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

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Summary

The Bank regards liquidation as the default resolution for insolvency and liquidation provides a tried and tested legal process for fairly apportioning assets between creditors. The purpose of this report is to ensure creditors have a better understanding of the implications of accepting the proposed scheme as the mechanism for dealing with insolvency, should that occur.

A fundamental difference between liquidation and the proposed scheme is the difference in fairness between distributions amongst creditors of the same class. The pari-passu principle that applies in liquidation means that creditors of the same class all receive the same proportion of assets and adjustments would be made retrospectively to distributions if the asset position allowed it. This contrasts with the distribution of assets under the proposed Scheme which could involve different creditors receiving distributions that represent a different proportion of assets with no mechanism to retrospectively adjust distributions.

The Scheme has been presented as a contingency in case insolvency occurs at some point in the future. KPMG has provided an independent actuarial valuation of claims costs and expenses, and their key results are estimated costs that are higher than those of ACS and also highlighting a substantial level of uncertainty. ACS has advised of an intention to make available to creditors a version of the KPMG report with commercially sensitive information removed. The Bank's view is that there is greater than 25% chance of a shortage in assets to cover costs, and a higher likelihood that insurer solvency requirements which come into effect from 30 June 2012 will not be met. This view has been informed by the KPMG report and various information supplied by ACS including some planned actions and some solvency calculations.

There is potential for a component of funding (described as Adverse Development of Claims Cover) to be withdrawn if the scheme does not proceed and for changes to be made to the scheme after implementation. The Bank has asked ACS to explain its intentions in relation to the Adverse Development of Claims Cover if the scheme does not proceed and considers it appropriate that this intention, and any other intended changes likely at this time, are signalled upfront.

The Bank is not taking direct action to stop the Scheme and considers it appropriate that the proposed vote continues before further assessing its position. In general terms, the Bank would respect the will of creditors and claimants as expressed in the vote on the proposed Scheme; hence this paper is framed as provision of information, without a specific recommendation.

The Reserve Bank's role in relation to ACS (NZ) Ltd

1. The Bank is responsible for administering the Insurance (Prudential Supervision) Act 2010. The purposes of the Act are to promote the maintenance of a sound and efficient insurance sector and to promote public confidence in the insurance sector. These purposes are achieved by establishing a system for licensing insurers, imposing prudential requirements on insurers, providing for the supervision by the Bank of compliance with those requirements and conferring certain powers on the Bank to act in respect of insurers in financial distress or other difficulties.

2. The requirements under this new legislation are being phased in so that all insurers, including ACS (NZ) Ltd ("ACS"), must be in full compliance by 7 September 2013 or they must have ceased to carry on insurance business before then.

3. As a provisionally licensed insurer, ACS is required to meet the conditions of its licence which include that it must hold a minimum level of capital by 30 June 2012 with the amount of that capital being calculated under the Solvency Standard for Non-Life Insurance Business in Run-off.

The purpose of this report

4. The Bank has a view on the financial position of ACS which has been informed by analysis of financial information received from ACS and by an independent report provide by KPMG. The Bank considers it appropriate to make this information available to creditors in this report, together with views on some key issues relating to the proposed Scheme. The Bank also expects ACS to make a copy of KPMG's report available to creditors ahead of the vote.

