Actuarial Report on Scheme for Transfer

Transfer of the Insurance Business of HDI-Gerling Australia Insurance Company Pty Limited to HDI-Gerling Industrial Insurance Company – Australia Branch

May 2010

21 May 2010

Mr K Devlin
HDI-Gerling Australia Insurance Company Pty Limited
Level 4
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SYDNEY NSW 2000

Dear Ken

Actuarial Report on Scheme for Transfer

We are pleased to enclose our actuarial report prepared for the transfer of the insurance business of HDI-Gerling Australia Insurance Company Pty Limited to HDI-Gerling Industrial Insurance Company – Australia Branch.

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

Yours sincerely

Adam Payne
Appointed Actuary

Estelle Pearson

Fellows of the Institute of Actuaries of Australia

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Actuarial Report on Scheme Transfer

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Part I Our Findings

1 Introduction

This report has been prepared at the request of HDI-Gerling Australia Insurance Company Pty Limited (HDI-GAUS) and HDI-Gerling Industrial Insurance Company – Australia Branch (HG/AUST). The report covers the proposed transfer of assets and liabilities relating to the insurance business written in Australia of HDI-GAUS to HG/AUST.

This report has been prepared by Adam Payne and Estelle Pearson. The authors are Fellows of the Institute of Actuaries of Australia and are employed by Finity Consulting Pty Limited ("Finity"), a firm of consulting actuaries. Finity is independent of HDI-GAUS and HG/AUST. Adam Payne is the Appointed Actuary for both HDI-GAUS and HG/AUST.

The transfer will take place in accordance with a scheme prepared under Part III Division 3A of the Insurance Act 1973 (referred to in this report as the "Scheme") and in accordance with APRA's Prudential Standard GPS 410 Transfer and Amalgamation of Insurance Business for General Insurers.

The report explains our understanding of the Scheme and examines the impact of the Scheme on the policyholders of HDI-GAUS and HG/AUST. We understand that the report will be provided to APRA and to the Federal Court as part of the documentation supporting the transfer.

Unless stated to the contrary, all amounts in this report are expressed in Australian Dollars.

Readers of this report should note the reliances and limitations detailed in Section 11 of this report.

2 Background and Purpose of the Scheme

2.1 Nature of HDI-GAUS' Business

HDI-GAUS was licensed to carry on insurance business in Australia in 1995 and is a 100% owned subsidiary of HDI-Gerling Welt Services AG (HGWS). HGWS is itself a subsidiary of HDI-Gerling Industrie Versicherungs AG (HGI) which is a company within the Talanx AG Group.

The classes of business underwritten by HDI-GAUS and the premium volumes are summarised in the following table.

Table 2.1 – Gross Written Premium ($m)

Underwriting Year	Class of Business										
	Aviation	Aon CPF	Traded Credit	Engineering	Liability[1]	Marine	PAAH	Prof. Indemnity	Property	Space	Total
1995	0.0	0.0	0.0	0.6	0.0	0.0	0.0	0.0	0.3	0.0	0.9
1996	0.0	0.0	0.0	4.7	6.3	0.3	0.0	0.9	5.6	0.0	17.7
1997	7.0	0.0	0.3	7.4	12.5	0.8	0.0	1.6	8.8	0.0	38.3
1998	7.2	0.0	1.4	4.8	17.7	1.3	8.2	1.6	12.5	1.4	56.1
1999	7.9	13.7	2.6	5.9	39.0	4.2	16.5	6.6	19.5	1.4	117.3
2000	9.8	34.4	2.5	9.7	13.4	4.4	16.7	12.3	27.1	0.0	130.4
2001	12.1	0.0	3.8	19.2	24.6	8.5	19.2	22.3	45.7	0.0	155.5
2002	0.0	0.0	5.5	11.4	25.0	8.8	12.6	56.5	56.9	0.0	176.9
2003	0.0	0.0	2.5	0.0	1.3	0.0	2.7	0.0	1.3	0.0	7.9
2004	0.0	0.0	0.0	0.3	0.9	0.0	0.0	0.0	1.2	0.0	2.4
2005	0.0	0.0	0.0	0.0	2.4	0.0	0.0	0.0	2.2	0.0	4.6
2006	0.0	0.0	0.0	0.0	3.2	0.0	0.0	0.0	1.6	0.0	4.8
2007	0.0	0.0	0.0	0.0	2.8	0.0	0.0	0.0	2.1	0.0	5.0
2008	0.0	0.0	0.0	0.1	3.3	0.0	0.0	0.6	2.0	0.0	6.0
2009	0.0	0.0	0.0	0.0	2.2	0.4	0.0	0.0	2.7	0.0	5.4
Total	44.0	48.1	18.6	64.0	154.5	29.0	76.0	102.3	189.5	2.9	729.1

[1] Inlcudes Sports, Leisure Entertainment (SLE) and Clinical Trial business

The HDI-GAUS portfolio experienced rapid growth in gross written premium until 2002, when the written premium for the year was around $177 million. HDI-GAUS ceased writing most business on 31 December 2002 other than the International Programme (IP) business of the HGI/Talanx Group and annual gross written premium dropped to around $5 million

HDI-GAUS ceased writing any new or renewal business from 1 October 2009.

HDI-GAUS' insurance exposures fall into two different categories.

a) Legacy Business

HDI-GAUS refers to the non-IP business written on or prior to 31 December 2002 as the 'Legacy Portfolio'. This business has been in run-off for more than seven years.

HDI-GAUS had many quota share, surplus and XOL treaties together with catastrophe cover protecting the Legacy Portfolio. The maximum net retention to HDI-GAUS for any one claim was $500,000.

With effect from 15 December 2008, HDI-GAUS entered into a Combined Cover Australia (CCA) reinsurance agreement reinsuring the net insurance liabilities in respect of the Legacy Portfolio (excluding claims handling expenses). The CCA also provides reinsurance against third party reinsurer default of Legacy Portfolio reinsurance recoveries. The CCA agreement is with HDI-GAUS' parent company HGWS.

b) IP Business

HDI-GAUS continued to write IP business to 1 October 2009. As noted above, this business comprised the Australasian content of business underwritten by HGI/Talanx Group companies. The main classes of business written were liability (including clinical trials) and property. All IP risks are 100% reinsured with HGWS and (from 1 January 2008) Royal & Sun Alliance Reinsurance Limited (RSA).

