

SENSITIVE

CHRISTCHURCH INSURANCE UPDATE

Date	17 March 2011	Report number	4650
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Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	Note the contents of this report	To be discussed at 17 March meeting
Minister for Earthquake Recovery (Hon Gerry Brownlee)	Note the contents of this report	None

Contacts

	Position	Telephone		1 st contact
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Minister of Finance's Office Actions

If agreed, forward this report to the Prime Minister for his information.

PURPOSE

1. This report provides an update on the financial impact of the Christchurch earthquake on the NZ insurance sector and makes recommendations on the Government's response.
2. The report comprises a joint RBNZ/Treasury recommendations and summary section and an appendix with details about individual insurers is also provided.

3. A fuller report on these matters is being finalised and will be submitted to you in the next few days.

RECOMMENDATIONS AND EXECUTIVE SUMMARY

- a. **Note** Treasury and the Reserve Bank are in agreement with the recommendations of this report.

Situation assessment

- b. **Note** that pending the large quantum of claims after the 22 February Christchurch earthquake, the following insurers are at high risk of failure:
 - AMI – a large Christchurch based mutual company specialising in residential cover;
 - Western Pacific – a small Queenstown based private company specialising in small business cover; and
 - Civic Assurance and, LAPP – special purpose nationally based local authority owned companies specialising in local authority cover;
- c. **Note** there are a range of other insurers that officials are monitoring that may be at risk should insured losses exceed current expectations, and officials will report separately should these insurers become high risk.
- d. **Note** that at this stage officials do not consider that the recent Japanese calamity should have a significant impact on reinsurers' financial capability to meet their Christchurch earthquake obligations, but it could add pressure on future New Zealand reinsurance pricing and terms of cover.
- e. **Note** that, other than Western Pacific which is likely to fail within the next week or so, the timing of possible insurance company failures is not clear, depending on the on-going assessment by the companies of their own solvency and ability to manage their own positions;
- f. **Note** that until there is more information from the companies, it is not clear the size of any solvency shortfall, or capital shortfall to ensure future viability (the current estimate for AMI is between positive net assets of \$200m and negative net assets of \$500m, although there remains considerable doubt about loss estimates and the actual position is unlikely to be known for a number of months or even over a year);
- g. **Note** There are several triggers that could necessitate an immediate response from Government in relation to AMI over the next few days (these include media interest, rating agency actions and AMI board decisions in relation to solvency risk).

Intervention objectives and constraints

- h. **Agree** that the following are the objectives and principles/constraints for guiding possible Government intervention, taking into account your stated preference to be commercial to the greatest extent possible, provide the Government with the necessary control and provide clear exit options:

Proposed objectives

1. In considering the Government's response to events in the insurance sector, we propose that the primary objectives be to:
 - a. ensure that the rebuild of Christchurch and the survival of the local economy is not jeopardised by solvency or liquidity issues for some insurers;
 - b. maintain the soundness and efficiency of, and confidence in, the NZ insurance sector.

Principles/ Constraints

2. We propose the options also be evaluated against the following constraints or principles:
 - a. Government support is targeted at meeting the proposed objectives and fiscal risks are appropriately managed;
 - b. Solutions are commercially-oriented as far as possible;
 - c. The government's interests are appropriately recognised and aligned in any resolution process, including through the degree of control it has over decision making;
 - d. The government has options and flexibility regarding the exit strategy;
 - e. Implications for perceptions of New Zealand's sovereign risk profile (both directly and indirectly through what it signals about government's likelihood of intervention in future); and
 - f. Resolution options will need to reflect administrative, legal and commercial practicalities.

In any actions featuring direct and significant involvement of the RBNZ, the RBNZ will need to be mindful of the purposes and principles under the Insurance Prudential Supervision Act (IPSA) in order to maintain the integrity of the regime for the longer term, even though the regime does not apply to insurance companies at this point in time.

Problem definition

- i. **Note** that if AMI determines it is unable to continue as a going concern then purely private sector solutions (such as purchase of the failed company or additional capital from owners or private investors) are not realistic for AMI (or for Western Pacific) in the near term.
- j. **Note** that if AMI were to go into liquidation, this would be expected to have major implications for the rebuilding effort in Christchurch as well as nation-wide implications. It would be expected to:
 - a. significantly delay the claims process, possibly for years (AMI has approximately 30% market share in Christchurch);
 - b. result in claims only partially being met (e.g., something in the order of a 50% payout could be possible);
 - c. result in many AMI policy holders in Christchurch, not having insurance cover for an extended period of time (this could be anything from several months to over a year);
 - d. result in AMI policy holders outside of Christchurch needing to find new insurance providers. AMI is the second largest residential insurer in New Zealand. There are 450,000 policy holders, and 1.2m AMI policies throughout New Zealand. In the current market we do not know the willingness or capability of other insurance providers to pick up these policy holders, or how long that would take given the difficult market conditions at present (it would require them to obtain more reinsurance, more capital etc., which may be difficult, at least in the short term); and
 - e. it may have contagion effects to other insurers, although we are not able to quantify the extent of this risk.
- k. **Note** there are risks of government intervention in AMI that need to be managed to the extent that they can, including:
 - a. precedent effects of any government support of AMI and/or its policy holders; and
 - b. minimal knowledge of AMI's business and the extent of any potential solvency or business viability problem.

