Office of the Minister of Finance

Chair
CABINET

Increasing the Earthquake Commission's Levy

Proposal

1 This paper proposes that the Earthquake Commission's levy be increased by 200% to 15 cents per $100 of cover, applying from 1 February 2012, and that I instruct PCO to draft regulations to give effect to this decision. The paper has been subject to some late revisions to take account of revised financial forecasts from the Earthquake Commission (EQC), which may still move; the numbers related to table 1 in this paper are therefore subject to uncertainty.

Executive Summary

2 The Earthquake Commission levy should be set at a level which reflects the long term costs of the EQC providing natural disaster cover to holders of home fire insurance.

3 I am proposing that the levy be increased from 5 cents per $100 of coverage to 15 cents per $100 of cover. This will mean the levy more accurately reflects the actual costs of coverage and it will reduce the fiscal risk that the Crown is exposed to via the Crown guarantee of the EQC.

4 The levy has not been set based on a full actuarial forecast of future liabilities, but this can wait until the planned review of the EQC. I believe it is important we raise the levy now. It is clearly too low, and the Government is not in the position to absorb significant mispricing, even for a short period of time.

5 The proposed levy would see the EQC coverage reaching pre-Christchurch earthquake levels in around 30 years. I believe this is a good compromise between not wanting to put the levy up too high, but wanting the National Disaster Fund (NDF) to be rebuilt over a reasonable period of time given the expected infrequency of large natural disasters. This level should reduce the call on the Crown guarantee over the next 5 years, assuming current estimates and no additional major nature disasters.

Background

6 The EQC provides natural disaster coverage for purchasers of residential home fire insurance. It provides coverage of up to $100,000 for property, $20,000 for contents and full coverage for land. The coverage provided by the EQC is paid for via a levy applied to the premiums that households pay for their private home fire insurance.

7 The EQC has been set up as a self-funding entity and the levy should be set at a level which reflects the long term costs of the EQC providing the cover. The rate of the levy is set by clause 3 of the EQC Regulations 1993. The current levy is set at 5 cents per $100 of cover (excluding land which has no premium). This results in an annual cost for most households of $69. The levy generates income of around $86 million per annum for the EQC.

8 The EQC manages its risk exposure via a combination of self-insurance and purchasing reinsurance on the international market. Self-insurance involves the EQC using some of the levy income to build up a pool of assets that can be used to meet claims in the event of a disaster. This pool of assets is referred to as the Natural Disaster Fund (NDF).

9 As at 30 June 2009, the NDF stood at around $6 billion and the EQC held reinsurance of $2.5 billion. Reinsurance was costing EQC around $39 million per year and it had annual business as usual costs (BAU) of around $59 million per year[1]. BAU costs include the EQC operating costs and costs to meet "normal" claims that occur during the year. Although the levy funding of $86m was not able to cover the total annual costs of around $98m, the NDF was generating significant income for the EQC ($377 million in 2009/10) and so the EQC had a significant surplus overall.

10 All the assets in the NDF are now required to meet the liabilities generated by the Christchurch earthquakes. In fact, as at 30 June 2011, there are not enough assets in the NDF to meet all the expected claims and the EQC is estimated to have liabilities exceeding its assets by $1.156 billion. The Crown is ultimately liable for any shortfall under a guarantee it gives under section 16 of the Earthquake Commission Act 1993. The rundown of the NDF will occur over several years as claims are paid out, and as this occurs the income generated by the NDF will also drop away. With current settings EQC is forecasting that the government will have to put around $1.2 billion of cash into the EQC once the NDF is fully depleted.

11 In addition, the reinsurance costs faced by the EQC have risen significantly [withheld - s(9(2)(b)(ii)] The current levy is now significantly below BAU costs, let alone generating the surpluses EQC would need to begin rebuilding the NDF.

12 Unless the levy is increased, the EQC will not be operationally sustainable and insurance holders will not be being charged a levy that represents the cost of the government providing natural disaster coverage to them. The Crown will be left to pick up any shortfall.

[1] Excluding the Crown underwriting fee of $10m. This inter-crown transaction is not relevant for this analysis.

Comment

13 The levy should be increased to reflect the increased cost of providing earthquake coverage in New Zealand and to ensure EQC is operationally sustainable. Without raising the levy the Crown will be subsidising earthquake coverage in New Zealand for those households with home insurance. This is not economically efficient.

14 In increasing the levy we need to consider two questions. When should we raise it, and by how much?

Timing

15 I am intending to review the EQC model and will bring a proposed terms of reference for the review to Cabinet in the coming months. This review may make various recommendations in terms of the ongoing role and size of the EQC based on considerations of the costs of providing coverage in New Zealand.

16 I do not want to wait for the outcome of this review before changing the levy, however, as this could leave the Crown effectively subsidizing earthquake coverage in New Zealand for a significant period of time. Raising the levy as soon as possible also reduces fiscal pressure on the Government, as it will help reduce EQC's forecast call under the guarantee.

17 I believe we have enough information now to know that the levy needs to be significantly increased. The level can be reconsidered again as part of the review of the EQC model, so any changes can be seen as transitional in nature. While we cannot precisely estimate the actuarially fair price of EQC cover at this time, I am confident that we will be moving the levy closer to the correct value than it is now.

18 It is possible that the levy may reduce in future (say because reinsurance costs subside as uncertainty around seismological risk reduces), but I am prepared to accept this volatility. The fiscal challenges we face now are very real and we are not in a position to absorb any mispricing, even for the short term.

