

# The Treasury

## Proactive release of Treasury advice related to the increase to the EQC Residential Building Cap

October 2021

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### Cabinet Document Details

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## **Property Insurance Markets: Options for Further Work**

### **Proposal**

1. The purpose of this paper is to update Cabinet on the extent and causes of changes in residential property insurance markets and to set out a proposed Government response.
2. In light of the issues present, I recommend that we direct the Treasury to assess and provide advice on options for improving the affordability and availability of residential property insurance. The prioritised options are a flat across-the-board increase to the Earthquake Commission (EQC) cap; a targeted increase to the EQC cap (for high-risk regions or property-types only); and the provision of targeted natural hazard reinsurance by government.
3. In addition, I have asked the Treasury to engage with insurers to encourage them to improve information for consumers about property insurance pricing and risk, and to consider the Government's options for facilitating better public understanding of property insurance and risks.
4. I propose to report back to the Cabinet Economic Development Committee in mid-2020 with final policy recommendations.
5. Separately from this process, I have also directed Treasury to prepare a proposal for a small EQC Bill. The Bill would make technical changes to the way in which residential building cover is calculated under the Act. I expect to bring a paper to Cabinet on this early next year.

### **Executive Summary**

6. Property insurance plays a significant role in managing the financial impact of natural disasters, including earthquakes. Substantial increases in insurance prices, or a reduction in the availability of insurance, could reduce the financial resilience of households, and their ability to recover well from natural disasters.
7. The Treasury has reported to me with its findings on changes to the pricing and availability of property insurance in New Zealand. These findings are based on limited data, and the Treasury is still working to obtain further information. Average dwelling insurance premiums in New Zealand increased materially following both the Canterbury and the Kaikoura earthquakes.<sup>1</sup> For some properties, including multi-unit residential buildings in high-risk regions and some high-risk houses, the price increases over the last few years have been significant<sup>2</sup>.

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<sup>1</sup> Based on CPI data, dwelling insurance prices have risen 40% since Q3 2016 (note that the sum insured, which is quoted by Statistics New Zealand to obtain this figure increased by 12.7% over the same period).

<sup>2</sup> High-risk properties have seen recent annual premium increases of up to 50%. There are several factors that, in different combinations, can lead to a multi-unit residential property or a house being considered a "high-risk" property, including proximity to fault lines, location on soft land or in a tsunami zone, and structural defects.

8. These changes appear to be caused, at least in part, by insurers increasingly pricing risk more granularly – in other words, increasingly allocating the cost of disaster risk to regions and properties with the highest perceived risk (so-called “risk based pricing”). Some large insurers also appear to be reaching their maximum desired level of exposure to Wellington risk (as increasing their exposure to Wellington risk beyond this point would require them to hold more capital or buy more reinsurance, in order to maintain the same level of solvency capital, which is not commercially desirable).
9. These changes place financial pressure on the owners of high-risk properties, and have an impact on their wellbeing. In the longer term, these changes could result in higher levels of non-insurance or underinsurance<sup>3</sup>, and reduce New Zealand’s natural disaster resilience – implicitly increasing government’s fiscal risk. I expect that the affordability and availability of property insurance in high-risk areas is likely to worsen in the near term. The longer-term impacts are uncertain, but the shift towards granular risk pricing does appear to be a permanent change.
10. Given the ongoing changes in residential property insurance markets, I think it is important to investigate options with the objective of ensuring affordable and available residential property insurance in New Zealand that can appropriately contribute to New Zealand’s long-term resilience. In undertaking this work I am mindful of the importance of ensuring that incentives are strong for developing and building resiliently and in the right places, and ensuring that there is adequate signalling of risk.
11. To address the changes in property insurance markets, I recommend that we direct the Treasury to assess and provide advice on the following options for improving the affordability and availability of property insurance:
  - **A flat across-the-board increase to the Earthquake Commission (EQC) cap from \$150,000 up to between \$250,000 and \$400,000.** This option would increase the amount of the first loss from natural disasters covered by EQC. It would have the effect of increasing the sharing of risk between higher-risk regions and properties (eg. Wellington and central New Zealand) and properties, and lower-risk regions and properties (eg. Auckland and Northland). This option would increase affordability and availability for higher-risk regions and properties.
  - **A targeted increase to the EQC cap (targeted at higher-risk regions or property types).** This option would increase the amount of the first loss from natural disasters accepted by EQC for certain high-risk regions and property types only. It would provide targeted cost relief to the people most affected by recent changes in property insurance pricing, and could increase the availability of property insurance.
  - **Targeted natural hazard reinsurance (by region or property type) provided by government.** This would involve government accepting a portion of insurers’ risk – potentially a percentage share, or all risk above a given level of loss for certain regions or property-types – in return for a premium. It may have some similar effects to a targeted increase to the EQC cap.

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<sup>3</sup> Under-insurance occurs when the maximum amount that a person can claim under their insurance policy is lower than the amount of loss that they could suffer from a disaster.

12. I have also directed the Treasury to undertake further work on:
  - **Facilitating better public understanding of insurance and risks.** This option would improve decision making about where to buy property, mitigating risks, and the coverage required. It is currently difficult for members of the public to ascertain the riskiness of properties from an insurance perspective and how that affects the cost of insurance.
13. The further work proposed in this Cabinet paper will support two of the key economic shifts in the Government's Economic Plan:
  - **Transform our housing market to unlock productivity and growth and make houses more affordable.** Rising insurance costs translate into rising housing costs. Measures that enhance the affordability and availability of insurance will support more affordable housing – particularly for residents of multi-unit buildings.
  - **Land and resource use delivers greater value and improves environmental outcomes.** Better public understanding of insurance and risks will lead to more informed decision-making about the use of land for urban development.
14. Separately from this process, I have also directed Treasury to prepare a proposal for a small EQC Bill. The Bill would make technical changes to the way in which residential building cover is calculated under the Act. I expect to bring a paper to Cabinet on this early next year.
15. A summary is set out in the diagram under Annex 1.

## **Background**

16. On 7 August 2019 the Cabinet and Economic Development Committee (DEV) invited me to:
  - report to DEV in November 2019 on the extent and cause of changes in property insurance markets, and
  - seek in-principle agreement on recommended or prioritised options to improve or maintain property insurance uptake,(refer DEV-19-MIN-0208).
17. I have directed the Treasury to obtain more comprehensive information on property insurance pricing and availability, and explore options for addressing identified issues. In doing so, I have been mindful of wider connections with other Government work streams.
18. In particular, much of the Government's work to improve New Zealand's management of natural hazard risk is coordinated through a joint central and local government work programme led by the Ministerial Group on Community Resilience. The proposals in this Cabinet paper feed into this wider work on resilience.
19. A table of insurance-related initiatives across Government is attached as Annex 2. This includes work by the Minister of Commerce and Consumer Affairs on insurer conduct regulation, and work by the Minister for Building and Construction to develop options to grow the market for guarantee and insurance products for residential new builds.

## **Current issues in property insurance markets**

### *Natural disaster risk in New Zealand*

20. Natural disasters, including earthquakes, are significant risks for New Zealand. These risks are borne, to varying degrees, by property owners, the Crown, insurers, reinsurers, and society at

large. It is important that these risks are managed effectively and efficiently to minimise their potential impact on the living standards of New Zealanders. This will enhance resilience and allow communities to recover quickly from significant natural disasters.

*The current approach to managing these risks*

21. The Government has a comprehensive approach to managing disaster risk. The National Disaster Resilience Strategy is issued by the Minister of Civil Defence. The objectives of the strategy are focussed around:
  - identifying risk and supporting risk reduction (eg. by reducing risk in the built environment and ensuring new development is risk-aware),
  - enabling, empowering, and supporting community resilience (eg. by taking a whole of city/district/region approach, considering critical infrastructure systems, and enabling a culture of resilience), and
  - planning for effective response to and recovery from emergencies (eg. by strengthening the leadership of emergency management systems, and ensuring capability and clarity of responsibility for disaster response).
22. Insurance is a key financial tool for managing natural disaster risk. The main way in which government supports property insurance markets in New Zealand is through the EQC scheme. EQC provides a basic level of insurance for residential buildings and associated land against a defined list of perils. EQC cover is funded by a flat-rate levy on the insurance policies of every insured residential building in New Zealand. The EQC scheme is therefore grounded on the principle of solidarity – because it provides the same level and cost of cover, regardless of the risk characteristics of individual properties or regions.
23. EQC is a “first loss” insurance scheme where the EQC scheme covers the initial losses suffered from a natural disaster up to a cap of \$150,000 (plus GST). As the bulk of the risk is borne by the EQC scheme, insurers are willing to include “top-up” cover as a standard feature of their insurance policies. Private insurers cover for losses above the EQC cap up to a specified sum insured. In addition, EQC cover automatically attaches to private insurance fire policies for residential buildings. These two features of the EQC scheme have helped to ensure high levels of natural hazard insurance cover for residential buildings in New Zealand.
24. The New Zealand market is distinctive by international standards. In other jurisdictions, insurers tend to exclude earthquake cover from insurance policies in high-risk regions, unless the customer pays an extra premium for earthquake cover. In California, for example, earthquake insurance is purchased separately to the standard residential housing cover with substantial additional premiums. As a result, just over 10% of residential properties in California have earthquake insurance, compared to around 90% in New Zealand.

### **Box 1: Recent changes to the EQC scheme**

The EQC scheme has already evolved significantly in response to challenges in insurance markets.

The 2010-11 Canterbury earthquakes were the first major test of the modern EQC scheme. In light of the lessons learned from this experience, the Government decided to make a number of changes to the coverage provided by EQC. The headline changes were:

- a. the removal of EQC contents cover, and
- b. an increase in the cap of residential building cover from \$100,000 (plus GST) to its current level of \$150,000 (plus GST).

These changes took effect on 1 July 2019.

### **The Public Inquiry into EQC**

The Public Inquiry into EQC, led by Dame Silvia Cartwright, is due to report by 31 March 2020. The Inquiry's purpose is to ensure that lessons are learnt from these past experiences and that the Commission has the appropriate policies and operating structures in place for improved operational practices in the future. The Inquiry has a particular focus on EQC's response to the Canterbury earthquakes, but it will also address experiences with EQC across New Zealand.

25. If the Government did not offer EQC cover, it is likely that many New Zealand homeowners would be under-insured or uninsured against catastrophe risks. In such situations, governments face significant pressure to provide *ad hoc* assistance to those homeowners after large natural disasters. The EQC scheme is therefore designed to protect against the risk and uncertainty associated with *ad hoc* assistance.

#### *What is changing and why*

26. The Treasury has reported to me with its findings on changes to the availability and pricing of property insurance in New Zealand. These findings are based on limited data, and the Treasury is still working to obtain further information.
27. Over the past decade the residential insurance market has gone through a period of substantial change. Dwelling insurance premiums in New Zealand increased materially on average following both the Canterbury (2010-2011) and Kaikoura (2016) earthquakes. For some properties – particularly multi-unit residential buildings in high-risk regions and some high-risk/high-value houses – the price increases since the Kaikoura earthquakes have been significant.

28. The availability<sup>4</sup> of insurance has also declined in certain high-seismic risk regions. These changes do not appear to have resulted in a material increase in the number of uninsured properties. However, it is likely that underinsurance has increased since the Canterbury earthquakes, largely due to a move from 'full replacement' to capped 'sum insured' policies (which require consumers to estimate the likely rebuild cost of a house). The affordability and availability of property insurance in high-risk areas are likely to worsen in the near term.
29. The premium changes appear to be driven, at least in part, by better understanding among insurers about the underlying risk. This is the result of learnings from the Canterbury and Kaikoura earthquakes, as well as the development of more sophisticated catastrophe risk models.<sup>5</sup> Insurers are also reducing the amount of cross-subsidisation across their books. This means that higher-risk properties are now facing increasingly higher premiums. The industry describes this change as a shift to more granular risk-based pricing.
30. Some large insurers also appear to be reaching their maximum desired level of exposure to Wellington risk. In order to ensure they can pay claims, insurers buy reinsurance (a substitute for capital) to cover much of the risk they take on from policyholders. Wellington has a high concentration of buildings in a high earthquake risk area. Some insurers have reached a position where they would need to increase the capital or reinsurance held by their entire group in order to increase their exposure to the Wellington region. This is a commercial driver for insurers to cap their exposure in Wellington.
31. There is now a constrained availability of insurance in the Wellington region. A recent survey of residential property owners, commissioned by the Treasury, indicated that one-third of Wellington homeowners who had made enquiries in 2019 felt that they did not have enough insurance company options to achieve a good insurance outcome.

*The impact of the changes on natural hazard policy*

32. Increases in property insurance pricing, and a reduction of availability may have different impacts on the Government's overall natural hazard policy objective to maximise national wellbeing:
  - In the short-term, these trends may reduce household resilience and the ability to recover from disaster if increased premiums and reduced availability lead to lower insurance uptake or underinsurance for higher-risk properties. Property owners who are without insurance (or underinsured) face a higher risk of social distress from financial loss in the event of a disaster. In turn, this could increase the pressure for *ad hoc* Government intervention after a disaster, with associated fiscal risk.
  - In the long-term, insurance pricing and availability that accurately reflects risk can improve incentives for risk reduction, along with changes to planning rules and improvements in construction standards. There is some evidence that the market is responding by constructing new buildings to be more seismically resilient. However, the lack of available information about the drivers of insurance pricing and availability means that the incentives to reduce risk, particularly for existing buildings, may currently be muted.

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<sup>4</sup> In this Cabinet paper, "availability" refers to the number of insurers offering insurance for a property.

<sup>5</sup> Catastrophe risk models have limitations. They produce estimates of loss to assets from uncertain events. The main models used by insurers are updated only every 5-10 years. Specific information about particular properties is often not available to insurers, and is therefore approximated based on assumptions.

### *The impact of the changes on wellbeing and regional solidarity*

33. I am concerned about the impact of changes in property insurance markets on the wellbeing of the people living in high-risk properties and regions. I have heard from a number of people with high-risk properties that the changes are already diminishing their sense of financial security. These changes are likely to lead to an increase in the overall cost of housing for people living in higher-risk areas. Rental prices may increase if the cost of insurance is passed on to renters. The effects could lead to lower disposable incomes and impact on local economies. Very granular risk pricing may affect the long-term demographic and economic prospects of some regions.
34. I think it is in the interests of all of New Zealand to maintain resilience through a high level of natural disaster insurance. Otherwise, a greater proportion of the cost of natural disasters will fall on the Government and on New Zealand taxpayers. In addition, the Canterbury earthquakes showed that natural disasters can strike any part of our country, regardless of the area's risk profile at the time. If granular risk pricing had been in place before 2011, the cost of the residential rebuild in Canterbury would have been funded disproportionately by higher-risk regions paying higher house insurance premiums.
35. I also think that it is important to retain a sense of solidarity in the pricing of natural disaster risk, so that the burden of paying for this risk does not fall too heavily upon particular regions, and the protection gaps that the EQC scheme was originally designed to address do not reappear.

### **A proposed Government response to these challenges**

#### *Guiding objectives for Government action*

36. I believe the issues arising in property insurance markets are of sufficient seriousness to warrant further work by the Government on options for addressing them. In formulating a response, however, it is important that we reach a clear view on the objectives we are seeking to achieve. I have identified two key objectives to shape the Government's response:
  - ensuring that property insurance is affordable and available (particularly in higher risk areas) and can appropriately contribute to New Zealand's long-term resilience, and
  - facilitating better public understanding of insurance and property risks to help people manage their risks.
37. The options for achieving these objectives were initially assessed against the '4Rs' framework, with particular consideration of the role played by insurance in supporting **readiness** and **recovery** from natural disasters.
  - **Reduction:** Identifying and analysing long-term risks and taking steps to eliminate these risks if practicable, or if not, to reduce their likelihood and the magnitude of their impact (e.g., land use planning, development of hazard maps, fit for purpose building codes and standards, infrastructure upgrade programmes).
  - **Readiness:** Developing operational systems and capabilities before an emergency happens (e.g. public education campaigns (Drop, Cover, Hold) insurance in place, business continuity plans, national, regional and local civil defence plans).
  - **Response:** Taking action immediately before, during, or directly after, a significant event (e.g. activation of civil defence plans and emergency management operations centres, co-ordinated response efforts, building assessments).

- **Recovery:** Using coordinated efforts and processes to bring about immediate, medium-term, and long-term, regeneration (e.g. repair and rebuild of buildings and infrastructure, access to insurance payments).
38. The options in this Cabinet paper are targeted at addressing the issues in relation to property insurance pricing and availability arising following earthquakes over the past decade. The wider issue of how insurance markets respond to future climate change-related events will require more specific work in the future.

*Resilience work across government*

39. Much of the work to improve New Zealand's management of natural hazard risk (including adaptation to risks that are exacerbated by climate change) is coordinated through a joint central and local government work programme to enhance community resilience led by the Ministerial Group on Community Resilience. I am one of seven Ministers in this group. The proposals in this Cabinet paper will feed into the work of the Ministerial Group on Community Resilience. insurance/risk markets work stream.
40. Any government action in insurance markets is intended to complement our broader work on enhancing resilience to natural disasters and the effects of climate change. The Government has already launched a wide-ranging programme of work to reduce the exposure and vulnerability of the built environment to natural hazards. This includes:
- the review of the Resource Management Act 1991 (one of the objectives of which is to ensure the system has sufficient resilience to manage risks posed by climate change and other natural hazards),
  - work being undertaken by the Ministry for Business Innovation and Employment (MBIE), Engineering New Zealand, and the Structural Engineering Society to support enhanced resilience in New Zealand's built environment,
  - carrying out national climate change risk assessments, which is a requirement under the Climate Change Response (Zero Carbon) Amendment Bill, and
  - the development of options to support seismic strengthening (via tax and non-tax measures) to lift the New Building Standard (NBS) rating of buildings.
41. The Community Resilience Ministers reported to Cabinet in November 2019 on the scope, direction and progress of the joint work programme, and any resourcing and budget implications. The report recommended that data-driven decision making to understand and manage risk should be a priority. My proposal for work on measures to enhance public understanding of risk and insurance is one part of this wider data workstream.

**Options for improving the affordability and availability of property insurance**

42. I have considered a wide range of options for responding to these issues. All of these options were assessed against my objectives of ensuring that property insurance is affordable and available (particularly in higher risk areas) and can appropriately contribute to New Zealand's long-term resilience. I have now identified four preferred options for further assessment, including public consultation. These options are set out below.

## A flat across-the-board increase to the EQC cap

### *Increasing the EQC cap*

43. I propose to investigate the option of increasing the current cap of \$150,000 (plus GST) on EQC building cover. This could take the form of a moderate increase (to \$250,000 or \$300,000) or a more significant increase (up to a maximum of \$400,000 – as proposed by the Wellington Mayoral Insurance Taskforce).
44. An increase in the cap would increase the amount of risk borne by EQC, but it would also increase the revenue from the EQC premium levy. A higher cap would enhance the affordability of insurance for higher risk areas and building types by reducing the cost of private insurer top-up cover as EQC assumed more risk. It would do so by sharing risk across homeowners in different regions of New Zealand.
45. As is the case with the other options I am considering, increasing the EQC cap is likely to contribute to the availability of insurance in high-risk areas by transferring some catastrophe risk from insurers to government. This reduces the amount of capital or reinsurance insurers need to hold, or reinsurance they need to purchase, to provide cover to property owners, and may enable them to insure a greater number of properties.
46. There are trade-offs to be considered in association with all options under consideration. Increasing the EQC cap will have the effect of diminishing the signal that insurance pricing can send in relation to the riskiness of properties. The impact of each option on pricing signals will be considered further by the Treasury, alongside the positive impact that facilitating better public understanding of insurance and risks could have for signalling risk.
47. A reallocation of risk through EQC is likely to achieve my objectives in a more cost-effective manner, and with fewer significant unintended consequences, than most alternative options.
48. Recent modelling by EQC's broker is summarised below. Of note, EQC currently covers over 90 percent of expected earthquake losses. An EQC cap of \$400,000 sees EQC's modelled breakeven premiums that are about \$250 per dwelling per annum higher than the modelled breakeven at the current \$150,000 cap.

