

The Treasury

Material Provided to the Public Inquiry into EQC Information Release

August 2021

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Treasury Report: EQC Legislative Review: Decisions on EQC Building and Land Cover

Date:	18 April 2017	Report No:	T2017/950
		File Number:	BM-1-7-323

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Steven Joyce)	Decide which of the three options for reforming the EQC scheme described in this paper you wish to develop further for Cabinet consideration.	None.
Minister Responsible for the Earthquake Commission (Hon Gerry Brownlee)	Decide which of the three options for reforming the EQC scheme described in this paper you wish to develop further for Cabinet consideration.	None.

Contact for Telephone Discussion (if required)

Name	Position	Telephone	1st Contact
Steve Cantwell	Principal Advisor, Financial Markets	[39]	[23] ✓
Melody Guy	Manager, Financial Markets	[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: Yes (attached)

Treasury Report: EQC Legislative Review: Decisions on EQC Building and Land Cover

Executive Summary

As requested when we met on Monday 3 April, this report provides a summarised analysis of the pros and cons of the three options that we have previously discussed with you for reforming key elements of EQC cover. This is to support a discussion and decisions on which option to develop for Cabinet consideration. The three options are:

- 2015 discussion document (separate land cover only available if a site cannot be rebuilt on)
- modified status quo (separate land cover retained and limited to land damage associated with reinstatement, replacement or protection of the building and its access way); and
- status quo (current land and building design (with some improvements)).

All three options provide homeowners significant levels of building cover and provide the same cover when land damage makes reinstatement or rebuilding on the site uneconomic.

The key difference between the options is they represent different choices about protecting homeowners from costs and losses from damage to residential land that is either (1) economic to repair or rebuild on, or (2) does not directly affect the insured dwelling. Therefore we see the design choice resting on two central questions:

The discussion document proposal is the simplest option and for claims without significant land damage is likely to result in the best claims experience for claimants, EQC and insurers.

- Does the design's potential for land damage to lead to under-insurance outweigh those advantages? and:
- Is removing EQC separate land cover for land damage that does not directly affect the dwelling and its access way a sustainable reform?

We also test your interest in an EQC scheme design that addresses potential under-insurance issues with a design where EQC building cover would not reduce private insurers' building cover, resulting in a higher sum-insured for EQC-covered hazards than for hazards not covered by EQC. Properly assessing this proposal requires examining it within a broader project that also examines non-EQC options for reducing homeowner under-insurance.

Lastly, we seek your permission to brief ICNZ in confidence on your decisions on EQC design, so that we may consult them on technical issues associated with that design.

Annex 2 provides a suggested agenda for a meeting on these issues.

Recommended Action

We recommend that you:

- a **note** that on Monday 3 April you asked Treasury to prepare a paper outlining the pros and cons of the three previously discussed reform options for the EQC scheme:
- 2015 discussion document (land cover only available if a site cannot be rebuilt on)
 - modified status quo (separate land cover retained and limited to land damage associated with reinstatement, replacement or protection of the building and its access way); and
 - status quo (current land and building design (with some improvements)).

Either, if you wish to select the discussion document option (EQC recommendation):

- b **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

Agree/disagree

Steven Joyce
Minister of Finance

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

- c **confirm** that the discussion document proposal that EQC continue to offer land cover for total losses (i.e. where a site cannot be rebuilt on) be proceeded with;

Agree/disagree

Agree/disagree

Steven Joyce
Minister of Finance

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

Or, if you wish to select the modified status quo option (Treasury recommendation):

- d **agree** that EQC land cover continue to apply to situations where a site has suffered land damage and the insured residential building can be reinstated or replaced on-site;

Agree/disagree

Agree/disagree

Steven Joyce
Minister of Finance

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

- e **agree** that EQC land cover be limited to land damage that needs to be responded to as part of the cost-effective reinstatement, replacement or protection of the dwelling and its access way;

Agree/disagree

Agree/disagree

Steven Joyce
Minister of Finance

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

f **agree** that in those situations EQC land cover be directed to the costs of siteworks and other building work that represents the most cost-effective engineering response to the land damage;

Agree/disagree

Agree/disagree

Steven Joyce
Minister of Finance

Hon Gerry Brownlee
Minister Responsible for the Earthquake Commission

g **agree** that EQC building cover be retained in broadly its current form;

Agree/disagree

Agree/disagree

Steven Joyce
Minister of Finance

Hon Gerry Brownlee
Minister Responsible for the Earthquake Commission

h **agree** that the monetary cap on building cover be increased to \$150,000+GST;

Agree/disagree

Agree/disagree

Steven Joyce
Minister of Finance

Hon Gerry Brownlee
Minister Responsible for the Earthquake Commission

i **confirm** that the discussion document proposal that EQC continue to offer land cover for total losses (i.e. where a site cannot be rebuilt on) be proceeded with;

Agree/disagree

Agree/disagree

Steven Joyce
Minister of Finance

Hon Gerry Brownlee
Minister Responsible for the Earthquake Commission

A new proposal to further address homeowner under-insurance

j **note** that T2016/560 described an EQC scheme design that addresses potential under-insurance issues with a design where EQC building cover would not reduce private insurers' building cover, resulting in a higher sum-insured for EQC-covered hazards than for hazards not covered by EQC;

k **note** that if this option is pursued consultation with other agencies and insurance industry stakeholders is recommended to ensure that EQC-based options for addressing underinsurance are considered alongside other policy options; and

l **indicate** if you would like to discuss initiating further work on underinsurance issues with the Minister of Commerce and Consumer Affairs at a future BGA Investment Ministers' meeting;

Agree/disagree

Agree/disagree

Steven Joyce
Minister of Finance

Hon Gerry Brownlee
Minister Responsible for the Earthquake Commission

Next Steps

- m **note** that, once you have chosen your preferred design option, we will provide further reporting and advice on a wide range of follow-on technical issues;
- n **note** that we would like to consult the Insurance Council of New Zealand (ICNZ) and its membership on some of these technical issues; and
- o **agree** that as part of those consultations, and subject to confidentiality undertakings, officials brief ICNZ and its members on the design of EQC land and building cover chosen by responsible Ministers via this paper;

Agree/disagree

Steven Joyce
Minister of Finance

Agree/disagree

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

- p **note** the suggested agenda at Annex 2; and

- q **indicate** if you would like to meet with officials to discuss this report.

Agree/disagree

Steven Joyce
Minister of Finance

Agree/disagree

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

Melody Guy
Manager, Financial Markets

Steven Joyce
Minister of Finance

Hon Gerry Brownlee
Minister Responsible for the Earthquake Commission

Treasury Report: EQC Legislative Review: Decisions on EQC Building and Land Cover

Purpose of Report

1. As requested when we met on Monday 3 April, this report provides a summarised analysis of the pros and cons of the three options that we have previously discussed with you for reforming EQC cover. This is to support a discussion and decisions on which option to develop for Cabinet consideration.
2. This report also seeks an indication of your interest in further broader work on home owner under-insurance.
3. A suggested annotated agenda for a meeting on these issues is attached at Annex 2.

