Strictly Confidential

Actuarial Report on Schemes for Transfer

Insurance Australia Group

September 2016

22 September 2016

Mr B Ward
Chief Actuary
IAG
388 George St
SYDNEY NSW 2000

Dear Brett

Actuarial Report on Schemes for Transfer

I am pleased to enclose my actuarial report relating to the transfer and amalgamation of general insurance business within Insurance Australia Group. I understand that this report will be used to assist with the case presented to a dispensation hearing in relation to the transfer.

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

Yours sincerely

Estelle Pearson
Fellow of the Institute of Actuaries of Australia

Actuarial Report on Schemes for Transfer

Part I Report

1 Introduction

1.1 Purpose of Report

This report has been prepared at the request of Insurance Australia Limited (IAL). IAL is a Level 1 general insurer authorised by the Australian Prudential Regulation Authority (APRA), and is one of nine APRA-authorised insurers which are subsidiaries within Insurance Australia Group (IAG). IAG proposes to consolidate its general insurance licences by transferring the business[1] of seven of its other APRA authorised general insurers into IAL[2]. The seven insurers are:

- Mutual Community General Insurance Proprietary Limited (MCGI)
- HBF Insurance Pty Ltd (HBF)
- WFI Insurance Limited (WFI)
- CGU-VACC Insurance Limited (CGU-VACC)
- IAG Re Australia Limited (IAG Re Australia)
- Swann Insurance (Aust) Pty Ltd (Swann)
- CGU Insurance Limited (CGU).

IAG is proposing seven separate but concurrent Schemes under Division 3A of Part III of the Insurance Act that will transfer the insurance liabilities and assets of the seven insurers into IAL effective from 1 August 2017.

This report will be used by IAL and the seven other insurers to assist with the case they will present to a dispensation hearing in relation to the schemes. The insurers are seeking dispensation from the requirement to notify affected policyholders by reason of the nature of the schemes.

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

[1] For clarity, the transferring business will exclude CGU's interest in the issued capital of CGU Workers Compensation (NSW) Limited, the NTI Agreement, Dynamiq Pty Ltd and the underwriting agencies currently sitting under CGU Insurance Limited. Post schemes, all policies written through the underwriting agencies will be underwritten by IAL. The schemes will also exclude the CGU-VACC debenture business.

[2] Insurance Manufacturers of Australia Pty Limited (IMA), the ninth APRA-authorised insurer in IAG Group, is **not** in scope of the proposed consolidation, being only 70% owned by IAG. The Group also has non-Australian entities which are not part of the proposed schemes.

In relation to my opinion, I note the following:

- I have only preliminary information on the expected post scheme finances, including the post scheme balance sheet
- It has been prepared largely on the basis of financial information at 30 June 2016.

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 Practice Note CM 7: "Expert Witnesses in Proceedings in the Federal Court of Australia".

1.3 Authorship of Report

This report has been prepared by Estelle Pearson of Finity Consulting who has been appointed by IAL 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.

1.5 Approach

The approach to forming this opinion has been to gain an understanding of:

1. The nature of the schemes being proposed
2. IAG's business operating model
3. The business within each insurance entity, and the size, nature and valuation of the liabilities

4. The key risks or uncertainties relating to each entity that were identified in the Appointed Actuary's Financial Condition Report (FCR) and/or risk profiles
5. IAG's capital management plan
6. The capital adequacy of each relevant entity and of the Level 2 entity
7. The estimated capital adequacy of the consolidated business post transfer.

The purpose of item 1 is clear. Item 2 involves consideration of the interrelationships of the companies subject to the schemes and the way in which the policyholder interacts with the organisation/insurer. These are relevant due to the intra-group nature of the transfer. I explore whether the schemes will have an impact on the manner in which the entities are managed in aggregate.

The purpose of items 3 and 4 is to assist consideration of whether the liabilities of the insurers are adequately provided for, and whether the schemes change the risk profile of any of the insurers in a manner that would be material to the interests of policyholders. Items 5 to 7 relate to the capital positions of the insurers, and enable consideration of whether the schemes would materially impact on the solvency protection provided to policyholders.

1.6 Information

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

1.7 Structure of this Report

Section	Content
2	Sets out my conclusions about the impact of the schemes on policyholder interests.
3	Describes my understanding of the schemes being proposed.
4	Summarises IAG's current operational model, the business within each of the eight relevant licensed Level 1 general insurance entities and the insurer liabilities.
5	Documents the capital adequacy of each Level 1 general insurance entity at 30 June 2016. It also shows the estimated capital adequacy position after the proposed schemes, had they taken effect at 30 June 2016.
6	Discusses the other impacts of the proposed schemes on the entities and their policyholders.
7	Describes the reliances and limitations that apply to my advice.

Appendix A provides a list of key terms used in the report. The other appendices include other supporting material.

2 Findings: Conclusions

My view is that the interests of policyholders should not be adversely affected in a material way as a consequence of the schemes. This is based on the following assessments, which are the result of my review (as detailed in Sections 3 to 6 of this report):

2.1.1 Impacts on the Eight Insurers in Aggregate

- The schemes are intra-group. The capital management approach, risk management, and external reinsurance arrangements for IAL post transfer (the aggregation of the eight insurers involved in the schemes) will not change as a result of the schemes.
- The ultimate security currently provided to policyholders is from IAG Group and this would be unchanged.
- Policyholders will have their policies and claims managed under the same practice and philosophy as before the transfer.
- Policy terms and conditions will not change as a result of the schemes.
- Post consolidation, IAL will hold appropriate provisions for liabilities.
- Capital levels would be well in excess of the minimum regulatory level for IAL post transfer. I am satisfied that the schemes provide adequate financial security to the policyholders – while noting that there is always uncertainty with the outcome of insurance business, and ongoing solvency cannot be guaranteed.
- The insurance business of the consolidated entities is expected to be profitable, which provides a further buffer against adverse experience.

2.1.2 Impacts on Policyholders of Individual Insurers

- There are no material adverse changes to the risk profile for any group of policyholders.
- The post transfer insurer will be larger and more diversified than any of the individual insurers pre transfer.
- The estimated post transfer capital adequacy position is better than the pre-scheme position for all of the individual insurers except Swann and the two run-off entities HBF and MCGI. While the PCA Multiples would be lower post transfer for these entities, the expected PCA Multiple of 2.15 represents a healthy solvency position; in addition, the policyholders of these entities would benefit from being part of a larger and more diversified insurer. In my view there would not be any material increase in the risk to policyholders of Swann, HBF and MCGI.
- The security provided to policyholders by external reinsurance would be unchanged. While the individual insurers except IAG Re Australia currently benefit from intra-group reinsurance provided by IAG Re Australia, the security of this cover is dependent on the financial position of IAG and this position is unchanged post consolidation.
- The main change for the entities other than IAG Re Australia is direct exposure to the default and dispute risk relating to reinsurance of IAG's international business, and particularly the reinsurance recoveries relating to the NZ earthquake events which remain unresolved after more than five years. The entities are currently exposed to these risks via their reinsurance with IAG Re Australia as well as by being part of IAG Group, but the exposure becomes direct after the schemes. An

