

The Treasury

Treasury Advice Related to Modernising the EQC Act Information Release

December 2021

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Treasury Report: Future EQC Policy Work: Policy Rationale and Intervention Model (Report 2 of 2)

Date:	12 March 2020	Report No:	T2019/4058
		File Number:	TY-2-1-17 (Disaster Insurance)

Action sought

	Action sought	Deadline
Hon Grant Robertson Minister Responsible for the Earthquake Commission	Confirm , for the time being, to retain the EQC scheme current policy rationale.	Prior to your meeting with officials at 3:30pm on 17 March 2020

Contact for telephone discussion (if required)

Name	Position	Telephone	1st Contact
Craig Fookes	Principal Advisor, Earthquake Commission Policy Team ^[39]	N/A (mob)	✓
Helen McDonald	Manager, Earthquake Commission Policy Team	^[35]	

Minister's Office actions (if required)

Return the signed report to Treasury.

Note any feedback on the quality of the report

Enclosure: No

Treasury Report: Future EQC Policy Work: Policy Rationale and Intervention Model (Report 2 of 2)

Executive Summary

The scope and sequencing of decisions around the future design of the Earthquake Commission (“EQC”) scheme is complex and difficult to anticipate given the multiple streams of advice that will consider the future of the scheme from different perspectives throughout 2020. These include:

- advice in our companion report on the scope and timing of a review of the EQC scheme (T2020/212 refers)
- the report of the Public Inquiry (the “Inquiry”) into the Earthquake Commission (late March)
- advice on the affordability and availability of residential property insurance (April), and
- advice on the review of the EQC Act (the “Act”)(June-December).

To provide context for your future consideration of changes to the design of the EQC scheme, this report provides background advice on the current policy rationale for the EQC scheme and the current features of the intervention model.

Our forthcoming advice on residential property insurance and the Inquiry will focus primarily on issues relating to earthquake cover. Notwithstanding this, the policy rationale discussed in this report is relevant to the other perils that the EQC cover. These perils would be considered within the proposed review of the Act.

The policy rationale of the EQC insurance scheme

The EQC insurance scheme provides compulsory first loss catastrophe insurance cover direct to the owners of residential properties.

The overriding policy rationale of the EQC scheme is to minimise socially unacceptable distress (or loss) to avoid the need for an *ad hoc* intervention after a major event. The scheme achieves this by encouraging high levels of insurance uptake.

A high level of insurance ensures that sufficient capital will be available to rebuild and/or recover after a major natural disaster.

The scheme’s current policy rationale will be considered when developing forthcoming advice

The recommendations arising from the Inquiry and the residential property insurance work will consider the EQC scheme from different perspectives.

To ensure we have a common basis for assessment this report recommends that you retain the current policy rationale of the EQC regime for the time being, then reassess that rationale once you have made decisions on the residential property insurance work and decisions on the Government response to the Inquiry.

As discussed in the companion paper, the extent to which decisions are consistent with the current policy rationale of the EQC scheme will be a key determinant of whether the scope of the review should adopt an “*evolutionary*” versus “*first principles*” approach.

Further advice may be required on how, or whether, the purpose and/or policy rationale of the EQC scheme should evolve once the decisions on residential property insurance work have been made.

Strengths and limitations of the current intervention model

The EQC scheme targets the factors the scheme can directly influence (i.e. uptake of catastrophe insurance cover). EQC insurance cover automatically attaches to any private insurance policies offering cover for fire. The Act also defines the risks the EQC insurance scheme covers and the institutional and administrative mechanisms by which this risk is managed.

Changes to public cover redefine the risks covered by the insurance industry, but private and public EQC insurance cover distinct pools of risk. Our forthcoming advice on insurance pricing will discuss the level of influence that the EQC has and the range of other factors that private insurers will consider in setting prices.

