The Treasury

Treasury Advice Related to Modernising the EQC Act Information Release

December 2021

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[33] 9(2)(f)(iv) - to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials

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[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

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TE TAI ŌHANGA
THE TREASURY

Treasury Report: Catastrophe Insurance: Policy Interventions and International Comparators

Date:	29 August 2019	**Report No:**	T2019/2590
		File Number:	SH-11-4-3-4-7

Action sought

	Action sought	Deadline
Hon Grant Robertson **Minister of Finance** **Minister Responsible for the Earthquake Commission**	**Agree** to discuss this report with officials on 5 September 2019. **Refer** this report to the Public Inquiry into the Earthquake Commission. **Refer** this report to the Community Resilience Ministers and other Ministers with related portfolios.	Meeting with officials at 10.45 am on 5 September 2019.

Contact for telephone discussion (if required)

Name	Position		Telephone	1st Contact
Steve Cantwell	Principal Advisor, Earthquake Commission Policy Team	[39]	N/A (mob)	✓
Shivani Middlemiss	Analyst, Earthquake Commission Policy Team		N/A (mob)	
Helen McDonald	Manager, Earthquake Commission Policy Team		[35]	

Minister's Office actions (if required)

Return the signed report to the Treasury.
Refer a copy to the Public Inquiry into the Earthquake Commission.
Refer the report to the Community Resilience Ministers and other Ministers with related portfolios.

Note any feedback on the quality of the report	

Enclosure: No

Treasury Report: Catastrophe Insurance: Policy Interventions and International Comparators

Executive Summary

Building on international experience

This report is part of a wider package of advice on property insurance in New Zealand

The report outlines a high-level policy framework for government-sponsored catastrophe insurance or reinsurance schemes. This framework sets out a range of interventions aimed at increasing either or both, the supply of, or demand for natural hazard property insurance. International examples of these supply and demand measures are provided to illustrate the benefits of various models and interventions.

This information is to help inform: decisions on the content of an upcoming Cabinet paper on property insurance markets (T2019/2190 refers), and the review of the Earthquake Commission (EQC) Act.

We recommend that you read the accompanying report on current market trends before you read this report (T2019/2234 refers).

Review of the Earthquake Commission (EQC) Act

The outcomes generated by the EQC scheme are closely linked to conditions in the private insurance market. The Government has indicated its intention to review the EQC Act. In addition to the impact of market trends on EQC, the Government has a number of strategic choices regarding the parameters of the EQC scheme and the functions of the EQC to help future-proof the scheme.

Next steps

Ahead of in-principle decisions in November 2019, we will provide you with advice on options for addressing property insurance pricing and availability issues, including analysis of how options affect the review of the EQC Act.

Recommended Action

We recommend that you:

a **agree** to discuss this report with officials on 5 September 2019 (as arranged with your office).

Agree/disagree

b **refer** this report to the Public Inquiry into the Earthquake Commission.

Refer/not referred

c **refer** this report to:

- the Community Resilience Ministers (the Minister of Local Government, the Minister of Civil Defence, and the Minister for Climate Change), and

- other Ministers with related portfolios (the Minister for Building and Construction, the Minister of Commerce and Consumer Affairs, and the Minister for Land Information).

Refer/not referred

Helen McDonald
Manager, Earthquake Commission Policy Team

Hon Grant Robertson
Minister of Finance
Minister Responsible for the Earthquake Commission

Treasury Report: Catastrophe Insurance: Policy Interventions and International Comparators

Purpose of report

1. The purpose of this report is to outline a high-level policy framework for government-sponsored catastrophe insurance or reinsurance schemes. We have provided you with international comparators to outline the benefits of various models and interventions.

2. This information is to help inform: decisions on the content of an upcoming Cabinet paper on property insurance markets (T2019/2190 refers), and the review of the Earthquake Commission (EQC) Act.

3. This report is part of a wider package of advice on property insurance. We recommend that you read an accompanying report on current market trends before you read this report (T2019/2234 refers).

Background

4. New Zealand property insurance is undergoing a period of change. There appear to be large price increases and challenges accessing insurance in some areas and for certain property types. Early indications show that pricing is attributed to seismic risk (T2019/2234 refers).

