acs
claims services

Response to the Reserve Bank Document: *The view of the Reserve Bank on ACS (NZ) Limited's proposed scheme of arrangement under Part 15 of the Companies Act 1993*

1. Introduction

The Reserve Bank of New Zealand (or "the Bank ") plays an important role as prudential regulator and supervisor of the insurance industry. As such, the Bank has prepared a document providing its view of ACS (NZ) Limited's (or "ACS" or "the Company") proposed Scheme of Arrangement (or "Scheme"). This document has been published on ACS's website – www.acsclaimsservices.co.nz.

The Bank has indicated (see page 2 of its paper) that it is not making a specific recommendation on whether or not claimants should vote for or against the Scheme and will respect the will of creditors and claimants as expressed in the vote on the proposed Scheme.

ACS believes the Bank's analysis raises some useful points and should be carefully considered by Creditors. There are, however, a number of conclusions and key points made in the Bank's analysis that require further explanation or context from ACS. These are summarised below.

2. Solvency

The Reserve Bank states (page 2 of its paper) that "there is greater than 25% chance in a shortage of assets to cover costs, and a higher likelihood that insurer solvency requirements which come into effect on 30 June 2012 will not be met."

ACS's view is that the greater the risk of the Company's insolvency, the more the Scheme becomes desirable, or an attractive alternative to liquidation.

Before considering the Reserve Bank's comment, creditors should be aware that there are two solvency thresholds that will be applied to ACS.

The first standard is the solvency test under the Companies Act. Essentially, this test requires the company to be able to meet its liabilities as they fall due. If ACS fails to meet that test, it should be placed into liquidation or, if the Scheme is in place, a Trigger Event should be called. Under this test, ACS is currently solvent and directors believe it will continue to remain solvent until the settlement of all claims.

The second solvency test is a standard that will become effective on 30 June 2012 and is called the Solvency Standard for Non-Life Insurance Companies in Run-Off. This sets a much higher solvency bar for companies in ACS's position. It effectively requires a solvency "buffer" significantly higher than the Companies Act standard, on the basis that there may be a need for further capital if circumstances change adversely. This higher threshold allows for additional capital to cover all events which may occur, so that insolvency is unlikely to a 90% degree of probability. This could be seen as having additional back-stop cover.

Actuarial analysis by the Company indicates it will be able to meet this new standard also.

The Reserve Bank has, however, required the preparation of a second opinion from KPMG[1].

ACS is carefully considering the implications of the KPMG report, which has come to a materially different conclusion to ACS's own analysis on this point. The KPMG report takes a conservative stance on a number of matters critical to its conclusions.

However, the final KPMG report has been only very recently completed and directors will carefully consider its implications, particularly in the context of any decision under the Scheme to call a Trigger Event.

3. Fairness between claimants

The Reserve Bank says that (page 2) "[a] fundamental difference between liquidation and the proposed scheme is the difference in fairness between distributions amongst creditors of the same class." The Bank is concerned that the Scheme could involve "different creditors receiving distributions that represent a different proportion of assets with no mechanism to retrospectively adjust distributions."

ACS does not believe that the Scheme is unfair. Distributions will be made to creditors relative to the reinsurance in place for each event causing the insured damage on which a claim is based. If there is insufficient reinsurance to go around, payments will be made on an equal, pro-rata basis amongst entitled claimants under the Scheme. The Reserve Bank suggests that proportional payments may decline so late settlers are prejudiced. ACS would be very surprised if the Scheme Administrators would set payment percentages after a Trigger Event so that percentages decline over time. Typically in these circumstances, a series of progress payments are made to each creditor which increase the creditors' total pay-out until everyone is paid an equal proportion, so that this doesn't happen. It would be wrong to assume otherwise.

There is a chance that early settlers may get paid a higher percentage of their claims if a Trigger Event occurs after they settle, than late settlers would get if the Company's financial position was to seriously deteriorate. The Scheme requires the Scheme Administrators to assess, however, whether payments made to claimants prior to a Trigger Event should be recovered. The Scheme Administrators themselves can't "claw back" payments but, if deemed necessary, and after consultation with the Creditors' Committee, liquidators may be appointed to the

[1] At the direction of the Bank, ACS commissioned KPMG Actuarial Pty Ltd to examine reserve uncertainty as at 31 December 2011. KPMG's report is available on the ACS website.

Company so that recoveries (and other causes of action only available to liquidators) can be pursued.

It does not follow, necessarily, that a liquidator would seek to claw back any or all payments made by ACS, prior to liquidation, to claimants. Whether there is any claw-back realistically available to a liquidator will depend on several factors in the case of each payment. ACS believes that there would not be any substantial difference (between the Scheme and a liquidation) in this regard.

The Directors are acutely conscious of the need to consider the fairness between claimants when settling claims and will act properly when doing so and when considering whether a Trigger Event should be called. Again, it would be wrong to assume otherwise.

It should be emphasised that fairness has been a key consideration in design of the Scheme. The Scheme is required to be sanctioned by the High Court, and it would not be sanctioned if the Court considered it would result in unfair treatment for some creditors.

A fundamental difference between the Scheme and insolvent liquidation is that the Scheme will result in a faster, less disruptive settlement of outstanding claims and will maximise the value of claim payments to creditors. The Bank acknowledges (page 6) that "[a] scheme of arrangement may also provide less disruption to the timing of claims payments compared with liquidation."

