

Date: 23 March 2011

LA-7-39



THE TREASURY
Kaitohutohu Kaupapa Rawa

To: Minister of Finance

AIDE MEMOIRE: CHRISTCHURCH INSURANCE UPDATE

Key Points

- AMI and Treasury/RBNZ have started discussions with AMI, in response to their request for Government support.
- We have developed a proposal to table with AMI. A summary of the terms sheet is attached below. It includes conditions such as the ability to replace directors and requirements to meet service standards for settling claims.
- Currently there are differences between the proposal being contemplated by officials and those contained in a proposal tabled by AMI with Treasury and the Reserve Bank, yesterday.
- No legally binding arrangement will be entered into with AMI until the terms of a subscription or similar agreement has been signed by the Crown on terms satisfactory to the Crown,
- It will be announced tonight that AMI is being downgraded two notches by its credit rating agency and that reaction to that announcement will be carefully monitored.
- AMI might need to have the Government stand behind it for anything between \$400 million to \$1billion, but even if no monies are called upon, the level of support that the Government may commit to might be required to be recorded as a liability in the Crown accounts.
- Officials are scoping possible alternative courses of action, in the event that negotiations between AMI and Government do not prove to be successful or if there is a change in circumstances that would merit more direct Government intervention.
- These matters will be discussed with you further at a meeting arranged for 11am tomorrow (Thursday). Following that meeting, we would plan to share our draft proposal with the company and negotiate possible final terms for your consideration.

Analysis

1. We refer to T2011/513 when:
 - (a) Treasury advised that AMI is concerned that its reserves and reinsurance might not be sufficient to cover the total value of claims under AMI policies resulting from the recent Canterbury earthquakes and has therefore approached Government for support;
 - (b) you agreed that:
 - (i) AMI's request for Government support merits serious consideration;
 - (ii) Treasury enter into discussions with AMI regarding necessary measures that may be negotiated;
 - (iii) those measures should reflect the Government's objectives and provide comfort to AMI's directors that the company's operations can remain on foot for an appropriate period.
 - (c) You were also advised that as a first step, Treasury would provide AMI with a "comfort" letter, a copy of which was attached to T2011/513. That letter has now been sent.
2. Treasury and the Reserve Bank met with the AMI on 22 March 2011. At that meeting AMI tabled a proposal for government support.
3. We have been developing its own set of proposals as to the way in which Government may provide support to AMI. These proposals are contained in a draft Term Sheet, a summary of which is **attached**.
4. Officials' proposals have been drafted so as to reflect Government's objectives and are intended to provide comfort to AMI's directors that the company's operations can remain on foot for an appropriate period, while alternative capital raising options are explored. These proposals are still being finalised and have not yet been referred to or made known to AMI.
5. The two sets of proposals are similar in that both contemplated some form of equity or quasi equity injection into AMI. There are however differences between the two sets of proposals. These differences are partly explained by AMI's view as to what constitutes equity for the purposes of the IFRS rules and (in turn) the Reserve Bank's emerging solvency requirements under the Insurance (Prudential Supervision) Act 2010.
6. Treasury propose to table officials' proposals with AMI shortly. These will be put forward on a basis that would make it clear that no commitment is being made by Government as to the provision of support or as to the nature of that support, until a legally binding subscription or similar agreement is signed by the parties. This will not occur of course without you being fully briefed on the final terms and your approval of those arrangements.

7. You should also be aware that AMI's credit rating agency will tonight (at 10 pm) be announcing that it has downgraded AMI "two notches" from A+ to A- with a negative outlook. Treasury together with the Reserve Bank will be carefully monitoring reaction to that announcement.
8. The exact extent of the support required is not yet known. However estimates of possible levels of support range anything from \$400 million to \$1billion (in a worst case scenario). The nature of the support planned may mean that Government need not part with actual cash, if the announcement of Government support "buys" AMI time to recapitalise sufficiently. However it might be necessary to record this exposure in the Crown accounts as a liability.
9. Treasury is also scoping possible alternative courses of action, in the event that negotiations between AMI and Government do not prove to be successful or if there is a change in circumstances that would merit more direct Government intervention. We will report to you shortly on possible options.

Brian McCulloch, Director, [Withheld under s9(2)(a)]
Jeremy Salmond, Treasury Solicitor, [Withheld under s9(2)(a)]

PROJECT SMILE
Summary of Draft Indicative Terms Sheet for Crown Support

- 1 *Terms Sheet non-binding:* the Terms Sheet is not binding except in relation to confidentiality and an obligation for Smile to meet the Crown's costs.
- 2 *Crown's objectives and principles:* any formal documents are to be consistent with certain stated objectives and principles of the Crown.
- 3 *Nature of support:* capital injections in the form of subscription for preferred redeemable shares. The shares will be convertible at the Crown's option into ordinary shares in Smile to enable the Crown to obtain control, if necessary. The shares will accrue dividends at a margin above OCR and will be redeemable at the Crown's option provided that, following redemption, AMI will be able to meet its obligations out of its resources and reinsurances, and that redemption would not result in a breach of any prudential or solvency requirements.
- 4 *Subscription Triggers:* the Crown will subscribe if:
 - 4.1 the Crown considers AMI will not be able to meet its obligations (including claims) out of its own resources and reinsurances; and
 - 4.2 AMI's board certifies to the Crown that it will not be able to meet its obligations (including claims) out of its own resources and reinsurances.
- 5 *Safe Harbour:* the Crown will not trigger a capital injection under paragraph 4.1 above if it considers AMI is in realistic negotiations with a third party.
- 6 *Amount of Support:* any capital injections will be for an amount the Crown considers sufficient to enable AMI to meet its obligations, subject to an overall cap. The Crown will determine the timing and amount of subscriptions (which may be multiple) having regard to matters such as AMI's prudential or solvency requirements, maintenance of its credit rating and AMI's ability to pay its debts.
- 7 *Fees:* the Crown will charge commitment and line fees.
- 8 *Directors:* the Crown will be able to appoint observers to attend board, committee and senior management meetings. If AMI breaches specified covenants or the Crown makes a capital contribution, the Crown will have the ability to replace AMI's directors. This may only apply to the directors of AMI Insurance not AMI Holdings because of difficulties associated with AMI Holdings' shareholding structure.
- 9 *Operation and Management:* AMI will provide covenants in relation to this, including to settle claims at least as quickly as other insurers and agreed service standards.
- 10 *Covenants:* AMI will provide a range of covenants in relation to its business and assets, including provision of information consistent with Deposit Guarantee Scheme covenants.

- 11 *Constitution:* from the outset the Crown will hold a special share in AMI to protect the Crown's interests. As with the ability to appoint directors, this may only apply to AMI Insurance, not AMI Holdings.
- 12 *Termination by the Crown:* the Crown will have limited termination rights prior to any capital injection being made. This will be limited to events such as insolvency, material non-disclosure and breach. Once a capital injection has been made the Crown may only terminate once any shares have been redeemed in full.
- 13 *Termination by AMI:* AMI may terminate if all shares have been redeemed and it will be able to meet its obligations (including claims) out of its own resources and reinsurances.