The purchase of the CCA reinsurance protection together with the IP portfolio being 100% reinsured means that HDI-GAUS' net insurance liabilities are equal to the claims handling expense provision and policy administration provision.

2.2 Nature of HG/AUST Business

HG/AUST was licensed with effect from 1 October 2009 and is an APRA licensed branch of HDI-Gerling Industrie Verisherung AG (HG-I).

As at 31 December 2009, HG/AUST's exposures relate to the multinational Insurance Placement programs (IP). The Australasian content of IP business underwritten by HG-I/Talanx Group companies for the following classes:

- Clinical trials
- Liability
- Property
- Engineering
- Marine.

These treaties are 100% reinsured with HDI-Gerling Welt Service AG (HGWS) and Royal & Sun Alliance Reinsurance Limited (RSA).

Local (non International Program) Business

HG/AUST also plans to write non-IP business consisting of Engineering and Clinical Trial business on a net retained basis. The 2010 business plan assumes $10 million of written premium in respect of the Engineering portfolio and $3 million in respect of the Clinical Trial portfolio for the 2010 underwriting year. HG/AUST has not written any of these Specialty Lines as at 31 December 2009. HG/AUST's planned net retention is around 22% of claims in the initial years of operation for these lines of business.

2.3 Purpose of the Transfer Scheme

HGI submitted a letter dated 4 June 2008 to APRA detailing its preferred business model for HGI's long term underwriting presence in Australia. The long term strategy was expressed as a desire to operate a Branch Office of HGI with its own mandate to underwrite specialty lines of business, on a "net retained" basis, whilst continuing to support the Australasian servicing requirements for the IP business.

With the branch now established, HGI has expressed a wish to close HDI-GAUS and repatriate surplus capital. A transfer scheme has been identified as the most effective means of achieving this, while saving on compliance costs and consolidating the Australian insurance operations of HDI-GAUS and HG/AUST.

3 Information Used

We have used the following information in preparing this report:

- The Scheme document "Scheme for the Transfer of the Australian Insurance Business of HDI-Gerling Australia Insurance Company Pty Limited to HDI-Gerling Industrie Versicherung AG".
- The Transfer Agreement between HDI-Gerling Australia Insurance Company Pty Limited HDI-Gerling Industrie Versicherung AG.
- The Insurance Liability Valuations undertaken for HDI-GAUS and HG/AUST by Adam Payne of Finity as at 31 December 2009. We understand that the liability estimates prepared by Finity have been adopted by HDI-GAUS and HG/AUST in preparing their respective APRA returns.
- The audited APRA Returns prepared by HDI-GAUS and HG/AUST as at 31 December 2009.
- The Run Off Plan of HDI-GAUS effective 31 December 2009 prepared by HDI-GAUS and reviewed by Finity in accordance with APRA Prudential Standard GPS 220.
- All relevant information provided by HG/AUST as part of its licence application to APRA. The information included, but was not limited to, three year business plan, Risk Management Statement and Reinsurance Strategy Statement.
- HG/AUST's Business Plan forecasts and Capital projections as at 31 December 2009. The forecasts have been prepared both including and excluding the transfer of the HDI-GAUS business.
- The results of our assessment of the insurance liabilities of HDI-GAUS up to a 99.5% level of sufficiency at 31 December 2008 as documented in our report "Assessment of Insurance Liabilities to 99.5% Level of Sufficiency" dated 22 June 2009.
- The Combined Cover Australia Treaty Endorsement between HG/AUST and HGWS.
- The Master Endorsement Loss Deposit Account agreement between HG/AUST and HGWS.

We received all the information requested and answers to all our questions from HG/AUST and HDI-GAUS.

4 Our Approach

Our approach involved the following steps:

1. *Review and understand the Transfer Agreement and Scheme* (Section 5).
2. *Review the nature and valuation of the liabilities to be transferred* (Section 6). We considered the suitability of the valuation of HDI-GAUS liabilities for the purposes of assessing the Scheme.
3. *Assess capital adequacy for each entity* (Section 7). This step involved consideration of the latest APRA balance sheet and Minimum Capital Requirement ("MCR") calculations as at 31 December 2009 as well as the forecast position to 30 June 2010.
4. *Assess capital adequacy post transfer* (Section 8). We assessed the capital adequacy of HG/AUST after the proposed transfer of assets and liabilities as at 30 June 2010 (the expected transfer date) based on the business plan and capital forecasts.
5. *Assess impact of Scheme on policyholders* (Section 9). This included consideration of the terms and conditions offered to transferring policyholders and planned changes to claims handling procedures and brings together the work from Steps 1 to 4 and involves both quantitative and qualitative considerations.

Our main analysis of the Scheme has focussed on the forecast financial position of the two entities as at 30 June 2010. The forecast position has been based on the starting position as at 31 December 2009 taken from the audited APRA returns (i.e. the latest available data) and projected to 30 June 2010 based on HDI-GAUS and HG/AUST's business plans.

In terms of assessing the impact of the Scheme on policyholders, it is first necessary to identify the interests of the policyholders of both HDI-GAUS and HG/AUST. Primarily, these relate to the ability and willingness of the insurer to pay valid claims as and when they fall due. In reviewing the impact on policyholders, we have considered three key areas:

- The financial security of the insurer(s) pre and post the transfer, including the capital position.
- The policy terms and conditions for policyholders.
- The claims handling policies and procedures.

5 The Scheme

5.1 Timing

The Scheme will be effective from the first business day following confirmation of the Scheme by the Federal Court. Application for the Scheme is expected to be heard on or around 1 July 2010.

