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Actuarial and Insurance Consultants

30 April 2019

Mr Anthony Honeybone
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NEW ZEALAND

Dear Anthony

# Earthquake Claim Liabilities as at 31 March 2019

We have been asked by Southern Response Earthquake Services Limited ("SRES") to make an assessment of its insurance liabilities as at 31 March 2019. 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 2019. This valuation follows on from the update provided at 31 December 2018 and is based on a roll forward of our detailed valuation as at 30 June 2018, with changes to valuation assumptions where emerging experience suggests this is appropriate. We include commentary on the key changes to the assumptions later in the letter.

This letter does not deal with the other non-earthquake events that were retained by SRES following the transaction on 5 April 2012.

## Summary of Results

Table 1 summarises our estimates of SRES' earthquake liabilities and recommended provision at 31 March 2019. The provision includes an estimate of SRES future claims handling expenses (CHE) and a risk margin which we believe to be consistent with the requirements to establish provisions which incorporate at least a 75% probability of sufficiency. The line below the table indicates our estimate of the total amount which will ultimately be paid once all claims are settled (including payments already made but excluding SRES CHE). This represents our central estimate of the ultimate liability.

Note that our recommended provision does not include the potential costs arising from the GCA class action. Based on previous discussion with its auditors, and the information known as at 31 March 2019, SRES considers this to be a contingent liability. We understand that if any liability





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were to emerge from this class action, SRES would be indemnified for the outcome by the Crown. We understand further that legal costs relating to SRES' defence are not covered by the Crown indemnity and SRES is provisioning separately for the expected legal costs.

**Table 1 – Recommended EQ Provisions at 31 March 2019**

| Provisions for Outstanding Claims as at 31 Mar 2019 | Cat 93 4-Sep-10 $m | Cat 106 22-Feb-11 $m | Cat 112 13-Jun-11 $m | Total Major $m | Total Minor $m | Total Overall $m |
|---|---|---|---|---|---|---|
| **Gross Incurred Cost in 31 Mar $ after EQC** | 690.3 | 2,437.8 | 86.4 | 3,214.5 | 39.7 | 3,254.3 |
| less paid to 31 Mar 2019 | -670.3 | -2,261.2 | -80.3 | -3,011.8 | -38.4 | -3,050.1 |
| **Gross Outstanding Claims** | | | | | | |
| Inflated Values | 20.0 | 176.8 | 6.1 | 203.0 | 1.4 | 204.3 |
| Discount to Present Value | -0.2 | -2.0 | -0.1 | -2.3 | 0.0 | -2.3 |
| **OSC Discounted to 31 Mar 2019** | **19.8** | **174.8** | **6.1** | 200.7 | 1.3 | 202.0 |
| Claims Handling | [redacted] | [redacted] | [redacted] | [redacted] | [redacted] | [redacted] 9(2)(i) |
| **Gross Central Estimate** | [redacted] | [redacted] | [redacted] | [redacted] | [redacted] | [redacted] |
| Catastrophe R/I Recoveries | 0.0 | 0.0 | -6.1 | -6.1 | -0.9 | -7.0 |
| Aggregate R/I Recoveries | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| **Net Central Estimate** | [redacted] | [redacted] | [redacted] | [redacted] | [redacted] | [redacted] 9(2)(i) |
| Risk Margin | [redacted] | [redacted] | [redacted] | [redacted] | [redacted] | [redacted] |
| **Recommended provision** | [redacted] | [redacted] | [redacted] | [redacted] | [redacted] | [redacted] |
| **Inflated Gross Central Estimate (Incl paid to date, excl CHE)** | **690.3** | **2,438.0** | **86.4** | **3,214.7** | **39.7** | **3,254.4** |
| **Change on 31 Dec 2018 Valuation** | **-1.6** | **3.0** | **-2.2** | **-0.8** | **0.0** | **-0.7** |

Our central estimate of the total amount that will ultimately be paid (before reinsurance) at 31 March 2019 is $0.7 million lower than the 31 December 2018 estimate. [redacted] 9(2)(i)

[redacted] 9(2)(i)

