The Treasury

Material Provided to the Public Inquiry into EQC Information Release

August 2021

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CROWN OWNERSHIP MONITORING UNIT

Treasury Report: T2011-2148 Re-examining EQC's levy: Is an Increase now Justified?

Date:	28 September 2011	**Report No:**	T2011/2148

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	**Note** that Treasury considers that an increase in the EQC levy is now justified on the basis that current levies are not reflecting the cost of earthquake insurance **Note** that Treasury has not had the actuarially fair premium estimated **Agree** to increase the EQC levy from 5 cents plus GST per $100 of cover to 11 cents plus GST per $100 of cover **Agree** that the new EQC levy should apply from early 2012 **Agree** that the new EQC levy should apply indefinitely, with any further changes stemming from a review of EQC policy settings in light of the Canterbury earthquakes **Direct** Treasury to draft a Cabinet paper for your signature, seeking Cabinet's agreement to increase the EQC levy	Tuesday 4 October 2011

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
Thomas Quirk	Graduate Analyst, Sector Performance and Balance Sheet, COMU	[39]	[23]	✓
Joanne Hughes	Manager, Financial Markets	[39]	[23]	

Minister of Finance's Office Actions (if required)

Forward the report to the Hon Gerry Brownlee for his information

Enclosure: **No**

Treasury Report: T2011-2148 Re-examining EQC's levy: Is an Increase now Justified?

1. You have requested advice from Treasury on whether you should increase the EQC levy due to recent information that the National Disaster Fund (NDF) is likely to be exhausted by claims from the Canterbury Earthquakes.

2. In light of new information, we consider that increasing the EQC levy is now justified.

3. Treasury advice from early 2011 was not to increase the levy, or to only increase it by a limited amount [TR 2011/1104 and TR 2011/1202 refers]. This advice was based on the view that, given EQC's liability estimates at the time, there was little immediate need to increase the EQC levy as investment income on the $3 billion NDF would lead to a 'natural' rebuilding of the NDF over time. We considered it preferable to consider the appropriate long-term level of the levy in light of the upcoming review of the EQC model.

4. New information has led us to reconsider this view and conclude that it is now advisable to increase the levy in the near-term. In particular:

   - **Current levies are not reflecting the cost of earthquake coverage in New Zealand**. With no change in levy or Crown funding, EQC is expected to run an on-going operating deficit and will not be able to rebuild the NDF. With no investment income flowing from a likely exhausted NDF, and increased costs of reinsurance, we project EQC's operating balance to be indefinitely in deficit by around $70-80 million per year[1]. This deficit would still likely be $10 million per year even in the absence of reinsurance cost increases, leading to an on-going funding requirement from the Crown.

   - ***The expected depletion of the NDF leads to a shortfall that must be made up either by increased levies or by the Crown.*** Under current levy settings, EQC has estimated that it will face an $823 million shortfall in meeting its obligations for the Canterbury event. Given other pressures on the fiscal situation, we consider that at least some of the projected shortfall could effectively be paid for by insurance policy holders. This would involve the policyholders paying the anticipated higher levies as soon as possible and before the completion of the review.

The scale of the increase is a balancing act...on balance, we would recommend an increase of 120% (from 5c per $100 cover to 11c)

5. The decision on how much to increase the levy is essentially a judgement call on how much is required to make the EQC operationally sustainable, and how quickly it should be rebuilding its fund. When to change the levy is a judgment between wanting certainty over the level of increase versus the need to reduce fiscal risk to the Crown; any shortfall in the NDF that is not made up by levy holders can be thought of as a contingent liability on the Crown's balance sheet.

6. The level of the levy will need to be reconsidered again as part of the full review of the EQC model, so any changes now can be seen as transitional in nature. Hence we have not sought to precisely estimate the actuarially fair price of EQC cover.

[1] Figure 1 in Annex 1 shows, relative to pre-earthquake EQC conditions, the genesis of this operating deficit.

Instead we have modelled some indicative scenarios of EQC's expected financial position under a range of levy scenarios, based on EQC's best estimates of its cash outflows. Table 1 below outlines a range of the scenarios considered. We stress that these scenarios are subject to a lot of uncertainty, especially around the final cost of the Canterbury event to EQC, but also around investment returns going forward.

