24 October 2014

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

Dear Peter

Earthquake Claim Liabilities as at 30 September 2014

We have been asked by Southern Response Earthquake Services Limited ("SRES") to make an assessment of its insurance liabilities as at 30 September 2014. SRES is the Crown-owned entity which emerged from a transaction whereby, with effect from 5 April 2012, the ongoing business of AMI Insurance Limited ("AMI") was separated from the existing AMI entity and sold to Insurance Australia Group.

The purpose of this letter is to provide an estimate of the earthquake claim liabilities for Southern Response Earthquake Services Limited ("SRES") as at 30 September 2014. This valuation is predominantly based on a roll forward of our 30 June 2014 valuation with changes to valuation assumptions where emerging experience, or new information in respect of emerging issues, suggests changes are appropriate. We include commentary on the key changes to assumptions later in this letter.

This letter does not deal with the other non-earthquake retained events that were transferred from AMI Insurance Limited to SRES at the close of business on 5 April 2012.

Summary of Results

Table 1 summarises our estimates of SRES' earthquake liabilities at 30 September 2014. The line below the table indicates our estimate of the total amount which will be ultimately paid once all claims are settled (including payments already made but excluding SRES CHE expenses). This represents our central estimate of the ultimate liability which is recoverable under SRES's reinsurance treaties. Our recommended provisions incorporate a risk margin which we believe to be consistent with the requirements to establish provisions which incorporate at least a 75% probability of sufficiency.

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Table 1 – Recommended EQ Provisions at 30 September 2014

Provisions for Outstanding Claims as at 30 Sep 2014	Cat 93 4-Sep-10 $m	Cat 106 22-Feb-11 $m	Cat 112 13-Jun-11 $m	Total Major $m	Total Minor $m	Total Overall $m
Gross Incurred Cost in 30 Sep $ before EQC	1,033.9	2,094.1	81.9	3,209.8	34.3	3,244.2
Expected EQC Share	-318.5	-534.3	-32.1	-884.9	-5.8	-890.7
Gross Incurred Cost in 30 Sep $ after EQC	715.4	1,559.8	49.8	2,324.9	28.6	2,353.5
less paid to 30 Sep 2014	-415.0	-739.4	-30.4	-1,184.8	-18.6	-1,203.5
Gross Outstanding Claims						
In 30 Sep 2014 Values	300.4	820.3	19.4	1,140.1	9.9	1,150.0
Allowance for Future Inflation	25.9	59.9	2.2	88.0	0.5	88.5
Inflated Values	326.3	880.3	21.6	1,228.1	10.4	1,238.5
Discount to Present Value	-13.7	-36.0	-0.9	-50.6	-0.3	-50.8
OSC Discounted to 30 Sep 2014	**312.6**	**844.2**	**20.7**	1,177.5	10.2	1,187.7
Claims Handling	[redacted]					
Gross Central Estimate						
Catastrophe R/I Recoveries	-181.4	0.0	-20.7	-202.1	-7.8	-209.9
Aggregate R/I Recoveries	0.0	0.0	0.0	0.0	0.0	0.0
Net Central Estimate	**146.3**	**884.8**	**1.0**	**1,032.1**	**2.9**	**1,034.9**
Risk Margin	[redacted]					
Recommended provision						
Inflated Gross Central Estimate (Incl paid to date, excl CHE)	**741**	**1,620**	**52**	**2,413**	**29**	**2,442.0**
Change on 30 Jun 2014 Valuation	**59**	**18**	**1**	**78**	**0**	**78**

withheld pursuant to qcargm1 (9)(2)(b)(ii)

Since 30 June 2014 there has been an increase of around $78 million in the central estimate of the gross inflated ultimate cost.

Most of the increase in the central estimate since June relates to the higher expected cost of Over Cap repairs (detailed later in this letter). The projected OOS claim costs reduced slightly, although this was largely offset by some minor increases to temporary accommodation and lost rent claims. There has also been an increase of [redacted] in the project management cost allowance, and a small increase to the central estimate resulting from a slight lengthening of the payment pattern.

withheld pursuant to section (9)(2)(b)(ii)

There has been a small reallocation of costs away from the February event towards the September event, although this has no impact on SRES' net liabilities since both events are expected to exceed to the limit of the reinsurance cover anyway.

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

Table 2 – Estimated Ultimate EQ Liabilities at 30 September 2014

	30 Jun 14 $m	30 Sep 14 $m	Mov't from Jun 14 $m
Ultimate Outflows			
Over Cap	2,647	2,720	72
Out of Scope	305	301	-4
Other	152	155	3
Claims Cost (Excl PM Cost)	3,104	3,176	71
Project Management Costs	[redacted]	[redacted]	[redacted]
SRES Claims Handling	137	137	0
Ultimate Inflows			
EQC Contributions	900	902	2
Reinsurance Recoveries	1,240	1,241	1
	[redacted]	[redacted]	[redacted]
Gross Outflow (net EQC, ex CHE)	2,364	2,442	78
Net Outflow (net of RI)	[redacted]	[redacted]	[redacted]
Cum. Paid Net of EQC (excl CHE)	1,069	1,203	135
Net Liability			
Central Estimate	1,062	1,035	-28
Risk Margin	[redacted]		
Provision Required	[redacted]	[redacted]	[redacted]

withheld pursuant to section (9)(2)(b)(ii)

The ultimate cost of claims (net of EQC, excluding CHE) has increased by $78 million, before reinsurance, since the June 2014 valuation. We comment on the key movements below.

Key Observations

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

Claims Costs

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

Over Cap

The estimated gross cost (gross of EQC and reinsurance) of Over Cap claim inflated costs has increased by $72 million since March 2014. The increase is mainly due to an increase in the average claim size for Over Cap Repairs (around $65 million of the increase). The slower assumed payment pattern contributed a further $7 million.