Background

4. We have previously provided extensive analysis of the three options being considered by Ministers (T2016/560 *EQC Legislative Review: Decisions on EQC Building and Land Cover* and T2016/2178 *EQC Legislative Review: Decisions on EQC Building and Land Cover* refer).
5. The three options under consideration are:
 - **Discussion document proposal:** that the monetary cap on EQC building cover be \$200,000 (+GST) and that building cover be extended to include any siteworks necessary to replace, reinstate or protect the building. EQC land cover would continue to be available only if insured residential land cannot economically be used to sustain the insured dwelling (i.e. the site is an actual or constructive total economic loss). This option was previously recommended by Treasury and EQC to be the Government proposal for inclusion in the discussion document. It is still recommended by EQC but no longer by Treasury;
 - **Modified status quo** (Building cover excludes siteworks): this retains the same total footprint of EQC cover as the discussion document proposal, but it is divided into separate building and land components. The monetary cap on EQC building cover be \$150,000 (+GST) and separate land cover be retained to meet the costs of siteworks or any other building work that represents the most cost-effective reinstatement, replacement or protection of the dwelling in response to the land damage. Land cover would also continue to be available if the site is an actual or constructive total loss. This option is now Treasury's recommended option; and
 - **Status quo:** Retaining EQC land and building cover broadly as is, perhaps with a higher cap, with changes so that land cover can be directed to foundation and building works when this is the best repair solution. This is aimed at addressing awkward interactions between EQC land and building cover that caused difficulties dealing with claims arising from the Canterbury earthquakes. The key difference between this option and the modified status quo is this option retains EQC cover for all land within 8 metres of an insured dwelling.

Analysis of Land and Building Options

6. The key strategic difference between the options is they represent different choices about protecting homeowners from costs and losses from damage to residential land that is either (1) economic to repair or rebuild on, or (2) does not directly affect the insured dwelling.
7. Treasury and EQC agree that all three options are implementable choices representing a different allocation of risk between the Government (EQC), insurers and homeowners. All three options provide homeowners with significant levels of building cover and provide the same cover for land that is a total economic loss (i.e. where land damage makes reinstatement or rebuilding on the site uneconomic). So the options are not separable on those grounds.
8. The central policy case for any EQC insurance scheme is a political-economy one. Effectively protecting homeowners via insurance markets forestalls pressures that would otherwise develop for ad-hoc public post-disaster financial assistance. Therefore, choosing between these options requires judgement by the Government about the minimum configuration of EQC scheme coverage that will prove politically sustainable following a disaster. From a policy perspective, ideally the scheme should be no bigger than it needs to be to achieve its political-economy goals.
9. We see the design choice resting on two central questions:

The discussion document proposal is the simplest option and for claims without significant land damage is likely to result in the best claims experience for claimants, EQC and insurers.

- Does the design's potential for land damage to lead to under-insurance outweigh those advantages? and:
- Is removing EQC land cover for land damage that does not directly affect the dwelling and its access way a sustainable reform?

10. The differing EQC and Treasury advice reflects different weights being given to the simplicity and quality of the claims experience for most claims versus the potential for under-insurance arising from significant land damage to create pressures for post-disaster ad-hoc public financial support (e.g., Wellington hill sides in the event of a major earthquake). The change in the Treasury advice reflects our doubts about the sustainability of the discussion document option in light of arguments made in submissions. However, choices on political-economy problems are ultimately political choices, not economic ones.
11. The answer to the first question depends in part on the number of homeowners affected by land claims. T2016/560 included this historic land claims data. Historic claims data need careful interpretation as they show claims patterns of the scheme as it is, not as it might be. About one-third of land damage claims have been less than \$10,000, and about 4 percent have been 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.

**Cost distribution of EQC Land Claims 1996-2016
(CPI-indexed to 2016 values and excluding claims from Canterbury seismic sequence)**

	Value of Land Claim Paid						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%

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+	
No. of Claims	56,006	17,495	5,869	1,517	80,887
% of Claims	69%	22%	7%	2%	100%
Value of Claims	\$0	\$31.82m	\$138.38m	\$138.97m	\$309.17m
% of Claims Value	0%	10%	45%	45%	100%

12. Annex 1 assesses the options against a wider range of considerations, including EQC scheme design and coverage, claims administration, insurance adequacy, insurers' views on options, and fiscal risk.
13. As advised in T2016/560, compared to the current EQC exposures, the fiscal differences between the reform options are relatively small. All three options are broadly cost and risk-reducing to neutral. That 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. In addition the discussion document proposed regular reviews of EQC's premium to ensure that EQC's premium income meets the expected costs and risks of the scheme's claims and the costs of running EQC.

