

The Treasury

Material Provided to the Public Inquiry into EQC Information Release

August 2021

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- [36] 9(2)(h) - to maintain legal professional privilege
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Treasury Report: EQC Legislative Review: How Should EQC's Building and Land Cover be Configured?

Date:	8 November 2016	Report No:	T2016/560
		File Number:	CM-1-3-15

Action Sought

	Action Sought	Deadline
Minister Responsible for the Earthquake Commission (Hon Gerry Brownlee)	<p>Confirm the discussion document proposal that EQC will only cover land damage that affects an EQC-insured building and its access way, with land damage that does not affect the insured building or its access not being covered by EQC.</p> <p>Decide whether siteworks repairs should be part of EQC building cover, or separate EQC land cover.</p> <p>Indicate if you want officials to further explore a new EQC design option intended to help reduce the potential impacts of home owner under-insurance.</p> <p>Note that proper commissioning of work on that option requires consultation with the Ministers of Finance, Justice, and Commerce and Consumer Affairs, and a broader policy process (which would likely be led by MBIE).</p> <p>Discuss this report with officials.</p>	<p>None.</p> <p>Note recommendation (j) asks you to indicate if you would like to discuss initiating further work on underinsurance issues with the Ministers of Finance, Justice and Commerce and Consumer Affairs at the next BGA Investment Ministers' meeting on 14 November 2016.</p>
Associate Minister of Finance (Hon Steven Joyce)		

Contact for Telephone Discussion (if required)

Name	Position	Telephone	1st Contact
Steve Cantwell	Principal Advisor	[39]	[23] ✓
James Beard	Manager - International, Financial Markets & Tax Strategy	[39]	[23]

Actions for the Minister's Office Staff (if required)

Return the signed report to Treasury.

Note any
feedback on
the quality of
the report

Enclosure: No

Treasury Report: EQC Legislative Review: How Should EQC's Building and Land Cover be Configured?

Executive Summary

This report seeks decisions on two key design questions arising from submissions on the 2015 discussion document *New Zealand's Future Natural Disaster Insurance Scheme*, namely:

- *For land damage, should the discussion document proposal to limit EQC cover to land damage that affects the insured building (and access to it) proceed, or should EQC continue to insure all land within a certain distance of an insured building, even if the land damage has not affected the insured residential building or main access way?*
 - ⇒ The key trade-off is between focussing the EQC scheme only on damage whose repair is necessary as part of repairing the insured's home, or protecting the wider financial or amenity value of the insured's land.
- *For building replacement or reinstatement on the same site, how should the EQC scheme deal with land damage that affects the insured building? Should the discussion document proposal to include the resulting repairs in EQC building cover proceed, or should those sitework repairs continue to be part of separate EQC land cover?*
 - ⇒ The key trade-off is between on one hand, simplicity and alignment with commercial insurer practice, and on the other hand protecting homeowners whose home repairs have become more expensive due to land damage caused by a natural disaster.

Those strategic design decisions will determine the shape of the scheme into which further advice on the remaining technical details of the design will be situated. Once a fully-described reform package is agreed by responsible Ministers we will draft a Cabinet paper seeking Cabinet agreement to the entire reform package.

You are also invited to indicate if and how we should proceed with additional work to further address issues raised by submitters regarding under-insurance arising from the recent shift of the standard residential insurance offering from full replacement to sum-insured cover. That would require a broader project involving the Justice and Commerce and Consumer Affairs portfolios.

Compared to the EQC current exposures, the modelled differences in scheme costs and risks between the reform options are relatively small, and therefore should not be a primary driver in decision-making.

What land damage should be covered by EQC?

An intended consequence of the discussion document proposal that siteworks be included in EQC building cover was that EQC would not provide any land cover if a building could be cost-effectively replaced or reinstated on the same site. EQC land cover would only be available where land damage meant it was not possible or practicable to replace or reinstate the building on the site.

EQC currently insures all land within 8 metres of an insured building¹. Some submitters expressed concerns about potential financial loss and/or amenity impacts associated with damage to land next to the dwelling that is not relevant to building replacement or reinstatement works, but still has amenity or financial value.

Officials' advice continues to be that future EQC cover for land should only focus on siteworks required as part of building replacement or reinstatement work.

Should siteworks be part of the building cover or separate land cover?

Siteworks options

At present siteworks² form part of EQC's land cover. The discussion document proposed that siteworks instead be included in EQC's building cover. The Building Act treats siteworks as building work, as do private insurance policies in the absence of EQC.

A range of submitters opposed this change due to concerns that land damage would lead to affected homeowners being under-insured.

In light of those concerns Treasury now recommends that siteworks remain as part of a separate EQC land cover. EQC, however, recommends that the proposal in the discussion document to move siteworks from land to building cover be confirmed. The key reasons for the different conclusions are that:

- Treasury attaches greater weight to submitters' concerns regarding the potential for the discussion document proposal to exacerbate homeowner under-insurance (i.e., where land damage impacts significantly on repair costs); and
- EQC attaches greater weight to simplification of claims management and speed of settlement benefits from the conceptual and operational clarity of the discussion document proposal.