This report is prepared on the basis of the entities' financial positions as at 31 December 2009 and forecast to 30 June 2010. The forecast position is based on the actual position as at 31 December 2009 rolled forward based on expected outcomes. We have not explicitly considered any changes in the financial position since 31 December 2009. We are not aware of any matters that may make the analysis as at this date misleading for examining the Scheme.

5.2 Business to be Transferred

It is our understanding of the Transfer Agreement and the Scheme that:

- All of HDI-GAUS' gross insurance liabilities for business written in Australia will transfer to HG/AUST (including Incurred But Not Reported (IBNR) claims).
- All rights and obligations of HDI-GAUS under those policies will become rights and obligations of HG/AUST.
- The policies will remain unchanged but for the substitution of HG/AUST for HDI-GAUS as the insurer.
- All of HDI-GAUS' reinsurance recoveries under the various reinsurance arrangements for business written in Australia will be transferred to HG/AUST.
- All rights and obligations of HDI-GAUS under those reinsurance policies will become rights and obligations of HG/AUST.
- The net insurance liabilities of HDI-GAUS being equal to the claims handling expense provisions (including associated risk margins) as well as an equivalent amount of assets.
- All other liabilities and equivalent value of assets (including the balance of any loss deposit accounts, employee entitlements, leasing arrangement, fixed assets etc.) of HDI-GAUS as well as the right and obligations of those assets and liabilities will become the rights and obligations of HG/AUST.
- Assets equal to the Net Asset position (equal to shareholder capital and retained earnings) less any amount of additional capital deemed necessary by the Appointed Actuary to be transferred under the Scheme will remain in HDI-GAUS. It is the intention to repatriate the Net Assets on completion of the Scheme and revocation of HDI-GAUS' insurance licence by APRA.

Note that we have not recommended that any additional capital be transferred as part of the scheme.

Following the transfer, all future payments to or from policyholders will become the responsibility of HG/AUST.

We understand that it is the intention of HG/AUST that the HDI-GAUS claims will continue to be managed by the same staff as at present.

5.3 Transfer Amount

We understand that assets equal to the Transfer Amount (as defined in the Scheme and summarised below) will be transferred to HG/AUST and will comprise cash and other fixed interest securities.

The Transfer Amount is calculated as:

- the value of HDI-GAUS's Net Insurance Liabilities (calculated in accordance with *Prudential Standard GPS 310 Audit and Actuarial Reporting and Valuation* made under the Insurance Act) as reported in the accounts for the quarter ending 30 June 2010
- The shortfall MCR as at the Effective Date, calculated as the difference (if any and equal to a minimum of zero) between:
  - (a) 145% of the Minimum Capital Requirement of HG/AUST immediately following the transfer; and
  - (b) HG/AUST's APRA Capital Base immediately following the transfer.

In determining the level of assets to transfer, the net insurance liabilities will be measured including risk margins at a 75% probability of sufficiency, consistent with the basis on which liabilities are held in Australia for both entities. This is discussed further in the next section.

5.4 Other Assets and Liabilities

Other Assets and Liabilities (as defined in the Scheme) of equal and offsetting value will also be transferred to HG/AUST as part of the Scheme. The Other Assets and Liabilities are in respect of the Loss Deposit Account and other non-insurance related balance sheet items and are not expected to have a material impact on the Scheme.

No other assets or liabilities of HDI-GAUS will be transferred to HG/AUST.

5.5 Reinsurance

Each of HDI-GAUS' reinsurance contracts will also transfer to HG/AUST, so that HG/AUST receives the recoveries and associated benefits that HDI-GAUS previously received.

5.6 Following the Transfer

After the transfer is completed, HG/AUST will be responsible for managing the run-off of the transferred portfolio. This includes managing the reinsurance recoveries and overseeing claims handling.

Following the transfer, HDI-GAUS will:

- make payments for tax and any other liabilities outstanding
- apply to APRA for revocation of its APRA licence
- repatriate the remaining funds to HGWS
- liquidate and deregister the company.

6 Summary of Insurance Liabilities to be Transferred

6.1 HDI-GAUS' APRA Insurance Liabilities

The following table shows the discounted net insurance liabilities of HDI-GAUS as at 31 December 2009 as reported to APRA and audited by HDI-GAUS' auditors KPMG. The outstanding claims and premium liabilities were estimated by Finity as described in our report "Actuarial Valuation of Insurance Liabilities as at 31 December 2009; HDI-Gerling Australia Insurance Company Pty Limited" dated 5 March 2010.

Table 6.1 – HDI-GAUS Insurance Liabilities at 31 December 2009[1]

	Gross Central Estimate	Reinsurance Recoveries	Net Central Estimate	CHE & PAE	Risk Margin	Total Provision
	$m	$m	$m	$m	$m	$m
Legacy Portfolio						
Outstanding Claims	100.6	100.6	0.0	3.8	0.6	4.3
Premium Liabilities	0.0	0.0	0.0	0.0	0.0	0.0
IP Portfolio						
Outstanding Claims	15.7	15.7	0.0	0.6	0.1	0.7
Premium Liabilities	1.0	1.0	0.0	0.0	0.0	0.1
Excess Technical Provisions						0.1
Total Insurance Liabilities	117.2	117.2	0.0	4.4	0.7	5.2

[1] Note balances may not add due to rounding

The total net insurance liabilities as at 31 December 2009 were $5.2 million.

The premium liabilities for the legacy portfolio were nil, reflecting the fact that this portfolio has been in run-off since 31 December 2002 and that HDI-GAUS has no exposure to new claims occurring in respect of future accident periods for the Legacy portfolio. This does not preclude the possibility of late reports from accident years 2002 or prior.

The gross outstanding claims central estimate is dominated by 3 individual large claims with case reserves at 31 December 2009 of $66 million. Clearly the gross outstanding claims liabilities and associated reinsurance recoveries are heavily reliant on the outcomes of these claims.

As noted in Section 2.1, the CCA reinsurance of the Legacy portfolio and 100% quota share reinsurance of the IP portfolio means that HDI-GAUS' net central estimate is nil. The total insurance liabilities of $5.170 million (as per Table 6.1 above) comprises allowance for expense provisions and associated risk margins. We consider this an appropriate allowance given the reinsurance arrangements of HGI-GAUS.