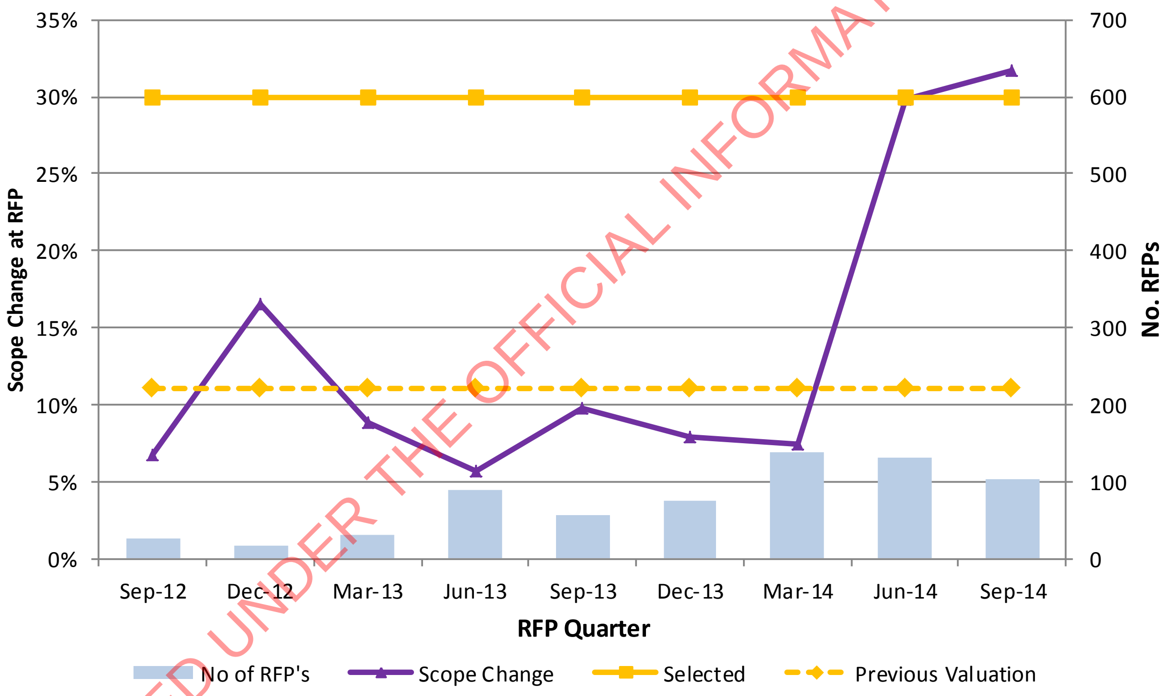
The Over Cap rebuild claim size is virtually unchanged since June. The projected ultimate number of Over Cap claims (rebuild and repair) is also unchanged from June 2014.

<u>Over Cap Repairs</u>

Our assessment of Over Cap average claim size is based primarily on Arrow's assessed costs. We then assess the adequacy of the DRA estimates against the emerging contract experience to make adjustments to the DRA estimates where appropriate. For the details of this process we refer the reader to our 30 June 2014 valuation report.

In the emerging experience, a critical point is the RFP DRA. At this time the DRA is revised for escalation in rates since the previous DRA was completed, as well as any additional scope requirements. The chart below shows the impact of scope related changes at the RFP stage over time (by the quarter in which the RFP DRA was completed).

Figure 1 – Scope Change at Repair RFP



While we had previously observed scope related increases at the RFP stage of up to 10%, the most recent RFPs have had scope related increases of around 30%. At this stage there is no single factor to which the increase appears to be attributable. Discussions with SRES and Arrow suggest it could be a combination of a number of factors such as:

- Increased scoping of repair works as a result of the "qualitative easing" policies introduced earlier this year
- Greater complexity of the repairs now being undertaken leading to more complex engineering and foundation solutions being required than envisaged in the original DRAs
- Council requirements for scaffolding at all sites creating added cost that was not required in most cases previously

Regardless of cause, there is nothing to suggest that the recent experience will not continue or that it was due to exceptional circumstances unlikely to be repeated.

Reflecting this experience in our assumptions means a 20% increase to the value of all Over Cap repairs at the pre-RFP stage, of which there are around 1,300. The overall impact on the cost of the Over Cap claims is $65 million.

Payment Pattern

The payment pattern has been lengthened slightly. This is largely a result of a lengthening of the projected repair construction pattern. Repair construction starts are expected to be a bit slower than previously anticipated due to the capacity constraints in respect of available builders as well as Repair throughput experience in the last quarter continuing to be slower than expected.

The cash settlement payment pattern has also been slightly lengthened. We had previously assumed cash settlements would be completed by June 2016; however SRES now expects that a small proportion of cash settlement activity will continue into FY17.

The total impact of the above adjustments is an increase of around $7 million.

Out of Scope (OOS)

The estimate of OOS claim costs decreased by around $4 million compared to June 2014 due to a lower projected ultimate number of OOS claims.

Southern Response has recently undertaken a clean-up of inactive OOS claims leading to around 230 claims being withdrawn from the system. These are effectively claims that were previously expected to have a cost but have been closed for nil amounts. New OOS claim reports have also been lower than expected. As a result we have reduced our projected ultimate number of OOS properties by around 500. A small increase in the average size of OOS claims has offset some of the impact of lower claim numbers.

Other areas

There were some minor adjustments made to other claim type assumptions resulting in an increase of around $3 million. Approximately half of the increase is due to a higher expected size for Lost Rent claims, as these claims are remaining active for longer than anticipated. The rest of the increase relates to an increase in the projected size of Temporary Accommodation claims.

Project management Costs and Claims Handling Expenses

The claims handling expense forecasts are largely unchanged since June. SRES expects an additional [redacted] in project management costs. This is due to an increase in staff resources required, an increase in Arrow's rates and an additional allowance for processing claims with weather tightness issues.

withheld pursuant to section (9)(2)(b)(ii)

Uncertainty of our Estimates

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

- while SRES has progressed most of the way through the damage assessment phase, a large proportion of the overall incurred cost is yet to be settled
- there remains some uncertainty as to the eventual cost of enhanced foundations in TC3 and TC2 properties, and the extent of land remediation compensation SRES will receive from the EQC in respect of these issues
- the outcome of the declaratory judgment regarding repairs to properties with Increased Flood Vulnerability (IFV), detailed in Attachment A, could have a very large impact on the ultimate claims cost
- the run-off is exposed to a higher level of variability in claims experience than a typical residential property run-off portfolio. As the claim settlement process has progressed, a greater proportion of outstanding claims liability relates to more complex claims, meaning the uncertainty around future settlement outcomes for outstanding claims is magnified (as compared to 'normal' residential property claims).

In response to the inherent uncertainties, we have maintained our risk margin at 10% of the estimated liability (net of EQC contributions but gross of reinsurance recoveries). Under accounting standards, in response to the inherent uncertainty, it is expected that provisions will contain a margin sufficient to produce at least a 75% probability of sufficiency.

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

Reliances and Limitations

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

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

Our letter should be considered as a whole. Members of Finity staff are available to answer any queries, and the reader should seek that advice before drawing conclusions on any issue in doubt.