Treasury and EQC recommend that if the Treasury-recommended approach is agreed, the building cap be \$150,000+GST, compared to the \$200,000+GST that was proposed in the discussion document. The lower recommended cap is because the \$200,000 in part reflected the transfer of costs associated with siteworks and access ways from EQC land cover to building cover.

The option now recommended by Treasury has slightly lower expected costs and risks – perhaps 5 percent or so lower - than the option included in the discussion document. That is because of the lower monetary cap on EQC building cover. Lower costs and risks result in lower EQC premiums and lower risks for the Crown as guarantor of the EQC scheme.

The key question to consider is: *Do Ministers think that the EQC scheme should meet the sometimes expensive or difficult to predict land remediation or repair costs arising from land damage caused the natural hazards covered by EQC?*

If the answer is “no”, the discussion document proposal is the best option.

If the answer is “yes”, retaining siteworks as part of a separate EQC land cover is the best option.

¹ And land under up to 60 metres of main access way. This access provision is proposed to be retained under all options.

² Siteworks are any works on a building site, including earthworks, preparatory to, or associated with, the construction, alteration, demolition, or removal of a building.

Do you want further work on options to address homeowner under-insurance?

In response to concerns of submitters and Ministers regarding post-disaster under-insurance as a result of inadequate sum-insured cover, officials have developed a design of EQC cover intended to further reduce post-disaster under-insurance. The option could operate with either of the above two designs for building cover. We have dubbed it “*Sum-insured plus EQC*”. The practical effect of this would be that the owners’ sum-insured would be increased by the value of the EQC cap if the damage was from an event covered by EQC.

This report tests responsible Ministers’ interest in developing that proposal further. Consultation with the Ministers of Finance, Justice, and Commerce and Consumer Affairs would be required prior to initiating this work, which would need to be balanced against work on other Government priorities and would likely be led by MBIE. A discussion at a BGA Investment Ministers meeting would in principle be a useful next step if you wish to pursue issues surrounding sum-insured policies further. However timing is difficult this as the next BGA Investment Ministers meeting is scheduled for Monday 14 November. That is the last scheduled meeting of that group prior to Christmas.

Recommended Action

We recommend that you:

- a **note** that, following consideration of submissions on the 2015 discussion document *New Zealand’s Future Natural Disaster Insurance Scheme* Treasury and EQC now offer a mix of different and shared recommendations for EQC land and building cover;

Confirming EQC land cover focus on replacement and reinstatement of residential buildings

- b **agree** that the following features of proposals made in the discussion document be retained:
 - i. that EQC land cover be limited to land damage affecting land that supports or protects the EQC-insured residential building, and the main accessway;
Agree/disagree
 - ii. that EQC payments for land damage be able to be directed to building work that is not siteworks, when such building work enables the most cost-effective building replacement or reinstatement method;
Agree/disagree
 - iii. that EQC cover for retaining walls and culverts be changed from indemnity cover (i.e. depreciated value of the failed retaining wall) to their reinstatement cost;
Agree/disagree
 - iv. that EQC continue to offer land cover for total losses (i.e. where a site cannot be rebuilt on);
Agree/disagree

Should siteworks be part of the building cover or land cover?

Treasury recommendation (as an alternative to EQC recommendation f below)

- c **agree** that the discussion document proposal that EQC building cover be extended to include siteworks not be proceeded with, with EQC building cover instead being retained in broadly its current form;
Agree/disagree

Recommendations supported by Treasury and EQC, if recommendation c is agreed to

- d **agree** that the proposed monetary cap on building cover be increased to \$150,000+GST;
Agree/disagree
- e **agree** instead that EQC land cover continue to apply to situations where a site has suffered land damage and the insured residential building can be replaced or reinstated on-site;
Agree/disagree

EQC recommendation (as an alternative to Treasury recommendation c above)

- f **confirm** that the discussion document proposals that EQC building cover be extended to include siteworks and the monetary cap raised to \$200,000+GST be proceeded with;
Agree/disagree

Remaining recommendations supported by Treasury and EQC

A new proposal to further address homeowner under-insurance

- g **note** that we have identified a “Sum-insured plus EQC” option to address potential underinsurance issues by providing that EQC building cover does not reduce private insurers’ building cover, resulting in a higher sum-insured for EQC-covered hazards than for hazards not covered by EQC;
- h **note** that consultation with other agencies and insurance industry stakeholders is advisable to ensure that EQC options for addressing underinsurance issues are considered alongside other policy options;
- i **indicate** if you would like to discuss initiating further work on underinsurance issues with the Ministers of Finance, Justice and Commerce and Consumer Affairs at the next BGA Investment Ministers’ meeting on 14 November;
Agree/disagree

Next Steps

- j **note** that, once you have made decisions on these key issues, we will provide further reporting and advice on a wide range of follow-on design issues; and
- k **indicate** if you would like to meet with officials to discuss this report.
Agree/disagree

James Beard
Manager - International, Financial Markets & Tax Strategy

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

Hon Steven Joyce
Associate Minister of Finance

Treasury Report: EQC Legislative Review: How Should EQC's Building and Land Cover be Configured?