Objectives for a review of the current scheme

Our past advice proposed four objectives or priorities to inform a review of the Act (T2019/77 refers). Our objectives for a review sought to ensure that the EQC scheme:

- continues to effectively deliver its purpose or policy rationale (objective one & two below)
- considers the wider public sector operating context and impact on or interaction with industry (objective three), and
- applies lessons from past events while ensuring consistency with other Government policy (objective four)

Our proposed objectives for a review were to:

- minimise the potential for property owners to experience socially unacceptable distress to reduce the need for *ad hoc* financial support following a natural disaster
- contribute to the effective management of fiscal risks
- support an efficient approach to the overall management of natural disaster risk and recovery, both nationally and across the regions, and
- the future of the Act both reflect lessons from previous events, and positions EQC to support government and national preparedness, mitigation and response to future natural disasters, including those exacerbated by climate change.

We are not seeking a decision on the objectives or scope of a review at this point in time.

We will provide follow up advice on our proposed objectives once you have made decisions on the Government response to the Public Inquiry and residential property insurance work.

Recommended Action

We recommend that you:

- a **note** the forthcoming advice on residential property insurance and the Inquiry into the Earthquake Commission (the “**Inquiry**”) will consider the future and purpose of the Earthquake Commission (“**EQC**”) insurance scheme from different perspectives
- b **confirm**, for the time being, to retain the EQC insurance scheme’s current policy rationale, which is to minimise socially unacceptable distress with a focus on ensuring that catastrophe insurance uptake remains high

yes/no
- c **note** the historic policy rationale (referenced in rec b) provides a common analytical basis for assessment, but this rationale may not fully capture the range of motivations the Government may have in considering change
- d **note** our forthcoming advice on residential property insurance and proposed response to the Inquiry will consider whether proposed changes support the current policy rationale for the EQC insurance scheme (referenced in rec b), and
- e **note** that the current policy rationale for the EQC insurance scheme (referenced in rec b) will be re-examined once the Government has made decisions on the residential property insurance work and its response to the findings of the Inquiry.

Helen McDonald
Manager, Earthquake Commission Policy

Hon Grant Robertson
Minister Responsible for the Earthquake Commission

Treasury Report: Future EQC Policy Work: Policy Rationale and Intervention Model (Report 2 of 2)

Purpose of Report

1. This report provides context about the policy rationale for the current Earthquake Commission (“**EQC**”) insurance scheme and the key features of the EQC intervention model. This context is intended to inform your consideration of the different streams of advice you will receive on potential changes to the design of the EQC scheme during 2020. These streams of advice include:
 - advice in our companion report on the scope and timing of a review of the EQC scheme (T2020/212 refers)
 - the report of the Public Inquiry into the EQC (late March)
 - advice on the affordability and availability of residential property insurance (April), and
 - advice on the review of the EQC Act (June-December).
2. This report also seeks your confirmation, for the time being, to retain the current overarching policy rationale for the EQC Act to minimise socially unacceptable loss by maintaining high levels of catastrophe insurance uptake. This will enable this policy rationale to be used as the starting point for assessment of potential changes to the EQC scheme in our forthcoming advice.
3. This report discusses our forthcoming advice on residential property insurance and the Inquiry, which will focus primarily on issues relating to earthquake cover. Notwithstanding this, the policy rationale discussed in this report is relevant to the other perils that the EQC cover. These perils would be considered within a review of the Act.

Background on EQC related work underway

4. As noted above, there are a number of streams of work underway, which are considering the future of the EQC scheme from different perspectives throughout 2020. We are keen to ensure that potential changes from each of these work streams are considered as a package to ensure that any changes: improve the operation of the Act; refine the quality of cover provided to customers; and advance the Government’s wider objectives for the scheme. The main work streams underway are listed below.

The Inquiry into the EQC

5. On 12 November 2018, the Government announced the Inquiry into the Earthquake Commission (the “**Inquiry**”). The Inquiry may recommend changes to how the EQC operates in future on the basis of lessons arising from the Canterbury earthquakes.
6. The Inquiry is scheduled to report back in late March.