Yours sincerely

[redacted]

Withheld under section 9(2)(a)

[redacted]

Fellows of the New Zealand Society of Actuaries
Fellows of the Institute of Actuaries of Australia

A Other Standing Issues

Enhanced Foundation Costs

There remains uncertainty in regard to the division of responsibility (between EQC and the private insurers) for the costs involved in remediating land to a standard suitable for building on, particularly in TC3. Land damage classifications prepared by the EQC suggest there would be around 220 properties where EQC's land payments will become a contribution to the cost of enhanced foundations; in others to land remediation.

Assuming SRES is able to recover the full cost of the enhanced foundations for these properties (around [redacted] per property), SRES can expect to recover around $10 million in land damage compensation. withheld under section 9(2)(b)(ii)

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

Repairs in for properties with Increased Flood Vulnerability (IFV)

A declaratory court judgment is currently being sought regarding the right of insurers and the EQC to merely repair properties with Increased Flood Vulnerability to existing floor heights (instead of raising floor levels to compensate for the increased vulnerability to flooding).

If the court concludes that the insurers' proposed approach is not acceptable then the cost of repairing affected properties would be far higher than the planned repair works. We estimate that there may be between 1,500 to 2,000 SRES insured properties with increased flood vulnerability that may be affected by the declaratory judgment. The majority of these properties currently have either only OOS or EQC only claims lodged. The estimate of numbers is itself highly uncertain due to the limited IFV data available to SRES at the time of this valuation.

At this stage, SRES plans to repair the affected properties as planned (or do nothing where it is an EQC claim only). However, an adverse outcome regarding the floor levels to which these properties must be built would have a very large impact on SRES's earthquake claims liabilities, and remains a significant source of uncertainty to the valuation.

Southern Response Earthquake Services

Earthquake Liabilities at 30 September 2014

Withheld under section 9(2)(a)

Presented by [redacted]

The Headline Numbers

	30 Jun 14 $m	30 Sep 14 $m	Mov't from Jun 14 $m
Ultimate Outflows			
Over Cap	2,647	2,720	72
Out of Scope	305	301	-4
Other	152	155	3
Claims Cost (Excl PM Cost)	3,104	3,176	71
Project Management Costs	[redacted]		
SRES Claims Handling	137	137	0
Ultimate Inflows			
EQC Contributions	900	902	2
Reinsurance Recoveries	1,240	1,241	1
	[redacted]	[redacted]	[redacted]
Gross Outflow (net EQC, ex CHE)	2,364	2,442	78
Net Outflow (net of RI)	[redacted]	[redacted]	[redacted]
Cum. Paid Net of EQC (excl CHE)	1,069	1,203	135
Net Liability			
Central Estimate	1,062	1,035	-28
Risk Margin	[redacted]	[redacted]	[redacted]
Provision Required	[redacted]		

withheld pursuant to section (9)(2)(b)(ii)

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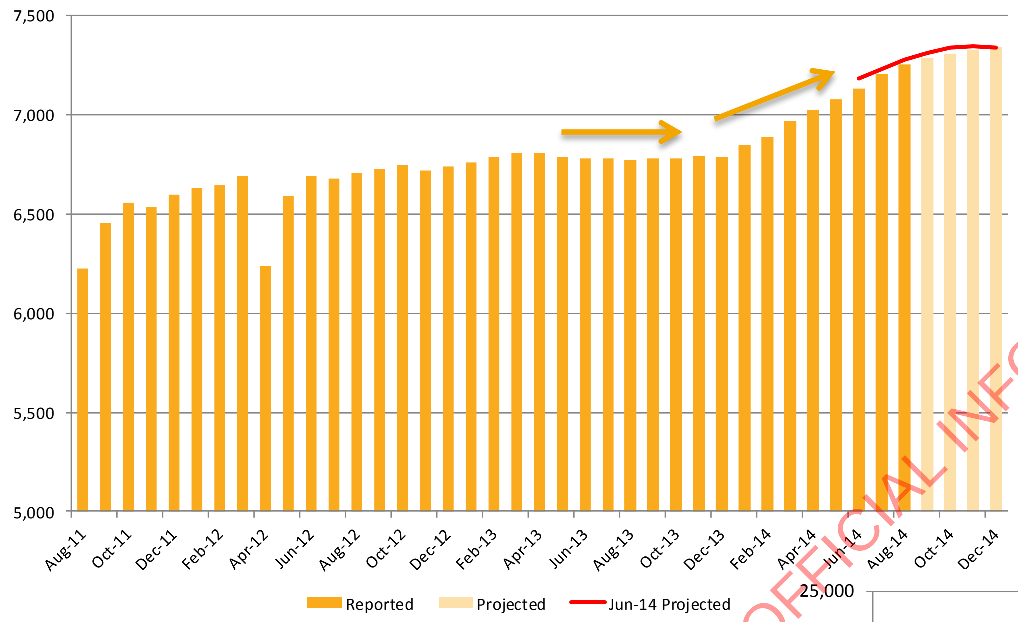
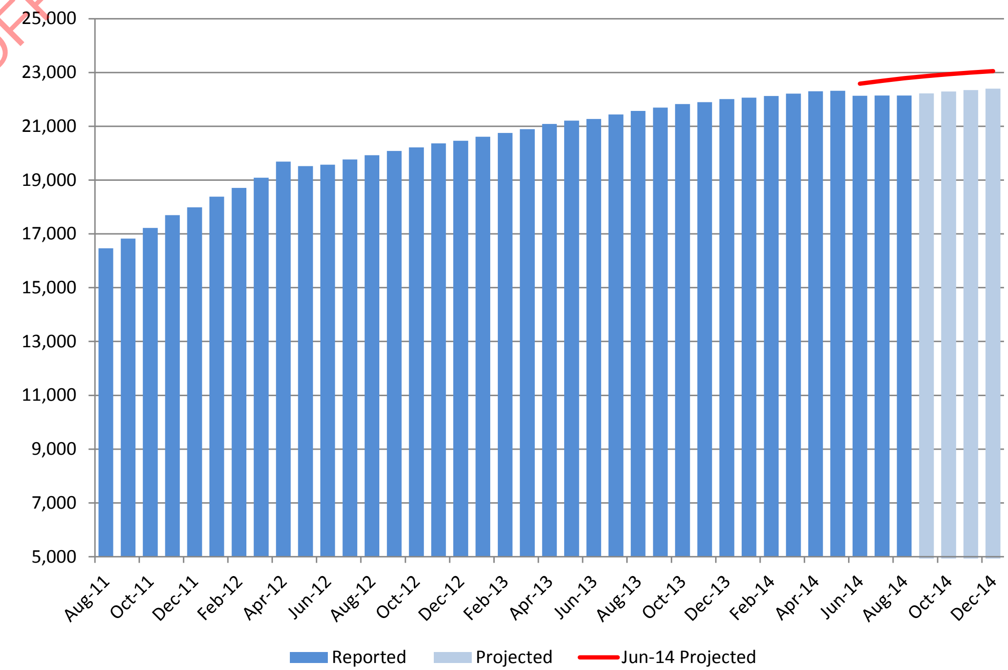
Buildings – Number of Damaged Properties