Resolution recommendations

- 1. **Note** that officials consider maintaining AMI as a going concern is the best solution because (compared to a wind-down solution):
 - f. it will ensure continued orderly function of insurance markets nation-wide;

- g. it will minimise the spill-over effects of the company winding up in the current environment; and
 - h. our assessment is that the company has a sound business model and management and our current assessment is that there are reasonable prospects for the business to continue as an un-supported going concern in future.
- m. **Agree** that a resolution of AMI should maintain the firm as a going concern, and in order to avoid the significant disruption to the industry and the local Canterbury economy that could result from wind-up solutions;
- n. **Agree** that if the Government was to support AMI, the existing AMI management should, initially at least, remain in place;
- o. **Note** that there are two broad categories of going-concern resolution mechanisms – direct government financial support to the firm and supporting the firm in statutory management;
- p. **Note** that officials’ view is that direct support is likely to be the most effective way of maintaining AMI as a going concern and has the following advantages over statutory management:
- a. it will likely preserve AMI’s existing contractual relationships, critically its reinsurance agreements, while statutory management may not to do so;
 - b. it is more likely to secure AMI’s future as a going concern because it is less intrusive and its signal value is more clearly that the entity is expected to remain in operation where statutory management is likely to be perceived as a wind-down solution;
 - c. it provides maximum flexibility – it does not close off the option of using statutory management at any stage the outlook for the firm deteriorates as more information becomes available;
 - d. it provides the Crown the ability to include any direct control mechanisms it wishes to have; and
 - e. its low key nature means it is less likely to lead to any flow on effects about the health of the insurance sector more generally.
- q. **Note** that there are a range of methods for providing support to AMI including a capital injection, guarantee or loan;
- r. **Note** that officials will provide further advice on the best method of providing support while also protecting the Government’s interests, providing an adequate level of Government control and maintaining suitable exit options;

- s. **Note** that under any direct support mechanism, “ring fencing” support to earthquake related Christchurch claimants is unlikely to be possible;
- t. **Note** officials’ preliminary view that Western Pacific’s financial distress would have occurred even without the recent earthquakes;
- u. **Agree** that – based on our current understanding of the company’s situation - government support should not be provided to Western Pacific or its policy holders at this point in time as the same rationale for intervention does not apply (regarding the impact on rebuilding in Christchurch and supporting the operation of insurance markets nationally);
- v. **Note** that any decision to treat Western Pacific different from AMI will be assessed for legal risk by Crown Law.

Next steps

- w. **Agree** AMI be advised by the RBNZ and Treasury of the Government’s stance on Friday 18 March, ahead of their meeting with their rating agency on Monday 21 March;
- x. **Note** that officials will work to further develop options as to the form of support, including preferred options for your agreement;

Communications

- y. **Agree** that in the interim that Ministers keep public comments to a minimum, but if necessary comments could generally cover:
 - the Government’s commitments to Christchurch’s recovery and the importance of private insurance to this end;
 - the need to monitor that policy holders’ needs continue to be met;
 - the general desire for commercial solutions where possible, but if this is not possible the government will assess its options;
- z. **Note** Reserve Bank’s communication would explain that its supervisory powers are not yet in force (as no insurers are licensed) but as the appointed prudential regulator of the insurance sector it does have a role in advising Government on the soundness and efficiency of the insurance sector.

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

Please sign the enclosed original and contact Alison McKessar at the Reserve Bank on 417 3607 to arrange collection.

Agreed:

