

# The Treasury

## Material Provided to the Public Inquiry into EQC Information Release

August 2021

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- [31] 9(2)(f)(ii) - to maintain the current constitutional conventions protecting collective and individual ministerial responsibility
- [33] 9(2)(f)(iv) - to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials
- [34] 9(2)(g)(i) - to maintain the effective conduct of public affairs through the free and frank expression of opinions
- [35] 9(2)(g)(ii) - to maintain the effective conduct of public affairs through protecting ministers, members of government organisations, officers and employees from improper pressure or harassment;
- [36] 9(2)(h) - to maintain legal professional privilege
- [37] 9(2)(i) - to enable the Crown to carry out commercial activities without disadvantage or prejudice
- [38] 9(2)(j) - to enable the Crown to negotiate without disadvantage or prejudice
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## Treasury Report: EQC Act Review: Key Policy Choices

<b>Date:</b>	11 December 2012	<b>Report No:</b>	T2012/3048
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### Action Sought

	<b>Action Sought</b>	<b>Deadline</b>
Minister of Finance (Hon Bill English)	<b>Read</b> the report before your meeting with officials in the New Year. <b>Note</b> the draft agenda for that meeting (in Appendix 1)	Tuesday 29 January 2013
Minister Responsible for the Earthquake Commission (Hon Gerry Brownlee)	<b>Read</b> the report before your meeting with officials in the New Year. <b>Note</b> the draft agenda for that meeting (in Appendix 1)	Tuesday 29 January 2013

### Contact for Telephone Discussion (if required)

<b>Name</b>	<b>Position</b>	<b>Telephone</b>	<b>1st Contact</b>
Bevan Lye	Senior Analyst	[39]	[23] ✓
Steve Cantwell	Project Leader, EQC Review	[39]	[23]

### Actions for the Minister's Office Staff

<b>Return</b> the signed report to Treasury.
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**Enclosure:** Yes (attached)

## Treasury Report: EQC Act Review: Key Policy Choices

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### Executive Summary

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The purpose of this report is to support a discussion with officials in the New Year on key policy choices, as well as process and timing, for the EQC Act Review.

#### Government policy interests

In order to begin developing recommendations on the future configuration of the EQC scheme, we need to articulate the Government's specific interests in the provision of disaster insurance.

The purpose of the EQC scheme is to channel and limit the demands for assistance from property-owners that invariably arise after disasters. The current scheme is based on the assumption that the Government can manage these demands by ensuring insured homeowners receive enough money through the scheme to rebuild a 'basic, adequate' house. Looking ahead, we would like to test whether you are comfortable with the following articulation of the Government's interests in the EQC scheme:

#### Putting a roof over people's heads

- The Government's primary interest is to ensure sufficient resources are available to homeowners for the restoration of basic, adequate housing after a disaster.
- The Government does not have an interest in land for its own sake; rather, the Crown's interest in land is tied to its desire to re-establish an adequate dwelling for the occupants of the property (on the same site or elsewhere). *Note this represents a considerable narrowing of the scheme.*
- EQC should not provide cover for contents or for non-residential property.

#### Disaster risk management and recovery interests

- In order to best support the recovery process, the EQC scheme must be designed such that EQC can discharge its statutory responsibilities to insured homeowners as quickly and efficiently as possible.

#### Scheme design

There are many different ways to structure an insurance product, but the set of viable options for the EQC scheme will be constrained by insurance industry willingness and capability. The submissions received to date suggest there is little appetite among insurers or others for the scheme to move away from the current 'first loss' approach, or for EQC to provide lower levels of cover.

Instead, there appears to be a preference to make the existing approach work more efficiently, particularly by increasing clarity, reducing complexity and streamlining the claims handling interface between EQC, insurers and homeowners. This feedback is causing us to lean in our own thinking towards a reform of the first loss model rather than the introduction of a new model.

## Roles and responsibilities

It has become evident from the submissions we have received that there is considerable confusion about the role of EQC during a recovery period, and the resulting expectations upon the organisation. We think the Government needs to form a view about the primary role of EQC in the context of a recovery, so that other parties (including within Government) are clear about what it does and does not do.

We propose to establish the following set of expectations on EQC:

### **Insurer vs. recovery agency**

- EQC should be established as a single purpose insurer with a focus on settling claims. This will require Ministers to establish a clear set of expectations that other agencies will deliver recovery functions similar to those assumed by EQC in Canterbury.

### **Claims handling**

- EQC should exit from claims handling if Ministers can secure robust undertakings regarding:
  - The capability that the insurance industry will maintain, and the quality of the industry's planning/preparation, to deal with future events.
  - The management of fiscal risk as claims handling is outsourced to third parties.

## Pricing and financing

The major challenges regarding pricing and financing are to ensure the scheme is fiscally sustainable and to ensure the arrangements can evolve as time passes and conditions change.

The Review is also examining the benefits of risk-based pricing for EQC cover. We see value in ensuring the scheme pricing reflects its overall long-run cost, but are cautious about the benefits of extremely granular risk-based pricing. We therefore propose the following approach to pricing and financing arrangements:

### **Fiscal sustainability**

- Pricing and financing arrangements need to be able to evolve over time.
- The aggregate revenue from the EQC scheme should match (or at least approximate) the long run cost of the scheme.

### **The pricing mechanism**

- The legislation should open the way for risk-based pricing to occur, but avoid specifying a particular approach or level of granularity to follow.

## Process and timing

The next major milestone for the Review is the development and release of a discussion document, currently scheduled for March. We propose extending this deadline two months to allow more time to test the feasibility of proposed policy options with the insurance sector, on a confidential basis. The support of the insurance sector, including offshore based reinsurers, is critical to the success of any reform and our view is that we should not release options for public consultation that will not ensure the insurance sector's ongoing commitment to the New Zealand market.

## Recommended Action

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We recommend that you:

- a **read** the report and discuss with officials in the New Year, and
- b **note** that a draft agenda for the meeting is attached as Appendix 1.

Steve Cantwell  
**Project Leader, EQC Review**

Hon Bill English  
**Minister of Finance**

Hon Gerry Brownlee  
**Minister Responsible for the Earthquake Commission**

### **Purpose of Report**

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1. The purpose of this report is to support a discussion with officials in the New Year on key policy choices, as well as process and timing, for the EQC Act Review.