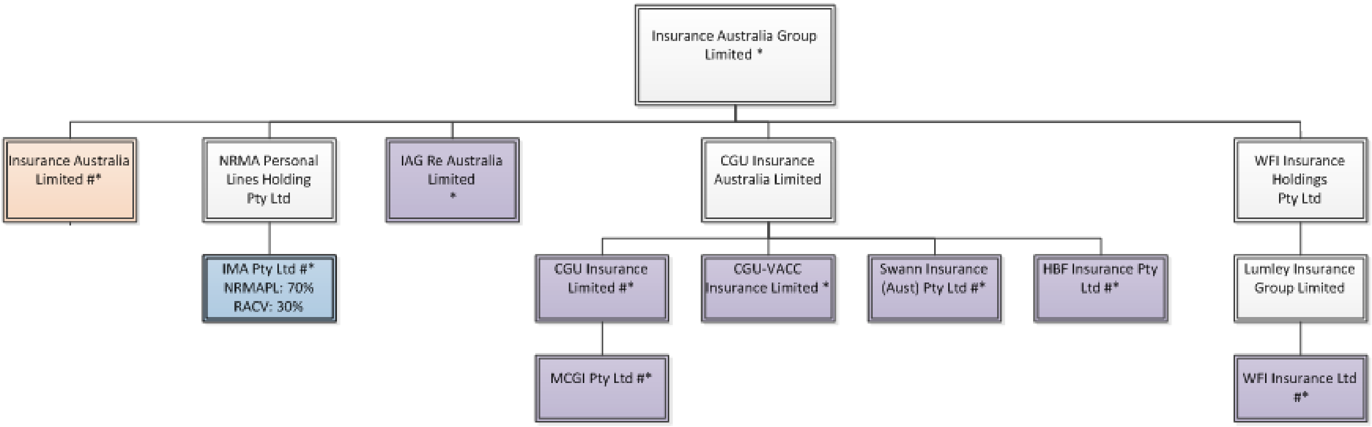
assessment of this potential risk has satisfied us that it does not materially adversely impact the interests of the relevant policyholders.

3 Proposed Schemes

3.1 Business to be Transferred

Figure 3.1 shows the current corporate structure of IAG's Australian entities and highlights (in purple) the insurers which are the subject of the proposed transaction.

Figure 3.1 – Current IAG Insurance Entities and Holding Companies (Australia Only)



* APRA-authorised insurer

Australian Financial Services Licensee

I note that:

- Insurance Manufacturers of Australia Pty Limited (IMA; blue in the diagram) is **not** in scope of the proposed consolidation, being only 70% owned by IAG
- IAG Group includes international entities which are not part of the proposed schemes and are not shown in Figure 3.1; some of these entities access the external reinsurance market via IAG Re Australia.

The scheme transfers are expected to result in benefits relating to risk reduction, cost management, simplified regulatory compliance and capital benefits.

3.2 Nature of the Schemes

It is proposed that all insurance contracts, rights and obligations and insurance liabilities of the seven insurance entities listed in Section 1.1 will be transferred to IAL. The proposed scheme transactions are:

1. IAL will pay to each transferring entity a **transfer value** which is equal to the total net book value of the transferring entity's insurance assets and liabilities
2. The resulting excess capital in each of the transferring entities will be transferred to IAG Group
3. That capital (from all seven entities) will then be transferred to IAL.

After the transfer IAG intends to apply to APRA for revocation of the APRA authorisations of the seven entities.

3.3 Timing

The proposed transfer date is 1 August 2017, assuming confirmation by the Federal Court.

At the time of writing this report, 30 June 2016 is the most recent annual balance date for IAG, and I have been provided with financial information as at that date.

In my assessment of policyholders' interests, I have taken into account three events that have occurred within the last year:

- IAG's entry into a partnership with Berkshire Hathaway, including a number of reinsurance contracts with National Indemnity Company (a Berkshire Hathaway company) – effective 1 July 2015, and reflected in the financial position at 30 June 2016[3]
- The NSW Government's announcement of its intention to make (potentially significant) reforms to the NSW CTP scheme[4]
- IAG's operational restructure (see Section 4.1)
- The sale by Swann of its motor dealer distribution rights to Avea Insurance, which was announced in June 2016 (see Section 4.2.5).

I am not aware of any other significant matters that need to be considered in reaching my conclusions as set out in Section 2.

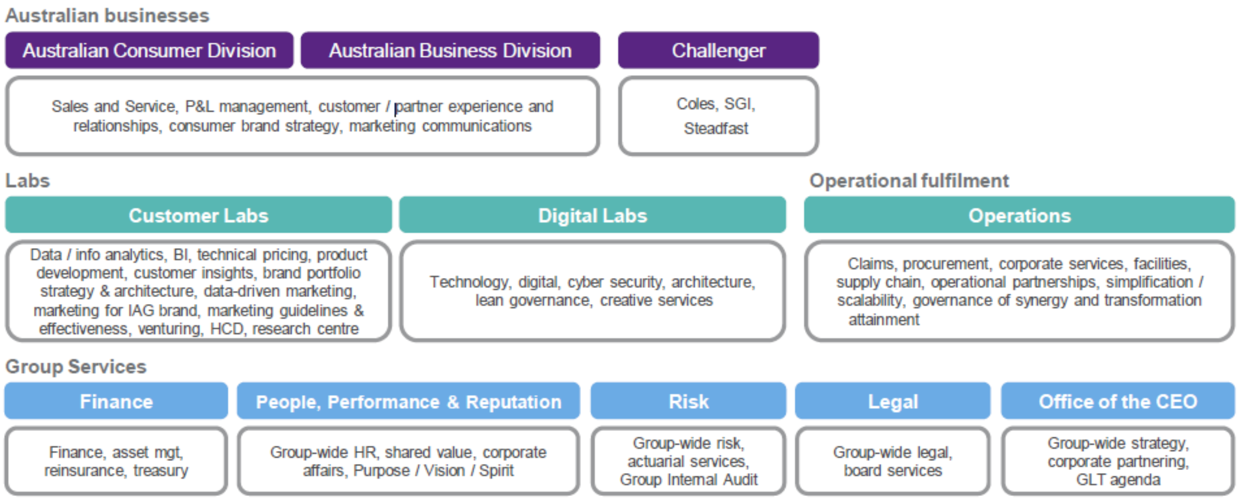
[3] The relationship with Berkshire Hathaway includes a 10-year whole of account 20% quota share, expected to reduce IAG Group's capital requirement by $700 million over the five years from 1 July 2015, with around $400 million of that benefit realised in FY16.
[4] CTP = Compulsory Third Party motor vehicle bodily injury insurance

4 Description of Business

4.1 Operating Structure

IAG Group's Australian operating structure is summarised in Figure 4.1.

Figure 4.1 – IAG Operating Structure: Australia



IAG operates the Australian general insurance business as three customer facing divisions – Consumer, Business and Challenger – which are independent of the licensed entities:

- The **Consumer Division** manages individual and family products (such as home, motor and CTP) which are written across the general insurance licences, under a variety of distribution arrangements and brands (NRMA, SGIO etc).
- The **Business Division** manages all business covers (such as property, liability and workers compensation) written under any of the general insurance licences.
- The **Challenger Division** carves out the 'challenger' insurance brands.

Sales, service and marketing are separate functions under each of the divisions.

The customer facing divisions are supported by a number of **functional areas**:

- **Customer Labs** is responsible for the Group's customer experience strategy, product and marketing innovation, brand architecture and development of new business and ventures
- **Digital Labs** provides digital and design support. It is intended to identify and harness 'disruptive' technology
- **Operations** is responsible for claims and operational functions such as procurement and supply chain management
- **Group Services** is responsible for finance, outward reinsurance, actuarial services, risk, legal, group strategy and human resources.

This structure is reasonably new, having been announced in December 2015. It evolved from the previous structure, which had two business divisions – Personal Insurance and Commercial Insurance.

These were supported by an Enterprise Operations Division, which provided services now delivered by the Operations area, as well as the functions of the two Labs.

This operating structure means that, in the context of the proposed schemes, the policyholders' interface with IAG will be unaffected – since operations are already independent of the individual licensed entities underwriting individual policies. From a policyholder's perspective, the only obvious change will be the name of the licensed insurer appearing on the policy documentation.

