl CHE)</b>	667	842	929	87	263
<b>Net Liability</b>					
Central Estimate	974	1,013	1,047	35	73
Risk Margin	█	█	█	█	█
Provision Required	█	█	█	█	█

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The ultimate cost of claims (net of EQC, excluding CHE) has increased by \$30 million, before reinsurance, since December.

## Key Observations

In this section we document the key movements in the valuation during the quarter. Attachment A summarises a range of “standing issues” that we are monitoring as part of the ongoing valuation process.

## Claims Costs

We note that there were a number of other movements to the underlying assumptions. The key changes were as follows –

### Over Cap

The estimate of Over Cap claim inflated costs has increased by \$30 million since December 2013. The increase arises from our expectation that the ultimate number of Over Cap properties will be 175 more than previously projected. The increased number of Over Cap properties is a result of a stronger than anticipated stream of new Over Caps arising from the EQC settlement process.

In recent months the EQC has been focusing on settling under cap MUB claims. In many cases, this has triggered new Over Cap claims being reported to SRES. Around 85% of new Over Cap

claims reported are MUB claims. It is expected that the EQC settlement process will continue until around September this year. Our projections allow for a level of future claim reporting that is in line with recent volumes until that time, resulting in an additional 175 Over Caps expected relative to December 2013.

The effect of the increased number of Over Caps has been moderated by a couple of factors:

- The majority of claims being reported now are lower value repairs, meaning the ultimate average size across all Over Cap properties had reduced slightly.
- A greater proportion of customers appear to be selecting cash settlement options over an Arrow managed rebuild/repair than previously assumed, resulting in a higher level of savings relative to DRAs than previously allowed for.

### *Out of Scope (OOS)*

Our estimate of the ultimate cost of OOS claims has increased by around \$6 million. The total number and underlying size of OOS claims has not changed. However, a recent ISO ruling has resulted in insurers not being able to charge an excess in respect of OOS only claims, as SRES has been doing. This means that SRES will need to refund the excess collected on claims settled to date, and exclude the deduction of an excess from claims settled in future.

The excess is approximately \$200 a claims, meaning the net average claim size for SRES increases by \$200, all else being equal. Allowing for around 30,000 OOS only claims in total, this equates to an additional cost of around \$6 million relative to what would have been the case had SRES been able to collect an excess.

### *Other areas*

There were some adjustments made to other claim type assumptions. Notably, we have reduced our estimate of temporary accommodation claims. Temporary accommodation claim reporting has been slower than expected over the last few quarters, and we have reduced our estimate of the overall volume of temporary accommodation claims (by about \$5 million) in response.

This has been partly offset by an increase in the estimated cost of lost rent claims by around \$1.5 million. Following an update of some old case estimates on lost rent claims, and the finalisation of long standing lost rent claims, these claims appear to be settling with higher average claim sizes than anticipated. We have increased the assumed average size of lost rent claims in accordance with the experience.

## **Project management Costs and Claims Handling Expenses**

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Further refinements have been made to project management cost and claims handling expense forecasts. SRES expects an additional \$■ million in project management costs, compared to December 2013, and an additional \$■ million in claims handling expenses. The increased project management costs are a result of continuing refinements made to the forecasts. In the case of the claims handling expenses, the increase relates to higher anticipated staff costs, a longer time expected in winding down the Auckland operations and increased IT requirements.

## Uncertainty of our Estimates

It should be noted that considerable uncertainty still surrounds the projection and valuation of SRES' EQ liabilities. In this regard, some points to be noted include:

- while SRES has progressed most of the way through the damage assessment phase, a large proportion of the overall incurred cost is yet to be settled
- there remains some uncertainty as to the eventual cost of enhanced foundations in TC3 and TC2 properties, and the extent of land remediation compensation SRES will receive from the EQC in respect of these issues
- the outcome of the court appeal regarding repairs in the Flood Management Area (FMA), detailed in Attachment A, could have a very large impact on the ultimate claims cost
- the run-off is, of course, still exposed to the "normal" sources of variability in claims experience; particularly the rate of building cost escalation in Canterbury. In the case of Canterbury, the sheer scale of the construction programme across both residential and commercial sectors and the complexity introduced by the interplay with the cover provided by EQC act to magnify the potential variability of ultimate outcomes (as compared to 'normal' residential property claims).

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In response to inherent uncertainties, we have maintained our risk margin at ■% of the estimated liability (net of EQC contributions but gross of reinsurance recoveries). Under accounting standards, in response to the inherent uncertainty, it is expected that provisions will contain a margin sufficient to produce at least a 75% probability of sufficiency.

While the unique nature of the Canterbury events makes it impossible to derive with any accuracy a precise probability for various levels of risk margin, we are of the view that the margin adopted is sufficient to produce a probability of sufficiency of at least 75%.