The New Zealand intervention in catastrophe insurance

5. The current government intervention in catastrophe insurance is the EQC scheme. EQC is an example of what is sometimes called a “protection gap entity” (PGE). PGEs are government-owned or mandated institutions that use market mechanisms (typically insurance or reinsurance) to advance governments’ social objectives (Jarzabkowski, Chalkias, Cacciatori, & Bednarek, 2018). The EQC provides first loss cover for natural disaster risk for residential properties up to a cap, with insurers providing coverage for the damage incurred above that cap.

6. Without EQC cover, international evidence suggests that many New Zealand homeowners would be underinsured or uninsured against natural hazard risks. In such situations governments face significant pressure to provide ad hoc assistance to those homeowners after large natural disasters, and have a diminished level of resilience to shocks. This creates risks and uncertainty for homeowners, insurers and government.

7. Three features of the current intervention through the EQC scheme combine to support high rates of catastrophe insurance coverage:

   - **coverage:** EQC covers the first $150,000 (+GST) of natural hazard loss. EQC modelling suggest this captures 87 percent of EQC-modelled long-run residential losses, relieving private insurers (and the associated private premiums) of this risk,

   - **affordability:** EQC’s premium is the same nationwide. This means EQC cover for higher-risk areas and buildings is affordable (as it is cross-subsidised from lower-risk participants in the scheme), and

- **ubiquity:** EQC cover is mandatory for residential buildings privately insured against fire. Therefore residential owners cannot buy fire insurance without also buying at least EQC cover against natural catastrophe. Private insurers collect and pass on the associated EQC premiums.

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

9. The Government has indicated its intention to review the EQC Act. In addition to the impact of market trends on EQC, there are a number of other strategic choices, regarding the parameters of the scheme and the functions of the EQC. Strategic choices between policy interventions may help future-proof the scheme. If not progressed sooner, the review is an opportunity to consider a range of measures for modifying the existing EQC scheme, including, raising the EQC cap and extending coverage for particular property types.

Frameworks and examples from other countries

10. Internationally, successful government interventions must increase either or both the *supply* of, and *demand* for, natural hazard property insurance (OECD, 2018).[1]

11. Broadly, there are a number of ways in which governments can increase the supply of, and demand for insurance (as advised previously, T2019/1337 refers, see Annex 1 for further details). On the supply side, measures include:

    - government provision of catastrophe insurance or reinsurance,
    - insurer regulation or compulsion, and
    - better understanding and management of risk by insurers.

12. On the demand side, measures include:

    - better policy-holder/property-owner understanding and management of risk,
    - financial support to take out insurance, and
    - buyer compulsion.

13. A number of interventions could be combined. For example, government could directly provide insurance or reinsurance (a supply side option), while incentivising better policy holder/property information (a demand side option).

14. The current government intervention in catastrophe insurance through the EQC scheme increases *supply* directly, and indirectly by making private top-up cover more attractive for insurers to offer, and by funding research that helps insurers and other stakeholders understand New Zealand risks and mitigations. It increases homeowner *demand* for disaster insurance though research and education, the flat-rate pricing structure, and the requirement that cover compulsorily attach to fire insurance. This prevents homeowners buying fire cover without buying any catastrophe cover (as is common in other countries).

[1] We have found 49 different international catastrophe schemes in our research (both public and private). A select number are described in this report based on relevance. We are able to provide you with additional advice, if you have a particular interest in any country or scheme.

Measures to boost insurance supply

15. As noted, the government has a number of strategic choices in increasing the supply of insurance, including through ownership (*direct government provision* of insurance or reinsurance), or through regulation (*insurer compulsion or regulation*), e.g. specifying aspects of the coverage or terms of private insurance policies.

16. In deciding between these two broad approaches, a key question is the relative willingness and ability of the government, or private insurers and reinsurers, to bear the policy-relevant risks. Other questions include, the impact the intervention may have on claims management, and in post-disaster recovery.

Government provision of catastrophe insurance

17. The following are some international comparators that provide insights into other models of insurance coverage and relevance to New Zealand.

Consorcio de Compensacion de Seguros (CCS) (Spain)

18. The CSS is a government administered programme in Spain. Certain forms of insurance are extended through the CSS, including for natural hazard, seismic, and terrorism risk. The CSS only pays out if the risk is not covered by private insurers. Premiums are part of a mandatory additional coverage attached to private insurance (OECD, 2005). Premiums have flat-based pricing (Consorcio de Compensacion de Seguros, 2019).