4. Class voting issue

The Reserve Bank says that claimants who have the benefit of reinsurance should be treated as a separate class of creditors for the purpose of the scheme meeting.

The Bank correctly records that ACS has arranged the meeting so as to include all claimants in a single meeting, or class. ACS considers that is the correct approach, because there will be only one class of creditor under the Scheme.

It is important to note that no claimant is wholly reinsured. ACS' reinsurance is structured so that ACS will always retain responsibility for paying a portion of each claim. This is an orthodox structure for a reinsurance programme. The reinsured portion will vary across the different claims. Until now, there were a small number of non-earthquake related creditors whose claims were not reinsured. Those creditors comprise less than 5% of all claimants, and less than 1% of the total claims. ACS has recently taken steps to obtain additional reinsurance cover so that those claimants will also have the benefit of reinsurance.

The result is that every claim affected by the Scheme will be reinsured to some extent. This means that all creditors can be treated as one class and it is not necessary for claimants to consider the Scheme at two separate meetings.

5. The *Re Western Pacific* case

The Reserve Bank says that creditors should seek a clear explanation from ACS of how it intends to pay claims, in light of the case of *Re Western Pacific*. That case ruled that reinsurance proceeds should be paid to the insured claimants whose claims resulted in the reinsurance proceeds, rather than being divided amongst unsecured claims.

The Scheme preserves any charge that claimants have under the statute on which the *Western Pacific* decision was based. ACS has not reserved the right, in the Scheme, to depart from the law. The scheme requires ACS and the Scheme Administrators to give effect to any charge created by that statute. If the law is later changed, the Scheme will give effect to the law as it is changed, but such a change would affect policy holders regardless of whether a scheme or a liquidation were in place.

6. Adverse Development Cover

The Bank notes that the NZ$22 million of Adverse Development Cover ("ADC") provided by Ecclesiastical Insurance Office ("EIO") could be cancelled if the Scheme is not approved. This is correct, the ADC was provided partly as an incentive for creditors to support the Scheme. EIO was not legally obliged to grant the ADC, and so EIO was able to provide it on any basis it thought fit. It chose to provide the ADC (and pay for it) as an incentive for claimants to accept the Scheme in claimants' best interests. It was designed to make the Scheme pretty compelling. Whether the ADC is cancelled is a matter for EIO to decide at the time if the Scheme is not approved. EIO hopes it won't need to have to make that decision. However, the ACS directors believe, having generously provided the ADC, it is unlikely EIO will withdraw the cover.

7. Changes to ACS Ownership Structure

The Bank states that, because ACS has changed its name from Ansvar Insurance Limited and because ownership of the company has been transferred to the Canterbury Church and Heritage Charitable Trust, EIO is "distancing itself" from ACS. This is incorrect.

The name change was for practical reasons. First, to avoid confusion between Ansvar Insurance Limited in New Zealand and the company of the same name in Australia. Unfortunately there were no distinguishing features in either company names when set up, and this was potentially problematic for the Australian business, particularly when the Australian Ansvar Insurance Limited was offering to provide from Australia the balance of New Zealand policyholders' insurance after 1 December 2011.

Secondly, the name change was made to more accurately reflect the company's business which, following cancellation of policies, is entirely focused on claims management. ACS is an acronym for Ansvar Claims Services.

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In respect of the transfer of shares to the Trust, it was recognised early on that it would be wrong for EIO to withdraw any value of its existing business from New Zealand when it withdrew from the market. The intention culminated in the establishment of the Trust which benefits the community affected by the earthquake if there are any surplus funds. Any surplus of up to $5million will be distributed to the community, the remainder will be used to repay certain loans to EIO and then any balance after that will again go to the community.

In addition, transfer of shares to the Trust prevented the (albeit unlikely) prospect of any worldwide failure of the EIO group causing ACS to be placed into liquidation by its shareholders (contrary to the intentions of the Scheme). The international advisers recommended the separation of ACS from the EIO Group for this reason.

An ancillary benefit was that the EIO Group foreign shareholders were themselves subject to regulatory capital thresholds which were adversely affected by the losses in New Zealand. Separation of ACS from the EIO Group relieved further capital requirements on them.

The more important point is that, even though ACS is now not strictly part of the EIO Group, EIO is continuing to provide support to ACS in many ways and will continue to do so through its committed contributions, ADC cover and contracted management, actuarial and administrative services.

8. Support from EIO

The Reserve Bank concludes that, “The proposed Scheme is based on an inadequate injection of capital” by EIO.

This is an incorrect and unfair statement.

It is worth remembering that ACS was set up as a separate company. It had sufficient insurance in place for a one in 250 year earthquake event which was considered prudent at the time. What was experienced was an unprecedented series of earthquakes leading to losses beyond the one in 750 year modelled event for New Zealand. Like most insurers in Canterbury, this placed substantial stress on ACS. EIO had no legal obligation to contribute to ACS. Nevertheless, as ACS’s ultimate parent, EIO has made a significant contribution to relieving this stress and in supporting claimants in New Zealand. As noted in the Scheme documents provided to creditors, this has amounted to a commitment in excess of NZ$70 million. This is eight to nine times the value of EIO’s asset in New Zealand. This is a level of commitment any other international insurance company is unlikely to have made.

It is important to note that the idea of the Scheme of Arrangement was to improve the position of creditors; to expedite claims settlements and allow claimants to get on with their lives and restoring the community. There is no doubt in the minds of ACS directors that a Scheme will result in better outcomes for creditors than an insolvent liquidation.