RESERVE BANK OF NEW ZEALAND

THE TREASURY
Kaitohutohu Kaupapa Rawa

Joint Report: Christchurch Insurance Update

Date:	10 March 2011	Report No:	T2011/391

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	Note the contents of this report	11 March 2011
Minister for Earthquake Recovery (Hon Gerry Brownlee	Note the contents of this report	11 March 2011

Contact for Telephone Discussion (if required)

Name	Position	Telephone	1st Contact
Jeremy Corban	Deputy Secretary, Business Environment and Skills, Treasury	[Withheld under s9(2)(a)]	✓
Toby Fiennes	Head of Prudential Supervision Reserve Bank of New Zealand		

Minister of Finance's Office Actions (if required)

None.

Enclosure: **No**

Joint Treasury/RBNZ Report: Christchurch Insurance Update

Executive Summary

AMI's Chairman yesterday raised with your office the risk that, if the initial estimates of 10,000 homes needing to be rebuilt/written off are correct, there is a chance it may not be able to meet all its obligations to policy holders.

Officials have since had discussions with AMI to try and understand its financial position. The outlook for AMI is very uncertain, as it is likely to be some weeks before the outlook is clearer, given that the key uncertainty is the number of Christchurch homes that are assessed as requiring total rebuild or to be written off.

Our initial assessment is that if the 10,000 is accurate, AMI's is vulnerable but there are wide error bounds around its financial position in that event. Our current estimates are that this would place their net asset position at $80m +/- $120m although does not preclude a significantly worse outcome.

Officials will step up their monitoring of the situation and will investigate resolution options should Ministers wish to intervene in the event of AMI's financial distress.

We do not expect other insurers to be as vulnerable as AMI. [Withheld under s6(b)]

We would recommend you keep public comment to a minimum at this stage given the high degree of uncertainty about AMI's position.

Communications

Given the high degree of uncertainty about AMI's actual position, we would recommend that you keep comment to a minimum at this time, focussing any comments on the soundness of the sector as a whole. Some suggested talking points are:

- The Government is well aware that the Christchurch quakes have had a significant effect on the insurance industry.
- The advice we've received to date is that the insurance system is sound and that reinsurance cover is sufficient.
- Officials continue to monitor the insurance industry.
- The Government does not comment on the situation of individual firms.

Recommended Action

We recommend that you:

a Note that AMI's financial situation is uncertain at this time

b Note that officials will be stepping up their monitoring of the situation and will be considering a range of resolution options, including private sector resolution options, in case they are required

c Note that we recommend that Ministers limit any public comment to commenting on the overall stability of the insurance sector

Jeremy Corban
Deputy Secretary,
for Secretary to the Treasury

Toby Fiennes
Head of Prudential Supervision,
Reserve Bank of New Zealand

Hon Bill English
Minister of Finance

Treasury/RBNZ Report: Christchurch Insurance Update

Purpose of Report

1. This report provides you with initial advice on the financial position of AMI insurance and outlines how we will be monitoring its position over the near-term. It also outlines the expected economic impacts in the event of its insolvency and provides some preliminary thinking on options for government involvement should it occur. Finally we provide some suggested communication lines for the near-term

Initial Assessment of Financial Position of AMI and the wider insurance sector and Near-term Monitoring Plan

2. Yesterday the CEO of AMI informed you that he was concerned that if estimate of 10,000 homes to be rebuilt/written off was correct, he was concerned about AMI's ability to meet its obligations.

3. We stress that at this stage, while around 10,000 is EQC's best estimate of the number of homes that may require rebuild or written off, this is based on an initial drive-by assessment of the area. At this stage EQC have not done any individual assessments of properties and it is likely to be some weeks before they complete this kind of assessment. AMI's commercial insurance exposure is far less significant.

Background on AMI

4. AMI Insurance Limited is New Zealand's fourth largest general insurer. Their network of 73 branches, 2 call centres and 22 agencies is the largest network of any fire and general insurer in New Zealand. It offers house contents, car and boat insurance. The main house insurance product provides full replacement (rebuilds your home as new to the same floor area) which places any inflation risks on to the insurer, not the policyholder.

5. In the year ended 30 June 2010, their gross written premiums (turnover) amounted to $342m and their capital base stood at $364m. They have stated that their market share in Canterbury is 35 percent. Market share will be lower outside of Canterbury and much lower outside of the South Island. The annex contains further information on AMI

AMI's solvency position

6. AMI retains the first $5m under its catastrophe reinsurance programme with cover, for the 22 February 2011 earthquake and its aftershocks, up to $600m. Any amount over this $600m falls back on to AMI. They now have in place reinsurance of up to $1 billion for further catastrophes. EQC are the first loss insurer for homes damaged by earthquake up to $100,000 with AMI picking up the balance.