Turkish Catastrophe Insurance Program (TCIP) (Turkey)

19. Created after the Marmara earthquake in 1999, the TCIP has a number of similarities to the EQC scheme. These include a set premium and a cap, and the requirement for private insurers to attach earthquake coverage on TCIP's behalf as part of their policies. Earthquake insurance is compulsory for owners of particular types of land. Prior to the creation of TCIP, the Turkish government provided ad hoc post-disaster recovery support, including the rebuilding of private homes.

Government mandated, insurer owned

20. Not all of the international insurance schemes are government owned, and managed. The following schemes have a government mandate, but are privately funded.

Government provision for catastrophe reinsurance

21. A reinsurance scheme provides a mechanism for insurers to transfer risks to other insurers (in essence, reinsurance schemes act as insurance for insurers).

Flood Re – United Kingdom (UK)

22. Flood Re is an insurer initiated reinsurance scheme in the UK (Environment, Food and Rural Affairs Committee, House of Commons, 2013). Flood Re is a transitional arrangement intended to end by 2039 (Flood Re, 2018). Every insurer in the UK that provides a form of home insurance, is required under legislation to pay a levy into the Flood Re fund. The insurer can choose to pass flood risk to Flood Re for a fixed price, however the insurer is responsible for claims management.

Japan Earthquake Reinsurance Company (JER)

23. The JER is owned by Japanese insurers, and provides reinsurance. The underlying principle of JER is availability of insurance. Earthquake cover is available as an optional attachment to fire cover for private insurance policies. The earthquake policies are then fully reinsured with JER.

Implications

24. More complex reforms, such as establishing insurer-owned reinsurers along the lines of Flood Re or JER would be a major change in New Zealand reinsurance markets, and insurers' relationship with their reinsurers. Such a reform would be unlikely to succeed without strong support from insurers (Flood Re and JER started as insurer-led initiatives).

25. A reinsurance model would move substantial natural hazard risks to private insurers. Requiring insurers to cover earthquake risk could exacerbate current price and availability pressures in higher-risk areas and building types. We have not sounded out New Zealand-based insurers on their views regarding establishing a government-mandated, industry-based catastrophe reinsurer such as Flood Re, but anticipate that they would oppose it.

Parametric insurance

26. A parametric product involves a pre-agreed payment for policy holders. This claim is guaranteed once an event occurs meeting a pre-defined parameter or metric. Parametric insurance involves short-term liquidity. This results in governments being able to potentially undertake a fast settlement process. Importantly, parametric insurance does not cover the actual loss suffered, rather it provides a pre-defined amount.

Caribbean Catastrophe Risk Insurance Facility (CCRIF) (Caribbean)

27. An international comparator for parametric insurance is the Caribbean Catastrophe Risk Insurance Facility (CCRIF). The CCRIF enables member governments to purchase various catastrophe coverage through parametric products (The Caribbean Catastrophe Risk Insurance Facility, 2018). This limits the fiscal impacts of natural disasters to the Caribbean. CCRIF is not a sole government or state intervention. It is a not-for-profit company with a multi-country pool, and reflects recent trends in insurance markets around parametric products.

28. The trade-off for parametric insurance is that policy holders may be underinsured. This type of scheme is likely to be unsuitable for homeowners in New Zealand, as levels of underinsurance would likely result in an ad hoc government intervention post disaster.

Insurer regulation or compulsion

29. Insurer compulsion measures range from simply requiring insurers to cover a certain risk, to more complex designs. This includes the creation of bespoke entities with special regulatory powers or protections (such as a compulsory insurer-owned mutual reinsurer), insurer compulsion with government ownership, and insurer-government sharing of the insured risk.

California

30. This design complexity of insurer compulsion is often in response to concerns that simply requiring insurers to cover certain risks will not achieve the policy aims of increasing insurance supply. 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 in 1996.

California Earthquake Authority (CEA) (State of California, USA)

31. The CEA is a publicly-managed, but privately-funded insurance scheme. In California, private insurers can provide their own earthquake insurance or become a participating insurance company in the CEA (selling the CEA policy). Between 10-15% of

Californian homes have cover through the CEA (California Earthquake Authority, 2019). A combination of the mandated actuarial pricing, high claims excesses, and higher premiums for some properties, has likely affected the uptake of insurance (Middleton, 2012).

Better understanding and management of risk by insurers

32. As part of the measures to improve the supply of insurance, measures can be taken to improve the understanding of risk by insurers. The reflection of these risks in insurance pricing can, in turn, incentivise reductions in levels of risk. In New Zealand, the current intervention in catastrophe insurance includes funding of hazard research through the EQC. [2]

33. There are also measures that could be undertaken to help building performance, including stronger building codes, land planning rules, and flood protection works. However, these measures are unlikely to mitigate against all factors, for example property owners are unable to change soil type, which impacts on risk (T2019/2234 refers).

