

The Treasury

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

October 2021

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Coversheet: Options to address insurance availability and affordability including through the EQC cap

Advising agencies	<i>The Treasury</i>
Decision sought	<i>Agreement to increase the EQC cap</i>
Proposing Ministers	<i>The Minister Responsible for the Earthquake Commission</i>

Summary: Problem and proposed approach

Problem definition

Ministers have directed officials to undertake a review of the Earthquake Commission Act 1993 (EQC Act) to modernise the legislation and embed lessons learned following the Canterbury earthquake sequence in 2010 and 2011.

The proposal in this Regulatory Impact Statement (RIS) seeks to address rising residential property insurance premiums in regions with high seismic risk,¹ to help ensure that residential property insurance is affordable, available and appropriately contributes to New Zealand's long-term resilience.

The Earthquake Commission (EQC) scheme provides "first loss" cover for insured residential properties for a range of natural hazards up to a cap of \$150,000 per property. Based on international comparisons, without something like the EQC scheme many homeowners may not be insured against natural hazard risks. High uptake of residential property insurance reduces the level of distress that can be suffered by communities after a natural disaster and supports disaster recovery. It also reduces fiscal risk and uncertainty because Government is less likely to be drawn into ad hoc responses to private loss following natural disasters.

Government intervention can socialise the pricing of natural disaster risk, so that the burden of paying for this risk does not fall too heavily upon particular regions.

Summary of preferred option

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. The Cabinet paper associated with this RIS [DEV-SUB-0151] recommends the option of increasing the cap to \$300,000 plus GST. This reflects different weighting placed on the decision-making criteria and the trade-offs between them.

¹ Seismic risk refers to the risk of damage from earthquake.

The cap level requires a choice along a spectrum, and there is no 'perfect' level. A \$200,000 cap is preferred by the Treasury as it should have moderate net positive impacts for affordability and availability of residential insurance in high risk areas, while reducing the risks associated with a larger cap increase, including the impact on risk signals.

The higher cap increase recommended in the Cabinet paper will put greater downward pressure on insurance prices in higher-risk areas, and therefore is more likely to support Cabinet's objective to ensure that property insurance is affordable and available. However, it places greater upward pressure on insurance prices in lower-risk areas and comes with higher risks such as such as a reduction in insurer interest in retaining the remaining natural disaster risk.

Insurance uptake rates currently remain high, perhaps suggesting the current \$150,000 cap does not need to be increased at all. The preferred Treasury option and Cabinet paper proposal both reflect a view that early intervention, before price pressures result in declining uptake, is preferable to waiting for the decline in uptake 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 then face the difficult task of getting people who have chosen not to insure, to begin taking out insurance again. Voluntary demand for natural disaster insurance is known to be weak in risk-prone jurisdictions where figures are available (e.g. Japan and Chile).

Section B: Summary impacts: Benefits and costs

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

The main beneficiaries of raising the EQC cap are homeowners in high seismic risk areas. These homeowners should experience downward pressure on the private insurer component of their premiums.

We expect that an increase to the cap will increase the aggregate capacity (private insurer plus EQC) available to cover houses in high risk areas and should therefore also improve the availability of insurance.

Where do the costs fall?

A higher EQC cap would be paid for through an increase in the EQC premium (the EQC levy is called a premium). EQC's current financial risk management structure is set up with the intention that the premiums collected by EQC are sufficient to meet the expected losses from the scheme and the cost of its administration. In 2017, Cabinet agreed to increase the EQC premium to 20 cents per \$100 of cover as the "breakeven premium". If the EQC premium is under-priced, then the Crown will cover the remaining risk, which, if realised, would ultimately be met through public funds. This could be considered an

ongoing subsidy, meaning that all taxpayers, including those who do not own residential property, would be paying for a benefit they do not receive.

Cabinet has agreed that EQC's key financial settings, including the premium and cap, should have a maximum review period of five years, which provides the Government with a regular opportunity to ensure that the premium is sufficient.²

A cap increase will affect insurers (and reinsurers), whose business is to charge premiums to cover risk, as the amount of residential property-related risk they are able to provide cover for has decreased.

When we refer in this RIS to insurance prices, we are referring to the total premium paid, which is made up of both the EQC premium and the private insurer's premium.

The final insurance premium for each property following an EQC cap increase depends on how insurers price the above-cap portion of the cover. The price impacts would depend on the property and the insurer – the impacts may be more noticeable for lower-value properties, but more limited for high value, high risk properties who rely on private insurers for a larger proportion of cover. Insurers will only be able to cover risk above the cap, where they could face more volatile and unknown risks.

The cost of an increase in the cap falls primarily on homeowners in lower seismic risk regions (for example, Auckland and Hamilton). We expect that, overall, a cap increase will result in upward pressure on insurance premiums for all homeowners apart from those with properties subject to high risk from EQC-covered hazards, including high seismic risk areas (for example, Christchurch or Wellington), and houses that already face high insurance prices as a result of granular risk-based pricing. The reason for this new distribution of costs is because cover that was previously provided by private insurers and priced based on local risk factors, would instead be provided by EQC and priced at a flat rate, irrespective of local risk factors.

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

Claims handling

Insurers and EQC have agreed to a claims partnership model, where insurers process the EQC portion of natural disaster claims on EQC's behalf. The model is the main way in which the need for customers to interact with both EQC and their insurer is minimised.³ At higher levels of the cap:

² DEV-21-MIN-0062 refers.

³ Page 64 of the Public Inquiry into the EQC report noted that increasing the cap would reduce the number of over-cap claims. This would thereby reduce the number of people who are required to deal with both EQC and their private insurance company and reduce the delays associated with settling their claims. See the Inquiry report here: <https://eqcinquiry.govt.nz/assets/Inquiry-Reports/Report-of-the-Public-Inquiry-into-EQC.pdf>

- There is a greater risk of moral hazard as more claims will be ‘under cap’, meaning the commercial incentive for insurers to keep claim costs down when processing them is lower. As a result, EQC could be exposed to higher claims costs. EQC is developing a comprehensive assurance programme to ensure that private insurers managing claims on EQC’s behalf are meeting all statutory, contractual and service level obligations to mitigate this issue.
- [38]

Market attractiveness

Most insurers have argued against increasing the cap. The few smaller insurers that have not argued against a cap increase have taken a neutral position. There is uncertainty about decisions that insurers might make. Insurance capacity issues could worsen if a large insurer were to decide to place less focus on maintaining or growing its New Zealand business. On the other hand, capacity issues could improve by freeing up large insurers’ capacity, or by making the market more attractive to new entrants and smaller insurers through enabling them to hold less capital on a per-risk basis.

The role of insurance as a signal

Insurance pricing can act as a signal for the level of risk to a property. However, insurance price signals have limitations, particularly in the short-term, as core elements of buildings such as location and materials cannot be changed in a way that reduces the insurance premium. Insurance price signals may offer better signals in the longer term, as councils and developers are making decisions about where new residential property should be built.

Insurance can spur tough decisions around necessary strengthening or demolition. This can contribute to safety and the strengthening of the built environment over time, but can also have a significant impact on the wellbeing of those whose homes are affected. The Government and local councils have other tools such as the Building Code, Land Information Memoranda (LIMs), risk management frameworks etc, to ensure that the built environment is safe and resilient.

Setting a precedent for the Government’s approach to climate change losses

The Government already takes on some climate change-exacerbated risks through EQC via its cover of residential buildings for landslip damage, and its cover of residential land for storm and flood damage. However, building damage caused by sea level rise and storm damage is not covered by EQC, and Government policy in this area is in the early stages. It is likely that there will be pressure on the Government to include such risks within EQC cover in the future, regardless of whether the cap is increased.^[34]

Fiscal Risks

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. This risk is paid for through the EQC premium, which takes into account the EQC's expected losses. However, if there were a large natural disaster with damages above the expected loss, then the Crown would bear the costs through the permanent legislative authority in section 16 of the EQC Act that commits the Crown to cover all costs associated with the scheme (the Crown guarantee). This risk is mitigated partly by ensuring the EQC premium remains correctly priced to meet the expected losses.

Section C: Evidence certainty and quality assurance

Agency rating of evidence certainty?

Understanding of the existing insurance market

While we understand the general trends over time, our access to data in assessing trends in property insurance markets has been limited. There is no public data source (via EQC or otherwise) that would enable us to determine whether a given property is insured, and how much that insurance costs. Our information is based on a combination of pricing information provided in confidence by insurers, information about Wellington multi-unit buildings (MUBs, e.g. apartment buildings) provided by property managers, anecdotal evidence from property owners, analysis of price changes following the 2019 increase of the cap, Statistics New Zealand data, and a Treasury survey on insurance uptake commissioned in late 2019.

Through targeted consultation with insurers and groups such as the Insurance Council of New Zealand (ICNZ) and Consumer NZ, and information provided through the Public Inquiry into the EQC (the Public Inquiry), we have provided estimates of the insurance market, including:

- annual changes in premiums across high and low risk seismic areas, and
- uptake and availability.

Loss modelling data

EQC 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").

The data on loss modelling and breakeven EQC levies were provided by EQC's reinsurance broker, AON. There is a risk of the loss modelling data understating the risk because the models are built on incomplete data. For example, neither EQC nor private insurers have modelled the losses arising from volcanic or tsunami events, though EQC has included an estimate of potential losses based on input from GNS Science.

Policy impact

As the EQC cover is one of several factors that determine the final insurance premium paid, it is difficult to determine the specific impacts on premiums from an increase to the cap at any level. We can be confident that a higher cap creates downward pressure on premiums for higher-risk properties, but the magnitude of the downward pressure is uncertain. The impacts of a cap increase would differ depending on the property and the insurer.

Higher-value properties in high risk areas may see little difference to their insurance premium as they remain reliant on private insurance for a significant portion of their cover. Insurers could increase the granularity of their pricing for private cover to offset the downward pressure from a higher EQC cap. However, such shifts in pricing granularity would have likely happened over time even in the absence of an EQC cap increase.

We have estimated the potential pricing impacts of a cap increase based on regional data provided by Aon. However, this data is based on the breakeven EQC premium in different regions. As well as the fact that insurers have risk models that differ from Aon's, the data also does not take into account insurers' profit margins or how they would price the above-cap cover or hazards such as storm and flood risk that are not covered by the EQC.⁴ Decisions about how to price the private insurance portion are at the discretion of insurers, leaving a high level of uncertainty

about the final premium customers will pay following a cap increase.

In 2019 the EQC cap was increased from \$100,00 plus GST to \$150,000 plus GST. We do not have specific data on the impact of the 2019 cap increase, because it is not possible to differentiate the impact of the cap against other factors such as inflation and changes to risk modelling. However, we have heard that from a broker's perspective the 2019 increase in the cap was positive for insurance availability for MUBs in Wellington.

In many instances we have had to rely on information provided to us by parties that have a direct interest in the policy and therefore could have conflicts of interest.

Quality Assurance Reviewing Agency:

The Treasury and the Ministry of Business, Innovation and Employment

⁴ EQC only covers land for storm and flood events.

Quality Assurance Assessment:

The Quality Assurance Panel has reviewed the RIS in accordance with the Quality Assurance criteria set out in the [Guide to Cabinet's Impact Analysis Requirements](#). The panel considers that the information and analysis summarised in the RIS **meets** the Quality Assurance requirements.

Reviewer Comments and Recommendations:

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.

Impact Statement: Options to address insurance availability and affordability including through the EQC cap

Section 1: General information

1.1 Purpose

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 final decisions to proceed with a policy change to be taken by Cabinet.

1.2 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 policymakers and regulators.

Due to the limitations around data availability, it is difficult for the Treasury to state with confidence the actual scale of the problem 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 for the proposed options.

Through targeted consultation with body corporates, property owner representatives, Consumer New Zealand, insurers, and through information provided through the Public Inquiry,⁵ we have provided estimates of the insurance market, including:

- annual changes in premiums across high and low risk seismic areas, and
- uptake and availability.

We are confident that the estimates prepared around the proposed cap increase changes provide a reasonably accurate picture of how those costs will fall after the amendments are made.

Some options highlighted, such as a competition study, are constrained by existing work programmes. If these options were progressed, they would need to be traded off against other priorities.

⁵ <https://www.eqc.govt.nz/public-inquiry>

1.3 Responsible Manager (signature and date):

Helen McDonald

Earthquake Commission Policy Team

Economic System

The Treasury

May 2021

Section 2: Problem definition and objectives

2.1 What is the current state within which action is proposed?

Policy

Ministers have directed officials to undertake a review of the EQC Act to modernise the legislation and embed lessons learned following the Canterbury earthquake sequence in 2010 and 2011. The 'modernisation' scope of the work means that a first principles examination of the purposes and design of EQC has not been undertaken.

Related Regulatory Impact Statements

This RIS is one of four to support proposals to amend the Earthquake Commission Act 1993. The three related RISs cover:

- Modernising the EQC Act (with issues including EQC institutional design, funding and risk management)
- The treatment of mixed-use buildings under the EQC Act
- EQC Act technical issues.

All RISs will be published on the Treasury website once the EQC Amendment Bill is introduced.

New Zealand's housing market

Positioned in the collision zone of two of the world's major tectonic plates, New Zealand is subject to thousands of earthquakes every year, most of which go unnoticed by the public. Many New Zealanders live near the coastline or rivers, with the risk of flooding or tsunami, or beneath hills or sloping land with potential for landslips. The location of the housing stock in risky areas is a result of historical town planning decisions. Just over 72,000⁶ New Zealanders are exposed to

⁶ NIWA Report *Coastal Flooding Exposure Under Future Sea-level Rise for New Zealand* prepared for the Deep South Challenge https://www.deepsouthchallenge.co.nz/sites/default/files/2019-08/2019119WN_DEPSI18301_Coast_Flood_Exp_under_Fut_Sealevel_rise_FINAL%20%281%29_0.pdf

“present-day extreme coastal flooding”, along with about 50,000 buildings worth \$12.5 billion. This exposure increases markedly with sea-level rise.

New Zealand is ranked as the second riskiest country in the world when it comes to natural disasters, according to a Lloyds’s of London study. We sit only behind flood-prone Bangladesh.⁷

New Zealand has had strong building cost growth for the last 20 years. As house rebuild costs rise, sums insured rise. To an extent, the true value of past increases in the cap may be eroded by a homeowner increasing the sum their property is insured for,⁸ in line with inflation.

When natural disasters occur in a New Zealand community, the economic impact can be exacerbated because we have a relatively low capacity in our built environment to absorb the shock partly due to our uncompetitive urban land market. Insurance (risk transfer) is an essential part of supporting financial resilience and disaster recovery.

For these reasons, insurance coverage for property against losses from natural disasters has long been viewed as essential in the New Zealand context.

New Zealand has high levels of property insurance uptake

Internationally, private markets for catastrophe insurance⁹ tend to have low rates of insurance uptake, and fluctuations in supply of this type of cover. This results in significant levels of under-insurance or non-insurance among homeowners.

Based on international comparisons (e.g. Japan and California), without something like the EQC scheme, many homeowners may not be insured against catastrophe risks. The experience elsewhere in the world is that, in that situation, Governments provide ad hoc assistance to those homeowners after large natural disasters. This creates risks and uncertainty for homeowners, insurers and Governments. Through its “first loss” insurance scheme (public-private partnership), EQC gives New Zealanders access to affordable natural hazard insurance.

Table 1 below shows New Zealand’s very high rates of disaster insurance, compared to other countries affected by destructive earthquakes since 1980.

Table 1: Ten costliest earthquakes worldwide 1980 – 2014 Ordered by percent of loss insured¹⁰

⁷ Lloyds’s of London study: *A World at risk: Closing the insurance gap*.

⁸ The sum insured is the maximum amount your insurance company will pay to rebuild your house in the event of a total loss.

⁹ Catastrophic risk is commonly interpreted to mean the chance of a single event resulting in large numbers of injuries, fatalities, or extensive property damage.

¹⁰ Data sourced from Munich Re download centre for statistics on natural catastrophes at <http://www.munichre.com/>

	Date	Event	Affected Area	Losses, in Original Values		Percent of Losses Insured
				Overall \$US m	Insured \$US m	
1	13.6.2011	Earthquake	New Zealand	2,700	2,100	78%
2	4.9.2010	Earthquake	New Zealand	10,000	7,400	74%
3	22.2.2011	Earthquake	New Zealand	24,000	16,500	69%
4	17.1.1994	Earthquake	USA: CA, Northridge	44,000	15,300	35%
5	27.2.2010	Earthquake, tsunami	Chile	30,000	8,000	27%
6	11.3.2011	Earthquake, tsunami	Japan: Tohoku	210,000	40,000	19%
7	20/29.5.2012	Earthquake (series)	Italy	16,000	1,600	10%
8	26.12.2004	Earthquake, tsunami	Indonesia, Indian Ocean	10,000	1,000	10%
9	17.10.1989	Earthquake	USA: CA, Loma Prieta	10,000	960	10%
10	17.1.1995	Earthquake	Japan: Kobe	100,000	3,000	3%

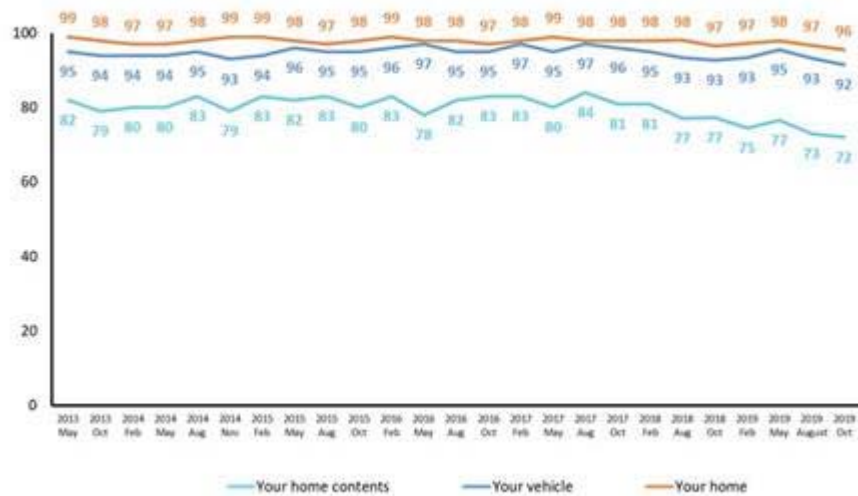
EQC takes on a lot of the risk under the current scheme design. This contributes to high rates of insurance among New Zealand homeowners compared with other countries that face similar high risks from natural disasters. The scheme plays an important role in re-establishing local communities hit by natural disasters.

There is currently limited information on residential property insurance uptake in New Zealand. Information on whether a home is insured is held by insurers, and this information has not been consolidated to provide a comprehensive national picture of residential insurance uptake. The assessment that insurance uptake is high is based on:

- ICNZ surveys of homeowners which consistently report high residential property insurance uptake of 96-99 percent, as depicted in the below graph sourced from ICNZ.

Assets insured

Total 'Yes' (%)



Base dependent on ownership of home or vehicle

- EQC premium data does not suggest major changes in insurance uptake over recent years. EQC assumes insurance uptake of 87 percent to assess premium payment compliance. Government-owned residential properties, which are not insured with EQC, are likely to account for some proportion of the difference between 87 percent and insurance uptake reported by the ICNZ survey.

Natural hazards cost New Zealanders millions of dollars.

Table 2: Natural disasters that have occurred in New Zealand since November 2019, and the cost to the insurance industry in paying claims for damage resulting from those events.

Year	Event	Cost (\$m)
January 2021	Canterbury Southwards Rain and Hailstorm	2.93*
September 2020	Tasman low and Polar blast	4.54
October 2020	Lake Ōhau Fire	35.18
November - December 2020	Greater Wellington Floods	4.05*
November 2020	Napier Flooding	73.30*
June 2020	Upper North Island Storm and Tornado	17.45

July 2020	Upper North Island Flooding	44.19
February 2020	Southland Flooding	29.64
December - February 2020	Marlborough-Nelson Hailstorm	40.73*
November 2019	Timaru Hailstorm	170.98
November 2019	Christchurch Tornado	4.04
Total		306.02

Source: Insurance Council of New Zealand (ICNZ)

Notes:

CPI is calculated as at 30 June 2017.

Numbers marked with an asterisk () are provisional*

International policy

The Australian Competition and Consumer Commission (ACCC) recently released a report on its Northern Australia Insurance Inquiry.¹¹ It looked at insurance uptake as a part of these and used the following examples:

- Prior to the introduction of the California Earthquake Authority (CEA), companies representing 93% of the California homeowner insurance market had either restricted or stopped writing homeowner policies altogether.
- Prior to the introduction of the Turkish Catastrophe Insurance Pool (TCIP) in Turkey, only around 3% of residential buildings had earthquake insurance.
- In comparison, the rate of home non-insurance in northern Australia is estimated to be approximately 20%, with the highest rate of non-insurance in north Western Australia at approximately 40%. ACCC notes that submissions to its second update report consider availability may be worsening.

The ACCC notes that, internationally, government insurers that have been introduced to increase the uptake of insurance have had mixed success. For example, only 35% of households in high flood risk areas in the US have flood insurance, even though insurance is offered through the National Flood Insurance Program (NFIP). Similarly, while most of California is at some risk of earthquake, in 2017 only approximately 11% of policies in California include earthquake insurance.

¹¹ <https://www.accc.gov.au/system/files/Northern%20Australia%20Insurance%20Inquiry%20-%20Final%20Report%20-%2030%20November%202020.pdf>

Turkey has had success in improving earthquake insurance rates since the introduction of the TCIP. Eleven years after the TCIP's introduction, insurance rates for earthquake insurance had improved from 3% to 23% of dwellings, and up to 40% of dwellings in high risk areas.

New Zealand's insurance market is concentrated

The two largest residential property insurers have around 75% market share.

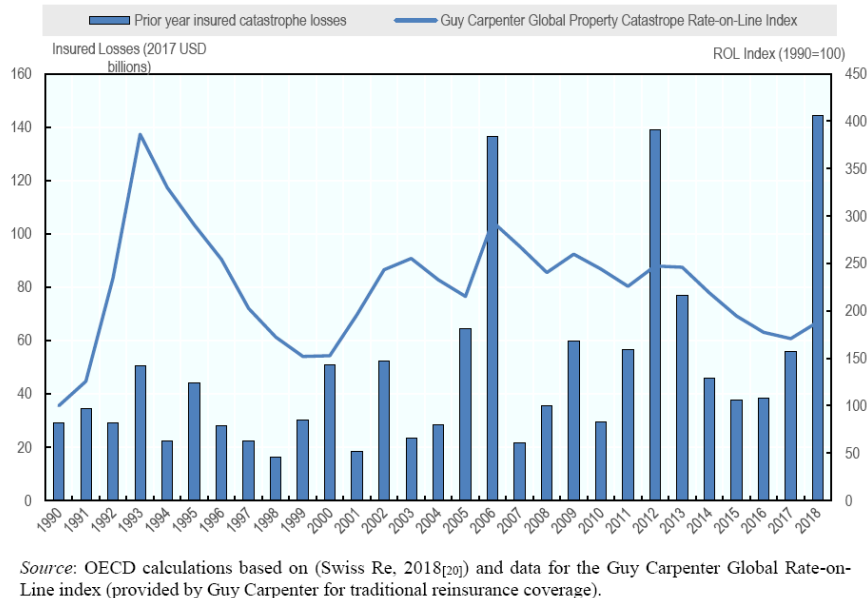
Reinsurance pricing

New Zealand insurers transfer the great bulk of property catastrophe risk that they assume from policyholders to reinsurers. Reinsurance therefore is a large portion of insurer expenses. Each insurer's reinsurance programme differs depending on that insurer's group structure.

The OECD has noted that:¹²

- The global reinsurance market for property catastrophe risks has historically gone through cycles of high prices and limited capacity (a "hard market"), and low prices and significant capacity (a "soft market"). See Figure 1 below.
- The cycles have normally been driven by the occurrence of major catastrophes.
- A catastrophe typically causes pricing to rise in the short term as reinsurers' capital base is reduced and/or reinsurers re-evaluate their exposures based on the impacts of the event.

Figure 1: The impact of insured capacity losses on reinsurance pricing



¹² OECD, *The Contribution of Reinsurance Markets to Managing Global Catastrophe Risk*, 2018, p.21.

New Zealand insurers' experience with reinsurance markets since the Canterbury earthquakes follows the trends shown in Figure 1 above.¹³ However, because the Canterbury earthquakes occurred in New Zealand, the impact on reinsurance prices for New Zealand risks was magnified and more sustained than that shown for global reinsurance markets, as the major losses suffered by reinsurers caused them to rethink their true level of exposure to loss from New Zealand earthquake risk.

It appears that reinsurance pricing for New Zealand risks had settled by around 2014-2015 (but is still much higher on average than it was prior to the Canterbury earthquakes). Reinsurers have indicated that their catastrophe risk models have not significantly repriced their reinsurance cover for Wellington over the last few years. Pricing is, and has always been, impacted by global markets.

Recent policy changes

The Canterbury earthquakes and the changes in insurance markets that followed led to the EQC cap being reviewed. Following a Cabinet decision in March 2018, the cap was increased from \$100,000 plus GST to \$150,000 plus GST in July 2019, following policy work that commenced in 2012.

A move to granular risk-based pricing

New Zealand insurers have historically under-priced insurance for seismic risk, and, at the same time, community-rated the risk across the country. Historic pricing reflected less understanding of risk and the damage that could be caused by seismic activity. The Canterbury and Kaikōura earthquakes changed this understanding and led to the development of more advanced risk models. In the future, climate change-related risks may also affect the insurance market.

Since 2018, New Zealand's largest insurers have been using updated catastrophe risk models and pricing risk more granularly, which has resulted in a reduction in cross-subsidisation of risk between policies.

A house insurance premium consists of the EQC premium, the Fire and Emergency New Zealand Levy, reinsurance costs, the insurer's costs, and GST. The insurer's costs include the cost of claims and overheads. Insurers use modelling to determine the level of risk for a policyholder.

While insurance prices have risen for many buildings, we have evidence of only a few buildings not being able to get insurance at all, or bodies corporate choosing not to insure despite the requirement to do so under the Unit Titles Act. Given the annual nature of insurance policy renewals, we cannot be certain in predicting future trends – increasing premiums in international reinsurance markets is likely to lead to premium increases and there is also potential for an upward impact on premiums if the Reserve Bank of New Zealand's review of solvency standards results in a higher capital charge for insurers.

¹³ Based on conversations with insurers, brokers, and the annual reports of listed insurers since 2010

We do not know the main reason why some New Zealand homeowners choose not to purchase residential property insurance. However, the northern Australia Insurance Inquiry looked into this and found:

- More than nine in ten survey respondents in northern Australia had home building insurance.
- Of the homeowners in northern Australia who responded that they did not have home building insurance, 61% said they had had it in the past.
- Cost was the main reason not to have home building insurance. The top two reasons given for this decision were not being able to afford the premium (52%) and not being able to justify the cost (45%). The third most common reason was the perception that their risk was low (6%).

Residential property price trends

We have seen the following trends over the last few years:

1. Dwelling insurance prices in the Consumer Price Index (CPI) have increased 36% across New Zealand since the fourth quarter of 2016. The cost of building new housing, which increases the value of the risk, increased 13.6% over the same period.
2. Increases in premiums in high seismic risk areas depend on the relevant house and insurer, but many appear to have been in the vicinity of 10-20% per year, and there have been price increases of over 20% year-on-year for a small proportion of high risk, high value houses in those regions.
3. Some Wellington MUBs have had price increases of over 50% in a given year, with some increases over 100% in a year. Commercial properties face similar premium conditions.
4. Insurance is expensive across the board for MUBs in Wellington when compared with lower risk locations. The MUBs with particularly high prices well above Wellington averages have high risk characteristics.
5. There have been premium decreases for some properties in lower risk regions.
6. The availability of insurance for residential houses, MUBs and commercial property in the greater Wellington region declined following the Kaikōura earthquake – availability issues appear to have eased somewhat for houses in the past year, but not for MUBs.
7. The Treasury has not seen any evidence of insurance uptake falling or properties having no access to insurance – except for a very small number of MUBs that have told us that they do not have access to full cover, and have been warned that if they do not undertake seismic strengthening, their insurer may decline cover in the future.

Significant changes in the residential property insurance market in recent years have occurred largely after the policy work on the 2019 cap increase was carried out. These changes include the transition to more granular risk pricing, leading to an overall decrease in insurance affordability, especially in high risk areas. The

changes have the potential to place financial pressure on the owners of properties in high risk areas, and to have an impact on their wellbeing.

2.2 What regulatory system(s) are already in place?

As first-loss insurer, EQC pays for the damage costs up to a \$150,000 cap (plus GST) for an insured dwelling.¹⁴ The homeowner's private dwelling insurer (second insurer) covers the value of the claim above the cap, up to the sum-insured or replacement cost of the building, and less any private insurer excess if applicable, depending on the particular policy terms. The EQC regulatory system, described above, has succeeded in achieving very high coverage for residential properties, and the land they are built on. It did this by having the same low premiums nationwide, no matter how risky the area was to natural disasters (i.e. risk sharing).

There has been broad acceptance over time of this cross-subsidy from low risk areas to high risk ones. Most importantly, EQC cover has succeeded in reducing political pressure for unplanned Government interventions to repair or replace housing after a disaster, with costs borne not only by the Government, but by a mix of public and private insurers and homeowners. The EQC administers the Natural Disaster Fund (NDF) with income to the NDF from premiums paid by homeowners, returns on investment and reinsurance funds. Outlays from the NDF include reinsurance premiums, insurance claims, a guarantee fee paid to the Crown and EQC operating expenses. The Crown guarantee (permanent legislative authority in section 16 of the EQC Act) provides an efficient way of back-stopping the scheme without tying up cash in a fund that may hardly ever be drawn down. The EQC scheme and its predecessor scheme (under the Earthquake and War Damage Commission) has had several reviews, particularly after major disasters.

Interdependencies with related work streams

EQC Act review

Ministers have directed officials to undertake a review of the EQC Act to modernise the legislation and embed lessons learned following the Canterbury earthquake sequence in 2010 and 2011. The outcomes of the review will be implemented in an Earthquake Commission Amendment Bill to be introduced by the end of 2021. The 'modernisation' scope of the work means that a first principles examination of the purposes and design of EQC has not been undertaken.

The following core features of the existing scheme and institutional arrangements were retained in all reform options:

- EQC cover being first-loss cover (i.e. EQC takes the first loss in the event of a covered natural disaster, with the private insurer picking up losses beyond the EQC cover as required)

¹⁴ <https://www.eqc.govt.nz/what-we-do/insurance-overview>

- access to EQC cover being compulsory for any residential building with a fire insurance policy
- EQC premiums being collected by private insurers and passed to EQC
- the EQC scheme being focused on only residential property
- separate EQC building and land covers are retained, and
- EQC continues to be a Crown Entity.

Officials consider that the above limitations did not impede the review of the EQC Act in addressing the relevant recommendations of the Public Inquiry into the EQC.

The policy work has built on previous Treasury work on the Act, including the 2015 discussion document: [New Zealand's Future Natural Disaster Insurance Scheme: Proposed changes to the Earthquake Commission Act 1993](#) (July 2015).

See also [Submissions Received in 2015 by the Treasury](#).

Public Inquiry into the EQC

Following the release of the report of the [Public Inquiry into the Earthquake Commission \(EQC\)](#), the Government has issued a formal response and outlined a work programme to take forward the Inquiry's recommendations. [Read the full Government response to the Public Inquiry into EQC](#).

Central and local government are also considering a broad range of policy initiatives to improve the management of risk in the built environment. These initiatives, as outlined below, will have an impact on the property insurance market.

- EQC's Resilience Strategy for Natural Hazard Risk Reduction focuses on promoting sharing of risk information.
- Work to improve New Zealand's management of natural hazard risk is coordinated through a joint central and local government work programme to enhance community resilience.
- An Independent Panel released [an issues and options paper](#) in 2019 following their review of the Resource Management Act 1991.
- National climate change risk assessments will be carried out as a requirement of the Climate Change Response (Zero Carbon) Amendment Act 2019.
- 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.
- Local government policies and planning rules can encourage risk reduction.
- The Wellington Insurance Taskforce (established by the Mayor of Wellington), was comprised of representatives from local government, bodies corporate, GNS, risk consultants, commercial developers, ICNZ and academics. In November 2019, the Wellington Insurance Taskforce published a discussion document, which looks at ways to address increasing uncertainty in the city's insurance environment.

2.3 What is the policy problem or opportunity?

Trends in insurance pricing

- More granular risk-based pricing of property insurance has led to significant changes in premiums across regions and building types. Higher-risk areas have seen significant increases, while premiums in lower-risk regions have fallen.
- We expect this trend to continue as natural hazard risk modelling continues to become more sophisticated.
- It is possible that following more granular pricing of risk, some buildings will choose not to insure, or be unable to secure insurance as has been seen internationally.

The Government's objective

- Cabinet's objective¹⁵ for this work is to ensure that residential property insurance is affordable and available in New Zealand (particularly in higher-risk areas) and can appropriately contribute to New Zealand's long-term resilience. This objective is informed by the importance of affordable insurance for:
 - supporting New Zealand's readiness for, and ability to recover from, natural disasters in the short-term through high levels of insurance uptake, and
 - enabling a socially optimal level of catastrophe risk-sharing.

¹⁵ DEV-19-MIN-0332 and DEV-19-MIN-0208 refer.

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 through a reduction in insurance uptake, or the quality of insurance through higher excesses, lower fixed-sum insurance levels, and greater use of exclusions for higher-risk residential properties. This risk is greater for apartment buildings in Wellington than houses, given the more significant premium increases (and more limited availability of insurance offerings).

If this risk eventuates, it will 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 or distress for property owners who are unable to transfer their residual risk into insurance markets, resulting in an accumulation of private losses in a particular region. This, in turn, creates an implicit fiscal liability to the Government to provide ad hoc financial support if called upon in the event of a disaster.¹⁶

Despite an increase in prices, we have not seen evidence that the uptake of property insurance is declining and have found few examples of properties being unable to insure. New Zealand is unusual in that it possesses high levels of insurance uptake. The existence of basic earthquake coverage through a state-sponsored insurance, risk-sharing, scheme is a key factor in this high uptake.

Over time, there is a risk of a transition away from property insurance. For decades, disaster cover has been readily available in private insurance contracts, leading to strong reasons to insure (e.g. mortgage contracts). However, as significant seismic events are infrequent, significant premium increases could eventually result in this changing. A higher EQC cap limits the impact of significant premium increases for a particular region based on new understanding of seismic risk because the cost of this risk is shared by all premium payers.

As set out above, policy interventions in other countries have had limited success in improving property insurance uptake. In this case, there is a rationale for early intervention before evidence of declining uptake. As EQC cover only applies to those who already have a private insurance policy, it is easier to maintain uptake through putting downward pressure on prices, and difficult to capture people who have already chosen not to insure. Voluntary demand for natural disaster insurance is known to be weak in risk-prone jurisdictions where figures are available (e.g. Japan and Chile). On this basis, it makes sense to utilise an existing Government scheme that has been successful in maintain strong uptake of insurance.

¹⁶ This is seen in overseas cases where, due to low levels of insurance coverage, Governments have been forced to step in to provide cover after the event, (e.g. Japan following the 2011 Tohoku tsunami), and hurricanes Sandy (2012) and Harvey (2017) on the eastern seaboard of the United States.

Problem 2: Negative impact on certain groups of people and regions from reallocation of insurance costs and changes in risk sharing

Property insurance also has wider economic benefits by providing the confidence necessary for economic activity and investment (e.g. banks require evidence of insurance coverage to lend on properties which, all other things being equal, enables greater investment in residential and commercial buildings). If property insurance becomes unaffordable or unavailable in certain areas, there may be wider social implications (e.g. reduced mobility where homeowners face difficulties selling their properties, or commercial investment is slowed).

The nature of natural disasters means that it is challenging to allocate the cost of natural disasters to those who benefit from insurance. In particular:

- natural disasters are low frequency
- the costs are catastrophic
- the potentially affected areas are widespread, and
- the expected costs and affected parties are constantly changing as scientific knowledge develops.

Markets for catastrophic risk are known to have deficiencies. It is not uncommon for disaster insurance to become completely unavailable at times, such as after major natural disasters. The supply of natural disaster insurance is also a function of cycles in the stringency of underwriting standards, the capacity of the insurance industry, and the impact of the international reinsurance cycle. These cycles may not be related to insurers' exposure to risk.

The challenges of accurately allocating the cost of natural disasters and deficiencies in the private market suggests that some degree of risk-sharing across society may provide a more stable and socially optimal approach.

EQC's flat-rate pricing allocates a significant proportion of natural disaster risk across all property owners. Recent shifts towards more granular pricing have eroded EQC's effectiveness at sharing risks.

In the absence of intervention, there are expected to be different impacts at the regional level, with high risk regions (e.g. lower North Island through upper South Island) seeing greater increases in pricing and possible availability issues, compared to lower-risk regions, which are expected to benefit from lower insurance costs. There is a risk that areas with widespread insurance issues could face long-term decline and dislocation of communities.

2.4 What do stakeholders think about the problem?

A number of stakeholders in New Zealand have supported revising the cap, while others have raised concerns with this approach.

A 2015 discussion document about the EQC scheme consulted on whether the monetary cap on building cover should be combined with EQC land cover and increased to \$200,000 plus GST. We considered the submissions that came from this previous consultation when developing the interventions to address the policy problem in this RIS.

In addition, the Public Inquiry into EQC noted that consideration should be given to increasing the cap to cover the average cost of building a house in New Zealand, or to removing the cap to provide for EQC cover to the individual sum-insured level.

Recent consultation has been with groups with a specific interest in the EQC cap (Consumer NZ, Inner City Wellington and the Body Corporate Chairs Group) rather than with the public more broadly. Through our targeted consultation, most insurers have expressed strong opposition to increasing the cap.

Key themes from recent targeted consultation

The section below sets out some thematic issues that arose during our recent targeted consultation.

Evidence of problems with insurance availability and affordability

Insurers argue that widespread affordability issues are not evident. Several insurers noted they continue to write business in Wellington. One insurer recognised that some property owners in Wellington, in particular some apartment owners, are finding it harder to secure and to afford premiums but noted that insurance availability largely remains.

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 on increasing pricing and that some earthquake prone buildings were becoming uninsurable.

Claims handling

Several insurers of different sizes raised concerns that increasing the cap above \$150,000 would mean that, under the claims partnership model insurers have agreed with EQC, insurers would essentially become claims handlers for EQC, with very little risk in the financial outcome of many claims. They noted that raising the cap may not be desirable for some insurers and could result in a reduction in the number of buildings they insure. We consider that an insurer's exposure and expected loss, which indicates the risk it is taking in the system, is more likely to determine its involvement in the market.

Modelling and risk figures

Several insurers raised concerns with the EQC's claims numbers and risk exposure forecasts. ICNZ suggested that detailed analysis is required before justifying a major change to the EQC cap.

The Society of Actuaries (SOA) recognised that insurer and reinsurer reactions to change would differ and are hard to predict. SOA recognised that insurers may not reduce reinsurance programmes following a cap increase as much as would be expected, as Boards are more risk averse or could use it as an opportunity to increase coverage.

EQC considers that its models reflect a likely outcome, and it is covering its best understanding of the underlying risks. In the ordinary course of its business, EQC regularly assesses its approach to risk financing and modelling, and any decision to increase the cap will impact on EQC's approach to reinsurance purchasing.

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 premium charged to insured homeowners (the "breakeven premium"). The premium charged by EQC is set via Ministerial decisions.

Risk allocations

ICNZ questioned the rationale for intervention, as shifting the cap simply shifts risk from private insurers to EQC without changing the overall cost. ICNZ suggested capacity is driven by reinsurers and changes to the cap do not solve the capacity issue.

ICNZ and SOA raised concerns that if the current modelling is wrong, the risk on the Crown is far greater at high cap levels.

Insurers noted that a higher cap could have potential benefits to smaller competitors who do not have a comparative advantage in buying reinsurance. The market may be more attractive to new entrants and smaller insurers through enabling them to hold less capital on a per-risk basis. A higher cap could help reduce the exposure of insurers to high risk areas.

One bank submitted support for a \$400,000 cap if the main objective was to ensure affordability and availability of insurance for properties in high risk areas and suggested that, from a bank credit risk perspective, an increase to the cap is preferred.

Price signals and climate change

Insurers suggested that granular risk pricing is arguably fairer, as it enables those with lower risks to pay less than those with high risks. It also helps inform decisions to reduce risk.

They suggested that given the risks present in Wellington, the Wellington market is behaving predictably given the scale relative to the size of the New Zealand market and the small number of participating insurers. Insurers suggested that a high cap may incentivise the conversion of weak mid-rise commercial buildings from the 1960s and 1970s into apartments.

ICNZ is concerned about the impact of muting price signals, and the precedent it creates, on the longer-term impact of climate change for properties at higher-risk locations. A higher cap, in effect, recognises that the cost of earthquake and volcano risk should be socialised, but it also could mute the price of climate risk and therefore weakens incentives to respond to these risks.

Insurers noted that the strengthening of buildings, including base isolation in new Wellington buildings, illustrated that the market was working as it should.

Cross-subsidisation

ICNZ and several insurers raised concerns that increasing the cap would increase the overall cost of insurance for many people. They suggested a higher cap should result in a price reduction for Wellington-based properties. There is more detail about what impact an increase to the EQC cap will have in *Section 3 – Options identification* of this RIS.

ICNZ suggested that increasing the cap will mean people in less risky areas will pay more than they currently do, which could in turn affect uptake in those areas. However, Consumer NZ was sceptical that increasing the cap would result in price increases in low risk areas.

Options and solutions

One insurer suggested that the EQC cap should remain at \$150,000, and officials should work with insurers and stakeholders to explore targeted solutions to address insurance availability and affordability instead of a cap increase. These might include:

- A separate EQC cap for residential units in a registered body corporate that would only be available for a fixed period in specific high seismic risk locations, and that is linked to risk reduction programmes.
- A Crown-backed not-for-profit reinsurance pool that is dedicated to body corporates in high seismic risk locations.

- A means-tested Government-provided subsidy on earthquake insurance premiums that would be available for a fixed period to individual property owners in body corporates that are in high seismic risk locations.

They suggested focusing building standards on saving the building rather than simply life preservation of occupants.

The level of the cap

No insurers raised what, in their view, would be an optimum level of cap. The higher the cap is, the more prominent the points that submitters raised become.

Balancing submitter views

The groups we spoke to have a specific interest in the EQC cap. It is hard to assess society's preference for risk sharing and the cross-subsidisation between high risk and low risk areas.

There are trade-off to consider when determining the appropriate level of cap. Decision-makers will need to determine whether the cost increases that some regions will experience following a cap increase are justified by the benefits offered by a higher cap.

2.5 What are the objectives sought in relation to the identified problem?

Cabinet has agreed that its objectives are to ensure that property insurance is **affordable and available** and appropriately contributes to New Zealand's **long-term resilience**.

Natural disaster policy under the National Security Framework

Recent New Zealand Governments situate natural hazard policy within the National Security Framework. National security is described in the framework 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. It encompasses the preparedness, protection and preservation of people, and of property and information, both tangible and intangible.

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:

- **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 standards; and 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).¹⁷

In this framework, the Government's overall objective with regard to natural disasters is essentially to maximise national wellbeing over time, taking into account the full range of pre-disaster costs (e.g. mitigation, insurance) and expected occasional large post-disaster costs (e.g. disruption, loss, recovery).

Property insurance is one element that can be used to contribute to the 4Rs.

Property catastrophe insurance contributes to the 4Rs by:

- Encouraging financial readiness for disasters by pre-funding expected financial losses to provide financial resources for recovery (i.e. the optimal level of insurance uptake and coverage to reduce national aggregate social distress from financial loss in the event of a disaster, and the likelihood of unfunded Government intervention post-disaster).
- In the context of the insurance market, the readiness objective is assessed through insurance uptake so homeowners purchase insurance to repair their homes if it is damaged by disaster. Uptake is influenced by insurance availability and affordability.
- Supporting an efficient approach to risk reduction through appropriate incentives for the optimal management of risk (i.e. discouraging moral hazard and encouraging the avoidance, mitigation or transfer of risk where such options are economically beneficial).
- In the context of the insurance market, the objective is therefore for insurance pricing to act as a signal to encourage risk reduction and minimises the risks of negative precedents (e.g. in the case of climate change, does the option establish a precedent that could create fiscal risks in terms of Government response to climate change).

There is a trade-off between these objectives.

¹⁷ DPMC, *National Security System Handbook*, August 2016, p.7.

- In the short-term, highly granular insurance pricing may reduce financial readiness and the ability to recover from a disaster if increased premiums and reduced availability lead to lower insurance uptake or underinsurance for higher-risk properties. Property owners without insurance (or underinsured) may be at higher risk of social distress from financial loss in the event of a disaster. In turn, the Government faces an increased fiscal risk from ad hoc Government intervention post-disaster.
- Over the longer-term, insurance pricing and availability that accurately reflects risk can improve incentives for risk reduction.

In addition, the Government's objectives are also to:

- *Minimise fiscal risks and costs* such as ad hoc calls for assistance following a natural disaster, implementation and operating costs.
- *Minimise unintended consequences*, such as reducing the competitiveness of the private insurance market or reducing New Zealand's attractiveness to international reinsurers.

Section 3: Option identification

3.1 What options are available to address the problem?

In December 2019,¹⁸ Cabinet directed the Treasury to 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:

- Option Set 1 – A flat across-the-board increase to the EQC cap from \$150,000 up to between \$250,000 and \$400,000, and
- Option Set 2 – Targeted options, including 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.

At that time, the Minister also informed Cabinet that he had decided not to pursue further analysis of a broader range of options. These options are set out in section 3.3 of this RIS. Full analysis of these options is included in the RIS that accompanied the December 2019 Cabinet paper.

Options assessed in this paper

¹⁸ DEV-19-MIN-0332 refers.

Status Quo

Without any intervention, we expect insurers will continue to price risk more granularly. It is likely that property insurance price pressures will increase over the next few years in high risk regions across New Zealand. MUBs will likely remain unattractive to insurers and could see further price increases. For this reason, the status quo will not meet Cabinet's affordability and availability objectives.

Option Set 1. A flat across-the-board increase to the EQC cap

An increase to the EQC cap would flatten insurance costs across different risk profiles. The cost of risks up to the cap amount would be shared by all premium payers, regardless of the risk profile of their property.

However, high risk high value properties and high risk MUBs are likely to continue to face price increases unless the cap was high enough to cover all of their natural disaster risk. On balance, an increase in the cap would probably create additional capacity for MUBs in Wellington. However, insurer decision-making around reinsurance purchasing may offset the impact on availability to some extent. For example, some insurers have noted that the impact on capacity for Wellington MUBs may be limited on the basis that varying the cap will lead insurers to reduce reinsurance cover in response to a cap change.

While insurability is determined by insurers, the EQC scheme automatically provides cover to properties that private insurers choose to insure. The scheme has a limited impact in circumstances where the insurer is declining cover (for example, for particularly high risk buildings).

A broad intervention will not address the concerns of all property owners. However, it has the least complexity by being applied across all property owners and does give clearer certainty to property owners than more bespoke options. It is possible to pursue more targeted options separately.

*Option 1a. A **moderate** increase in the EQC cap such as to \$200,000 plus GST (Treasury recommended option)*

A moderate increase in the cap from \$150,000 plus GST to \$200,000 plus GST would spread the costs of insurance across New Zealand homeowners, resulting in flatter prices.

For houses in high risk areas such as Christchurch and Wellington, increasing the cap to \$200,000 plus GST may lead to a moderate downward pressure on insurance premiums (if EQC premiums increase less than private insurer premiums decrease (for a given sum insured)), as well as more certainty about future coverage as they are less reliant on private insurance.

Some houses (those that are already expensive to insure) may see premiums stay constant or increase moderately due to the market effects and limitations of the cap's impact on price.

Increases in the cap could result in insurance price increases for properties in low risk regions as EQC premiums may increase by more than private insurer premiums would decrease (for a given sum-insured). More granular risk pricing by insurers may partially offset EQC premium increases for low risk properties.

Option 1b. A substantial increase to the EQC cap such as to \$300,000 plus GST (Option recommended in the Cabinet paper), or to \$400,000 plus GST or sum insured

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 EQC 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 in Table 3 (below, calculated by insurance multinational Aon) explains how much this exposure costs EQC at a breakeven rate for each region.

If insurers used the same model as Aon used to calculate the figures in Table 3 for the breakeven premium, then Column C would be a good proxy for the amount that insurers may reduce their prices by and Figure 2 would show a potential price increase following an increase to the cap. 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 3: Break even EQC premiums at a regional level

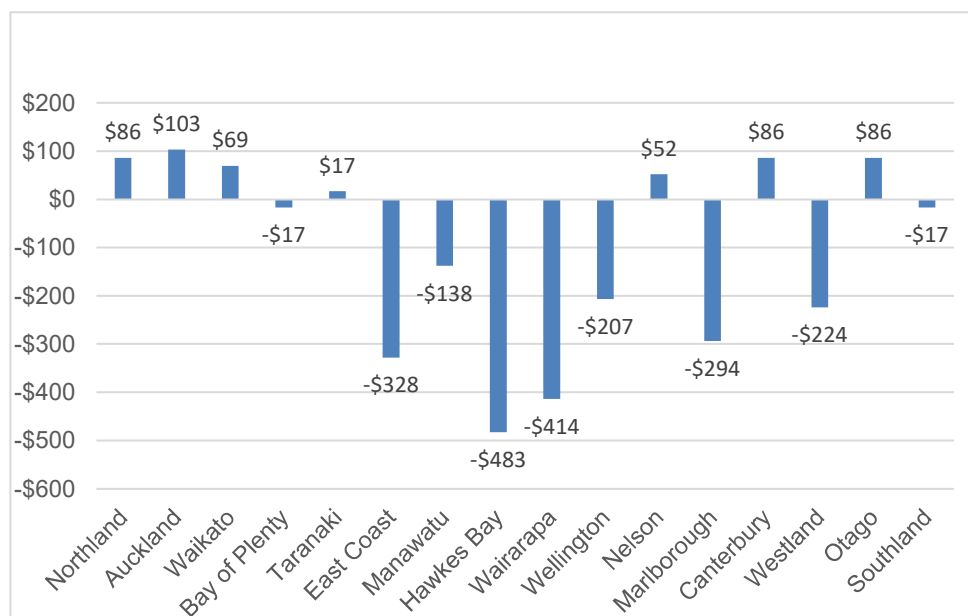
CRESTA ¹⁹ Name	(A)	(B)	(C)	(D)
	Regional risk-priced break even EQC premium at \$150,000 cap Incl GST	Regional risk-priced break even EQC premium at \$300,000 cap Incl GST	(= B – A) Break even additional premium from cap increase to \$300,000	(=552– B) Level of cross subsidisation at \$300,000
Northland	121	173	52	379
Auckland	138	173	35	379

¹⁹ **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.

Waikato	173	242	69	310
Bay of Plenty	535	690	155	-138
Taranaki	362	483	121	69
East Coast	914	1380	466	-828
Manawatu	1070	1346	276	-794
Hawkes Bay	1484	2105	621	-1553
Wairarapa	1139	1691	552	-1139
Wellington	828	1173	345	-621
Nelson	328	414	86	138
Marlborough	983	1415	432	-863
Canterbury	259	311	52	241
Westland	880	1242	362	-690
Otago	190	242	52	310
Southland	259	414	155	138

Average Break Even 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)

Figure 2: Potential net effect on total premium from increase in EQC cap from \$150,000 to \$300,000 (plus GST)



Source: AON data
Annual levy per household

Option Set 2. Targeted options

Bespoke solutions would be more effective in affecting the affordability and availability for properties that face the greatest affordability and availability challenges. We have considered at a high level some alternative options to increasing the EQC cap to improve insurance affordability, especially for high risk, high value MUBs. These options go beyond the scope of the modernisation of the EQC Act (and beyond what can be developed within the timeframes of the review), but they are useful comparators to the cap when it comes to addressing affordability and availability objectives. At least one insurer has expressed an interest in exploring targeted options with the Government.

A Government insurance intervention may not be the best answer where property owners are paying high insurance prices, due to the characteristics of the particular insured building causing a significant level of risk.

The three targeted options that could be most effective are:

Option 2a. Targeted EQC cap

The cap could be increased to target particular buildings or areas, or only existing residential buildings in those categories. This option has some of the same limitations as an across-the-board increase in the cap – it has significantly different effects for different types of MUBs, and its transmission is still subject to insurer pricing decisions. It is significantly more complex to implement than an across-the-board increase.

Option 2b. Targeted reinsurance

This option would involve the Government providing reinsurance to participating insurers in relation to high risk MUBs and/or to incentivise resilient developments. This could reduce the insurers' costs of providing insurance to the relevant properties, depending on the structure and level of Government support offered.

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, that was time limited and linked to resilience work. Under the Flood Re model, insurers have the option to transfer the premiums (and claims liability) from eligible policies to Flood Re or retain the risk themselves. 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). A key difference between New Zealand and the UK however is that there are many more insurers operating in the UK.

Option 2c. Direct provision of natural disaster insurance for certain MUBs

This could be via EQC, another government agency or a contracted private sector organisation. The main difference between this option and targeted reinsurance is that it gives the Government direct control of the insurance premium that the customer pays, because it is not transmitted through an insurer to the customer. This option requires difficult choices about how eligibility would be set out and how insurance would be priced; for example, whether the risk would be priced at the market price, or lower than the market price with the Government carrying the risk. If provided at a subsidised rate, cover could be linked to strengthening to a percentage of the National Building Standard, or an enhanced seismic safety standard. Without a wider portfolio for cross-subsidisation or direct Government subsidisation, premiums are likely to still be very high, reflecting the risk. A subsidy for insurance premiums for MUBs in high risk areas would support the Government's objectives of insurance being affordable and available and contributing to long-term resilience.

Each of the above alternative options have pros and cons. Generally, these options all have the potential to provide premium relief and/or availability to buildings with insurance problems. Additionally, they have the potential to be targeted at resilient new buildings to incentivise good development. However, they also involve significant design complexity, establishment costs, boundary issues (choosing how to determine which buildings have an acceptable/insurable level of risk and which don't, as well as who gets the benefit of the targeted scheme), and a precedent for the approach to climate change-induced risk and loss. The risk would need to be financed, either through additional levies on property owners, or via general Crown/taxpayer subsidisation.

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

We consider the following in our assessment of the merits of the options:

- *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 financial readiness and helps finance the recovery from a natural disaster event).
- *Precedent risks*: what risks the option establishes precedents for (e.g. does the option establish a precedent that could create fiscal risks in terms of Government response to climate change).
- *Affordability* (for high risk properties): 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.
- *Unintended consequences*: the likelihood the option has unintended consequences or that the negative impacts of the option are more significant than expected.

- *Fiscal risks and costs*: this includes the costs and risks to the Crown of the explicit social safety net, implementation, and operating costs.
- *Implementation complexity*: time necessary to implement the option and the degree of complexity of its implementation.

Regarding criteria weighting, the Treasury ranks the criteria as follows:

- First ranking – We rank affordability and availability highest given these are Cabinet’s stated objectives. However, there is limited evidence for widespread reductions in insurance uptake due to insurance affordability or availability issues.
- Second ranking – Long-term resilience and precedent risk is highly rated because incentives for risk reduction permeate many aspects of behaviour.
- Third ranking – We rank unintended consequences just below long-term resilience given significant uncertainty about the response from the insurance market to any intervention.
- We rank fiscal risk and costs last because EQC premiums are intended to be set to offset the long-term cost of any EQC-based intervention.

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

In December 2019, the Minister informed Cabinet that he had decided not to pursue further analysis of a broader range of options. Full analysis of these options is included in the RIS that accompanied the December 2019 Cabinet paper.

- *Establishing a Government-owned retail 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 did not recommend pursuing this option in the previous RIS, because 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. 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.
- *Regulating insurers to compel greater flat-rate pricing, or to take on more risk in higher-risk areas*. 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. 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. 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.

- *Insurance premium subsidies.* 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 (e.g. 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.
- *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.

- 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 (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. Treasury does not recommend this option given the possible financial stability risks. An upcoming review of the Insurance (Prudential Supervision) Act 2010 is currently underway.
- Buyer compulsion. The Government could require property owners to buy full natural disaster 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 severe affordability issues or choose not to for other reasons. It is not economically efficient to fully insure all residential properties. Property owners already have strong preferences and incentives to purchase property insurance (e.g. mortgage terms requiring insurance). Note that:
 - Homeowners are already required to purchase EQC cover when entering into a contract of fire insurance with a private insurance company in respect of any residential building situated in New Zealand (section 18 of the Earthquake Commission Act 1993). The EQC cover is, however, flat-rate priced and capped (currently at \$150,000), limiting the negative financial impacts on property owners who are unable to insure due to severe affordability issues.
 - Body corporates are already effectively required to purchase insurance under section 135 of the Unit Titles Act 2010. However, the rationale for compulsory insurance for unit titles is based on protecting minority unit title holder interests (e.g. to have insurance), and to

reduce complexity allocating and recovering costs following damage from a natural disaster.

- 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 have 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.

Competition study

The Treasury considered in 2020 whether a Commerce Commission market study could be useful to inform policymaking in this area. This would be particularly valuable ahead of making decisions around any significant cap increase or targeted intervention. An effective and competitive property insurance market is an important enabler of economic activity and has significant implications for New Zealand's resilience to natural disasters. The market is concentrated; the two largest residential property insurers have around 75% market share.

However, unless other studies are reprioritised, it would take several years before a study could be completed. It is also important to bear in mind that there are significant regulatory reforms underway that affect insurers, including the Insurance Prudential Supervision Act review and the Financial Markets (Conduct of Institutions) Amendment Bill. Any changes to address the affordability and availability of insurance, and any market study, would need to be sequenced bearing in mind the overall regulatory burden on the industry.

Section 4: Impact Analysis

Marginal impact: How does each of the options identified in section 3.1 compare with taking no action under each of the criteria set out in section 3.2?

Table 4: Impact analysis

	Status quo	Moderate flat rate increase to the EQC cap	Large flat rate increase to the EQC cap	Targeted increase to the EQC cap	Targeted reinsurance	Direct provision of natural disaster insurance for certain MUBs
Affordability (for high risk properties)	0	+	++	++	+	+
Availability (for high risk properties)	0	+	+	+	+	+
Long-term resilience	Readiness	0	+	++	+	+
	Risk reduction	0	0	--	--	--
Fiscal	Costs to the Crown	0	0	0	Med	Med
	Risks to the Crown	0	-	--	--	0
Precedent risks	0	-	--	---	---	--
Implementation complexity		low	low	med	high	high
Unintended consequences	0	-	--	---	---	--
Overall assessment	0	+ +	0	---	---	-

Key:

- ++ much better than doing nothing/the status quo
- + better than doing nothing/the status quo
- 0 about the same as doing nothing/the status quo
- worse than doing nothing/the status quo
- much worse than doing nothing/the status quo

In calculating the overall assessment, we have weighted the ability to achieve Cabinet’s objectives twice as high as other criteria.

Description of impact analysis

		Status quo	
Affordability (for high risk properties)		0	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 buildings, we anticipate continued insurance premium increases and availability difficulties.
Availability (for high risk properties)		0	We do not have reason to expect any change to the availability of insurance for houses. For multi-unit buildings, 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.
Long-term resilience	Readiness	0	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.
	Risk reduction	0	There is a medium risk of a reduction in resilience in the short-term for houses if the quality of insurance coverage declines (e.g., 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.
Fiscal	Risks to the Crown	0	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.
	Costs to the Crown	0	Nil
Precedent risks		0	Nil
Implementation complexity		0	Nil
Unintended consequences		0	Nil
Overall assessment		0	

Option 1a.		Moderate flat rate increase to the EQC cap	
Affordability (for high risk properties)		+	We expect a moderate increase to the cap to lead to a small to moderate decrease in the insurance prices for high risk properties. Some houses may see premiums stay constant or increase moderately due to continuing implementation of risk pricing from some insurers and limitations of the cap's impact on price. Downward pressure on premiums from a moderate cap increase is limited because these properties still rely on private insurance for a significant part of their cover and this part is priced based on their risk. For this reason, the impact on premiums for high risk, and high value, buildings in high risk regions (e.g. some apartments) is likely to be marginal.

Availability (for high risk properties)		+	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.
Long-term resilience	+	+	The downward pressure on prices can support the continued uptake of insurance by mitigating the risk that price increases lead to a reduction in uptake. This gives Government more certainty about the level of coverage in areas vulnerable to natural disasters which will support a recovery post disaster.
	0	0	Insurance signals can support resilience if they lead to planning decisions to build in safe areas. A moderate cap level is unlikely to interfere with these signals.
Fiscal	0	0	Nil, if EQC premiums are adjusted to meet the costs of the scheme.
	-	0	Small risk that a large event happens before the EQC has had time to build up premiums in the NDF.
Precedent risks		-	Limited marginal precedent effects, if the increase is modest.
Implementation complexity		Low	A flat increase to the cap could be implemented after a Cabinet decision by regulations under the existing EQC Act. Insurers would need time to implement the change in their policies. Administrative costs of this are unknown, but are not expected to be large, as it is a recalibration of an existing intervention and, if implementation and transition mirrors that for the 2019/20 increase, may be able to draw on resources developed for that.
Unintended consequences		-	A modest increase to the cap means unintended consequences are low. 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. May shape expectations in other areas, e.g. climate change policy, of Government willingness to take on homeowner risks.
Overall assessment		+ +	

Option 1b.	Large flat rate increase to the EQC cap	
Affordability (for high risk properties)	++	We expect a large cap increase will result in a greater decrease in insurance prices for high risk properties than option 1a. The effect is more significant at higher cap levels because a greater proportion of the risk is community rated. However, some houses may see premiums stay constant or increase moderately due to continuing implementation of risk pricing from some insurers and limitations of the cap's impact on price

Availability (for high risk properties)		+	Nature of the impact is likely to be the same as option 1a, but to a greater extent. However, there is limited evidence of widespread availability problems.
Long-term resilience	++	++	We expect greater impacts on readiness for a higher cap because the impact on pricing is greater.
	--	--	Higher levels of cap may mute the price signals offered by insurance, meaning that some buildings do not pay the true cost of their risk and are less incentivised to consider how they can minimise these risks.
Fiscal	0	0	Nil, if EQC premiums are adjusted to meet the costs of the scheme.
	--	Med	Higher risk than with a lower cap option.
Precedent risks		--	Increased risk, compared to option 1a, that this option will shape expectations in other areas, e.g. climate change policy, of Government willingness to take on homeowner risks.
Implementation complexity		Low	Greater than option 1a as the magnitude of the increase could require broader changes to insurer systems and pricing.
Unintended consequences		--	There is greater risk than option 1a of a reduction in insurer interest in retaining the remaining natural disaster risk. Increased incentives to convert high risk non-residential property to residential property may undermine broader reduction and readiness efforts.
Overall assessment		0	

Option 2a.		Targeted increase to the EQC cap	
Affordability (for high risk properties)		++	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 premiums, or a flat increase in the EQC premium. If the funding is from a flat increase in the premium, 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 premium 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 premium component for high risk properties, and the reduced cover required above the cap from the private insurer (even with the higher premium, the total premium for high risk property would fall as the proportion covered by EQC increased and the over-cap proportion declined).
Availability (for high risk properties)		+	A targeted solution allows the Government to provide relief for high insurance premiums directly to specific regions that face higher prices
Long-term resilience	+	+	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.