### **Where do we stand now?**

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#### **The EQC scheme has helped us in Canterbury, but needs reform in key respects**

2. The experience in Canterbury suggests the EQC scheme has been a successful intervention in two main respects: it has ensured high levels of insurance coverage among homeowners (directly through EQC cover and indirectly through private 'top-up' cover), and it has helped the Government manage the financial impacts of the Canterbury earthquakes. Any reform should preserve these successes.
3. But there are problems with the scheme. Key aspects of the legislation (such as the definition of land cover) are unclear. The claims interface between EQC, private insurers and homeowners has not worked smoothly. It is also clear that there had been little pre-event planning or preparation across the insurance industry to deal with the impact of a major disaster in an urban area.
4. Looking toward the future, we need to ensure the scheme responds to the key lessons from Canterbury but is also robust to the challenges that lie ahead. In this regard, there are two main challenges:

#### **Insurance industry changes will constrain and shape choices for the scheme**

5. With EQC cover acting as a large deductible, the configuration and pricing of private top-up cover has been extremely generous over the past twenty years. After Canterbury, that will no longer be the case. The New Zealand insurance market is reverting to global norms: uncapped replacement cover is disappearing, prices are hardening and terms and conditions are tightening. Insurer appetites for New Zealand risk may well increase significantly in the long term (although the evidence from other hazard-prone jurisdictions such as California and Japan suggests otherwise), but, at least for the time being, insurers will continue to be extremely cautious about how and where they increase their risk exposure.
6. Given that the EQC scheme and the private insurance market are inextricably linked, the future configuration of EQC will shape, and will in turn need to be shaped by, the evolution of private insurance markets.

#### **We need to guard against designing the perfect scheme for the last event**

7. The experience from the Canterbury earthquakes has motivated the Review, but we need to be careful that we do not design a scheme that would have worked perfectly in Christchurch but cannot cope with future events.

8. In order to begin developing recommendations on the future configuration of the EQC scheme, we need to articulate the Government's specific interests in the provision of disaster insurance. We think it is particularly important to develop a clear statement of the Government's interests because the experience in Canterbury suggests many stakeholders (including within Government) did not understand what EQC was intended to do and what this meant for the cover it provided.

### **The EQC scheme must constrain demands for post-disaster assistance**

9. The underlying rationale for a disaster insurance scheme is based on political economy concerns:
- Markets for disaster insurance around the world are marked by inconsistent supply and weak demand, resulting in widespread under-insurance or non-insurance among property-owners. Given the choice, many property-owners simply choose not to insure: among key comparator jurisdictions, the residential earthquake insurance penetration rate ranges from approximately 25% in Chile and 23% in Japan to only 12% in California.<sup>1</sup>
  - In response to disaster losses, and particularly when there are large numbers of uninsured households facing the prospect of significant wealth loss, the global experience has been that Governments feel compelled to provide generous financial support to affected households. These packages tend to have high fiscal costs and generate ongoing moral hazard risks, as they are usually developed in the immediate aftermath of an event, when generosity trumps other considerations.
10. The key argument for a disaster insurance scheme is that it allows the Government to limit and channel the demands for compensation that invariably emerge after a disaster. An insurance scheme also allows Government to charge households for the benefit they receive, reducing the net fiscal costs of post-disaster assistance.
11. In order to achieve the goal of intervention, however, the Government needs to design a scheme that is perceived to represent an adequate response to the demands for assistance that emerge after a disaster.

### **Policy interest 1: Put a roof over people's heads**

12. The current scheme is based on the assumption that the Government can manage demands for assistance by ensuring insured homeowners receive enough money through the scheme to rebuild a 'basic, adequate' house. The restoration of an adequate standard of housing, and the mitigation of at least some of the wealth loss experienced by affected homeowners, were considered sufficient to respond to the distress and loss caused by disaster, and to limit expectations and channel demands for compensation and assistance that would otherwise emerge. At its core, then, the aim of the EQC scheme is to ensure people have the means to put a roof back over their heads after disaster strikes.
13. In our view, the restoration of an adequate standard of housing for disaster victims represents a core and justifiable public policy interest and an appropriate basis for the future configuration of the EQC scheme.

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<sup>1</sup> New Zealand's system of quasi-mandatory disaster insurance, in which EQC cover is automatically attached to residential fire insurance policies, has resulted in near universal disaster insurance cover in the residential sector. As a result, insured losses account for approximately 80% of the total economic losses in each of the September 2010 and February 2011 Canterbury earthquakes, compared to only 17% of the total economic losses from the 2011 Tohoku Earthquake in Japan.

14. Once the Government has ensured that resources are available to restore housing to a basic, adequate standard, it is difficult to construct a policy rationale for providing further support to wealthier homeowners. The strongest reason for doing so is if the Government feels that further support is necessary for it to have confidence that the scheme will largely forestall post-disaster demands for ad hoc compensation. That requires a political judgement about social expectations, although this judgement can be informed by measures such as what fraction of dwellings or residential sections fall within certain price caps.

### *Land*

15. If it is accepted that the Government's interests are based on the restoration of an adequate standard of housing, it follows that the Government does not have an interest in land for its own sake. Instead, the Government's interest in land is tied to its desire to re-establish an adequate dwelling for the occupants of the property. On this basis, we suggest that the design of land cover needs to achieve the following:
  - If it is feasible and efficient to repair or rebuild the dwelling, the scheme should ensure sufficient resources are available to help meet the costs of any land remediation, stabilisation or debris removal necessary to allow:
    - i. the repair or rebuild of the dwelling to proceed
    - ii. reasonable access to the dwelling site, and
    - iii. the connection of essential services.
  - If the land is a total loss, the scheme should ensure resources are available to help the homeowner purchase an adequate dwelling elsewhere.
16. The major implication of redesigning land cover on this basis is that land damage that does not compromise the habitability of the dwelling would be largely excluded from EQC cover. This would represent a significant narrowing of the current approach to land cover.

### *Contents*

17. We do not think there is a strong policy rationale for EQC to continue to cover contents. There are three main reasons for taking this position:
  - Contents claims tend to be small, so it is difficult to argue they will impose unacceptable levels of distress and loss on property-owners.
  - Other instruments are available to manage the impact of such losses. Based on our discussions with insurers, we are confident that private insurance cover will continue to be available for contents, while the social welfare system provides assistance for emergency expenses.
  - From an organisational perspective, EQC's involvement in contents claims actively detracts from its ability to focus on its core housing responsibilities: because contents claims tend to be complex and numerous, they take disproportionate resources to resolve.
18. We propose to remove contents cover from the EQC scheme.