4.2 Nature of Business

Table 4.1 summarises the net earned premium for 2015/16 (the last full financial year) for each of the eight insurance entities involved in the proposed consolidation. The table splits the business between Consumer and Business divisions; challenger business is not identified separately here. I have shown net premium instead of gross due to a significant volume of intercompany reinsurance; IAG's current reinsurance arrangements are described in Appendix D.[5]

Table 4.1 – Net Earned Premium: Year ending 30 June 2016

	IAL	CGU	VACCI	Swann[1]	WFI	HBF	MCGI	IAG Re Aust	**Total**
	$m	$m	$m	$m	$m	$m	$m	$m	$m
Consumer Division									
Householders	186	427	0	0	52	0	0	0	**665**
Domestic Motor	244	252	0	0	142	0	0	0	**638**
Travel	0	46	0	0	0	0	0	0	**46**
Consumer credit	0	9	0	0	0	0	0	0	**9**
Marine	4	0	0	0	0	0	0	0	**4**
Other	15	1	0	0	6	0	0	0	**22**
CTP	424	0	0	0	0	0	0	0	**424**
Total: Consumer	874	734	0	0	201	0	0	0	**1,809**
Business Division									
Public and product liability	37	218	0	0	70	0	0	0	**324**
Professional indemnity	0	78	0	0	0	0	0	0	**78**
Employers liability	250	0	0	0	27	0	0	0	**276**
Commercial motor	26	293	0	0	166	0	0	0	**485**
Fire and ISR	28	213	0	0	143	0	0	0	**384**
Marine	0	35	0	0	14	0	0	0	**49**
Other accident	1	100	0	0	49	0	0	0	**150**
Householders				0	95				**95**
Domestic Motor				72	36				**107**
Consumer credit				26	0				**26**
Other				63	0				**63**
Total: Business	342	937	0	161	600	0	0	0	**2,038**
Inwards Reinsurance	0	0	12	0	0	0	0	-339	**-327**
Total	1,216	1,671	12	161	801	0	0	-339	**3,520**

[1] Swann's (personal lines) business sits within the Business Division due to the nature of its intermediary relationships.

Net earned premium for 2015/16 across the active general insurance entities was $3.52 billion, with 51% in the Consumer division.[6] The three most significant underwriting entities are IAL, CGU and WFI.

[5] The premium figures exclude the internal adjustments for the adverse development cover (National Indemnity Company) between IAG Re Australia and the other entities

[6] The net earned premium for 2015/16 is lower than 2014/15, largely due to the 20% quota share arrangement with Berkshire Hathaway described in Appendix D; overall the reduction is about 20% for the Consumer division and 25% for the Business division.

The net premium for IAG Re Australia was negative, reflecting the payment of external reinsurance premiums, including the 20% quota share with Berkshire Hathaway[7]; the net premium for this entity will continue to be negative.

The following sections give a brief overview of the main insurance exposures in each licensed entity.

4.2.1 IAL

IAL earned $1.2 billion of net premium in 2015/16, with about 70% of that in the Consumer Division. IAL's Consumer business includes:

- Home, motor, and boat insurance, written under the NRMA brand (NSW, ACT, Queensland, Tasmania), SGIC (SA) and SGIO (WA). Business written in NSW/ACT[8] is transferred to IMA via the 100% quota share. The main claim risks are natural perils.
- CTP business in NSW and ACT. The CTP business is exposed to the personal injury legal environment (inflation risk) in NSW and ACT, and to regulatory/political risk in these jurisdictions. I discuss CTP further in Section 4.6.2.

Within the Business Division, IAL underwrites:

- Workers compensation business in WA, Tasmania, the ACT and NT (CGU brand) – exposed to economic and inflation risks
- Motor, fire and liability business (NRMA brand) – with natural perils the main claim risks.

4.2.2 CGU

CGU earned $1.7 billion of net premium in 2015/16, of which about 55% was in the Business Division.

In the Consumer Division, CGU underwrites short tail business only: home, domestic motor and boat insurance. Distribution channels include direct, partners and brokers.

CGU underwrites a range of Business Division products, distributed through brokers. Most of the premium is concentrated in liability, commercial motor and fire & ISR (property) products, largely written as SME 'packages' – bundled motor, property and liability covers for small to medium sized businesses. As part of the Berkshire Hathaway partnership effective 1 July 2015, Berkshire Hathaway acquired the renewal rights to IAG's large corporate property and liability insurance business in Australia.

The motor business also includes CGU's 50% quota share of the NTI joint venture, a heavy motor specialist underwriting agency.

The short tail products written in the Business Division (motor and property) exhibit more volatility in claim costs than the equivalent domestic business, with the larger, more complex risks and greater exposure to large losses.

The long tail business – liability, professional indemnity and D&O – is exposed to the legal environment (inflation risk) and to the economic environment (especially professional indemnity and D&O).

[7] Each entity has a reinsurance arrangement with IAG Re Australia, which has the arrangement with Berkshire Hathaway on a 'back to back' basis.
[8] A small number of Victorian policies are written under the NRMA brand, and these are also quota shared into IMA.

4.2.3 WFI

75% of WFI's net earned premium of $0.8 billion in 2015/16 was in the Business Division.

WFI underwrites commercial motor, commercial property, marine, construction & engineering, and public liability via the Lumley and WFI brands. This portfolio is dominated by short tail products which are exposed to large losses and natural peril events.

WFI underwrites domestic motor and home insurance under the brands Lumley (Consumer Division), WFI (classified as Business Division) and Coles (Challenger). The Lumley and WFI business is distributed via brokers, while Coles business is sold via the internet and Coles supermarkets (as authorised partners). WFI also underwrites Retail Warranty insurance through retail partners (Consumer Division).

4.2.4 CGU-VACC

In 2015/16 CGU-VACC's net earned premium was only $12 million of inwards reinsurance, representing a 100% quota share of consumer credit insurance (CCI) business for certain intermediaries for both Swann and CGU. This business is exposed to economic risks (particularly unemployment).

4.2.5 Swann

Swann earned about $160 million of net premium, entirely within the Business Division. Swann is a specialised underwriter of motorbike and bicycle insurance, including ancillary insurance products such as loan protection, tyre and rim insurance, purchase price protection and guaranteed buyback insurance.

The vehicle claim risks are short tail, but the ancillary product portfolio is exposed to changes in the economic environment.

In June 2016 IAG announced the sale by Swann of its motor dealer distribution rights[9] to Avea Insurance, a specialist in niche insurance products. As of late July, Avea underwrites and manages claims relating to new business signed under these distribution channels; Swann continues to write new business in the Motorcycle Dealer channel and Motorcycle Direct channel, and will run off the existing motor dealer business. The business now underwritten by Avea represents about 70% of Swann's total premium.

The change in Swann's distribution arrangements has been taken into account in my assessment of the impact of the proposed schemes.

4.2.6 HBF and MCGI

HBF and MCGI previously wrote home and motor business. They are now in run-off and do not underwrite new business.

4.2.7 IAG Re Australia

IAG Re Australia, a captive reinsurance vehicle, provides IAG Group with efficient access to the external reinsurance market by consolidating the buying power of the direct insurance entities; see Section 4.3 below. Its exposures relate to the retained portion of property, engineering, marine, CTP and liability risks relating to the Australian entities. IAG Re Australia also includes the run-off liabilities underwritten by NZI (Australian entity), including asbestos and molestation liabilities.

[9] Also includes distribution via finance brokers and Swann's fleet network.

IAG Re Australia's claim risks include its retained exposure to natural perils and to personal injury risks. Specific risks for this entity include exposures to latent claims (asbestos and molestation; see Section 4.5.1) and exposure to the non-payment risk relating to external reinsurers (Section 4.6.3).

4.3 Reinsurance Arrangements

IAG Group includes three captive reinsurance entities, which are known collectively as 'IAG Re':

- **IAG Re Australia** – APRA-authorised entity which is part of the proposed transfer scheme, and is a subsidiary of IAG Limited
- **IAG Re Singapore** and **IAG Re Labuan**, which are both subsidiaries of IAG International Pty Limited, which is itself a subsidiary of IAG Limited.