Further Steps to Address Under-Insurance

14. Previous reporting (T2016/560 refers) also outlined an option developed by officials in response to concerns expressed by submitters and the Minister Responsible for EQC about homeowner under-insurance. Under this option the sum-insured would be increased by the value of the EQC cap if the damage was from an event covered by EQC. We have dubbed it "Sum-insured plus EQC". This option could operate with either of the above three designs for building cover. It is strongly opposed by insurers.

15. In June 2015, Treasury reporting to Ministers on under insurance [T2015/1294 refers] included estimates that 40-85 percent of homes could be underinsured by 10 to 50 percent. [26]
16. It is worth noting, however, that even after a major event, relatively few houses suffer so much damage as to reach the limits of their cover. As a result, the impact of under-insurance would be much more limited than these figures suggest (though still serious for affected individuals). Treasury has previously estimated that the underinsurance shortfall for a modelled Wellington reference event¹ would be from 0.3 to 7 percent of the total loss, with the best estimate being about \$135 million.
17. It is too early to tell the extent to which homeowners affected by the Kaikoura earthquakes may be under-insured.
18. If this proposal is developed further it would be best pursued as part of a broader piece of policy work on under-insurance and potential policy responses. Consultation with the Minister of Commerce and Consumer Affairs would be required prior to initiating this broader work, which would likely be led by MBIE and need to be balanced against work on other Government priorities as it is not on MBIE's current work programme. If initiated, Treasury would progress the "sum insured plus EQC" option within the broader review. A discussion at a BGA Investment Ministers meeting would be a useful next step if you wish to pursue this further.

Next Steps

19. Once you have made decisions on the key scheme design choices canvased in this report, we will provide further reporting on other issues raised by submitters and officials. The quality of that advice will be improved if officials can consult the Insurance Council of New Zealand (ICNZ) and its members when developing advice on the detailed design of the chosen option. That would require briefing ICNZ on Ministers' preferred option for development into an EQC legislative reform package for Cabinet. We seek your agreement to do that on a confidential basis.
20. 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.

Consultation

21. The Earthquake Commission and the Ministry of Business, Innovation and Employment were consulted in the preparation of this report.

¹ A magnitude M_w 7.5 event on the main Wellington fault.