Over Cap

OOS



Buildings – Number of Damaged Properties

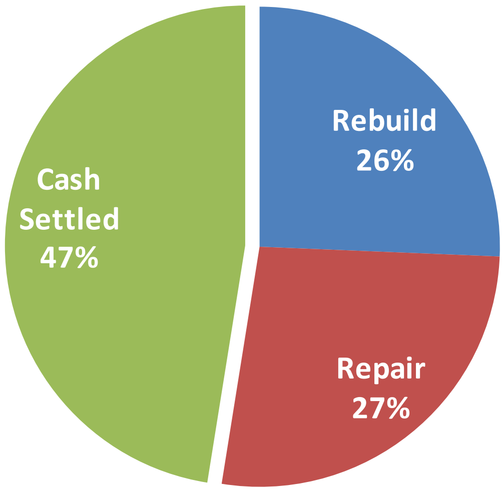
Properties with Buildings Claims	All Events Combined Jun-14[2]	Sep-14	Movt from Jun14
Over Cap			
No. ever reported as Over Cap	8,289	8,484	195
Overcaps Recorded Currently	7,080	7,256	176
Future additions	315	130	-185
Estimated Ultimate No to be assessed	8,604	8,614	10
No. moved under cap	-1,408	-1,402	7
Ultimate No with Over cap damage	7,196	7,212	17
Arrow Managed			
- Rebuild	1,870	1,850	-21
- Repair	1,917	1,938	22
	3,787	3,788	1
Cash Settlements	3,408	3,424	16
Out of Scope Damage Only			
No in Database	21,797	21,836	39
Estimated further additions	791	280	-511
	22,588	22,116	-473
Total No of Properties with Claims	29,784	29,328	-456
No of EQC Only Properties	24,920	25,375	455
Total with EQ Damage[1]	54,704	54,703	-1

[1]Total assumed to be equal to total recorded to date on EQC database

[2]Jun-14 numbers modified after a clean up on addresses w ith multiple policy numbers

Over Cap ultimate numbers largely unchanged

Minor movements in mix



Over Cap Mix

Building Claim Sizes

Over Cap – Summary of Claims Sizes

	No of Properties	Average Claim Size $000			
		Recorded	Adjust.	Value in $Sep14	Previous in $Sep14
Rebuild	1,850	[redacted]			
Repair	1,938				
Arrow Managed	**3,788**				
Cash Settlements	**3,424**				
All Over Cap	**7,212**				

Gross Inflated Average Size	[redacted]	[redacted]
Gross Inflated Claims Cost ($m)	[redacted]	[redacted]

withheld pursuant to sections 9(2)(i) and 9(2)(j)

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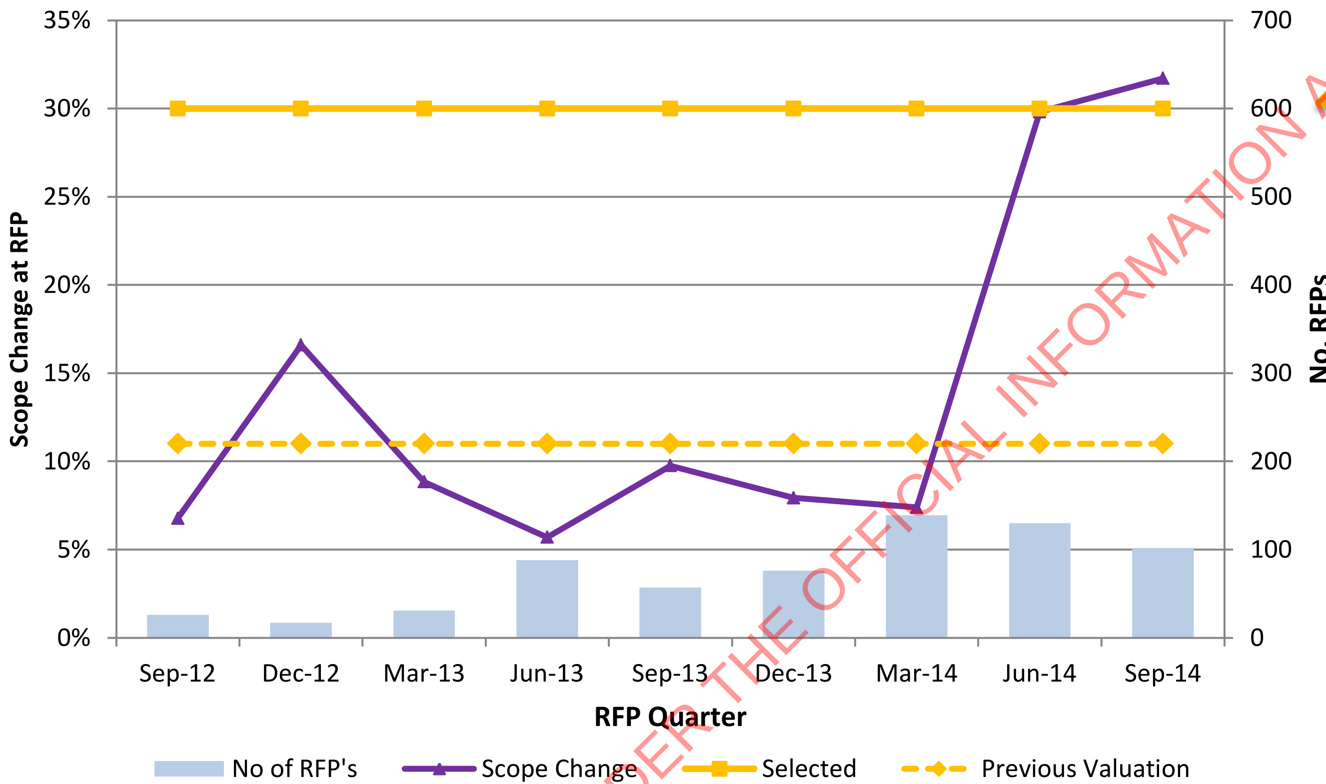
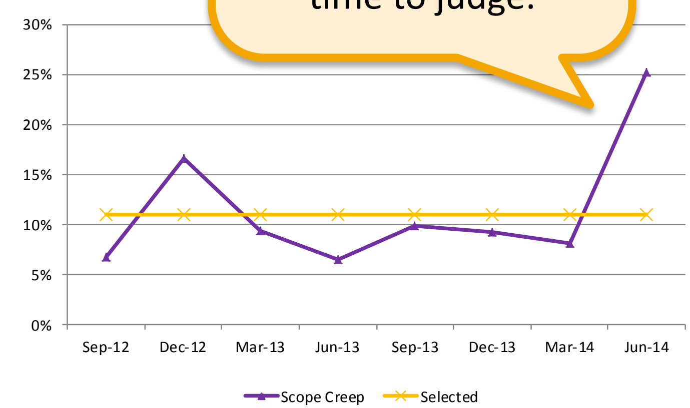
Over Cap Repairs – RFP Revisions