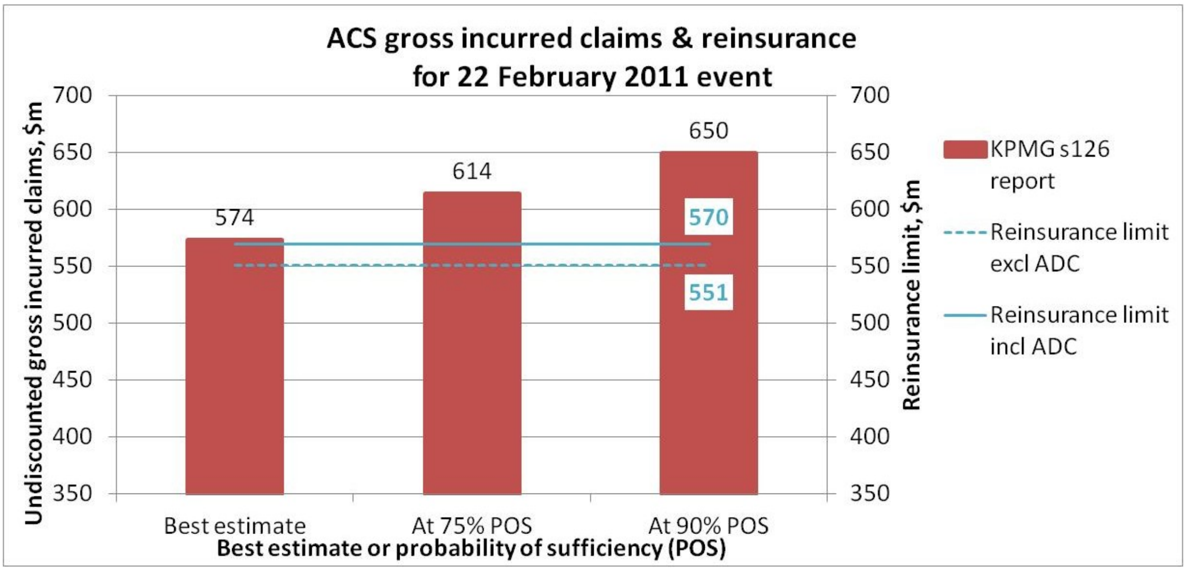
5. The Bank has a particular interest as a regulator and the purpose of this report is to ensure creditors are fully informed before voting on the Scheme.

Key matters to bring to the attention of creditors

<u>An independent report on claims and expenses of ACS</u>

6. At the direction of the Bank, ACS has commissioned KPMG Actuarial Pty Ltd (KPMG) to independently value outstanding claims, reinsurance and expenses (but not assets) as at 31 December 2011 but incorporating up to date information provided by ACS. Key KPMG observations, as summarised by the Bank, are noted in paragraphs 7 to 10.

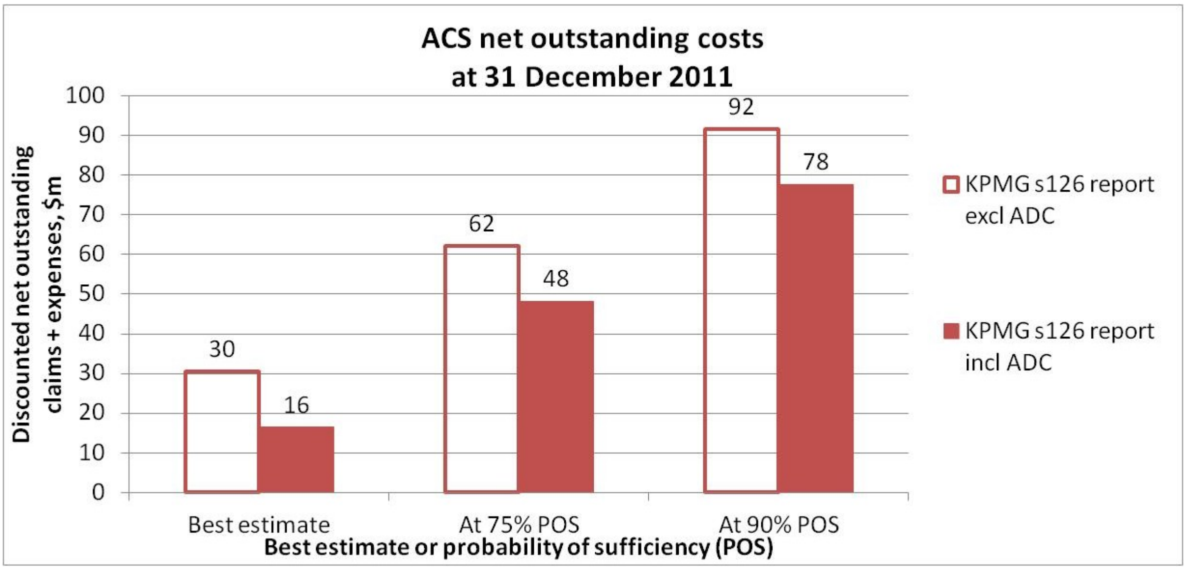
7. Earthquake claims are likely to exceed reinsurance coverage, inclusive of Adverse Development of Claims Cover (ADC) (note that ADC cover may be cancelled if the proposed Scheme of Arrangement is not approved). There is a 10% chance (90% probability of sufficiency) that claims are at least $80 million higher than reinsurance inclusive of ADC.