There were no particular issues or uncertainties identified in the Finity insurance liability valuation report that we believe are material to the Scheme.

6.2 Suitability of Valuation Methods and Assumptions

Gross Central Estimate

The valuation of HDI-GAUS' gross outstanding claims liabilities have been based on an analysis of HDI-GAUS' actual claims experience supplemented with industry benchmarks where the claims data is either not available or sparse. In our opinion, the valuation methods and assumptions adopted are suitable given the relative size and nature of HDI-GAUS' claims exposure.

Reinsurance Recoveries

The estimate of the reinsurance recoveries has been calculated by applying the specific details of the reinsurance programme to the gross liabilities at an individual claim level. After considering the items in paragraph 40 of GPS310, including the credit rating of the reinsurers, we have assessed that the probability of non-recovery of the reinsurance is remote. The valuation of the insurance liabilities, therefore, assumes full recoverability of the reinsurance assets.

As all rights and obligations of HDI-GAUS under the reinsurance cover will transfer to HG/AUST under the Scheme, we consider this an appropriate basis on which to assess the Scheme.

Claims Handling Expenses (CHE) and Policy Administration Expenses (PAE)

The CHE and PAE assumptions were selected based on an analysis of the expected costs associated with managing the run-off of policies and claims based on expense forecasts to 2014 and allowing for expected cost sharing between HDI-GAUS and HG-AUST.

We note that the valuation of the insurance liabilities uses CHE assumptions of 4% and 8% of the gross outstanding claims liabilities for long tail and short tail classes respectively.

The PAE assumption was 0.5% of the gross premium liabilities which reflects the fact that there is significantly less administration required for the IP portfolio than for many other insurers.

This approach was considered appropriate for an insurer in run-off, but the claims handling provision may be overstated if the liabilities are to be transferred to an on-going business such as HG/AUST. This is because many of the fixed costs will be spread between a larger number of outstanding claims, therefore reducing the proportion of costs allocated to HDI-GAUS claims. In our opinion the impact of this change is immaterial. As such, this is a suitable (possibly slightly conservative) approach on which to base the Scheme.

Risk Margins

In accordance with APRA requirements the risk margin included in the liabilities shown in Table 6.1 are intended to provide a 75% Probability of Sufficiency (PoS). Our valuation of the gross insurance liabilities as at 31 December 2009 included an increase in the risk margin to allow for the additional uncertainty associated with estimating the outstanding claims liabilities in respect of portfolios in run-off.

Importantly, the risk margins adopted for the gross outstanding claims liabilities have no impact on the net insurance liabilities as the net central estimate is nil. A risk margin of 15% is added to the CHE to allow for uncertainty surrounding the future costs of these expenses and we consider this an appropriate basis on which to assess the Scheme.

6.3 Projected Insurance Liabilities to 30 June 2010

We understand that the Transfer Amount and Other Assets and Liabilities will be calculated based on their respective values as reported in the 30 June 2010 quarterly APRA return of HDI-GAUS.

HDI-GAUS has projected the insurance liabilities to 30 June 2010 by deducting the expected claim payments from the opening outstanding claims liabilities (both gross and net) and allowing for the release of risk margins as the liabilities run-off. We have also compared these projections to our valuation of the insurance liabilities as at 31 December 2009 for reasonableness. We consider the forecast insurance liabilities a reasonable basis on which to base the scheme, bearing in mind that the net insurance liabilities are nil (except for CHE provisions).

The following table shows the projected insurance liabilities as at 30 June 2010.

Table 6.2 – Projected HDI-GAUS Insurance Liabilities at 30 June 2010[1]

	Gross Estimate	Reinsurance Recoveries	Net Estimate	CHE & PAE	Risk Margin	Total Provision
	$m	$m	$m	$m	$m	$m
HDI-GAUS						
Outstanding Claims[2]	109.0	109.0	0.0	3.9	0.6	4.4
Premium Liabilities[3]	1.0	1.0	0.0	0.0	0.0	0.0
Total Insurance Liabilities	109.9	109.9	0.0	3.9	0.6	4.5

[1] Balances may not add due to rounding
[2] Gross Outstanding Claims includes gross risk margin
[3] Gross Premium Liabilities are estimated as UEP less DAC

Based on HDI-GAUS' forecast net insurance liabilities the appropriate net insurance provision for HDI-GAUS on which to base the Scheme is $4.491 million as at 30 June 2010. The net provision is $0.679 million lower than the provision as at 31 December 2009 in the APRA return due to CHE and PAE expenses expected to be incurred in the six months 30 June 2010.

7 Capital Adequacy – Pre Transfer

7.1 Statement of Financial Position

The table below summarises the financial position of both HDI-GAUS and HG/AUST, as per the audited APRA returns at 31 December 2009. These figures reflect the most recently audited position. The projected financial position of both companies based on the forecast models prepared by HDI-GAUS and HG/AUST as at 30 June 2010 is also shown.

Table 7.1 – Statement of Financial Position – Pre-Transfer

	31-Dec-09		30-Jun-10	
APRA Balance Sheet	HDI-GAUS	HG/AUST	HDI-GAUS	HG/AUST
	$m	$m	$m	$m
Assets				
Cash and liquid assets	6.1	14.1	8.1	16.1
Investments	36.1	0.0	32.3	0.0
Investment income receivable	0.1	0.0	0.0	0.0
Premium receivables	0.4	0.6	0.0	1.6
Non-reinsurance recoveries	0.3	0.0	0.0	0.0
Reinsurance recoveries on OCP	116.2	0.2	109.0	2.5
Reinsurance recoveries on PL	1.3	0.6	1.0	5.8
Other receivables	3.2	0.0	3.2	0.3
Deferred tax assets	1.9	0.0	1.5	0.1
Other assets	0.2	0.0	0.0	0.0
Total assets	165.8	15.6	155.0	26.3
Liabilities				
Creditors	1.9	0.1	0.0	0.0
Amounts due on reinsurance contracts	16.3	0.7	15.9	1.3
Outstanding claims provision	121.2	0.2	113.5	2.6
Premium liabilities	1.5	0.7	1.0	8.4
Other	0.9	0.1	0.0	0.3
Total liabilities	141.7	1.7	130.3	12.6
APRA Net Assets	24.1	13.8	24.6	13.7

The table shows that HDI-GAUS assets and liabilities are significantly larger than HG/AUST in most respects. The most significant items on the balance sheets in respect of the Scheme are the insurance related assets (reinsurance recoveries), insurance liabilities (gross outstanding claims and premium liabilities) and the investments.

The following table shows the capital adequacy position of both HDI-GAUS and HG/AUST as at 31 December 2009, determined in accordance with APRA's prudential standards. The projected position at 30 June 2010 is also shown.

Table 7.2 – Capital Adequacy – Pre-Transfer

	31-Dec-09		30-Jun-10	
	HDI-GAUS	HG/AUST	HDI-GAUS	HG/AUST
	$m	$m	$m	$m
APRA Capital Base[1,2]	22.3	13.7	23.2	13.4
APRA MCR	8.3	5.0	7.7	5.0
Capital Adequacy Multiple (Capital Base / MCR)	2.68	2.74	2.99	2.67
Excess Capital	14.0	8.7	15.4	8.4

[1] HDI-GAUS APRA Capital Base = APRA Net Assets plus net of tax technical provision in excess of liability valuation less Deferred Tax Assets

[2] HG/AUST APRA Capital Base = APRA Net Assets less assets outside of Australia plus net of tax technical provisions in excess of liability valuation less Deferred Tax Assets

The difference between the net assets from the Statement of Financial Position (Table 7.1) and the APRA Capital Base is described in the notes to the table.

The Minimum Capital Requirement (MCR) is the minimum amount required to meet APRA's capital adequacy standard. It is a risk-based assessment, and the components are shown in Appendix A. A minimum capital requirement of $5 million applies to HG/AUST.

The Capital Adequacy Multiple (CAM) is the ratio of the Capital Base to the MCR. At 31 December 2009, the CAM is 2.68 for HDI-GAUS and 2.74 for HG/AUST.

8 Capital Adequacy – Post Transfer

8.1 Loss Deposit Account

Under the terms of the CCA Endorsement, HDI-GAUS will transfer the balance of the Loss Deposit Account (LDA) with HGWS to HG/AUST. Immediately following the transfer, HG/AUST will hold the Loss Deposit Account in assets in Australia and equal in value to the reinsurance recoveries under Section 1 of the CCA contract (including case estimates, IBNR balances and risk margins) as reported in the Statutory Accounts as at 30 June 2010. The expected balance of the Section 1 CCA recoveries at 30 June 2010 (i.e. the initial balance of the Loss Deposit Account for Section 1 recoveries) is $12.3 million. All future claims under Section 1 will be paid from this account (until such time as the balance is nil).

It is our understanding that prior to the transfer of the HDI-GAUS insurance liabilities HG/AUST will establish an additional $10 million in a separate Loss Deposit Account (also held in assets in Australia) against all other sections of the CCA as well as the IP reinsurance. In the event of reinsurer default (either HGWS or external third party reinsurer), this money would be available to HG/AUST to meet its cost of claims.

We understand that both LDAs will be binding on both parties (HG/AUST and HGWS) and that the balance of the Loss Deposit Accounts can only be repaid to HGWS on the satisfaction of certain conditions.

8.2 APRA Capital Adequacy Basis

The following table shows the financial position of both HDI-GAUS and HG/AUST before and after the transfer of the assets and liabilities under the terms of the Scheme (on the APRA reporting basis projected to 30 June 2010 consistent with figures presented in Section 7) and consistent with our understanding of the Loss Deposit Agreement. The impact of the transfer on the capital adequacy positions of the entities, assuming the transfer took place on 30 June 2010 is also shown.

Table 8.1 – Statement of Financial Position as at 30 June 2010 – Pre- and Post-Transfer

	HDI-GAUS			HG/AUST		
APRA Balance Sheet	Pre Transfer	Transferred	Post Transfer	Pre Transfer	New Provisions	Post Transfer[1]
	$m	$m	$m	$m	$m	$m
Assets						
Cash and Liquid Assets	8.1	4.0	4.1	16.1	6.9	27.0
Investments	32.3	12.6	19.7	0.0		12.6
Investment Income Receivable	0.0	0.0	0.0	0.0		0.0
Premium Receivables	0.0	0.0	0.0	1.6		1.6
Non-reinsurance Recoveries	0.0	0.0	0.0	0.0		0.0
Reinsurance Recoveries on OCP	109.0	109.0	0.0	2.5		111.4
Reinsurance Recoveries on PL	1.0	1.0	0.0	5.8		6.8
Other Receivables	3.2	3.2	0.0	0.3		3.5
Deferred Tax Assets	1.5	0.0	1.5	0.1	1.3	1.4
Other Assets	0.0	0.0	0.0	0.0		0.0
Total Assets	155.0	129.7	25.2	26.3	8.3	164.3
Liabilities						
Creditors	0.0	0.0	0.0	0.0		0.0
Amounts Due on Reinsurance Contracts	0.0	0.0	0.0	1.3		1.3
Loss Deposit Account[2]	15.3	15.3	0.0	0.0	6.9	22.3
Gross Outstanding Claims Provision	109.0	109.0	0.0	2.5		111.4
Claims Handling Expense	4.5	4.5	0.0	0.2		4.7
Premium Liabilities	1.0	1.0	0.0	8.4		9.3
Other	0.0	0.0	0.0	0.3		0.3
Total liabilities	129.7	129.7	0.0	12.6	6.9	149.2
APRA Net Assets	25.2	0.0	25.2	13.7	1.3	15.0
APRA Capital Base	23.2			13.4		13.4
APRA MCR	7.7			5.0		8.8
APRA CAM	2.99			2.67		1.52
Excess Capital	15.4			8.4		4.6

[1] HG/AUST Post Transfer = HG/AUST Pre Transfer + HDI-GAUS Transferred + HG/AUST New Provisions

[2] Immediately following the transfer, and under the terms of the CCA Endorsement, HG/AUST will hold assets in Australia equal to the balance of reinsurance recoveries under Section 1 of the CCA as at 30 June 2010 ($12.3m) plus $10m

When viewed on an APRA capital basis, the net assets of both entities are unchanged after the transfer. This reflects that the assets transferred from HDI-GAUS are equal to the value of the liabilities transferred.