<b>EQC Building Cap, \$, excl. GST</b>	<b>\$150k</b>	<b>\$200k</b>	<b>\$250k</b>	<b>\$300k</b>	<b>\$400k</b>	<b>uncapped</b>
<b>Annual expected cost of EQC claims (\$m) <sup>(1)</sup></b>						
Earthquake	\$167.50	\$170.10	\$174.30	\$176.90	\$179.50	\$183.30
Volcano, tsunami, attritional	\$204.00	\$234.40	\$259.70	\$284.70	\$293.10	\$302.70
Total expected cost, all hazards	\$371.50	\$404.50	\$434.00	\$461.60	\$472.60	\$486.00
<b>EQC losses as percent of all residential claims</b>						
Earthquake	91%	93%	95%	97%	98%	100%
Volcano, tsunami, attritional	67%	77%	86%	94%	97%	100%
All residential claims, all hazards	76%	83%	89%	95%	97%	100%
<b>Total EQC insured exposure</b>						
Gross total sum insured by EQC (\$m)	\$256,920	\$331,963	\$394,519	\$442,563	\$501,337	\$550,156
EQC cover as a percent of all residential cover	47%	60%	72%	80%	91%	100%

EQC break-even premiums						
Break-even EQC premium, per \$100 of cover <sup>(2)</sup>	\$0.23	\$0.19	\$0.17	\$0.16	\$0.14	\$0.13
Maximum annual EQC premium per dwelling (\$) <sup>(3)</sup>	\$397	\$437	\$489	\$552	\$644	x
<i>(1) These estimates are subject to a range of modelling and other assumptions and caveats.</i>						
<i>(2) The current EQC premium rate is 20 cents per \$100.</i>						
<i>(3) Including 15% GST. EQC's current maximum annual premium per dwelling is \$345, including GST.</i>						

## A targeted increase to the EQC cap

### *Potential positive impacts for property insurance availability*

49. A targeted increase of the EQC cap, or the targeted government provision of natural hazard reinsurance, would have the effect of removing a proportion of risk from insurers in the relevant targeted areas, and increasing the portion of risk taken by government. This could have benefits for insurance pricing and availability in those areas.

### *Targeted increase to the EQC cap*

50. I propose to investigate an increase in the EQC cap for buildings that appear to be facing particular insurance affordability and availability issues (for example, residential buildings in high seismic-risk areas, multi-unit buildings in high seismic-risk areas, or multi-unit buildings across New Zealand). The increased cap could be funded by either the general EQC levy, or by a targeted levy paid by those accessing the higher EQC cap.
51. More targeted changes to the EQC cap could achieve my objectives of ensuring that property insurance is affordable and available in a way that more specifically addresses areas where insurance pricing and availability issues are prevalent. However, the advantages of specifically addressing high-risk properties and the insurance premium cost benefits for those properties will need to be weighed against the resulting policy, administrative, equity and precedent issues.

## Targeted natural hazard reinsurance

### *Considering natural hazard reinsurance alongside targeted EQC cap increases*

52. I think it is prudent to consider the option of government providing natural hazard insurance to insurers (reinsurance) for high-risk properties or regions alongside targeted EQC options. Although there is no lack of reinsurance availability for New Zealand risks, it is worth keeping this option open. This is because, at a high level, it is likely to have some similar effects to targeted changes to EQC (removing risk for targeted buildings or areas from insurers and transferring it to government, potentially improving pricing and availability in high-risk regions), but could have lower complexity and cost. The option may also provide an opportunity to put a solution in place for a limited period rather than as part of the more permanent EQC structure.
53. The key difference between a targeted EQC cap increase and government provision of targeted natural hazard reinsurance relates to the layers of risk that are assumed by government. A targeted EQC cap increase would result in government assuming more of the *first* loss to buildings in a disaster, whereas targeted natural hazard reinsurance is more likely to result in the government assuming losses *above* a certain level, or a *share* of the loss on a percentage basis. My goal in recommending this option for further consideration is to understand whether government reinsurance could help to alleviate insurance capacity constraints in higher-risk

areas by government taking on some risk as a compliment to (and not replacing) commercial reinsurance held by insurers.

#### *Potential reinsurance designs for consideration*

54. I propose to investigate several potential options for government reinsurance schemes. These include schemes in which government could provide reinsurance in return for a premium paid by each insurer, for example:
- government could take on a percentage of the residential property risk currently taken by insurers in a specified region or area, or
  - government could take on the risk for a defined amount of loss to particular residential properties in a specified region or area, or
  - government could take on insurers' catastrophe risks over a defined threshold.
55. Government reinsurance could be delivered via EQC or another government entity.

#### **Further considerations to work through**

##### *Detailed assessment of options*

56. In assessing the options of a flat, across the board increase in the EQC cap, a targeted increase to the EQC cap, and government provision of reinsurance, I would ask the Treasury to undertake a detailed assessment of a number of factors. These would include:
- likely impacts on property insurance markets (and, in particular, on the pricing of private insurance),
  - implications for building resilience,
  - the level of risk and the quality of risk assumed by government, and the financing of that risk,
  - the fiscal implications for government (including in relation to risks exacerbated by climate change), and
  - operational implications for EQC (including its reinsurance and risk transfer requirements, its risk modelling arrangements, as well as implications for the EQC levy).
57. In order to move forward with one of the EQC cap or reinsurance options, I will be looking for clarity that the option achieves my objectives more effectively than maintaining the status quo.

##### *Unintended consequences*

58. I am mindful that the options set out in this Cabinet paper could have unintended consequences. In particular, there is a risk that these options reduce the incentive for homeowners to improve the resilience of their homes, or result in more earthquake-prone buildings remaining in the residential housing stock for longer than they otherwise would have. There is also a risk that undertaking further work on options will raise public expectations of government support in response to the issues currently observed, or similar issues in the future (including in relation to property risk exacerbated by climate change). These risks will require careful attention and consideration of potential mitigation strategies in the policy work to come.

## **Measures to enhance public understanding of risk and insurance**

### *Improving understanding*

59. It is sometimes difficult for members of the public to ascertain the riskiness of properties from an insurance perspective. I have heard that consumers do not understand what risks drive insurers' decisions about pricing and availability of insurance. This may be muting the effectiveness of insurance pricing as a signal that leads to changing behaviour (such as increasing property resilience). Recent changes towards more granular risk-based pricing are adding to this. There is now a very high level in asymmetry in information on pricing.
60. I have asked the Treasury to report to me on measures to enhance public understanding of risk and insurance. In conjunction with this work, I expect the Treasury to engage with the Insurance Council of New Zealand, and with insurers directly, to explore how the insurance industry can improve communications and data provision in relation to property insurance risk and pricing. The work will also involve engagement with consumer groups to determine what information consumers would find useful to assist them to understand risk and insurance pricing. If better communication and data provision by insurers cannot be achieved via this engagement with industry, I intend to look at regulatory options to achieve this.
61. Improving public understanding of insurance and risks would improve decision-making about where to buy property, and how to reduce or mitigate property risks. <sup>[33]</sup>
62. Better information should also lead to better-informed decisions about the purchase of insurance. Together, these actions should enhance community resilience by encouraging property owners to mitigate their disaster risk.

### *Coordination across government*

63. As part of this work, the Treasury will also liaise with other government agencies that provide information about hazards and financial literacy. I wish to test whether there are opportunities to coordinate and improve government's approach to increasing the information available to the public on insurance and property risk.
64. This could include working with:
  - the Department of Internal Affairs (DIA) in relation to its project as part of the central and local government work programme to enhance community resilience, looking at the disclosure regime for property purchases (being considered as part of a joint central and local government community resilience work programme), and
  - the Ministry of Business, Innovation and Employment (MBIE) in relation to its work on insurance contract law and introduction of a new regulatory regime to govern conduct in the financial sector.

### **Broader insurance considerations**

65. I am proposing to focus further work on the residential property insurance market. I am mindful, however, that there are also pricing and availability issues in the commercial property insurance market in high-risk regions in New Zealand. The options in this Cabinet paper may enhance the availability of commercial property insurance by transferring some risk from private insurers to government, thereby freeing up capacity for the commercial market.

## Options not recommended for further work

*I have considered a wide range of options*

66. During the course of my work, I have considered a wide range of options. It is not possible to pursue all of them, and some of them are likely to have considerable unintended consequences. The key options I decided not to pursue were:
- the establishment of a new government-owned retail insurer, and
  - the regulation of insurers to compel greater flat-rate pricing of seismic risk, or to mandate an increase in the exposure of private insurers to higher-risk areas.

*Government-owned retail insurer*

67. I have decided not to recommend the establishment of a government-owned retail insurer for several reasons. Firstly, it would likely have similar effects to the option of increasing the EQC cap for certain properties and some of the reinsurance options but with greater associated costs (including the time and cost of establishment). In addition, it is less targeted at natural hazard risk (since it would provide cover for all perils, including fire and theft), and would likely come with greater financial cost and operational complexity than the EQC and reinsurance options. Finally, the option could encourage established insurers to reduce their exposure to higher-risk areas (and the new insurer could face public pressure to provide affordable cover to high-risk properties). As a result, the government-owned insurer would probably end up with a risky portfolio, and associated performance, profitability, and solvency issues.

*Regulating insurers to compel greater flat-rate pricing, or to take on more risk in higher-risk areas*

68. I have decided not to further explore options to regulate insurers to compel greater flat-rate pricing of seismic risk, or to take on more risk in higher-risk areas, because it may be of limited effectiveness, and it is a high-risk policy with the potential for significant unintended consequences.
69. This option would require a detailed and complex regulatory regime covering all aspects of insurance product and pricing. Without heavy regulation, insurers could respond by changing the unregulated parts of their product offerings, such as the quality of the cover, underwriting approaches and the number of policies offered.
70. It is likely that regulating the price and provision of insurance would exacerbate current price and availability pressures, and potentially cause insurers to exit the affected market entirely. For example, following the 1994 Northridge earthquake, California required insurers offering fire policies to also offer cover against earthquakes. This resulted in insurers simply exiting that market, leading to the creation of the California Earthquake Authority (CEA) in 1996. A complex regulatory regime would also raise the barriers to entry to New Zealand property insurance markets.
71. New Zealand's EQC scheme achieves many of the objectives of regulating insurance markets (that is, shielding owners of higher risk properties from some of the effects of more granular risk-based pricing by increasing the cross-subsidisation between high and low risk properties). However, increasing the EQC cap (or a reinsurance option) is likely to be more administratively simple and have a lower risk of unintended outcomes that have negative effects for consumers.

## Interlinkages with other work underway

### *Interactions with the Public Inquiry into EQC*

72. The Public Inquiry into EQC is due to report by 31 March 2020. The findings of the Public Inquiry (including in relation to the EQC claims experience and interaction with private insurers) will be a relevant consideration for the Treasury to take into account in assessing the options set out in this Cabinet paper.

### *EQC Act Review*

73. I intend that the EQC Act be reviewed following the Public Inquiry into EQC. The policy work on options proposed in this Cabinet paper essentially brings forward the timing for policy work on the level of the EQC cap that would otherwise have occurred within the review – I think this is necessary due to the pace of changes in property insurance pricing and availability. The review will still consider the purpose of EQC, the policy rationale, and the merits of competing reform options. In broad terms the objective will be to capture lessons from experiences to date, and position EQC to be able to respond effectively to future natural hazard events covered by the scheme, including those affected by climate change.

### *Small EQC Bill*

74. Separately from this process, I have also directed the Treasury to prepare a proposal for a small EQC Bill. The Bill would make targeted changes focused on the EQC Act's calculation of residential areas for the purposes of determining if a building is a residential building, better aligning the EQC Act's treatment of public residential spaces, such as access corridors to apartments, with private residential spaces, such as apartments. I expect to bring a paper to Cabinet on this early next year.

### **Box 2: Wellington Mayor's Insurance Taskforce**

- The Wellington Mayor's Insurance Taskforce released recommendations on 5 November 2019. The Taskforce was convened to provide a Wellington perspective on issues in the insurance markets, and to help inform my consideration of the issues.
- One of the Taskforce's main recommendations is to create a Wellington Risk Leadership Group to improve risk management and resilience in Wellington. I support this proposal, however as a Minister, it is not appropriate or necessary for me to be involved directly. I have asked the Treasury and the EQC to meet with the Wellington City Council to discuss the Taskforce's recommendations and to consider how the Wellington Risk Leadership Group can support the Government's broader work programme relating to resilience and insurance. For example, a range of the Taskforce's recommendations relate to improving information to the public and local and central government about insurance and risk, which is a key proposal in this Cabinet paper. Similarly, the Taskforce's recommendation about investigating increasing the EQC cap to \$400,000 is also proposed in this Cabinet paper.
- Two recommendations of the Taskforce relate to the building regulatory system, including the seismic performance of non-structural building elements, and the focus of the New Building Standards (known as NBS) on life risk. I have referred these recommendations to the Minister for Building and Construction for consideration.
- I intend to write to the Taskforce to inform them of my response to their recommendations. Annex 3 sets out the Taskforce's recommendations and my proposed response.

## **Next steps and timing**

75. I am coordinating several different strands of insurance and EQC related work over the next 12 months and beyond. These include advice regarding targeted legislative changes addressing mixed-use buildings, both flat-rate and targeted increases in EQC monetary caps, any policy work to support the Government response to the Public Inquiry into EQC, and advancing the policy work and decisions necessary for a thorough review of EQC policy and legislation. This longer-term work also needs to be coordinated with broader work across government on insurance markets, and New Zealand's broader natural hazard risk management frameworks, including developing policy to respond to hazards exacerbated by climate change.
76. Accordingly, I propose to report back to Cabinet in July 2020 on the recommended option for ensuring that property insurance is affordable and available (particularly in higher risk areas) and can appropriately contribute to New Zealand's long-term resilience.

## **Consultation**

77. The following agencies have been consulted on this paper: the Department of Internal Affairs, the Ministry of Business, Innovation and Employment (Building and Construction, Commerce), the Reserve Bank of New Zealand, the Financial Markets Authority, Land Information New Zealand, the Ministry of Civil Defence and Emergency Management, the Ministry for the Environment, the Ministry of Housing and Urban Development, and the Earthquake Commission.
78. In assessing options to-date, the Treasury has engaged in high-level consultation with the Insurance Council of New Zealand and insurers. The Treasury has also presented on options at a high level to the Wellington Mayoral Insurance Taskforce.
79. Further external consultation with stakeholders and the public will be undertaken in early 2020 in conjunction with the Treasury's assessment of the preferred options set out in this Cabinet paper.

## **Financial Implications**

80. At this stage there are no financial implications of the proposals in the paper. Financial implications of the prioritised options will be assessed as part of the further work to be undertaken by the Treasury.

## **Legislative Implications**

81. At this stage there are no legislative implications of the proposals in the paper. Legislative implications of the prioritised options will be assessed as part of the further work to be undertaken by the Treasury.

## **Impact Analysis**

82. The impact analysis requirements apply to the proposals in this paper. An impact assessment has been prepared and is attached as Annex 4.
83. A quality assurance panel with representatives from the Reserve Bank of New Zealand and the Treasury has reviewed the 'Residential Property Insurance for Natural Disaster Cover' interim Regulatory Impact Statement (RIS) produced by the Treasury and dated November 2019.

84. The panel considers that the interim RIS meets the quality assurance criteria and that the RIS provides a convincing case for in-principle decisions to discontinue work on some options and to consult on others. The panel will be looking for a greater level of quantification for final decisions, but considers that the RIS is sufficiently progressed at this stage of the policy development process and will provide a good basis for consultation.

### **Human Rights**

85. There are no human rights implications of the proposals in the paper.

### **Gender Implications**

86. There are no gender implications on the proposals in the paper.

### **Disability Perspective**

87. There are no disability perspective implications on the proposals in the paper.

### **Publicity**

88. I intend to announce the prioritised options set out in this Cabinet paper to the public in December.

### **Proactive Release**

89. A version of this paper, along with key advice papers received from the Treasury on insurance markets and the options will be published on the Treasury's website in December, subject to withholdings that are consistent with the Official Information Act 1982.

### **Recommendations**

I recommend that the Committee:

1. **note** that changes in insurance markets over the past few years have seen multi-unit buildings in high seismic-risk regions and some high-risk/high-value houses facing significant increases in insurance prices;
2. **note** that the changes in property insurance markets, at least in part, appear to be caused by insurers' better understanding of risk and the damage that can be caused by earthquakes, and insurers increasingly allocating the cost of the risk posed by higher risk properties to those properties (i.e. more granular risk pricing);
3. **note** that some large insurers appear to be reaching the maximum level of exposure to Wellington risk they are willing to take on, given their desired level of capital and reinsurance, and this has caused relatively low insurance availability for some Wellington properties;
4. **note** that it is currently relatively difficult for the public to ascertain the riskiness of properties and mitigation strategies from an insurance perspective and how that affects the cost of insurance;
5. **note** that I have asked the Treasury to continue seeking information from insurers and body corporates in relation to changes in insurance premiums for multi-unit residential buildings;

6. **note** that I have asked the Treasury to engage with insurers to encourage them to improve information for consumers about property insurance pricing and risk and to consider the Government's options for facilitating better public understanding of property insurance and risks, including regulation.
7. **agree** that Treasury undertake further work and provide advice on the following prioritised options to address changes in property insurance markets, with the aim of ensuring that property insurance is affordable and available (particularly in higher risk areas) and can appropriately contribute to New Zealand's long-term resilience:
  - a flat across-the-board increase to the EQC cap from \$150,000 up to between \$250,000 and \$400,000,
  - a targeted increase to the EQC cap (targeted at certain regions or property types), and
  - the provision of targeted natural hazard reinsurance (targeted at certain regions or property types) by the Government.
8. **invite** me to report to the Cabinet Economic Development Committee by July 2020 on the recommended options to pursue (if any).
9. **note** that, separate from this process, I intend to bring a proposal to Cabinet early next year for a small EQC Bill to make targeted changes focused on the EQC Act's calculation of residential areas for the purposes of determining if a building is a residential building under the EQC Act. The Bill is intended to better align the EQC Act's treatment of public residential spaces, such as access corridors to apartments, with private residential spaces, such as apartments.

Authorised for lodgement

Hon Grant Robertson

Minister of Finance

Minister Responsible for the Earthquake Commission

# Annex 1: Property insurance markets

## Objective

*Ensuring that property insurance is affordable and available (particularly in higher risk areas) and can appropriately contribute to New Zealand's long-term resilience.*

## Options for further work

### Current State

- Average property insurance premiums increased materially following both the Canterbury and Kaikoura earthquakes
- Increasing granularity in risk pricing by insurers
- Small proportion of properties facing significant premium increases
- Financial uncertainty for some property owners
- Average affordability and availability in high-risk areas expected to worsen in the short term
- Limited public information on risk
- Longer term impacts uncertain – higher housing costs in high risk regions, potential for decline in cover (and therefore resilience)

### Changes to risk cost allocation



More natural disaster risk with EQC, less insurer top-up cover required across NZ

Targeted additional cover for high risk properties or regions only

### Improve information



Insurers / government providing more information about risk

Improves consumer understanding of insurance price signal

### Reduction of risk



RMA review

MBIE work on structural engineering

Climate change risk assessments

Support for seismic strengthening

DIA real estate disclosure work

\*Insurance-specific options – agreement to further work sought in Cabinet paper

## Annex 2: Insurance-related initiatives underway across government

The table below sets out current insurance-related initiatives across government and their potential impacts on property insurance markets. The agencies involved in this work are coordinating where relevant.