	--	--	A targeted increase in the cap mutes risk price signals and reduces incentives to manage risk. The reduction in incentives is a 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.
Fiscal	0	0	Nil, if EQC levies adjusted to meet the costs of the scheme.
	--	Med	Medium risk; increased contingent liability under the Crown guarantee for the increase in risk borne by EQC.
Precedent risks		---	More likely than option set 1 to shape expectations in other areas, e.g. climate change policy, of Government willingness to take targeted measures, and take on homeowner risks, to support affected populations.
Implementation complexity		Med	Complexity and associated costs are likely to be high. A significant departure from current scheme's flat-rate cover and premium rate, so likely to require major systems changes for insurers and EQC.
Unintended consequences		---	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 premium payers outside the target benefit group, and they would have been better off to be included in the target group. 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 home-owners 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.
Overall assessment		---	

Option 2b.		Targeted reinsurance	
Affordability (for high risk properties)		+	This option could reduce the insurers' costs of providing insurance to the relevant properties. This would reduce the insurance prices for some properties but the level of pass through of price relies on an effective structure.
Availability (for high risk properties):		+	Some reinsurance structures 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.
Long-term resilience:	+	+	Improves affordability and access so may improve readiness for the targeted population
	-		A targeted increase in the cap mutes risk price signals and reduces incentives to manage risk. The reduction in incentives is greater in 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.

Fiscal	Med	Med	Medium risk; increased contingent liability under the crown guarantee for the increase in risk borne by EQC.
	-	0	Nil, if EQC premiums are adjusted to meet the costs of the scheme.
Precedent risks		---	If a structure that involves some subsidisation of risk is pursued, sets a precedent of Government taking on private risk for natural hazards.
Implementation complexity		High	High implementation complexity as it would require the creation of a new function for Government and complex commercial arrangements with insurers.
Unintended consequences		---	The reinsurer option is likely to involve difficult boundary issues, may create distortion of the market in unintended ways, and have difficulty with unwinding.
Overall assessment		---	

Option 2c.		Direct provision of natural disaster insurance for certain MUBs	
Affordability (for high risk properties)		+	This option gives the Government direct control of the insurance premium that the customer pays because it is not transmitted through an insurer to the customer. The cost of a scheme that insures only higher-risk properties would be reasonably high. Unless there was a Government subsidy attached, this price would be reflected in the price of the insurance.
Availability (for high risk properties)		+	Under this option the Government can provide insurance directly, giving them more control over the availability. Under a cost recovered model – high prices may limit the uptake as has been seen in other jurisdictions where there is a Government provider.
Long-term resilience	+	+	Improves the financial resilience of MUB owners following a natural disaster.
	--	--	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.
Fiscal	Med	Med	Through insuring MUBs directly the Crown takes on exposure for those risks, although the group of MUBS may be small.
	0	0	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).
Precedent risks		--	A non-commercial insurer would create a precedent of Government subsidising the risks of private property owners. [34]
Implementation complexity		High	Would require the establishment of a new Government insurer, with associated pricing and claims management expertise. Could involve complexity managing overlap and consistency issues with private insurance policies.

Unintended consequences	--	Some insurers may currently be staying in the higher-risk areas out of competitive pressures and to protect 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-focused Government-owned insurer is likely to face public pressure to provide affordable cover to high risk properties, potentially leading to under-pricing.
Overall assessment	-	

Section 5: Conclusions

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

The EQC cap level requires a choice along a spectrum, and there is no 'perfect' level. The Treasury's preferred option is to increase the EQC cap level from its current level of \$150,000 plus GST, to \$200,000 plus GST. The Cabinet paper recommends increasing the cap level further, to \$300,000 plus GST. This reflects a difference in how the options are assessed against the decision-making criteria, and how the criteria are weighted and trade-offs are made.

Increasing the EQC cap will support the affordability and availability of property insurance and New Zealand's long-term resilience

Cabinet's objectives are to ensure that property insurance is **affordable and available** and appropriately contributes to New Zealand's **long-term resilience**.

We have assessed different options against the above objectives and against the following criteria: precedent risks; unintended consequences; fiscal risks and costs; and implementation complexity.

It is likely that property insurance price pressures will increase over the next few years in high risk regions across New Zealand. MUBs will likely remain unattractive to insurers and could see further price increases. For this reason, the status quo will not meet Cabinet's affordability and availability objectives.

Insurance uptake rates currently remain high, perhaps suggesting the current \$150,000 cap does not need to be increased at all. The preferred Treasury option and Cabinet paper proposal both reflect a view that early intervention, before price pressures result in declining uptake, is preferable to waiting for the decline in uptake 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 then face the difficult task of getting people who have chosen not to insure, to begin taking out insurance again. Voluntary demand for natural

disaster insurance is known to be weak in risk-prone jurisdictions where figures are available (e.g. Japan and Chile).

Increasing the EQC cap to \$200,000 plus GST goes some way towards improving affordability and availability, while minimising risks and unintended consequences

A \$200,000 cap is preferred by the Treasury as it should have moderate net positive impacts for affordability and availability of residential insurance in high risk areas, while retaining the ability of the insurance market to provide signals to homeowners, regional planners, and land developers on seismic risk.

In Treasury's view, higher levels of cap warrant caution, due to the risk of unintended consequences, so we recommend against a significant increase at this stage. For instance, a higher cap increase sets a stronger precedent for how the Crown might deal with greater climate change-related loss in the future, mutes the price signal from insurance to reduce risk, and poses more uncertainty around EQC/insurer claims handling models and how insurers choose to participate in the market. There is uncertainty about how likely it is that these risks eventuate, but the Treasury has taken a cautious approach in our assessment.

In addition, there are distributional impacts from increasing the cap, as higher levels of cap will lead to higher cost increases in low risk areas (some of which have low median housing-adjusted incomes).

Other options were considered but ruled out, including: a targeted increase to the EQC cap; a targeted reinsurance scheme; and direct provision of insurance for certain MUBS. Whilst these options had the potential to provide targeted relief to affected households, they also had a higher level of unintended consequences and precedent risk.

On balance, in order to advance Cabinet's objectives while keeping unintended consequences to a minimum, the Treasury recommends increasing the cap to \$200,000 plus GST.

Increasing the EQC cap to \$300,000 plus GST reduces the risk that risk-based pricing will significantly erode the affordability and availability of property insurance

The Cabinet paper recommends increasing the EQC cap to \$300,000 (plus GST).

This recommendation reflects a preference for applying more of a community-rated insurance price, rather than a risk-based approach. This option can address the impacts of risk-based pricing on the affordability and availability of property insurance in high risk areas, which could affect insurance uptake. A \$300,000 (plus GST) cap is more likely than Treasury's preferred option to have a significant impact on insurance prices in regions with high seismic risk.

This approach reflects a greater weight placed on Cabinet's objective to ensure that property insurance is affordable and available, and less weight on the potential, but uncertain, risks of a substantial increase in the cap, and is informed by the responsible Minister's engagement with individual insurers and reinsurers to understand the impacts of a price increase.

Stakeholders views on raising the EQC Cap

A number of stakeholders in New Zealand have supported revising the cap, while others have raised concerns with this approach.

The Public Inquiry into EQC noted that consideration should be given to increasing the cap to cover the average cost of building a house in New Zealand, or to removing the cap to provide for EQC cover to the individual sum-insured level.

Treasury's recent consultation has been with groups with a specific interest in the EQC cap (Insurers, Consumer NZ, Inner City Wellington and the Body Corporate Chairs' Group) rather than with the public more broadly. Through our targeted consultation, most insurers have expressed strong opposition to increasing the cap arguing that widespread affordability issues are not evident. Other 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 on increasing pricing and that some earthquake prone buildings were becoming uninsurable.

ICNZ and several insurers raised concerns that increasing the cap would increase the overall cost of insurance for many people. They suggested a higher cap should result in a price reduction for Wellington based properties but will mean people in less risky areas will pay more than they currently do, which could in turn affect uptake in those areas. However, Consumer NZ was sceptical that increasing the cap would result in price increases in low risk areas.

Several insurers of different sizes raised concerns that increasing the cap above \$150,000 would mean insurers are essentially claims handlers, with very little risk in the financial outcome of many claims. They noted that raising the cap may not be desirable for some insurers and could result in a reduction in the number of buildings they insure.

ICNZ is concerned about the impact of muting insurance price signals, and the precedent it creates, on the longer-term impact of climate change for properties at higher-risk locations. A higher cap, in effect, recognises that the cost of earthquake and volcano risk should be socialised. If a future Government were to add climate exacerbated risks like storm and flood into the EQC Cap, perhaps in response to future pressures from affected communities, then this could mute the price of climate risk and therefore weaken incentives to respond to these risks.

Limitations of consultation

There has been significant previous public consultation on the issues with the current EQC Act and potential options for change, both in 2015 and during the more recent Public Inquiry, which included extensive consultation. The Public Inquiry's consultation focused particularly on the people of Canterbury. Consequently, the Minister Responsible for the EQC decided not to undertake a full public consultation process as part of the more recent EQC Act review, or to consult on an exposure draft of the proposed EQC Bill. The Treasury has instead undertaken a targeted consultation process with key stakeholders on relevant proposals.

While the package of proposals to modernise the EQC Act do not propose fundamental reforms, they are fairly complex and technical in nature. The targeted consultation process does create a risk that groups not included in the targeted consultation could raise technical or other issues at Select Committee that officials have not considered.

Lack of consultation with iwi/hapū also creates specific risks for the legislative process. Officials could not identify any issues regarding the EQC scheme that iwi might have a particular or distinctive interest in, and expect to be consulted on. EQC cover attaches to all residential buildings with a fire insurance policy, which includes iwi-based living and ownership arrangements such as papakāinga. As with other groups not included in the targeted consultation process, there is a risk that iwi-specific issues associated with the EQC scheme may be raised at Select Committee.

The Treasury is confident in the assessment of the relative merits between the various options (see previous section). As noted, however, the Treasury is unable to provide an assessment of the monetised costs and benefits given the limited available data.

