

The Treasury

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

October 2021

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<https://www.treasury.govt.nz/publications/information-release/proactive-release-treasury-advice-related-increase-eqc-residential-building-cap>

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- [25] 9(2)(b)(ii) - to protect the commercial position of the person who supplied the information or who is the subject of the information
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- [27] 9(2)(ba)(ii) - to protect information which is subject to an obligation of confidence or which any person has been or could be compelled to provide under the authority of any enactment, where the making available of the information would be likely otherwise to damage the public interest
- [33] 9(2)(f)(iv) - to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials
- [34] 9(2)(g)(i) - to maintain the effective conduct of public affairs through the free and frank expression of opinions
- [35] 9(2)(g)(ii) - to maintain the effective conduct of public affairs through protecting ministers, members of government organisations, officers and employees from improper pressure or harassment;
- [38] 9(2)(j) - to enable the Crown to negotiate without disadvantage or prejudice
- [39] 9(2)(k) - to prevent the disclosure of official information for improper gain or improper advantage

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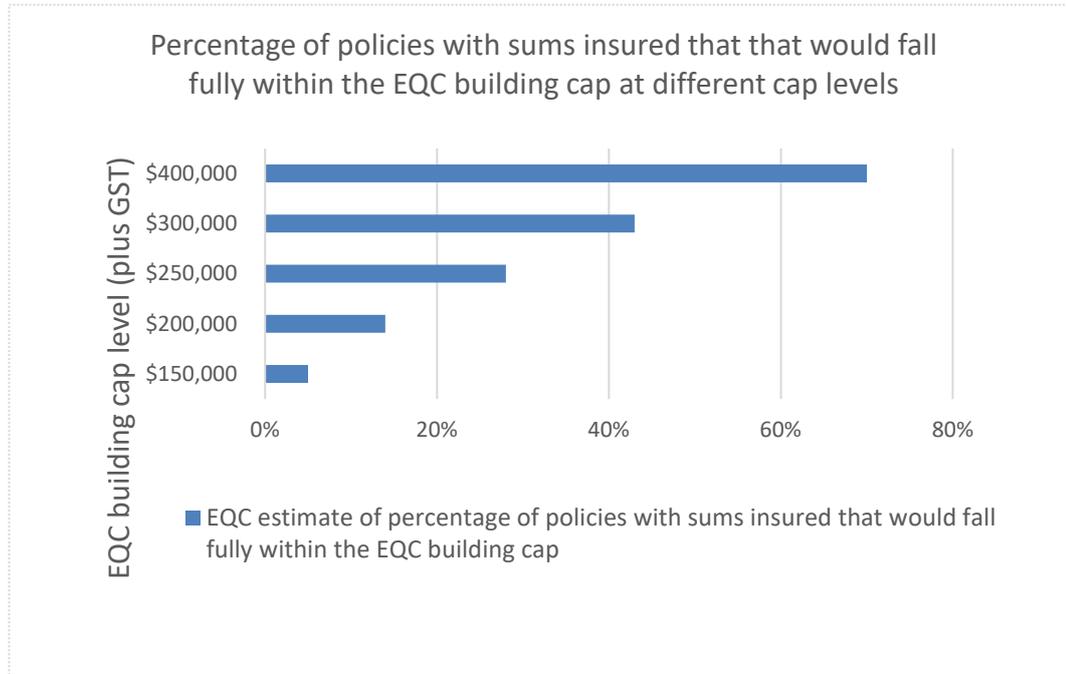
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Additional Information

To support our advice, IAG provided data to us on a commercial-in-confidence basis. We have withheld that material. We have recreated the relevant graph without IAG's data.

Chart 1¹



¹ These charts show EQC modelled estimate subject to a range of assumptions and derived from publicly available rateable valuation data and estimate rebuild costs based on a sample of construction types)

Treasury Report: Modernising the Earthquake Commission Act: Summary of advice on the EQC cap

Date:	1 April 2021	Report No:	T2021/760
		File Number:	SH-11-4-3-4-7

Action sought

	Action sought	Deadline
Minister Responsible for the Earthquake Commission (Hon Dr David Clark)	<p>Agree to your preferred increase to the EQC cap.</p> <p>Indicate your preferred mechanism for implementing an EQC cap increase.</p> <p>Agree to review the EQC cap either through a five-year review or annually.</p> <p>Forward this report to the Minister of Finance.</p>	Tuesday 6 April 2021

Contact for telephone discussion (if required)

Name	Position	Telephone	1st Contact
Siobhan Duncan	Senior Analyst, Financial Markets ^[39]	N/A	✓
Sam Thornton	Acting Manager, Financial Markets	^[35]	

Minister's Office actions (if required)

Return the signed report to the Treasury.

Note any feedback on the quality of the report

Enclosure: No

Treasury Report: Modernising the Earthquake Commission Act: Summary of advice on the EQC cap

Executive Summary

The purpose of this report is to seek your decision about what level the Earthquake Commission (EQC) building cap should be set at.

Cabinet's objective 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. We provided substantive advice about how to support those objectives in December 2020 (T2020/3282 refers). The Treasury's recommendations are unchanged from that report. Since then, we have met with you to discuss that advice, and you have also met with several insurers to get their feedback on a cap increase.

We understand that you want to achieve the following objectives for residential property insurance in New Zealand:

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

An increase in the EQC building cap can support some of your objectives through putting downward pressure on insurance prices in areas with high seismic risk, which could encourage the continued high uptake of residential property insurance. High uptake of insurance can support the resilience of New Zealand and mean we are in a better position following a natural disaster.

The key trade-offs with an increase to the EQC cap are that:

- homeowners in lower-risk areas could see increases to their insurance premiums
- a high cap could mute the price signal from insurance and therefore incentives to build resiliently
- a higher cap may increase pressure on the Government to include other perils such as storm surge and flood in the EQC building cap. If the EQC cap is extended to include these perils, this could signal how the Government might deal with climate change-related loss.

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 can support some of your objectives for affordability and availability of residential insurance in high risk areas, while minimising some of the unwanted consequences of a cap increase.

The EQC cap can be increased either by regulation or legislation. If you prioritise faster implementation, we suggest that you increase the cap by regulation, then confirm this later in the forthcoming Bill to modernise the EQC Act.

Ideally, commencement dates for changes to the EQC cap would align with the annual renewal of EQC and private insurers' reinsurance contracts in June each year. 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.

If you announce a decision to increase the cap following Cabinet confirmation in May 2021, and introduce the regulations shortly after, this will give insurers 13 months to implement the changes. Any delays to the timing signalled above will create more challenges in achieving the timeframe, which insurers already see as challenging.

Recommended Action

We recommend that you:

- a **note** that increasing the EQC cap is likely to have some positive, but limited, impacts in aggregate for residential property insurance affordability and availability in high risk areas
- b **note** that increasing the cap is likely to have some costs, including price increases for those in low risk regions, and muted insurance price signals (which could impact long-term incentives to improve building resilience)
- c **note** that to address Cabinet's objectives of ensuring that property insurance is affordable and available (particularly in higher-risk areas) and can appropriately contribute to New Zealand's long-term resilience, on balance the Treasury recommends increasing the cap to around \$200,000 plus GST

Either

- d **agree** to leave the cap at \$150,000 plus GST

Agree/disagree

Or

- e **agree** to increase the EQC cap to \$200,000 plus GST (*Treasury recommended option*)

Agree/disagree

Or

- f **agree** to increase the EQC cap to \$300,000 plus GST

Agree/disagree

Or

- g **agree** to increase the EQC cap to around \$380,000 plus GST (the average consented value of a new house in the year to February 2021)

Agree/disagree

- h **indicate**, if you decide to increase the cap, whether you prefer to do so via the forthcoming Bill to modernise the EQC Act or regulations made under section 36 of the EQC Act.

<i>Preferred mechanism for increasing the EQC cap</i>	
Bill to modernise the EQC Act	<i>Yes/no</i>
Regulations made under section 36 of the EQC Act	<i>Yes/no</i>

Either

- i **agree** to review the level of the EQC cap through a five-yearly review of the cap and other monitoring measures that the EQC Bill will establish (*Treasury recommended option*)

Agree/disagree

Or

- j **agree** to review the level of the EQC cap annually

Agree/disagree

- k **Forward** a copy of this report to the Minister of Finance.

yes/no.

Sam Thornton
Acting Manager, Financial Markets

Hon Dr David Clark
Minister Responsible for the Earthquake Commission

Treasury Report: Modernising the Earthquake Commission Act: Summary of advice on the EQC cap

Purpose of Report

1. The purpose of this report is to seek your decision about what level the EQC building cap should be set at.

Context

2. We provided our substantive advice to you in December 2020 in the Report *Modernising the Earthquake Commission Act: Options to address affordability and availability of insurance, including through the EQC cap* (T2020/3282).
3. The Treasury's recommendations are unchanged from that report. Since then, we have met with you to discuss that advice, and you have also met with several insurers to get their feedback on a cap increase. You received written briefings for the meetings with IAG, Tower, FMG, Suncorp, and Ando.
4. We have also provided the following two aide memoires:
 - *Modernising the Earthquake Commission Act: Percentage of houses falling fully within different cap levels* (T2021/24).
 - *House price increases and the Earthquake Commission cap* (T2021/342).
5. Our previous advice has considered the merits of other options that could achieve your objectives (summarised in Annex 3).

How the cap coverage has changed overtime

6. The EQC residential building cap was originally set at \$100,000 plus GST effective at the beginning of 1994. This was roughly the cost of building a basic house at that time. The intent was that the EQC's monopoly on disaster insurance cover should be discontinued, and that the scope of the EQC's cover would become progressively limited, as market conditions allowed and private insurance became available.
7. Based on data from Statistics New Zealand on the value of building consents, the average consented value of a new house (excluding land) is around \$380,000¹. The average consented value of a new dwelling unit (including houses, apartments, townhouses, granny flats and other dwellings) is around \$320,000.
8. The graph below shows that at a cap of \$400,000, the EQC estimates that 70% of policies would be fully covered by the EQC for EQC-covered perils.^[27]

¹ GST has been removed from the figures on Statistics New Zealand website for easier comparison against the EQC cap. Data is for the year ended February 2021.

Graph 1: EQC coverage at different caps

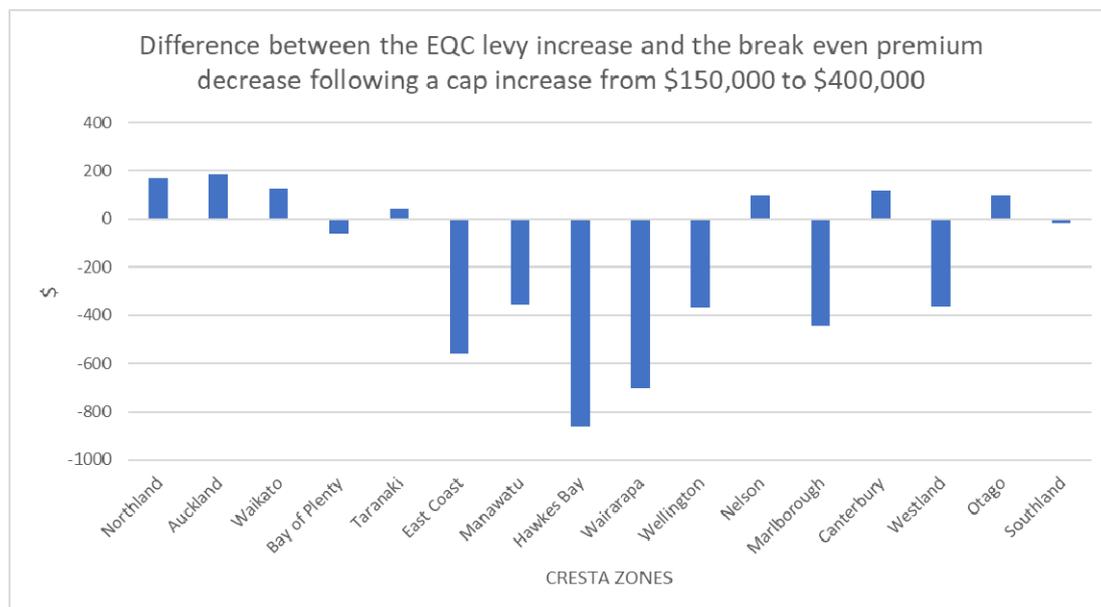
[27]

What the EQC cap does

9. Discussions about the EQC cap arose following Cabinet's agreement to objectives that residential property insurance should be available and affordable (refer DEV-19-MIN-0332).
10. As a blunt tool, the cap is effective in smoothing out the regional differences in prices that result from seismic risk. While insurers price insurance based on the risk, the EQC cap is currently priced on a flat community-rated basis, i.e., the EQC levy rate is the same rate for all homes regardless of underlying risks.
11. If the EQC cap is increased, homeowners receive more cover from EQC and less cover from insurers for EQC covered perils. As a result, properties that currently pay low amounts for natural disaster cover may see an increase to their prices, and regions that pay high insurance prices for natural disaster cover may see price decreases.
12. The main benefit from community-rating the EQC levy is that it could encourage a continued high uptake of insurance through downward pressure on prices. Insurers' use of granular pricing of risk has resulted in higher prices for some regions, however we have not seen evidence of a declining uptake of insurance in New Zealand.
13. Even though there is no widespread evidence that uptake is declining, you may want to maintain high uptake, and a higher EQC cap could support this. Policy interventions in other countries have had mixed success in improving property insurance uptake. On this basis, you may see a rationale for early intervention before evidence of declining uptake in order to support ongoing resilience. High uptake of insurance can also support people's sense of safety and security, and limit distress following a natural disaster.
14. Greater community rating of insurance prices could be justified on the basis that insurers have good models for seismic risk but rely on estimates for other risks such as volcanoes and tsunamis. Whilst there are models about the expected loss over time for different regions, we do not know where the next natural disaster will be in New Zealand.

15. Another aspect of community rating the risk is that, because there is a high uptake of insurance, there is a wide pool of levy payers. The cost of the cross subsidy from low risk to high risk areas is therefore able to be spread over a large group of properties.

Graph 2: Potential overall price effects of a shift to an EQC cap of \$400,000²



16. The key trade-offs with an increase to the EQC Cap are that:
- homeowners in low risk areas could see increases to their insurance premiums
 - a high cap could mute the price signal from insurance and therefore incentives to build for resilience, and
 - a higher cap may increase pressure on the Government to include other perils such as storm surge and flood in the EQC building cap. If the EQC cap is extended to include these perils, this could signal how the Crown might deal with climate change-related loss.
17. We have provided more detailed advice about the likely price impact of a cap increase on different regions (T2021-2537 refers). It is your decision whether you believe this redistribution is justified based on achieving the objectives you are seeking through the cap increase.
18. We have also provided advice about the role of insurance prices as a signal of risk.
- In the short term, insurance prices may spur tough decisions around necessary building strengthening or demolition of existing buildings. However, we have also heard that households facing high insurance prices have limited options to make changes to their homes in a way that will reduce their insurance premiums.
 - In the longer-term, insurance price signals create incentives to improve the resilience of new buildings. However, as insurance policies are renewed on an annual basis, it can be difficult to predict how insurance prices could change over the longer-term.
19. There are also other tools such as the Building Code that can support the resilience of the built environment.

² See Annex 2 for more context about how Graph 2 was made.

Fiscal risks

20. 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 levy, the price of 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 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 levy remains correctly priced to meet the expected losses and through the Government's risk management strategy, including the amount of reinsurance EQC purchases. For example, a cap increase results in higher levy revenue which enables more reinsurance cover to be purchased.

Is the EQC Cap regressive?

21. The EQC levy currently costs 20 cents for every \$100 (+GST) of home insurance that a home has with a private insurer, up to the maximum cover. The maximum annual cost for the levy is \$345 (including GST) per insured dwelling; homes with a sum insured that is less than the cap do not pay the maximum levy.
22. After a major earthquake, large homes are much more likely than smaller homes to claim higher amounts from EQC. While both properties pay the same levy into the scheme, people with larger and higher-value houses are likely to get greater benefits from the scheme. The higher the amount of the cap (especially at levels far above the average rebuild level), the less regressive the scheme is in this regard, as owners of houses under the cap will be paying lower levies than owners of more expensive houses.
23. However, in other respects, a higher cap could be considered more regressive. For example, if there is an element of government subsidisation in the scheme (i.e. where levies fall below the breakeven level over time), that is a subsidy from government to homeowners – the higher the cap, the higher the subsidy. A higher cap could also be considered more regressive in the sense that higher-risk locations like Wellington and Christchurch have relatively high average household incomes after housing costs, and homeowners in those locations are subsidised under the scheme by homeowners in lower-income regions.

Your objectives

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

25. There are trade-offs between your objectives. For example, at higher levels of EQC cap, regions that have a higher seismic risk will see more downward pressure on their insurance premiums which improves affordability. On the other hand, at higher levels of EQC cap, because there is downward pressure on insurance prices in regions with high seismic risk, this mutes the price signal.

The level of the EQC cap

26. The cap level requires choice along a spectrum, and there is no perfect level. A \$200,000 cap is preferred by the Treasury as it should have 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.

Your objectives	Status quo	Moderate cap increase (e.g. to \$200,000)	Large cap increase (e.g. \$300,000 or higher)
New Zealanders can access affordable residential property insurance, to ensure that as many New Zealanders as possible can repair their homes if they are damaged by a natural disaster.	Insurance prices have been rising especially in regions that have high seismic risk. Although we have not seen widespread evidence of diminishing uptake of residential property insurance, if rising prices do lead to this it can cause distress in communities after a natural disaster, and delay disaster recovery.	An increase to the cap will put some downward pressure on insurance prices in areas that have high seismic risk. It will also put some upward pressure on prices in lower-risk areas. A moderate increase to the cap leading to downward pressure in prices could support continued uptake of insurance. Higher-value properties are likely to see insurance price increases.	A large increase to the cap will have a greater impact on lowering insurance prices in regions with high seismic risk. It will also put more upward pressure on insurance prices for households in lower-risk areas. Higher-value properties may still see insurance price increases.
The risk to the Crown is minimised through having sufficient funds to repair/rebuild following a natural disaster.	Given high levels of insurance uptake, New Zealand is well placed to rebuild after a disaster. If rising prices lead to a reduction in insurance uptake, this can lead to fiscal risk as government may be drawn into ad hoc responses to private loss following natural disasters. If homes are under-insured, this could lead to a fiscal risk.	The fiscal risks described in the box to the left will be diminished as the EQC cap is increased but some groups such as multi-unit buildings (MUBs) are likely to continue to create a risk.	At higher levels of cap, the EQC is providing more insurance cover meaning people rely less on their private insurer to cover their risks. This is only the case for EQC-covered perils. Risks such as storm surge and flood cover for buildings will continue to be covered by the private market. Higher levels of the EQC cap increase the risk to the Government from the EQC scheme. However, this risk can be mitigated partly by ensuring the levy remains correctly priced to meet the expected losses, and through the Government's risk management approach, such as the amount of reinsurance EQC purchases.