Changes to improve affordability and availability of insurance

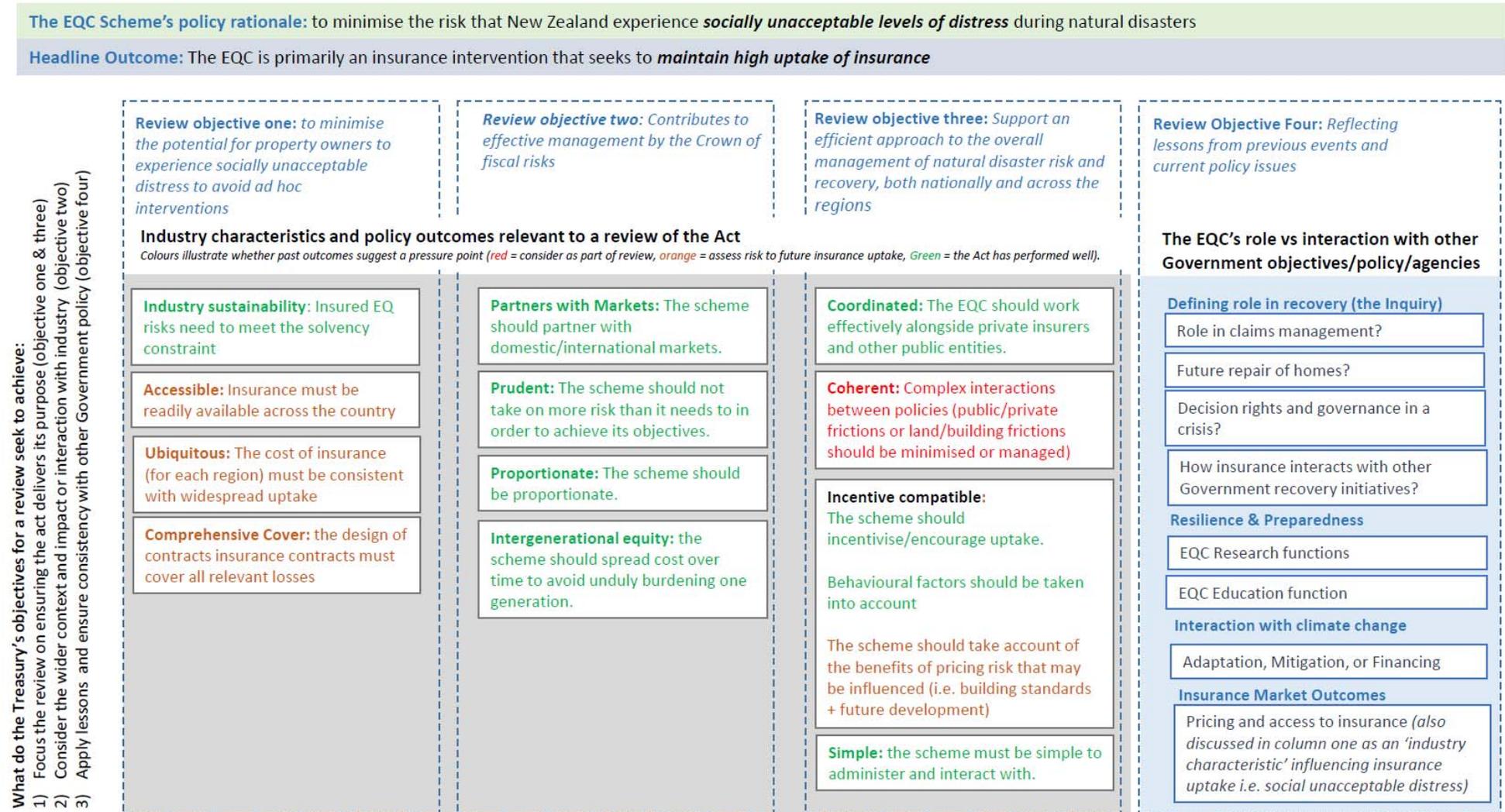
7. You have requested advice on whether changes to EQC insurance cover could address emerging issues relating to affordability and availability of residential property insurance in at-risk regions.

8. The Cabinet Development Committee agreed that you should report back on the following changes to the EQC insurance regime (DEV-19-MIN-0332):
 - A flat across-the-board increase to the \$100k EQC cap (the “**cap**”) up from \$150,000 to between \$250,000 to \$400,000
 - A targeted region-specific increase to the EQC cap (targeted at certain regions or property types), and
 - The provision of targeted natural hazard reinsurance (targeted at at-risk regions or property types).

A comprehensive review of the Act

9. As discussed in our companion paper *Future EQC Policy Work: Scope and Timing of Review of EQC Scheme and Act (Report 1 of 2)*, you have a range of options regarding the scope and timing of a review of the EQC Act, including targeted reform, evolutionary reform, or a first principles review.

Figure One: Objectives for a review of the Act and the wider outcomes the Treasury would consider



Use of the EQC scheme's current policy rationale in forthcoming advice

10. The policy motivation for a public insurance intervention has historically been that if homeowners are uninsured, future governments may feel compelled to provide *ad hoc* assistance and/or compensation. A regional rebuild will take time and will require significant resources. Post-event losses or distress that exceed community expectations, create an implicit liability for the government regardless of New Zealand's pre-disaster policy.
11. Given New Zealand's geography, there is a significant public interest in ensuring that New Zealand property owners insure their properties against natural disaster to ensure that damage remains *socially acceptable*. As such, the current policy rationale for the EQC scheme is to ensure that distress/losses remain socially acceptable by maintaining or encouraging high levels of catastrophe insurance uptake. Insurance is pre-funded to ensure the New Zealand population has the resources they may require to recover and rebuild.
12. To ensure we have a common basis for assessment this report recommends that you retain the current policy rationale of the EQC regime for the time being, then reassess that rationale once you have made decisions on the residential property insurance work and decisions on the Government response to the Inquiry.
13. The scope and sequencing of decisions around the review of the EQC Act is complex and difficult to anticipate given the multiple streams of advice that will consider the future of the scheme from different perspectives.
14. Opting to retain the current policy rationale at this point will not exclude any of the changes that you are considering, but it will provide a basis for assessment of potential changes. While a range of factors or outcomes are important, above all else we see high levels of insurance uptake to be central to the continued success of the EQC scheme.
15. As discussed in the companion paper, the extent to which decisions on other work are consistent with the current policy rationale of the EQC scheme will be a key determinant of whether the scope of the review should adopt an "*evolutionary*" versus "*first principles*" approach.
16. Further advice may be required on how, or whether, the purpose and/or policy rationale of the EQC scheme should evolve once the decisions on residential property insurance work have been made.

The current EQC intervention model

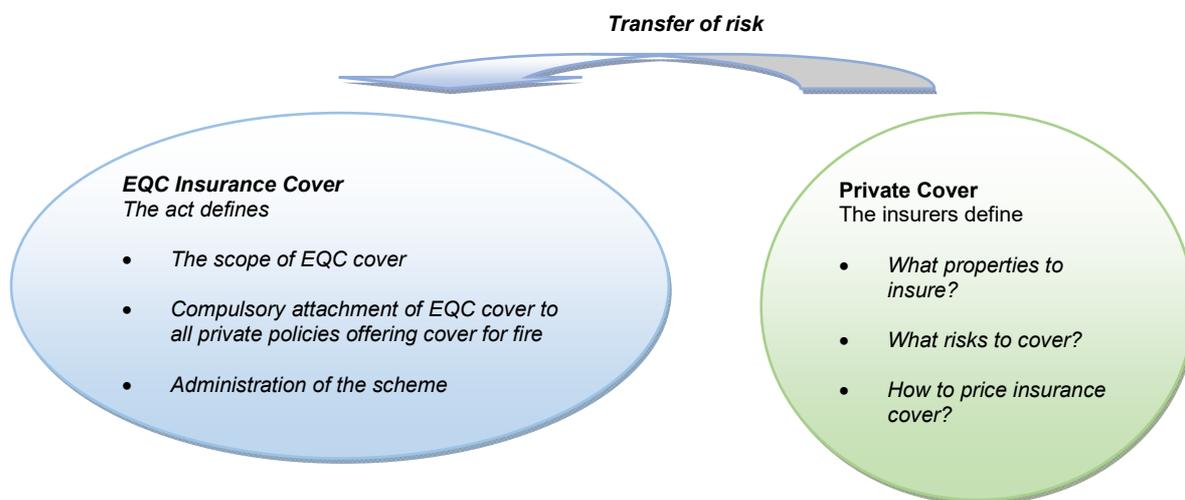
17. This section describes the current EQC intervention model used to achieve high levels of insurance uptake. We differentiate the factors that the EQC insurance scheme seeks to directly control versus those that it may only indirectly influence.