Scope related increases at RFP stage have been much higher in most recent periods

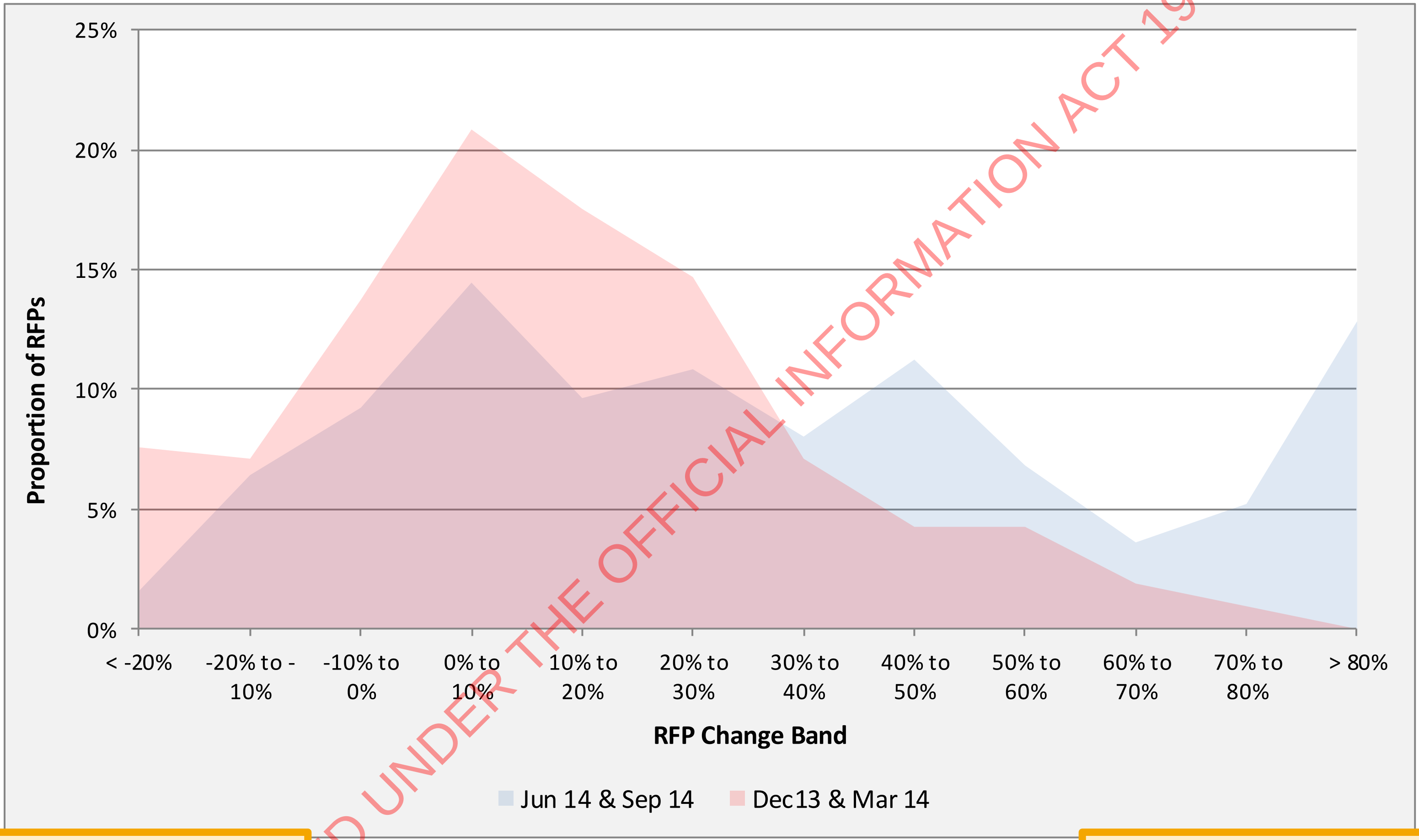
Observed early indications at June but insufficient experience at that time to judge.



No single factor to which the increase appears to be attributable

Repair process changes were made at the start of the year which were expected to have some effect from 2nd quarter (consistent with timing of observed "shift")