Initiative	Impact on property insurance markets	Status
<i>Insurance market regulation</i>		
1. Conduct of financial institutions review [MBIE].	Improved consumer confidence in insurers and insurance as a product, but may create costs that are passed through to premiums.	Legislation introduced by end 2019, to be passed by end of 2020.
2. Work with banks and insurers on conduct and culture [RBNZ, FMA].	As above. Further to the conduct and culture review of life insurers, the RBNZ and FMA have asked all health and general insurers to assess themselves against the conduct and culture review and the Australian Royal Commission.	Implementing.
3. Review of insurance contract law [MBIE].	As above.	Policy decisions by end 2019. Legislation introduced by end of 2020.
4. Implementing changes to financial advice legislation [MBIE, FMA].	Improved consumer confidence in financial advice, including advice on insurance products.	Implementing.
5. Review of the Insurance Prudential Supervision Act and solvency standards [RBNZ].	Could improve confidence in insurer solvency, if higher solvency requirements are introduced, but may put upward pressure on insurance premiums.	Aim to re-initiate in the first half of 2020.
<i>Property insurance availability and pricing</i>		
6. Obtain comprehensive data on changes in property insurance markets and explore intervention options [Treasury].	Will inform future interventions in insurance markets, which could have a significant impact on the risk allocation.	Report to DEV on 4 December 2019.
7. Review of the Earthquake Commission Act [Treasury].	Could have significant impact on residential insurance pricing if it shifts the allocation of risk between the EQC and private insurers, the types of properties covered by the EQC, and the type of intervention/form the EQC takes.	Public consultation in 2020 or 2021.
<i>Government risk financing work</i>		
8. Development of EQC's risk financing strategy [EQC, Treasury].	Leverage EQC's existing modelling capability alongside Treasury's Fiscal Policy and Financial Markets capability to develop a framework for a risk financing strategy for EQC, which should establish an integrated risk financing framework incorporating Crown risk appetite. This could have an impact on reinsurance markets, opening capacity in certain areas.	During 2020

9. Alternative risk financing solution for government agencies [MBIE].	This work is focused on enhancing Crown's resilience against natural disasters by centralising risk and insurance management. Its impact on insurance availability is uncertain.	Cabinet considers business case in mid-2020.
<i>Canterbury earthquake resolution and issues</i>		
10. The Canterbury Earthquakes Insurance Tribunal [MoJ].	The Tribunal is intended to help resolve unsettled claims from the Canterbury earthquakes of 2010/11. This will help improve consumer confidence in insurance markets by resolving outstanding claims.	Operational.
11. Greater Christchurch Claims Resolution Service [MBIE].	Like the Tribunal, the GCCRS has been created to assist claimants resolve their unsettled residential property claims; this should help improve confidence in property insurance markets.	Operational.
12. Public Inquiry into the EQC [Independent, for the Minister Responsible for the EQC].	Improved consumer confidence in insurance by improving the EQC's claims management policies and operating structures.	Report due by March 2020.
<i>Other insurance-related initiatives</i>		
13. Building system legislative reform programme – develop options to grow the market for guarantee and insurance products for residential new builds [MBIE]	Options, [33] could support growth in the market for insurance for residential new builds, but may increase the upfront cost of building new housing. A well-functioning and competitive market could create incentives for building quality improvement, through risk-based pricing or entry standards that limit high risk factors.	Public consultation closed 21 June 2019, with a finding that the current market is unlikely to support mandatory insurance for residential new builds. Further policy proposals will be developed in 2020.
14. Fire and Emergency New Zealand Funding Review [DIA].	Could reduce insurance premiums if alternative funding streams are used; or could maintain current premiums or increase insurance premiums if alternative insurance-based liability mechanisms are used (currently Fire and Emergency NZ is almost entirely funded through a levy on property insurance). The levy is particularly significant for commercial property owners.	Consulting publicly until 5 February 2020. Detailed options for funding will be developed from March 2020 onwards.

## Annex 3: Proposed response to Wellington Mayor’s Insurance Taskforce

	Recommendation	Relates to Central Government?	Key central government agency	Proposed response
<b>General</b>				
1	<p><b>Establish an integrated Wellington Risk Leadership Group</b> to lead a shift of focus to a holistic approach to risk management and resilience. The Group would facilitate better coordination of effort in the Wellington community and actively sponsor the appropriate balance of transferring, mitigating, accepting and avoiding risk. The Group could be chaired by the Mayor of Wellington and the Minister with Responsibility for the Earthquake Commission.</p>	Yes.	Treasury, EQC	<p><b>Support</b> the proposal for a Wellington Risk Leadership Group. <b>Invite</b> the Treasury and EQC to meet with WCC to discuss the Taskforce’s recommendations and links to related initiatives the Government is undertaking. <b>Decline</b> MREQC co-chair of the Wellington Risk Leadership Group but interested in continuing to be informed about the Group’s work.</p>
<b>Transfer</b>				
2	<p>With Treasury, insurers, brokers, EQC, RBNZ and building owners, develop a pragmatic mechanism to monitor:</p> <ul style="list-style-type: none"> <li>• Dynamics in market pricing of insurance and the drivers related to market risk appetite.</li> <li>• Actual limitations on the availability of insurance in Wellington.</li> <li>• If building owners (and particularly bodies corporate) are not taking out insurance because of price or availability issues.</li> <li>• Trends or factors that might indicate systematic under-insurance of Wellington households.</li> </ul>	Yes.	Treasury	<p><b>Noted.</b> Invite the WCC discuss further with the Treasury and EQC, including opportunities for coordination. The Treasury is currently gathering information on the property insurance market.</p>

	Undertake further analysis to determine what, if any, monitoring and interventions are required to maintain an understanding of the state of the property insurance market and the drivers of cost and availability.			
3	Consider options for increasing the competition in, and transparency of the insurance market.	Yes.	Treasury	<b>Noted.</b> Invite the WCC to discuss further with the Treasury, MBIE and EQC, including the existing work the Treasury and MBIE are undertaking to improve information to the public, including about risk and insurance pricing.
4	Investigate options for addressing the affordability of insurance for some classes of residential buildings in Wellington. The Taskforce identified that one of the options is the possibility of increasing the EQC first-loss limit to \$400k, and considers that should be one of the options considered by Treasury. Another option is to investigate EQC going back to providing some form of insurance for commercial property. The ICNZ does not agree with this recommendation.	Yes.	Treasury, EQC	<b>Support</b> further analysis on increasing the EQC cap, including to \$400,000. <b>Note</b> that an intended EQC Act review may consider the scope of properties covered by the scheme.
5	Clarify the Government's and Local Government's respective position and capacity for funding repairs to horizontal infrastructure damaged by natural hazard events.	Yes.	DIA	<b>Noted.</b> Invite the WCC discuss further with DIA.
6	Facilitate dialogue with insurance brokers about alternative insurance products (protected cells for example) for those who do not currently have access to such products, and where that might result in lower premiums.	No.	Treasury	<b>Noted.</b> Invite the WCC discuss further with the Treasury and EQC,

7	Facilitate dialogue with the banking sector's Risk Manager group to clarify that sector's perspectives on portfolio exposure of lending institutions to Wellington risk.	No.		<b>Noted.</b> Invite the WCC discuss further with the Treasury.
8	Provide advice to building owners on options to help consumers test whether they are receiving the best value insurance available. Promote strategies for optimising premium cost.	Yes.	MBIE, Treasury	Refer to recommendation 3.
9	Investigate the potential for pooling buying power and access to off-shore insurance (through brokers, or a Crown entity such as EQC).	Yes.	EQC, Treasury	<b>Noted.</b> Invite the WCC discuss further with the Treasury and EQC.
10	Investigate the possibility of multi-unit building owners purchasing insurance layers to spread insurer risk.	No.		<b>Noted.</b> Invite the WCC discuss further with the Treasury and EQC.
11	Investigate potential for purchasing private insurance excluding earthquake perils to at least secure EQC cover. This option would require careful communication management in regards to transparency with EQC's reinsurers.	Yes.	Treasury	<b>Noted.</b> Invite the WCC discuss further with the Treasury and EQC.
12	If private insurance cannot be obtained, investigating the availability of voluntary insurance from EQC.	Yes.	EQC	Property owners can apply for Direct EQC Cover if private insurance is unavailable.
<b>Mitigate</b>				
13	The Crown is requested to urgently facilitate an update of the National Seismic Hazard Model to integrate the lessons learned from the past decade of earthquakes into the Earthquake Loadings Standard NZS1170.5. Global risk markets are well aware of the scientific and	Yes.	TBC	<b>Noted.</b> Invite the WCC discuss further with the Treasury.

	engineering lessons learned from recent earthquakes. This is not a research problem. It is an operational priority to communicate and apply existing knowledge to support seismic design and construction practice and to assure future investor confidence in Wellington and New Zealand.			
14	With equal urgency, the Crown and trade associations are requested to facilitate a systematic analysis to achieve consistent, practical compliance around the seismic performance of non-structural or “internal fit-out” building elements. The vulnerability of these parts of buildings in particular contributes greatly to social and economic disruption following strong earthquakes and to the tightening of terms for insurance coverage in certain classes of building in New Zealand.	Yes.	MBIE (Building and Construction)	The Minister of Finance will refer the matter to the Minister for Building and Construction.
15	The Crown is requested to facilitate through GNS and NIWA on a basis to be worked out with input from EQC, ICNZ and WCC, the development of a publicly accessible hazard and risk portal to underpin transparent assessment of natural hazards.	Yes.	TBC	<b>Noted.</b> Invite the WCC discuss further with the Treasury and EQC.
16	Wellington City Council would undertake to use the models supporting the portal to inform and support land use planning decisions.	No.		
17	Wellington City Council would welcome the opportunity to consider how the insurance sector including EQC could be consulted on hazard risk in relation to land use planning decisions.	Partial (EQC)	EQC	<b>Noted.</b> Invite the WCC discuss further with the Treasury and EQC.

<b>Accept</b>				
18	Ensure that Wellingtonians have easy access to the best available science and information, so that they can take better-informed decisions.	No.		Refer to recommendation 3.
19	Investigate the consequences for Wellington City Council if people are prepared to tolerate risk.	No.		
20	With the Property Council and ICNZ, determine how best to support building owners to install building health monitoring systems (such as accelerometers) to achieve rapid, accurate assessment of buildings following strong earthquakes in order to prioritise recovery action and maintain public confidence.	No.		
21	Make better linkages between known natural hazards and LIMS, ensuring that all hazards are noted on LIMS to consistent criteria.	Yes.	DIA	<b>Noted.</b> Invite WCC to discuss with DIA.
22	Request that the Crown formally review the adequacy of the current building regulatory framework's focus solely on life safety. Modern expectations of economic continuity and social recovery following natural hazard events demands a more holistic view of resilience incorporating functional recovery, low damage, enhancing repairability, continued occupancy and business function.	Yes.	MBIE (Building and Construction).	The Minister of Finance will refer the matter to the Minister for Building and Construction.
<b>Avoid</b>				
23	Ensure the Wellington City District Plan constrains development in inherently risky	No.		

	areas, or decision makers formally accept the risk of their decisions.			
24	As new science and knowledge is confirmed, ensure it is reflected in planning.	No.		
25	Investigate a requirement that the Rating Valuation Rules 2008 include a natural hazards statement for all transactions.	Yes.	TBC	<b>Noted.</b> Refer to recommendation 21.
26	Investigate requiring real estate transactions to require a building inspection and a natural hazards statement.	Yes.	TBC	<b>Noted.</b> Refer to recommendation 21.

# Residential Property Insurance for Natural Disaster Cover

Advising agencies	The Treasury
Decision sought	Agreement to narrow options and undertake further work on a flat, across-the-board increase to the monetary cap on Earthquake Commission (EQC) cover, targeted increases in the EQC cap, and the option of a state reinsurer.
Proposing Ministers	Hon Grant Robertson, Minister of Finance, Minister Responsible for the Earthquake Commission.

## Summary: Problem and Proposed Approach

**Problem Definition**

**What problem or opportunity does this proposal seek to address? Why is Government intervention required?**

Private insurance markets for catastrophe insurance tend to be marked by low rates of insurance uptake and fluctuations in the provision of catastrophe cover<sup>1</sup>. The experience elsewhere in the world is that, after large natural disasters, governments provide ad hoc assistance to affected homeowners. This creates risks and uncertainty for homeowners, insurers and governments.

By international standards New Zealand homeowners carry high rates of catastrophe insurance. The EQC provides affordable, capped natural disaster insurance cover. By taking on the great bulk of the disaster risk, the scheme also indirectly supports the provision of disaster insurance beyond the EQC monetary cap by private insurers. Experience internationally suggests that without something like the EQC scheme, many homeowners would not be insured against catastrophe risks.

Following the Canterbury and the Kaikōura earthquakes of 2010/11 and 2016, average dwelling insurance premiums in New Zealand increased materially. For some properties, including multi-unit residential buildings in high-risk regions and some high-risk houses, the price increases over the last few years have been significant. These changes appear to be caused, at least in part, by insurers increasingly pricing risk more granularly, and allocating a greater proportion of the cost of disaster risk to regions and properties with the highest perceived risk. Some large insurers also appear to be reaching their maximum desired level of exposure to Wellington risk.

These changes place financial pressure on the owners of high-risk properties (and therefore have an impact on their wellbeing). These changes could also result in higher levels of non-insurance or under insurance if they reduce the effectiveness of the EQC scheme (as currently calibrated) to keep disaster cover ubiquitous in private insurance contracts.. This, in turn, reduces New Zealand’s natural disaster resilience and increases the potential for property owners to experience distress and loss in the event of a natural disaster, implicitly increasing the Government’s fiscal risk. The February 2018 regulatory impact statement on increasing the EQC cap from \$100,000 to \$150,000 noted that, at

<sup>1</sup> For example, countries exposed to significant earthquake risk (for example Italy, Japan, and the United States) have significantly lower levels of residential property insurance than New Zealand.

that time, it was not known what level of the EQC cap would be required to maintain the scheme's performance in the face of changing market conditions, particularly more granular pricing.

The long-term impacts are uncertain, but the shift towards the increased application of granular risk pricing appears to be a permanent shift. Given the ongoing changes in residential property insurance markets, there is a need to further investigate and consider options for ensuring the affordability and availability of residential property insurance in New Zealand. This will also contribute to New Zealand's long-term resilience.

### **Proposed Approach**

#### **How will Government intervention work to bring about the desired change? How is this the best option?**

The proposals outlined in this regulatory impact assessment include options to address the affordability and availability of residential property insurance. Agreement is sought from Cabinet to undertake further analysis of a narrower set of options. This is, in effect, a decision to narrow the options to be considered (alongside the status quo), rather than a final decision on any one option at this stage.

In this preliminary analysis, Treasury's preferred option for further work, in terms of which option presents the greatest net benefits with least cost and fewer distortions or unintended consequences to the insurance market, is for a flat across-the-board increase in the EQC cap. The Minister of Finance has also instructed Treasury to undertake further analysis of the impacts of a targeted increase to the EQC cap and of a public reinsurer, both targeted at supporting insurance for high risk properties or for properties in high risk areas,.

Further options around subsidies, a public insurer, prudential requirements and regulation have also been considered. These have been dismissed on the basis that the likely negative impacts of the intervention outweigh any positive outcomes.

# Section B: Summary Impacts: Benefits and costs

## Who are the main expected beneficiaries and what is the nature of the expected benefit?

The main net beneficiaries of raising the EQC cap or a state reinsurer are expected to be to residential property owners in high seismic risk areas and residential property owners with properties more vulnerable to seismic damage. The main benefits are an increase in both the affordability and availability of insurance for homeowners of high risk properties (relative to the status quo).

The transfer in risk from private insurers to EQC may give private insurers the ability to increase the supply of insurance in higher risk markets, such as Wellington, where there are indications that there are supply constraints for some insurers. The magnitude of the benefits cannot be provided at this stage given the lack of data and timing constraints which has meant that financial cost benefit analysis has yet to be completed. This will also depend on the specific detailed design of the various options. This will be provided in the next round of analysis of the options in early 2020, when a second RIS on the options will follow a more substantive process seeking stakeholder views.

## Where do costs fall?

The quantification and scale of the costs cannot be provided at this stage, given the lack of data and timing constraints. The costs will also depend on the specifics of the detailed design of the various options.

### Flat across-the board increase in the cap

The net benefits to those in high risk properties would be cross-subsidised by owners of lower risk properties. At an institutional level, a higher monetary cap means that (all else being equal): risk will shift from private insurers to the EQC (and therefore the government), as the EQC will take on a greater proportion of risk from higher expected claims costs. At the property owner level, there will be a transfer in the pricing of risk from higher risk properties to lower risk properties; premiums will increase for property owners of lower risk properties and fall for higher risk.

### Targeted increase in the cap

The incidence of costs depends on this option's design

- If the costs of the targeted increase are spread across all EQC levy payers the incidence of the costs is similar to the impacts of a flat across-the board increase in the cap, in that the costs will be borne by lower risk properties as costs to higher risk properties are offset by the targeted increase in the cap. There is a larger shift in the benefits to owners of high risk properties and a higher net cost to owners of low risk properties than in the flat across-the board increase in the cap.
- If the costs of a targeted increase are spread across a particular region or type of property, the net incidence of the costs will fall on the owners of properties that are below average risk within that group.

### Public reinsurer

In the case of a public reinsurer the change in net costs will depend on the response of private insurers and reinsurance costs for the government. Targeted reinsurance would

provide lower costs to owners of high risk properties (although how much of the benefits of this subsidised cover insurers would transfer to high risk properties is uncertain, as it would depend on the extent of competition in the insurance market); by providing subsidised cover to high risk properties by insurers having access to additional targeted reinsurance cover from a public reinsurer, then this should mean that insurers would not need to increase costs to low risk properties (all else being equal). However, there is a risk transfer to government, which has choices about how to treat the increased risk it had taken on (e.g. buying further reinsurance).

## **What are the likely risks and unintended impacts, how significant are they and how will they be minimised or mitigated?**

### **Flat across-the board increase in the cap**

Although increasing the EQC cap improves community readiness for an event, it can perversely slow the pace of risk reduction generally, as it reduces the incentive for property owners to purchase in areas of lower risk or purchase more resilient buildings. This is likely to increase the time it will take it will take New Zealand to shift to a lower risk built environment at the aggregate level (ie. the “stock-flow” problem) than would be the case in the status quo option. It is difficult to mitigate against this effect without either undoing the benefits of the solidarity principle<sup>2</sup> that is intrinsic in the EQC framework, or introducing other unintended consequences.

Increasing the EQC cap may also inadvertently set a precedent for the Government’s overall approach to climate change. As the climate strategy has yet to be fully developed, and implemented, the signal that Government will take on natural disaster risk, may pre-empt other decisions (for example, government funding for adaptation)..

There is the possibility with a large increase in the EQC cap that insurers may withdraw from providing natural disaster cover. Insurers have fixed costs to maintain the administrative side of claims handling. A large increase in the cap would reduce insurers natural disaster revenue stream while their fixed costs for maintaining a claims handling service would remain. Increasing the cap beyond a certain (untested) point could see insurers decide that the fixed costs were no longer worth the reduced premium revenue. Further consultation with EQC and insurers is required to test this threshold. In addition, increasing the cap may make the residential insurance market less attractive to insurers, as this reduces the size of the “top-up” cover provided by insurers, and therefore reduces their revenue.

There is a risk that the benefits of the increase in the cap may not be passed on to consumers due to lack of competition in the market among insurers.

### **Targeted increase in the cap**

The differential benefits (ie. in a targeted scheme, different levels of benefit apply to different groups of property owners, depending on the level of risk they face) of this option may erode policy and community commitment to the EQC solidarity model. As for a flat across-the-board increase in the EQC cap, targeted higher caps may cause insurers to withdraw from providing natural disaster cover. Increased incentives to convert high-risk non-residential property to residential property may undermine broader reduction and readiness efforts, as property owners would be able to access cheaper residential insurance cover via EQC. There is a risk that these options reduce the incentive for homeowners to improve the resilience of their homes, or result in more earthquake-prone buildings remaining in the residential housing stock for longer than they otherwise would have. These risks will require

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<sup>2</sup> The solidarity principle, in an EQC context, sees risk pooled with property owners paying the same percentage levy for cover regardless of the location risk or property type risk.

attention in the policy work to come.

### Public reinsurer

As with a targeted increase in the EQC cap, further work is required to fully understand the advantages and disadvantages of a government reinsurance scheme, including the potential unintended consequences. The public reinsurer option may involve boundary issues, distortion of the market in unintended ways, for example enabling incumbent insurers to grow at the expense of smaller players, and be difficult to unwind. This also sets a precedent of government stepping in to take on (and potentially subsidise) private risk when insurance becomes expensive in particular high-risk areas.

### Identify any significant incompatibility with the Government's 'Expectations for the design of regulatory systems'.

As the proposals at this stage are only for an in-principle decision by Cabinet, further analysis will be undertaken before recommendations on final decisions are to be presented. In terms of the three options for further analysis – a flat across-the-board increase in the EQC cap, a targeted increase in the cap, and a public reinsurer – the options are compatible with the list of expectations for the design of regulatory systems:

- the objectives of the proposal are clear;
- the proposal seeks to achieve the objectives in a least cost way, with the least impact on market competition, property rights, and individual autonomy and responsibility;
- the options are proportionate, fair and equitable in the way they treat regulated parties and aligns with existing requirements; it may significantly affect the current EQC design or purpose (further analysis is required);
- the options remain consistent with relevant standards and practices in the international reinsurance market (the cover remains restricted to residential property and does not cover commercial property);
- the options conform to established legal and constitutional principles and supports compliance with New Zealand's international and Treaty of Waitangi obligations; and
- the recommendations do not impact on the Government's ability to choose other options if the dynamics or market conditions change (ie. optionality remains).

## Section B: Insurance options: Summary of impacts

Policy option	Affordability (for high risk)	Availability (for high risk)	Long-term resilience		Fiscal impacts		Unintended consequences (incl. potential precedent risks)	Distributional impacts <sup>2</sup>		Implementation complexity	Overall assessment
			Risk Reduction	Readiness	Cost	Risk		Vertical equity	Horizontal equity		
Status quo <sup>1</sup>	0	0	0	0	0	0	0	0	0	0	0
<b>Further work proposed on these options</b>											
<b>A. Flat across-the-board increase to the EQC cap</b>											
1. Moderate flat rate increase to the EQC cap	+	+	-	+	0	Med	0	+	-	Low	+
2. Large flat rate increase to the EQC cap	++	+	--	++	0	Med	-	++	- <sup>4</sup>	Low	+
<b>B. Alternative options for more targeted interventions</b>											
3. Targeted changes to EQC cap	++	+	--	+	0	Med	--	-	--	High	-
4. Government reinsurer (targeted high risk)	+	+	-	+	Med	Med	-	-	--	High	-
<b>C. No further work proposed on these options</b>											
5. Subsidise premiums	+	0	--	+	Med	Low	--	-	-	High	-
6. Subsidise seismic strengthening	+	+	+	+	High	Low	--	-	-	High	-
7. Government insurer (all risk)	0	0	0	0	High	High	--	0	0	High	--
8. Regulate insurers to increase cross-subsidisation	? <sup>3</sup>	--	--	--	0	High	--	? <sup>3</sup>	? <sup>3</sup>	High	--
9. Reduce solvency capital requirements	+	+	0	+	0	High	-	0	0	Low	--

**Key:** ++ much better than the status quo; + better than the status quo; 0 about the same as the status quo; - worse than the status quo; -- much worse than the status quo

**Notes:** 1 We expect average affordability and availability to worsen in the near term, which could result in a decline in resilience and an increase in fiscal risk. Longer term impacts are uncertain.

2 Distributional impacts: Vertical equity – does the option improve progressivity; horizontal equity – does the option treat different people in like circumstances the same.

3 Impact is particularly uncertain, depends on option design and insurer response.

4 There are larger negative horizontal equity implications from a large increase in the EQC cap compared to a small or moderate increase, but less impact than from a targeted increase in the cap.

# Section C: Evidence certainty and quality assurance

## Agency rating of evidence certainty

Treasury is confident in the assessment of the *relative* merits between the various options. As noted, however, Treasury is unable to provide an assessment of the monetised costs and benefits given the limited available data. In addition, timing has restricted the extent of stakeholder engagement and consultation. Further consultation is planned with EQC and insurers in particular, to assess the likely impacts on the residential insurance market from the proposed changes to the EQC cap.

## Quality Assurance Reviewing Agency:

The Treasury

## Quality Assurance Assessment:

Meets the Quality Assurance criteria

## Reviewer Comments and Recommendations:

*“A Quality Assurance Panel with representatives from the Reserve Bank of New Zealand and the Treasury has reviewed the ‘Residential Property Insurance for Natural Disaster Cover’ interim Regulatory Impact Statement (RIS) produced by the Treasury and dated November 2019.*

*The Panel considers that the interim RIS meets the Quality Assurance criteria.*

*The RIS provides a convincing case for in-principle decisions to discontinue work on some options and to consult on others.*

*The Panel will be looking for a greater level of quantification for final decisions, but considers that the RIS is sufficiently progressed at this stage of the policy development process and will provide a good basis for consultation.”*

# Impact Statement: Residential Property Insurance for Natural Disaster Cover

## Section 1: General information

**Purpose**

The Treasury is solely responsible for the analysis and advice set out in this Regulatory Impact Statement, except as otherwise explicitly indicated. This analysis and advice has been produced for the purpose of informing in-principle policy decisions to be taken by Cabinet in December 2019 on policy options to undertake further work on, relating to the affordability and availability of residential property insurance for earthquake risks.

**Key Limitations or Constraints on Analysis**

There are limitations around the availability and quality of data on residential property insurance in New Zealand. For reasons of commercial confidentiality, insurer data is limited and fragmented for policy makers and regulators. Treasury is seeking further data from insurers and is also commissioning surveys in order to provide greater clarity on trends in insurance markets.

Due to the limitations around data availability it is difficult for Treasury to say at this point what the actual scale of the problem is around insurance affordability and availability. Impact analysis for the proposed policy options have therefore been made at a high level, without the ability to provide monetised costs and benefits of the proposed options.

In addition, stakeholder consultation has been limited due to the limited amount of time available before Treasury has been directed to report back to Ministers and Cabinet in December 2019.

**Responsible Manager (signature and date):**

Helen McDonald  
Manager, Earthquake Commission Policy Team  
Economic Systems Directorate  
The Treasury

27 November 2019

## Section 2: Problem definition and objectives

### 2.1 What is the context within which action is proposed?

Natural disasters, including earthquakes, are a significant risk for New Zealand. Property insurance provided by the private sector currently plays an important role in managing these risks (alongside other mechanisms like EQC and building rules). Property insurance contributes to New Zealand's resilience via the '4 Rs': *reduction, readiness, response, and recovery*), reduces uncertainty for property owners and the Crown, and reduces the implicit liability to the Crown. The extent to which property insurance contributes to resilience will change if the number of under-insured or uninsured properties increases. Insurance can also impact the property market and investment (where insurance is generally a condition of mortgage lending).

#### Direction to Treasury to provide in-principle recommendations

This paper sets out the basis of in-principle decisions for policy options that will address the problem of affordability and availability of residential property insurance.

The options analysis in this regulatory report relate to current, short-term trends in insurance markets (which appear to primarily relate to seismic risk).<sup>3</sup>

Initial findings on trends in the residential housing insurance market:

- residential house insurance premiums are increasing moderately<sup>4</sup> across regions with high seismic risk;
- significant price increases (ie over 50 percent increases) appear to be limited to a small proportion of high-perceived risk, high value houses in those regions;
- there have been premium decreases from at least one insurer for some properties in lower risk regions, roughly equivalent in aggregate to the increases for high risk properties; and
- the availability (ie. the number of insurers offering insurance for a particular property) of insurance for residential houses in the greater Wellington region appears to have declined, but the Treasury has not seen any evidence of insurance uptake falling or properties having no access to insurance.

#### Additional factors affecting MUBs and commercial buildings

The following factors have impacted pricing and availability of insurance for Multi-unit Buildings (MUBs) and commercial buildings in high risk seismic areas:

- there have been high insurance premium increases for MUBs and commercial buildings in Wellington<sup>5</sup>;
- a small number of MUBs had premiums more than doubling in the past year (a common theme among such properties is the relative softness of the land they are built on);
- the availability of insurance for MUBs and commercial buildings in Wellington appears to have declined (eg, reports of properties being able to renew existing insurance policies, but unable to obtain an offer of insurance from any other insurers), but we

<sup>3</sup> The initial findings in this paper will be reviewed when further analysis is undertaken in early 2020 ahead of final recommendations to Cabinet.

<sup>4</sup> Comprehensive data is not available, however (based on a number of sources) average increases are likely to be around 20-30 percent per year over recent years for higher risk regions (but with high variability between insurers and different properties within the same region).

<sup>5</sup> As above, comprehensive data is not available, however indicative increases (based on anecdotal evidence and a small sample survey) suggests increases of 50 to 100 percent or more per year over recent years for some properties.

have not seen evidence of properties having no access to insurance;

- some commercial property insurers have reduced their exposure to Wellington following the Kaikoura earthquakes [33] (Allianz), possibly leaving a gap in the market;
- Treasury has not seen evidence yet of significant pricing or availability issues for MUBs and commercial buildings in areas outside the lower North Island;
- insurance issues relating to the perception of risk are generally magnified for MUBs and commercial buildings due to their higher complexity and vulnerability to damage from earthquakes;
- experience from the Canterbury earthquakes was that there are often additional administration costs involved in settling MUBs claims; and
- Insurers have said that the New Building Standard (NBS) is designed to protect life, not buildings, and therefore increasing a building's NBS percentage will not necessarily decrease the likelihood of monetary loss caused by a major earthquake.

### **Market structure/concentration**

The three main insurers (IAG, Suncorp and Tower) cover about 85 percent of the New Zealand consumer market for residential property insurance. The high degree of concentration in the residential insurance market may have an impact on the ability of new entrants to enter the market and on the pricing decisions made by incumbents; however, Treasury currently does not have sufficient information to judge the influence of market structure or competition dynamics.

## 2.2 What regulatory system, or systems, are already in place?

### EQC Framework

The EQC scheme provides capped first-loss insurance to homeowners against a limited range of natural hazards. With the government taking the first-loss for residential properties, a “top-up” market remains for private insurers to provide additional cover above the EQC cap.

The scheme has the following features that combine to support New Zealand’s high rate of natural disaster insurance cover:

- **coverage:** EQC covers the first \$150,000 (+GST) of natural hazard loss. EQC modelling suggest this captures 87 percent of EQC-modelled long-run residential losses, relieving private insurers (and the associated private premiums) of this risk;
- **affordability:** EQC’s premium is the same nation-wide. This means EQC cover for higher-risk areas and buildings is affordable (as it is cross-subsidised from lower-risk participants in the scheme); and
- **ubiquity:** EQC cover is mandatory for residential buildings privately insured against fire. Therefore residential owners cannot buy fire insurance without also buying at least EQC cover against natural catastrophe (the top-up private catastrophe cover is optional). Private insurers collect the associated EQC premiums.

The EQC scheme increases *supply* directly, and indirectly by making private top-up cover more attractive for insurers to offer<sup>6</sup>, and by funding research that helps insurers and other stakeholders understand New Zealand risks and mitigations.

This is achieved by EQC taking on an estimated 90 percent of the risk, thereby reducing the risk to insurers who can then price this risk and transfer it to reinsurance markets, helping insurers meet their prudential requirements. The scheme also means homeowners purchase natural disaster cover by default, when they purchase fire cover insurance. This avoids the adverse selection problem where homeowners of low risk properties might not elect to purchase natural disaster cover while owners of high risk properties would. This would lead to a poorer quality in insurers covered risks, increasing risk to the insurer.

It increases homeowner *demand* for disaster insurance through research and education, the flat-rate pricing structure, and the requirement that cover compulsorily attach to fire insurance. This prevents homeowners buying fire cover without buying natural disaster cover (as is common in other countries).

Without EQC cover, international evidence suggests that many New Zealand homeowners would be underinsured or uninsured against natural hazard risks. In such situations governments face significant pressure to provide ad hoc assistance to those homeowners after large natural disasters, and have a diminished level of resilience to shocks.<sup>7</sup> This creates risks and uncertainty for homeowners, insurers and government. A key benefit of the EQC scheme is that it reduces this political pressure to provide unplanned government funding in the recovery phase after a natural disaster. The scheme means these costs are met by a mix of public and private insurers and homeowners.

The EQC administers the Natural Disaster Fund (NDF) with income to the fund from premiums, returns on investment and reinsurance funds. Outlays from the NDF include reinsurance premiums and insurance claims, a guarantee fee paid to the Crown and EQC operating expenses. The Government has a statutory obligation to cover any deficiency in the fund, which has been called on by EQC following the Canterbury and Kaikoura

<sup>6</sup> Caveat: noting the point made earlier that increasing the cap past a certain level, given insurers fixed claims handling costs, could disincentivise insurers to remain in the market (although we consider this unlikely).

<sup>7</sup> For table of international comparisons of covered loss v actual loss see Treasury Discussion Document, “New Zealand’s Future Natural Disaster Insurance Scheme” (2015), where New Zealand ranks as the highest level of insured cover compared to the actual loss.

earthquakes of 2010/11 and 2016. The table below shows the total payments (excluding GST) into the NDF that have been made under the terms of the EQC Deficiency Funding Deed.

**Table: Payments into the NDF (under the EQC Deficiency Funding Deed)**

Payment Date	Shortfall Amount (\$ Million)	Cumulative Amount (\$ Million)
1 November 2018	50	50
1 March 2019	30	80
31 May 2019	45	125
1 August 2019	40	165
1 October 2019	50	215

The outcomes generated by the EQC scheme are closely linked to conditions in the private insurance market. For example, EQC cover is attached to private insurance policies, if the take-up of private insurance falls due to market conditions, then the take-up of EQC cover will also fall.

## EQC Public Inquiry and Act Review

The Public Inquiry into the EQC is reporting on operational experiences for the EQC after the Canterbury earthquakes. There are a wide range of issues that can be most usefully be progressed after the Inquiry reports. The Inquiry will inform the EQC Act Review, which has already started and is planned to continue during 2020/21. The review is intended to consider design features of the EQC.

## Levies and taxes

Increased levies and taxes are a portion of insurance price increases for residential properties. Most homeowners now pay approximately \$280 more in Fire and Emergency New Zealand (FENZ) and the Earthquake Commission (EQC) levies on their residential building insurance policy than they did before the Canterbury earthquakes (increasing from \$126 plus GST in 2010). The current EQC levy is \$300 (excluding GST) and the current FENZ levy is \$106 (excluding GST). GST of 15 percent applies on top of the insurance premium and the levies.

**Table: Residential house insurance levies**

		Rate (cents per \$100 insured)	Capped sum insured for levy calculation	Levy (excl. GST)*	Levy (incl. GST)**
Fire levy	1-Jul-10	7.6	\$100,000	\$76	\$85.50
Fire levy	1-Jul-19	10.6	\$100,000	\$106	\$121.90
EQC levy	1-Jul-10	5	\$100,000	\$50	\$56.25
EQC levy	1-Jul-19	20	\$150,000	\$300	\$345.00
<b>Total (FENZ + EQC)</b>	<b>1-Jul-10</b>			\$126	\$142
<b>Total (FENZ + EQC)</b>	<b>1-Jul-19</b>			\$406	\$467
<b>Total increase (2010-2019)</b>				<b>\$280</b>	<b>\$325</b>
*Assumes sum insured exceeds cap for levy calculation.					
** GST increased from 12.5% to 15% on 1 October 2010.					

The latest EQC levy increase on residential buildings (excluding contents) of \$100 (plus GST) took effect on 1 July 2019 and was part of a package that increased the residential building cap from \$100,000 (plus GST) to \$150,000 (plus GST). Overall this change is expected to have reduced the net cost of insurance policies for high-risk properties and increasing the net cost of insurance policies for low-risk properties.

For commercial property, the uncapped FENZ levy can be significant for some properties, at 10.6 cents (recently increased from 7.6 cents) per \$100 insured (plus GST). The Department of Internal Affairs is reviewing how FENZ is funded. The review is considering options other than an insurance-based funding model.

### **Insurer Prudential Requirements (RBNZ)**

Insurers are compelled to hold a minimum level of capital (or reinsurance) pursuant to the solvency standard (Solvency Standard) set by the Reserve Bank under the Insurance Prudential Supervision Act 2010 (IPSA). In short, under the Solvency Standard insurers must hold enough capital and/or reinsurance to cover an insurer's maximum probable loss for a 1:1000 year event for earthquakes. This reduces the fiscal risk to the government of having to respond after an event to fund the recovery process by transferring more of this risk to insurers and the reinsurance market. The 1:1000 year calibration is the highest in the world meaning that New Zealand insurers are required to maintain more capital or reinsurance to back policy obligations than insurers in other countries.

The Reserve Bank announced in May 2019 that it intends to review whether additional solvency buffer requirements for insurers are justified. Indications are that the prudential requirements are likely to be increased, which may have an impact on insurers pricing decisions. The relationship, however, between prudential capital requirements and insurance pricing is complex; it is influenced by the cost of reinsurance, competition, and the cost of capital, among other factors. It is uncertain therefore, what impact an increase in capital requirements may have on premiums. There is a clear benefit however that higher capital requirements reduce the fiscal risk with the increased likelihood that insurers will be able to pay out policy holders following a major natural disaster. ...

## 2.3 What is the policy problem or opportunity?

### Natural hazard policy in the national security framework

Natural hazard policy falls within the national security framework. National security is described as the condition that permits the citizens of a state to go about their daily business confidently free from fear and able to make the most of opportunities to advance their way of life. New Zealand takes an “all hazards – all risks” approach to national security natural hazards, biosecurity events and pandemics. To achieve this, New Zealand takes a holistic and integrated approach to managing national security risk. Known as the 4Rs, this encompasses<sup>8</sup>:

- *Reduction*: Identifying and analysing long-term risks and taking steps to eliminate these risks if practicable, or if not, to reduce their likelihood and the magnitude of their impact;
- *Readiness*: Developing operational systems and capabilities before an emergency happens;
- *Response*: Taking action immediately before, during, or directly after, a significant event; and
- *Recovery*: Using coordinated efforts and processes to bring about immediate, medium-term, and long-term, regeneration.

Natural disaster insurance contributes to the 4Rs by:

- a. improving financial **readiness** and helping finance **recovery**, as insurance premiums effectively pre-fund disaster recovery, and
- b. improving incentives on insureds to fully consider efficient risk **reduction**, as insurance pricing and availability signals risk.

In this framework, the overall objective of current policy work would be to test if insurance markets are adequately contributing to national wellbeing via the 4Rs, and, if not, to identify and evaluate options to address the gaps.

### Contribution of insurance to national wellbeing

Private insurance markets for catastrophe insurance tend to be marked by low rates of insurance uptake and fluctuations in the provision of catastrophe cover<sup>9</sup>. The experience elsewhere in the world is that, after large natural disasters, governments provide ad hoc assistance to affected homeowners. This creates risks and uncertainty for homeowners, insurers and governments.

Experience internationally suggests that without something like the EQC scheme, many homeowners would not be insured against catastrophe risks. EQC gives higher risk properties access to natural hazard insurance at lower premiums. This contributes to high rates of insurance among New Zealand homeowners compared with other countries that face similar high risks from natural disasters. Accordingly, New Zealand’s high insurance coverage for residential property means insurance makes a significant contribution to improving financial readiness and helping finance recovery.

### Impact of changes in the insurance market

Following the Canterbury and the Kaikōura earthquakes of 2010/11 and 2016, average dwelling insurance premiums in New Zealand increased materially. For some properties,

<sup>8</sup> DPMC, National Security System *Handbook*, August 2016, P.7.

<sup>9</sup> For example, countries exposed to significant earthquake risk (for example Italy, Japan, and the United States) have significantly lower levels of residential property insurance than New Zealand.

including multi-unit residential buildings in high-risk regions and some high-risk houses, the price increases over the last few years have been significant. These changes appear to be caused, at least in part, by insurers increasingly pricing risk more granularly, and allocating a greater proportion of the cost of disaster risk to regions and properties with the highest perceived risk. Some large insurers also appear to be reaching their maximum desired level of exposure to Wellington risk.