Purpose of Report

1. This report seeks strategic design decisions on the proposed future configuration of EQC's insurance cover to inform further advice and decisions on scheme design choices for inclusion in a subsequent Cabinet paper and drafting instructions.

Background

2. Since 1993 the cover and limits of EQC cover for residential buildings and land for each natural disaster event are typically as follows:
 - **Building cover:** the replacement value of each dwelling up to \$100,000 + GST, less excess.
 - **Land cover:** the lower of the value of the damaged insured land (up to the minimum lot size under the applicable district plan), or the cost of reinstating the land to its pre-event condition, less excess. Covered land includes land under the building or within 8 metres of it, up to 60 metres of main access way, and associated retaining walls, bridges and culverts.
3. In 2012 the Government announced a legislative review of the Earthquake Commission Act 1993 (the EQC Act or the Act). A discussion document inviting public submissions on all legislative aspects the EQC scheme was released on 6 July 2015. We received 32 submissions from individuals and 29 from businesses and other organisations.
4. This report deals only with the configuration of EQC's cover for residential land and buildings. Decisions on these issues are central to the final design and will help anchor future advice on a raft of other technical design issues. We consider land and building cover together, as decisions on the coverage of one can affect the other.

Introduction

The discussion document proposals

5. Core elements of the discussion document proposals relevant to this report are:
 - That siteworks be part of EQC building cover. EQC land cover would only be available in a total loss situation where it was not possible or practicable to replace or reinstate a damaged building on the same site;
 - That, when a building can be cost-effectively replaced or reinstated on the same site, EQC would no longer cover land damage beyond the siteworks required to replace or reinstate the building

- Focusing EQC cover on works necessary to replace or reinstate the residential building also meant that EQC cover would no longer be available for land damage that does no building damage now, but increases the risk of future building damage (e.g., increased vulnerability to hazards such as flood or liquefaction).³

Key concerns raised in submissions

6. Submitters' concerns with these proposals focussed on:

- the potential for the combined land and building cover to leave home owners with insufficient insurance if the site suffered unpredictably expensive land damage;
- the risks of under-insurance more generally due to the market shift to sum-insured cover;
- concerns that limiting EQC land cover to damage affecting a building (and access to it) would disadvantage home owners that in future suffered land damage that is currently insured, and would not be covered under the new scheme (for instance, cliff collapse near a residential building, or appurtenant structures, that does not damage the primary residential building or place it at imminent risk).

7. We see the three key policy questions raised by submitters' concerns as:

- *For land damage, should the discussion document proposal to limit EQC cover to land damage that affects the insured building (and access to it) proceed, or should EQC continue to insure all land within a certain distance of an insured building, even if the land damage has not affected the insured residential building or main access way?*
- *For building replacements or reinstatements on the same site, how should the EQC scheme deal with land damage that affects the insured building? Should the discussion document proposal to include the resulting repairs in EQC building cover proceed, or should those sitework repairs continue to be part of separate EQC land cover?*
- *Has the recent shift of the standard residential insurance offering from full replacement to sum-insured cover created under-insurance exposures that warrant consideration of a further policy response?*

8. Over the past months we have analysed (and discussed with EQC, insurers, and others) these issues and potential alternatives for EQC building and land cover. This report summarises that analysis and seeks decisions from you on core design features of EQC cover.

Should EQC land cover only apply to land damage that affects the insured building (or access to it)?

For land damage, should the discussion document proposal to limit EQC cover to land damage that affects the insured building (and access to it) proceed, or should EQC continue to insure all land within a certain distance of an insured building, even if the land damage has not affected the insured residential building or main access way?

³ The key point being that, provided insurance cover is still available for residential buildings on the site, any future damage that is covered by the EQC scheme will be claimable if and when it occurs.

Feedback from submitters

9. The discussion document proposal that EQC no longer cover land damage that does not directly affect the residential building was supported by seven individual submitters and opposed by ten individual submitters and two institutional submitters. Opposing submitters considered the EQC scheme should compensate for financial and amenity losses arising from the loss of land near the home.

Analysis of submitter feedback

10. We recognise that restricting the scope of land cover would leave some residential building owners at risk of potentially significant losses in amenity and land value. This risk cannot be insured elsewhere. Private insurers do not offer land cover in home insurance policies, and are unlikely to do so in future.
11. Per the discussion document, we recommend not retaining the current land cover because:
 - retaining it is inconsistent with focussing the EQC scheme on the core government interest of putting a roof over peoples' heads – the replacement or reinstatement of damaged housing;
 - the current land cover generates claims costs unrelated to housing replacement or reinstatement;
 - retaining it would mean that the significant interpretive and administrative advantages of strongly linking land cover to replacement or reinstatement of the insured dwelling would not be achieved.
12. The key opposing arguments are political-economy judgements:
 - That the government should protect homeowners from these losses (a view about the appropriate role of the state);
 - That any EQC design should be durable, and that a reform that excludes land damage unrelated to building repair risks being reversed if there are widespread homeowner land losses following a large natural disaster.
13. We seek confirmation of the discussion document proposal to limit EQC cover to land damage that affects the insured building and access to it.