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 2019**

| | 31 Dec 18 $m | 31 Mar 19 $m | Mov't Dec18 to Mar19 $m | |
|---|---|---|---|---|
| **Ultimate Outflows (Net of EQC)** | | | | |
| Over Cap | 2,548 | 2,546 | -2 | |
| Out of Scope | 331 | 331 | 0 | |
| Other | 159 | 158 | -1 | |
| Claims Cost (Excl PM Cost) | 3,039 | 3,036 | -3 | |
| Project Management Costs | [redacted] | [redacted] | [redacted] | 9(2)(b)(ii) |
| SRES Claims Handling | [redacted] | [redacted] | [redacted] | 9(2)(i) |
| **Reinsurance Recoveries** | 1,280 | 1,278 | -2 | |
| **Ultimate Net Outflow (net of RI)** | [redacted] | [redacted] | [redacted] | 9(2)(b)(ii) and 9(2)(i) |
| **Cum. Paid Net of EQC** | 3,200 | 3,228 | 27 | |
| **Discounted Net Liability** | | | | |
| Central Estimate | 238 | 214 | -23 | |
| Risk Margin | [redacted] | [redacted] | [redacted] | 9(2)(i) |
| Recommended Provision | [redacted] | [redacted] | [redacted] | |

The ultimate outflows net of reinsurance increased by [redacted]. The key experience and movements over the quarter are detailed below.

Table 3 shows the breakdown of the outstanding claims liabilities.

**Table 3 – Estimated Outstanding Liabilities at 31 March 2019**

| | Outstanding 31 Dec 18 $m | Outstanding 31 Mar 19 $m | Mov't Mar19 to Dec18 $m | |
|---|---|---|---|---|
| **Net Outflows** | | | | |
| Claims Cost (Excl PM Cost) | 220 | 197 | -22 | |
| Project Management Costs | [redacted] | [redacted] | [redacted] | 9(2)(b)(ii) |
| SRES Claims Handling | [redacted] | [redacted] | [redacted] | 9(2)(i) |
| | 241 | 217 | -24 | |
| **Net Central Estimate (undisc)** | 241 | 217 | -24 | |
| Discounting | -3 | -2 | 1 | |
| **Net Central Estimate (disc)** | 238 | 214 | -23 | |
| Risk Margin | [redacted] | [redacted] | [redacted] | 9(2)(i) |
| **Recommended Provision** | [redacted] | [redacted] | [redacted] | |

## Summary of Key Movements

As shown in Table 2, the inflated ultimate cost is $4.7 million higher relative to 31 December 2018. The key underlying movements in the estimate of the ultimate cost are set out in Figure 1.

**Figure 1 – Summary of Key Movements in Ultimate Cost Estimate (net of EQC and Reinsurance)** 9(2)(i) and (j)

[redacted]



The key movements were:

9(2)(i) and (j)

- The ultimate cost for Over Cap claims reduced by [redacted] as a result of new assessments having a lower size than expected. We made no change to the projected ultimate number of Over Cap claims.

9(2)(i)

- Out of Scope and Other claims reduced by [redacted] due to better than expected experience for lost rent and contents claims (this was a result of a number of open claims being closed for nil cost). This was partially offset by an increase in the allowance for future temporary accommodation costs.

9(2)(i)

- Project Management and Claims Handling costs have increased by [redacted] in total. SRES now forecasts these costs together. Given the absorption of Arrow staff into SRES' operations, as a result of Arrow being placed into voluntary administration, SRES now considers these costs as part of the operational cost forecast. The Project Management component is the main driver of the increase. Project Management payments in the quarter were [redacted] higher than expected. The rest of the increase is a result of the previous forecasts assuming Project Management support would not be required beyond March 2019. SRES is now allowing for these costs to be incurred for the remainder of calendar year 2019. The longer timeframe reflects that there remain a substantial number of properties that are yet to have assessments completed. 9(2)(i)

9(2)(i)

- Reinsurance recoveries reduced by [redacted] (increasing the net ultimate cost). Changes to the assumed allocation of outstanding claims costs to the June 2011 and December 2011 events reduced reinsurance recoveries by [redacted]. This was partially offset by a slightly higher apportionment to these two events than expected for claims finalised during the quarter. 9(2)(i)

We discuss aspects of the experience during the quarter in more detail below.

## Post Oct16 Over Caps

It is our understanding that new Over Cap reports are primarily an outworking of failed Under Cap repairs that are only now being identified. These properties are reopened by the EQC once a customer has approach the EQC. EQC has been sharing information on claim reopening volumes, although it should be noted that claims can be reopened for a variety of reasons, and only a minority of reopened cases ultimately turn Over Cap.

At previous valuations we had made some high level assumptions about the level of future reopening activity that might occur, and the proportion of those that could turn Over Cap. We have since been in discussions with the EQC to better understand trends relating to reopened claims – specifically to understand how long, and at what rate, reopenings might continue, as well as the propensity for reopenings to lead to new Over Cap claims.

Unfortunately, our discussions with EQC have not yet provided any meaningful new data. From our discussions to date, we understand that the EQC is undertaking more detailed work to understand the magnitude of rework required on their Under Cap settlement program. They have indicated that EQC will not be able to share the findings of this work with us for another month or two. They have, however, indicated that:

- They expect that re-openings will continue for some time into the future, possibly one to five years.
- It is not clear whether reopening volumes will reduce, although we note there does seem to be a slow downward trend in reopening activity.

At this stage, we have left the ultimate number of Over Cap claims unchanged, noting that new Over Cap reports over December 2018 to February 2019 have been very low, and that the IBNR allowance based on the existing project Ultimate Over Cap position is for around 300 more Over Caps. Based on what is known now, it is difficult to say whether this figure is too high or too low, and we will seek to continue our discussions with the EQC in order to make a more informed projection of IBNR for the 30 June 2019 annual valuation.

## Settlement experience for properties that are not litigated

The table below summarises settlement experience over the quarter.

9(2)(i) and (j)

**Table 4 – Summary of Settlement Experience (net of EQC)**

[redacted]

The settlement experience during the quarter was broadly in line with expectations. Settlements for Pre Oct16 Over Cap properties were [redacted] higher than expected for Repairs and [redacted]

9(2)(i) 9(2)(i)

9(2)(i) [redacted] higher than expected for Rebuilds. Settlements for Post Oct16 Over Cap properties were [redacted] lower than expected.

During the quarter we've observed that:

- Builders Price assessments are emerging a little lower than projected.
- There is some deterioration in Pre 1 Oct 16 claims, which have settled on average above our assumed settlement cost, although the number of outstanding Pre 1 Oct 16 claims is relatively low now.
- Post 1 Oct 16 claims are settling within our projections.

The majority of outstanding claims relate to Post 1 Oct 16 claims. Based on this and some of the other offsetting factors, our projected size assumptions are unchanged from 31 December 2018.

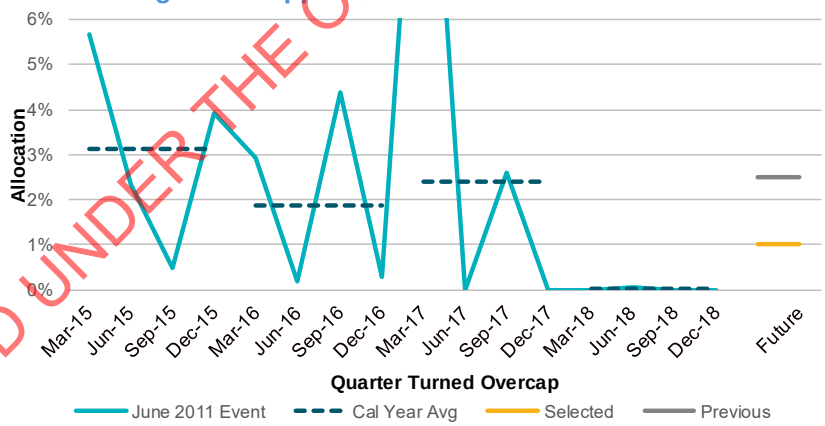
## Event Apportionment

We have reviewed our assumptions regarding the apportionment of future costs to the June 2011 and December 2011 events. As these events are the only two events with reinsurance recoveries outstanding, the apportionment of costs to these events impacts the allowance for reinsurance recoveries.

**We have reviewed the actual apportionments from claims which are completed, by the quarter in which they turned Over Cap.**

Figure 2 shows this analysis for the June 2011 event.

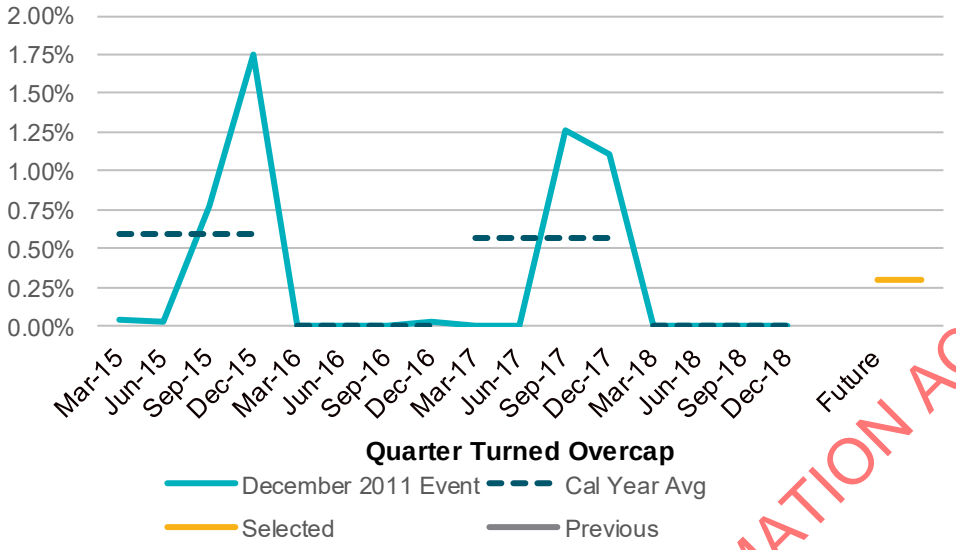
**Figure 2 – Apportionment to June 2011 Event**




We have reduced our selected apportionment for future Over Cap claims from 2.3% to 1.0% for the June 2011 event, noting the generally reducing trend in allocation toward this event. The actual apportionment of cost to the June 2011 event has decreased for more recent Over Cap claims. Settled claims which turned Over Cap in 2018 saw no apportionment to the June 2011. However, given that only a small volume of 2018 reported claims have settled, and based on experience in prior years, we expect that there will be future settlements with some apportionment to the June 2011 event.

Figure 3 shows the same analysis for the December 2011 event.

Figure 3 – Cost Allocation to December 2011 Event




We have increased our apportionment to the December 2011 event for future Over Cap claims from nil to 0.3%. Experience for the apportionment to this event is scarce. This means that the actual apportionment to emerge for this event is highly uncertain, but it can be seen that there continues to be some apportionment to this event, and we have updated our assumption accordingly.

9(2)(i)

The total impact of these changes is to decrease ultimate expected reinsurance recoveries by [redacted] million – a decrease of [redacted] for the June 2011 event partially offset by an increase of [redacted] million for the December 2011 event. This puts the total expected future reinsurance recoveries (including RI receivables, for payments on claims that are not yet finalised) at $7.9 million. The apportionment of reinsurance recoveries by event is shown in Table 5. 9(2)(i)

Table 5 – Future RI Recoveries ($000) at 31 March 2019

[redacted]

## Uncertainty of our Estimates

9(2)(i) and (j)

It should be noted that considerable uncertainty still surrounds the projection and valuation of SRES' EQ liabilities. As the claim settlement process has progressed, an increasing proportion of SRES' outstanding claims relates to more complex claims, meaning the uncertainty around future settlement outcomes for outstanding claims is magnified (as compared to 'normal' residential property claims).

In our view, there remain two key areas of uncertainty which could result in material adjustments to the ultimate outcome for SRES' remaining claims:

- The volume of future new Over Cap claims which might emerge, and the proportion of these which will ultimately be the subject of dispute and/or litigation.
- Higher than allowed escalation in settling the remaining body of outstanding claims, including the additional costs involved in settling disputed and litigated claims.

In light of this uncertainty and the increase in the proportion of the central estimate relating to the IBNR liability for Over Cap claims, we have left the risk margin unchanged in dollar terms for this update.

[redacted]

9(2)(i) and (j)

## GCA Class Action

On May 29 2018, GCA Lawyers initiated a new class action proceeding against SRES, proposing to represent all policyholders that entered into a settlement agreement with Southern Response prior to 1 October 2014 (which is when the Court of Appeal issued its decision in *Avonside Holdings*). The class action seeks to re-open full and final settlements, seeking the difference between what was recorded in the 'Office Use' version of a DRA and the 'Customer DRA' that was issued to policyholders.

As at 31 March 2019, SRES continues to defend against the action within the courts. SRES has also received an indemnity from the Crown in respect of the class action. Based on discussion with its auditors, and the information known as at 31 March 2019, SRES considers this to be a contingent liability. Therefore, our recommended outstanding claims provision as at 31 March 2019 makes no allowance for any liability arising from the GCA Class Action. If any liability were to emerge from this class action, we understand that SRES would be indemnified for the outcome by the Crown. Legal costs relating to SRES' defence are not covered by the Crown indemnity and SRES is provisioning for the expected legal costs separately. The expected legal costs are not included in our claims liability estimate.

[redacted]

[redacted]

9(2)(i), (j), (h)

## EQC MOUs

SRES and EQC have agreed on an MOU under which SRES takes over the management of certain Under Cap claims. We understand that the MOUs dictate that all cost incurred by SRES in the management of these Under Cap claims will be recovered from the EQC. Our liability valuation does not allow for any additional liability to arise for SRES as a result of these MOUs.

## Reliances and Limitations

This letter has been prepared for the use of SRES' management and Board for the stated purpose. 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

[redacted]

9(2)(a)

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**Fellows of the Institute of Actuaries of Australia**

[redacted]

9(2)(a)