<p>Insurance prices are used to signal risk.</p>	<p>Over the next few years, we expect to see continued granular risk pricing (different insurers are at different stages).</p> <p>Prices for MUBs are difficult to predict – they are likely to rise, with the highest risk the hardest hit.</p> <p>Beyond the next few years, prices may continue on an upward trend but with increases less severe as implementation of granular pricing comes to an end.</p>	<p>As a blunt tool, the cap is effective in smoothing out the regional differences in prices that result from seismic risk. A community-rated price could be justified on the basis that insurers have good models for seismic risk, but rely on estimates for other risks such as volcanoes and tsunamis.</p> <p>A moderate cap increase would mean that the majority of natural disaster insurance continues to be provided by the private market, meaning there would be a substantial amount of risk-based pricing.</p>	<p>At higher levels of cap, the EQC is providing more insurance cover at a community-rated price. This means people rely less on their private insurer to cover their risks, diminishing the price signal.</p> <p>This is only the case for EQC-covered perils. Risks that the EQC cap does not cover such as storm surge and flood cover for buildings will continue to be covered and priced by the private market.</p> <p>Even at cap levels of around \$400,000 plus GST, higher-value properties would still face granular risk-based, insurer pricing for EQC-covered perils.</p>
<p>There is a robust and competitive private insurance market.</p>	<p>We do not have evidence that tells us how competitive the insurance industry is, but we know it is concentrated. The Treasury has previously suggested that a Commerce Commission market study could be useful to inform policy making in this area.</p>	<p>A moderate increase to the cap is unlikely to have a significant impact on competition in the insurance market.</p>	<p>At higher levels of cap, the large insurers argue that the market becomes less attractive as they have less business and the risks left for them to insure above the cap are more volatile and unknown. Smaller insurers are either indifferent to, or supportive of, a cap increase. A better understanding of market competition would be particularly valuable before considering a significant increase.</p> <p>[38]</p>
<p>New Zealand continues to be able to purchase cost-effective reinsurance.</p>	<p>There is likely to be a slight hardening in prices in the global reinsurance market. However, there is still significant global capacity available to reinsure New Zealand natural hazard risks.</p>	<p>An increase to the cap is unlikely to change the overall level of reinsurance available for New Zealand. As EQC buys more reinsurance, insurers may reduce their reinsurance by a similar amount.</p>	<p>Same as to the left, however at higher EQC caps, EQC is likely to buy more reinsurance and private insurers may buy less.</p>

How the EQC cap can be adjusted

27. You have indicated that you would like advice about how the EQC cap could be adjusted for inflation.
28. 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 you to reconsider whether the level of cap is appropriate based on house cost inflation, and evidence of how the cap is impacting insurance prices (T2020/2886 refers).

29. House rebuild costs do not rise at the same rate as median house price inflation, as land is a big driver of price increases. For this reason, we recommend using the existing five-year funding review rather than a new process to consider cap increases.

Next Steps

30. The EQC cap can be increased either by regulation under section 36 of the EQC Act or via legislation.
31. If you prioritise the EQC cap change being implemented before the Bill to modernise the EQC Act is enacted, we suggest that you increase the cap by regulation, then confirm this increase in the Bill which will be introduced by the end of 2021.
32. Ideally for insurers and the EQC, commencement dates for changes to the EQC cap would align with the renewal of EQC and private insurers' reinsurance contracts, which happens in June each year. Aligning the cap increase with this date allows insurers and EQC to negotiate with reinsurers based on the new cap level. If these dates are not aligned, insurers and EQC may struggle to get the best reinsurance terms.
33. 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. They do not believe that a commencement in June 2022 is feasible.
34. If you announce a decision to increase the cap following Cabinet confirmation in May 2021 and introduce the regulations shortly after, this will give insurers 13 months to implement the changes. Insurers have signalled they do not think this timing is reasonable.
35. Following an implementation of a cap increase, any pricing changes will be passed on to customers as annual policies are renewed. It takes a full year before all insurance policies are renewed at the new EQC cap level.
36. Any delays to the timing signalled above will create more challenges in achieving the timeframe.

Annex 1: Australian Competition and Consumer Commission inquiry about insurance affordability and availability in northern Australia

The Australian Competition and Consumer Commission (ACCC) recently undertook a three-year inquiry to help the Australian Government address concerns about insurance affordability and availability in northern Australia, and to promote more informed and more competitive insurance markets. The inquiry largely focused on home, contents and strata (e.g. apartments) insurance for storm, cyclone and flood risks.

The ACCC concluded that there is not currently a significant widespread insurance availability issue, and rather for many households it is an issue of the cost of insurance becoming unaffordable. They noted that there is no single policy response that will resolve these acute affordability issues without a significant call on public funds or cross-subsidisation across consumers.

The ACCC recommendation is that a targeted direct subsidy would be the more effective, and lower cost, way to assist consumers experiencing acute affordability issues compared to other measures. This is due to the ability to provide immediate relief to customers facing acute pressures; the extent to which premiums are lowered being largely dependent on the funding amount of the subsidy. However, the ACCC did note that:

- Even a significant subsidy may not be sufficient to make insurance affordable for some higher-risk properties, but could help to make insurance more affordable to those who currently do not purchase insurance.
- There is a risk of distorting price signals to consumers and the subsidy being absorbed over time by insurers where price competition is not strong.