Cover for siteworks

Should the discussion document proposal to include siteworks in EQC building cover proceed, or should siteworks remain as part of separate EQC land cover?

Feedback from submitters

14. The proposal to include siteworks in building cover were supported by 13 and opposed by 3 individual submitters. However only three insurers or reinsurers supported the proposal (Southern Response, Munich Re and Tokio Marine), along with the Christchurch City Council and NZ Climate Change Research Institute. The proposal was opposed by the Insurance Council of New Zealand (ICNZ), seven individual insurers, Swiss Re, the Bankers Association, the NZ Society of Actuaries, and Tonkin + Taylor.

15. Opposition to the proposal centred on concerns about potential under-insurance of individual dwellings and/or residential buildings. With sum-insured residential policies, higher than expected replacement or reinstatement costs fall on the owner once the sum-insured is reached.

Analysis of submitter feedback

16. Private insurers' moving from full replacement to sum-insured policies has greatly increased the risks of home owners being under-insured, as replacement or reinstatement costs in excess of the sum insured are now borne by homeowners. [34]
17. That said, insurer concerns regarding under-insurance go to a core rationale for the EQC scheme. The EQC scheme is (and was) not intended to completely eliminate under-insurance. To do so, EQC would need to provide uncapped full replacement cover. However, government policy, including via the EQC scheme, needs to sufficiently limit under-insurance by residential building owners so that pressure for further ad-hoc government assistance is unlikely to succeed.
18. The Treasury has previously reported to the Minister of Finance, with copies referred to both of you, on the implications of sum-insured policies and under-insurance (T2015/1294 *Home Insurance – Implications of Sum-insured Cover* refers). That report concludes that under-insurance is very common, with an estimated 40-85 percent of dwellings under-insured. However the owner is only disadvantaged if the under-insured residential building suffers damage in excess of the insured value, as any damage up to that point will be fully paid out by the insurer.
19. Analysis in that report estimates that, at current sum-insured values, a large Wellington earthquake would result in 1,000-5,000 dwellings, or 1-5 percent of dwellings affected by the earthquake, suffering damage greater than their insured values. The value of the uninsured damage is roughly estimated at \$135 million. This represents about 2-3 percent of the estimated \$5.8 billion cost of dwelling damage from that event. Where the level of individual under-insurance is modest, home owners have mitigation options such as rebuilding a smaller or lower-cost home. Therefore only an (unknown) subset of this group is likely to be of policy concern.
20. A key judgement for Ministers is whether or not that level of under-insurance would force ad-hoc government financial support for those households. If so, steps should be taken now to reduce the number of expected under-insured to levels that are unlikely to force additional post-disaster support.
21. Submitters, including ICNZ and insurers, emphasise that retaining walls and siteworks introduce risky and difficult to estimate elements into owners' sum-insured calculations. Siteworks and/or specific design foundation costs can be very expensive and difficult to estimate in advance as costs can increase significantly as a result of land damage caused by the natural disaster that generates the claim. EQC claims data (at Annex 1) suggests that expensive land claims are relatively few in number, with about 7 percent of land claims, on average 50-60 claims a year, costing more than \$50,000 to settle. In Canterbury to date about 1,500 land claims have cost more than \$50,000 to settle. However as these numbers include an unknown number of total loss land claims that would continue to be paid under all proposed future options, they are best seen as indicating an upper bound, rather than best estimate, of the numbers of affected claimants.

22. The discussion document proposals have attractive features, including more closely following insurer private practice, removing the existing difficult boundary between land and building cover, and strongly focussing the EQC scheme on residential buildings and the homes they provide.
23. That said, officials accept submitters' view that the discussion document's proposed incorporation of retaining walls and siteworks into EQC building cover has potential to increase the estimated 1-5 percent "tail" of under-insured residential buildings. Accordingly, we have developed options that aim to retain the advantages of the discussion document proposals while also responding to submitters' concerns.

Policy options

24. The options for building cover are:
 - **Building cover including siteworks (discussion document proposal):** Where it is possible and practicable to replace or reinstate on the same site, necessary siteworks would be covered under a single building cap of \$200,000⁴.
 - **Building cover excluding siteworks:** Makes minimum changes necessary to address the core problems with status quo. As with the status quo, siteworks would be covered by separate land cover that applied if land damage had contributed to building damage⁵. However, there would be no separate land repair obligation on EQC beyond using the monies from a land claim to contribute to the most cost-effective mix of land and building works to replace or reinstate the residential building.

If this option is chosen we recommend a monetary cap for building cover of \$150,000. That monetary cap is supported by ICNZ. We recommend a lower cap because the discussion document proposed a cap of \$200,000 in recognition of the cost increases from moving siteworks (and other elements such as driveway surfaces) into the proposed building cover. Therefore if the siteworks remain in a separate land cover, a lower building cap can apply.

25. Under both these options the total "footprint" of EQC cover is almost identical, monetary caps aside. In both cases EQC would cover building repairs up to a nominated monetary cap, and associated siteworks to protect and support the home and access to it.
26. Treasury and EQC agree that the discussion document proposal is conceptually and operationally attractive. EQC continue to prefer the *building cover including siteworks* proposal presented in the discussion document, for the reasons presented in that document. EQC consider that submissions overstate the under-insurance risks of the proposal.
27. Treasury now recommend the *building cover excluding siteworks* option as it addresses submitters' concerns about under-insurance stemming from unforeseen significant costs due to land damage, while also largely addressing the problems associated with the current boundary between land and building cover. Insurers are now also in favour of this option (which is a shift in position from the proposal ICNZ submitted in its formal submission on the discussion document).

⁴ Where replacement or reinstatement is not practicable (including for reasons of cost), EQC total-loss cover for land would be triggered, and would operate much as the current EQC land cover does when it is not practicable to rebuild on a site.

28. Treasury and EQC agree that of the two options, the *building cover excluding siteworks* option has the smaller increase in the scheme's expected costs and risks, due to the recommended lower monetary cap (annex 2 details the impact of the options on the expected fiscal costs and risks of the scheme).
29. Under both options, if it was not practicable to reinstate or replace a residential dwelling on the existing site, it is proposed that the monetary cap for land cover would be set at the value of a minimum lot size. In practical terms, this cap would also be used by EQC when assessing the cost of repair or reinstatement options under the *building cover excluding siteworks* option, i.e., EQC would not pay more to repair a site than the value of the site.
30. Treasury also seriously considered recommending a Hybrid option. Under this option the design proposed in the discussion document would normally apply. Siteworks would only be covered separately if more than \$50,000 of land repair was required. This design was attractive as it would see the great bulk of claims being dealt with under the model proposed in the discussion document, while also protecting homeowners against under-insurance arising from costly land repair. Ultimately we did not recommend it as it is EQC's and insurers' least-preferred option due to concerns with its operational complexity.

Table 2 Comparing key features of competing options for land cover

Option	Design Feature				
	Siteworks covered	Land repair monies can be directed to most economic siteworks or other building work mix	EQC land cover focussed only on building replacement or reinstatement	Retaining walls and culverts fully insured	Homeowner protected from under-insurance due to unexpectedly high costs due to land damage
Separate land and building cover (status quo)	✓	✗	✗ Other land also covered within 8m	✗ insured for indemnity value	✓
Building cover includes siteworks (DD proposal and EQC recommendation)	✓	✓	✓	✓ only land improvements required for the building and access to it are covered	✗ siteworks funded from EQC building cap
Siteworks included in land cover (land cover limited to land damage affecting residential buildings) (Treasury recommendation)	✓	✓	✓	✓ only land improvements required for the building and access to it are covered	✓ Up to the value of the minimum lot size
Hybrid option (DD proposal applies unless total damage exceeds \$200k and land damage exceeds \$50k)	✓	✓	✓	✓ only land improvements required for the building and access to it are covered	✓ Up to the value of the minimum lot size

31. Another way to consider the options is to assess them against the four Government objectives set out in the Review's terms of reference. This table summarises the options' against those four objectives.

Table 3: Evaluating options for building and land cover against the objectives for the EQC Review

	Well-functioning Insurance industry	Manage Crown risk ⁶	Efficient disaster recovery	Minimise owner distress/loss
Status quo	Land and building interactions create friction and uncertainty	Lowest explicit Crown risk of all options due to \$100k building cap.	Land and building interactions cause delay.	Land and building interactions cause delay.
Building cover includes siteworks (DD proposal)	Strongly opposed by insurers due to uncertainty and pricing concerns.	Higher Crown risk due to the \$200k total cap	Dealing with all repairs and rebuilds via only building cover adds certainty and assists timely repair. Unforeseen higher costs due to land damage may be under-insured, delaying repair/recovery for those affected.	Good option for owners unless there are unforeseen high costs due to land damage.
Siteworks included in land cover (Modified status quo)	Insurers preferred option.	Intermediate risk due to \$150k building cap and retention of land repair	Interaction of land and building cover significantly improved but not entirely removed. More complex than DD proposal for claimants whose damage does not exceed their private cover, but provides more cover to those who have suffered land damage.	Good option for owners.
Hybrid option (DD proposal applies unless total damage exceeds \$200k and land damage exceeds \$50k)	Insurers' least-preferred option.	Highest Crown risk as combines \$200k building cap with retention of land repair	Combines advantages of DD proposal for 90 percent or more of claimants with extra cover for claimants suffering significant land damage. If insurer and EQC concerns were borne out post-disaster its complexity could cause delays.	Same advantages as DD option for owners suffering less than \$50k of land damage. More complex for owners suffering more than \$50k of land damage and \$200k of total damage.

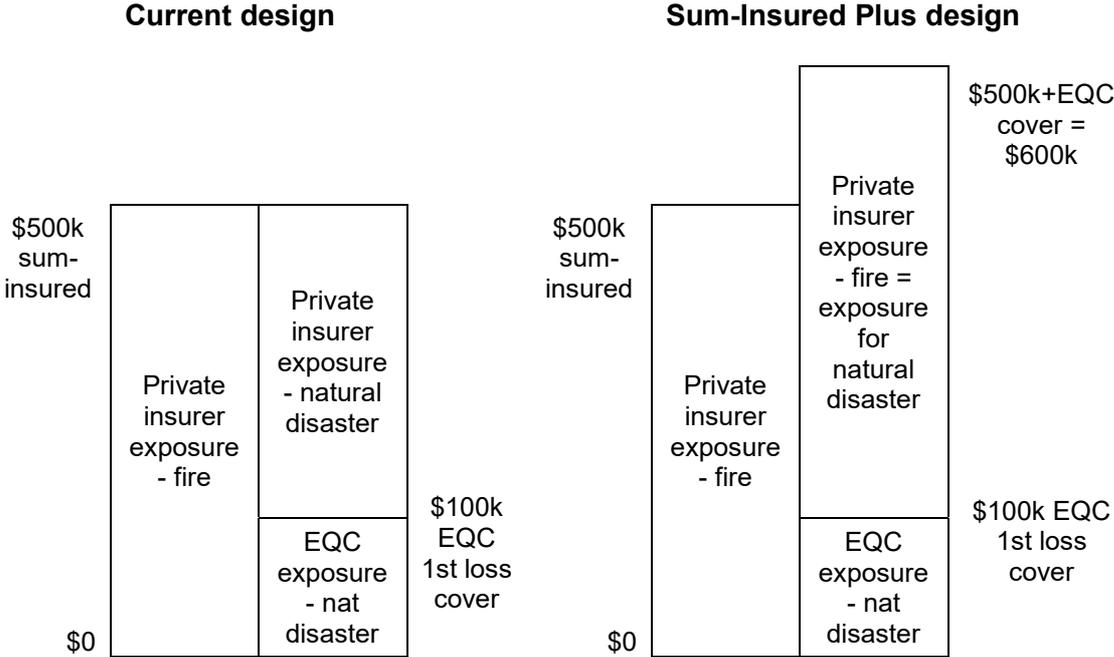
⁶ To aid comparability the discussion in this column ignores the risk impacts of the proposed exit of EQC from contents cover, and from increasing EQC claims excesses. Total cost and risk impacts of packages including those reforms are in Annex 2.

32. The key judgement between these options is what option best balances these objectives, and is sustainable over time? Sustainability requires a largely political economy judgement of what outcomes are acceptable or unacceptable in a post-disaster environment. Outcomes judged unacceptable after a disaster are likely to provoke ad-hoc policy responses.
33. Annex 2 details the impact of the options on the fiscal costs and risks of the EQC scheme. The options are risk-neutral to risk-reducing for the Crown as the increased exposures from a higher monetary cap on building cover is more than offset by reductions in exposures due to EQC exiting contents cover and introducing higher claims excesses.

Should the design of EQC building cover do more to address under-insurance?

- *Has the recent shift of the standard residential insurance offering from full replacement to sum-insured cover created under-insurance exposures that warrant a further EQC policy response beyond the decision on the treatment of siteworks?*
34. In response to concerns of submitters and Ministers regarding post-disaster under-insurance, officials have developed a design that if implemented would further reduce post-disaster under-insurance. It could operate with either of the above two designs for building cover. We have dubbed it “*Sum-insured plus EQC*”.
 35. At present, under sum-insured policies, payments made under EQC building cover reduce private insurers’ payment obligations dollar-for-dollar. An alternative approach would be to not permit insurers to adjust their payouts in this way. The practical effect of this would be that insurers would always face the same maximum sum-insured liability, irrespective of the source of the risk (e.g. fire or natural disaster), and the owners’ sum-insured would be increased by the value of the EQC cap if the damage was from an event covered by EQC. This is shown diagrammatically for a dwelling insured for \$500,000.

Fig. 4: Current and sum-insured plus EQC designs



36. This report tests responsible Ministers' interest in developing that proposal further. This option is responding to systemic concerns with under-insurance, rather than a problem with the EQC design. Potentially there are better options for addressing those concerns, for instance a regulatory response. As this option arose within the context of the EQC Review, none of that broader option analysis has been carried out. ICNZ and insurers oppose this proposal as highly intrusive and are unlikely to shift position without an analysis that includes other potential policy responses.
37. To be in a position to offer well rounded advice on the pros and cons of the competing options for addressing homeowner under-insurance, non-EQC options for addressing under-insurance, such as education or regulatory options, would need to be tested with other government agencies and insurance industry stakeholders. Consultation with the Ministers of Finance, Justice, and Commerce and Consumer Affairs would be required prior to initiating this work, which would need to be balanced against work on other Government priorities and likely be led by MBIE. A discussion at a BGA Investment Ministers meeting would in principle be a useful next step if you wish to pursue issues surrounding sum-insured policies further. However timing is difficult as the next BGA Investment Ministers meeting is scheduled for Monday 14 November. This is the last scheduled meeting of that group prior to Christmas.
38. Previous Treasury advice on homeowner under-insurance (this was provided separately from advice on the review of the EQC Act, T2015/1294 *Home Insurance – Implications of Sum Insured Cover* to the Minister of Finance, also referred to the Minister Responsible for the Earthquake Commission, refers) noted in part that:
- *“Precise figures are hard to assess, but 40-85% of homes could be under insured by 10-50%;*
 - *However, for 95% or more of homeowners, this is unlikely to crystallise into a significant insurance shortfall even after a major event;*
 - *Industry participants are working to improve coverage levels and consumer information, but could do more.”*