Table 1

Levy change	Levy per $100 of coverage (cents)	Annual Cost to households ($)	Expected call on the Crown ($ millions)*	Total EQC Coverage after 5 years ($ millions)*	Total EQC Coverage after 10 years ($ millions)*	Total EQC Coverage after 30 years ($ millions)*
Status Quo	5.0	69	770	2,500	2,500	2,500
50%	7.5	104	576	2,500	2,500	2,500
100%	10.0	138	381	2,517	2,644	3,719
120%	11.0	152	304	2,534	2,795	5,001
150%	12.5	173	187	2,561	3,022	6,924
200%	15.0	207	-	2,613	3,413	10,174
250%	17.5	242	-	2,864	4,101	14,550

*These figures represent point estimates that lie within a confidence interval.

7. Without full actuarial costings, it is not possible to calculate the expected full cost recovery level for the levy. However, our judgment is that, given the increased costs of catastrophe insurance, there is enough certainty that the review will result in significantly increasing the levy (if EQC coverage is unchanged) to justify increasing the level now.

8. We recommend an increase that is at least large enough to ensure that EQC can meet its ongoing operational costs, including the ongoing cost of reinsurance, without continued recourse to the Crown. This would imply an increase of at least 80% to 9 cents.

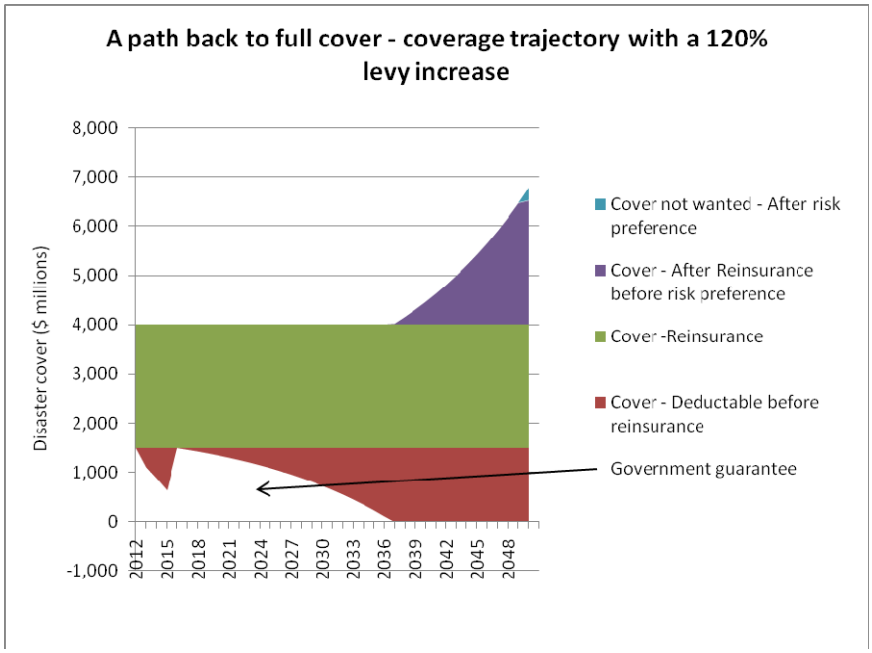
9. We consider that it is worth increasing the levy somewhat further than the 'bare minimum' required to cover EQC's ongoing costs. A larger increase will allow the NDF to start to be rebuilt, which is consistent with EQC cover being a self funded model. However, we are mindful of imposing too sharp an increase on households who are also likely to be facing increases in their private insurance costs of around 30%. On balance we consider that an increase of 120% (from 5.0c to 11.0 cents per $100 of coverage) would be appropriate.

10. You will note, though, that even with this substantial percentage increase in the levy, it would take until around 2045 for the NDF to reach pre-earthquake levels, in the absence of any further events. This highlights that further adjustments are likely to need to be made to EQC's coverage level and/or funding as a part of the wider review of EQC.

11. Over the medium-term, the funding of EQC can also be set within the broader fiscal strategy, including the use of any cyclical revenue windfalls. These windfalls could be allocated across reductions to net debt, extra contributions to the NZSF, or indeed some rebuilding of the NDF.

12. Figure 1 shows how the Government's cover will build up under our suggested levy increase of 120%. Please note that our estimates assume that reinsurance costs stay at current historically high levels. As such, Figure 1 is conservative and it would not be unreasonable to see these time frames reduce by up to 7 years[2].

Figure .1



13. A percentage increase of the scale recommended is considerably larger than the types of price increases being put in place by private insurers at the moment. Private house and contents insurance is forecast to increase by substantially less during the coming year than the EQC levy increase (20-30% versus 120%). This is not surprising given the differing nature of the risk covered by the private market and EQC. EQC covers the first loss from any event (from $0 up to its coverage limits – which covers much of the risk), and as such, should be more sensitive to perceived risk and cost increases. Private premiums are also buffered and diversified by pricing associated with coverage beyond EQC's scope; for example, burglary, fire and flood. An increase now would be the first time the EQC levy has been increased since the Earthquake Commission Act was passed in 1993, whereas private insurance pricing is revisited much more frequently.