Affordability issues in northern Australian insurance markets are comparable to the issues being seen in some areas of New Zealand's property insurance markets. However, northern Australian affordability issues are for flood, storm and cyclone risks, compared to seismic risks in higher-risk regions in New Zealand, and the nature of these risks is quite different.

It is also important to note that northern Australia, in the twelve years to 2018-19, made up only about 5% of national insurance contracts. This means that the proportion of homeowners who are facing insurance affordability issues constitutes less than 5% of all of Australia. As large areas of New Zealand are subject to relatively high seismic risk, the scale of seismic-related affordability issues could be larger in New Zealand.

Annex 2: Pricing impacts of a cap increase

Community-rating risk

EQC community-rates the EQC levy so all properties pay the same levy rate for EQC cover. If the EQC cap was lifted to \$400,000, all properties that had a sum insured of \$400,000 would pay \$644 for EQC cover.

Risk-based pricing of regions based on Aon Modelling

We expect that low-risk areas pay relatively low retail prices for their catastrophe cover already.

For example, if the EQC levy was risk-priced for regional differences in risk, Aon modelling shows that EQC's average breakeven rate for a property in Auckland would be around 4 cents per \$100 insured when the cap is \$400,000. This means that the average property in Auckland would pay \$184 for \$400,000 of EQC cover at a breakeven premium based on EQC's expected losses for properties in that area.

A Hawkes Bay property has a breakeven rate of 56 cents per \$100 insured. A property with a sum insured of \$400,000 would therefore pay \$2,576 for EQC cover at a breakeven premium.

Table 1: Breakeven EQC premium for different CRESTA zones³ based on Aon Modelling⁴

CRESTA Code	CRESTA Name	(A) Regional risk- priced breakeven EQC premium at \$150,000 cap Incl GST	(B) Regional risk- priced breakeven EQC premium at \$400,000 cap Incl GST	(C) (= B – A) Breakeven additional premium from cap increase to \$400,000	(D) (=644 – B) Level of cross- subsidisation at \$400,000 cap
1	Northland	121	184	63	460
2	Auckland	138	184	46	460
3	Waikato	173	276	103	368
4	Bay of Plenty	535	828	293	-184
5	Taranaki	362	552	190	92
6	East Coast	914	1702	788	-1058
7	Manawatu	1070	1656	586	-1012
8	Hawkes Bay	1484	2576	1092	-1932
9	Wairarapa	1139	2070	931	-1426
10	Wellington	828	1426	598	-782
11	Nelson	328	460	132	184
12	Marlborough	983	1656	673	-1012
13	Canterbury	259	368	109	276
14	Westland	880	1472	592	-828
15	Otago	190	322	132	322
16	Southland	259	506	247	138
	Community rated premium	414	644	230	

³ 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.

⁴ This table was prepared by the Treasury based on Aon data provided by the EQC. Quality assurance was provided internally and by the EQC as thoroughly as time and availability of key staff allowed.

The table above shows the breakeven premiums for different regions at a \$150,000 cap (Column A) and at a \$400,000 cap (Column B). Column C represents the difference between Column B and A.

Column D shows the level of cross-subsidisation at a community-rated premium for a cap of \$400,000.

It shows that some regions such as Northland and Auckland pay more through the community-rated price than what it costs EQC to insure them. Other regions such as Wellington and Hawkes Bay pay less for EQC cover than it costs at a breakeven rate.