## Two Primary Issues/Problems

### **Problem 1: Reduction in New Zealand's readiness for, and ability to recover from, natural disasters in the short-term**

There is a risk that changes in New Zealand insurance markets will result in lower insurance coverage (ie a reduction in insurance penetration, or the quality of insurance through higher excesses, lower fixed-sum insurance levels, and greater use of exclusions) for higher-risk residential properties. This may be a greater risk for apartment buildings in Wellington than houses, given the apparently more significant premium increases (and more limited availability of insurance offerings).

If this risk eventuates, it may reduce the contribution that insurance makes to disaster readiness and recovery in the short-term. This is a problem because it creates a risk of either: financial hardship/distress for property owners without insurance in the event of a disaster; or an implicit fiscal liability to the government to provide financial support if called upon in the event of a disaster.<sup>10</sup>

The changes described above potentially reduce the effectiveness of the EQC scheme (as currently calibrated) to keep disaster cover ubiquitous in private insurance contracts. The February 2018 regulatory impact statement on increasing the EQC cap from \$100,000 to \$150,000 noted that, at that time, it was not known what level of the EQC cap would be required to maintain the scheme's performance in the face of changing market conditions, particularly more granular pricing.

Balanced against this, insurance pricing and availability that more accurately reflects the underlying natural hazard risk could improve incentives to take adaptation measures that reduce risk in the longer-term. There is evidence that the market is responding to insurance pricing in higher risk areas by constructing new buildings to be more seismically resilient. However, the lack of public understanding of the drivers of insurance pricing and availability means that the incentives to reduce risk may currently be muted.

A key issue, therefore, is how changes in insurance markets towards more granular risk-pricing and lower availability of insurance for higher-risk properties can balance the long-term benefits of insurance price signals whilst minimising the short-term gap in resilience as a result of lower insurance coverage.

### **Problem 2: Negative impact on certain groups of people and regions**

The unanticipated shift to more granular risk-pricing and lower availability of insurance for higher-risk properties is likely to have negative financial impacts on owners of higher risk properties, such as older properties in higher seismic areas. The Treasury does not have information about whether these property owners are more likely to be socially and financially vulnerable (eg, low income or low wealth). These trends could also have wealth impacts by reducing the value of properties in high risk areas, with limited ability for property owners to move to low risk properties.

There are expected to be different impacts at the regional level, with high risk regions (eg lower North Island through upper South Island) seeing greater increase in pricing and possible availability issues compared to lower risk regions, which are expected to benefit

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<sup>10</sup> This is seen in overseas cases where due to low levels of insurance coverage, government has been forced to step in to provide cover after the event, (eg. Japan following the 2011 Tohoku tsunami), and hurricanes Sandy (2012) and Harvey (2017) on the eastern seaboard of the United States)..

from lower insurance costs. There is a risk that areas with widespread insurance issues could face long-term decline and dislocation of communities.

### Information limitations

The lack of available data at this point constrains our ability to quantify the scale of the problems that have been identified. Further analysis will be undertaken in early 2020 to fill in these gaps, providing better data on the nature of the problem, its scale, and estimates of the financial and fiscal impacts. This will enable more granular objectives to be defined, with the possibility of being able to include specific performance indicators to monitor the impact of the options.

## 2.4 Are there any constraints on the scope for decision making?

The analysis in this paper does not consider the impact of, or solutions to, longer-term trends or risks in insurance markets, for example, a significant reduction in reinsurance availability or the impact of risk exacerbated by climate change.

### Interdependencies with related work streams

Central and local government are considering a broad range of policy initiatives to improve the management of risk in the built environment. These initiatives will have an impact on the property insurance market<sup>11</sup>:

- Much of the work to improve New Zealand's management of natural hazard risk (including adaptation to risks that are exacerbated by climate change) is coordinated through a joint central and local government work programme to enhance community resilience. This work programme is led by a Ministerial Group on Community Resilience. The Community Resilience Ministers intend to report back to Cabinet on the scope, direction, and progress of the joint work programme in November 2019.
- The review of the Resource Management Act 1991 (one of the objectives of which is to ensure the system has sufficient resilience to manage risks posed by climate change and other natural hazards).
- National climate change risk assessments will be carried out as a requirement of the Climate Change Response (Zero Carbon) Amendment Bill.
- The Ministry for Business Innovation and Employment (MBIE), Engineering New Zealand, and the Structural Engineering Society are considering initiatives to support enhanced resilience in New Zealand's built environment.
- The development of options to support seismic strengthening (via tax and non-tax measures) to lift the New Building Standard (NBS) rating of buildings.
- The Department of Internal Affairs (DIA) is considering a project looking at the disclosure regime that informs property purchases;
- The Ministry of Housing and Urban Development (HUD) is preparing advice on the Unit Titles Act (UTA) requirement for body corporates to insure to full insurable value. This is considering options to amend the UTA to allow body corporates to take out indemnity value insurance, even if full replacement value insurance is available (but with protections for unit title holders who would prefer full replacement value);
- Local government policies that encourage risk reduction (eg. planning rules and enhanced information about risk) are an important complement to any insurance market intervention that could either enhance or blunt insurance price signals to

<sup>11</sup> These initiatives (for example, reviewing and updating planning and zoning rules, and building codes) are complementary to the insurance options being considered in this paper; they will not address the underlying trends that have been identified in the short term, but will help to assist addressing the long-term resilience objectives.

incentivise risk reduction; and

- The Wellington Insurance Taskforce (established by the Mayor of Wellington), comprising of representatives from local government, body corps, GNS, risk consultants, commercial developers, ICNZ and academics, has been examining property insurance issues.

## 2.5 What do stakeholders think?

Feedback has been sought from and provided by stakeholders. Treasury will follow-up with further consultation with stakeholders in the first half of 2020, on the in-principle decisions from this first round of analysis.

### Insurers

Limited consultation outside the public sector has been undertaken thus far given the short timeframe required to prepare this advice. Consultation was limited to initial engagement with the Insurance Council of New Zealand (ICNZ), representing insurers' views on the suite of possible options. More extensive consultation will be undertaken as part of further work on any selected prioritised options agreed by Cabinet for addressing property insurance pricing and availability issues.

ICNZ suggested that further analysis of the problem definition and the principles underlying any government involvement be undertaken, before considering options any further. ICNZ advises that issues of insurance availability and affordability appear modest and where risks are clearly high. ICNZ suggested further analysis of the nature and scale of insurance availability and affordability problems. ICNZ noted that the problem defined (affordability of insurance for some residential property (largely apartments) in Wellington) is narrow and specific, so the solutions need to be proportionate and appropriate. The Treasury intends to undertake further analysis of the issues, as outlined in section 7.

ICNZ has stated that insurance cost increases/affordability issues are being driven by increased understanding of risks of building vulnerability (due to increased understanding of earthquake risk and building vulnerability). ICNZ noted that it is important that insurers are allowed to provide a technical price for the risks they accept as:

- it is necessary from a prudential and sustainable perspective,
- is expected by reinsurers who share in those risks,
- it enables insurance to signal through prices the need to build resilience.

A key theme of ICNZ's feedback was that government should invest in infrastructure and resilience, not in becoming an alternative source of capital (ie. subsidising risk). As regards increases to the EQC cap, ICNZ has indicated insurers prefer a smaller increase ie. to \$200,000.

Insurers and EQC noted that the NBS rating does not indicate building resilience but instead is a measure for protecting life. Implicit in this position is that the current building standards are insufficient from a built environment resilience and recovery in the event of a natural disaster, and need to be lifted. This is a similar position from international reinsurers, who made a similar observation about the need for the government to address issues around development and zoning decisions, in addition to building standards.

## Property owners

Treasury has yet to engage with property owners on the issues raised in this paper and the proposed options for addressing them. Treasury attended the Wellington Insurance Taskforce as an observer and has taken the views that property owners raised in this forum into account in its consideration of the issues in this paper. Formal consultation will need to take place with property owners in the next stage of the insurance market work in early 2020.

## Stakeholder consultation

Further work will be undertaken in early 2020 where stakeholders will be consulted in more detail on the options for further analysis. Also included in this second round of consultation will be local councils and lending institutions, in addition to the stakeholders identified above. Treasury will invite stakeholders to contribute their views to a Discussion Document process on the options for further analysis in early 2020.

## EQC

EQC has noted the varying complexity between the options: raising the cap is reasonably straight forward as this can be done by regulation, whereas other options require changes in legislation and in some cases potentially new entities. Also, EQC notes the need for time for engagement with reinsurers so that potential changes are not misunderstood or undermine views of the New Zealand market.

## Section 3: Options identification

### 3.1 What options are available to address the problem?

#### 1 and 2. Flat across-the-board increases to the EQC monetary cap on residential buildings

**The EQC monetary cap could be raised to between \$200,000 and \$400,000.**

A flat across-the-board increase in the EQC cap achieves the best fit with the affordability, availability and resilience objectives that are outlined in section 2.3 (the size of the increase in the cap will affect the magnitude of this change, as shown in the summary impacts table in section 4). This option achieves this in a more cost-effective manner, with fewer significant unintended consequences than alternative options, such as regulating insurers' product offerings or establishing a government insurer, or reinsurer.

Increasing the EQC cap reallocates risk and impacts different groups in different ways. It will improve affordability and availability in higher risk areas and building types by increasing the cross-subsidisation of risk (assuming the continuation of a flat-rate EQC premium). This is expected to increase total premium costs in low-risk areas. The flat-rate EQC premium has the effect of cross-subsidising higher risk properties and regions. However, the extent to which increases in the EQC cap translate into lower private insurance premiums for higher-risk properties is uncertain and there are currently no means of monitoring or enforcing this.

The table below summarises recent modelling of annual expected costs of various caps by EQC's broker. Of note, EQC currently covers over 90 percent of expected earthquake losses. An EQC cap of \$400,000 sees EQC's modelled breakeven premiums that are about \$250 per dwelling per annum higher than the modelled breakeven at the current \$150,000 cap.

EQC Building Cap, \$, excl. GST	\$150k	\$200k	\$250k	\$300k	\$400k	uncapped
<b>Annual expected cost of EQC claims (\$m) <sup>(1)</sup></b>						
Earthquake	\$167.50	\$170.10	\$174.30	\$176.90	\$179.50	\$183.30
Volcano, tsunami, attritional	\$204.00	\$234.40	\$259.70	\$284.70	\$293.10	\$302.70
Total expected cost, all hazards	\$371.50	\$404.50	\$434.00	\$461.60	\$472.60	\$486.00
<b>EQC losses as percent of all residential claims</b>						
Earthquake	91%	93%	95%	97%	98%	100%
Volcano, tsunami, attritional	67%	77%	86%	94%	97%	100%
All residential claims, all hazards	76%	83%	89%	95%	97%	100%
<b>Total EQC insured exposure</b>						
Gross total sum insured by EQC (\$m)	\$256,920	\$331,963	\$394,519	\$442,563	\$501,337	\$550,156
EQC cover as a percent of all residential cover	47%	60%	72%	80%	91%	100%
<b>EQC break-even premiums</b>						
Break-even EQC premium, per \$100 of cover <sup>(2)</sup>	\$0.23	\$0.19	\$0.17	\$0.16	\$0.14	\$0.13
Maximum annual EQC premium per dwelling (\$) <sup>(3)</sup>	\$397	\$437	\$489	\$552	\$644	x
<p>(1) These estimates are subject to a range of modelling and other assumptions and caveats.</p> <p>(2) The current EQC premium rate is 20 cents per \$100.</p> <p>(3) Including 15% GST. EQC's current maximum annual premium per dwelling is \$345, including GST.</p> <p>Note: The maximum annual premium = break-even premium x EQC cap.</p>						

The impact on overall resilience is unclear. This will depend on the extent to which the increase in the EQC cap contributes to maintaining readiness via more widespread insurance coverage (compared with what would otherwise be expected), compared to the impact of reducing risk reduction via blunting risk price signals that incentivise that behaviour.

Although increasing the EQC cap improves readiness for an event, it can perversely slow the pace of risk reduction generally, as it reduces the incentive for property owners to purchase in areas of lower risk or purchase more resilient buildings. This is likely to increase the time it will take it will take New Zealand to shift to a lower risk built environment at the aggregate level (ie. the “stock-flow” problem) than would be the case in the status quo option. It is difficult to mitigate against this effect without either undoing the benefits of the solidarity principle under EQC, or introducing other unintended consequences.

Increasing the EQC cap may also risk setting a precedent for the Government’s overall approach to climate change. As the climate strategy has yet to be fully developed, and implemented, the signal that Government will take on natural disaster risk, may undermine other decisions (for example, mitigation strategies, and managed retreat). It is possible that the quality of the EQC ‘book’ would be reduced.

Lifting the EQC cap, all else being equal, reduces the risk faced by insurers as it shifts risk from insurers to the Government, thereby freeing up capacity for insurers. It is also possible, that with reduced capital needs new entrants may be incentivised to enter the market, increasing competition and affordability.

Treasury will undertake further analysis of the possible impacts of a flat across the board increase to the EQC cap, to assess whether potential benefits might mitigate the associated costs and risks of the option.

## Alternative, targeted options for higher risk properties

### 3. Targeted changes to EQC

The monetary cap for EQC building cover, recently increased to \$150,000, could be further increased to **target buildings that appear to be facing particular insurance affordability and availability issues**, for example Wellington buildings, or MUBs, or MUBs in Wellington, or just existing residential buildings in the categories mentioned (to maintain insurance price incentives to construct new buildings to be resilient). The increased cap could be funded by either the general EQC levy or a targeted levy paid by those accessing the higher EQC cap.

More targeted changes to EQC's caps and/or funding need to weigh up the advantages of a more targeted change against the resulting complex policy, administrative and precedent issues. This would also need to be balanced against equity issues associated with the pooling and pricing of defined and specific risks across a wide population of policy holders.

A key aspect of EQC is flat-rate pricing across residential buildings in New Zealand. Modifying the cap for particular types of buildings/regions is a significant policy departure from the current design (which would require amending the EQC Act). Therefore this option would best be explored within the broader policy work supporting the review of the EQC Act. Our assessment at this stage is that we are unlikely to recommend moving away from the current flat-rate design of the scheme.

Natural disasters happen in low risk as well as high risk areas. It could be difficult to defend asymmetric EQC coverage to any individuals or communities that suffer natural disaster losses and are disadvantaged compared to claimants in regions or buildings with greater EQC entitlements. The high level of public support for the EQC cover derives from the universality of its application. Changing the EQC framework to provide greater levels of subsidy to specific regions or properties could undermine support for the EQC scheme more widely from those who see increases in their pricing to pay for these transfers, and lead to a reduction in New Zealand's high level of natural disaster cover.

Treasury will undertake further analysis of the possible impacts of a targeted increase to the EQC cap, to assess whether potential benefits might mitigate the associated costs and risks of the option.

### 4. Government provision of natural hazard insurance to insurers (reinsurance)

The Government could **provide natural hazard insurance to insurers (reinsurance)** for high-risk properties or regions alongside targeted EQC options. This is because some targeted government reinsurance structures are likely to have similar effects to targeted changes to EQC, but could potentially have lower complexity and cost. This option is not for the provision of standard ('treaty') reinsurance covering an insurer's entire portfolio of risks (for which we are informed there is sufficient availability on private international markets).

Treasury will investigate several potential options for reinsurance schemes. These include schemes under which the government could provide insurance to insurers in return for a premium paid by each insurer, for example:

- the Government could take on a percentage of the residential property risk currently taken by insurers in a specified area; or
- the Government could take on the risk for a defined amount of loss to particular buildings in a specified area; or
- the Government could take on all insurers' risks over a defined threshold.

#### *Further considerations to work through*

Further work is required to better understand the pros and cons of the Government providing targeted natural hazard reinsurance, including:

- which targeted reinsurance design would be the most effective in addressing availability and pricing issues;
- whether a targeted reinsurance scheme can effectively address availability and pricing issues without essentially operating as a government subsidy to property owners;
- having sufficient data upon which to effectively price the risk being taken on by the Crown; and
- how the Government would approach the risk it took on under a reinsurance scheme financially (ie. by further reinsuring it to a third party or through alternative means).

As with a targeted increase in the EQC cap, further work is required to fully understand the advantages and disadvantages of a government reinsurance scheme, including the potential unintended consequences.

The fiscal impacts of reinsurance options would depend on the amount of risk government accepted, and whether the Government kept the risk (taking on very high contingent liabilities), bought reinsurance from a third party, or used alternative risk transfer mechanisms (eg. parametric insurance). Any final pricing impact for consumers would also depend on the extent to which these changes resulted in different reinsurance allocation decisions made by private insurers that purchase reinsurance at the Australasian group-level (and allocate a portion to New Zealand), such as IAG and Suncorp.

Treasury expects that lifting the EQC monetary cap on buildings would have a similar effect to government reinsurer options (as it shifts risk from insurers to the Government, thereby freeing up capacity for insurers). Lifting the cap is less complex implement, as a flat increase in the cap can be achieved by existing regulations under which the EQC operates, as compared to the complexity, and substantial additional cost, of creating a completely new entity (in a public reinsurer) which presents a significant structural change to the residential insurance market. In addition, the targeted reinsurance options are likely to involve different boundary issues (eg. property owners in different regions seeking a broadening of the cover to improve their own affordability), distortion of the market in unintended ways (eg. enabling incumbent insurers to grow at the expense of smaller players), and difficulty with unwinding. They also set a precedent of government stepping in to take on (and potentially subsidise) private risk when insurance becomes expensive in particular high-risk areas.

Treasury will undertake further analysis of the government reinsurer option to assess whether potential benefits might mitigate the associated costs and risks of such a scheme.

### **The problem with targeted options (3-6)**

Targeted options are likely to be complex to define and justify who is in and out, with significant equity implications. The targeted changes to EQC and a government natural hazard reinsurer would be more complex to implement (requiring legislative change or establishing a new entity, respectively), compared to a flat increase in the EQC cap (which can be implemented by regulation).

Similarly, the targeted options risk a precedent that the Government will support insurance affordability and availability, and adaptation, for properties subject to other non-seismic natural hazards, including those exacerbated by climate change. Adjusting an existing intervention (lifting the EQC cap across-the-board) is less likely to create a difficult new precedent.

As noted above, the broad review of the EQC Act is intended to consider the core policy and design features of the EQC Act. Accordingly, we suggest considering significant changes to EQC or related policies (such as lifting the EQC cap, targeted EQC caps, or government reinsurance) as part of that the EQC Act Review over 2020-2021 when the boarder strategic questions about the role of EQC are considered.

## No further work proposed on the following options

### 5. Subsidise premiums

In this option, **subsidies could be provided to building owners with major insurance affordability problems**. The overall impact of this option on insurance affordability would depend on the design of the subsidy (eg. the size of the subsidy, whether it is narrowly targeted, and whether it is time-limited). It is unlikely to affect the availability of insurance.

Supply constraints for residential insurance in higher-risk areas could result in direct subsidies contributing to higher average insurance premiums, with a relatively small proportion of the incidence of the subsidy benefit falling on the property-owner. This option also establishes a precedent that the government will contribute to increasing insurance costs for properties subject to other risks, particularly the increasing risks associated with climate change. Treasury, therefore, does not recommend this option given the equity, boundary and precedent issues this creates.

### 6. Subsidise seismic resilience improvements

In this option, **subsidies could be provided to assist seismic resilience of existing buildings**. The Government is currently developing options to support seismic strengthening (via tax and non-tax measures) to lift the New Building Standard (NBS) rating of buildings. This includes a suspensory loan scheme to assist unit title holders to finance seismic strengthening. Strengthening buildings to lift the NBS rating is a regulatory requirement.

However, the NBS focuses on life risk, which means seismic strengthening for the purposes of raising the NBS may have marginal impact on reducing expected insured loss and therefore insurance premiums. Additional government funding for improvements to reduce the risk of seismic damage could improve insurance affordability and availability, but the impact on insurance affordability and availability would depend on engineering feasibility and insurers' willingness to provide premium discounts, which we are not confident about (given there is a lack of certainty around how retrofitting buildings would translate into improved building resilience to seismic damage, and therefore lower insurance costs; in addition whether insurers will pass on these reduced costs to homeowners where the value of these resilience improvements can be quantified).