Hon Bill English
Minister of Finance

APPENDIX – DETAILED ASSESSMENT OF THE NEW ZEALAND INSURANCE SECTOR

AMI

1. AMI has an approximate 35% share of the residential market in Christchurch. As a mutually-owned insurer there is no additional capital support from a parent company in the event of financial difficulties and capital raising is difficult.
2. There is fundamental uncertainty over the level of claims for which AMI will be liable due to the unprecedented nature of two major earthquakes in a relatively short time period, and a complicated interaction with EQC cover. Assessments for the 4 September 2010 quake had not been completed when the 22 February 2011 quake struck.
3. The biggest driver for the uncertainty is the number of houses needing to be rebuilt. A further large driver for uncertain claims costs is the cost of repairing houses with damage exceeding EQC limits but not requiring a complete replacement. A single house repair claim could cost a private insurer almost nothing (if the cost of repairs is close to EQC limit), or hundreds of thousands of dollars depending on the extent of damage. Thus to materially reduce uncertainty on claims costs there needs to be more certainty on which insured houses need to be rebuilt or repaired, and some indication of the costs of doing so. Clarity on the total number of houses needing to be rebuilt will reduce, but will not of itself remove, uncertainty on the claims costs.
4. On 11 March 2011 EQC announced an initial 30-minute assessment of all houses in Christchurch and Lyttelton will take 2 months, and thus the fundamental uncertainty on claims costs will remain for the next month at least. A full assessment of houses at say 5-6 hours per assessment will take months (say nine months or more).
5. On the assumption of 10,000 houses needing to be rebuilt, AMI estimates gross claims arising from 22 February 2011 quake in the order of \$1-1.5b. The AMI estimates are broadly in line with RBNZ internal estimates, although neither precludes actual claims being higher or lower than the range. RBNZ met with AMI's senior management on 11 March 2011 and the information provided to us was slightly more negative than RBNZ assumptions.
6. The number of major-damage house claims reported in the first 18 days following the 22 February 2011 quake are about 50-60% of those for the 4 September 2010 quake, but with greater average claim costs. Their number of temporary accommodation (a benefit on contents policies) and motor claims for 22 February 2011 already exceeds the number for 4 September 2011. The gross cost estimate for 22 February 2011 claims reported to date exceeds gross claims costs for 4 September 2010.
7. The number of major-damage house claims not yet reported is highly uncertain. The areas subject to major land damage (largely covered by EQC) are not well defined. Assessments on which homes suffered major damage are initially performed by EQC and this process has only begun this week. Adding to the uncertainty is the prospect of political decisions to

relocate some suburbs and the lack of information on how any additional costs arising will be borne.

8. AMI has reinstated reinsurance cover for a third event for \$600m and for a fourth event for \$400m. They have spent \$33m on purchasing these reinstatements, and are currently in the market for an additional \$200m protection (total \$800m) against a third event.
9. AMI has \$600m reinsurance protection for the 22 February 2011 quake and had net assets of about \$370m at 21 February 2011. It is looking likely their reinsurance protection will be exhausted. The net assets now are estimated to be in the range plus \$200m to minus \$800+m, based on the information provided by AMI.
10. AMI's board is meeting on 17 March 2011. The executive is putting 3 options to it:
 1. Raise capital – the company has approached their reinsurance brokers to see if any reinsurers are willing to do this;
 2. Sell part of the business (non-Christchurch) to another insurer; and/or
 3. Obtain Government support.
11. The Directors are likely to consider their position under the Companies Act in respect of trading while insolvent. This is a matter for them and, given the inherent uncertainties referred to above, we cannot be sure what they or their professional advisers, will conclude.

Civic/LAPP

12. Civic Assurance, LAPP and RiskPool are owned by local authorities and together provide a range of general insurances to local government. Broadly, Civic insures the above ground property and motor risks, LAPP the underground infrastructure (for the 40% of costs borne by local government) and RiskPool the liability risks. Civic administers LAPP and RiskPool. There is also some self-reinsurance between the 3 insurers and the amounts ultimately retained by each insurer are unclear to us at present.
13. **Withheld: OIA s 8(c)(i) - making the information available would be contrary to the provisions of s135 of the Insurance (Prudential Supervision) Act 2010** LAPP insures the 40% local government contribution (60% is funded by central government) to repairs of underground infrastructure (ie water and sewerage), as well as sharing reinsurance with Civic. **Withheld: OIA s 8(c)(i) - making the information available would be contrary to the provisions of s135 of the Insurance (Prudential Supervision) Act 2010**
14. AM Best recently put Civic's rating on review due to concerns with LAPP being able to fund their reinsurance share of Civic's claims. Civic have requested the Bank review their solvency calculations that they have undertaken, which will assist their decisions on a proposed \$20m capital injection from councils. It appears likely that both Civic and LAPP have less capital than required under RBNZ draft solvency standards (not yet in effect) and may currently have negative net assets.

Western Pacific

15. Western Pacific is a small Queenstown insurer run by two owner/directors.
16. In our view, its letter to the Minister of Finance indicates that it is both illiquid and insolvent. Western Pacific would find capital raising difficult. And it is unlikely that any insurer would be willing to take over its liabilities.
17. Based on Western Pacific's letter to the Minister, it is unlikely that Western Pacific has funds other than the \$0.5m deposit with Public Trust. At the moment and going forward, Western Pacific's reinsurers are reluctant to pay claims to Western Pacific, due to Western Pacific's inability to pay premiums and pay the first \$1m of claims for each earthquake.
18. Again based on Western Pacific's letter, if Western Pacific failed and the reinsurers are not appeased, total claims could be around \$25m, including \$22m on the Christchurch earthquakes. If a liquidator reached agreement with the reinsurers, the total earthquake claims shortfall might reduce to around \$7m, with around \$3 of other claims.
19. Our assessment, from public information, prior to the February earthquake was that the company would struggle to be licensed as an insurer continuing to write new business.

Insurers that might have exceeded the top level of catastrophe cover

Tower

Tower Insurance Limited is the sixth largest general insurer in NZ and operates mainly in personal lines. Withheld: OIA s 8(c)(i) - making the information available would be contrary to the provisions of s135 of the Insurance (Prudential Supervision) Act 2010

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