The MCR for HG/AUST post transfer is lower than the sum of the combined pre-transfer amounts for the two entities. This is because the $5 million minimum capital requirement for HG/AUST is no longer applicable once the insurance liabilities of HDI-GAUS are transferred to HG/AUST. The HG/AUST CAM decreases from its pre-transfer level of 2.99 to 1.52 post-transfer as no additional capital is transferred from HDI-GAUS to HG/AUST. We consider why this reduction in CAM is not expected to materially impact on the probability of claims not being paid in the following sections.

It should be noted that there are no insurance liabilities remaining with HDI-GAUS post-transfer.

8.3 Review of 99.5% Level of Sufficiency

Finity prepared a report "Assessment of Insurance Liabilities to 99.5% Level of Insurance Liabilities" as at 31 December 2008 as set out in our report dated 22 June 2009 in respect of the insurance liabilities of HDI-GAUS. We estimated that the discounted net insurance liabilities at a 99.5% level of sufficiency as at 31 December 2008 to be $16.4 million.

We have considered the findings of that report when considering an adequate level of capital necessary to provide adequate financial security to policy holders of HDI-GAUS following the transfer to HG/AUST.

The net insurance liabilities as at 30 June 2010 at a 99.5% level of sufficiency is likely to be lower than at 31 December 2008 due to the run-off of the Legacy Portfolio relative to the new IP business written over the same period. Nevertheless, we have compared the expected balance of funds held in Australia of $35.7 million ($13.4 million in capital plus $22.3 million held in Loss Deposit Accounts) against net insurance liabilities at a 99.5% level of sufficiency of $16.4 million. On this basis, we consider the probability of HG/AUST not being able to meet its insurance liabilities following the portfolio transfer to be less than 0.5%.

8.4 Prospective Capital Adequacy

We understand that HG/AUST intends to manage its capital in line with its Capital Management Plan which states that that HG/AUST will continue to retain earnings to ensure adequate capital coverage above a minimum target CAM of 1.40.

We have been provided with projections undertaken by HG/AUST which show that the CAM is expected to remain above the target minimum of 1.40 provided HG/AUST meets its budgeted profit levels. The following table shows the CAMs taken from these projections both excluding and including the transfer of HDI-GAUS.

Table 8.2 – Projected HG/AUST CAM Pre- and Post-Transfer

		As at 31 December			
Scenario	1-Jul-10	2010	2011	2012	2013
Capital Projection pre transfer of HDI-GAUS	2.67	2.68	2.75	2.25	1.83
Capital Projection post transfer of HDI-GAUS	1.52	1.63	1.82	1.69	1.68

These projections appear reasonable, however there is no guarantee that the assumptions on which the projections are based will be realised - i.e. it is possible for the CAM to vary materially from the expected position.

Our detailed review of the basis of these projections is described in Appendix B.

Whilst the projected CAM including HDI-GAUS is lower than the projected CAM excluding HDI-GAUS, we consider the reduction in the CAM shown as somewhat "illusory". The additional funds available to HG/AUST post transfer (in the form of the

Loss Deposit Accounts) from which to pay claims against the reinsurance recoveries together with the net assets means there is no material increase in the probability of HG/AUST not being able to meet the cost of claims.

The conclusion from the analysis is that HG/AUST can reasonably be expected to have a robust capital position going forward, and that the transfer from HDI-GAUS does not present any significant risks to HG/AUST.

9 Assessment of Impact of Scheme on Policyholders

In this report, we have considered the interests of the policyholders of HDI-GAUS and HG/AUST, having regard to the Scheme. In particular, we have considered the issues of financial security, policy terms and conditions and claims handling processes.

9.1 Policyholder Security

The main interest of policyholders is to have their valid claims paid when due. We refer to the financial ability of the insurer to pay as 'policyholder security'.

An important aspect of policyholder security is that the insurer maintains adequate provision for liabilities and a capital buffer in excess of those liabilities, and in sections 6 to 8 of this report we examined those issues in detail.

Capital adequacy, though, is only a point in time measure and the liabilities will extend many years into the future. There are other elements of policyholder security relating to the longer term future that we also consider in this section.

Regarding the current measure of capital, we note that almost any transfer of liabilities will lead to a lower CAM for at least one of the insurers involved. The key issue is whether the likelihood of valid claims being paid is *materially* affected.

For HDI-GAUS the main uncertainty to policyholders relates to the run-off of existing claims and the estimated outstanding claims liabilities. As the liabilities are fully backed by reinsurance, it is the recoverability of that reinsurance from the reinsurers that is crucial to policyholder security.

For HG/AUST the main uncertainty to policyholders relates not only to the run-off of existing claims, but also to the future financial security of HG/AUST and its ability to pay claims that may be incurred in the future to the extent that this is impacted by the Scheme.

HDI-GAUS Policyholder Security

Table 9.1 summarises the security for HDI-GAUS policyholders by identifying the different resources that are available to meet their valid claims. There are both 'directly available' resources, i.e. those contractually available in Australia and subject to APRA supervision, and 'backup resources' which could potentially be available if the directly available resources are inadequate.