“Distribution” of % increases at RFP



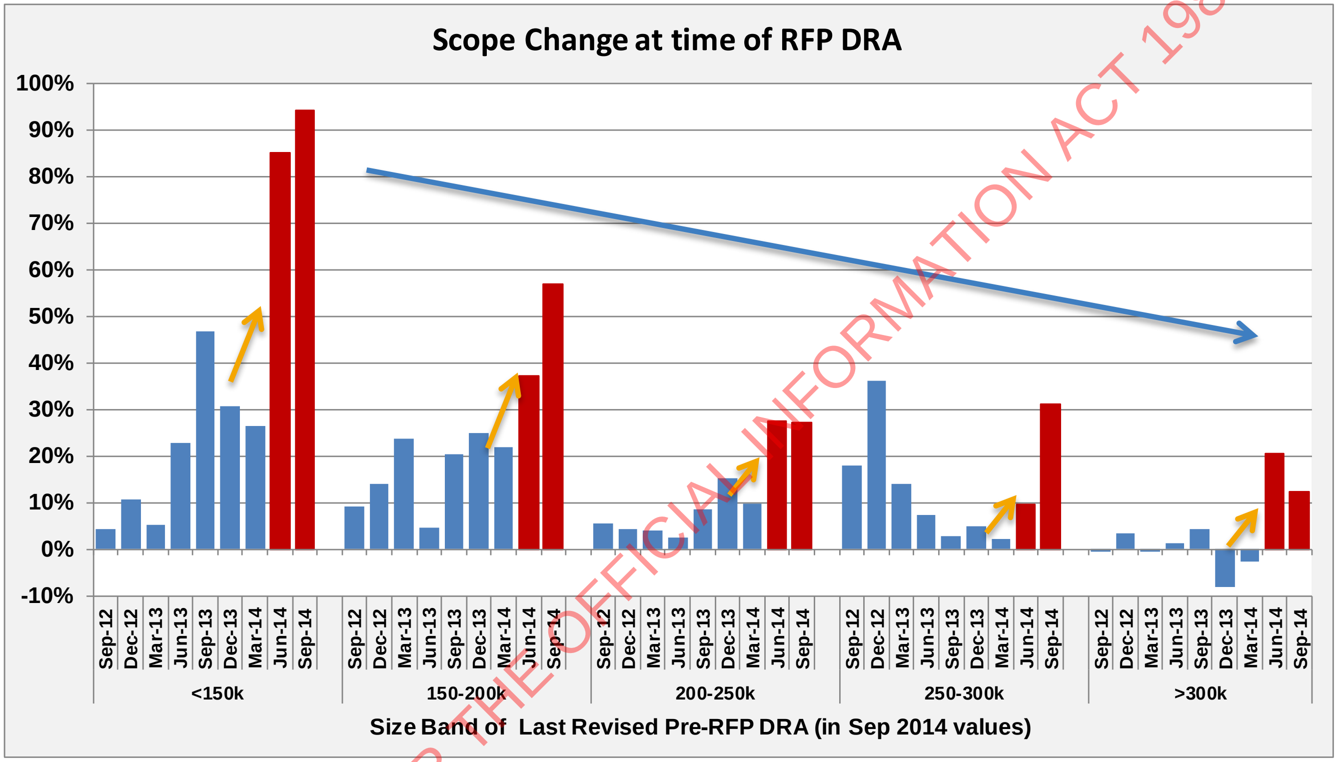
DRAs experiencing **reductions** at RFP stage:

- Last 6 months – 17%
- Prior – 28%

Increases of 40% or more at RFP stage:

- Last 6 months – 40%
- Prior – 10%

Observations on Repairs - Size of Pre-RFP DRAs



The amount of scope change is negatively correlated with the size of the original DRA. i.e. Lower original sizes have always experienced higher levels of scope creep.

In the last two quarters, there has been material scope creep across all size bands, even in the $250k+ bands. In lowest band the increase has been very dramatic, with scope creep now almost doubling the repair cost estimate

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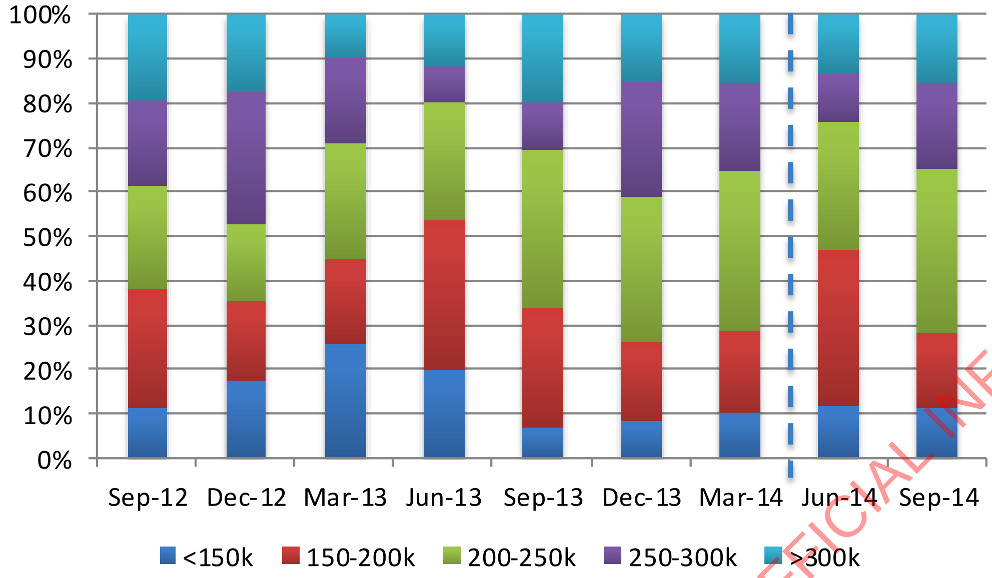
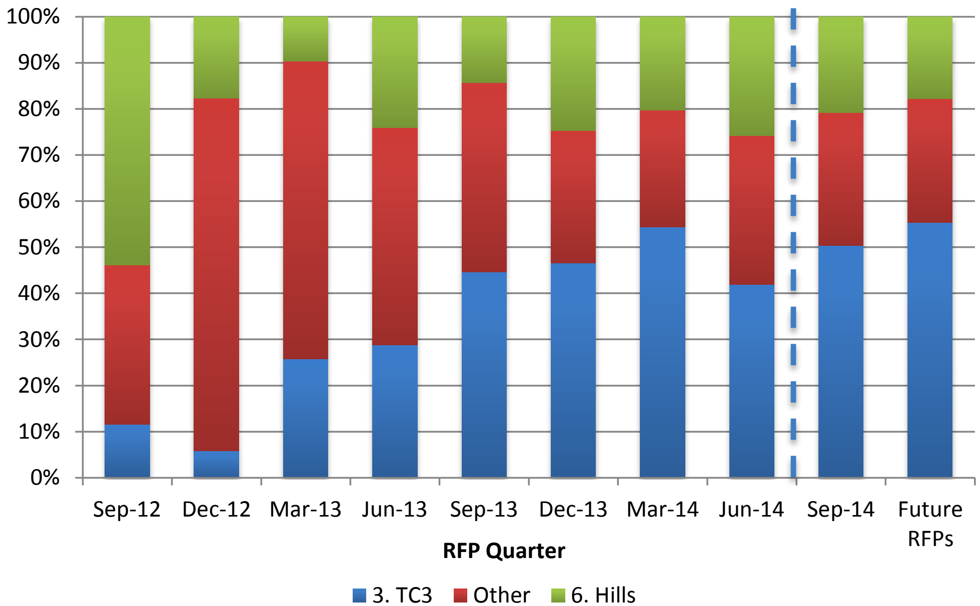
Influence of mix changes