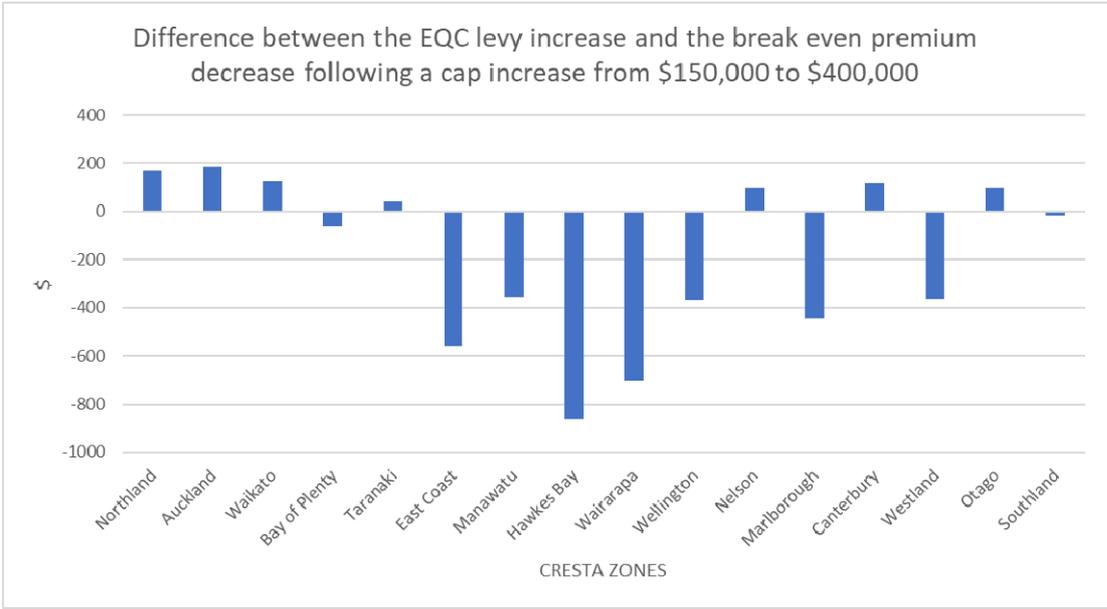
Premium impacts of a cap increase

If there is a cap increase from the current \$150,000 to \$400,000, the EQC takes on an additional \$250,000 of exposure for covered perils. At a community-rated price, the levy would increase from a breakeven rate of \$414⁵ to \$644, (an increase of \$230 to be paid by homeowners). The private insurers’ exposure for EQC-covered hazards would reduce by \$250,000. Insurers would no longer charge for that cover and should reduce premiums. Column C in Table 1 (above) explains how much this exposure costs EQC at a breakeven rate for each region.

If insurers had the same model as Aon used to calculate the figures in Table 1 for the breakeven premium, then Column C would be a good proxy for the amount that insurers may reduce their prices by. We do not know whether insurers’ breakeven price is comparable to Aon’s modelling. Insurers have told us that they use different risk models to the EQC.

Each household will experience both an increase in their EQC levy of \$230 and a reduction in their private insurance premium. The balance of these two factors will determine whether they see an overall increase or decrease in their insurance premium.

Graph 1: Potential overall price effects of a shift to an EQC cap of \$400,000



⁵ The current EQC levy is \$345 but this is based on 2016 modelling. The latest modelling suggests that a breakeven levy at the current cap is \$414. We have used the breakeven price in the examples above.

Graph 1 above illustrates the difference between the flat \$230 levy increase based on the community-rated premium and the breakeven premium decrease for each specific region following a cap increase from \$150,000 to \$400,000 (Column C in Table 1).

On this basis, areas like Auckland would pay \$167 more following a cap increase whereas Hawkes Bay pays \$862 less and Wellington \$368 less.

As well as the fact that insurers have different risk models to Aon, the graph does not take into account insurers' profit margins or how they would price the above-cap cover or perils such as storm and flood risk that are not covered by the EQC.⁶ This means there is uncertainty about the final premium customers will pay following a cap increase.

⁶ EQC only covers land for storm and flood events.

Annex 3: Alternative options

Problem definition and options

Insurance interventions can shift costs resulting in flatter prices between regions, but they do not deal with underlying risk. Increased insurance prices relate to a range of complex public policy issues and the preferred solution depends on the specific problem you are trying to address. We have set out below examples of three ways you could think about the problem and how this may lead to a different approach.

Regional differences in pricing due to different seismic risk

As a blunt tool, the cap is effective in smoothing out the regional differences in prices that result from seismic risk. A community rated price could be justified on the basis that insurers have good models for seismic risk, but rely on estimates for other risks such as volcanoes and tsunamis. Some higher risk, higher value MUBs may see only a limited price decrease following a cap increase because insurers still price a significant portion of their cover.

Genuinely high-risk buildings facing high insurance prices due to location/ build

An increase to the cap will put downward pressure on the premiums paid by higher risk buildings but will have a limited impact on high value MUBs. It would also mute potentially useful insurance signals. Targeted options may be more appropriate if you are worried about specific groups as there are opportunities to means test or link the solution to resilience or risk mitigation measures such as earthquake strengthening. IAG has written to the Minister about exploring insurer led targeted solutions.

Low risk buildings facing high insurance costs due to other factors (e.g. asymmetric information/uncompetitive market)

An increase to the cap will put downward pressure on the premiums paid by higher risk buildings but will have a limited impact on high value MUBs. We don't have any strong evidence that there are a lot of buildings in this category, but we also cannot rule that out. A market study into the insurance industry would help our understanding about whether the market is operating efficiently.

Targeted options

37. We considered at a high level some alternative options to the EQC cap to improve insurance affordability 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.
38. The Treasury's view is that targeted insurance options could be most appropriate either if there was a lack of insurance capacity for well-designed new builds on good land or for existing buildings with these characteristics that are struggling to get insurance at "affordable" rates. However, a government insurance intervention may not be the best answer where property owners are paying high insurance prices because of a significant level of risk due to the building.