8. For events other than 22 February 2011 claims are unlikely to exceed reinsurance coverage. The provisions of ACS at 31 December 2011 for non-earthquake claims appear to be reasonably adequate. Expenses during run-off are likely to be significant and are estimated at $7-10 million excluding legal fees arising from any disputes and extra costs arising in the event of financial distress or a triggered Scheme of Arrangement.

9. To date very few earthquake claims have been completely settled. Claims could be substantially higher or lower than expected. Outcomes where reinsurance (inclusive of ADC) is not exhausted are quite plausible, albeit with less than 50% likelihood.

10. Claims and expenses net of reinsurance are likely to be significant (ADC premiums of $4.5 million, which will be funded by way of capital from Ecclesiastical Insurance plc are excluded from the graph below. Also to note is that KPMG has identified some material risks that are also not included).



Funding of net costs

11. The costs of claims net of reinsurance and expenses (excluding ADC premium) are funded from provisions and capital. At 31 December 2011, ACS held provisions of $9.5 million and capital of $1.0 million. ACS has announced capital injections by 30 June 2012 of $24 million (excluding capital to fund the ADC premium). On KPMG figures, there appears to be a greater than 25% chance of a shortage in assets to cover costs, and potential for a large shortfall to arise.

12. Some elements of uncertainty may not be capable of being resolved until late in the run-off process, and therefore any remaining outstanding claims could face a large shortfall.

Compliance with RBNZ insurer solvency requirements

13. ACS will be subject to legislated solvency requirements (Solvency Standard for Non-life Insurance Business in Run-off) from 30 June 2012, and has previously informed the Bank that it intends to be compliant with the solvency requirements from that date.

14. ACS recently submitted its first solvency return to the Bank, which was calculated effective 31 December 2011. The Bank's review of their solvency calculations has identified several questions and areas of concern. All insurers were required to provide Director sign-off of their solvency return (or failing that CEO). ACS did not provide this sign-off initially. Discussions with ACS in relation to the Bank's questions and concerns are continuing but not yet resolved.

15. ACS has informed the Bank of a number of actions that it is considering or planning to take which might improve their solvency position as measured by the solvency standards. However, as of 5 June ACS has not provided to the Bank a convincing

explanation of how compliance with solvency requirements will be achieved when they come into effect.

16. The Bank's view is that pro-rata payments made under the proposed Scheme of Arrangement are a distress management tool, and the proposed Scheme does not of itself provide a means to comply with insurer solvency requirements.

Alternative to the proposed Scheme

17. There are some key differences between the proposed Scheme and the most likely alternative of ACS being put into liquidation in the event of insolvency.

18. The proposed Scheme may include a higher overall level of financial protection for creditors because the Adverse Development Cover (ADC) can be cancelled if the proposed Scheme is not approved. Consequently, comparison between the proposed Scheme and the alternative of liquidation starts with a lower level of funding. We note at this point that ACS and Ecclesiastical have not provided any reason for cancelling the ADC in the event the Scheme does not proceed: if the motive for putting it in place is to provide additional funds to claimants, then we cannot see why that motive should be less compelling if the Scheme does not proceed.

19. A scheme of arrangement may also provide less disruption to the timing of claims payments compared with liquidation.

20. The Scheme though, could result in an unfair distribution between creditors. The 'pari-passu principle' that would apply under liquidation provides for the equal distribution of available assets among all creditors, regardless of where an individual creditor sits in the queue for payment. The pari-passu principle means that creditors of the same class all receive the same proportion of assets and adjustments would be made retrospectively to distributions if the capital position allowed it. The scheme contains inequities as between creditors of the same class, who would otherwise be dealt with on a pari passu basis in a liquidation, insofar as:

  i. pre-Trigger event creditors will be paid 100 cents in the dollar;
  ii. post-Trigger event creditors will be paid on the basis of the scheme administrators' then projected assessment of a dividend, and dividend value may be reduced as the scheme administrators value claims and determine the available assets with which to meet them;
  iii. thus the creditors who have the more complex claims to calculate, may be prejudiced and receive a lesser dividend than others with more straightforward claims who get paid sooner;
  iv. the scheme administrators have no power to set aside pre-Trigger event payments as voidable transactions.