14. In the event of further disasters, or significant upwards revaluations of EQC's liabilities, we would want to review our advice of a 120% increase in the levy.

There are some arguments against making a change now

15. We note that there are arguments in favour of limiting/not increasing the levy. We explore these below:

- ***A levy change may be short-term given the impending EQC review –*** There is an argument that it is more efficient to change the levy structure only once, when the full review has been completed.

[2] We have examined the levy increase on the basis of current EQC settings; however, another method for pricing the levy increase is looking at the hypothetical cost of EQC cover based purely on reinsurance or purely on self-insurance (asset accumulation). We have used this type of analysis to check the reasonableness of our suggested levy increase. Figure 2 in Annex 1 shows this analysis.

If EQC cover is not markedly reduced, the review will likely point to an increase in the levy - As noted above, EQC will need to increase its operating surplus by more than $10 million just to cover EQC's current operating costs. Conservatively increasing the levy now should allow you to smooth any future increase.

The completion of the EQC review is far enough away that increasing the levy will have a material impact – The EQC review will not likely start before the election, and even then we believe it will likely take 6-12 months to complete. We imagine that it might then take an additional year for Cabinet decisions and changing the legislation. In that time a levy increase of 120% would likely recover additional costs of approximately $160-200 million.

- ***Historically high reinsurance costs may subside –*** Current reinsurance pricing reflects a degree of current uncertainty around seismological risk. If there are no further major natural disasters, the elevated reinsurance prices that EQC is facing may not be sustained in future years. As a result it may be better to see if prices are at their equilibrium before changing the levy.

  Pre-earthquake reinsurance costs would still place EQC's balance sheet on an unsustainable trajectory – Without investment income from the NDF you will likely need to increase the levy despite the current high price of reinsurance. Analysis of EQC's operational health is available in Figure 1 in Annex 1. We think increasing the levy by 120% is conservative enough that a reduction in future reinsurance costs will not deem the levy excessively high.

- ***Increasing the levy exacerbates inequities in the current scheme –*** EQC's coverage is regressive because EQC cover has generally the same limit for all households, yet has a far 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 compared to a house worth $300,000). Increasing the levy will mean that lower value households will pay an even higher percentage of their house value towards insurance that they have a lower probability of calling.

  Pricing issues will be considered as part of the wider EQC review, flowing on from decisions about the scope of EQC cover - We do not consider that a levy change now should be deferred because of issues around pricing and inequities given the continued under-pricing of cover that this would imply.

Changing EQC's levy is done by regulation

16. An increase in the EQC levy would require a Cabinet decision, followed by an amendment to the Earthquake Commission Regulations 1993.

17. We think it would be desirable to give private insurers sufficient advance notice of any levy increase. This is necessary so that insurers can adjust their systems and pass the increase on to their customers. Earlier this year you received a letter from the Chief Executive of the Insurance Council of New Zealand (ICNZ), Chris Ryan, suggesting that any levy increase should be signalled four months in advance to limit the administrative cost to insurers. Should you decide to increase the levy, we would look to consult with ICNZ to ensure that the increase was timed in such a way as to not place undue burden on a sector that is already under operational pressure.

18. An increase to the levy will apply to all policies renewed after the levy increase date (early 2012 - tentatively 1 February). We will consult with the ICNZ to discuss any anti-avoidance issues that might arise from the announcement.

19. We have consulted with the EQC Board who supports a Government decision to increase the levy. The Board's support is for a levy increase that is viewed as a short-term adjustment which will need to be reassessed in a wider review. They comment that this levy increase is not actuarially priced, and that they would also prefer a "round figure" levy increase to 10c per $100 of coverage. We agree with the levy being a short term adjustment pending the full EQC review, but do think that there is justification for the additional 1c increase. The Board's comment can be found below.

20. The table below outlines a possible timeline for increasing the levy should you decide to do so:

Table .2

Date	***Action***	***Notes***
29 Sep 2011	Decide on levy change	Treasury Report
25 Oct 2011	Cabinet approval (CBC)	Treasury draft Cabinet paper
14 Nov 2011	New regulation passes through Cabinet (EC)	Your office - public communications
Early 2012 (tentatively 1 February)	Levy increases	

EQC Board Comment

21. The EQC Board have indicated their support for a Government decision to increase the levy as an interim measure, pending a full review of the EQC scheme, including coverage and funding.

22. The Board considered it important to communicate that the interim levy increase could not be based on a full actuarial forecast of future liabilities at this time, and as such should be based principally on the EQC's forecast operating position over the next two years.