### *Non-residential property*

19. We do not think the EQC scheme should be extended to cover non-residential property. There are two main reasons for taking this position:

- Market participants generally appear to be accepting the outcomes delivered by the market. Insurance markets are going through a major transition – underwriting standards are tightening, prices are hardening and terms and conditions are becoming less generous – but market participants appear to be adapting to the new environment through the use of other risk management tools (including building strengthening and self-insurance).
  - In the absence of Government intervention, there are likely to be higher levels of under- and non-insurance in the non-residential sector than would otherwise be the case. Some types of property are now effectively uninsurable. However, there appears to be a widespread community consensus that it is reasonable to expect the owners of non-residential (and particularly commercial) property to manage their own risks in the private market without Government assistance. We see no need to include non-residential property in the EQC scheme if the Government can be confident it will be able to resist demands for compensation from the owners of non-residential property in future disasters.
20. One possible counter to this position is that there may be an economic growth rationale to ensure a dependable supply of insurance to the commercial property sector, in particular. The experience in Canterbury shows, however, that many firms can be surprisingly flexible and adaptable in response to the constraints imposed by damage to the premises within which they operate (and which they do not always own). Moreover, Treasury’s discussions with commercial stakeholders in Canterbury indicate that the most useful support mechanisms offered by the Government were actually the temporary business continuity measures, such as the Employee Support Subsidy, that provided firms with a financial breathing space in which to regroup and plan a way forward.
21. We propose to continue excluding non-residential property from the EQC scheme.

**Policy interest 2: Support broader disaster risk management and recovery efforts**

22. The Government’s broader goals for disaster risk management and recovery are articulated in the National Civil Defence Emergency Management Strategy:
- Increasing community awareness, understanding, preparedness and participation in civil defence emergency management.
  - Reducing the risks from hazards to New Zealand.
  - Enhancing New Zealand’s capability to manage civil defence emergencies.
  - Enhancing New Zealand’s capability to recover from civil defence emergencies.
23. EQC’s key contribution to these goals is to enhance New Zealand’s capability to recover by providing a substantial proportion of the capital for the residential rebuild. EQC’s research and education programme also contributes to the goals around community awareness and risk reduction.
24. In order to best support the recovery process, the EQC scheme must be designed such that EQC can discharge its statutory responsibilities to insured homeowners as quickly and efficiently as possible. It is also important that the Government and other stakeholders have a clear understanding about how EQC’s responsibilities are intended to fit into broader recovery arrangements.

## Question: Are you happy with this definition of Government's policy interests?

### Putting a roof over people's heads

- The Government's primary interest is to ensure sufficient resources are available to homeowners for the restoration of basic, adequate housing after a disaster.
- The Government does not have an interest in land for its own sake; rather, the Crown's interest in land is tied to its desire to re-establish an adequate dwelling for the occupants of the property (on the same site or elsewhere). *Note this represents a considerable narrowing of the scheme.*
- EQC should not provide cover for contents or for non-residential property.

### Disaster risk management and recovery interests

- In order to best support the recovery process, the EQC scheme must be designed such that EQC can discharge its statutory responsibilities to insured homeowners as quickly and efficiently as possible.

## What counts as 'basic' and 'adequate'?

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### This definition requires a combination of technical input and political judgement

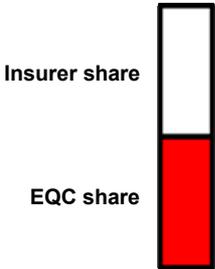
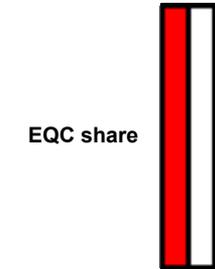
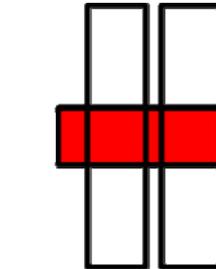
25. If the aim of the EQC scheme is to ensure sufficient resources are available to restore 'basic, adequate housing,' then the Government will need to decide:
  - What constitutes a basic, adequate house?
  - How much it will cost to rebuild a basic, adequate house?
  - How much of this cost must be borne by the Government and how much can be borne by the private sector?
26. The definition of 'basic' and 'adequate' is necessarily a subjective exercise that will require a combination of technical input and political judgement.
27. We think the best way to start placing some boundaries around this definition is to establish a cost of reconstruction based on multiplying estimated building costs per square meter by potential floor areas for various types of houses.
28. We have used standard building rates published by the Ministry for Business, Innovation and Employment (MBIE) to estimate the costs of rebuilding what could be considered to be fairly basic houses. Depending on the floor area (100m<sup>2</sup>-145m<sup>2</sup>) and the amenities included in the house, the costs of construction flowing from these calculations range from approximately \$210,000 to \$270,000 (including GST) in 2012 dollars. These figures provide a ballpark for thinking about a maximum limit to the Government's interest in dwelling cover.
29. It is important to remember, though, that EQC does not actually need to cover this entire amount in order to achieve the Government's objectives. Instead, EQC simply needs to provide enough cover to support the ongoing (and dependable) market participation of private insurers. On this point, the insurance industry does not have a single view about how far EQC cover should extend. But insurers are almost unanimous in the position that the Government should not reduce the value of the cover it already provides for residential property, and, if anything, are looking for the Government to assume a greater share of these costs in the future.

30. The definition of adequacy is more challenging with regard to land cover. Land values (unlike construction rates) vary considerably around the country. An amount that is sufficient to purchase an 'average' property in one region may be insufficient to do so in another region. For this reason, the structure of cover may generate quite different outcomes for homeowners in different regions even if the dollar value of the payout they receive is the same. Our thinking on how to deal with this and other issues in the structure of land cover is still evolving. We will look to provide you with further advice on options for land cover in the New Year.