IAG's external reinsurance is arranged at Group level:

- The IAG Re entities reinsure other entities within the Group; in particular IAG Re Australia reinsures the Australian entities and IAG Re Singapore and IAG Re Labuan reinsure the international entities.
- IAG Re Australia reinsures IAG Re Singapore and IAG Re Labuan and is in turn reinsured by external reinsurers; IAG Re Australia does not retain any net liability in respect of the international entities
- There are also some external covers provided directly to entities within the Group and not via IAG Re.

4.3.1 Current Reinsurance Arrangements

Appendix D summarises the reinsurance programme for 2015/16 – both external covers and intra-Group reinsurance.

4.3.2 Past Arrangements

IAG's historical reinsurance arrangements also protect its current liabilities. All reinsurance covers since 2005 have included a clause with the effect that movement of liabilities from one Group entity to another (such as being proposed under the current schemes) will not represent a 'terminating event' – that is, the cover will continue regardless of where within the Group the liabilities sit.

In relation to pre-2005 reinsurance arrangements (pre-2014 for WFI), IAG's intention is to communicate with and obtain consent from reinsurers to transfer the historical reinsurance arrangements to IAL. There are some potential complications with the reinsurance arrangements for the asbestos liabilities, which I discuss in section 4.5.1.

4.4 Premium Adequacy

IAG's June 2015 FCR includes an assessment of the adequacy of premium rate levels for key classes of business, based on information available at 30 June 2015:

- All of the **Consumer Division** products except CTP were assessed as producing profit margins well in excess of the required return on capital.

- For **Business Division** products, the overall assessed premium adequacy fell short of the required return on capital, but the business was assessed as profitable; the competitive nature of the market was observed to be impacting on premium adequacy.

IAL's **NSW CTP** premiums were assessed (as at March 2015) as falling well short of the level required to achieve target return on capital, and the business was expected to be loss making. I note, however, that:

- There is significant uncertainty regarding expected claim costs outcomes for CTP business
- Remedial premium increases have subsequently been filed and accepted by the scheme regulator
- The NSW Government has announced proposals to reform the NSW CTP scheme, which are aimed at stabilising and reducing claim costs, and improving certainty and stability (see Section 4.6.2).

I conclude that there is no material premium adequacy risk that would affect policyholders under the proposed transfer.

4.5 Insurance Liabilities and Uncertainty

Table 4.2 shows the APRA net insurance liabilities of each of the eight entities involved in the proposed transfer, as determined by the Appointed Actuary as at 30 June 2016[10]. The provisions are discounted and include risk margins at an estimated 75% probability of sufficiency; IAG holds insurance liabilities at a much higher probability of sufficiency on its balance sheet.

IAG's Appointed Actuary has overall responsibility for the insurance liabilities, which at June 2016 were subject to External Peer Review by Ernst & Young, and External Audit process by KPMG. Internally, three regional actuaries prepare the central estimates of the insurance liabilities in respect of Australia, New Zealand and Asia, and risk margins are estimated by IAG's Group Actuarial function. The Appointed Actuary's valuation report highlighted the risks relating to the NZ earthquake costs, as well as the emerging risks relating to the NSW CTP claim experience.

The External Peer Review as at 30 June 2016 assessed the outstanding claims and premium liabilities as reasonable as at 30 June 2016.

[10] The liabilities were taken from the 30 June 2016 APRA returns

Table 4.2 – APRA Net Insurance Liabilities as at 30 June 2016

	IAL	CGU	VACCI	Swann	WFI	HBF	MCGI	IAG Re Aust	**Total**
	$m	$m	$m	$m	$m	$m	$m	$m	$m
Net Outstanding Claims									
Householders	45	113	0	0	17	0	0	0	**175**
Domestic Motor	39	50	0	0	35	0	0	0	**124**
Travel	0	15	0	0	0	0	0	0	**15**
Consumer credit	0	1	0	0	0	0	0	0	**1**
Marine	1	0	0	0	0	0	0	0	**1**
Other	4	0	0	0	2	0	0	0	**6**
CTP	2,544	0	0	0	0	0	0	0	**2,544**
Total Consumer Division	2,632	180	0	0	54	0	0	0	**2,867**
Public and product liability	92	573	0	0	308	1	0	3	**976**
Professional indemnity	0	123	0	0	3	0	0	0	**126**
Employers liability	468	3	0	0	44	0	0	3	**518**
Commercial motor	6	84	0	0	48	0	0	0	**137**
Fire and ISR	9	118	0	0	43	0	0	2	**173**
Marine	0	19	0	0	2	0	0	0	**22**
Other accident	0	24	0	0	10	0	0	0	**34**
Householders				0	44				**44**
Domestic Motor				15	6				**21**
Consumer credit				5	0				**5**
Other				2	0				**2**
Total Business Division	575	944	0	23	509	1	0	8	**2,059**
Total Reinsurance	0	4	3	0	0	0	0	210	**217**
Total OSC	3,207	1,128	4	23	563	1	0	218	**5,143**
Net Premium Liabilities									
Householders	78	162	0	0	25	0	0	0	**265**
Domestic Motor	124	111	0	0	78	0	0	0	**313**
Travel	0	17	0	0	0	0	0	0	**17**
Consumer credit	0	10	0	0	0	0	0	0	**10**
Marine	2	0	0	0	0	0	0	0	**2**
Other	6	1	0	0	34	0	0	0	**42**
CTP	284	0	0	0	0	0	0	0	**284**
Total Consumer Division	493	302	0	0	137	0	0	0	**932**
Public and product liability	13	81	0	0	12	0	0	0	**107**
Professional indemnity	0	43	0	0	0	0	0	0	**43**
Employers liability	171	0	0	0	10	0	0	0	**181**
Commercial motor	11	173	0	0	69	0	0	0	**252**
Fire and ISR	12	160	0	0	26	0	0	0	**198**
Marine	0	14	0	0	0	0	0	0	**14**
Other accident	0	30	0	0	8	0	0	0	**38**
Householders				0	33				**33**
Domestic Motor				31	12				**43**
Consumer credit				13	0				**13**
Other				41	0				**41**
Total Business Division	206	500	0	86	171	0	0	0	**963**
Total Reinsurance	0	0	4	0	0	0	0	182	**186**
Total Premium Liabilities	699	801	4	86	308	0	0	182	**2,080**
Total Insurance Liabilities	**3,907**	**1,929**	**8**	**108**	**871**	**1**	**0**	**400**	**7,223**

Total net insurance liabilities at 30 June 2016 across all eight entities exceed $7.2 billion. The liabilities for IAL's CTP business represent almost 40% of the total.

The June 2015 FCR (the most recent FCR currently available) indicated that the net insurance liability provisions for each entity involved in the proposed schemes have historically been more than adequate.

I note that in relation to the NZ earthquakes of 2010 and 2011, the outstanding claim provisions for other IAG entities – IAG NZ and IAG Re Singapore – have not been adequate. However there is no net exposure for the earthquakes within IAG Re Australia.

4.5.1 Latent Claims

IAG has exposure to latent claims, including asbestos and child molestation claims, across a number of key business entities:

- Asbestos exposures sit largely within IAG Re Australia and CGU, and to a lesser extent in IAL[11]
- Molestation exposures sit mostly with IAG Re Australia.

Liabilities for these exposures are particularly challenging to estimate. At 30 June 2016 the provisions held across the Group, at a 75% probability of sufficiency and before allowing for the loss portfolio transfer to Berkshire Hathaway[12], were:

- **Asbestos**: Gross central estimate of $497 million and gross provision of $739 million (49% risk margin).
- **Molestation**: Gross provision of $30 million. This provision comprises $4.6 million of reported liabilities, $22.4 million of IBNR provision and a $3.0 million (11%) risk margin.