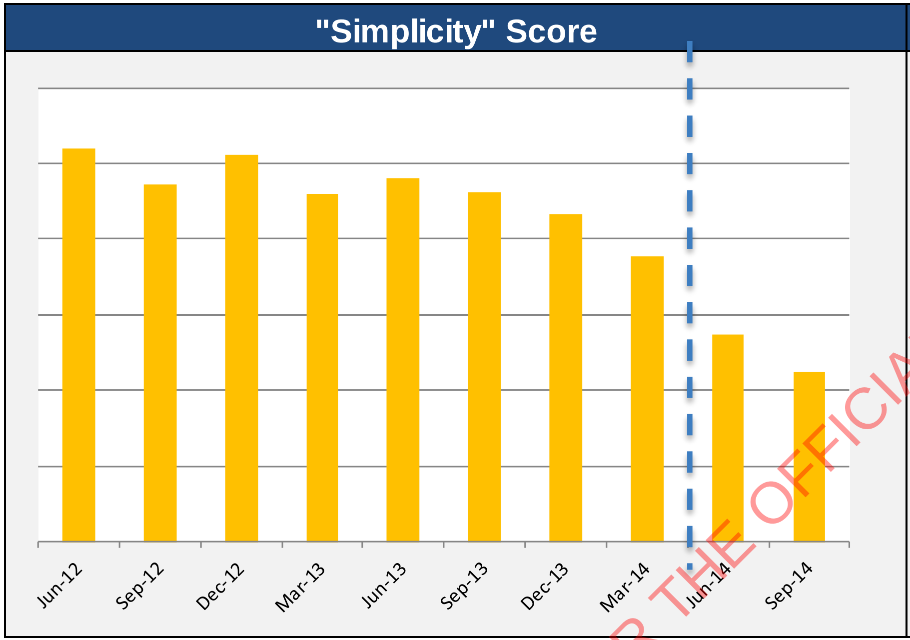


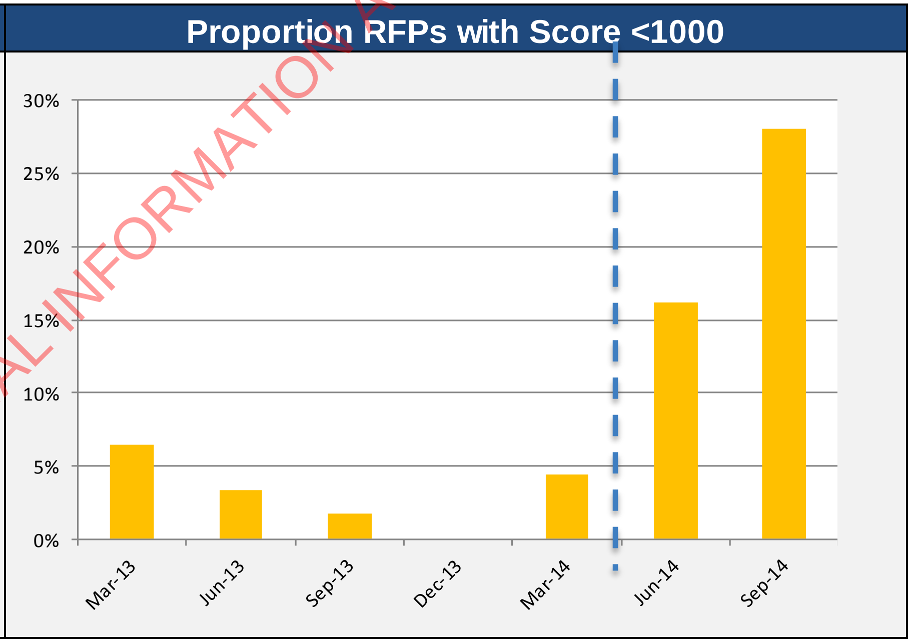
No major movement in mix by size that would account for the jump in scope related revisions

Land zone mix relatively stable in the last 12 months



Increasing complexity of repairs reaching RFP





Complexity of jobs has increased, although this was observed prior to Jun14 as well. May be that complexity only impacting cost (compared to initial assessments) beyond a certain threshold and we are now in that zone.

“Complexity” and RFP revision size relationship unclear

More complex

Less complex

	< -3000	-3000 to -2000	-2000 to -1000	-1000 to 0	0 to 1000	1000 to 2000	2000 to 4000
No. of RFPs Jun14 and Sep14	8	2	12	25	8	148	46
No. of RFPs Prior	1	0	2	7	3	154	255
Jun14 and Sep14	73%	110%	20%	37%	32%	26%	31%
Prior	10%		3%	7%	25%	7%	9%

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Sample of QS comments re: recent RFPs

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Summary

- We previously observed scope related increases at the RFP stage of up to 10%, the most recent RFPs have had scope related increases of around 30%
- No single factor to which the increase appears to be attributable. Discussions with SRES and Arrow suggest it could be a combination of a number of factors
- Regardless of cause, there is **nothing to suggest that the recent experience will not continue** or that it was due to exceptional circumstances unlikely to be repeated.
- Impact of 30% scope change vs 10%
  - Average projected size increased by $40k per property for over 1,300 repairs at Pre-RFP stage
  - ~$55 million in current values ($65 million inflated)

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Hypotheses regarding cause

- General compliance (scaffolding, wiring etc.)
- Increasing engineering education and caution around solutions
- Increasing complexity (land and damage)
- Foundation repair and consequential damage
- Throughput pressure
- Qualitative easing
- Arrow incentives in respect of throughput
- Arrow/SRES staff incentives and focus on throughput
- Use of Rover uncovering more unseen scope

Other factors

Escalation

- No change relative to June in assumed pattern of future escalation
- June quarter experience was in line with projections
- No change to Arrow cost schedules during the quarter suggests Arrow are not observing any particular cost pressures

	Dec-11	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14
Arrow Std Home Costings $000								
Arrow Cost Schedules	[redacted]							
% movement (annualised)								
Movt since Dec 11 (annualised)								
Market Testing								
% movement (annualised)								
Statistics NZ Indices								
Canterbury	1259	1386	1432	1473	1498	1518	1541	1567
% movement (annualised)		10%	14%	12.0%	7.0%	5.4%	6.2%	6.9%
Movt since Dec 11 (annualised)				11%	10%	10%	9%	9.1%
Auckland	*1214*	*1217*	*1221*	*1240*	*1252*	*1271*	*1293*	*1308*
% movement (annualised)		*0%*	*1%*	*6%*	*4%*	*6%*	*7%*	*5%*

withheld pursuant to sections 9(2)(i)and 9(2)(j)

Other Areas (1)

- Out of scope (~$4 million reduction)
  - Reduced numbers - clean up and removal of inactive claims (finalised for nil) and new claim reporting lower than anticipated
  - Minor increase in claim size (more complex claims) partly offset reduction to numbers
- Temporary Accommodation (~$1 million increase)
  - Reduced numbers - Under Cap claim lodgements slowing down more quickly than expected
  - Average size of Over Cap and Under Cap claims continues to increase