While subsidies can be targeted and time-limited, there are significant equity, boundary, and precedent issues. It would be difficult to define and justify why certain property owners should qualify to receive subsidies, while others should not. There would also be pressure to provide benefits to property owners for non-seismic insurance issues, such as flooding, which are likely to be exacerbated by climate change. For these reasons Treasury does not recommend further work on insurance subsidies or funding for improvements to private properties to reduce the risk of seismic damage for insurability purposes.

### 7. Government insurer

The Government could establish a **new retail insurer** (or purchase and grow an existing retail insurer) that could provide additional competition and capacity to property insurance markets, particularly in high risk regions.

Treasury does not recommend this option because it would likely have similar effects to the option increasing the EQC cap for certain properties and some of the reinsurance options but with greater associated costs. It is less targeted at natural hazard risk, and would likely come with greater financial cost and operational complexity than the EQC and reinsurance options. In addition, the option could encourage established insurers to reduce their insurance offering in higher-risk areas to focus on lower risk areas, and the new insurer could face public pressure to provide affordable cover to high-risk properties. This could potentially lead to the insurer having a risky portfolio with associated performance, profitability, and solvency issues.

## 8. Regulate to compel flat-rate pricing of seismic risk

The Government could **regulate insurers to compel greater flat-rate pricing of seismic risk**. This would require heavy regulation of multiple dimensions of core features of insurers' product offerings, including the provision of cover, the nature of the cover, and the pricing of cover (eg. the granularity of insurance pricing). This may be of limited effectiveness, as the complexity of regulating in this way and uncertainty as to insurers response, means this is a high-risk policy with potential for significant unintended consequences. The effectiveness would likely be compromised by insurer responses to regulation (eg. tightening underwriting requirements further), and increased insurers' perceptions of regulatory risk reducing their appetite for, or increasing the pricing of, New Zealand risk. The more ambitious the regulation, the greater the risk of confounding price or availability responses from insurers (as was the case following the Northridge earthquake in California in 1994 where insurers withdrew earthquake cover).

In comparison to regulating insurer pricing and offerings, a flat increase in the EQC cap is administratively simple (the simplest of any option except the status quo) but can increase the extent of flat-rate pricing of insurance.

## 9. Lower the solvency requirements on insurers

Treasury is uncertain whether **lowering the solvency requirements on insurers** would have a material positive impact on insurance availability in Wellington or elsewhere (based on initial conversations with insurance industry stakeholders), as insurers may continue to hold the same level of capital for their own business reasons. If insurers did reduce the levels of capital they hold, it could increase financial stability risks (such as the risk of insurer failure). The setting of regulatory capital levels is the responsibility of the Reserve Bank, and the Government has limited influence over this process. An upcoming review of the Insurance (Prudential Supervision) Act 2010 is planned, but the timing of this is uncertain. Treasury does not recommend this option given the possible financial stability risks.

## 10. Buyer compulsion

The Government could **require property owners to buy insurance**. However, this will not improve insurance affordability, and may have significant negative financial impacts on property owners who are unable to insure due to affordability issues or choose not to for other reasons. Property owners already have strong preferences and incentives to purchase property insurance (eg. mortgage terms requiring insurance).

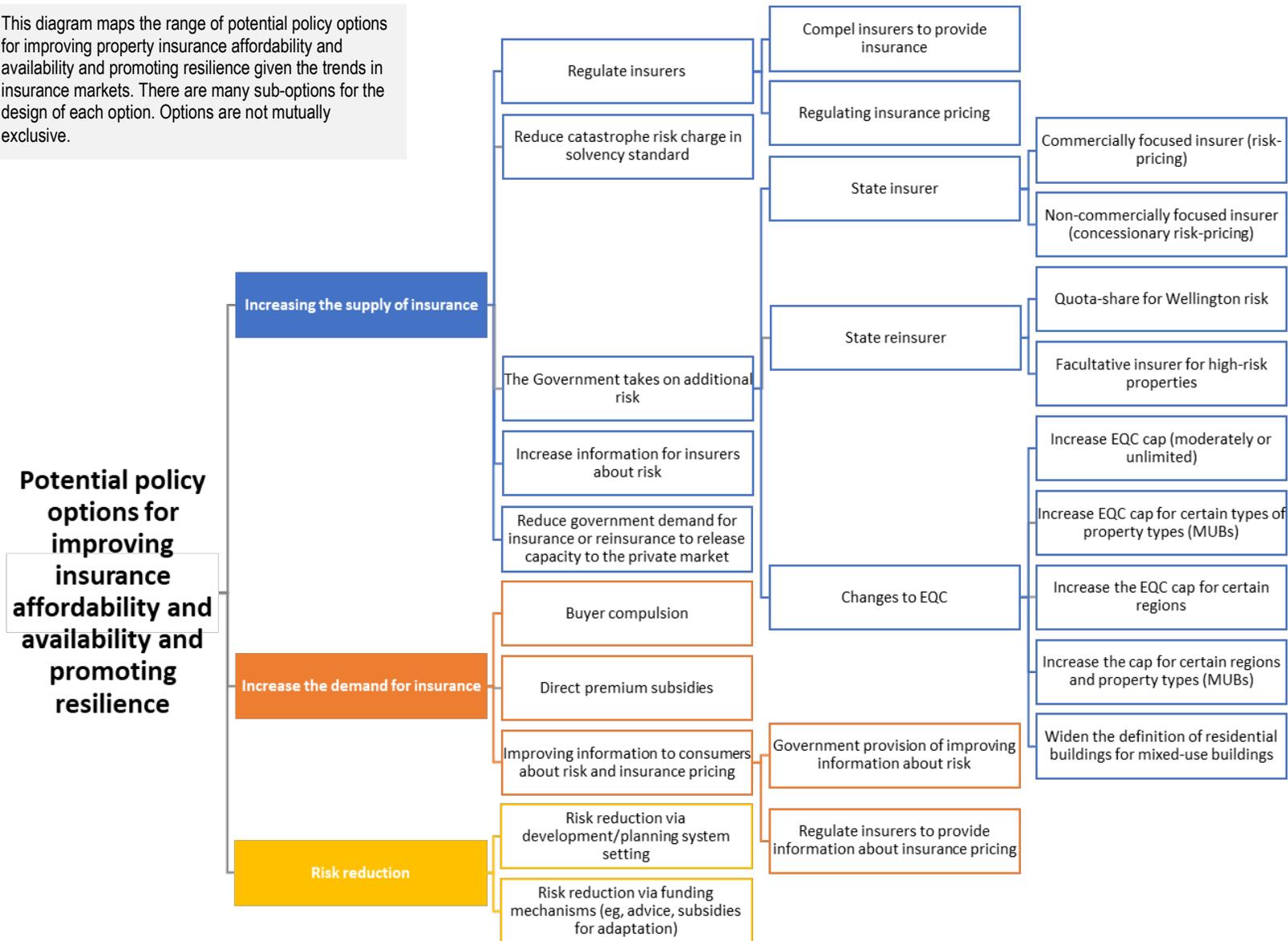
## 11. Reduce government demand for insurance

The Government could **reduce the amount of insurance it purchases** (and instead self-insure) to free-up capacity for the private market. This option is unlikely to be effective at improving insurance affordability and availability as residential insurance and government assets different risk profiles, many government assets are not in high risk areas, and government insurance has higher excesses.

MBIE is currently considering a pooled government insurance procurement model that may achieve this effect. Although a pooled government insurance may be ineffective at improving the private market insurance availability and affordability, it may improve the government's management of risk and provide cost savings.

# Issues map: potential policy options

This diagram maps the range of potential policy options for improving property insurance affordability and availability and promoting resilience given the trends in insurance markets. There are many sub-options for the design of each option. Options are not mutually exclusive.



### 3.2 What criteria, in addition to monetary costs and benefits, have been used to assess the likely impacts of the options under consideration?

Analysis of the options in this paper considers the following variables:

- *Affordability (for high risk properties)*<sup>12</sup>: the impact the option has on the cost of insurance (premiums).
- *Availability (for high risk properties)*: whether the option improves the ability of homeowners to access residential insurance cover.
- *Long term resilience*: this covers *risk reduction* (the extent to which an option addresses long term risks, taking steps to eliminate these risks if practicable, or reduce the likelihood and magnitude of their impact); and *readiness* (the degree to which the option improves the financial readiness and helps finance recovery from a natural disaster event)
- *Fiscal risks and costs*: this includes the costs and risks to the Crown of explicit fiscal risks such as the cost to the social safety net, implicit fiscal risks, implementation and operating costs (the *low, med, high* rating is a relative indication for estimating the fiscal cost and risk of the option).
- *Precedent risks*: what are the risks that the option establishes negative precedents (eg.in the case of climate strategy, does the option establish a precedent that could create fiscal risks in terms of government response to climate change).
- *Distributional impacts*: this is defined in two ways: by *vertical equity* (does the option improve progressivity), and *horizontal equity* (does the option treat different people in like circumstances the same).
- *Implementation complexity*: time necessary to implement the option and the degree of complexity of its implementation.
- *Unintended consequences*: the likelihood the option has unintended consequences or that the negative impacts of the option are more significant than expected.

### 3.3 What other options have been ruled out of scope, or not considered, and why?

#### Parametric insurance and catastrophe bonds

Parametric products<sup>13</sup> and catastrophe bonds are alternative options for the Government (including EQC), or private insurers, when considering how best to finance risk, but they do not directly affect affordability or availability of property insurance. If Treasury proceeds with further work on a higher EQC cap or other options that increase the risk carried by the government, we can investigate alternative risk financing options to potentially help manage the increased risks. Parametric insurance and catastrophe bonds are generally not available directly to, nor suitable for, homeowners as they do not insure against actual loss.

#### EQC direct cover

EQC is able to provide direct cover (Direct EQCover, under section 22 of the EQC Act) to homeowners who are unable to obtain insurance for the perils covered by EQC up to the EQC cap of \$150,000.

<sup>12</sup> Although the Affordability and Availability criteria focus is on the impact of the option for high risk properties, the paper also considers the impact that these transfers of risk have on low risk properties (ie. where reducing the price for high risk properties results in a transfer of that risk to be covered by low risk properties).

<sup>13</sup> Parametric products are designed with a simple trigger/threshold and pay-out mechanisms to speed up the claims payment process (assuming criteria are clear, unambiguous and not subjective). A party is buying a pre-defined amount of protection which will pay-out based on pre-defined terms. For example, an earthquake catastrophe bond will typically specify both the magnitude and proximity of an earthquake to a reference point location.

EQC currently provides Direct EQCover to seven homeowners. In the past 12 months, EQC has received less than 50 enquiries for Direct EQCover, and a total of ten applications. Eight of these applications had been considered as at the time of the August annual review of EQC direct cover. Two were declined as they gave affordability as the reason for their application (affordability is not a relevant factor in the current operational policy).

*[NOTE: Figures above were correct as at August 2019]*

The EQC Board has considered the Direct EQCover policy as part of its annual review and it does not see a need to change the criteria it applies for providing Direct EQCover given the small number of enquiries and applicants. EQC will review this policy if enquiries and/or applications change significantly.

EQCover is not available to homeowners for reasons of affordability. EQC will only provide Direct EQCover if homeowners are able to demonstrate that are unable to find an insurer who will offer cover. Due to Direct EQCover being designed to address a very narrowly focused issue (unavailability of insurance cover), this option is not a general solution to the affordability and availability issues that have been raised in this paper.

## Section 4: Impact Analysis

Policy option	Affordability (for high risk)	Availability (for high risk)	Long-term resilience		Fiscal impacts		Unintended consequences (incl. potential precedent risks)	Distributional impacts <sup>2</sup>		Implementation complexity	Overall assessment
			Risk Reduction	Readiness	Cost	Risk		Vertical equity	Horizontal equity		
Status quo <sup>1</sup>	0	0	0	0	0	0	0	0	0	0	0
<b>Further work proposed on these options</b>											
<b>A. Flat across-the-board increase to the EQC cap</b>											
1. Moderate flat rate increase to the EQC cap	+	+	-	+	0	Med	0	+	-	Low	+
2. Large flat rate increase to the EQC cap	++	+	--	++	0	Med	-	++	- <sup>4</sup>	Low	+
<b>B. Alternative options for more targeted interventions</b>											
3. Targeted changes to EQC cap	++	+	--	+	0	Med	--	-	--	High	-
4. Government reinsurer (targeted high risk)	+	+	-	+	Med	Med	-	-	--	High	-
<b>C. No further work proposed on these options</b>											
5. Subsidise premiums	+	0	--	+	Med	Low	--	-	-	High	-
6. Subsidise seismic strengthening	+	+	+	+	High	Low	--	-	-	High	-
7. Government insurer (all risk)	0	0	0	0	High	High	--	0	0	High	--
8. Regulate insurers to increase cross-subsidisation	? <sup>3</sup>	--	--	--	0	High	--	? <sup>3</sup>	? <sup>3</sup>	High	--
9. Reduce solvency capital requirements	+	+	0	+	0	High	-	0	0	Low	--

**Key:** ++ much better than the status quo; + better than the status quo; 0 about the same as the status quo; - worse than the status quo; -- much worse than the status quo

**Notes:** 1 We expect average affordability and availability to worsen in the near term, which could result in a decline in resilience and an increase in fiscal risk. Longer term impacts are uncertain.

2 Distributional impacts: Vertical equity – does the option improve progressivity; horizontal equity – does the option treat different people in like circumstances the same.

3 Impact is particularly uncertain, depends on option design and insurer response.

4 There are larger negative horizontal equity implications from a large increase in the EQC cap compared to a small or moderate increase, but less impact than from a targeted increase in the cap.

## Intervention options

The criteria for the interventions options are described in section 3.2. In the analysis of the options below, it is worth noting the different interpretations that are possible when considering *distributional or equity impacts* of the option. Vertical equity considers the impact the option will have from an income distribution perspective (does the option increase vertical equity by transferring benefits from higher income households to lower income households); horizontal equity looks at equity from the perspective does the option treat similar households in a consistent and similar way.

Defining equity, however, is difficult. There will always be different perspectives and interpretations and in the way it which it is defined and can be applied, particularly depending on how the policy question is framed. There are a broad range of outcomes by which equity can be measured and no single metric for doing so, even in what appears at first to be a narrow question of affordability and availability of insurance for households. Vertical equity, in the insurance context, is reasonably clear to consider in terms of its income/wealth dimension; horizontal equity, however, is more contested. In the context of the analysis in this report, horizontal equity considers how the option will impact on similar property types with similar risk profiles.

Default option		"Status quo"
<b>Description:</b>		The Government continues to monitor trends in insurance market pricing and access, but does not intervene in the short-term (that is, allows the shift in pricing and availability to continue to play out).
<b>Recommendation in Cabinet paper</b>		<u>Further analysis proposed to be undertaken.</u> There is a risk that current trends in insurance markets will result in lower insurance uptake and quality, leading to lower short-term resilience to natural disasters and increasing the implicit fiscal risk to the Government. More information is necessary on the scale and likelihood of this occurring, compared to the costs and benefits of alternative intervention options.
<b>Impacts of option</b>		
<i>Insurance affordability (for high risk)</i>		We expect further increases in insurance premiums for higher-risk houses over the next 1-2 years (in the case of low risk properties, premiums could fall in some instances). For multi-unit apartments, we anticipate continued insurance premium increases and availability difficulties.
<i>Insurance availability (for high risk)</i>		We do not have reason to expect any change to the availability of insurance for houses. For multi-unit apartments, we anticipate continued insurance premium increases and availability difficulties. There is a downside risk that the issues may be exacerbated by limited availability of insurance on international markets. Conversely, there is an upside risk that higher insurance premiums encourage new insurers to enter the New Zealand market.
<i>Long-term resilience</i>	<i>Reduction (risk)</i>	There is a medium risk of a reduction in resilience in the short-term for houses if the quality of insurance coverage declines (eg, higher excesses, lower fixed-sums). In the longer-term, insurance pricing and availability that more accurately reflects the underlying natural hazard risk could improve incentives to take adaptation measures that reduce risk over time.
	<i>Readiness</i>	A low risk that insurance uptake declines materially for residential houses. There is a medium to high risk that insurance coverage (both uptake and quality) declines for existing multi-unit buildings, reducing readiness in the short-term.
<i>Fiscal cost</i>	<i>Cost</i>	Nil
	<i>Risk</i>	The risk of a reduction in insurance coverage in the short-term (particularly for multi-unit buildings) increases the implicit fiscal risk on the Government.
<i>Unintended consequences (incl potential precedent risks)</i>		There is a risk of a reduction in housing supply if property insurance pricing and availability hampers housing development in higher seismic risk areas. As new buildings are generally built to higher standards (relative to the average existing building), we do not expect insurance availability to be an issue for most housing developments. Not intervening supports a precedent that property-owners are primarily responsible for managing the impacts of increasing risk, potentially including hazards exacerbated by climate change.
<i>Distributional impacts</i>	<i>Vertical equity</i>	Vertical equity declines over time as increasing application of granular risk based pricing sees higher income households more able to afford increasing insurance premiums in high risk areas compared to lower income households in the similar locations.
	<i>Horizontal equity</i>	As noted in the introduction of this section, this depends on the definition of equity and the framing of the policy question. From a risk perspective, horizontal equity improves as risk based pricing sees similar homes but in different risk locations charged different premiums based on this different level of risk.
<i>Implementation complexity / timing / administrative costs</i>		Not applicable.

<b>Option 1</b>		<b>Moderate flat rate increase to the EQC cap</b>
<b>Description:</b>		Increase the monetary cap in EQC building cover to between \$200,000 to \$300,000 (+GST).
<b>Recommendation in Cabinet paper</b>		Further analysis proposed to be undertaken. rating:+ Increasing the cap by the amount indicated in this option achieves the closest fit with the affordability, availability and resilience objectives. It achieves this in a more cost-effective manner, with fewer significant unintended consequences than alternative options such as regulating insurers' product offerings or establishing a government insurer or reinsurer.
<b>Impacts of option</b>		
<i>Insurance affordability (for high risk)</i>		Increasing the cap transfers improves affordability for homeowners in higher risk properties. This risk from insurers to EQC, and community-rates the EQC premium. Therefore it is expected to improve affordability and availability in higher risk areas and building types, while increasing total premium costs in low-risk areas (the increases for low risk property owners is likely to be small given this is spread over a much wider pool of lower risk properties compared to a smaller number of higher risk properties).
<i>Insurance availability (for high risk)</i>		Availability for high risk properties improves through an increase in the EQC cap. An increase in the EQC cap transfers a proportion of the risk that insurers are carrying in high risk areas to EQC, providing insurers with the ability to allocate the capital they had previously allocated to high risk properties under the lower EQC cap to extend availability of coverage. Whether insurers choose to increase availability in this way is a decision that will be taken by individual insurers. There is no availability issue for low risk properties.
<i>Long-term resilience</i>	<i>Reduction</i>	An increase in the cap mutes risk price signals and therefore reduces incentives to manage risk.
	<i>Readiness</i>	Improves affordability and access so may improve readiness.
<i>Fiscal cost</i>	<i>Cost</i>	Nil, if EQC levies adjusted to meet the costs of the scheme.
	<i>Risk</i>	Medium risk; increased contingent liability under the crown guarantee for the increase in risk borne by EQC.
<i>Unintended consequences (incl potential precedent risks)</i>		EQC taking on more risk may reduce insurer interest in retaining the remaining risk. Higher caps weaken the case for insurers acting as EQC's agent. Increased incentives to convert high-risk non-residential property to residential property may undermine broader reduction and readiness efforts. Limited marginal precedent effects, if the increase is modest. May shape expectations in other areas, eg climate change policy, of government willingness to take on homeowner risks.
<i>Distributional impacts</i>	<i>Vertical equity</i>	Vertical equity improves as increasing the EQC cap reduces the impact of granular risk based impacts which higher income households are more able to afford compared to lower income households in similar locations. It increases the geographical and building risk cross-subsidies of the current scheme. Higher cap reduces within-scheme regressively.
	<i>Horizontal equity</i>	From a risk based perspective, increasing the cap leads to a decline in horizontal equity as increasing the cap leads to a transfer from homeowners in low risk properties to high risk properties. Homeowners of low risk properties are paying higher premiums than would otherwise have been the case with a lower cap, reducing horizontal equity.
<i>Implementation complexity / timing / administrative costs</i>		Low. A flat lifting of the cap could be implemented shortly after a Cabinet decision by regulations under the existing EQC Act; insurers would need a further 12 months approximately following the change in the regulations to be able to implement the change in their policies. Administrative costs are unknown: Not expected to be large, if implementation and transition mirrors that for the 2019/20 increase (and can so draw on resources developed for that).