Net reserves for the Group and each entity for asbestos and molestation are zero, after allowing for the loss portfolio transfer. The limits provided by this cover are:

- Asbestos: $1.5 billion (2.0 times gross provision at June 2016). There is also an additional amount of up to $250 million, depending on the outcome of current proceedings and negotiations with Aviva regarding past arrangements for the Australian branch of General Accident (subsequently purchased by NZI); additional premiums would be payable, should the increased cover be required.
- Molestation: sub-limit of $40 million (33% above June 2016 gross provision).

For asbestos exposures, the limit is a multiple of the current reserve – which means that the liabilities can develop well above the current estimated levels before IAG Group retains further cost. There is also the access to additional cover to replace the Aviva arrangements, if needed.

There is less 'headroom' in the cover for molestation liabilities. I note, though, that the current molestation provision of $30 million is small in the context of the total provisions for the relevant entities (more than $7 billion), and the IBNR estimate is large in relation to reported claim costs. Even if the

[11] Exposure in CGU-VACC has been transferred to IAG Re Australia via a loss portfolio transfer

[12] IAG holds reserves to a 90% probability of sufficiency on its balance sheet, with gross provisions of $1.216 billion for asbestos (144% risk margin) and $37 million for molestation (37% risk margin).

ultimate cost were a multiple of the current provisions, it would still represent only a small proportion of the liabilities for the combined entities.

4.5.2 Impact of Schemes

My overview of the liabilities in each entity, undertaken in preparing this report, did not identify any issues relating to either the valuation or the transfer of the liabilities that I believe are material to policyholders. After the proposed schemes:

- The policyholders of the seven insurers transferring into IAL will be newly exposed to the CTP liabilities, which are material in size, and inherently more uncertain than many other risks that the entities have been exposed to in the past. Assessments of reserve adequacy by the Appointed Actuary and the External Peer Review Actuary at 30 June 2015 both led to the conclusion that the CTP insurance liability reserves in IAL were prudently adequate. I discuss the CTP risk further in Section 4.6.2.
- The policyholders of insurers other than IAG Re Australia, CGU and IAL will be newly exposed to asbestos liabilities.
- The policyholders of insurers other than IAG Re Australia will be newly exposed to molestation liabilities.

I do not believe that the extra risk to policyholders from exposure to these liabilities is material, noting the relative size and nature of the liabilities, the inclusion of risk margins which reflect the inherent uncertainty, and the protection afforded by the loss portfolio transfer for asbestos and molestation claims.

4.6 Risk Exposures

I have reviewed IAG's FCR and its risk profiles[13] to understand the key risks faced by each entity. I have considered in particular instances where:

1. The risk profile of any of the insurers would change materially following the transfer, **and**
2. The change in profile would not be covered by changes in capital levels of the insurer.

In relation to the second requirement:

- For most of the risks faced by the insurers APRA specifies capital requirements intended to deliver a 99.5% probability of policyholder liabilities being met in full.
- For this reason I am only concerned about situations where the risk profile of the insurer changes and that extra risk is **not** covered by capital requirements.

4.6.1 Risks Identified

There is overlap between the risks identified in the Business and Consumer divisional risk profiles. Table 4.3 sets out the risks which are common to both. The assessed risk levels for some of these risks are different in the two divisions.

[13] See Appendix C.2

Table 4.3 – Risks Common to Consumer and Business Risk Profiles

Risk	Assessed Risk Level	
	Business	**Consumer**
Responding to **needs of customers** (and partners, for Business)	Critical	Critical
Execute **strategy and change**	Low	Critical
Adhering to **processes and controls**	High	Critical
Technology/agility	Medium (Critical, for IT platform-specific)	Critical
Work environment – safe and constructive	Critical	High

Risks which are unique to the **Business Enterprise Risk Profile (ERP)** are shown in Table 4.4.

Table 4.4 – Business ERP Risks

Risk	Comments	Assessed Risk Level
Pricing and risk selection	Risk relates to level of sophistication	Medium
Distribution disruption	Brokers, digital capability	High
Maximise benefits of Australian operating model	This will be enabled by the Labs focus	Critical
Ineffective business resilience	Business continuity, crisis management	Medium

This group includes risks which are more pertinent to commercial than consumer business (e.g. pricing and risk selection), as well as risks which are specific to IAG's current circumstances (e.g. Wesfarmers integration).

Table 4.5 sets out the risks which are particular to the **Consumer ERP.**

Table 4.5 – Consumer ERP Risks

Risk	Comments	Assessed Risk Level
CTP	Increased claim frequency and price increases in NSW, review of NSW system	Extreme
Claim performance	Events. Claim sustainability.	Critical
Partnership	RACV, IMA, Coles and Steadfast business.	High
Regulatory and political	Government intervention, or changes in regulation	High
Fraud	Approach to, and execution of, fraud management	High

4.6.2 CTP Risk

The risk relating to **CTP business** in NSW (currently in IAL) stands out. The risk level is currently elevated due to developments in the claim experience and the market, coupled with the size and importance of this business to the IAG Group.

The NSW CTP scheme's claim experience has deteriorated in the last two years, with higher frequency (especially for relatively minor claims, which is believed to be linked to fraudulent behaviour in some cases) and increased costs. Insurers have increased their prices in a series of steps as the worsening experience has emerged.

Now, however, the NSW Government has announced its intention to make changes the scheme that will reduce prices for policyholders and reduce some of the uncertainties for insurers who write the business; all stakeholders including the NSW government, the regulator SIRA and the legal professions are committed to making improvements. An industry taskforce is addressing the specific issues of fraudulent claim behaviour, and claim management changes have been made by IAG as well as other insurers operating in the NSW CTP scheme.

While there are inherent risks in writing CTP business (as for other long tail classes), and even with the current issues in NSW, I do not believe that exposure to CTP business represents a material additional risk for policyholders of the seven insurers to be transferred into IAL by the proposed schemes:

- IAG (IAL) is well reserved in terms of CTP business it has written in the past, and has significant capital allocated to the CTP business
- I view the current issues in NSW as temporary, given the insurers' responses to date to the deteriorating experience, the fraud prevention measures and the Government's plans for reform. More generally, NSW CTP risks are mitigated:
  - There is a legislative requirement for insurers' premiums to be fully funded
  - The NSW market is disciplined, well informed and well regulated – and has historically responded to changes in the claim experience and economic conditions via price changes.
- Over the long term, this business has been consistently profitable.

4.6.3 Risks Relating to Reinsurance Arrangements

Impact of Schemes on Reinsurance Arrangements

IAG has advised me that **external** reinsurance arrangements are expected to remain unchanged post transfer.

In relation to **intra-Group** reinsurance arrangements, IAL will continue to provide cover to other Group entities as IAG Re Australia does now; IAL will therefore reinsure:

- IAG Re Singapore and IAG Re Labuan. As is the case for IAG Re Australia now, IAL will retain zero net exposure to international risks
- IMA.

IAG has advised me that the 100% quota share of IAL's NSW/ACT personal lines business (written under the NRMA brand) to IMA will also continue.

While IAG is not currently planning to make changes to its reinsurance arrangements, changes could be made with or without the proposed schemes. No retrospective changes to reinsurance arrangements are anticipated[14]. The proposed schemes themselves do not impact on reinsurance arrangements.

Reinsurance Risks

I assess that the main risks associated with reinsurance arrangements derive from IAG's **external** reinsurance arrangements – and in particular to the risk of default or dispute in respect of recoveries from these covers.

With external reinsurance arrangements expected to remain essentially unchanged, I assess that the **Group**'s exposure to default or dispute (including risks arising from IAG Group's international exposures) is unchanged by the proposed schemes.

The key issue is whether the proposed consolidation represents a material increase in risk for the consolidating entities (other than IAG Re Australia, which has always been directly exposed) – which would now sit within the 'reinsuring entity'.