What factors does the current EQC intervention directly control?

18. The EQC's precursor insurance scheme took on the role as the sole provider of catastrophe insurance with private markets evolving to provide cover around the public cover provided. The EQC scheme is not a co-insurance or re-insurance scheme. As such, private markets and the EQC cover separate pools or tranches of risk, which are managed and priced separately.

19. By changing the cap, the Crown can alter the pool of risk it covers via the EQC insurance scheme. While a change in the cap also affects the scope of risk that is managed by private insurers, the Act does not regulate how insurers manage the risks that they insure.

Figure two: the Act defines EQC insurance cover



20. The Act only provides direct controls over the operation and management of risk accepted by the Government insurance scheme. Among other things, the Act defines:
- the scope of publicly provided cover
 - a requirement that all insurance policies that provide cover for fire include compulsory EQC cover for earthquakes (referred to as 'compulsory attachment')
 - the administrative mechanisms by which the Commission may set and collect levies, and
 - the mechanisms by which the Commission may manage and transfer risk.

Strengths of the current intervention model

21. The strength of the current EQC scheme is that the intervention model applies compulsion upon consumers (refer point ii above). Compulsory attachment removes the consumer's option to acquire insurance without any form of catastrophe cover.
22. The Californian Earthquake Authority ("**CEA**") provides an interesting comparison. The CEA provides a catastrophe insurance product provided as an optional addition. Californian insurers must offer earthquake cover, but there is no requirement that consumers accept this cover. Despite California's exposure to earthquakes, only 10 percent of Californian homes are currently insured against earthquakes.
23. The degree of subsidisation (i.e. price) does not appear to be definitive in encouraging uptake. While different pricing approaches have been adopted, the evidence suggests that behavioural factors, such as short sightedness, have a particularly significant impact on catastrophe insurance uptake. While most owners insure their homes, many prove reluctant to take out cover for infrequent events.

24. Given an objective to reduce loss by maintaining insurance uptake, we see the three positive features of the current EQC scheme as being:
- **Focus on consumers:** regulation of consumers has proven less costly and complex to administer compared to industry regulation abroad. The collapse of the Californian insurance industry following compulsory earthquake cover and price caps is often cited as an example of the risks and complexity associated with industry regulation. While the design of regulation could seek to avoid these mistakes, effective regulation would need to consider the industry's long-term solvency and the unique characteristics of the industry.
 - **Compulsory attachment:** compulsory attachment directly targets the behavioural impediments that impact consumer uptake of cover for risks that occur infrequently.
 - **Community pricing:** The EQC scheme addresses affordability via pooling of risk between high and low risk properties¹. The EQC scheme does not receive public subsidies. The scheme currently seeks to charge a fairly priced flat national rate for cover based on the dollar value of the insurance cover.