## Scheme design

### The option set will be constrained by industry willingness and capacity

31. There are many different ways to structure an insurance product. Given the multiplicity of potential options, we have focused our efforts on sketching out three broad options:

<p><b>First loss (status quo)</b></p>  <p><b>Costs per claim</b></p> <p>EQC pays the first tranche of losses on each claim up to a cap. Private insurers are free to provide top-up cover above the cap.</p>	<p><b>Co-insurance</b></p>  <p><b>Costs per claim</b></p> <p>EQC and private insurers share the losses on each claim on a proportional basis. The proportions could vary as the size of the loss increases.</p>	<p><b>Reinsurance pool</b></p>  <p><b>Aggregate losses for each insurer</b></p> <p>EQC pays part of the <i>total</i> costs faced by each insurer across all of their policies after a disaster.</p>
<b>Who would handle claims?</b>		
<p><b>EQC and private insurer, or private insurer only.</b></p> <p><i>Note: stakeholders (including reinsurers) have expressed a strong preference for EQC to exit claims handling.</i></p>	<p><b>Private insurer.</b> EQC will not deal with homeowner.</p>	<p><b>Private insurer.</b> EQC will not deal with homeowner.</p>
<b>Do terms and conditions across EQC and insurer policies need to be the same?</b>		
<p>Consistent if possible, but <b>not necessary.</b></p>	<p><b>Yes.</b> EQC and the private insurer are sharing the costs of the same policy.</p>	<p><b>Yes,</b> for two reasons:</p> <ul style="list-style-type: none"> <li>Govt will want to ensure the policies it reinsures achieve its policy goals.</li> <li>It will be difficult for EQC to price reinsurance cover across differing policies.</li> </ul>

32. Depending on how the liability is structured, there may be little difference between the options in terms of *economic substance*, but greater differences in terms of the *incentive effects* on different parties.
33. The major benefit of a co-insurance scheme, for example, is that it could align the financial interests of EQC and the private insurers during loss adjustment. In order for this incentive to bite, however, private insurers would need to assume a substantial proportion of the losses on each policy (perhaps as much as half of the total liability). Given the insurance industry's apparent unwillingness to assume a greater share of the liability, the co-insurance model appears to offer greater complexity without offsetting benefits in terms of incentive effects.
34. Nevertheless, the position of the insurers on this and other issues may evolve in the context of more detailed discussions about the future model for the EQC scheme. As this suggests, we have now reached a point where we need to move into closer discussions with insurers about their willingness and ability to structure the liability in different ways, in order to ascertain whether different configurations of the liability and different delivery mechanisms are feasible.

### **Reform of the first loss model appears to be the preferred way forward**

35. Our current preference is to reform the first loss model. On the basis of the submissions we have received to date, there appears to be little appetite among insurers or other stakeholders to move away from the current first loss approach. The absence of stakeholder pressure for an alternative approach is striking. Instead, the submissions point to a strong desire to make the existing first loss approach work more efficiently, particularly by increasing clarity, reducing complexity and streamlining the claims handling interface between EQC, insurers and homeowners. This feedback is causing us to lean in our own thinking towards a reform of the first loss model rather than the introduction of a new model.

## **Pricing and financing**

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### **Pricing and financing arrangements need to be able to evolve over time**

36. The major challenge regarding pricing and financing is to ensure the arrangements can evolve as time passes and conditions change. One of the major problems with the current scheme is that there has been no incentive for policymakers to review policy settings as time has passed. The result is that key aspects of the scheme, such as the caps on coverage and the value of the levy, have become increasingly outdated, exposing the Government in some cases to a higher level of fiscal risk.
37. This experience demonstrates a major challenge in managing low-probability/high-magnitude risk: even when policymakers have good intentions, the consideration of such matters is often crowded out by the short-term priorities of governing during the long time periods between major disasters. Our goal in the Review is therefore to establish institutional arrangements that will enable and incentivise policymakers to adjust the scheme as conditions change.
38. We think the legislation should establish a set of principles and parameters to guide decision-making on pricing and risk financing. This means the initial phase of legislative review will need to be followed by a secondary phase of operational policy development, as the principles established in the legislation are translated into specific arrangements for pricing and financing.

## The revenue from the scheme should meet its costs

39. We place a strong weight on fiscal sustainability concerns in considerations of pricing. At a high level, we therefore propose that the aggregate revenue from the levy should match (or at least approximate) the long-run cost of the scheme, in order to ensure the scheme is fiscally sustainable over time.
40. The Government must then decide how to distribute these costs across individual homeowners. The relevant design choice here relates to the 'granularity' of the pricing mechanism: the level at which risk is classified, assessed and priced. At one extreme, the pricing mechanism could establish a single national price of risk; alternatively the mechanism could establish prices on a regional basis (using units such as hazard zones, local authority boundaries, or postcodes), or on a house-by-house basis.
41. The major argument usually advanced for granular risk-based premiums is that they can encourage better risk management decisions by providing a signal about the extent of risk facing each property and creating a financial incentive for mitigation. We are cautious about the extent to which homeowner behaviour will actually change. A substantial body of research provides evidence of myopia and bounded rationality on the part of property-owners regarding the likelihood of catastrophic loss in natural disasters. Homeowners are unlikely to invest in mitigation against events they judge to be rare, especially if upfront mitigation costs outweigh the annual saving in insurance payments.
42. But the granularity of the mechanism is likely to affect the social acceptability of the scheme, although the net impact of granularity is likely to be ambiguous. For example, pricing on a house-by-house basis could strengthen the social acceptability of the scheme by reducing the need for lower-risk property-owners to subsidise higher-risk property-owners, but it could also reduce support for the scheme if the levy charged in some areas is considered to be unfair or unaffordable. On the other hand, a national price of risk might build support for the scheme if citizens share a strong sense of solidarity, but could reduce support if the price is unacceptably high in low-risk areas.

### The potential for price variation is high

The natural hazard profile varies across New Zealand. As a result, households in different regions are likely to face very different prices in a granular scheme. In order to show the potential for variance, we have calculated the average annual loss (AAL) associated with dwellings under current EQC policy settings for earthquake damage in key regions:

Region	AAL per dwelling (\$)	% of national AAL per dwelling
Auckland	10	20%
Wellington	150	300%
Canterbury	50	100%
National	50	100%

*Losses rounded to the nearest \$10.*

*Note: The underlying model has not been updated to reflect new understandings of the seismic hazard in Canterbury. Other hazards such as volcanoes and tsunamis are also not currently modelled.*

The dollar figures represent earthquake losses only, not potential premium prices: a risk-adjusted premium would need to add loadings to account for the volatile nature of the liability in each region as well as administrative expenses. Nevertheless, relative variation in the loss data indicates the considerable potential for variation in the prices paid by households.