39. The three targeted options that could be most effective are:
- *Targeted reinsurance* – to participating insurers in relation to high-risk MUBs and/or to incentivise resilient developments. This could reduce the cost to insurers 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, 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).
 - *Direct provision of natural disaster insurance for certain MUBs* – this could be via EQC, another government agency or 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 very involved decision making about how eligibility would be set out and how insurance would be priced, for example, whether the risk would be priced at a market price or lower than market with the government carrying the risk. If provided at a subsidised rate, cover could be linked to strengthening to a percentage of the building code, 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.
 - *Targeted EQC cap* – the cap could be increased to target particular buildings or areas, or just 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.
40. Each of the above alternative options has pros and cons. Generally, these options have the potential to provide premium relief and/or availability to buildings with insurance problems. Alternatively, they have the potential to be targeted at resilient new buildings to incentivise good development. However, they also involve significant design complexity and establishment costs, boundary issues (choosing how to determine which buildings have an acceptable/insurable level of risk and which ones don't as well as who gets the benefit of the targeted scheme), and a precedent for the approach to climate change induced loss. The risk would need to be financed, either through additional levies on property owners, or via general Crown/taxpayer subsidisation.

	Strengths	Weaknesses
No action	<ul style="list-style-type: none"> • Simple, no implementation • Lower fiscal risk than the other options, particularly while uptake remains high • Government does not further subsidise private property risk • Over time, price signals likely to lead to the demolition of unsafe buildings • No precedent set that government will take on private property risk caused by climate change 	<ul style="list-style-type: none"> • Does not address the financial pressures people face from high insurance premiums in high-risk regions (particularly Wellington), and could lead to non-insurance for buildings with particularly high prices • Could reduce the rate of intensification/developments in Wellington, acting as a barrier to achieving government housing policy in the region • Results in uncertainty for property owners, government and council
Moderate increase in the cap	<ul style="list-style-type: none"> • Simple, relatively easy to implement • Will have some impact on pricing in high risk regions, although not proportionate to risk transfer • A relatively simple and broad intervention, easy to understand and implement • [34] • Government and homeowners will have certainty about extent of customer coverage and levy 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 	<ul style="list-style-type: none"> • Price increases for lower risk regions like Northland, Auckland and Hamilton (some of these regions have lower average income after housing than high risk regions) • Not effective in solving the affordability problem for high-risk high value apartments • [34] • Higher Crown exposure • Precedent for Crown approach to climate risk

<p>Large increase in the cap</p>	<ul style="list-style-type: none"> • Simple, relatively easy to implement • Will have larger impact on pricing in high risk regions (although not proportionate to risk transfer) • A relatively simple and broad intervention, easy to understand and implement • [34] • Government and homeowners will have certainty about extent of customer coverage and levy up to cap amount (the higher the cap, the higher the certainty about the final premium) 	<ul style="list-style-type: none"> • Higher price increases for lower risk regions (e.g. Northland, Auckland, Hamilton), some of these regions have lower average income after housing than highest risk regions • Not effective in solving the affordability problem for particularly high-risk high value apartments • Mutes insurance price signals, and incentivises conversion of high-risk buildings to cheap apartments • [34] • Potential to cause larger insurers to consider exiting the residential property insurance market • Precedent for Crown approach to climate risk
<p>Cap increase targeted at certain properties</p>	<ul style="list-style-type: none"> • More targeted at localised issues • May be possible to design in a way that does not increase costs in low-risk areas • Could apply means testing 	<ul style="list-style-type: none"> • Adds complexity and administration cost into the EQC Scheme, which is currently simple • Difficult boundary issues (where does government draw the line on who gets the benefit?) • Increases risk weighting of EQC's portfolio • Not effective in solving the affordability problem for particularly high-risk high value apartments (unless taking very high levels of their risk) • Mutes insurance price signals • Precedent for Crown approach to climate risk

<p>Direct provision of natural disaster insurance for high-risk MUBs</p>	<ul style="list-style-type: none"> • More scope to directly impact availability and affordability • Potential for lower Crown risk-exposure compared with cap increase • Can be directly linked to resilience incentivisation • A less broad intervention for a localised issue (compared with the cap) - does not necessarily increase costs for lower risk regions • Does not require insurer agreement or rely on insurer pricing decisions 	<ul style="list-style-type: none"> • Higher administrative cost and longer implementation period • Less certainty for buildings about whether they are covered (compared with cap) • More pressure to decide what prices are reasonable • More intensive to maintain updated • Equity problems for buildings that are not covered but have high insurance costs • If heavily subsidised, would mute price signals and could come at significant fiscal risk
<p>Targeted reinsurance (e.g. Flood Re model)</p>	<ul style="list-style-type: none"> • More scope to directly impact availability and affordability for MUBs • No or lower Crown exposure (especially if actuarially priced) • Brings along private insurers (agreement and assistance) – ideally can be run by private sector • Can be directly linked to resilience incentivisation • Does not necessarily increase costs for lower risk regions 	<ul style="list-style-type: none"> • Higher administrative cost, longer implementation period, requires insurer agreement or leadership • More pressure to decide what prices are reasonable • Depending on design, could potentially have less certainty about who is covered (compared to cap) • Depending on design, equity problems for buildings that are not covered but have high insurance costs • Depending on subsidisation, could still mute price signals