23. Given the approximate cost estimates on which an increase would be based, the Board expressed a preference for a "round figure" doubling of the levy (to 10c per $100) but indicated they would also support an increase to 11c per $100.

24. Given the timeframes available, this is the Board's preliminary view and will not be confirmed until the next Board meeting.

Recommended Action

25. We recommend that you:

    a **note** that Treasury considers than an increase in the EQC levy is now justified on the basis that current levies are not reflecting the cost of earthquake insurance and that without a levy increase EQC is expected to run an on-going operating deficit

    b **note** that we have not had the actuarially fair premium estimated, given that further changes to the scheme could be made in the upcoming EQC review, but instead the recommended estimate seeks to balance putting EQC on a operationally stable footing while not increasing the levy too sharply

    EITHER:

c **discuss** the contents of this report with Treasury

OR:

d **agree** to increase the EQC levy from 5 cents plus GST per $100 of cover to:

i 11 cents plus GST per $100 of cover, or

Agree/disagree.

ii another amount (please indicate)

Agree/disagree.

e **agree** that the new EQC levy should apply from early 2012, subject to consulting with the Insurance Council on the practicality of this timing

Agree/disagree.

f **agree** that the new EQC levy should apply indefinitely, with any further changes stemming from a review of EQC policy settings in light of the Canterbury earthquakes (with the timing and content of that review to be decided), and

Agree/disagree.

g **direct** Treasury to draft a Cabinet paper for your signature, seeking Cabinet's agreement to increase the EQC levy.

Agree/disagree.

Joanne Hughes
Manager, Financial Markets

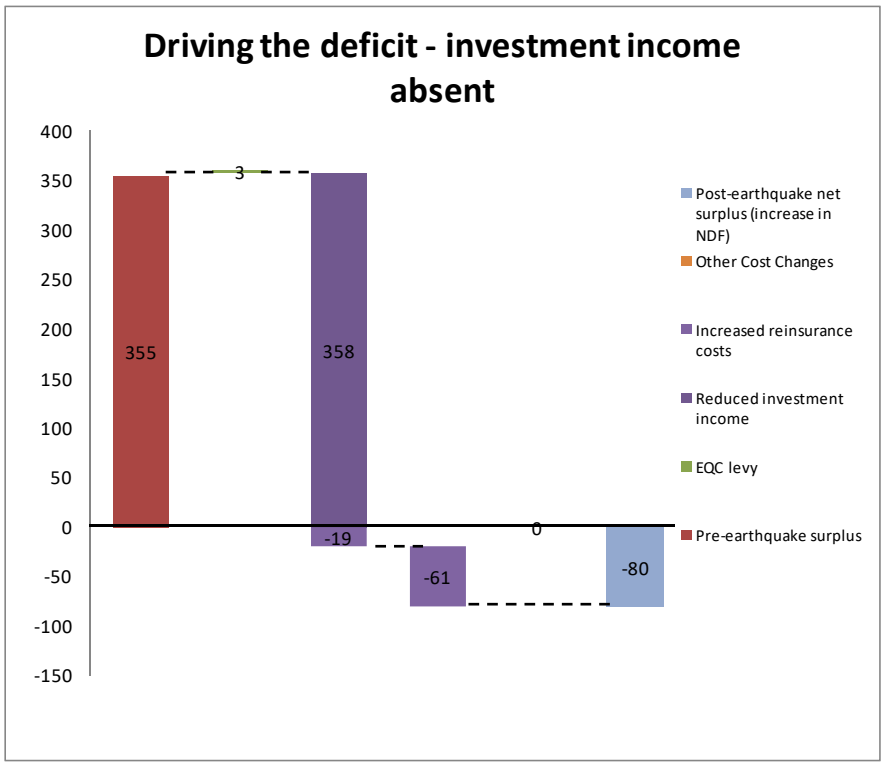
Hon Bill English
Minister of Finance

Annex 1

Operating deficit breakdown

1. Figure 1 shows that increased reinsurance costs and reduced NDF investment income dominate EQC's income flows and are driving EQC's deficit.

Figure 1.