5.2 Summary table of costs and benefits of the preferred approach

Table 5: summary table of costs and benefits of the preferred approach

Affected parties	Comment:	Impact	Evidence certainty
Additional costs of Treasury preferred approach (compared to taking no action)			
Regulated parties			
Property owners in low risk regions	<p>We do not expect many homes in low risk regions to experience downward pressure on their insurance premiums from an increase to the EQC cap.</p> <p>Increase in net costs to owners of low risk properties.</p>	<p>Net increase in prices – the EQC premium would increase by about \$92 per year for a \$200,000 cap. These figures include the \$69 increase required to return to a breakeven premium. EQC premium increases are unlikely to be matched by insurer premium decreases, because natural disaster premiums are already low for most low risk properties. But EQC premium increases may be partially offset in cases where the relevant insurer was still implementing a move to more granular risk pricing.</p> <p>Beyond the year of implementation, insurance prices are likely to increase at a sustainable rate over time with building cost inflation and other expenses, but from the higher starting point.</p>	<p>The Treasury is not able to quantify the impact overall or for any specific home but is confident in the range of numbers presented.</p>

<p>Property owners in high risk regions</p>	<p>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).</p> <ul style="list-style-type: none"> • Lower-value houses in high risk regions should benefit the most from a cap increase. • Lower-risk apartments in high risk regions may see moderate decreases in premiums. • The impact on price for high risk, and high value apartments in high risk regions is likely to be marginal, as they rely on private insurers for a larger portion of their total cover. 	<p>In the year of implementation:</p> <ul style="list-style-type: none"> • Potential moderate decrease in premiums for a number of houses in high risk areas. Some houses may see premiums stay constant or increase moderately due to the continued implementation of risk pricing from some insurers and limitations of the cap's impact on price. • Lower-risk apartments in high risk regions may also see moderate decreases in premiums. • The impact on price for high risk, and high value apartments in high risk regions is likely to be marginal. <p>Beyond the year of implementation, insurance prices may trend upwards (as for a \$150,000 cap) but from the lower starting point.</p>	<p>The Treasury is not able to quantify the impact overall or for any specific home but is confident in the range of numbers presented.</p>
<p>Tenants</p>	<p>Tenants may experience higher or lower costs through their rent to the extent that landlords pass on changes in premiums. However, the current supply constraint in the rental market means rents are driven more by what tenants can pay rather than the cost to provide rental housing, so changes in insurance costs are unlikely to significantly affect rents.</p>		

<p>Private insurers</p>	<p>This reduces the revenues of insurers as the size of the above-cap section of the residential insurance market reduces (which may be partially offset as house price inflation causes sums insured to rise).</p> <p>The 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, despite their risk exposure being lower.</p> <p>However, if the above-cap risk is considered particularly risky, insurers may charge more for covering this.</p>		<p>Private insurers do not share the specific revenue details for commercial reasons. We are confident that an increase to the EQC cap would reduce revenues of insurers, but we do not know the extent.</p>
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EQC	<p>The EQC administers the Natural Disaster Fund (NDF) with income to the Fund from premiums, returns on investment, and reinsurance funds. 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 property owners through increases in the EQC premium so that there is no net cost to EQC.</p> <p>If there are higher than expected costs in the event of a natural disaster, the Crown will be exposed when the NDF is called on and the Crown guarantee is triggered in a significant disaster event.</p> <p>Cabinet has agreed that EQC's key financial settings, including the insurance premium and EQC insurance cap, should have a maximum review period of five years, which should ensure that the EQC premium is sufficient. This review will have a cost.</p>		
Treasury	As the monitor of EQC and policy lead for insurance affordability and availability, the Treasury will be responsible for monitoring the effectiveness of the policy.		
Total monetised cost	<i>n/a</i>		
Non-monetised costs	<i>Medium</i>		

Affected parties	Comment:	Impact	Evidence certainty
Additional benefits of Treasury recommended approach (compared to taking no action)			
Regulated parties	We expect that an increase to the cap will increase the aggregate insurance capacity (private insurer plus EQC) available to cover houses in high risk areas, and should therefore also improve the availability of insurance, noting that this risk covered by private insurers could be more volatile and unknown.	Medium	Medium
Regulators	A relatively simple and broad intervention, easy to understand and implement.	High	High
Wider government	<ul style="list-style-type: none"> • Government and homeowners will have certainty about the extent of customer coverage and the EQC premium up to cap amount – the higher the cap, the higher the certainty about the final premium. • Lower precedent value for climate risk than other options. 	Medium	High
Total Benefit		Medium	High

5.3 What other impacts is this approach likely to have?

N/A

Section 6: Implementation and operation

6.1 How will the new arrangements work in practice?

The cap can be increased either by regulation under section 36 of the EQC Act, or via legislation.

The Cabinet paper recommends that the EQC cap is increased by regulation made under sections 18 and 36 of the EQC Act, and subsequently confirmed 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.

The higher EQC cap will begin to be effective from 1 July 2022. This commencement date aligns with the annual renewal of EQC and some private insurers' annual reinsurance contracts. The higher cap would apply to any new insurance contracts and all renewals from 1 July 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.

A 1 July 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.

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

Once implemented, EQC's Board will be responsible for the ongoing operation and enforcement of the new provisions. The private insurance sector is monitored on the supply side by the Reserve Bank and on the demand side by the Ministry of Business, Innovation and Employment. The Treasury administers the EQC Act.

6.2 What are the implementation risks?

No significant implementation risks have been identified beyond achieving the relatively challenging timeframe.

Insurers have signalled there is a risk that they may retract from the market at higher levels of cap. While this is a risk, we consider the risk to be low. This risk can be mitigated by ongoing conversation with the insurance industry as well as our monitoring arrangement (below) that will allow us to understand the impacts of the EQC cap increase.

Section 7: Monitoring, evaluation and review

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

In order to assess the effectiveness of an increase to the EQC cap, the Treasury needs to understand:

- how insurance premiums have changed for different regions
- how the availability of property insurance (e.g. the number of insurers willing to insure a given property) has changed for different regions
- how the cap has influenced the points above compared to other factors such as inflation and a change in risks.

In order to achieve this, we would need a sample/set of insurance data to establish a baseline for before the cap is increased. We could use that same sample/set of data to assess how the policy has impacted price and availability.

Other factors outside of the EQC cap such as reinsurance costs, inflation, and change in risks can affect the price of insurance premiums. We want to understand specifically what impact an increase in the EQC cap has had on prices so that we can understand how effective the change was in improving affordability and availability of residential property insurance. This is likely to be achieved by comparing the change in prices against the change in risk.

The Treasury does not currently have comprehensive information about the uptake, price, availability, and level of underinsurance. Statistics New Zealand collects some data on insurance prices through the Household Economic Survey. However, this is at a general level and may not help to answer the questions set out above.

We are currently considering the most effective way of achieving the monitoring arrangement set out above. We will also engage with stakeholders, including insurers, consumer groups, and property owner representatives, to understand from their perspective the impact that the policy has had. We will use existing channels such as the Council of Financial Regulators, which the Treasury sits on, to monitor and discuss any issues as they arise.

7.2 When and how will the new arrangements be reviewed?

The Treasury will need to establish the methodology for this monitoring arrangement above prior to the implementation of the policy (late 2021).

Cabinet has agreed that EQC's key financial settings, including the insurance premiums and cap, should have a maximum review period of five years, set out in legislation, which should ensure that premium rates are sufficient.

Annex 1: Additional background on EQC financing

Fiscal risk and loss modelling

EQC’s current reinsurance programme covers EQC for up to \$6 billion of losses with a first loss excess of \$1.75 billion (which is currently covered by the Crown guarantee, as the natural disaster fund (NDF) is depleted). Above this level, the Crown covers the risk via its guarantee of EQC. The level of risk taken on by the Crown via its guarantee of EQC increases as the cap increases.

Average annual loss

Chart 1 below sets out the modelled average annual loss over 850 years at different levels of EQC cap in 2019. The model estimates that EQC’s long-term risk does not increase significantly above a cap of around \$400,000 (because relatively few claims are above that level).

Return period losses

Chart 1: Illustration of the 2019 “Return Period losses”, or the estimated losses to EQC with a 0.1 percent, 0.02 percent and 0.01 percent chance of occurring in the next year (i.e. very large events with low likelihood of occurring).

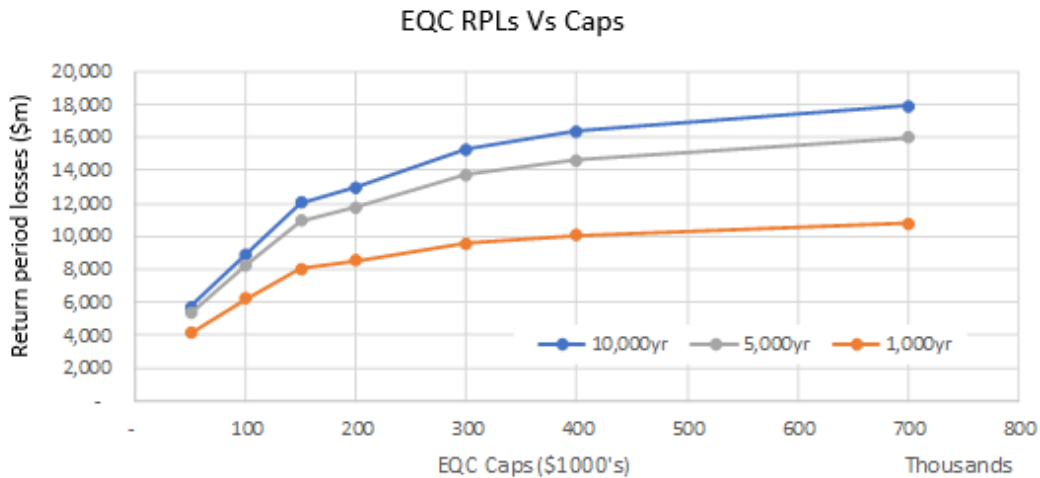


Table 1: Loss exposure and levy modelling shared with insurers (including AON’s modelling of EQC losses as a percent of all residential claims).

Modelling of annual expected losses (2019)

EQC Building Cap, \$, excl. GST	\$150k	\$200k	\$250k	\$300k	\$400k	uncapped
Annual expected cost of EQC claims (\$m) ⁽¹⁾						
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
EQC losses as percent of all residential claims						
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%
Total EQC insured exposure						
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 ⁽²⁾	\$0.23	\$0.19	\$0.17	\$0.16	\$0.14	\$0.13
Breakeven annual EQC premium per dwelling (\$) ⁽³⁾	\$397	\$437	\$489	\$552	\$644	x

(1) These estimates are subject to a range of modelling and other assumptions and caveats.

(2) The current EQC premium rate is 20 cents per \$100.

(3) Including 15% GST. EQC's current maximum annual premium per dwelling is \$345, including GST.

Note: The maximum annual premium = breakeven premium x EQC cap.

Table 2: Updated exposure figures and levies (essentially an update of some components in Table 6 for 2020).

All figures in \$m unless explicitly stated otherwise

	Year	2016	2020	2020	2020	2020	2020
	Buildings	\$150k cap	\$150k cap	\$200k cap	\$250k cap	\$400k cap	uncapped
	Contents	not included	not included	not included	not included	not included	not included
Expected Cost of Claims ⁽¹⁾							
	Earthquake		173.6	180.8	184.8	189.4	190.9
	Volcano		103.5	109.6	110.8	112.9	113.9
	Tsunami		73.5	98.0	122.6	159.3	163.4
	Attritional		32.1	32.1	32.1	32.1	32.1
	Total Expected Cost of Claims:		382.7	420.5	450.2	493.7	500.3
Expenses ⁽²⁾							
	Cost of risk financing ⁽³⁾		154.3	158.9	162.0	165.1	170.3
	Total Break Even Premium Pool		617.1	659.4	692.3	738.8	750.6
Gross total sum insured ⁽⁴⁾							
	Break Even Premium (\$)	0.20	261,558	338,920	404,452	520,397	576,191
	Break Even Premium (\$)	0.20	0.24	0.19	0.17	0.14	0.13
Number of risks ⁽⁵⁾							
	Average Break Even Premium per risk (\$) ⁽⁶⁾		1,773,114	1,773,114	1,773,114	1,773,114	1,773,114
	Average Break Even Premium per risk (\$) ⁽⁶⁾		348	372	390	417	423
	Final EQC premium (including 15% GST)	345	414	437	489	644	