Under **current arrangements**, if there were dispute or default in relation to external reinsurance recoveries, the impacts on the Australian entities other than IAG Re Australia will be different depending on whether the event to which the recoveries relate was within Australia or overseas; see Table 4.6, which assumes that the 'event' is a major property catastrophe.

Table 4.6 – Impact of Major Property Catastrophe: Current Reinsurance Arrangements

<table>
<tr><th>Element</th><th>International Event</th><th>Australian Event</th></tr>
<tr><td>Impact on entity(ies) incurring losses</td><td colspan="2">Recovers from IAG Re up to limits.
Capital position may be impaired even after recoveries – and may need recapitalisation from Group resources.</td></tr>
<tr><td>Impact on IAG Re Australia</td><td colspan="2">Will incur losses up to limit of cover provided.
Carries credit risk of external reinsurers.
May require recapitalisation.</td></tr>
<tr><td>Consequential impact on Australian underwriting entities</td><td>May be unable to recover on their reinsurance with IAG Re Australia.
If Group capital resources are needed by these entities, they may be unavailable due to being used to support entity(ies) suffering catastrophe loss.</td><td>Each of the Australian entities which are actively writing business is likely to be directly impacted by event.
Possible secondary impacts as for international event.</td></tr>
</table>

The direct impact on the other Australian entities of dispute or default of external reinsurance recoveries on international events would be potential non-recovery of reinsurance from IAG Re Australia. At 30 June 2016, the seven consolidating entities (other than IAG Re) had $676 million of reinsurance recoverables relating to recoveries from IAG Re Australia (central estimate basis, and includes about $300 million of recoverables relating to the Berkshire Hathaway quota share). There would potentially be indirect impacts in the medium term, due to a drain on Group capital resources

Once the entities are **consolidated** as proposed, IAL will effectively play the role of IAG Re Australia in the Group's reinsurance arrangements, and the current policyholders of IAL and the policyholders of the

[14] *IAG Response to APRA*, dated 5 August 2016.

six other entities which are being consolidated into IAL will be exposed directly to the reinsurance credit risk, including in particular the default/dispute risk relating to international events.

IAG aims to minimise reinsurer credit risk in a number of ways, including:

- Maintaining a diverse panel of reinsurers
- High quality reinsurers with strong credit ratings
- Monitoring the ongoing exposure to any one reinsurer. IAG runs a counterparty credit model which measures the reinsurer exposures against Group-prescribed capital limits determined by the reinsurers' ratings. In the past, IAG has required reinsurers to inject capital or collateral to reduce the exposure risk
- Collateralising recoveries due from non-APRA authorised reinsurers.

The key international historical risk issue that needs to be considered is the **NZ earthquake events** – where the complexity of the insurance and reinsurance situations may give rise to disputes. At 30 June 2016, IAG Re Australia had $428 million of reinsurance recoverables in respect of international events, most of which relates to the NZ earthquakes. Dispute or default on the external reinsurance recoveries in relation to the earthquakes would impact IAG NZ and IAG Re Australia. There are currently no material formal disputes with external reinsurers.[15]

In relation to the reinsurance recoverables on the NZ earthquake events, as at 30 June 2016:

- About $235 million is due from APRA-authorised reinsurers
- IAG Re Australia holds about $100 million in collateral which has been provided in respect of recoverables from non-APRA authorised reinsurers; this collateral provides added protection and lowers the risk due to default. The collateral is in the form of letters of credit, reinsurance trusts and deposits which in each case comply with the requirements of APRA's GPS 114.

Considering all of the above, I assess that the increased exposure to reinsurer non-payment risk does not represent a material adverse impact on the policyholders of the consolidating entities.

20% Quota Share Arrangement

There are some specific issues to consider relating to the Group 20% quota share arrangement with Berkshire Hathaway (National Indemnity Company), since there are no ceding arrangements with IMA. Currently these issues impact IAG Re directly and the policyholders of the other Australian licensed entities indirectly. After the schemes the policyholders of IAL will be directly impacted. I have investigated these issues and concluded that:

- In the normal course of events there will be a small strain on the profitability of IAL, which is more than offset at Group level by the dividend stream from IMA
- In some adverse loss scenarios, the policyholders of IAL may benefit from additional recoveries from the quota share arrangement.

In my assessment, the impact on policyholders of post-scheme IAL due to the implementation of the 20% quota share in relation to the IMA business is not material.

[15] Via the management representation letter relating to reinsurer disputes

4.7 Capital Management

4.7.1 Approach

IAG takes a group-wide approach to capital management, and actively manages capital levels across its operating entities. The capital management approach is set out in the ICAAP Summary Statement. It describes the process by which the Group ensures that it has adequate capital to meet current and future policyholder obligations.

The Group targets (consistent with risk appetite) are intended to be consistent with:

- A less than 10% chance of the capital falling below the minimum capital requirement for the Group over a three year period ('regulatory distress')
- A less than 1% chance of assets falling below statutory liabilities over a three year period ('economic ruin').

The **Group** target operating range as at June 2016 is 1.4 to 1.6 times PCA. The internal trigger for board notification and remediation action is the bottom of this target range. The buffer above the internal trigger is held to absorb 'business as usual' volatility, including seasonal impacts.

The minimum amount of capital held in Australian **Level 1 entities** (excluding IMA) is set to the highest of the following:

1. 1.2 times PCA
2. PCA plus the retained loss from one catastrophic event
3. PCA plus a buffer based of expected volatility of earnings, designed to ensure that the chance of breaching the PCA is limited.

At entity level, targets are not generally set above these minimums; the focus is on ensuring each entity has a minimum amount to satisfy regulatory and liquidity requirements. Depending on cash flows and dividend payments, this results in some entities holding capital above the minimum.

The proposed schemes will not impact on the approach to capital management, and after the transfers IAL's capital targets will continue to be determined using the same framework.[16]

4.7.2 Capital Adequacy

The capital adequacy of the entities involved in the proposed schemes – both pre and post transfer – is discussed in Section 5.

[16] The same framework will also continue to apply for any remaining assets and liabilities of the transferring entities, until the revocation of their insurance licences by APRA.

5 Capital Adequacy

This section considers the impact of the proposed schemes on the capital positions of the entities involved. I am relying on IAG's calculations of regulatory capital requirements and capital base, both before and after the proposed transfer schemes.

5.1 Capital Adequacy Pre Transfer

Table 5.1 summarises the APRA capital base and Prescribed Capital Amount (PCA) for the Level 1 entities at 30 June2016, produced from the annual APRA returns. The capital position of the Level 2 Group is also shown.[17]

The PCA Multiple shown for each insurer represents the ratio of the capital base to the PCA. The target range for the Level 2 entity is 1.4 to 1.6 (see Section 4.7).

Table 5.1 – APRA Capital Adequacy at 30 June 2016

	Capital Base	Prescribed Capital Amount	Capital Surplus	PCA Multiple	ICRC
	$m	$m	$m		$m
IAL	2,064	1,092	972	1.89	71
CGU	871	554	317	1.57	116
WFI	386	262	124	1.47	82
Swann	134	62	72	2.16	21
HBF	23	5	18	4.57	0
MCGI	11	5	6	2.22	0
CGU-VACC	24	17	7	1.42	12
IAG Re Australia	871	507	363	1.72	130
IAG Level 2 Group	4,620	2,682	1,938	1.72	200

At 30 June 2016, the PCA Multiples in the eight licensed entities ranged from 1.42 for CGU-VACC to 4.57 for HBF, while the Level 2 group's PCA Multiple was 1.72.

The Insurance Concentration Risk Charge (ICRC) for the Level 2 Group is the Natural Perils Vertical Requirement (NPVR), and reflects the Group property catastrophe retention ($250 million property catastrophe retention, reduced to $200 million by the 20% quota share). In relation to the ICRC values for the Level 1 entities:

- For each of CGU, WFI and IAG Re Australia, the ICRC represents the entity's NPVR
- The ICRC value for each of IAL, Swann and CGU-VACC reflects the Other Accumulations Vertical Requirement.