## The legislation should enable rather than prescribe an approach

43. We think the legislation should open the way for risk-based pricing to occur, but avoid specifying a particular approach to follow. This will allow the price mechanism to evolve over time, subject to some general statement of policy principles.
44. We take this position because we expect insurers to adopt an increasingly fine-grained approach to risk assessment, but are unsure about how far and how fast this transition will go. It will take several years for modelling providers to update the major earthquake catastrophe models to reflect the observed data from the Canterbury earthquakes, and the insurers themselves are likely to reassess their policies and underwriting systems as they absorb their own lessons from Canterbury. It will also be necessary to develop an approach to currently un-modelled hazards, such as volcanoes and tsunamis.
45. A flexible approach will allow the pricing mechanism for the EQC scheme to evolve as the technology frontier in the insurance industry expands. Attempting to fix the exact approach to pricing in legislation now, on the other hand, may mean the EQC scheme's requirements move ahead of insurer capabilities (requiring investment to bring them up to speed) or alternatively leave the EQC scheme in a suboptimal position once the transition in private markets is complete.
46. Even then, there are limits to the predictive power of catastrophe models: a model is ultimately only as good as the assumptions built into it. [24,37]

### Question: Are you comfortable with the following approach to pricing?

#### Fiscal sustainability

- The aggregate revenue from the EQC scheme should match (or at least approximate) the long run cost of the scheme.

#### The pricing mechanism

- The legislation should open the way for risk-based pricing to occur, but avoid specifying a particular approach or level of granularity to follow.

## Roles and responsibilities

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### 'Insurer' vs. 'recovery agency'

47. It has become evident from the submissions we have received that there is considerable confusion about the role of EQC during a recovery period, and the resulting expectations upon the organisation. We think the Government needs to form a view about the primary role of EQC in the context of a recovery, so that other parties (including within Government) are clear about what it does and does not do. There are two ways to think about EQC's role:
  - As an **insurer**, EQC would focus on settling claims. It would not assume any other tasks and would not necessarily undertake any activities on the ground: it could contract out any claims handling activities for which it was responsible to private insurers, or have no role in claims handling at all.

- As a **recovery agency**, EQC would carry out recovery activities beyond the provision of insurance to support the Government's broader policy objectives. EQC would need to have a presence on the ground to deliver these functions.
48. In Canterbury, the Government has used EQC as a recovery agency. Ministers have tasked EQC with a range of additional functions (such as urgent repairs and home heating installations) which are beyond the scope of the scheme but were considered necessary or desirable to support the recovery. Ministers directed EQC to assume these functions partly because there was no other obvious candidate elsewhere in Government, and partly because EQC's claims handling responsibility gave it a clear predefined role on the ground, unlike other Government agencies.
  49. The assumption of additional functions has come at a cost to the delivery of EQC's core functions. The need to establish new operational capabilities has complicated EQC's efforts to deliver on its core obligations to homeowners at a time when it was already struggling to manage the challenge of gearing up from a small 'peacetime' agency to a major operation handling hundreds of thousands of claims.
  50. Looking forward, we think it would be preferable to establish EQC as a single purpose insurer. EQC, as an insurance provider, has no inherent comparative institutional advantage in the delivery of recovery functions. Providing a single clear objective for EQC, on the other hand, would aid organisational planning, prioritisation and resource allocation decisions, and also provide a clearer basis for EQC engagement with external stakeholders (especially insurers and reinsurers).
  51. Establishing EQC on this basis will only be successful, however, if it is backed up by a clear expectation on other Government agencies to be ready and prepared to assume recovery functions that would otherwise have been delivered by EQC. MCDEM will soon be launching a statutory review of the National Civil Defence Emergency Management Plan, and DIA is beginning to progress work on the legislative framework for recovery arrangements. These two projects represent a natural place to establish a clearer set of expectations across agencies about their roles in a recovery situation.

### **Claims handling responsibilities will likely determine EQC's role after a disaster**

52. Regardless of any policy decisions taken now, future Ministers are likely to use EQC as a recovery agency if it continues to be directly involved in claims handling on the ground. This is because Ministers and agencies will instinctively look to the agency with boots on the ground to deliver on other policy objectives involving the affected homeowners. If, on the other hand, EQC has no responsibilities on the ground, the Government will likely turn to other agencies to achieve its aims and EQC will not face the same pressure to play a leading role in recovery efforts.
53. We think EQC should exit from claims handling. There are four main reasons why:
  - Claims handling is a core function of private insurers. EQC has no comparative advantage in this area.
  - Private insurers have an existing institutional footprint to deal with the claims that arise in a major disaster: they do not need to build new institutional arrangements from scratch. It is unrealistic to expect EQC, on the other hand, to be able to gear up smoothly to handle hundreds of thousands of claims.
  - The involvement of two parties generates additional cost and delay for properties subject to 'double-handling.'

- The involvement of two parties creates uncertainty for homeowners regarding the management of their claim. The situation is particularly problematic in cases where EQC and the insurer do not agree on the treatment of the claim, leaving the homeowners in limbo until the situation is resolved. As homeowners need to suffer large losses to be in doubt as to who is managing their claim, this uncertainty is often distressing for affected individuals and appears inconsistent with the agreed policy objective for the Review of minimising socially unacceptable distress and loss.
54. We have also received clear and consistent feedback from stakeholders – including insurers, reinsurers and community groups – that EQC should not handle claims.
55. There are risks associated with an exit from claims handling. The quality and timing of EQC claims settlement will become dependent on the capability of the private insurance industry, so the Government will need to have confidence in the capability the insurance industry will maintain, and the quality of its preparation, to deal with future events. The Government will also need to establish robust audit/accountability mechanisms to manage the fiscal risk that results as claims handling is outsourced to third parties.
56. We think these challenges are surmountable, potentially through a mix of regulation and contracting. The state-sponsored California Earthquake Authority (CEA), for example, is a public insurer in the State of California that outsources all distribution and claims handling responsibilities to contracted insurers. Each distributing insurer is required to sign a ‘participating insurer agreement’ with the CEA which requires the insurer, among other things, to adhere to CEA claims and inspection guidelines, appoint a dedicated CEA liaison officer and participate in regular training exercises. The CEA approach demonstrates the existence of workable alternatives to the current configuration of responsibilities. We will work through the details of this and other approaches to outsourcing in the coming months.