Texas Windstorm Insurance Association (TWIA) (State of Texas, USA)

34. The TWIA is an example of a Fair Access to Insurance Requirements (FAIR) Plan, which is a state-mandated programme allowing access to insurance for individuals who are unable to insure their property due to a high level of risk. In order for property owners to qualify to TWIA, they must meet certain requirements. This includes meeting windstorm building codes (Texas Windstorm Insurance Association, 2019).

Measures to boost insurance demand

35. The government has a number of ways to intervene in the demand for insurance. However, the implications and merits of demand side measures are shaped by the decisions regarding insurance supply. For instance, an informed assessment of the merits of compulsory insurance requires a view on how that insurance is being priced. Additionally, boosting demand for insurance without improving supply may increase the price of premiums.

Better policy-holder/property-owner understanding and management of risk

36. Price signals sent through catastrophe insurance are related to consumers' understanding of risk. There are a number of ways in which government may be able to intervene to better inform homeowners. In particular, regulations could be utilised to aide in the transparency of consumer information.

Northern Australia Insurance Inquiry, Australian Competition and Consumer Commission (ACCC) (Australia)

37. In 2018, the ACCC established an insurance inquiry following concerns about insurance availability and affordability in Northern Australia. The following summarises some of the recommendations regarding information disclosure from the ACCC:

- disclosure of the premium, sum-insured and excess in renewal notices,
- insurance costs and renewal periods provided to consumers before a property is purchased, this includes information on the sum-insured, and

[2] Two of the 11 National Science Challenges are focused on natural hazard risk and climate change. In addition, the EQC has a statutory function "to facilitate research and education about matters relevant to natural disaster damage, methods of reducing or preventing natural disaster damage, and the insurance provided under this Act" (s. 5(e))

- information on how mitigation measures are utilised to reduce premiums, and discounts provided on those properties that adopt mitigation measures (Australian Competition and Consumer Commission 2019).

38. The government department considering insurer conduct is the Ministry of Business Innovation and Employment (MBIE). As part of the new conduct regime for financial institutions, a framework will be available to provide greater disclosure to customers (DEV-19-MIN-0082 refers). The intention is for legislation to be introduced by the end of this year. We have discussed our work on property insurance with MBIE, and will continue to maintain connections across work streams as we provide you with additional advice.

Financial support to take out insurance

39. Financial support includes a range of measures such as non-market pricing, premium subsidies, co-payments or vouchers. Flat-rate pricing, as currently practiced by the current government intervention through the EQC scheme, can be viewed as financial support for policyholders exposed to above-average risks. Internationally, financial support has not been widely adopted as a government intervention.

Buyer compulsion

40. Buyer compulsion can include either compulsory attachment of government cover to private cover (e.g. EQC), or compulsory insurance. Buyer compulsion would increase the uptake of insurance. New Zealand currently has a high penetration of property insurance, compared to international schemes. Compulsion is unlikely to impact on the granularity of price for consumers. Compulsory attachment to private cover is common practice internationally (e.g. EQC and TCIP).

Working across government

41. There are a number of work streams across government looking at resilience, risk mitigation, and climate change that will have an impact longer-term on the risks associated with catastrophe insurance. We will consider the wider implications of various work streams in more detailed advice.

42. The Earthquake Commission, Department of Internal Affairs, Ministry for the Environment, Reserve Bank of New Zealand, Ministry of Business Innovation and Employment, Financial Markets Authority, and Ministry of Housing and Urban Development were consulted on this report. The Department of the Prime Minister and Cabinet was informed. The Public Inquiry into the Earthquake Commission has requested this report for their information purposes.

Risks

43. The Public Inquiry into the EQC is reporting on operational experiences for the EQC after the Canterbury earthquakes. There are a wide range of issues that can be most usefully be progressed after the Inquiry reports. We suggest that technical changes to the EQC be made after the Inquiry has reported back in March 2020.

Next Steps

44. Ahead of in-principle decisions in November 2019, we will provide you with advice on options for addressing property insurance pricing and availability issues, including analysis of how options interact with the review of the EQC Act. (See Annex 2 for an indicative structure and timetable for enacting an EQC Bill).