21. The proposed Scheme could favour creditors best placed to take an early distribution and disadvantage creditors who may be some way down the queue.

22. In the light of the recent decision of the High Court in *Re Western Pacific*, policyholders of ACS who have the benefit of reinsurance contracts entered into by ACS ("reinsureds") fall to be treated as a separate class of creditor for the purpose of the Scheme, based on legal advice that the Bank has received. Those policyholders are in a different class because they have the benefit of security over the reinsurance recoveries and there are other creditors who don't.

23. As a result of the provisions of Section 9 of the Law Reform Act 1936 and of the above decision of the High Court, those policyholders who have the benefit of the reinsurance, at least to the extent of their benefits under the contracts of reinsurance, cannot properly consider the proposed Scheme at the same meeting as non-reinsureds of ACS. At present all policyholder creditors are included in one class. This classification by ACS of all creditors in one class may result in the High Court refusing to approve the Scheme, if creditors support it.

24. ACS is proposing the Scheme on the basis that it is bound by the decision of the High Court in *Re Western Pacific.* The Bank understands that ACS has nevertheless reserved its right to pay out claims to creditors on the basis that the decision does not apply. What that would mean would be that all reinsurance recoveries would be placed into a pool to meet all claims and no policyholder could claim the benefit of security over any reinsurance recoveries. This is highly likely to affect the payout to creditors, by reducing the amount available to meet those claims that would otherwise have been covered by reinsurance. Creditors should therefore seek a clear explanation from ACS of how it intends to pay claims and how any such decisions by ACS might affect individual creditors.

Proposed timeframe for the Scheme and changes to ownership

25. ACS was informed on 27 February 2012 by the Bank that:

> “Our initial response to ACS’s proposal to implement a contingent scheme of arrangement is that it could be an attractive option, relative to others such as liquidation, if a resolution process needs to be progressed. However, it is premature for us to support such a proposal, both because (a) you have not worked through the solvency calculations and decided on your approach to meeting the solvency standard, as required above, and (b) we need more time and information to assess your proposal and consider it alongside other options. Therefore, the Bank is not in a position to give its support to the scheme now and expects you to work through the solvency calculations and inform it of ACS’s solvency position and, if required, plans to increase capital, before the proposal is taken further.”

26. Alongside the development of the proposed Scheme, changes have been implemented to the ownership structure of ACS. ACS was a wholly-owned subsidiary of Australian insurer Ansvar Insurance which, in turn, was owned by Ecclesiastical Insurance. Recent restructuring means that ACS is now predominantly owned by the Canterbury Church and Heritage Trustee Limited (11,700,000 shares) with Ecclesiastical Insurance retaining 1 share (these are the shareholdings currently shown on the Companies Office website). The combination of the name change from Ansvar Insurance Ltd to ACS (NZ) Ltd and the change in ownership structure distance Ecclesiastical Insurance from ACS, both in terms of brand association and in terms of legal association.

Conclusions

27. The proposed Scheme is based on an inadequate injection of capital and is being promoted by a parent company (Ecclesiastical Insurance plc) that is distancing itself from ACS ahead of the planned implementation.

28. Whilst ACS is required to comply with solvency requirements from 30 June 2012, the Bank has received no information to suggest that it will have sufficient capital.

29. If the Scheme does not proceed, the default scenario in the event of insolvency is liquidation. The Bank considers the application of the pari-passu principle would provide for fair treatment between creditors. Ecclesiastical has the right to cancel the Adverse Development Cover if the Scheme does not proceed which would mean that liquidation would include a lower level of funding than the Scheme.

30. Different creditors may receive different treatment under the proposed Scheme with the potential for creditors with complex claims that still have some way to go before they are settled to be potentially most disadvantaged (i.e. at risk of a lower proportional settlement or no settlement). In very general terms, this may be a risk for residential policyholders with claims split between EQC and ACS as well as any policyholders not involved in cash settlements.

31. The Bank is not taking direct action to stop the Scheme and considers it appropriate that the proposed vote continues before further assessing its position. In general terms, the Bank would respect the will of creditors and claimants as expressed in the vote on the proposed Scheme – hence this paper is framed as provision of information, without a specific recommendation.