7. In the context of previous advice from AMI on their gross claims from the 4 September 2010 quake being $150m, the possibility of claims exceeding reinsurance limits of $600m from the 22 February 2011 quake seemed unlikely. With their advice yesterday that 4 September 2010 quake gross claims were $400m, the prospect of claims exceeding reinsurance limits is more plausible although not a certainty.

8. On a base scenario, assuming 10,000 Christchurch homes are at issue, the RBNZ has estimated AMI's net assets at $80 m +/- $120m. At this level AMI's solvency in terms of

the Companies Act is uncertain but it could be insolvent as measured by the RBNZ's draft non-life insurer solvency standards.

9. The net claims borne by AMI are very sensitive to one main assumption – how many homes do they insure which require either total replacement or are very badly damaged? Assumptions for contents damage, or for minor building damage are secondary in effect although still substantial sums. Other claims (such as motor and commercial) factor even less for AMI and have not been included in the Bank's analysis.

10. Relatively small changes in assumptions can change the position for AMI by large amounts. AMI estimated net assets vary by more than $400m depending on assumptions.

11. Here is a simple table summarising AMI's estimated financial position on a best estimate basis (i.e. without illustrating the uncertainty of +/-$400m)

AMI

Net assets at 30 June 2010	$	364,000,000	
Net claims from 4-Sep-10	$	5,000,000	
Adjusted net assets	$	359,000,000	
Catastrophe reinsurance cover	$	595,000,000	limit less retention
Available funds to meet claims	$	954,000,000	
Estimated gross claims	$	875,000,000	
Adjusted net assets after 22-Feb-11	$	79,000,000	

Assumptions - best estimate, 35% share of badly damaged houses

All of this indicates AMI is vulnerable, and that there is considerable uncertainty as to their current solvency position. The RBNZ will step up its monitoring and analysis with the aim of significantly reducing this margin of uncertainty. The RBNZ is not yet the supervisor of AMI so is relying on information provided by management. Should they have concerns over the quality of information provided, they will explore early licensing of AMI to allow the Insurance Act's investigation provisions to be used.

AMI says it has put in place enhanced reinsurance arrangements that now cover catastrophe risk of up to $1bn. This would mean they should be able to withstand another, separate event (say of a similar size to the 4 September earthquake).

Liquidity

12. Liquidity does not appear to be a problem. They hold over $500m of cash or high quality marketable securities. The issues are more of:

- **in a worst case, long term solvency risk** - under certain assumptions, AMI may in fact be unable to meet all policyholder claims in full.

- **in a slightly less worse case, long term viability risk** - AMI's capital resources and reputation could be impaired to the extent that the business is no longer viable. For example AMI may not be able to meet new prudential solvency standards.

- **market perception and loss of confidence in AMI** if AMI is believed to have been mortally damaged by the 22 February 2011 event, it could lead to a flight of business and policyholders.

Impact of a failure or loss of market confidence

13. Other major insurers are not expected to be adversely impacted by AMI's difficulties.
[Witheld under s6(b)]

14. As part of its monitoring the Reserve Bank will assess other insurers' vulnerability.
[Witheld under s9(2)(d) and s9(2)(b)(ii)]

Flow on effects of failure (in absence of government support)

15. As noted above, AMI's financial position is currently very uncertain and will only become clearer in the coming weeks. Likewise, the size of any funding shortfall is also unknown now and this will have an impact on the scale of the effect. This section gives a qualitative overview of the kinds of impacts its failure could have.

- **Impact on Christchurch rebuild** - Given AMI's dominance in the Christchurch residential market, its inability to pay out on earthquake damage claims could have a significant (at least short-term) impact on the rebuilding process in Christchurch particularly in the residential market. There are two broad channels by which this would impact on Canterbury's recovery. Firstly the confidence impacts from a likely protracted period of uncertainty about the likelihood of payout could be quite significant at a time when confidence is already very fragile. Secondly, the shortfall between payouts and claims represents a destruction of wealth in the Canterbury economy with the flow on effects to demand. The size of any shortfall is unknown at this time but clearly the larger it is the larger and more enduring this wealth effect will be.