<b>Option 2</b>		<b>Large flat rate increase to the EQC cap</b>
<b>Description:</b>		Increase the monetary cap in EQC building cover to \$400,000 (+GST).
<b>Recommendation in Cabinet paper</b>		Further analysis proposed to be undertaken. rating:+ The \$400,000 cap has more positive distribution/vertical equity impacts and higher impact in terms of affordability for high risk properties and readiness than is the case for a lower increase in the cap. There are increased risks with this option compared to a lower cap (in terms of risk reduction, and a small (but non zero) risk that insurers may withdraw from natural disaster cover if the cap is increased by this level.
<b>Impacts of option</b>		
<i>Insurance affordability (for high risk)</i>		As with the case with a lower cap increase, this option transfers risk from insurers to EQC, and community-rates the EQC premium. This will improve affordability in higher risk areas and building types, and increases total premium costs in low-risk areas as pricing of risk is transferred from high risk to low risk properties (an effective subsidy).. There is a higher level of benefit to owners of high risk properties than is the case with a smaller increase in the cap.
<i>Insurance availability (for high risk)</i>		Availability for high risk properties improves through an increase in the EQC cap, as is the case with a smaller increase in the cap. There is no issue of availability for low risk properties.
<i>Long-term resilience</i>	<i>Reduction</i>	A large flat rate increase in the cap further mutes risk price signals and further reduces incentives to manage risk, when compared to a smaller increase in the cap.
	<i>Readiness</i>	Further improves affordability and access, and is expected to lead to larger improvements in readiness when compared to a smaller increase in the cap.
<i>Fiscal cost</i>	<i>Cost</i>	Nil, if EQC levies adjusted to meet the costs of the scheme.
	<i>Risk</i>	Higher risk than with a lower cap in option 1. Contingent liability under the Crown guarantee increases by a larger amount than is the case with a smaller increase in the cap. However, the increase in risk is at a decreasing rate with higher EQC caps (see table of annual expected costs to EQC of various cap options in section 3.1).
<i>Unintended consequences (incl potential precedent risks)</i>		There is greater risk than in is the case with a smaller increase in the cap, that with the cap at \$400,000 this may reduce insurer interest in retaining the remaining natural disaster risk (although Treasury considers that this is a low risk). [38] Increased incentives to convert high-risk non-residential property to residential property may undermine broader reduction and readiness efforts. Increased risk, compared to option 1, that this will shape expectations in other areas, eg climate change policy, of government willingness to take on homeowner risks.
<i>Distributional impacts</i>	<i>Vertical equity</i>	Vertical equity improves as increasing the EQC cap reduces the impact of granular risk based impacts which higher income households are more able to afford compared to lower income households in similar locations. It increases the geographical and building risk cross-subsidies of the current scheme. Higher cap reduces the regressive nature of the scheme. The increase in vertical equity is higher than in the case with a smaller increase in the cap.
	<i>Horizontal equity</i>	Increasing the cap leads to a decline in horizontal equity as increasing the cap leads to a transfer from homeowners in low risk properties to high risk properties. Homeowners of low risk properties are paying higher premiums than would otherwise have been the case with a lower cap, reducing horizontal equity. The reduction in horizontal equity is not expected to be a linear decline <sup>14</sup> and so is given a similar rating as the impact of a smaller increase in the cap.
<i>Implementation complexity / timing / administrative costs</i>		Low. A flat lifting of the cap could be implemented 2-3 months following a Cabinet decision by regulations under the existing EQC Act; insurers would need a further 12 months approximately following the change in the regulations to be able to implement the change in their policies. Administrative costs unknown: Not expected to be large, if implementation and transition mirrors that for the 2019/20 increase (and can so draw on resources developed for that).

<sup>14</sup> This depends on the magnitude of the change in option 1: if the cap is doubled from \$150,000 to \$300,000, the impact of this change is greater than the smaller percentage shift from \$300,000 to \$400,000 in option 2 ie. there is a diminishing marginal impact on equity.

Option 3		Targeted changes to EQC
<b>Description:</b>		A targeted increase in the monetary cap in EQC building cover, currently \$150,000 (+GST). Targeting could be geographical (e.g. Wellington region) or building type (eg MUBs). Targeting could also be grand parented (e.g. only applies to existing buildings), or any combination of these. Funding could be by way of either a general increase in EQC levy, or a targeted increase that falls on the beneficiaries of the higher cap.
<b>Recommendation in Cabinet paper</b>		<u>Further analysis proposed to be undertaken.</u> rating:- A targeted increase of the EQC cap would have the effect of removing a proportion of risk from insurers in the relevant targeted areas, and increasing the portion of risk taken by government. This could have benefits for insurance pricing and availability in those areas.
<b>Impacts of option</b>		
<i>Insurance affordability (for high risk)</i>		A targeted increase in the cap, specifically to a small subset of the most affected high risk properties, transfers risks from insurers to EQC. It will improve affordability for the target population. Impacts on affordability elsewhere depend on whether the extra funding is from targeted levies, or a flat increase in the EQC levy. If the funding is from an across a flat increase in the levy this will improve affordability for high risk properties (similar to a large flat rate increase in the cap), while increasing premiums for low risk properties. Alternatively the targeted increase in the cap could be funded by only increasing the levy for the targeted group benefiting from this increase. In this case, low risk properties would not be affected. The impact on high risk properties would depend on the trade-off between an increase in the EQC levy component for high risk properties, and the reduced cover required above the cap from the private insurer (even with the higher levy, the total premium for high risk property would fall as the proportion covered by EQC increased and the over-cap proportion declined).
<i>Insurance availability (for high risk)</i>		Availability for high risk properties improves through a targeted increase in the EQC cap, as is the case with a moderate flat rate increase in the cap. Low risk properties are unaffected.
<i>Long-term resilience</i>	<i>Reduction</i>	A targeted increase in the cap mutes risk price signals and reduces incentives to manage risk. The reduction in incentives is greater degree than is the case with a moderate flat across-the-board increase in the cap for affected properties, but nil for those outside the target population.
	<i>Readiness</i>	Improves affordability and access so may improve readiness for the targeted population, but to a lesser degree for the non-targeted population, than is the case with a large across the board flat rate increase in the cap.
<i>Fiscal cost</i>	<i>Cost</i>	Nil, if EQC levies adjusted to meet the costs of the scheme.
	<i>Risk</i>	Medium risk; increased contingent liability under the crown guarantee for the increase in risk borne by EQC.
<i>Unintended consequences (incl potential precedent risks)</i>		Providing differential benefits may erode policy and community commitment to the EQC solidarity model. Time consistency risks: may be difficult to defend design if a large event affects EQC levy payers outside the target benefit group, and they would have been better off to be included in the target group. Targeted higher caps weakens the case for insurers acting as EQC's agent for those buildings. Increased incentives to convert high-risk non-residential property to residential property may undermine broader reduction and readiness efforts. There is a risk that these options reduce the incentive for homeowners to improve the resilience of their homes, or result in more earthquake-prone buildings remaining in the residential housing stock for longer than they otherwise would have. May shape expectations in other areas, eg climate change policy, of government willingness to take targeted measures, and take on homeowner risks, to support affected populations.
<i>Distributional impacts</i>	<i>Vertical equity</i>	Depends on the funding arrangements. If funded from general levies, a targeted increase in the cap would see a transfer from low risk properties to high risk properties and a likely decline in vertical equity. This increases the geographical and building risk cross-subsidies of the current scheme. If an appropriately targeted levy is used, other levy payers would be unaffected.
	<i>Horizontal equity</i>	Significant negative impact on horizontal equity if funded from general levies. A targeted increase in the cap if funded from an across the board increase in the EQC levy, this would see significant transfer in who bears the cost of high risk properties from high risk to low risk property owners. The distributional impacts of a targeted increase in the cap are considerably less equitable than is the case in either a moderate or large flat rate increase in the EQC cap.
<i>Implementation complexity / timing / administrative costs</i>		Complexity and associated costs are likely to be high. A significant departure from current scheme's flat-rate cover and levy rate, so likely to require major systems changes for insurers and EQC. Final timings would be subject to consultation with EQC and insurers. Administrative costs are unknown, but likely to be significant.

<b>Option 4</b>		<b>Government reinsurer</b>
<b>Description:</b>		<p>Government could provide natural hazard insurance to insurers (reinsurance). Examples of possible reinsurance schemes are the following:</p> <ul style="list-style-type: none"> <li>• government could take on a percentage of the residential property risk currently taken by insurers in a specified region or area, or</li> <li>• government could take on the risk for a defined amount of loss to particular residential properties in a specified region or area, or</li> <li>• government could take on insurers' catastrophe risks over a defined threshold.</li> </ul>
<b>Recommendation in Cabinet paper</b>		<p><u>Further analysis proposed to be undertaken.</u> rating: - Further work is required to better understand the pros and cons of government providing targeted natural hazard reinsurance, including:</p> <ul style="list-style-type: none"> <li>• which targeted reinsurance design would be the most effective in addressing availability and pricing issues,</li> <li>• whether a targeted reinsurance scheme can effectively address availability and pricing issues without essentially operating as a government subsidy to property owners,</li> <li>• having sufficient data upon which to effectively price the risk being taken on by government, and</li> <li>• how government would approach the risk it took on under a reinsurance scheme financially (ie. by further reinsuring it to a third party or through alternative means).</li> </ul> <p>As with a targeted increase in the EQC cap, further work is required to fully understand the advantages and disadvantages of a government reinsurance scheme, including the potential unintended consequences.</p>
<b>Impacts of option</b>		
<i>Insurance affordability (for high risk)</i>		The option may help to improve affordability marginally in high risk regions, but Insurers would still price risk granularly and high-risk properties would remain expensive to insure relative to lower risk properties. The effect on affordability could be more substantial if the option involved material levels of government subsidisation. Low risk properties would be unaffected.
<i>Insurance availability (for high risk)</i>		Some reinsurance structures (e.g. quota share) could give insurers more headroom (before hitting their maximum reinsurance capacity) to offer policies in Wellington, with benefits for availability (and potential knock-on effects for affordability) in the region. Depending on terms, this option may have benefits for MUBs by freeing up more Wellington capacity from NZ insurers.
<i>Long-term resilience</i>	<i>Reduction</i>	Does not necessarily negatively impact risk reduction (unless structure involves a material level of subsidisation)
	<i>Readiness</i>	Could help prevent worsening of availability, and thereby improve readiness
<i>Fiscal cost</i>	<i>Cost</i>	Fiscal cost depends on how government deals with the risk it takes on. Reinsuring the risk to third party reinsurers may be no less expensive than it is for private insurers (so to have any impact, government subsidisation may be required, implying a high cost to government)
	<i>Risk</i>	If risk not reinsured or defrayed via alternative risk transfer, potential for revenues to exceed costs but large contingent liability on government balance sheet.
<i>Unintended consequences (incl potential precedent risks)</i>		The reinsurer option is likely to involve difficult boundary issues, may create distortion of the market in unintended ways, and have difficulty with unwinding. If a structure that involves some subsidisation of risk is pursued, sets a precedent of government taking on private risk for natural perils.
<i>Distributional impacts</i>	<i>Vertical equity</i>	If the structure involves government subsidisation, it would be a regressive subsidy (ie. low vertical equity) as the main beneficiaries of the subsidy would likely include high income property owners in high risk areas. In the absence of subsidisation, the option is relatively neutral in terms of vertical equity.
	<i>Horizontal equity</i>	Would probably be beneficial for property owners in high density – high risk regions, and would not necessarily be at the expense of lower risk regions. If the option involved material government subsidisation, this would imply low horizontal equity because households with very different risk profiles would pay similar amounts for insurance due to the use of government funds. In the absence of subsidisation, the option is relatively neutral in terms of horizontal equity.
<i>Implementation complexity / timing / administrative costs</i>		Approximately one to two years depending on structure. Moderate transaction costs (legal, commercial negotiation).

<b>Option 5</b>		<b>Direct premium subsidies</b>
<b>Description:</b>		Government subsidises insurance for high-risk properties. For example, the government could reimburse a proportion of the insurance premium for property owners who have significant insurance affordability issues, potentially for a limited period of time.
<b>Recommendation in Cabinet paper</b>		<u>No further work proposed</u> : rating:- Direct government subsidies for the insurance costs of higher-risk properties would increase demand for insurance, which in turn would likely increase the average price of property insurance generally (given supply constraints). The overall effectiveness at improving insurance affordability depends on the design of the subsidy (eg, the size of the subsidy, whether it is narrowly targeted, and whether it is time-limited). These design choices would determine the fiscal cost, which could be significant. Subsidies for seismic-risk issues will establish a precedent that the government will contribute to insurance costs for properties subject to increasing risk exacerbated by climate change.
<b>Impacts of option</b>		
<i>Insurance affordability (for high risk)</i>		Affordability would improve for high risk properties, as subsidies would reduce insurance costs. However, this would increase demand for insurance, which in turn could increase the average price of property insurance generally (given supply constraints).
<i>Insurance availability (for high risk)</i>		Subsidies are not expected to affect insurance availability for either high or low risk properties, unless higher premiums attract new insurers to enter the market.
<i>Long-term resilience</i>	<i>Reduction</i>	Likely to reduce incentives for risk reduction by blunting price signals. Insurance subsidies for high risk properties would result in higher risk than would otherwise have been the case.
	<i>Readiness</i>	Limited impact on financial readiness as insurance coverage levels are already high. However, it may help prevent high-risk properties from stopping insuring and thereby improve readiness.
<i>Fiscal cost</i>	<i>Cost</i>	Medium fiscal cost: Depends on the scale of intervention. The fiscal cost to government would depend on how targeted the criteria are for accessing the subsidy, how generous the subsidy is, and the duration of the subsidy scheme (that is, whether it is a time-limited transitional measure).
	<i>Risk</i>	Low fiscal risk. This would depend on the design of the scheme; if this is limited to a small cohort of high risk properties and was time limited then the fiscal risk would be low.
<i>Unintended consequences (incl potential precedent risks)</i>		As noted above, insurance supply constraints in higher-risk areas could result in direct subsidies contributing to higher insurance premiums, with relatively small proportion of the incidence of the subsidy benefit falling on the property-owner. Insurance subsidies for seismic risk issues may create a precedent that the government will contribute to increasing insurance costs for properties subject to increasing risk exacerbated by climate change.
<i>Distributional impacts</i>	<i>Vertical equity</i>	Depends on the design of the scheme. The Government could target the subsidy at more vulnerable groups and/or provide the subsidy as a transitional measure. The more targeted the subsidies are to vulnerable or low income households the more likely that vertical equity increases under this option. The wider the subsidy in terms of eligibility, the greater the chance that vertical equity declines.
	<i>Horizontal equity</i>	Depends of the design of the scheme. As long as the subsidies are applied in a way where similar at risk properties are eligible for the subsidy then horizontal equity is maintained; however if the design of the scheme varies the eligibility for the subsidy depending on income/vulnerable households, then horizontal equity declines, as properties of similar type and similar risk would be treated differently based on income/wealth.
<i>Implementation complexity / timing / administrative costs</i>		Implementation could be relatively quick once the design issues have been addressed and the framework decided. We do not expect there to be material costs to insurers.

<b>Option 6</b>		<b>Subsidise seismic strengthening</b>
<b>Description:</b>		The government would fund earthquake strengthening to improve the seismic resilience of existing buildings.
<b>Recommendation in Cabinet paper</b>		No further work proposed. rating:- This option is likely to have a high fiscal cost and create a precedent that the government will fund climate change adaptation. There are significant equity, boundary, and precedent issues. It would be difficult to define and justify why certain property owners should qualify to receive subsidies, while others should not. [Note: MBIE is in the process of considering a related <u>but different</u> issue: that faced by low-income apartment owners in Multi unit buildings who cannot afford the earthquake strengthening work. That work targets earthquake strengthening for life-risk (a regulatory requirement) and issues with access to finance for some owners of multi-unit properties. Treasury's recommendation does not prejudge this work as it relates to a different problem.]
<b>Impacts of option</b>		
<i>Insurance affordability (for high risk)</i>		Affordability of insurance could increase for high risk buildings/properties that are strengthened, but the impact would depend on whether insurers are willing to adjust premiums to account for the strengthening work.
<i>Insurance availability (for high risk)</i>		Availability of insurance for high risk properties should increase as seismic strengthening should reduce the risk to insurers. However, this depends also on how much exposure to high risk areas some insurers may already have and whether they have reached their limits of exposure in particular locations.
<i>Long-term resilience</i>	<i>Reduction</i>	Seismic strengthening would reduce risk in the long-term by retrofitting existing high-risk buildings.
	<i>Readiness</i>	This would improve financial readiness if it led to increased cover or improved affordability of insurance from insurers.
<i>Fiscal cost</i>	<i>Cost</i>	Likely to be high. Fiscal costs depend on the design of the scheme. An estimate for NBS strengthening is estimated at around \$4.2bn to \$18.9bn, depending on the level of strengthening.
	<i>Risk</i>	Low fiscal risk. This would depend on the design of the scheme; if this is limited to a small cohort of high risk properties and was time limited then the fiscal risk would be low.
<i>Unintended consequences (incl potential precedent risks)</i>		This may increase risk if it favours strengthening of high-risk properties (which would still be relatively high risk) over full-rebuild to a significantly higher resilience standard. It is likely that financial readiness (and recovery) would improve by maintaining insurance coverage for strengthened high-risk buildings. This option could create a precedent that the Government will fund adaptation measures to reduce risk for properties subject to risk exacerbated by climate change. Policy work is underway on the role of the Government in supporting climate change adaptation for private property and local government property.
<i>Distributional impacts</i>	<i>Vertical equity</i>	Depends on the design of the scheme. The Government could target the subsidy at more vulnerable groups and/or provide the subsidy as a transitional measure. The more targeted the subsidies are to vulnerable or low income households the more likely that vertical equity increases under this option. The wider the subsidy in terms of eligibility, the greater the chance that vertical equity declines.
	<i>Horizontal equity</i>	Depends of the design of the scheme. As long as the subsidies are applied in a way where similar at risk properties are eligible for the subsidy then horizontal equity is maintained; however if the design of the scheme varies the eligibility for the subsidy depending on income/vulnerable households, then horizontal equity declines, as properties of similar type and similar risk would be treated differently based on income/wealth.
<i>Implementation complexity / timing / administrative costs</i>		At least one year. The government would have to design the funding scheme (including determining what improvements would qualify for funding, and the eligibility conditions for property owners). No material impact on administrative costs.

<b>Option 7</b>		<b>Government 'all-perils' retail insurer</b>
<b>Description:</b>		A new all-perils retail insurer could be established, either on a commercial basis (analogous to KiwiBank) or on a non-commercial basis.
<b>Recommendation in Cabinet paper</b>		<u>No further work proposed</u> rating: - - Establishing such an insurer would likely be costly, complex, risks significant unintended consequences, and the objectives sought could likely be achieved with more certainty in other ways. It would likely have some similar effects to some of the options around provision of reinsurance by government or changes to the EQC cap (i.e. spreading risk and freeing up capacity), but would come with greater financial cost and greater operational complexity. However, if the insurance market trends are due to market structure issues, a government-owned insurer could provide additional competition.
<b>Impacts of option</b>		
<i>Insurance affordability (for high risk)</i>		A retail insurer could help with affordability by offering insurance at lower prices than existing insurers in the market. However this could only be done on a commercial basis if existing insurers are currently overcharging for policies (ie. if premiums are currently higher than the genuine price of the risk plus administrative costs plus an ordinary profit margin).
<i>Insurance availability (for high risk)</i>		A retail insurer could help to improve availability by introducing a new player to the market with additional capacity. Effectively it would introduce an additional choice for consumers with few offers of property insurance from existing insurers.
<i>Long-term resilience</i>	<i>Reduction</i>	Negatively affects risk reduction if the government retail insurer subsidises risk.
	<i>Readiness</i>	If the counterfactual is existing insurers pulling back further from high risk regions, establishing a government-owned insurer would assist readiness by filling the gap in supply left by exiting insurers.
<i>Fiscal cost</i>	<i>Cost</i>	Substantial initial set up costs, as a parallel KiwiBank initial setup costs were approx. \$80m. A commercial insurer would be expected to make normal profits. A non-commercial insurer would imply ongoing subsidisation from government to cover fiscal costs.
	<i>Risk</i>	A government-owned retail insurer established on a non-commercial basis would be likely to end up with a high-risk portfolio, taking bad risks of existing insurers and uncompetitive in the market for good risks. Further risks set out in the <i>unintended consequences</i> section below.
<i>Unintended consequences (incl potential precedent risks)</i>		<p>Some insurers may currently be staying in the Wellington market out of competitive pressures and protecting their reputation as a full national coverage insurer. The emergence of a new government owned competitor could encourage them to withdraw to focus on lower risk areas. In addition, even a commercially focussed government-owned insurer is likely to face public pressure to provide affordable cover to high-risk properties, potentially leading to a riskier portfolio.</p> <p>The option would expand the government's role in the insurance industry into areas where it currently does not operate, and where pricing and availability issues have not been observed, such as insurance for fire and theft.</p> <p>Limited negative precedent impact from commercial retail insurer option.</p> <p>A non-commercial insurer would create a precedent of government subsidising the risks of private property owners. It could be difficult to justify not providing the same subsidisation for climate change issues like sea-level rise.</p>
<i>Distributional impacts</i>	<i>Vertical equity</i>	A non-commercial retail insurer would imply a subsidy from government to high-risk property owners. This would be a regressive subsidy as the main beneficiaries of the subsidy are likely to be people who are relatively well-off (eg. property owners are likely to have higher levels of relative wealth in terms of the value of their property compared to non-property owners) . A truly commercial retail insurer would be relatively neutral in terms of vertical equity.
	<i>Horizontal equity</i>	A non-commercial retail insurer would imply low horizontal equity because households with very different risk profiles would pay similar amounts for insurance due to the use of government funds. A truly commercial retail insurer would be relatively neutral in terms of horizontal equity.
<i>Implementation complexity / timing / administrative costs</i>		<p>More than 1-2 years. The expertise required to set up and run the insurer may be difficult to find extending the time required.</p> <p>No direct additional costs on existing insurers. If the new insurer took a significant share of business then the fixed costs for existing insurers would be spread across fewer clients potentially driving up their costs per policyholder.</p>

<b>Option 8</b>		<b><u>Regulate insurers to increase cross-subsidisation</u></b>
<b>Description:</b>		Description: Regulate insurers to compel a key price or non-price feature property catastrophe insurance; sub-options include: <ul style="list-style-type: none"> <li>• Regulate insurance price or pricing basis.</li> <li>• Regulate pricing granularity</li> <li>• Regulate insurance 'quality' (eg. coverage, hazards covered, reinstatement obligation, etc)</li> <li>• Regulate geographical coverage or availability eg. that insurers must offer policies nationally.</li> <li>• Regulate insurance provision (e.g. insurance needs to be offered)</li> </ul>
<b>Recommendation in Cabinet paper</b>		<u>No further work proposed:</u> rating:- - This would require heavy regulation of multiple dimensions of core features of insurers' product offerings, including the provision of cover, the nature of the cover, and the pricing of cover (e.g. the granularity of insurance pricing). This may be of limited effectiveness and is a high-risk policy with potential for significant unintended consequences. In the case of the regulatory changes following the Northridge quake in 1994 in California, this saw insurer withdrawal from the market. Treasury consulted with insurers and stakeholders, who were not in favour of this option.
<b>Impacts of option</b>		
<i>Insurance affordability (for high risk)</i>		Regulating price or price granularity will improve affordability in high-risk areas or property types, but is likely to reduce availability as insurers would likely raise underwriting standards or cease offering cover. Regulating availability or quality may increase price (worsen affordability) as insurers price in any negative business (risk and profit) consequences of the regulation.
<i>Insurance availability (for high risk)</i>		The impacts on availability and price objectives are basically the obverse of each other. Regulating for availability will improve availability in high-risk areas or property types, but may increase price, as insurers' price in any negative business (risk and profit) consequences of the availability regulation. Regulating price or price granularity is likely to reduce availability, as insurers would likely raise underwriting standards and/ or reconsider market share and participation objectives.
<i>Long-term resilience</i>	<i>Reduction</i>	Incentives to reduce risks are reduced, leading to a reduction in risk reduction efforts.
	<i>Readiness</i>	Readiness may be reduced by insurer price or availability reactions to regulation. The more ambitious the regulation, the greater the risk of confounding price or availability responses from insurers (per California post-Northridge earthquake).
<i>Fiscal cost</i>	<i>Cost</i>	Low fiscal cost.
	<i>Risk</i>	High risk if leads to insurer withdrawal, or if insurers respond to regulation by reducing other aspects of the insurance contract (eg. high excesses, limits on what is covered, availability, premiums). If Government regulates on coverage, insurers likely to respond with higher premiums; if regulate on price, insurers likely to respond by reducing coverage. In either case, the contingent risk to the Crown increases.
<i>Unintended consequences (incl potential precedent risks)</i>		Insurers likely to attempt to minimise impacts of regulation on their business by responding through unregulated parts of their product mix, eg tough underwriting. Regulating key policy features may increase insurers' perceived regulatory risk, negatively affecting attractiveness of and pricing in NZ insurance markets of current and potential new entrants. May shape expectations in other areas, eg climate change policy, of government willingness to regulate risk onto insurers, to support affected populations.
<i>Distributional impacts</i>	<i>Vertical equity</i>	Distributional impacts are very uncertain, as this depends on the regulatory design and insurer response. If the regulation succeeds, there will be increased cross-subsidies from policyholders in lower-risk areas and buildings, to higher-risk areas and buildings. If the policy is ineffective these distributional effects reduce, possibly to zero. However, the confounding price and availability outcomes will likely have negative distributional effects on the target population.
	<i>Horizontal equity</i>	Distributional impacts are very uncertain, as this depends on the regulatory design and insurer response.
<i>Implementation complexity / timing / administrative costs</i>		Considerable; would require substantial consultation with industry before legislative process and would be complex to implement. Cost to insurers to implement: unknown, likely to be high.

<b>Option 9</b>		<b>Reduce solvency capital requirements</b>
<b>Description:</b>		Description: RBNZ's insurer Solvency Standard currently has the highest catastrophe charge (the Charge) in the world at 1:1000 years. The Minister of Finance could direct RBNZ to have regard to government policy objectives that lead to a reduction in the catastrophe risk rating. Alternatively, the Government could legislate to reduce the catastrophe risk rating. The option would have little impact on the Rs (although has some potential to worsen the Response and Recovery position compared with status quo due to increasing the risk of insurer failure). It has potential to, but would not necessarily, help achieve distributional goals with less subsidisation than other options.
<b>Recommendation in Cabinet paper</b>		<u>No further work proposed</u> rating: - - Treasury is uncertain whether lowering the solvency would have a material positive impact on insurance availability, as insurers may continue to hold the same level of capital for their own business reasons. If insurers did reduce the levels of capital they hold, it could increase financial stability risks (such as the risk of insurer failure). The RBNZ is not contemplating any easing in the prudential requirements for insurers; instead the Bank has been indicating that there is a need for an increase in solvency buffers.
<b>Impacts of option</b>		
<i>Insurance affordability (for high risk)</i>		Reducing the Charge may give insurers more headroom to compete in Wellington, but only if there are insurers that have an appetite for more Wellington risk that are currently at their maximum aggregate exposure to Wellington. If there is such an appetite, the additional competition could improve premium affordability. However insurers would still price risk granularly. High-risk properties (eg. subject to liquefaction) would remain expensive to insure. May have indirect marginal benefit for MUBs by freeing up more Wellington capacity from NZ insurers.
<i>Insurance availability (for high risk)</i>		Could improve availability in Wellington (ie. the number of insurers offering insurance on a given property) because it could increase insurers' desired maximum aggregate exposure to Wellington (only to the extent they have appetite for Wellington risk).
<i>Long-term resilience</i>	<i>Reduction</i>	No different to status quo
	<i>Readiness</i>	No different to status quo (as at this stage insurance is high – but it may help prevent worsening of availability leading to more under insurance and thereby improve readiness)
<i>Fiscal cost</i>	<i>Cost</i>	Low fiscal cost
	<i>Risk</i>	Higher risk of insurer failure
<i>Unintended consequences (incl potential precedent risks)</i>		If capital requirements are lowered, then in a 1:1000 year event, there is an increased risk that smaller insurers may not be able to cover their liabilities. The Government would be under pressure to act as an insurer of last resort to prevent considerable harm to homeowners who would be left uncovered in the event of an insurer failure, increasing risk and potential liability to the Crown.  Reducing the prudential requirements would increase risk and is the opposite of the Bank's intentions.
<i>Distributional impacts</i>	<i>Vertical equity</i>	No vertical equity implications
	<i>Horizontal equity</i>	No horizontal equity implications
<i>Implementation complexity / timing / administrative costs</i>		Any decision to change the prudential requirements is in the exclusive domain of the RBNZ – the Government's only influence under the existing legislative framework is through the Minister of Finance making Government policy statements that the RBNZ must have regard to. No change in administrative cost to existing insurers. It has the potential to reduce costs for possible new entrants (insurers).

# Section 5: Conclusions

## 5.1 What option, or combination of options, is likely best to address the problem, meet the policy objectives and deliver the highest net benefits?

Initial analysis and assessment indicates that a flat across-the-board increase in the EQC cap results in a net positive benefit to the status quo with the least associated costs and less distortion or unintended consequences to residential insurance markets. The flat increase in the cap, appears at this stage of the analysis, to present greater benefits and less costs or distortions relative to the alternative options.

In this analysis, Treasury’s preferred option for further work, in terms of which option presents the greatest net benefits with least cost and fewer distortions or unintended consequences to the insurance market, is for a flat across-the-board increase in the EQC cap (either option 1 or 2). The Minister of Finance has also instructed Treasury to undertake further analysis of the impacts of a targeted increase in the EQC cap for high risk properties or for properties in high risk areas, and the public reinsurer option.

Additional work is needed to determine more clearly what the relative strengths and weaknesses and net impacts might be in and between these three cases. In addition, these options need to be assessed against the status quo option (no change to the current insurance market framework); it is possible that no change may be recommended unless there is unequivocal evidence that the net benefit test is met and that there is limited (if any) distortion to the residential insurance market and continued provision of high levels of natural disaster cover.

Further options around subsidies, a public insurer, prudential requirements and regulation have also been considered. These have been dismissed on the basis that the likely negative impacts of the intervention outweigh any positive outcomes.

## 5.2 Summary of costs and benefits of the options for further analysis

At the time of preparing this paper, the scope of financial estimates of the options is very limited and a cost benefit analysis of the options is therefore still to be done. Collection of further data, financial estimates, and further consultation with stakeholders is required to enable the modelling of financial and fiscal impacts of the options. It is intended that this will take place in the second stage of the insurance work in early 2020.

Affected parties	(i) Flat across-the-board increase in the cap	(ii) Targeted increase in the cap	(iii) Public reinsurer
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### Additional costs of proposed approach, compared to taking no action

#### Regulated parties

Property owner	Benefits to owners of high risk properties as affordability and availability improves (although uncertain how much of the benefits are passed on to property owners by insurers).  Increase in net costs to owners of low risk properties	A transfer of costs from high to low risk properties, targeted more specifically to those properties which are least affordable or where availability is most constrained (more efficient in terms of its targeting of where the problem lies). A differentiated benefits scheme may however undermine public support in the EQC model.	Similar to a targeted increase in the EQC cap, this would be expected to improve affordability and availability of insurance to owners of high risk properties. However, it is uncertain how much of the benefits insurers would transfer/pass on to high risk properties given limited competition in the market.
Private insurers	This reduces the revenues of insurers as the size of the above cap section of the residential insurance market reduces. The	A targeted increase in the cap has a more limited impact on the revenue stream of insurers. Insurers would not have to cover	This depends on the pricing design of the reinsurer. Net costs for insurers would fall if they could access cheaper reinsurance cover

	size of this change would depend on the scale of the increase in the cap. A large increase in the cap reduces the attractiveness of the residential insurance market to insurers, as fixed administrative costs remain against a declining revenue stream.	as much as the risk of the high risk properties as this would be covered by EQC. Net risks/costs for insurers would be lower than the no change option, but with higher revenues and profits than the flat increase in the cap.	than would otherwise have been the case. In effect this would be a subsidy for insurers to provide cover to the highest risk properties.
EQC	The increase in EQC costs depends on how much the additional risk covered costs to reinsure by third parties. This should be passed on to beneficiaries (property owners) through increases in the levy so that there is no net cost to EQC. There is increased risk of higher costs in the event of a natural disaster with associated increased risk to the Crown and likelihood of the NDF being called on and the Guarantee being triggered in a significant disaster event.	A targeted increase in the cap would have a smaller increase in the reinsurance costs for EQC, compared to the flat across-the board increase in the cap. However, as these can be neutralised by transferring the increased cost on to property owners through increases in the levy this means the net cost to EQC is the same in both cases. The increased risk from a targeted increase in the cap is considerably lower (compared to a flat across the board increase) as a much smaller portion of the insured residential market is being impacted by the change. The risk to the Crown has increased, but again by a lower amount compared to the flat increase.	If the public reinsurer is a new entity then EQC costs are unaffected. If EQC takes on the role of public reinsurer for certain high risk properties, then its costs will increase. If it charges a similar rate for reinsurance as other reinsurers then this doesn't change the status quo for insurers, and therefore would have no impact on the affordability/availability of insurance for high risk properties. For this option to reduce costs and improve availability for high risk properties, the reinsurance costs offered by the public insurer would need to be lower than currently offered by reinsurers; effectively this would be a subsidy to insurers and a cost to the new entity it couldn't fully transfer.
<b>Regulators</b>			
The Treasury	No additional cost	No additional cost	Additional monitoring costs of new public entity (or if role taken on by EQC)
MBIE	No additional cost	No additional cost	No additional cost
Commerce Commission	No additional cost	No additional cost	No additional cost
Reserve Bank	No additional cost	No additional cost	No additional cost
<b>Total Monetised Cost</b>	Not available	Not available	Not available
<b>Non-monetised costs</b>	Further analysis required	Further analysis required	Further analysis required

### 5.3 What other impacts are the options for further analysis likely to have?

Treasury sees no additional significant impacts or risks relating from a flat across-the-board increase in the EQC cap (or from the targeted option), as long as this is a low or moderate increase, ie. raising the cap from \$200,000 to \$300,000 (+GST). As noted earlier, an increase in the cap does not impose fiscal costs, as these can be offset by increasing the EQC levy to meet these increased costs. However fiscal risk does increase, as the contingent liability under the Crown guarantee increases, with increases in the cap. A moderate increase in the cap can be achieved by existing regulation under the EQC Act, and is less complex to implement compared to other options. A moderate increase in the cap would not structurally change the residential insurance market (in terms of its regulation).

In the case of a large increase in the EQC cap, to \$400,000 (+GST)) there are different views on whether insurers might choose to exit the market for natural disaster cover. Treasury needs to consult further with insurers and EQC on this issue and undertake further analysis before an informed assessment can be made.

The Inquiry into the EQC is still to deliver its findings, which may call for further changes to EQC. If there was an inconsistency between raising the cap and the findings of the Inquiry, the Review of the EQC Act that follows the Inquiry in 2020 would provide an opportunity to resolve any issues.

The case is a little more uncertain in the case of a public reinsurer, as this option is untested and would need considerably more consultation and analysis for Treasury to be able to provide an informed view. Given the limited information and the necessity for further consultation, it would be speculative to form any definitive response at this stage on the public reinsurer option.

### 5.4 Is the preferred option compatible with the Government's 'Expectations for the design of regulatory systems'?

The options for further review, increasing in the EQC cap (either a flat across-the-board or targeted increase) and a public reinsurer, are compatible with the Government's expectations for the design of regulatory systems for the following reasons:

- the objectives of the proposal are clear;
- the proposal seeks to achieve the objectives in a least cost way, with the least impact on market competition, property rights, and individual autonomy and responsibility;
- the Crown Entities Act provides EQC with the flexibility and governance arrangements it needs to make these changes, while retaining consistent and predictable outcomes for regulated parties;
- the options are proportionate, fair and equitable in the way it treats regulated parties and aligns with existing requirements; it does not significantly affect the current EQC design or purpose (but further analysis will be undertaken);
- the option remains consistent with relevant standards and practices in the international reinsurance market (the cover remains restricted to residential property and does not cover commercial property);
- the option conforms to established legal and constitutional principles and supports compliance with New Zealand's international and Treaty of Waitangi obligations;
- lifting the EQC cap is an efficient option that can be achieved by regulation and does not require legislative drafting; and

- the recommendations do not impact on the government’s ability to choose other options if the dynamics or market conditions change (ie. optionality remains).

As noted above, the lack of available data at this point constrains our ability to quantify the scale of the problems that have been identified. Further analysis will be undertaken in early 2020 to fill in these gaps, providing better data on the nature of the problem, its scale, and estimates of the financial and fiscal impacts. This will enable more granular objectives to be defined, with the possibility of being able to include specific performance indicators to monitor the impact of the options.

## Section 6: Implementation and operation

### 6.1 How will the new arrangements work in practice?

The early indication from ICNZ is that insurers would need at least one year advance notice to implement a flat across the board increase in the EQC cap (to make the necessary changes to their systems), implying an increase no sooner than about 1 July 2021. The extended implementation periods are in part to enable insurers’ (and EQC’s) annual reinsurance contract renewals to reflect the new caps on EQC cover.

Even putting aside insurer lead times, the soonest an increase in the EQC cap could occur is 1 July 2020, as the current transition to the \$150,000 cap runs until 30 June 2020.

A more targeted increase in the EQC cap, or a public reinsurer option, if selected, will take considerably more time to implement compared to either a flat across-the board increase or a targeted increase in the cap, and would be significantly more complex. There would need to be close consultation and development with EQC, international reinsurers and insurers to determine the appropriate design and framework that a public reinsurer model would require.

### 6.2 What are the implementation risks?

As this is only an in-principle decision to undertake further analysis on options, there are no implementation risks at this stage. Further consultation with insurers is required, seeking their views on the impact of increasing the cap by various increments, and what impact this would have on their continued participation in providing natural disaster cover. Property owners have not been consulted at this initial stage of the work; it will be important to seek their views during consultation with stakeholders on the proposed options in early 2020. EQC also requires sufficient time to engage with international reinsurers, to seek their views on possible changes on the level of the cap and how changes would affect their perception of covering New Zealand natural disaster risk.

# Section 7: Monitoring, evaluation and review

## 7.1 How will the impact of the new arrangements be monitored?

As mentioned earlier in this paper there are significant limitations around the availability of insurance data for policy makers and regulators. Further information will assist Treasury in providing future advice. At the time of writing the following issues had been identified in terms of additional data being sought:

- Treasury has commissioned a research survey of freehold residential owner-occupied buildings to better understand the availability of property insurance in Auckland, Wellington, and Christchurch.
- For MUBs, Treasury currently only has limited anecdotal information. Treasury does not have comprehensive information about the uptake, price, availability, and level of underinsurance. Insurers and brokers have so far been unwilling or unable to provide data. Treasury is currently exploring options to survey the owners of multi-unit buildings.
- Financial estimates of the impact of the options on EQC costs.

Further financial analysis and cost estimates will be undertaken of the options proposed for further work in early 2020.

As the decisions sought at this stage are only to undertake further analysis, it is too early to make a decision on monitoring or new data collection beyond what has already been identified for the next round of consultation and analysis with stakeholders in early 2020.

## 7.2 When and how will the new arrangements be reviewed?

At this stage, a review process is not applicable, as only a decision to undertake further analysis is sought.