## Reliances and Limitations

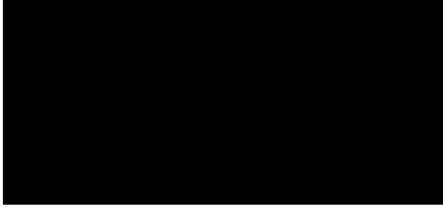
This letter has been prepared for the use of SRES for the stated purpose. We understand that a copy of the letter may be provided to the Board of SRES. No other use of, nor reference to, our letter other than as required by the Crown, should be made without prior written consent from Finity, nor should the whole or part of our letter be disclosed to any unauthorised person.

Third parties, whether authorised or not to receive this letter, should recognise that Finity will not be liable for any losses or damages howsoever incurred by the third party as a result of them receiving, acting upon or relying upon any information or advice contained in the report.

Our 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.

Yours sincerely

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## A Other Standing Issues

### *Enhanced Foundation Costs*

There remains uncertainty in regard to the division of responsibility (between EQC and the private insurers) for the costs involved in remediating land to a standard suitable for building on, particularly in TC3. Land damage classifications prepared by the EQC suggest there would be around 220 properties where EQC's land payments will become a contribution to the cost of enhanced foundations; in others to land remediation. The estimate of 220 properties allows for an increase of 10% to the previous estimate of 200 properties. Work undertaken by Golder and Finity earlier this year lead to an increase of 10% in the EQC's total estimate of properties expected to be eligible for some land remediation payments.

Assuming SRES is able to recover the full cost of the enhanced foundations for these properties (around \$44k per property), SRES can expect to recover around \$10 million in land damage compensation.

Our valuation basis assumes recoveries of around \$10 million in respect of enhanced foundation costs. The actual outcome will depend upon the terms ultimately agreed with the EQC.

### *Repairs in Flood Prone Areas*

We estimate there may be 500-600 Over Cap repair properties that are located in flood prone areas. The cost of rebuilding these properties would be far higher than the planned repair works should it not be possible to repair these houses without raising floor levels to compensate for the increased vulnerability to flooding. It would also mean that a number of under cap EQC only repair properties would likely become over cap.

At this stage, SRES expects to be able to proceed to repair the affected properties as planned. However, an adverse outcome regarding the floor levels to which these properties must be built would have a very large impact on SRES's earthquake claims liabilities, and remains a significant source of uncertainty to the valuation at this stage.

### *Apportionment of OOS Claims*

There remains uncertainty regarding the apportionment of OOS claims costs across the various events. Presently, we have apportioned costs in a simplistic fashion by spreading the cost based on the number of claims lodged against each event.

Consistent with how we have apportioned the OOS component of costs for Over Cap properties, we have explored using EQC's apportionment of their Under Cap costs on SRES' OOS only properties as the basis for allocating OOS costs across events. Adopting this approach would result in more of the cost being allocated to the June event (and away from the September event). If this view of apportionment was applied, then SRES' net liability would reduce as a greater allocation to June would result in SRES in the amount being shifted to June being recovered from reinsurers.

We are, however, not yet convinced that moving to this approach would be entirely appropriate for apportioning OOS costs across events. For example, in a number of OOS cases (around 2,000), EQC's apportionment implies that no damage was incurred in the September event even though

customers lodged an OOS claim for this event prior to any other significant earthquake events occurring.

If it eventuates that a reallocation away from September to June is considered appropriate, SRES' net liabilities would reduce (all else being equal). Given the inconsistencies in the various sources of information we have not changed our apportionment approach for this valuation. We are working with SRES to resolve the OOS apportionment issue ahead of the 30 June valuation.

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## B Number of Properties with Building Claims

The table below summarises the expected ultimate number of properties with building claims.

**Table B.3 - Properties with Building Claims**

Properties with Buildings Claims	Dec-13	Mar-14	Movt from Dec13
<b>Over Cap</b>			
No. ever reported as Over Cap	8,376	8,480	104
Overcaps Recorded Currently	6,844	6,939	95
Future additions	135	278	143
Estimated Ultimate No to be assessed	8,511	8,758	247
No. moving under cap	-1,700	-1,772	-72
Ultimate No with Over cap damage	6,811	6,986	175
<b>Arrow Managed</b>			
- Rebuild	1,841	1,823	-18
- Repair	1,814	1,830	16
	3,655	3,653	-2
<b>Cash Settlements</b>	3,157	3,334	177
<b>Out of Scope Damage Only</b>			
No in Database	22,216	22,432	216
Withdrawn/Declined Claims	-622	-627	-5
Estimated further additions	1,190	990	-199
	22,784	22,796	12
<b>Total No of Properties with Claims</b>	29,595	29,782	187
<b>No of EQC Only Properties</b>	25,722	24,925	-797
<b>Total with EQ Damage<sup>1</sup></b>	55,317	54,707	-610

<sup>1</sup>Total assumed to be equal to total recorded to date on EQC database

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