- **Impact on AMI's policyholders -** For those who have policies with AMI who have incurred claims or who are awaiting payment, the insolvency of AMI and its placement into a resolution process (eg liquidation, statutory management) will be very disruptive.

- **Impact on insurance availability and pricing more widely** - AMI's failure would lead to disruption for current policy holders as they will need to seek alternative insurers beyond the normal exclusion period after a calamity. This disruption is likely to be particularly pronounced in the domestic insurance market where AMI is the second biggest insurer (behind IAG). Given the time constraints for this report, we cannot say conclusively that other insurers will be prepared to expand their exposure to Christchurch and New Zealand more generally over a short-time frame (in close succession to a major insurance event). We will do further analysis to understand the likely wider insurance market reaction in coming days. Our assessment that the other major players in the sector are in good financial health bodes positively but this needs to be set against the firms' appetite to increase their exposure to New Zealand at this time. It any event, we would expect that the pricing of household insurances by other insurers will increase by more than what would have otherwise been the case, if insurers have some reluctance to increase their New Zealand exposure. This upward price pressure would be exacerbated if AMI had underpriced its Christchurch insurance because it had not purchased enough catastrophe cover.

Nonetheless, AMI's policy holders will likely lose any premium that they have prepaid (likely to be a maximum of one year). This is likely to cause discontent amongst some policy holders, but we would view it as a cost that is best borne by them. Given AMI has limited involvement in non-household insurance, we would not expect this to spill-over into reduced availability of other types of insurance products, such as the liability insurance that will be important for rebuild in Christchurch.

- ***Risk of spill over to the wider insurance/financial sector -*** unlike banks where instability in one bank can lead to a run on others, the only 'claim' policy holders have on their insurance company is any pre-paid premium so it is difficult to envisage a situation where the failure of one insurer would become contagious to others (cross-investments are low among insurers in New Zealand). The event is however likely to draw international attention to New Zealand's financial stability and so it will be important that, whether or not the government intervenes in the situation, the idiosyncratic nature of this failure is stressed. The immediate market reaction to any negative financial stability story is likely to be downward pressure on the currency and an increase in interest rate spreads, at least until the market learns more facts.

- ***Impact on bank asset quality*** - the impact on bank asset quality should be relatively contained across the system, given that Christchurch only accounts for around 10-15% of bank loan books and AMI only insures a subset of these.

- ***Lower than otherwise Crown revenue*** – due to a further slowing in the speed of recovery in Christchurch.

- ***Equity issues regarding payout***– in the event of insolvency, claims would be settled on a parri passu basis so that all policy holders would be treated equally. However, until the point of insolvency (potentially some time) claims will be settled on a first in first out basis which could raise equity issues as those who lodged claims first would get superior outcomes. In this situation there may have been good reason why some people were delayed in lodging their claims. EQC's experience is that it is typically those who have large claims who lodge earliest so this suggests that those adversely affected would be those at the lower end of the claims spectrum. We note that the EQC's first loss position means that no policy holder, regardless of when their claim was lodged would be left completely empty handed.

Intervention options

16. We expect the most significant impact of the failure of AMI is likely to be on the speed of the recovery in Christchurch, given AMI's dominant position in household insurance there.

17. A private sector solution is a first- best resolution option which would minimise any government intervention and may limit the potential impacts upon policyholders. An acquisition by another insurer would need to be explored if AMI is likely to be

insolvent. Capital cannot be raised from AMI's members because it is a mutual, but alternatives such as an investment stake from a capital rich partner may be possible. If AMI's mutual status was an impediment to any possible private sector solutions, demutualisation could have to be part of any necessary restructuring.

18. It may also be possible for additional owners (policy holders) to provide more capital, although this will require further investigation

19. The Insurance Prudential Supervision Act (IPSA) provides an efficient mechanism for an insurer to transfer its portfolio to another insurer with the Bank's approval. Court-based processes, that would otherwise apply, are unnecessary.