Table 9.1 – HDI-GAUS Policyholder Security

Nature of Resource	Pre Transfer	Post Transfer
Directly available	HDI-GAUS reinsurance treaties $23m capital in Australia[1] $16m Loss Deposit Account	HDI-GAUS reinsurance treaties $13m capital in Australia[2] $22m Loss Deposit Account Minimum capital adequacy multiple of 1.45 times MCR as at the transfer date HG/AUST Stop Loss reinsurance treaty protecting the CAM falling below 1.40 times MCR
Backup	HGWS resources Talanx Group resources	HGI resources Talanx Group resources

[1] Subject to reduction with the agreement of APRA

[2] Shared with policy holders of HG/AUST and subjects to the fortunes of HG/AUST in future

For HDI-GAUS policyholders, whilst the CAM will be lower than is currently provided by HDI-GAUS, it is important to recognise that:

- A significant component of HDI-GAUS' policyholder protection comes from the reinsurance of the gross liabilities with the related company HGWS. This remains unchanged after the Scheme.
- The $22 million Loss Deposit Account gives additional protection specifically for the run off of HDI-GAUS business.
- HDI-GAUS required to transfer additional capital (if necessary) to guarantee a minimum Capital Adequacy Multiple (CAM) of 1.45 MCR as at the transfer date.
- HG/AUST has an additional Stop Loss[1] reinsurance treaty protecting the CAM falling below 1.40 times MCR which provides an additional layer of protection following the transfer.
- HG/AUST is a branch company licensed and approved under APRA regulations. The same level of APRA regulation and asset security will continue after the Scheme transfer within HG/AUST.
- Whilst the level of capital is reduced, we consider the level of capital post transfer together with the balance of the Loss Deposit Accounts to be sufficient to secure the net insurance liabilities to a 99.5% level of sufficiency. The reduction in the level of capital is, therefore, immaterial in terms of the probability of claims not being paid.

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[1] In the event that HG/AUST's CAM falls below 1.40 times MCR, then HGWS will pay such amount as necessary to restore the CAM to 1.40 times MCR. HG/AUST may make a provision during the year to its reinsurance recoverables in respect of any expected loss to the Stop Loss (subject to APRA asset concentration risk charges on reinsurance recoveries). Any actual claim payment would only respond after the final year end balance date outstanding insurance liability provisions are established by the Appointed Actuary and is payable within 45 days of the final MVR calculation..

HG/AUST Policyholder Security

While the scheme review has focussed on the security of HGI-AUST policyholders, we regard it as important to also consider the security of HG/AUST policyholders:

- The insurance liabilities of HDI-GAUS are protected by reinsurance cover. HG/AUST is accepting the transfer of reinsurer default risk in the event of the reinsurance recoveries not being paid. Over 90% of the reinsurance assets are with insurers with a current S&P rating of A or higher. We consider the probability of reinsurer default as remote.
- The reduction in HG/AUST's CAM as at 30 June 2010 from 2.67 to 1.52 is somewhat "illusory" in that there is no additional claims risk to the existing HG/AUST policyholders following the transfer of the HDI-GAUS net liabilities (assuming all reinsurance recoveries are received). There are additional funds available to HG/AUST post transfer (in the form of the Loss Deposit Accounts) specifically to meet the increased risk of reinsurer default.
- Post transfer HG/AUST has an increased exposure to a potential asset concentration risk charge if the credit rating of HDI-GAUS' reinsurers were downgraded to BBB+ (APRA Grade 4) or worse. In the event of a downgrade in the credit rating for HGWS (however remote the likelihood of that downgrade may be), HG/AUST would incur concentration asset charges that, without remedial action, would result in its capital base falling below APRA's minimum capital requirement. HG/AUST's Capital Management Plan acknowledges this exposure and identifies various options available to HDI-GAUS to manage such rating downgrades including advance payments against specific case reserves or securitised capital instruments. In its letter data 14 July 2009, HGI has also given an undertaking to adhere to APRA's minimum capital requirements at all times and, if necessary, provide additional funds to the Branch in order to meet these requirements.

9.2 Policy Terms and Conditions

As discussed in Section 5.2, HG/AUST will assume liability for HDI-GAUS' insurance liabilities on the same terms and conditions as currently apply. To that end, HDI-GAUS policyholders will be in the same position as before the Scheme. Likewise, terms and conditions of HG/AUST policies are unchanged.

9.3 Claims Handling Processes

We understand that the same staff will continue to manage the claims for HDI-GAUS after the transfer and on this basis we are satisfied that there is no impact on policyholders in respect of claims handling processes.

9.4 Costs of the Transfer

Costs of the Scheme will be met by HG/AUST with no impact on policyholders. The costs are not anticipated to be material relative to the financial strength of HG/AUST.

9.5 Reinsurance Arrangements

We understand that all rights and obligations under HDI-GAUS' reinsurance programme will transfer to HG/AUST. On this basis there is no impact on the net liabilities of HDI-GAUS after the transfer.

9.6 Conclusion

We assess that HG/AUST still provides an adequate level of protection to policyholders as HDI-GAUS, despite the reduction in the CAM, to the extent that the likelihood of claims not being paid is remote. Similarly, we assess that the level of security afforded the policyholders of HG/AUST is not materially affected by the Scheme.

On this basis we are satisfied that the interests of the policyholders of HDI-GAUS and HG/AUST should not be adversely affected in a material way as a consequence of the Scheme.

10 Actuaries' Statement

In this report, we have considered the interests of the policyholders of HDI-GAUS and HG/AUST, having regard to the Scheme. In particular, we have considered the issues of financial security, policy terms and conditions and claims handling processes.

Based on our analysis, we make the following conclusions:

- Given the expected financial position of HG/AUST immediately following the transfer we are satisfied that the Scheme provides adequate financial security to the policyholders of both companies; noting that there is always uncertainty with the outcome of insurance business and ongoing solvency cannot be guaranteed.
- Given that the HDI-GAUS policies will be assumed by HG/AUST with no changes to the policy terms and conditions, we are satisfied that the Scheme will not adversely impact the interests of HDI-GAUS policyholders in this regard.
- Given the claims management practices of each company will remain unchanged as the same staff will continue to manage the claims following the transfer, we do not believe that there will be any detriment to policyholders in this regard.

In summary, we are satisfied that the interests of policyholders should not be adversely affected in any material way as a consequence of the Scheme.