Other Areas (2)

- Lost rent claims (~ $1.5 million increase)
  - Remaining open claims lingering for longer than expected
    Should construction for these homes be prioritised?
  - No limit of time (or money) on lost rent cover means these can continue indefinitely
  - Currently costing around $200k a month (but reducing)
- Enhanced foundations
  - No change, contracted costs continue to be less than FORs estimates
- Payment pattern
  - Capacity constraints means some reshaping of pattern (pushing back of some construction starts to "flatten" peak)

Standing Issues

- Repairs in flood prone areas
  - Still a potential game changer (up to 2,000 SRES insured policies may be affected)
  - Case now in the courts, expect to develop over the coming months
- Compensation for land damage
  - Expected recoveries against enhanced foundation costs for some properties
  - Ultimate outcome still uncertain (currently assuming $10 million worth of recoveries)

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Distribution & Use

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Reliances & Limitations

We have relied on the accuracy and completeness of all data and other information (qualitative, quantitative, written and verbal) provided to us for the purpose of this presentation. We have not independently verified or audited the data but we have reviewed it for general reasonableness and consistency. It should be noted that if any data or other information is inaccurate or incomplete, we should be advised so that our advice can be revised, if warranted.

It is not possible to put a value on outstanding claims with certainty. As well as difficulties caused by limitations on the historical information, outcomes remain dependent on future events, including legislative, social and economic forces. 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 emergence will likely deviate, perhaps materially, from our estimates.

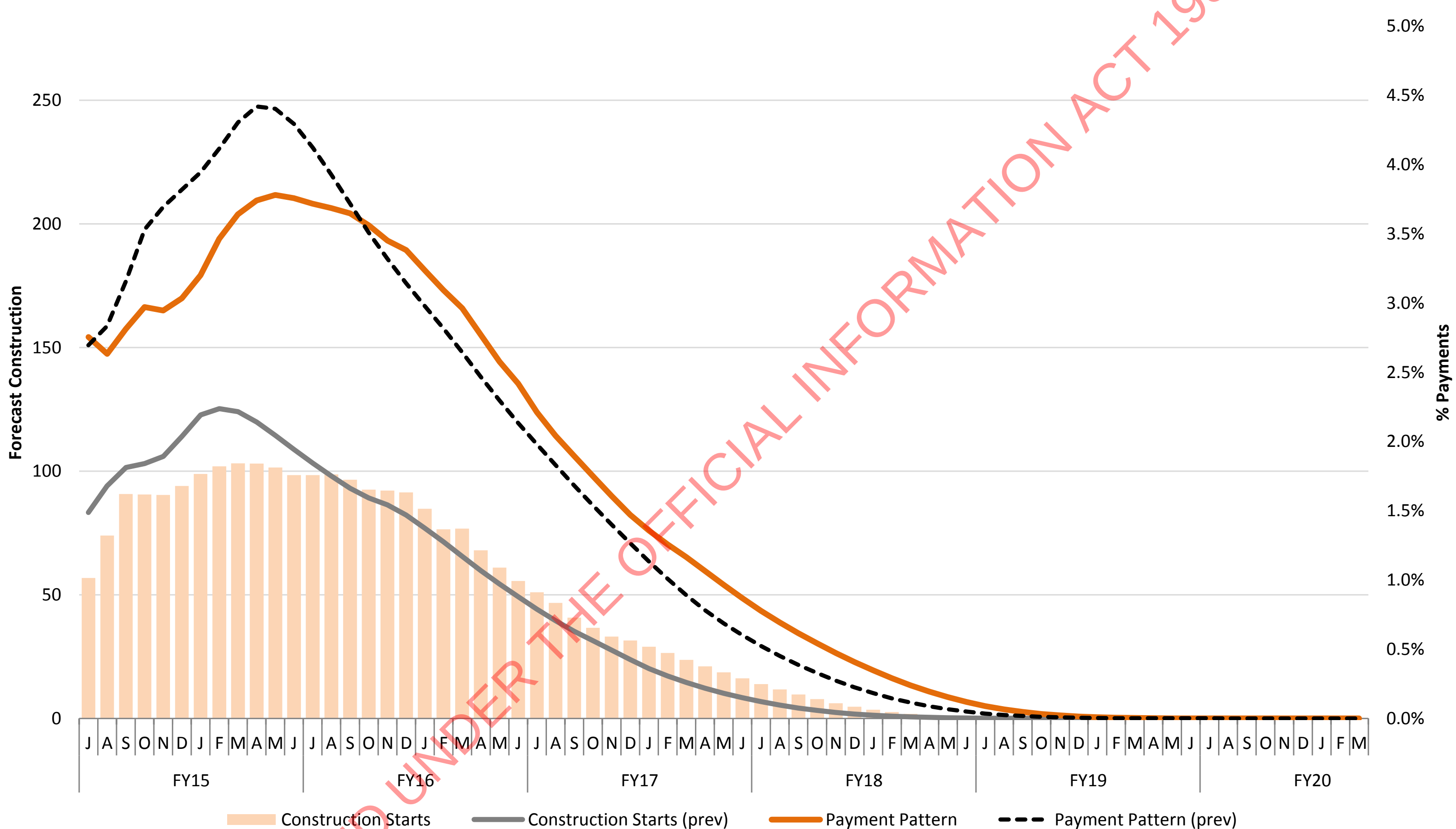
The presentation should be considered as a whole. Members of Finity staff are available to answer any queries, and the reader should seek that advice before drawing conclusions on any issue in doubt.

Throughput

Activity in Period Jan 14-Sep 14	Milestone						
	RFP Issued	Tender Response	Contract Signed	Consent Submitted	Consent Received	Site Established	Construct. Completed
Group Home Builds							
No Entering Phase		365	341	327	314	335	294
Arrow Target Completions	345	205	271	258	209	275	118
Finity Targets Aug 14	345	204	280	261	249	269	74
Actual No Completing	365	204	278	267	250	237	68
Shortfall vs Arrow Targets	-20	1	-7	-9	-41	38	50
% target	-6%	1%	-3%	-3%	-20%	14%	42%
Repairs							
No Entering Phase		395		316		248	235
Arrow Target Completions	467	164		154		176	125
Finity Targets Aug 14	467	172		132		168	88
Actual No Completing	395	123		155		198	97
Shortfall vs Arrow Targets	72	41		-1		-22	28
% target	15%	25%		-1%		-13%	22%

- Rebuild progress in line with projection
- Repairs
  - Tail of progress slower than allowed
  - Capacity constraints expected
- Some pushing out of payment pattern

Payment Pattern



finity