20. In the absence of a commercial solution, the Crown could look to provide some sort of support to AMI policy holders to minimise the economic impacts. This support could take two broad forms – providing support to AMI as an entity (either via an equity injection, loan or by guaranteeing its obligations) or the Crown could allow AMI to fail but assume its obligation to policy holders. In forming a judgement about whether to intervene, it seems that the key assessment is weighing the benefits in terms of avoiding any further knocks to Christchurch's recovery prospects against the direct fiscal impacts and indirect fiscal risks and the downsides of the government intervening in the commercial sector. In particular:

- ***Fiscal implications*** – the size of any capital shortfall is very uncertain now but it will add to the fiscal deficit

- ***Perceptions of sovereign risk profile*** – perhaps more significant than the direct dollar cost of any government support is the risk that any government support causes offshore investors to re-assess the Crown's risk profile if this is seen as a signal that future 'bail outs' of the financial sector are now more likely than previously thought. This is particularly relevant now given rating agencies are reviewing their methodologies and placing more weight on governments' contingent risks, of which the financial sector is a major one. It is difficult to gauge how large this risk is, but there is likely already some expectation of this built into markets, given recent experience around the world and here in the global financial crisis. Nevertheless, any government intervention would need to be carefully communicated to financial markets and rating agencies, stressing the idiosyncratic nature of this failure and the grounds for intervention.

- ***Moral hazard/precedent effects*** – any move by the government to support a failed financial sector participant is likely to strengthen the perception amongst consumers, and possibly the sector itself, that the government is prepared to step in to guard them against loss. In the first instance, it is quite likely that any type of intervention would lead to a strong expectation that the government would support any institution affected by this event. There is also the question of whether this would extend to building a more general expectation of the government supporting the financial sector firms in any distress scenario. A case can be made that this is a response to a very extreme event and so should not be seen by consumers as the kind of protection they should expect at all times. It may be possible to preserve an element of 'buyer beware' by applying some kind of modest haircut to all payouts but we would have to investigate this further.

21. Given limited time we have not formed a firm position on what the best intervention strategy would be if the government did wish to do so. The table below sets out the pros and cons of the two main options. As we monitor developments with AMI's financial position, we will continue to give thought to how the various trade-offs involved in different intervention options.

Table One: Pros and cons of high-level options

Option	Allow AMI to fail with no government support	Private sector solution (potentially with government support)	Support AMI in its entirety	Allow AMI to fail but Crown stands behind claims
Pros	Less direct fiscal costs to Crown Preserves market incentives	Minimise government intervention Reduce impact on policy holders Could help to preserve market incentives	Administratively simpler in the pay-out phase as preserves all existing infrastructure As AMI is not necessarily insolvent, it improves the ability of AMI to trade out of its difficulties, under close prudential supervision.	Preferable from a signalling/precedent perspective as doesn't preserve failed entity* Exit straightforward no on-going ownership interest
Cons	Slow down Christchurch rebuild Wealth effects Immediate confidence effects Equity implications if claims paid on first-come-first-served basis	Dependent on private sector firms Government support needed to facilitate any transaction	Poor signalling value/precedent effect by supporting a failed business* Residual Crown liability/ownership issues	Administratively more difficult in payout phase, likely to be delays

* A modest haircut to policy holders, if it could be implemented, would help to manage direct fiscal costs and precedent effects.

22. If AMI is to be allowed to fail there are several resolution options that may apply including liquidation, voluntary administration or statutory management under the Corporations Investigation and Management Act. Potentially aspects of the IPSA can be made to apply. The Reserve Bank can provide further advice.

Communication

23. Given the high degree of uncertainty about AMI's actual position, we would recommend that you keep public comment to a minimum at this time. If asked about this issue in the next few days, we suggest you use the following talking points:

- The Government is well aware that the Christchurch quakes have had a significant effect on the insurance industry.

- The advice we've received to date is that the insurance system is sound and that reinsurance cover is sufficient.

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- Officials continue to monitor the insurance industry.

- The Government does not comment on the situation of individual firms.

24. Two possible triggers for this issue gaining more public attention could be when other insurance firms re-enter the market in Christchurch, or when its rating agency makes any statement. We are following up to work out when these events could occur.

The RBNZ will take a similar line if asked

Annex: Further background on AMI

AMI has had an A+ rating from A.M. Best since 9 October 2008. An A+ rating is A M Best's second highest rating of 15 categories.

AMI is incorporated in New Zealand and is owned by AMI Insurance Holdings Ltd. New Zealand Permanent Trustees Ltd, the trustee of the AMI Members Trust, holds the shares of AMI Insurance Holdings Ltd in trust for the benefit of AMI policyholders. The AMI Members Trust is domiciled and operates entirely in New Zealand. It therefore has no shareholders and no parent to request additional funds from – it stands alone.

AMI has seven directors, all resident in New Zealand, including Kerry Nolan (Chairman) and John Balmforth (CEO), R M Flower, D J Wolfenden, T L Kerr, B D Gargiulo and P M Shewell..

AMI has a number of subsidiary companies (see below) – none of these are insurers (Clic targets young drivers and modified vehicles but insures them with AMI).