Paper	*Description*	*Timing*
Property insurance market trends	Noting briefing outlining current knowledge of property insurance price and availability trends, including information on risk-models used by insurers and the status of reinsurance markets for New Zealand risk.	Late August 2019
Intervention options	Advice on recommended options to be developed further for addressing any identified problems in property insurance markets.	September 2019
Cabinet paper and regulatory impact assessment	For consideration by DEV in November 2019 – to seek agreement in-principle on recommended or prioritised options for addressing property insurance pricing and availability issues.	October-November 2019
Public Inquiry into EQC reports	Government response to the Public Inquiry into EQC may have some overlaps with insurance pricing and availability issues.	March-April 2019

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Texas Windstorm Insurance Association (2019), Coverage and Eligibility, https://www.twia.org/

Annex 1: Measures to boost the supply and demand of catastrophe insurance

Measures to boost insurance supply

Measure	How it improves residential insurance uptake	Impact on customers	New Zealand responses / actions
Government provision of catastrophe insurance or reinsurance	Improves uptake by transferring risk to the Crown and spreading the cost of insurance across a broader group of insureds (with no profit margin to compensate for the risks).	A government entity could be customer-facing, and able to handle its own claims. This can provide the Government with options around the role played by the government entity in recovery following a major event.	EQC (note that this only applies to residential properties).
Insurer regulation or compulsion	Improves uptake for higher-risk properties by transferring risk to insurers who may recover some or all of the cost of insuring higher-risk properties from other insured customers.	Customers would continue dealing with private insurers. However, customers may lose access to insurance if regulation causes insurers to exit the market.	New Zealand does not require private insurers to provide cover.
Better understanding and management of risk by insurers	Improves uptake for properties which are found to be lower-risk than previously understood, and properties for which adaptation measures have reduced the long-term probability of loss from natural hazards.	Customers receive additional information about risks to their properties.	Measures include funding hazard research, (which reduces uncertainty, but can increase or decrease assessed risk) and better management of underlying hazards, through research on, for example, building performance, stronger building codes, planning, and flood protection.

Measures to boost insurance demand

Measure	How it improves residential insurance uptake	Impact on customers	New Zealand responses / actions
Better policy-holder/property-owner understanding and management of risk	Can support better understanding of the value of insurance to property owners.	Customers receive additional information about their insurance. This could be done through greater education on the nature of catastrophe insurance.	The EQC's statutory research and education function.
Financial support to take out insurance	Improves uptake for higher-risk properties (and reduces uptake for lower-risk properties) if it shares risk across all property owners through flat-rate pricing structures (e.g. EQC).	Customers would be incentivised to take-up insurance. For example, customers may receive a subsidy to insure against catastrophes. This may create moral hazard, where customers may not mitigate against existing risks.	EQC flat-rate pricing can be viewed as financial support for policyholders exposed to above-average risks.
Buyer compulsion	Impact on uptake depends on how granular the price is.	Customers would be provided coverage through their private cover.	Compulsory attachment of government cover (EQC) to private cover. Section 135 of the *Unit Titles Act 2010* requires body corporates to insure to full insurable value.

Annex 2: Enacting an EQC Bill

Enacting an EQC Bill that is well-informed by policy analysis and stakeholder engagement requires a number of phases that in total are likely to spread over several years. An indicative timeline following a standard policy process is as follows:

Indicative timing	Phase
To March 2020	Policy development (i.e. reports and meetings with you) and informal stakeholder engagement prior to Inquiry reports to progress issues that can be progressed prior to Inquiry report.
To late 2020	Policy development and stakeholder engagement following Inquiry report to progress remaining issues, culminating in Cabinet paper(s) seeking policy approval for proposals, and approving release of discussion document.
November 2020	Next general election required on or before 21 November 2020.
Late 2020	Final policy decisions for public consultation – Cabinet policy paper.
February 2021	Discussion document released (seeking public feedback on intended reforms, typically 6-12 weeks for submissions).
December 2021	PCO draft bill (we anticipate PCO requiring at least 16 weeks).
February 2022	Cabinet approve exposure draft of bill release, exposure draft released for public comment (typically 3-6 weeks for comment).
May 2022	Cabinet approves bill as amended for introduction, bill introduced.
Late 2022	Parliamentary process and passage (assuming usual 6 months consideration by select committee).
2023-2024	Phased implementation of new legislation (insurers have previously indicated that for major changes they need at least 18 months between enactment and implementation).