Reliances and Limitations

We refer readers the important reliances and limitations that are contained in Section 11 of the full report. These should be read in order to place our findings in their appropriate context. We understand that a copy of the full report is available to anyone entitled to receive the Scheme Summary.

The reliances and limitations include a statement that third parties, whether authorised or not to receive this report, 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.

11 Reliances and Limitations

This report has been prepared for the use of HDI-GAUS and HG/AUST for the stated purpose. HDI-GAUS Directors and employees, member of the HG/AUST Supervisory Board and affected policyholders are entitled to review this report. We understand that the report will also be provided to:

- HG/AUST's legal advisers for the Scheme (Allens Arthur Robinson)
- HG/AUST's auditor (KPMG)
- APRA (including the Australian Government Solicitor)
- The Federal Court of Australia.

No other use of, nor reference to, our report should be made without prior written consent from Finity, nor should the whole or part of our report be disclosed to any unauthorised person.

Third parties, whether authorised or not to receive this report, 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 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.

Reliance on Data

We have relied on the accuracy and completeness of the data and other information (qualitative, quantitative, written and oral) provided to us by HDI-GAUS and HG/AUST for the purpose of this report. In particular, reliance was placed on the audited APRA returns of both HDI-GAUS and HG/AUST as at 31 December 2009.

We have not independently verified or audited the data, but we have reviewed the information for general reasonableness and consistency. The reader of this report is relying on HG/AUST and not Finity for the accuracy and reliability of the data. If any of the data or other information provided is inaccurate or incomplete, our advice may need to be revised and the report amended accordingly.

Uncertainty

We have prepared our estimates on the basis that they represent our current assessment of the likely future experience of the portfolios of HDI-GAUS and HG/AUST. It should be noted that there is a limitation on the accuracy of our report in that there is inherent uncertainty in any estimates of claim reserves. This uncertainty is due to the fact that the ultimate liability for a claim is subject to the outcome of events yet to occur. In our judgement, we have employed techniques and assumptions that are appropriate, and the conclusions presented herein are reasonable, given the information currently available. However, it should be recognised that future claim experience will likely deviate, perhaps materially, from our estimates and hence impact the financial condition of HG/AUST.

Reinsurance

Both HDI-GAUS and HG/AUST depend heavily on intra-group reinsurance to protect their net positions. We have assumed that all reinsurance will be fully recoverable on a prompt basis. If any reinsurance proves not to be recoverable (either through insolvency of a reinsurer or contract dispute) the net liabilities of the affected entity (HDI-GAUS or HG/AUST) could be significantly higher. We are not aware of any current reinsurer solvency issues or disputes over reinsurance recoveries.

Part II Appendices

A APRA Minimum Capital Requirement Calculations

Table A.1 – APRA MCR Calculations as at 31 December 2009

	HDI-GAUS	HGI Australia	
APRA Risk Charge	Pre-Transfer	Pre-Transfer	Post-Transfer
	$000	$000	$000
Off Balance Sheet Risk Charge	0	0	0
Investment Risk Charge			
Direct Interest Holdings and Risk charge	460	184	488
Direct Equity Holdings and Risk Charge	0	0	0
Direct Property Holdings and Risk Charge	0	0	0
Loans and Advances and Risk Charge	0	0	0
Assets Indirectly Held and Risk Charge	0	0	0
Statement of Financial Position	105	84	111
Total Investment Risk Charge	565	268	599
Reinsurance Assets and Risk Charge	6,595	495	7,090
Off Balance Sheet Business [1]	0	0	-890
Asset Exposure Concentration Risk charge	0	0	0
Derivatives Activity and Risk Charge	0	0	0
Concentration Risk Charge	0	1,000	1,000
OCP Insurance Risk Charge	584	22	606
Premium Liabilities Insurance Risk Charge	0	500	500
Total Insurance Risk Charge	584	522	1,106
Minimum Capital Requirement	**7,744**	**5,000**	**8,905**

[1] Credit Support Received (Investment Risk Charge Reduction)

B Prospective Capital Adequacy of HG/AUST

Table B.1 below shows the CAMs in the latest HG/AUST capital projection both excluding and including HDI-GAUS business.

Table B.1 – Projected HG/AUST CAM Pre and Post-Transfer

		As at 31 December			
Scenario	30-Jun-10	2010	2011	2012	2013
Capital Projection pre transfer of HDI-GAUS	2.67	2.68	2.75	2.25	1.83
Capital Projection post transfer of HDI-GAUS	1.51	1.62	1.81	1.68	1.68

We have reviewed HG/AUST's capital projections and we are satisfied with the overall reasonableness of the projections. The results excluding HDI-GAUS are comparable to those shown in the HG/AUST licence application with APRA. HG/AUST's capital projection model is an annual model (for years ending 31 December). As the effective date of the transfer (financially) is 30 June 2009 some minor approximations were required when incorporating HDI-GAUS in the HG/AUST capital projection model. The approach taken by HG/AUST to incorporate the HDI-GAUS insurance liabilities was suitable.

HG/AUST's projected CAM (both excluding HDI-GAUS and including the HDI-GAUS business) is expected to exceed HG/AUST's target minimum CAM of 1.40 over each of the next four year end balance dates which demonstrates a relatively strong solvency position. The projected CAM is expected to decrease in 2012 as HG/AUST relies on reinsurance protection from non-APRA approved sources which attract significantly higher capital charges on outstanding balances of more than two years. HG/AUST have previously advised that arrangements would be put into place to collateralise some or all of its reinsurance recoveries (thereby not attracting the additional capital charge) if this presented a significant risk to its capital position. The CAM is expected to increase (albeit at a slower rate) beyond 2012.

Whilst the projected CAM including HDI-GAUS is lower than the projected CAM excluding HDI-GAUS, we consider the reduction in the CAM shown as "illusory". The CCA cover for the Legacy portfolio and 100% quota share of the IP portfolio effectively protects HG/AUST against any deterioration in the HDI-GAUS insurance liabilities (so long as the reinsurance is recoverable). HG/AUST's exposure to HDI-GAUS claims is limited to the cost of managing the run-off of claims.