19 The insurance industry will need time to implement the new levy based on information from the Insurance Council of New Zealand (they proposed any levy increase should be signaled four months in advance to limit the administrative costs to insurers). To give some time to the insurance industry to implement this change and so as not to put undue pressure on them, given other administrative pressures they are under, I propose that we apply the rate rise from 1 February 2012.

20 In order to give the insurance industry as much time as possible to make the change, I propose that we consider announcing our intention to raise the levy as soon as Cabinet has agreed to the policy (i.e. not wait until the regulations have been signed off).

How much to put the levy up

21 At a minimum the levy should be increased to allow the EQC to meet its ongoing BAU and reinsurance costs [withheld - s(9(2)(b)(ii)]

22 However, I believe the levy should also be set at a rate which allows the NDF to be rebuilt over time. In this way the levy will also include a component to cover the "cost" of self-insurance, and will more accurately represent the actual cost of EQC coverage. A higher levy should also eliminate the need for the EQC to call on the Crown to cover its projected cash shortfall over the next few years.

Table 1: Impacts of Different Potential Levy Rates

Levy change	Levy per $100 of coverage (cents)	Annual Cost to household ($)	Impact on OBEGAL assuming levy applied to full year ($million pa)	Expected call on the Crown ($ millions)*	Approximate Size of NDF after 25 years ($ billions) – from point of repayment expected call on Crown*
Status Quo	5.0	69	0	1200	0
100%	10.0	138	88	800	1b
200%	15.0	207	176	490	6b
300%	20.0	276	264	23	12b

*These figures represent point estimates that lie within a confidence interval and are indicative in nature given the inherent uncertainties. [withheld - s(9(2)(b)(ii)]
. [withheld - s(9(2)(f)(iv)]

23 Under our current policy settings for EQC, the levy rate decision largely depends on how quickly we want to see the NDF rebuilt and the amount of fiscal risk we are comfortable facing. I propose that we set the levy at 15 cents per $100 of cover. This would see the EQC coverage reaching pre-Christchurch earthquake levels in around 30 years. I believe this is a good compromise between not wanting to put the levy up too high, but wanting the NDF to be rebuilt over a reasonable period of time given the expected infrequency of large natural disasters. Given current estimates, this level should also reduce EQC's call on the Crown guarantee, and reduce the negative impact on net debt.

24 [withheld - s(9(2)(b)(ii)]

At 15 cents, the levy is still around or below other conceivable levies if the EQC was working under a different model (for example full reinsurance or full self insurance models). The EQC review may explore these other models, but I am comfortable the new level is not significantly out of line with these alternatives.

Mindful of increasing inequalities

25 This is a significant rise in the amount of the levy, and I am mindful that this may exacerbate inequalities in the current scheme. EQC's coverage is regressive because EQC cover has generally the same limit for all households, yet has a higher probability of being called upon for houses of high value (i.e. it is easier to do $100,000 of damage to a house worth $2 million than to a house worth $300,000). Increasing the levy will mean that lower value households will pay a higher percentage of their house value towards insurance that they have a lower probability of calling on. The fact that the levy is not applied to land cover further contributes to this inequality.

26 At this time, the need to address the current under pricing in a timely manner outweighs our ability to address these inequalities. I will be proposing, however that the EQC review look at this issue.

Consultation

27 EQC supports an increase in the levy as an interim measure, pending a full review of the EQC scheme, including coverage and funding. EQC notes that the increase is not based on full actuarial forecasts of future liabilities.

28 DPMC was informed of this paper.

Financial Implications

29 Increasing the levy to 15 cents from 1 February 2012 will increase the revenue of the EQC by approximately $73 million in 2011/12 and $176 million in 2012/13 and out years.

30 As EQC is fully consolidated into the Crown accounts there will be a corresponding positive impact on the Total Crown OBEGAL.

Human Rights

31 There are no human rights implications in this paper.

Legislative Implications

32 The proposal in this paper requires an amendment to the Earthquake Commission Regulations 1993.

Regulatory Impact Analysis

Regulatory Impact Analysis requirements

33 The Regulatory Impact Analysis (RIA) requirements apply to the proposal in this paper and a Regulatory Impact Statement (RIS) has been prepared and is attached.

Quality of the Impact Analysis

34 The Regulatory Impact Analysis Team (RIAT) has reviewed the RIS prepared by the Treasury and associated supporting material, and considers that the information and analysis summarised in the RIS meets the quality assurance criteria.

Consistency with Government Statement on Regulation

35 I have considered the analysis and advice of my officials, as summarised in the attached Regulatory Impact Statement and I am satisfied that, aside from the risks, uncertainties and caveats already noted in this Cabinet paper, the regulatory proposals recommended in this paper:

- are required in the public interest
- will deliver the highest net benefits of the practical options available, and
- are consistent with our commitments in the Government statement "Better Regulation, Less Regulation."

Gender Implications

36 There are no gender implications in this paper.

Disability Perspective

37 There are no disability implications in this paper.

Publicity

38 Regulations will be published in the Gazette. Any additional publicity required will be coordinated by the Minister of Finance.

Recommendations

39 It is recommended that you:

1 **agree** to increase the Earthquake Commission Levy to 15 cents per $100 of coverage to apply from 1 February 2012

Legal

2 **invite** the Minister of Finance to issue drafting instructions to Parliamentary Counsel Office to give effect to the above proposal by regulation

3 **authorise** the Minister of Finance to take decisions on minor policy matters that arise as the regulations are drafted

Publicity

4 **invite** the Minister of Finance to coordinate any publicity that may be required, and

5 **agree** that the Minister of Finance can make an announcement of the intention to change the levy, before the regulations are formally approved.

Hon Bill English
Minister of Finance

Date: