

The Treasury

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

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Office of the Minister Responsible for the Earthquake Commission
Chair, Cabinet Economic Development Committee

Modernising the Earthquake Commission Act: Increasing the Cap

Proposal

1. This paper seeks agreement to increase the monetary cap on Earthquake Commission (EQC) building cover from \$150,000 (plus GST) to \$300,000 (plus GST) per dwelling, to support residential property insurance that is affordable, available, and appropriately contributes to New Zealand's long-term resilience.
2. This paper is the last of three papers seeking agreement to a suite of proposed amendments to modernise the Earthquake Commission Act 1993 (EQC Act). The other papers have already been agreed by Cabinet [CAB-21-MIN-0128 and CAB-21-MIN-0177 refer].

Relation to government priorities

3. Housing is a Government priority. EQC exists to support a high level of homeowner insurance. High insurance uptake is critical for ensuring people have a home to return to following a natural disaster, maintaining the long-term quality of New Zealand's housing stock, and protecting what is many New Zealanders' largest financial asset.

Executive Summary

4. Government intervention is desirable as a high uptake of residential property insurance supports recovery, reducing the level of distress suffered by communities after a natural disaster. It also reduces fiscal risk and uncertainty because Government is less likely to be drawn into ad-hoc responses to address uninsured private losses following natural disasters.
5. Cabinet previously agreed that the Treasury should undertake further work on options to address insurance affordability and availability, including through increasing the EQC cap [DEV-19-MIN-0332 and DEV-19-MIN-0208 refer]. Increasing the EQC cap is one way to address rising residential property insurance premiums in regions with high seismic risk, to support residential property insurance that is affordable, available and appropriately contributes to New Zealand's long-term resilience.
6. Cabinet has agreed to progress a suite of amendments through a Bill to modernise the EQC Act [CAB-21-MIN-0128 and CAB-21-MIN-0177 refer].
7. Some of the amendments address recommendations of the Public Inquiry into EQC that reported in March 2020. Others update the EQC scheme to better align with Government's policy objectives. Together, the amendments will improve the scope and certainty of cover provided by EQC. The package of amendments has three overarching objectives:

- enabling better community recovery following a natural disaster,
 - updating and improving the clarity and certainty of the role of EQC and the cover it provides, and
 - supporting the future durability and flexibility of the EQC Act.
8. This paper proposes one further change: to increase the value of the monetary cap on EQC building cover (the cap) as part of a modernised EQC Act. I recommend an increase of the cap to \$300,000 (plus GST).
9. I have met with insurers and reinsurers to understand the implications of a cap increase.

Previous Cabinet consideration

10. In December 2019, Cabinet [DEV-19-Min-0332] agreed that the Treasury should provide advice on prioritised options to address increasing prices in property insurance markets. Cabinet's objective was affordable and available property insurance (particularly in higher risk areas) that can appropriately contribute to New Zealand's long-term resilience. The options Treasury considered were:
- 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.
11. Cabinet decided not to pursue the establishment of a new government-owned retail insurer, and the regulation of insurers to compel greater flat-rate pricing or to take on more risk in higher-risk areas.
12. The Public Inquiry into EQC, which reported in March 2020, also recommended that Government review the EQC cap on building cover.¹ The Inquiry suggested the cap could be raised to \$400,000 to bring it closer to covering the average cost of building a house in New Zealand.
13. I have prioritised work on the EQC cap because it aligns with other work currently being undertaken to modernise the EQC Act.
14. ^[33]

Objectives for residential property insurance

15. My objectives for residential property insurance in New Zealand are that:

¹ Recommendation 1.5.1 of the Public Inquiry into EQC.

- New Zealanders can access affordable residential property insurance, to ensure as many New Zealanders as possible can repair their homes if they are damaged by a natural disaster.
- Sufficient funds are available to repair/rebuild following a natural disaster, which minimises fiscal risks to the Crown, including risks such as the collapse of a private insurer.²
- There is a robust and competitive private insurance market.
- Insurance price is used to signal risk.
- New Zealand continues to be able to purchase cost-effective reinsurance.

The EQC Act and cap

16. The EQC Act provides for capped natural disaster insurance cover for residential buildings and associated residential land against earthquake, volcanic eruption, tsunami, landslip, and hydrothermal activity. Residential land is insured against storm and flood damage.³ The Act also covers fire occurring as a result of these natural disaster events.
17. EQC cover is mandatory for buildings, containing dwellings, insured against fire. Private insurers issuing fire policies collect and pass on EQC premiums (the EQC levy is called a premium). Currently the EQC premium is 20 cents (plus GST) for every \$100 of home insurance up to the maximum EQC cover. The maximum annual EQC premium is \$345 (including GST).
18. EQC building cover is currently capped at \$150,000 (plus GST), less the claims excess, for each dwelling in an insured building. A building can be made up of one or more dwellings (like self-contained apartments) and other non-residential parts. EQC building cover also includes the practical facilities needed to support day-to-day living in the dwelling, such as sewerage, and separate garages.⁴
19. Private insurers cover the remaining value of a claim, less any further private insurance excess, up to any sum-insured amount specified in each homeowners' private insurance policy. Private insurers also provide building cover for non-EQC covered perils such as storm surge and flood, and residential building items outside of EQC cover such as outdoor swimming pools and fences.
20. EQC cover helps to ensure affordable, defined insurance cover against the specified hazards for insured building owners. By covering the first \$150,000 of each insurance claim in relation to natural disasters, it reduces private insurers' risks and costs, enabling them to insure, and charge lower premiums to, higher-risk properties than would otherwise be the case.

² Following the passage of the Insurance (Prudential Supervision) Act 2010, New Zealand has fully implemented a prudential supervision regime for insurers, including requirements on New Zealand-incorporated insurers to hold capital or reinsurance for a 1-in-1000 year earthquake. However no risk can be completely eliminated.

³ EQC covers residential land separately to buildings and therefore land costs are not part of the building cap. EQC land cover provisions are covered in the companion Cabinet paper *Modernising the Earthquake Commission Act* [DEV-21-MIN-0062] and *Modernising the Earthquake Commission Act: Paper two* (which is being considered by DEV on 19 May 2021).

⁴ EQC covers 'appurtenant' structures, which means structures that belong to the dwelling in a way that is ancillary, i.e., ownership interest and used for household purposes.

Supporting insurance affordability and availability

- 21.** The EQC residential building cap was originally set at \$100,000 plus GST effective at the beginning of 1994. This was roughly the cost of building a basic house at that time. After 1994, a private insurance market for EQC top-up cover developed. Relative to today, there was minimal and unsophisticated pricing based on risk.
- 22.** Since 1993, risk-based pricing by insurers has become increasingly granular. This is putting financial pressure on homeowners in high-risk areas, which can materially impact their wellbeing. I am concerned sudden changes in insurance prices could put stress on some households and mean that they are no longer able to access affordable insurance.
- 23.** Further, as sum-insured values have increased in response to residential repair and construction costs, the portion of insurance that is risk based has increased. It is my intention to restore some balance back into the price structure and increase the portion that is community-rated. Generally, risk will still be a higher proportion of pricing than when the scheme was first introduced in 1993.
- 24.** Insurers are now taking a more conservative approach to writing new business in particular regions like Wellington, due to earthquake risk and a high population density which means a major event could cause significant losses for insurers.
- 25.** Insurers have told me in discussions that they have the ability to price at a very sophisticated granular level which could mean that different houses on the same street face different prices due to the particular risks that they face.
- 26.** Risk-based insurance pricing can have some benefits, for example, some consider it fair that where a property is considered to have higher risk, this is reflected through higher premiums.
- 27.** However, given insurance prices take a range of factors into account, they do not provide a perfect signal of risk. For example, if an insurer considers that it has too much exposure in one area, it may reflect this by pricing higher for that area. This can mean that similar households receive different price signals from the same insurer.
- 28.** I have also heard from property owners, especially apartment owners, and insurers, that risk mitigation changes a property owner may make in response to increased insurance prices, such as seismic strengthening, often do not result in lower insurance premiums. If a property is facing high prices because of the location, then there is very little that they can do to change this.
- 29.** Government intervention is desirable as a high uptake of residential property insurance supports recovery, reducing the level of distress suffered by communities after a natural disaster. It also reduces fiscal risk and uncertainty because Government is less likely to be drawn into ad-hoc responses to address uninsured private losses following natural disasters.

Options for achieving these objectives

30. I considered a range of options to address Cabinet's objectives. The key options previously considered and rejected by Cabinet, or I decided not to pursue at this time, are set out below.

Option	Reason for not pursuing
The establishment of a new government-owned retail insurer.	<p>This option would likely have similar effects to increasing the EQC cap for certain properties and some of the reinsurance options described below, but would have 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.</p> <p>Cabinet considered and decided not to pursue this option [CAB-19-MIN-0675 refers].</p>
Regulating insurers to compel greater flat-rate pricing, or to take on more risk in higher-risk areas.	<p>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 exiting that market, leading to the creation of the California Earthquake Authority (CEA) in 1996.</p> <p>When compelled to provide insurance, insurers could respond by changing the unregulated parts of their product offerings, such as the quality of the cover (e.g. exclusions and excesses). Regulation would be costly to administer and carry a high risk of unintended consequences.</p> <p>Cabinet considered and decided not to pursue this option [CAB-19-MIN-0675 refers].</p>
A targeted increase to the EQC cap (targeted at certain regions or property types).	<p>This option is significantly more complex to implement than a simple cap increase, and would challenge the current EQC scheme principles of equal national coverage and pricing. It would also create boundary issues in choosing which buildings or regions should receive a targeted increase. This option would not be resilient to changes in the risk profile of specific regions or property types over time (or only at the cost of significant volatility and complexity).</p>
The provision of targeted natural hazard reinsurance (targeted at certain regions or	<p>A reinsurance scheme could potentially be set up in a similar structure to Flood Re in the UK, providing a pool of reinsurance cover available to cover earthquake risk which: did not require Government funding; is time-limited (Flood Re</p>

Option	Reason for not pursuing
property types).	is planned to end in 2039); and is linked to resilience work. Flood Re is funded by the premiums collected from insurers on reinsured policies and a general levy collected from all insurers based on market share. Such a model would require significant leadership from the insurance sector (Flood Re was set up by the industry and formalised in legislation). The EQC scheme achieves a similar effect to Flood Re by smoothing insurance premiums between high and low risk properties. I have prioritised work on the EQC cap at this time because it aligns with other work currently being undertaken to modernise the EQC Act.

Increasing the EQC Cap

31. Having considered several options, I recommend that a flat increase to the EQC cap, to apply nationally, is the best way to achieve Cabinet’s objectives. Increasing the EQC cap can address rising residential property insurance premiums in regions with high seismic risk, to ensure residential property insurance is affordable, available and appropriately contributes to New Zealand’s long-term resilience. It is an option that makes good use of the existing EQC scheme.
32. There is not yet evidence of a widespread decline in insurance uptake in New Zealand. In my view, early intervention, before price pressures result in declining insurance, is preferable to waiting for the decline to occur. As EQC cover only applies to those who already have a private insurance policy, it is easier to maintain high uptake through pre-emptively putting downward pressure on rising insurance prices, than to allow uptake to decline and then face the difficult task of getting people who have chosen not to insure, to begin taking out insurance again. Voluntary uptake of natural disaster insurance is known to be low in risk-prone jurisdictions where figures are available (e.g. Japan and Chile).
33. The cap level requires a choice along a spectrum, and there is no perfect level. Three key options I considered were:
 - **\$250,000 (plus GST)** – This is a modest increase that will have the smallest effect on the insurance market and pricing.
 - **\$300,000 (plus GST)** – This is my recommended option. It balances my desire to improve insurance availability and affordability while leaving room for a robust private insurance market, including retaining a high degree of risk-based pricing signals. It also limits the risk of unintended consequences such as insurers exiting the New Zealand market. My preferred option also reduces insurers’ exposure following a natural disaster which means the Crown faces lower implicit fiscal risks in the event of an insurer failure, such as occurred with AMI in 2011.⁵

⁵ New Zealand has fully implemented a prudential supervision regime for insurers, including requirements on New Zealand-incorporated insurers to hold capital or reinsurance for a 1-in-1000 year earthquake.

- **\$400,000 (plus GST)** – I am advised that the original EQC cap of \$100,000 (plus GST) was set to be roughly the cost of building a basic house in 1994. The Public Inquiry into EQC suggested the cap could be increased to recognise that the average cost of building a residential property in New Zealand (excluding the cost of the land on which it is built) has increased since that time, which they considered to now be closer to \$400,000. There is no single or definitive approach to determining the cost of rebuilding an average home in New Zealand, and a number of different approaches are possible.

Expected impacts of a cap increase

EQC premium

34. The current EQC premium is priced based on 2016 modelling. New modelling from 2020 suggests that if the current cap of \$150,000 (plus GST) is retained, then the premium should be raised by around \$69 (from \$345 (including GST) to \$414 (including GST)) to meet the new breakeven rate. This is an increase from 20 cents to 24 cents per \$100 insured.
35. If the cap were increased to \$300,000 (plus GST) then the premium would be around \$552 per annum (16 cents per \$100 insured). This is an increase of up to \$207 a year⁶ from the current premium, or \$138 from the estimated current breakeven premium.

Price impacts in high and low-risk areas

36. Increasing the cap can smooth out the regional differences in insurance prices that result from natural hazard risk. Each household will experience both an increase in their EQC premium of \$207 and, I expect, a reduction in their private insurance premium. The balance of these two factors will determine whether they see an overall increase or decrease in their insurance premium.

EQC premium impact

37. While insurers generally price the insurance for a property based on its risk, the EQC premium rate is the same for all homes regardless of underlying risks. This is referred to as a “community-rated” price.
38. If the EQC cap is increased, homeowners receive more cover from EQC and less cover from insurers for EQC-covered perils. As a result, regions that currently pay low amounts for natural disaster cover may see an increase to their prices (as their EQC premium will increase, and EQC cover now makes up a bigger proportion of their total cover). Regions that pay high insurance prices for natural disaster cover from private insurers may see price decreases.
39. If there is a cap increase from the current \$150,000 to \$300,000, the EQC takes on an additional \$150,000 of exposure per property for covered hazards. At a community-rated price, the premium would increase from a breakeven rate of \$414 to \$552 (an increase of \$138 a year to be paid by homeowners). The private insurers’ exposure for EQC-covered hazards would reduce by \$150,000 per property. Insurers would no longer have liability for that cover and should reduce premiums. Column C

⁶ Homes that have a sum insured that is less than \$300,000 (plus GST) do not pay the maximum EQC premium.

in Table 1 (below, calculated by insurance multinational Aon) explains how much this exposure costs EQC at a breakeven rate for each region.

40. If insurers used the same model as Aon used to calculate the figures in Table 1 for the breakeven premium, then Column C would be a good proxy for the amount by which insurers may reduce their prices. EQC modelling is based on how EQC prices the risk, and cannot account for how private insurers will act following a cap increase. These figures should not be viewed as estimates of private insurers' price response. Insurers have told us that they use different risk models to the EQC. Also, insurer pricing is influenced by many factors beyond any risk model, including profit and competitive pressures, and marketing decisions aimed at growing, defending or controlling national and regional market and risk shares.

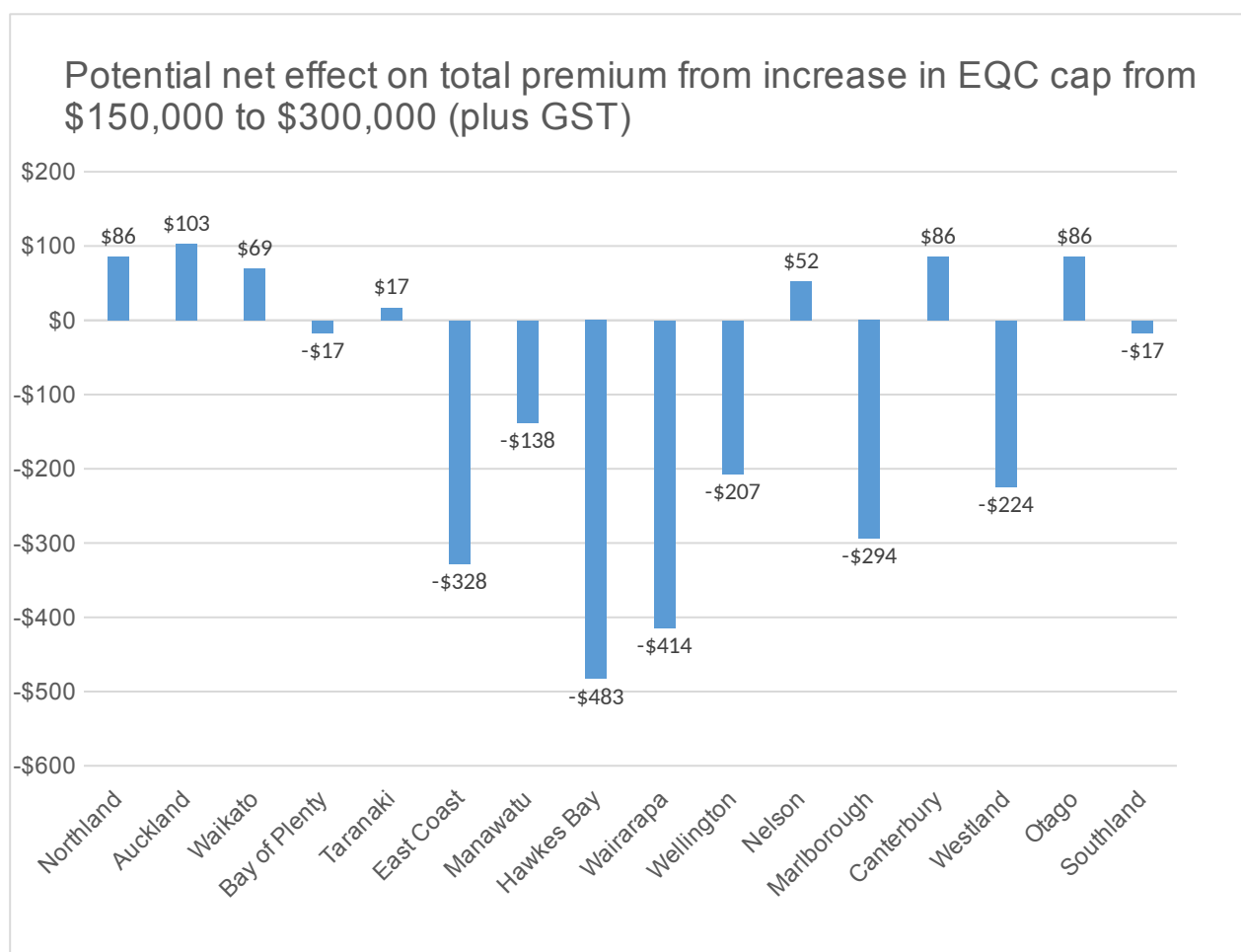
Table 1: Breakeven EQC premiums at a regional level

CRESTA ⁷ Name	(A)	(B)	(C)
	Regional risk-priced breakeven EQC premium at \$150,000 cap Incl GST	Regional risk-priced breakeven EQC premium at \$300,000 cap Incl GST	(= B – A) Breakeven additional premium from cap increase to \$300,000
Northland	121	173	52
Auckland	138	173	35
Waikato	173	242	69
Bay of Plenty	535	690	155
Taranaki	362	483	121
East Coast	914	1380	466
Manawatu	1070	1346	276
Hawke's Bay	1484	2105	621
Wairarapa	1139	1691	552
Wellington	828	1173	345
Nelson	328	414	86
Marlborough	983	1415	432
Canterbury	259	311	52
Westland	880	1242	362
Otago	190	242	52
Southland	259	414	155

Average Breakeven Premium per risk represents the average premium paid by consumers with a house of average value, under AON modelling (this is for illustration only as the actual modelling will differ by insurer so the actual change will differ).

⁷ **CRESTA Zones** (Catastrophe Risk Evaluation and Standardising Target Accumulations) are part of an international geographic zoning system which helps brokers and reinsurers manage natural hazard risk.

Figure 1: Potential net price impacts following an EQC cap increase (reflecting combined EQC and private insurance impact)



Source: AON data
Annual total premiums per household

41. Figure 1 above shows the difference between the increase in the EQC premium and the decrease in the risk-based breakeven premium following a cap increase from \$150,000 (plus GST) to \$300,000 (plus GST). If insurers charged the breakeven premium, then these numbers would reflect the net change in total premiums.
42. For example, following the cap increase, Northland properties may see overall price increases of around \$86 a year. This is because their EQC premium will increase by \$138 and their insurance costs may reduce by around \$52, this nets out to an overall increase of \$86. Hawke’s Bay properties could see overall price decreases of around \$483 a year, as while they pay \$138 more in EQC premiums, their private insurance could reduce by around \$621 a year.
43. Figure 1 is subject to the same limitations and caveats as Table 1.

Rationale for community-rated pricing

44. New Zealand is subject to many natural hazards with few homes that do not face any form of risk. Greater community-rating of insurance prices is justified because insurers have models for seismic risk but rely on estimates for other risks such as

volcanoes and tsunamis. For this reason, it makes sense to share the costs of these risks through the EQC scheme. Community-rating is also administratively simple so reduces costs.

45. I have considered how an increase to the cap will affect different households and whether an increase to the cap can be thought of as regressive.
46. After a major earthquake, large homes are much more likely than smaller homes to claim higher amounts from EQC as their home is larger and has higher rebuild costs. For example, at the current cap of \$150,000 – it is much more likely that a home with a rebuild of \$1,000,000 will claim the full capped amount than a home with a rebuild cost of \$300,000 after the same major event. While both properties pay the same premium into the scheme, people with larger and higher-value houses are likely to get greater benefits from the scheme. The higher the amount of the cap (especially at levels far above the average rebuild level), the less regressive the scheme is in this regard, as owners of houses valued under the cap will be paying lower levies than owners of more expensive houses.
47. A higher cap could also be considered more regressive in the sense that higher-risk locations like Wellington have relatively high average household incomes after housing costs, and homeowners in those locations are cross-subsidised under the EQC scheme by other homeowners, including from lower-income regions. However, because there is a high uptake of insurance with a wide pool of EQC premium payers, the cost of the cross-subsidy from low risk to high risk areas can be spread over a large group of properties.
48. Whilst I am concerned that a cap increase could mean that households in some lower-risk regions may pay more for their insurance overall, the EQC modelling suggests that these price increases will be modest, whereas downward pressure on households that are facing extreme increases to their insurance prices will be more significant.

Key trade-offs and risks

49. As noted, the pricing impacts set out above mean homeowners in lower-risk areas could see increases to their insurance premiums, while homeowners in higher-risk areas could see lower premiums. Further trade-offs to consider when considering an increase to the EQC cap are discussed below.

The role of the insurance industry

50. The private insurance market is an important part of New Zealand's resilience to natural disasters. My recommended level of cap strikes a balance where there is a good level of community-rated pricing by the EQC while maintaining a functioning private market, including elements of risk-based pricing.
51. I met with several insurers over March 2021 to discuss the options for increasing the value of the cap. Insurers have cautioned against a cap level that is too high, as they want to continue to provide cover against natural hazards in New Zealand which requires some level of market share.

52. If the cap is set too high, then insurers may be less incentivised to offer natural hazards cover in New Zealand as there is a more limited role for them. Several insurers of different sizes raised concerns that increasing the cap would mean insurers are essentially claims handlers when natural disaster events occur, with very little risk in the financial outcome of many claims and correspondingly little ability to benefit from premiums paid for unrealised risks.
53. At my recommended cap level of \$300,000 (plus GST), EQC has around 79 percent share of aggregate sum insured, compared to 45 percent at the current cap of \$150,000 (plus GST).
54. This leaves the opportunity for insurers to compete and innovate on the insurance above cap levels for hazards that are not covered by the EQC, such as storm surge and flood cover for buildings, and for elements of property not covered by EQC, for example, swimming pools.

EQC's Insurer Response Model

55. ^[37]

56.

Fiscal Risk

57. A higher cap would mean EQC, with the Government as a backstop, is taking on a greater share of the natural disaster risk for residential property from insurers. A higher cap increases EQC-levy revenue which, absent many or significant disaster events, allows the Government to build up the Natural Disaster Fund (NDF) faster. A higher cap reduces insurers' exposure following a natural disaster which means the Crown faces lower implicit fiscal risks to an insurer failure, such as occurred with AMI in 2011.⁸
58. Natural disaster risk is paid for through the EQC premium, the pricing of which takes into account the EQC's expected losses from perils covered and the costs to administer the scheme. The NDF is only around \$200m, following the Canterbury and Kaikōura claims. If there was a future natural disaster that exceeded the reserves of the NDF (which will grow over time absent a significant natural disaster event), the Crown would need to provide funding or liquidity support for the NDF through the permanent legislative authority in section 16 of the EQC Act that commits the Crown to cover funding deficiency associated with the scheme (the Crown guarantee) via a grant or an advance.

⁸ New Zealand has fully implemented a prudential supervision regime for insurers, including requirements on New Zealand-incorporated insurers to hold capital or reinsurance for a 1-in-1000 year earthquake.

- 59.** This risk is mitigated by ensuring the premium remains priced to meet the expected peril losses and the long-run cost to administer the scheme. This ensures the EQC scheme is fiscally neutral over the long term. In addition, risk can be further mitigated through the Government's risk management strategy, including the amount of reinsurance⁹ EQC purchases. For example, a cap increase results in higher premium revenue which enables more reinsurance cover to be purchased and will result in a faster build-up of NDF reserves absent a significant natural disaster event.
- 60.** A higher cap will also increase the operating balance before gains and losses OBEGAL absent a significant natural disaster event, although over the long term it should be fiscally neutral if the premiums are correctly priced and regularly reviewed and adjusted.

Reinsurance

- 61.** New Zealand insurers transfer to reinsurers the great bulk of property catastrophe risk that they assume from policyholders. Reinsurance premiums form a large part of insurers' costs.
- 62.** It is important that New Zealand can purchase cost-effective reinsurance. An increase to the cap is unlikely to change the overall level of reinsurance available for New Zealand. As EQC buys more reinsurance, insurers may reduce their reinsurance by a similar amount.
- 63.** While EQC is a globally significant buyer of reinsurance (and this significance would likely increase as the cap increases), other insurers operating in New Zealand are also considered to be large buyers. For example, IAG's current reinsurance cover for New Zealand alone is around AUD 10 billion¹⁰ whereas the EQC's reinsurance cover is around NZD 7 billion. However, it is worth noting that IAG's reinsurance cover is for a number of insurance products (i.e. not only for house insurance) and covers more perils. In addition, if the EQC cap is increased, EQC's reinsurance cover will likely increase and IAG's will likely decrease.
- 64.** While it is difficult to accurately assess whether EQC can buy reinsurance at a better price than the two largest private insurers offering home insurance in New Zealand, global reinsurers and global risk transfer intermediaries have indicated to me that EQC is likely to have a competitive advantage due to the scale of reinsurance purchased, the high deductible structure and the fully national portfolio of homes covered. In addition, it is highly likely that EQC can secure reinsurance at a better price than the smaller players. Accordingly, the smaller players may benefit from a higher EQC cap as it may assist their overall competitive pricing with the larger players. This may improve the competitiveness of the insurance market.

Interaction with community resilience work

- 65.** Cabinet is considering a range of resilience initiatives that will support a shift towards more proactive risk reduction in the natural hazards and climate change system. Community Resilience Ministers¹¹ oversee an all-of government programme to address key challenges in this area. Current work includes:

⁹ A process whereby one entity (the reinsurer) takes on all or part of the risk covered under a policy issued by an insurance company in consideration of a premium payment.

¹⁰ IAG financial results, year ended June 2020.

- improving the availability and use of data and information,
 - improving the disclosure of natural hazard risk through Land Information Memorandums (LIMs) and other information tools,
 - developing a national direction for flood risk management, and
 - developing a national funding model for flood risk management.
- 66.** Through the Resource Management Act reforms, officials are working on the Climate Adaptation Act. This Act intends to address the complex legal and technical issues associated with managed retreat and funding and financing adaptation.
- 67.** Increasing the EQC cap can support the Government’s overall resilience objectives as high levels of insurance uptake ensure that funds are available to rebuild following a disaster. While increasing the cap may soften the price signals offered by insurance, I consider that there would remain a sufficient level of over-cap insurance to provide an insurance price signal, alongside wider levers to manage risk to the built environment, such as the Resource Management Act and the Building Act.
- 68.** Wider policy work on the government’s approach to addressing the cost of climate change adaptation is separate from these decisions on the EQC cap. Accordingly, I suggest that we have clear public messaging that the EQC scheme protects against risks that all New Zealand homeowners face, and decisions on more concentrated risks, such as flood and storm damage to buildings, are being progressed through these other processes.

Implementation

- 69.** I propose to implement the EQC cap by regulations made under sections 18 and 36 of the EQC Act, and subsequently confirm it in the Bill to modernise the EQC Act. This enables the higher cap change to be implemented faster than the broader suite of changes in the Bill to modernise the EQC Act.
- 70.** The higher EQC cap will begin effective from 1 October 2022. The higher cap would apply to any new insurance contracts and all renewals from 1 October 2022. This means that insurance contracts established before that date would move to the higher EQC cap upon annual renewal of the policies (i.e. over the following 12 months). This approach is familiar to EQC and insurers, as it was used to phase in the increase in the EQC cap from \$100,000 (plus GST) to \$150,000 (plus GST) from 1 July 2019 to 30 June 2020.
- 71.** I note that a 1 October 2022 implementation timeframe is ambitious. Insurers have indicated that they would need at least 18 months’ advance notice to implement an increase in the EQC cap to make the necessary changes to their systems.
- 72.** The Bill to modernise the EQC Act will establish a five-yearly review of the cap and other monitoring measures. This regular process would allow reconsideration of

¹¹ Community Resilience Ministers include the: Minister for the Environment; Minister of Finance; Minister for Climate Change; Minister for Emergency Management; Minister for Economic and Regional Development; and the Minister for the Community and Voluntary Sector.

whether the cap is appropriate based on house cost inflation, and evidence of how the cap is impacting insurance prices [DEV-21-MIN-0062 refers].

Competition in the insurance market

- 73.** To be effective, a higher EQC cap relies on an effective and competitive property insurance market that passes on cost savings to their customers. However, there is insufficient information to assess the competitiveness of the market, including the influence of market structure on competition dynamics. Around 85 percent of the property insurance market is concentrated in three insurers.
- 74.** Some consumer advocate groups have expressed support for a cap increase as they believe there is a lack of competition (in both Wellington and to a lesser degree in Auckland) which makes it hard to shop around, leaving insurers with a large amount of price control. These groups raised concerns about increasing pricing and that some earthquake prone buildings were becoming uninsurable.
- 75.** The Treasury will consider the best way to monitor the price impacts on insurance following a cap increase. If there is no evidence of pass through of the higher EQC cap (i.e. downward pressure on insurance premiums in higher risk areas and aggregate national private premiums), I would be concerned that there is a lack of competition in the residential property insurance market. This would lead me to consider options such as a competition study into the residential property insurance sector.
- 76.** There is currently a pipeline of competition studies planned, meaning a competition study into residential insurance would need to be prioritised against other studies. I will consider this in my capacity as the Minister of Commerce and Consumer Affairs following an evaluation of the impact that the cap increase has had on private insurance prices.