Consultation

39. This report draws on views expressed in submissions on the 2015 discussion document *New Zealand's Future Natural Disaster Insurance Scheme* and subsequent extensive engagement with ICNZ and individual insurance industry members.
40. The EQC, MBIE, MfE, Department of Internal Affairs and Reserve Bank were provided drafts of this report for comment.

Further Reporting on Scheme Design Issues

41. Once Ministers make decisions on the broad configuration of EQC building and land cover, we will provide advice on remaining scheme legislative design details, such as:
 - Details regarding the calculation of cover (e.g., whether to maintain the current Act's approach to capping the value of land cover by reference to minimum lot size);
 - Operation of siteworks cover and decision rights around determining the most cost-effective building replacement or reinstatement method;
 - Application of cover for household units in multi-unit or non-residential buildings;
 - Better aligning EQC's required 'standard of repair' with insurer practice;
 - The design of future EQC storm and flood cover, which applies only to land (not buildings or contents);
 - Claims excesses;
 - Updating the penalties regime applicable to insurers in the event of non-compliance with obligations required by the EQC Act (such as passing on EQC premium income);
 - Information sharing and disclosure;
 - EQC's pricing, risk transfer and management of the Natural Disaster Fund; and
 - A raft of other technical and definitional issues.

Next Steps

42. Once you have made decisions on the key scheme design choices canvassed in this report, we will provide further reporting on other issues raised by submitters and officials. Ministers' decisions on issues covered in this and subsequent reporting will then be incorporated into a Cabinet paper seeking Cabinet agreement to a reform package and the issuing of drafting instructions to Parliamentary Counsel Office.

Annex 1: EQC Land Claims Data

- EQC has detailed historic land claims data from 1996. That data gives some insight into the costs that might be faced by home owners under the discussion document option. However data limitations mean the data needs to be interpreted very carefully. The data reflects the costs of claims for the scheme as it currently is, not as it is proposed to be, and the data also includes total loss land claims, which under all proposed options would continue to be paid, so would ideally be separately identified.
- Bearing that in mind, the cost distribution of those claims (CPI-indexed to 2016 values) is as follows:

Table 5: Cost distribution of EQC Land Claims 1996-2016 (excluding claims from Canterbury seismic sequence)

	Value of Land Claim						Totals
	\$0	\$1- \$1,000	\$1,000- \$10,000	\$10,000- \$50,000	\$50,000- \$100,000	\$100,000- \$2,800,000	
No. of Claims	13,018	1,646	7,930	4,096	597	511	27,798
% of Claims	47%	6%	29%	15%	2%	2%	100%
Value of Claims	\$0.00m	\$0.88m	\$34.40m	\$88.79m	\$41.33m	\$108.34m	\$273.74m
% of Claims Value	0%	0%	13%	32%	15%	40%	100%

- About half of all claims made result in no payment. This usually because the claim is not accepted (i.e. the damage is not covered by EQC) or because the damage is below the minimum excess of \$500 for land claims. About one-third of claims are less than \$10,000, and about 4 percent are more than \$50,000. However claims costing over \$50,000 represent over half of all claims by value. Many of those large claims would be for total losses but cannot be separately identified in EQC's claims database.
- Canterbury land claims have not yet been fully settled. At the time of writing there remain 6,862 Red Zone properties to settle with LINZ and 4,126 ILV and IFV claims to settle with private home owners. This is from a total of around 81,000 properties that lodged a land claim as part of the Canterbury Earthquake Sequence.
- The table below provides a cost distribution across the different categories of land damage as the end of August 2016. One of the features of this has been the relatively small number of land claims that have been settled for more than \$50,000. Whilst this number may change as the final Red Zone and ILV/IFV settlements are made, the proportion of costly land settlements is largely consistent with historic data from EQC's previous land settlements.
- That said, data from Canterbury shows a similar pattern with only 2 percent of all claims (and 6 percent of all non-zero claims) paying more than \$50,000. This represents about 1,500 claims totalling almost half the value of all land claims paid.
- One final feature that is worth noting is that it is expected that around 55 per cent of land claims will be settled for nil payment. In part this is due to homeowners making prospective "stop-loss" claims if no land damage is visible so they are covered if damage is identified later on. For this reason EQC encouraged claimants lodging building claims to also lodge a land claim.