5.2 Capital Adequacy Post Transfer

Table 5.2 shows IAG's estimate of the post transfer capital position of the consolidated IAL entity, as if the transfer occurred on 30 June 2016. The table compares the figures with the equivalent totals for the eight relevant entities (from Table 5.1).

[17] The Group position cannot be derived by adding the figures for individual entities.

Table 5.2 – Estimated Post Transfer Capital Adequacy at 30 June 2016

	Capital Base	Prescribed Capital Amount	Capital Surplus	PCA Multiple	ICRC
	$m	$m	$m		$m
Pre-transfer: sum of entities	4,383	2,504	1,879		
Post transfer: new IAL	**4,335**	**2,017**	**2,318**	**2.15**	**200**
Difference from pre-transfer sum	(48)	(487)			

The estimated post-transfer capital base is $48 million (1%) lower than the sum of the eight entities, due to elimination of intercompany balances. However, the PCA for the post-transfer entity is $487 million lower than the sum of the June 2016 PCAs, largely due to the following two factors:

- The ICRC of the combined entity at $200 million is well below the sum of the individual ICRCs
- Elimination of intercompany balances and associated risk charges.

The estimated PCA Multiple for the consolidated entity is 2.15; this represents a strong capital adequacy position, and sits above the current target range for IAG Group.

Considered from the perspective of the individual insurers, the capital adequacy is changed as follows:

- **Increased adequacy** for five insurers (which include the main ongoing underwriting entities), where the PCA Multiple increases to 2.15 from a lower value:
  - IAL (increases from 1.89)
  - CGU (up from 1.57)
  - WFI (up from 1.47)
  - IAG Re Australia (up from 1.72)
  - CGU-VACC (up from 1.42)
- **Reduced adequacy** for three insurers:
  - Small reductions for Swann – which writes only a small amount of business in the context of the Group (PCA Multiple down from 2.16 to 2.15) – and for MCGI, which is in run-off (down from 2.22)
  - A significant reduction for run-off insurer HBF (down from 4.57). However, the current PCA Multiple would likely be viewed as well above an acceptable range.

In conclusion, I have not identified any material adverse solvency impact to policyholders of any of the entities as a result of the proposed schemes.

6 Impacts of Proposed Schemes

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

6.1 Policies and Claims

The proposed schemes are expected to have no impact on policyholders in a range of important areas which relate to the cover provided to them, how claims will be handled and how premiums are determined:

- **Policy terms and conditions** – no changes are intended as part of the schemes
- **Claim handling** – the claim management approaches and procedures will not change as a result of the schemes
- **Pricing of policies** – no changes to the approach to pricing are intended to emerge from the proposed schemes.

6.2 Risk Exposures

After the schemes are completed policyholders of each business will be exposed to some new risks, and in particular:

- The seven insurers to be transferred into IAL will be exposed to the CTP risk which currently sits in IAL; see Section 4.6.2
- The entities other than IAG Re Australia will be more directly exposed to the risk of dispute or default in relation to external reinsurance; this is discussed in Section 4.6.3.

In this context I note that while risks can in one sense be seen to be 'isolated' to one part of the IAG business or another, all of the entities are essentially linked, from a risk (and financial) perspective, by being part of the Group.

While there are some additional risks for each set of policyholders, these need to be offset against the benefits of the proposed schemes in terms of more diversified risk within IAL afterwards. Overall I am satisfied that any changes in the risk profile as a result of the proposed schemes do not materially adversely affect the interests of policyholders of any of the eight entities involved. All insurers would benefit from a greater level of diversification post transfer. The business of the eight relevant entities has been profitable overall in recent years and is expected to remain so.

6.3 Profitability

The profitability of the business written by the relevant entities is expected to improve marginally overall as a result of the proposed schemes, due to efficiency savings.

IAG has advised me that no income tax or state level tax impacts are expected from the proposed schemes.

6.4 Capital Management

IAG does not intend to change its capital management approach after the proposed schemes. Section 5 deals with the expected impact of the proposed schemes on capital adequacy.

6.5 Reinsurance Arrangements

The impact of the schemes on the Group's reinsurance arrangements, and the associated risks, was discussed in Section 4.6.3.

I am of the view that changes in reinsurance arrangements will not materially adversely affect the interests of policyholders of any of the eight entities involved.

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 IAG (both qualitative and quantitative). In particular, reliance was placed on the APRA returns and insurance liability valuations of the general insurance entities as at 30 June 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 upon 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 IAG 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 schemes.

It is not possible to be certain about the impact of the proposed schemes on IAG's 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 IAG, for the purpose stated in Section 1. I understand that the report will also be provided to:

- IAG's legal advisers, Minter Ellison
- APRA
- The Federal Court of Australia

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 preparation of the 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

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.

Run-off: An insurer which is no longer writing business is said to be in run-off.

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.

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.

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

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.

Insurance liabilities: At least once a year the Appointed Actuary of an insurer 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*.

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 the financial condition of the company, 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.

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

Long tail: Business where claims can be reported long after the date of incident, and claims may take years to settle. Often involves insurance of personal injury.

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

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.
- *Excess of loss (XOL) cover* – The reinsurer pays any individual claim in excess of a specified retention, usually with 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.
- *Surplus cover* – Similar to quota share, but the percentage of premium ceded to and claims paid by the reinsurer is determined for each risk, depending on the size of the sum insured.
- *Facultative arrangements* – Reinsurance covers arranged for an individual risk or group of risks rather than all risks written in a portfolio.

Incurred But Not Reported (IBNR): Refers to past incidents where a claim has not yet been reported

Loss portfolio transfer: A reinsurance treaty in which an insurer cedes policies that have already incurred losses to a reinsurer. The reinsurer assumes and accepts the insurer's existing open and future claim liabilities through the transfer of the insurer's loss reserves.

B Information Received

The information received in the process of preparing this report is set out below.

Insurance Liability Valuation

- Group Insurance Liability Valuation Report dated 17 August 2015 (liabilities as at 30 June 2015)
- Finity's External Peer Review of ILVR at 30 June 2015, dated 10 September 2015
- Specific information summarising provisions held for asbestos and molestation exposures.

Financial Condition Report (FCR)

- Group FCR dated 18 September 2015 (as at 30 June 2015)

APRA returns

- APRA returns as at 30 June 2016

Capital

- Capital adequacy position for each entity as at 30 June 2016
- ICRC calculations for Level 1 and Level 2 entities at 30 June 2016
- Estimated post transfer capital adequacy position for IAL as at 30 June 2016
- ICAAP Summary Statement dated 22 September 2014
- ICAAP report for the year ended 30 June 2015, dated 9 September 2015

Organisational structure

- A range of documents describing current structure and operations, and proposed structure post transfer
- APRA Briefing Note on proposed schemes, dated March 2016

Reinsurance

- Reinsurance Arrangements Statements:
  - Dated July 2015: IAL, IMA, Swann, WFI
  - Dated January 2016: CGU, IAG Re Australia
- Reinsurance contracts:
  - IAG Re Australia Property catastrophe XOL cover for IAG Re Singapore and IAG Re Labuan
  - Aggregate XOL CTP Cover – cover provided by Munich Re to IAL
  - Asbestos Loss Portfolio Transfer – IAG Re Australia for IAG Group, cover provided by National Indemnity Company
  - CTP quota share – cover provided by Munich Re to IAL

- IAG Re Singapore Property catastrophe XOL cover for IAG NZ
- NZ Earthquake Adverse Development Cover – IAG Re Singapore for IAG Group, cover provided by National Indemnity Company
- 20% quota share cover – National Indemnity Company

- Information relating to estimated reinsurance recoveries as at 30 June 2016:
    - Summary of IAG Re Australia's gross and net outstanding claims liabilities in relation to non-Australian risk
    - Summary of reinsurance recoverables by entity, split into recoveries from internal and external reinsurers.
- Draft representation letter from Scott Grove, Group General Manager Reinsurance, relating to disputes with external reinsurers.
- *IAG Response to APRA*, dated 5 August 2016, which relates to reinsurance arrangements.