Annex 1: Summary of Design Considerations for EQC Scheme

Design Consideration	Discussion Document proposal	Modified status quo	Status quo
Design / Coverage			
Treatment of land when damaged building can be economically reinstated or replaced on the same site.	Land repaired to extent required as part of an efficient repair or rebuild. Funded from \$200k building cap.	Land repaired to extent required as part of an efficient repair or rebuild. Funded from land cover capped at value of minimum lot size for that area.	Land damage within 8m of home is covered. Funded from land cover capped at value of minimum lot size for that area.
Treatment of land damage that does not directly affect the insured home or access to it.	Not covered.	Not covered.	Covered if within 8m of home.
How are costs caused by land damage shared by EQC, insurers and homeowners?	Total land and building damage costs below \$200k met by EQC; Costs between \$200k and sum-insured met by private insurer; Costs above sum-insured met by homeowner.	Met by EQC up to the land cap value (the market value of the minimum allowable lot size on that site).	Met by EQC up to the land cap value. EQC also covers non-building-related land damage costs within 8m of the insured dwelling.
Claims Administration			
Administrative Simplicity for EQC	Best, as all claims are building-only claims except a small fraction where the building site is a total loss.	Second best as will require dealing with land-building interactions on some repairs and rebuilds. Reforms are likely to significantly reduce but not eliminate difficult interactions between land and building cover.	Worst as would need to administer claims per the modified status quo, plus land claims that do not involve any building damage. Reforms are likely to significantly reduce but not eliminate difficult interactions between land and building cover.
Claims simplicity for homeowners	Best, as all claims are building-only claims except a small fraction where the building site is a total loss.	Second best as will require dealing with land-building interactions on some repairs and rebuilds. Reforms are likely to significantly reduce but not eliminate difficult interactions between land and building cover.	Worst as would need to administer claims per the modified status quo, plus land claims that do not involve any building damage. Reforms are likely to significantly reduce but not eliminate difficult interactions between land and building cover.
Claims interaction with insurers	Administratively the simplest as all repair claims are building-only claims. Land-building claims interactions only occur when the site is a total economic loss so the building is also a likely a total loss and the full sum-insured is likely to be paid out. Also this option is the most closely aligned with private insurer practice.	Second equal due to interaction of land and building claims. Reforms are likely to significantly reduce but not eliminate difficult interactions between land and building cover.	Second equal due to interaction of land and building claims. Reforms are likely to significantly reduce but not eliminate difficult interactions between land and building cover.
Insurance Adequacy			
Homeowner premium affordability (assuming EQC premiums reflect the scheme's expected costs)	Best as higher building cap reduces private premiums in higher-risk areas.	Second best as compared to the status quo the narrower EQC land coverage reduces EQC premiums without increasing private insurers' premiums.	Worst as EQC premiums would be slightly higher to fund non-building-related land damage.
Homeowner insurance adequacy (without land damage)	All options equal. As there is no land damage the key differences between the options are not triggered.		
Homeowner insurance adequacy (with land damage)	Worst as under sum-insured policies the cost of repairing land damage is included in the sum-insured pay-out.	Second best as costs of responding to building-related land damage are not included in the sum-insured pay-out.	Best due to coverage of all land damage within 8m.
Insurer views on options	Opposed by insurers as complicates premium pricing (potentially increasing uncertainty margins in pricing) and when land damage increases building repair costs it exposes insurers and claimants to those higher costs.	Insurers' preferred option as they see it as addressing problematic land-building interactions while also protecting sum-insured values from costs arising from land damage.	Insurers' also support this option as long as it addresses problematic land-building interactions.
Fiscal risk	Worst due to higher (\$200k) building cap. EQC estimate that it would require annual premium of \$532m to cover the scheme's expected average annual losses.	Best due to \$150k building cap and smallest footprint for land cover. EQC estimate that it would require annual premium of \$485m to cover the scheme's expected average annual losses.	Second-best (assuming same \$150k building cap) due to the \$150k cap and larger footprint for land cover. EQC also estimate that it would require annual premium of \$485m as the differences in land cover cannot be modelled.

DESIGN OF EQC LAND AND BUILDING COVER - SUGGESTED AGENDA

1. Options

Note the three options under consideration are:

- discussion document proposal (separate land cover only available if a site cannot be rebuilt on –otherwise land repairs fall within the \$200k building cap)
- modified status quo (separate land cover retained and limited to land damage associated with reinstatement, replacement or protection of the building and its access way); and
- status quo (current land and building design (with some improvements)).

2. Key questions

Weighing claims simplicity versus addressing under-insurance caused by land damage

The discussion document proposal is the simplest option and, for claims without significant land damage, is likely to result in the best claims experience for claimants EQC and insurers.

Does the design's potential for under-insurance caused by land damage outweigh those advantages?

Do you see removing EQC land cover for land damage that does not directly affect the dwelling and its access way as a sustainable reform?

The discussion document and modified status quo options both limit EQC land damage to damage that needs to be responded to as part of the cost-effective reinstatement, replacement or protection of an insured building.

Do you see removing EQC land cover for land damage that does not directly affect the dwelling and its access way as a sustainable reform?

3. Other Issues

Do Ministers want to explore the “sum insured plus EQC” option further as part of a broader examination of residential under-insurance?

Can officials brief ICNZ on your decisions?