**Question: Are you comfortable with the following approach to EQC’s roles and responsibilities?**

**Insurer vs. recovery agency**

- EQC should be established as a single purpose insurer with a focus on settling claims. This will require Ministers to establish a clear set of expectations that other agencies will deliver recovery functions similar to those assumed by EQC in Canterbury.

**Claims handling**

- EQC should exit from claims handling if Ministers can secure robust undertakings regarding:
  - The capability the insurance industry will maintain, and the quality of the industry’s planning/preparation, to deal with future events.
  - The management of fiscal risk as claims handling is outsourced to third parties.

**Working towards the discussion document**

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**Scope of the discussion document**

57. Subject to your feedback on this report, and further consultation with insurers (see paragraph 66 below), we propose to include the following matters in the discussion document:

- A. A position on the Government's preferred role for EQC as either an insurer (our preferred option) or a broader recovery agency and what might this mean for the rest of the Government.
- B. A description of the Government's policy interests in providing disaster insurance, and the implications of these interests for the nature and extent of dwelling, land and contents cover.
- C. A preferred option for scheme design and identification of other options considered but not preferred. Based on our analysis and feedback to date, our view is that the discussion document should propose the continuation of the current first loss model (with adjustments) as the preferred model.
- D. A proposal on the institutional arrangements and processes needed to deliver on EQC's functions and insurance coverage, as well as the institutional mechanisms for pricing and financing the liability associated with the scheme.
- E. Proposals to promote and/or require better pre-disaster planning and systems integration between insurers and EQC.

### **Upcoming work**

58. We think we have conducted sufficient analysis and consultation on the question of EQC's role and on the determination of the Government's policy interests (points A and B above) to provide advice to Ministers on our preferred reform options. We now need your feedback on these points to progress work on scheme design. We have more work to do in the following areas:

#### *Scheme design*

59. We are continuing to work on scheme design details and will need to discuss details with the insurance sector in preparing the discussion document (see comments on insurer consultation below). This work includes:
- Modelling the expected liability to the scheme under different design parameters (e.g. caps) and determining the appropriate extent of risk sharing between the Government and private insurers.
  - Understanding the interaction of EQC changes with changes occurring in the insurance market (e.g. a shift to fixed sum insured policies).
  - Determining the extent to which the terms and conditions of EQC cover should be consistent with private cover.
  - Developing options for land cover, with a particular focus on how it would interact with dwelling cover.

#### *Institutional design, pricing and risk financing*

60. We are also working on the appropriate institutional design arrangements (e.g. whether EQC should continue to be a Crown Entity, the nature of Ministerial powers of direction), and the role of the Natural Disaster Fund in the Government's approach to risk management.

## Disaster planning

61. A key theme in the feedback we have received from stakeholders is the need for EQC and private insurers to work together in 'peacetime' to develop protocols and processes (including data collection and sharing) that will improve the efficiency of the response in future events, particularly if private insurers assume claims handling responsibilities from EQC. We are currently developing options on this matter and plan to include proposals for feedback in the discussion document.

## Timelines and stakeholder engagement

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### Project timelines

62. The timeframes for the completion of the Review are based on an objective of passing legislation this parliamentary term. While we still think this is a desirable objective, some of the interim timeframes are tight and, in our view, increasingly difficult.
63. We are concerned that the current March deadline for releasing the discussion document (announced in the Review's terms of reference) will not allow sufficient time to engage adequately with the insurance sector on the workability of proposed reform options. The support of the insurance sector, including offshore reinsurers, is critical to the success of any reform. Our view is that, if we can get the discussion document stage of the process done robustly and take key stakeholders along with us, then we are much more likely to move efficiently through the rest of the process.
64. For this reason, we propose to delay the release of the discussion document two months to June 2013 to allow more time for consultation with the insurance industry. The revised timeframes outlined below are challenging but achievable so long as we get effective engagement from all stakeholders. The implication of delaying the release of the discussion document is that it will push the completion of the Review much closer to the end of the parliamentary term.

Project phase	Completed by	Time allowed	Key Ministerial decisions
Industry consultation and drafting discussion document	End April 2013	12 wks	Agree to discussion document content
Cabinet approval for release of discussion document	End May 2013	4 wks	
Release discussion document and complete public submissions process	Mid July 2013	6 wks	
Policy revisions and Cabinet approval for legislative drafting	End August 2013	6 wks	Agree to any policy revisions following public consultation
Legislative drafting and Cabinet approval to introduce Bill	End December 2013	4 mths	Agree on content of legislation
Introduction	Early February 2014	2 wks	
Parliamentary process and Bill passed	End September 2014	8 mths	

**Question: Are you comfortable with the revised timeframe for release of the discussion document?**

## Further insurance sector consultation

65. We have already consulted with insurance industry participants, including insurers, reinsurers and brokers, to seek their views on the lessons they have learned about the operation of the EQC model in Canterbury. We have used this feedback to inform the development of the policy options discussed above.
66. We have discussed alternative models such as reinsurance and co-insurance in broad terms with insurance industry participants. While some expressed a preference for one model over another, the general view is that all of these options are, in principle, workable. Most insurers support a first loss scheme either explicitly or implicitly (by pushing for higher EQC caps), but are reserving their final judgement until more details can be discussed (e.g. regarding the extent of risk sharing between the Government and private insurers, the specific scope and terms and conditions of cover, etc).
67. In preparing the discussion document, it will be necessary for us to undertake additional targeted consultation with the insurance sector to test specific proposals. We will do this on a confidential basis. There are two reasons for this:
- We do not want to propose an option in the discussion document that the sector thinks is unworkable, or that will trigger insurers and/or reinsurers to reduce or limit their commitment to the New Zealand market. Any model will require a partnership between the Crown and the private insurance sector so we need to be sure the new approach will provide insurers and reinsurers with the necessary certainty and confidence to support the changes.
  - Targeted consultation should help the discussion document submissions process run smoothly and reduce the need for revisions prior to legislative drafting.
68. We have not yet determined whether it would be best to do this consultation bilaterally with each company or whether to run some sort of focus group. We will be guided by industry preferences, given the commercially sensitive nature of the issues.