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Financial Implications

81. The EQC's current risk management structure is set up with the intention that EQC's claims and expenses over 850 years are covered by the levies charged to insured homeowners (the "breakeven premium").
82. The current EQC premium is priced based on 2016 modelling. New modelling from 2020 suggests that if the current cap of \$150,000 is retained, then the premium should be raised by around \$69 (from \$345 to \$414) to meet the current estimate of the breakeven rate.
83. Increasing the cap to \$300,000 at the currently estimated breakeven rate would mean all property owners would pay up to around \$207 extra through EQC premiums.
84. EQC is currently forecasting approximately \$519 million in premium income for the Natural Disaster Fund (NDF) over the 2021/22 financial year, under current cap and premium rates. Increasing the premium on the current cap to a breakeven rate would increase that revenue by approximately \$100 million. EQC estimates increasing the cap and associated premium to \$300,000, would increase NDF revenue by around \$200 million compared to the current forecast for 2021/22.
85. At any cap level, the revenue received is to compensate for the risk being borne by the EQC scheme, EQC's expectations of its average annual loss, and the cost to administer the scheme. EQC's revenue forecasting assumes there is no change in the overall proportion of homes insured.
86. Raising the cap removes some risk from insurers and transfers it to EQC and, in effect, the Crown. A permanent legislative authority (PLA) or 'Crown guarantee' commits the Crown to cover all unmet costs associated with the EQC scheme. Other Crown Financial Institutions, such as the Accident Compensation Corporation (ACC), are fully funded from levies and have no formal PLA.
87. The guarantee ensures that sufficient finance will be available to fairly settle future EQC insurance claims. This is important because of the nature and volatility of the risks that the EQC scheme insures and because there is currently only around \$200 million of funds in the NDF following the Canterbury and Kaikōura earthquakes. If the EQC premiums are correctly priced the long-term impact should be fiscally neutral.
88. Additionally, much of EQC's exposure is reinsured. EQC's current reinsurance programme covers EQC for nearly \$7 billion of losses with a first loss excess of \$1.75 billion (which is currently mostly covered by the Crown guarantee given relatively low NDF funds). In the ordinary course of its business, EQC regularly assesses its approach to risk financing, and any decision to increase the cap will impact on EQC's approach to purchasing reinsurance. An increase in the cap and associated increase in EQC premium revenue will result in an upfront increase in total Crown revenue. However, if an event occurs before sufficient premiums have

accumulated in the NDF, the Crown guarantee will be called upon to meet any remaining expenditure not met by the NDF or reinsurance. The level of risk taken on by the Crown via its guarantee of EQC increases as the cap increases, which poses a risk to net core Crown debt in the short term. However, over the long term if EQC's premium is correctly priced the scheme should be fiscally neutral.

89. I note that in instances where Crown-owned agencies pay for EQC cover, most notably Kāinga Ora, they, like all insured homeowners, will be required to pay a higher EQC premium and should see decreases to insurance prices overall. It is assumed for any affected entity this will be able to be absorbed within normal operating costs.

Legislative Implications

90. Regulations under section 36 by way of section 18 of the current EQC Act are required to give effect to the proposed changes.
91. The changes will subsequently be confirmed through the Bill to modernise the EQC Act. I have made a bid for a category four priority for the Bill on the 2021 Legislation Programme.
92. The Bill's provisions are expected to be binding on the Crown, as the current EQC Act is binding on the Crown.

Impact Analysis

Regulatory Impact Statement

93. The impact analysis requirements apply to proposals in this paper. An impact assessment has been prepared and is attached as Annex 1. The Quality Assurance Panel's QA statement is below:

*A quality assurance panel with representatives from the Regulatory Impact Analysis Team at the Treasury and the Ministry of Business, Innovation and Employment has reviewed the Regulatory Impact Statement (RIS) "Options to address insurance availability and affordability, including through the EQC cap" produced by the Treasury. This RIS is one of four to support proposals to amend the Earthquake Commission Act 1993 (EQC Act). The panel considers that it **meets** the Quality Assurance criteria.*

The RIS clearly sets out the rationale for early intervention before there is evidence of declining property insurance uptake. A range of options have been identified and evaluated against a comprehensive assessment framework. While there are limitations in quantifying the likely impact of options, the use of modelled data provides a useful indication of the relative scale and distribution of the impacts of different options.

The panel notes that the Treasury's preferred option is to increase the monetary cap on EQC building cover from \$150,000 plus GST to \$200,000 plus GST, which differs from the option proposed in the Cabinet paper.

The panel further notes that there was no public consultation on the options, which increases the risk that technical or other issues may be raised at the Select Committee stage. However, this risk is mitigated by the extensive consultation that took place during previous public consultation, the Public Inquiry and the targeted consultation on the proposals.

Climate Implications of Policy Assessment

94. The Climate Implications of Policy Assessment (CIPA) team has been consulted and confirms that the CIPA requirements do not apply to this proposal as the threshold for significance is not met.

Population Implications

95. This policy is likely to result in lower insurance prices for some properties in regions with high seismic risk and higher insurance prices for some properties with low seismic risk.

Human Rights

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

Consultation

Relevant consultation during a previous review of the EQC Act

97. As part of a previous review of the EQC Act, a public discussion document was released in 2015 seeking feedback on reform proposals. In total, 63 submissions were received from individuals and a range of organisations. The proposals in this paper draw heavily on information and feedback gathered during consultation processes associated with that review.

More recent consultation as part of the current EQC Act review

98. The Treasury has worked collaboratively with EQC throughout the wider EQC Act review process. As part of this wider review, Treasury has also consulted with a targeted group of stakeholders, relevant government agencies, and other public bodies during 2020 and 2021 to inform policy development leading to this and the two companion Cabinet papers:

- **Relevant government departments or other public bodies:** EQC, the Department of Internal Affairs (DIA), the Ministry for the Environment (MfE), the Ministry of Business, Innovation and Employment (MBIE), Te Tūāpapa Kura Kāinga – Ministry of Housing and Urban Development (HUD), Land Information New Zealand (LINZ), the Financial Markets Authority (FMA), the Department of Prime Minister and Cabinet (DPMC), the National Emergency Management Agency (NEMA), and the Reserve Bank of New Zealand (RBNZ).
- **Relevant private sector organisations and public consultation processes:** the Insurance Council of New Zealand, IAG, Suncorp, MAS, Tower, Ando, FMG,

Society of Actuaries, Inner City Wellington, the Body Corporate Chairs Group, the EQC Claimant Reference Group, Wellington City Council, New Zealand Insurance Law Association, Aon and Munich Re. These stakeholders have been consulted on relevant policy proposals rather than on the policy package as a whole.

99. The Insurance Council of New Zealand (ICNZ) has raised concerns that consultation timeframes have been too short for adequate consideration of complex issues and that they have been consulted only on specific policy issues rather than being given an opportunity to comment on the EQC Act modernisation policy package as a whole. To ensure that the Select Committee has sufficient time to fully consider any concerns raised by stakeholders in submissions, including by ICNZ, I intend that, following the first reading of the Bill, the Select Committee be provided the usual six months to report back to House.

Consultation on this paper

100. EQC, DIA, MBIE, MfE, RBNZ, HUD, NEMA, and the FMA have been consulted on this paper. DPMC has been informed.

Communications

101. I intend to announce the proposed amendments shortly after Cabinet approval. The announcement will need to be outside of New Zealand Stock Exchange (NZX) trading hours due to the potential impact on the business of insurers of residential property in New Zealand.

102. I will proactively release this paper thereafter.

Proactive Release

103. A version of this paper will be published on the Treasury's website following Cabinet agreement to the proposals set out in this paper. The paper will be published subject to withholdings that are consistent with the Official Information Act 1982.

Recommendations

The Minister Responsible for the Earthquake Commission recommends that the Committee:

1. **Note** my objectives for residential property insurance in New Zealand are that:
 - New Zealanders can access affordable residential property insurance, to ensure as many New Zealanders as possible can repair their homes if they are damaged by a natural disaster.
 - Sufficient funds are available to repair/rebuild following a natural disaster, which minimises fiscal risks to the Crown, including risks such as the collapse of a private insurer.
 - There is a robust and competitive private insurance market.
 - Insurance price is used to signal risk.
 - New Zealand continues to be able to purchase cost-effective reinsurance.

- 2 **note** that increasing the EQC monetary cap on residential buildings will increase the level of community-rating of EQC-covered risks across New Zealand, which can mean, all else equal, lower insurance premiums for higher-risk regions, and higher insurance premiums for lower-risk regions;
- 3 **agree** to increase the cap from \$150,000 plus GST to \$300,000 plus GST;
- 4 **agree** that the increase to the cap be phased in over 12 months from 1 October 2022 to 30 September 2023, as new insurance policies are taken out or existing policies are annually renewed;
- 5 **note** that insurers have indicated that the timeframe set out in the recommendation above would be challenging for them;
- 6 **note** that the current EQC premium rate is \$0.20 (plus GST) per \$100 of EQC building cover, up to a maximum of \$345 (including GST), for the \$150,000 (plus GST) cap;
- 7 **agree** to set the EQC premium rate at \$0.16 (plus GST) per \$100 of EQC building cover, up to a maximum of \$552 (including GST), which is the estimated break-even point at a \$300,000 (plus GST) cap;
- 8 **note** that a cap increase to \$300,000 (plus GST), in combination with the proposed EQC premium rate of \$0.16 per \$100 of EQC building cover, would mean each residential property will pay up to \$207 (including GST) extra per annum in EQC levies;
- 9 **note** that the Bill to modernise the EQC Act will establish a five-yearly review of the cap and other monitoring measures, which will allow reconsideration of whether the level of cap is appropriate based on house cost inflation, and evidence of how the cap is impacting insurance prices;
- 10 ^[33]

Financial implications

- 11 **note** that raising the EQC cap will increase risk to net core Crown debt in the short-term due to the Crown guarantee of EQC, but will have no impact on net core Crown debt over the long-term if the EQC premium is set to cover the long-term cost of the EQC scheme;
- 12 **note** that Crown departments and agencies that own residential property, and currently pay EQC premiums, will be required to pay the higher annual EQC premiums, but may benefit from overall lower insurance premiums depending on the location of the properties they own;
- 13 **note** that any net increase in Crown department insurance premiums will need to be met from within existing baselines, and any net decrease in insurance premiums will benefit existing baselines;

Legislative implications

- 14 invite** the Minister Responsible for the Earthquake Commission to issue drafting instructions to the Parliamentary Counsel Office to give effect to the above proposals by regulations under section 36 by way of section 18 of the EQC Act;
- 15 note** that the new cap rate will be reflected in the Earthquake Commission Amendment Bill;
- 16 note** that the Earthquake Commission Amendment Bill holds a category four priority on the 2021 Legislation Programme (to be referred to Select Committee before the end of 2021);
- 17 note** the Minister Responsible for the Earthquake Commission's intention to introduce an Earthquake Commission Amendment Bill by the end of 2021;
- 18 authorise** the Minister Responsible for the Earthquake Commission to make decisions, in consultation with relevant portfolio Ministers as necessary, and consistent with the policy guidance provided by prior Cabinet decisions, on any additional policy, implementation and commencement, drafting or minor technical issues that arise during the development of the regulations and for Cabinet Legislation Committee;

Communications

- 19 note** the Minister Responsible for the Earthquake Commission will announce the intention to increase the EQC cap and introduce an Earthquake Commission Amendment Bill, subject to Cabinet agreement to the proposals set out in this and other relevant papers;
- 20 note** that this Cabinet paper will be proactively released as soon as possible following Cabinet decisions, subject to any redactions consistent with the Official Information Act 1982.

Authorised for lodgement

Hon Dr David Clark

Minister Responsible for the Earthquake Commission