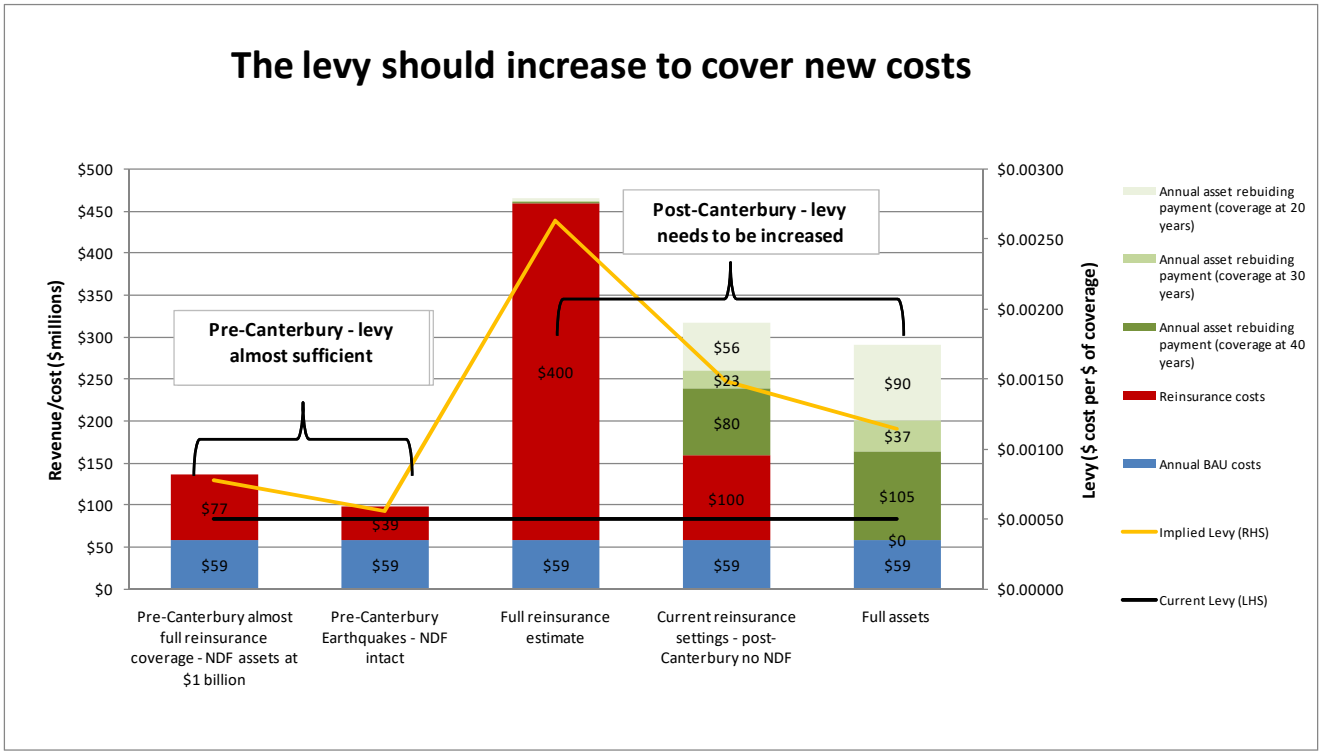
Alternative levy pricing methods

2. Figure 2 shows how EQC's different methods of covering risk (reinsurance and self-insurance) produce unequated suggested levy increases.[3] The gross cost of the coverage is on the right hand side axis, while the levy required is on the left hand axis. The cost of building up the fund is also noted.

3. The timeframe you wish to recover the asset portion of the EQC's cover will partly determine the necessary increase in the levy. Figure 2 gives the costs of considering different recovery timeframes.

[3] Note that comparing the cover and cost of reinsurance with that of self-insurance, as figure 1 does, is not entirely consistent. Each type of cover offsets subtly different risk. It is also important to note the cost of cover decreases sharply for assets (unlike reinsurance) once they have been built up. Therefore, too shorter timeframe introduces intergenerational inequity.

Figure 2


The levy should increase to cover new costs
Revenue/cost ($millions)
$500
$450
$400
$350
$300
$250
$200
$150
$100
$50
$0
Levy ($ cost per $ of coverage)
$0.00300
$0.00250
$0.00200
$0.00150
$0.00100
$0.00050
$0.00000
Pre-Canterbury - levy almost sufficient
Post-Canterbury - levy needs to be increased
$77
$59
$39
$59
$400
$59
$56
$23
$80
$100
$59
$90
$37
$105
$0
$59
Pre-Canterbury almost full reinsurance coverage - NDF assets at $1 billion
Pre-Canterbury Earthquakes - NDF intact
Full reinsurance estimate
Current reinsurance settings - post-Canterbury no NDF
Full assets
Annual asset rebuiding payment (coverage at 20 years)
Annual asset rebuiding payment (coverage at 30 years)
Annual asset rebuiding payment (coverage at 40 years)
Reinsurance costs
Annual BAU costs
Implied Levy (RHS)
Current Levy (LHS)