**Note that we intend to test specific options with the insurance industry on a confidential basis as we prepare the discussion document.**

## Ministerial decision points

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69. We are meeting you in late January to discuss your feedback on this paper, and get your initial thoughts on the focus of the discussion document and the options that should be tested with insurers and included for public consultation.
70. In addition to the January meeting, we expect we will need to meet with you frequently as we develop and finalise design details and the contents of the discussion document. Given the tight timeline for releasing the discussion document, regular meetings will be important for us to ensure we develop a document that meets your expectations and timings. We will work with your offices to set up these meetings.

## Consultation

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71. The Reserve Bank, Ministry of Business, Innovation and Employment, Canterbury Earthquake Recovery Authority, Earthquake Commission, Department of Internal Affairs, Ministry of Civil Defence and Emergency Management, and Department of Prime Minister and Cabinet have been consulted in the development of this report.
72. The Review's Governance Group has been involved in the preparation of this report and supports Treasury's advice.

## APPENDIX 1: DRAFT AGENDA FOR MINISTERS MEETING – JANUARY 2013

### 1. Proposed statement of Government interests

#### Putting a roof over people's heads

- The Government's primary interest is to ensure sufficient resources are available to homeowners for the restoration of basic, adequate housing after a disaster.
- The Government does not have an interest in land for its own sake; rather, the Crown's interest in land is tied to its desire to re-establish an adequate dwelling for the occupants of the property (on the same site or elsewhere). *Note this represents a considerable narrowing of the scheme.*
- EQC should not provide cover for contents or for non-residential property.

#### Disaster risk management and recovery interests

- In order to best support the recovery process, the EQC scheme must be designed such that EQC can discharge its statutory responsibilities to insured homeowners as quickly and efficiently as possible.

### 2. Scheme design issues

### 3. Proposed configuration of EQC roles and responsibilities

#### Insurer vs. recovery agency

- EQC should be established as a single purpose insurer with a focus on settling claims. This will require Ministers to establish a clear set of expectations that other agencies will deliver recovery functions similar to those assumed by EQC in Canterbury.

#### Claims handling

- EQC should exit from claims handling if Ministers can secure robust undertakings regarding:
  - The capability the insurance industry will maintain, and the quality of the industry's planning/preparation, to deal with future events.
  - The management of fiscal risk as claims handling is outsourced to third parties.

### 4. Proposed approach to pricing and financing

#### Fiscal sustainability

- Pricing and financing arrangements need to be able to evolve over time.
- The aggregate revenue from the EQC scheme should match (or at least approximate) the long run cost of the scheme.

#### The pricing mechanism

- The legislation should open the way for risk-based pricing to occur, but avoid specifying a particular approach or level of granularity to follow.

### 5. Process and timing

- Are you comfortable extending the date for releasing the discussion document?
- Note that we intend to test specific options with the insurance industry on a confidential basis as we prepare the discussion document.

## **APPENDIX 2: STAKEHOLDER FEEDBACK ON LESSONS LEARNED FROM CANTERBURY**

This note summarises feedback received from stakeholders on the lessons they have learned from the Canterbury earthquakes. The stakeholders include government agencies, local authorities, insurers, reinsurers, banks, brokers and community representatives. Refer to Appendix 3 below for the list of organisations who were invited to participate.

### **EQC's roles and responsibilities**

Before the earthquakes, stakeholders had either not given much thought to EQC's roles in a major event, or had some familiarity with EQC's statutory functions (basically to assess and settle claims) and expected them to carry them out as expeditiously as possible. As the primary catastrophe insurer, other stakeholders (including insurers and reinsurers) expected that EQC would or should lead or coordinate the insurance industry response and that predetermined, regularly reviewed plans should have been in place to facilitate this.

While the "what" of EQC's roles was generally understood in advance, the way things played out in Canterbury was not anticipated and did not meet stakeholders' expectations. This was largely the result of the scale of the event, the extent of collaboration built in to the dual-insurer model, and the lack of clarity in the legislation.

There was some consensus that the additional responsibilities given to EQC were necessary. In some cases, stakeholders thought these functions were necessary to support EQC's execution of its statutory roles (e.g. the PMO). In other cases, stakeholders considered the functions to be necessary given the scale and nature of the event and the support that residents required. There was a general view that, without EQC, it wasn't obvious which organisation would naturally have responsibility. Private insurers and some reinsurers saw these functions as reasonable things for a Crown agency to be involved in following a disaster. Other stakeholders did provide examples of alternative organisations that could have fulfilled these roles (e.g. Environment Canterbury for home heating).

- There was some agreement that the PMO decision was a good one, providing a level of quality control, cost management, and a coordinated approach to the rebuild. But with it came the need to set the structure up correctly, manage incentives and monitor progress; capabilities that weren't necessarily present in EQC. Additionally, there is a question about whether all the benefits have been realised and/or whether a standardised approach has caused additional or unnecessary distress for customers.
- The engineering advice for policy work was identified as being of exceptional value and residential zoning decisions would have been considerably more difficult without this information. There was a question though about whether the relationship with T&T as geotechnical advisers could or should have been owned at the cross-government level rather than solely by EQC.

There is a cost associated with the additional functions. Some stakeholders considered they created a blurring of the lines and distraction from the core role of settling claims. By taking on additional responsibilities, there is a sense that EQC has been seen as *the* recovery agency (or at least was seen that way early on in the recovery) which is not what it is currently set up to do.

There was some variation in views as to whether EQC should operate solely as an insurer settling claims on a commercial basis or more broadly as a recovery agent. Stakeholders identified a number of implications from this decision, including relationships with reinsurers, organisational independence vs. Ministerial control, and how EQC would/could sit alongside the 'pop-up' recovery agency (e.g. CERA) and any associated establishment legislation.

Those familiar with EQC's research and education roles were strongly supportive of them. They commented that EQC had played a critical role in supporting national understanding of natural disaster risk and used this very effectively in communication and relationship building with the global reinsurance market. Some stakeholders suggested broadening EQC's role to include more involvement in risk management and planning at all levels (e.g. building code research and development, monitoring local code enforcement and planning consents, encouraging retrofitting, disaster preparation, household level risk management).