Risk Management

- IAG Risk Management Strategy V1.1 effective 1 January 2015
- Group RAS Metrics 2015 V15
- IAG Limited Group Risk Appetite Statement V2.0 effective 19 August 2015
- IAG Enterprise Risk Profile dated August 2015
- Commercial Insurance LT Risk Profile dated September 2015
- Commercial Insurance Enterprise Risk Profile dated November 2015
- Consumer Risk Report dated 17 March 2016

Scheme documents

- Transfer agreement
- Scheme document for each of the seven insurers transferring into IAL

Other

- *IAG Response to APRA*, dated 1 August 2016, which responds to a range of questions raised by APRA in its discussions with IAG.

I have also liaised with and received assistance from IAG representatives.

C Risk Management

C.1 Risk Management Framework

IAG operates a Group-wide risk management framework (RMF), and the Risk Management Strategy (RMS) document defines the RMF. The RMS applies to all eight entities which are relevant to the proposed consolidation (IMA has its own RMS), and states the key principles and minimum requirements of the Group's approach to risk management.

Table 7.1 summarises some of the key elements of the Group RMF.

Table 7.1 – Elements of Group RMF

Element	Description
Risk management process	Enterprise approach, across all **risk categories**: • Insurance risk • Strategic risk • Financial risk • Operational Risk • Reinsurance risk
Risk governance	Key risk governance forums include: • Management level – Executive Committees in the divisions, and group management committees • Board Level – Boards and Board committees of IAG and subsidiaries.
Roles and responsibilities	The IAG Chief Risk Officer has key senior reporting roles covering GGM Enterprise Risk, GGM Internal Audit, CRO for each of Australia, New Zealand and Asia, Chief Information Security Officer, GC Underwriting Officer and Chief Actuary. Business risk owners are responsible for first line risk management, including embedding risk management processes and culture.
Group Risk Appetite Statement (RAS)	The Group RAS provides a consistent approach to risk for the Group, and links to strategy. It applies to all eight entities associated with the schemes. The RAS defines appetite, and develops metrics and tolerances, in each risk category. Divisional level risk appetite statements are also developed, and are aligned with the Group RAS.
Risk profiles	IAG's **Enterprise Risk Profile** discusses risks that can significantly impact the achievement of the Group's plans. **Divisional risk profiles** describe the key risks impacting at division level.

C.2 Risk Profile Documents

Consistent with other areas, the risk profiles of IAG's business are considered at **Group** and **Divisional** level. The three documents I have reviewed are:

1. **IAG Enterprise Risk Profile (ERP)**
   - Describes/defines high level risks which apply across IAG Group, including a plot of risks on a likelihood/severity diagram.

4. Business Insurance ERP [18]
   - Key risks for the Business Division, and also shows them on a likelihood/severity plot

5. **Consumer Division Risk Profile Report**
   - Discusses key risks which apply to the Consumer Division, once again also plotted on a likelihood/severity diagram.

[18] The document uses the previous nomenclature of "Commercial" rather than Business

D Current Reinsurance Arrangements

D.1 External Reinsurance

The key elements of the external reinsurance arrangements that incepted or renewed during 2015/16 are outlined below.

Whole of Account Quota Share

- 20% **quota share** of all business[19] of the consolidating entities of IAG Group
- IAG Re is reinsured by National Indemnity Company
- IAG Re has nil retained risk, due to 'back to back' arrangements with IAG's licensed entities (except IMA).

Property Catastrophe Program

- Limit of the program is $7 billion (the Australian earthquake 1 in 250 year loss)
- All covers are placed to 80%, reflecting the 20% quota share
- **Main covers** are:
  - 1st layer: $250m XS $250m (three reinstatements)
  - A further seven layers provide $6,500m XS $500m; each layer has one reinstatement
- **Underlying covers (Australia)** are:
  - In the $225m XS $25m layer, $450m cover XS aggregate deductible $375m
  - Natural perils stop loss of $100m XS $850m.

Additional CTP Covers (not through IAG Re)

- 30% **quota share** of IAL's $10 million retention for CTP business (NSW, ACT and Qld), with Munich Re as sole reinsurer; this means that after allowing for the whole account quota share, IAL retains 50% of its CTP business
- **Adverse development protection** covering amounts paid from 1 July 2014 in excess of $2.5 billion, with a limit of $1.4 billion. This is placed 30% with Munich Re, with IAL retaining the remaining 70%.

Adverse Development Cover – NZ Earthquakes

IAG Group took out an adverse development covers with National Indemnity Company, which protects the Group against development of costs for the NZ earthquakes of 2010 and 2011.

Loss Portfolio Transfer – Latent Claims

A loss portfolio transfer arrangement between IAG and National Indemnity Company relating to latent claims from asbestos and molestation exposures took effect 1 January 2016. The Group's net reserves for asbestos and molestation are zero, subject to limits of the loss portfolio transfer.

[19] Ten year arrangement which excludes only Nuclear business

Other External Covers

The main elements of cover for other classes include:

- Liability XOL covers: $10 million retentions for general liability, Motor third party property, workers' compensation; $20m for CTP
- XOL covers for PI and D&O business, with $5 million retentions for Australian business
- Marine XOL program with retention of $3 million
- Covers for Crop, Homeowners Warranty, Cyber Risk, Surety Bonds, Accident & Health.

External arrangements for individual IAG entities which are outside IAG Re are:

- Various facultative arrangements
- CTP covers for IAL discussed above
- As part of the Berkshire Hathaway partnership effective 1 July 2015, Berkshire Hathaway acquired the renewal rights to IAG's large corporate property and liability insurance business in Australia.
- The NTI reinsurance programme, which is written by a panel of external reinsurers.

D.2 Intra-Group Reinsurance

There are two catastrophe covers – one covering 'personal insurance' and one for 'commercial insurance' business.

The covers provided mirror the external arrangements, but with reduced retentions and covers in some areas; some of the covers are shared across the Level 1 licensed entities. The key arrangements that incepted or renewed during 2015/16 are summarised below.

Table D.2 – Key Covers Provided by IAG Re Australia

Cover	Business covered	Retention	Limit	Group Retention
Property catastrophe	Personal	$60m	$1.9bn	$250m
	Commercial	$40m	$2bn	
Liability XOL	Personal	$5m ($10m CTP)	Various	$10m ($20m CTP)
	Commercial	$5m	Various	
Workers Comp XOL	Commercial	$5m WFI $10m IAL	$200m	$10m
Marine XOL	Personal	$2m	$10m	$3m
	Commercial	$2m	$75m	

There is a range of other surplus, XOL and catastrophe buy-down arrangements to protect the net positions of the seven entities.

IAG Re Australia also provides cover to **IAG Re Singapore and IAG Re Labuan**, which in turn reinsure IAG businesses in New Zealand and Asia.[20]

IAL's personal lines business written under the NRMA brand in NSW/ACT (as well as the small volume of Victorian business written as NRMA) is 100% quota shared into IMA.

For the period 1 December 2015 to 30 June 2016, IAG Re Australia wrote a 90% whole account quota share of Steadfast personal lines business written by IAL. This agreement was initially entered into as part of the Berkshire Hathaway arrangement, and was written with a backdated commencement date of 22 April 2015 (ending 30 November 2015) as a 100% quota share to IAG Re Singapore.

[20] IAG Re Labuan reinsures Malaysian risks only, and IAG Re Singapore reinsures all other international risks. The NZ earthquake losses come to IAG Re via IAG Re Singapore.