Table 6: Cost distribution of EQC Land claims paid to August 2016 arising from Canterbury seismic sequence

	Value of Land Claim Paid				Totals
	Nil/ Not Yet Settled	\$1-\$10,000	\$10,000-\$50,000	\$50,000+	
ILV and IFV					
No. of Claims	9,532	1,318	2,249	182	13,281
Percent of Claims	72%	10%	17%	1%	100%
Claims Value	\$0	\$5.84m	\$48.75m	\$15.30m	\$69.89m
Percent of Claims Value	0%	8%	70%	22%	100%
Other Flat Land					
No. of Claims	44,555	14,177	864	100	59,696
Percent of Claims	75%	24%	1%	0%	100%
Claims Value	\$0	\$18.84m	\$17.24m	\$9.29m	\$45.37m
Percent of Claims Value	0%	42%	38%	20%	100%
Port Hills					
No. of Claims	1,919	2,000	2,756	1,235	7,910
Percent of Claims	24%	25%	35%	16%	100%
Claims Value	\$0	\$7.15m	\$72.39m	\$114.38m	\$193.92m
Percent of Claims Value	0%	4%	37%	59%	100%
All Land Claims					
No. of Claims	56,006	17,495	5,869	1,517	80,887
Percent of Claims	69%	22%	7%	2%	100%
Claims Value	\$0	\$31.82m	\$138.38m	\$138.97m	\$309.17m
Percent of Claims Value	0%	10%	45%	45%	100%

Note: The Nil payments includes all properties that have not yet been settled, including approximately 7,000 Red Zone properties and 4,000 ILV and IFV claims.

Annex 2: Impact of Options on Scheme/ Fiscal Costs and Risks

1. Compared to the current exposures, the cost differences between the reform options are relatively small, and should not be a primary driver in decision-making. All proposed options are broadly cost and risk-reducing to neutral. This is because the increase in liabilities associated with the increase in the building cap is more than offset by liability reductions associated with EQC exiting household contents cover, and increasing EQC claims excesses.
2. We assess the modified status quo option, with its \$150,000 cap on EQC building cover, as having about 4 percent lower expected scheme costs and risks than the discussion document option with its \$200,000 cap.

Modelled fiscal impacts of potential reform options (to nearest \$1m)

	Expected Annual Loss			Expected Liability, Wellington Reference Event		
	Building Cap			Building Cap		
	\$100k	\$150k	\$200k	\$100k	\$150k	\$200k
Expected Claims	\$122m	\$133m	\$139m	\$5,529m	\$6,060m	\$6,338m
Change From Status Quo						
Status quo design (with \$100k cap)	\$0m	\$11m	\$16m	\$0m	\$531m	\$809m
Building cover includes siteworks with \$200k cap (DD proposal)			\$16m			\$809m
Building cover excludes siteworks with \$150k cap (Modified status quo)		\$11m			\$531m	
<i>Modelled financial impact of other proposals in the discussion document that are not discussed in this report</i>						
EQC exiting contents cover	-\$14m	-\$14m	-\$14m	-\$659m	-\$659m	-\$659m
Increasing EQC excess to \$2,000 (DD proposal)	-\$9m	-\$9m	-\$9m	-\$240m	-\$240m	-\$240m
Increasing EQC excess to \$1,000 (note that future reporting is likely to recommend that the excess be lower than \$2,000, perhaps \$1,000)	-\$4m	-\$4m	-\$4m	-\$95m	-\$95m	-\$95m
Total change (negative numbers are reductions in modelled costs)	-\$18m to -\$23m	-\$7m to -\$12m	-\$2m to -\$7m	-\$754m to -\$899m	-\$223m to -\$368m	\$55m to -\$90m

Source: EQC Minerva model, November 2016

3. However modelling limitations mean that some material difference in the scheme design options cannot be modelled. During this project the costs of different EQC design options have been modelled using the Minerva model operated by EQC. The data above also comes from that model. As noted in EGI (15)/139 Minerva cannot model changes in the configuration of land cover. Therefore, it cannot model the impact on building cover costs of the discussion document proposal to move siteworks from land to building cover, nor of upgrading the cover for retaining walls from indemnity to full replacement cover. Therefore the above estimates are incomplete.
4. The non-status quo options include upgrading the cover for retaining walls from indemnity to full replacement cover. The non-inclusion of those extra costs in the estimates means the cost estimates for all the non-status quo options are biased downwards. This downward bias is greater if the discussion document proposals to limit land cover to land protecting and supporting the swelling is not confirmed as extra costs will be incurred providing full replacement cover for retaining walls on EQC-insured land that does not support or protect the dwelling.
5. In addition, the estimate of the costs of the discussion document option also includes an upward bias, as savings from moving expenses from land to building cover cannot be modelled. Our judgment is that correcting for these biases would reduce the cost differences between the modified status quo and discussion document options, but would not change their ranking.
6. Therefore Treasury's recommendation for the building cover to adopt the modified status quo option is in part based on a judgement that it better manages a core rationale for the scheme - under-insurance risks – at lower cost than competing options (with lower costs expected to flow through to lower scheme premium rates).