## **Scope of EQC cover and legislation**

*We asked stakeholders to identify the positive and negative aspects of EQC cover and identify any improvements necessary to address the issues raised*

### General

- The scheme has successfully achieved high levels of coverage and provided affordable, reasonably comprehensive coverage for land and dwellings. The physical reinstatement of properties will have benefits for the quality of the building stock and ongoing insurability in Canterbury. Any future model needs to preserve these positive features.
- The existing model means EQC is managed as a small financial institution in 'peacetime' and scales up into a large-scale insurer post-event. This has placed EQC under institutional stress. In an event the size of Canterbury, any entity, public or private, will experience challenges scaling up. However, private insurers have larger claims handling infrastructure already in place, with the additional ability to access international networks.

### Dwellings and contents

- The dual-insurer nature of the model results in significant duplication in the claims settlement process, puts pressure on the supply of resources (including assessors, loss adjustors etc), establishes differences in terms and conditions of cover across EQC and private policies, and creates major uncertainty and frustration for policy holders. Assuming some kind of ongoing partnership arrangement between EQC and private insurers, these inefficiencies need to be removed, greater consistency in terms is needed, and policy holders should only have to deal with a single entity.
- A lack of change to the scheme over time means it probably no longer achieves its policy objectives of restoring adequate housing post-disaster. Future proofing elements are needed in the new scheme e.g. levy and cap reviews.
- Contents have been a distraction. There is no need for EQC to continue to provide this cover as private insurers have the willingness and capacity to pick up this business.

### Land

- Land cover is complex and is the issue that is yet to fully play out in Canterbury. There were differences of view about the value-add of land cover but the key take-out from all stakeholders is that there is insufficient clarity around land cover and, from insurers, that there are future insurability implications for dwellings to be thought about in the context of land cover. There were divergent views about whether land should continue to be covered in its own right or whether it should be rolled in with the dwelling cover.

When asked, stakeholders identified alternative models to address current claims settlement difficulties. The two broad options were to turn EQC into a reinsurer or adopt a co-insurance model. There was no real consensus between insurers and reinsurers about which approach was preferable; they thought, in principle, that both models could be workable.

Any new approach needs to work for common as well as exceptional events, have regard to the implications for the roles and responsibilities of other entities, and respond to changes in New Zealand insurance markets (e.g. a shift to sum insured based policies) and global reinsurance markets.

## **Preparing for a disaster and working with EQC**

*We asked stakeholders to identify the key relationships EQC needed to have to facilitate the recovery, and how well these relationships have worked in the Canterbury context.*

Stakeholders identified a number of critical relationships for EQC during a major event, including Ministers, other government agencies, insurers, reinsurers, local authorities, utility providers, project management firms, community groups, and property owners. There were different views about the effectiveness of specific relationships with EQC, but all agreed that more needs to be done to prepare for future events. Some reinsurers were extremely positive about how EQC has communicated to reinsurance markets and about its ongoing commitment to maintain viable earthquake insurance markets in New Zealand.

The following were identified as future relationship priorities:

- **Joint EQC and insurer protocols and planning.** There was strong feedback that there were not sufficiently well developed working relationships and response plans in place between EQC and private insurers. While all eventualities can never be foreseen, stakeholders consistently said that EQC and private insurers need to build relationships and develop response protocols and processes during 'peacetime' to improve the efficiency of their response to future events. As part of this, consideration needs to be given to ownership of the relationship with the customer. The absence of these processes, and that the uncertainty about how the parts of the system would work together, have negatively impacted the relationships of all players with customers.
- **Data sharing and integration.** Some stakeholders identified data systems or integration issues as impediments to the Canterbury recovery. Particular issues included EQC not being able to share data across government, making providing policy advice on a range of issues difficult, and the lack of a single customer database between insurers and EQC where all information on properties and claims could be held. It was also identified that data integration capabilities between EQC and insurers need to be regularly reviewed and tested as part of disaster planning. If special powers are needed to enable data integration, these should be included in the revised legislation. Additionally, if data held by other entities (e.g. rating or valuation information) is also likely to be used in a future event (e.g. as the basis of a compensation scheme), consideration needs to be given to that now as well.
- **Public education.** There is a lack of public familiarity with the nature and terms of EQC cover combined with high expectations about what the scheme would deliver. The introduction of the new scheme needs to include a public communication and education campaign so that changes to coverage are widely understood.

### APPENDIX 3: STAKEHOLDERS CONSULTED TO DATE

Stakeholder	Response received	Stakeholder	Response received
EQC	√	Mapfre Re	
DPMC	√	Montpelier Re	
MBIE	√	MS Frontier Re	
CERA	√	Munich Re	√
MCDEM	√	Nephila	
DIA		New India	
Christchurch City Council	√	Novae Re	
Selwyn District Council	√	Odyssey Re	
Waimakariri District Council	√	Partner Re	
IAG	√	Platinum Underwriters Bermuda	
Vero	√	Renaissance Re	
Tower	√	SCOR Reinsurance	√
Lumley	√	Shelter Mutual	
Southern Response	√	Sirius International	
AA	√	Swiss Re	√
FMG	√	Argo Syndicate	
Insurance Council	√	Antares Syndicate	
NZ Bankers' Association	√	Chaucer Syndicate	
Marsh	√	AEGIS Syndicate	
CERA community forum	√	Torus Syndicate	
CanCERN	√	Ascot Syndicate	
Ace Tempest Re		Renaissance Syndicate	
Allianz Re		Amlin Syndicate	
Alterra Re		Catlin Syndicate	
American Agricultural		Cathedral Syndicate	
American Family		Brit Syndicate	
Amlin	√	Hiscox Syndicate	
AQR		Ark Syndicate	
Arch Re		Canopus Syndicate	
Argo Re		Liberty Syndicate	
Ariel Re		Kiln Syndicate	√
Asia Capital Re		QBE Syndicate	
Aspen Insurance	√	Atrium Syndicate	
Axis Specialty Limited		Beazley Syndicate	
Berkshire Hathaway		Beazley Syndicate	
Catlin Bermuda	√	Advent Syndicate	
Chartis		Kiln Syndicate	
DaVinci		Omega Syndicate	
Employers Mutual Casualty		ANZ Syndicate Management	
Endurance		Taiping Re	
Everest Re		Toa Re	
GIC		Tokio Millenium Re	
Hannover Re		Validus Re	
Hiscox		XL Re, Bermuda	
Houston Casualty Co		Willis Re	√
Lancashire Re			