Limitations of the current intervention model

25. Governments may intervene in insurance markets for reasons beyond ensuring uptake of catastrophe cover. However, the EQC scheme currently avoids the risk or complexity associated with industry regulation.
26. The following scheme characteristics simplify and focus the EQC scheme, but currently limit the wider influence on industry outcomes:
- **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 on insurability in circumstances where the insurer is declining cover.
 - **The scheme does not regulate private pricing and/or market dynamics:** There are no current controls within the scheme to regulate the total cost of cover or any other issues arising from market dynamics beyond the EQC scheme.
27. While changes in the scope or nature of EQC insurance cover will influence industry decisions, the effect of changes on factors such as pricing is currently indirect. Any change in coverage is just one factor affecting retail insurance market outcomes or decisions. The indirect nature of the intervention introduces a degree of uncertainty. Further work is required to understand the effect, magnitude, and/or long-term durability of any industry response to a change in EQC coverage.

Implications for a review of the Act

28. This section has differentiated between the factors the EQC scheme directly controls versus those that it indirectly influences. While, consistent with the policy rationale for the EQC scheme, the impact on insurance uptake will be a key focus of advice on the review of the EQC Act, a number of market characteristics or policy outcomes will also need to be considered. Price may, for example, affect future uptake of insurance.

¹ The decision to community price insurance is currently discretionary. The EQC Act allows the Commission to set differential prices.

29. Figure one has colour coded these industry characteristics or policy outcomes to illustrate areas of focus. Red suggests a pressure point that should be considered as part of the review. Orange indicates an area, such as affordability, that needs to be considered as a risk to future uptake or the performance of the scheme. Green is an area where the EQC scheme is currently considered to perform well.

Design objectives for a review of the EQC scheme

30. The Treasury recommended a review of the EQC Act to the previous Minister Responsible for the EQC (the Hon Dr Megan Woods). We proposed four objectives to inform work on a review of the EQC Act. These objectives for a review sought to ensure that the EQC scheme:
- continues to effectively deliver its purpose or policy rationale (objective one & two below)
 - considered the wider operating context the EQC operates within and the impact on or interaction with industry (objective three), and
 - applied lessons from past events, while ensuring consistency with other Government policy (objective four).
31. Figure one illustrates how the industry characteristics or policy outcomes that a review may consider are grouped under our four proposed objectives that are discussed below.
32. This section describes the objectives that we have previously proposed, but we have not asked you to agree to any objectives for a review at this point in time. We will provide advice on the scope and objectives for a review once the Government has made decisions on the residential property insurance work and the findings of the Inquiry.

Review Objective One: to minimise the potential for property owners to experience *socially unacceptable distress* to avoid *ad hoc* interventions

33. Our primary objective for a review of the Act would be to ensure that the scheme is correctly calibrated to achieve the objectives or outcomes that the Government is seeking. Key considerations may include the scope of cover, cost of insurance, or current uptake of insurance.
34. As noted, provision of EQC insurance cover currently seeks to reduce the risk that the Government may need to provide *ad hoc* support. This risk is illustrated by the extension of public earthquake cover that has tended to follow major events.
- The original EQC cover, for example, was provided via the War Commission after the 1942 Wairarapa earthquake.
 - The EQC scheme was extended to cover land following the 1979 Abbotsford landslide.
 - An EQC-based mechanism was used to compensate homeowners affected by the 2001 Waihi sinkhole.
 - This Government provided ex-gratia financial support to on-sold property owners.

35. In intervening via the EQC insurance scheme, successive Governments have sought to manage the loss arising from natural disasters through steps to ensure that the level of residential cover for nature disaster (i.e. insurance uptake) remains high. In doing so, the EQC scheme formally recognises a strong '*implicit*' liability for the Crown arising from natural disasters. Recognition allows the cost to be pre-funded by the property owners that directly benefit from the scheme.
36. A key question for Ministers has been as to what type of losses are likely to prove "*socially unacceptable*". Successive governments have reconsidered the scope of coverage, which has led to a more defined concept of what constitutes a "*socially acceptable loss*" overtime.
 - The initial 1945 intervention, implemented through the War Damages Commission, provided compulsory public earthquake cover for both commercial and residential properties insured against fire.
 - The Act was reviewed in 1993 and commercial coverage was discontinued.
 - The current Government has discontinued cover for contents.
37. The Treasury will provide advice on whether the EQC cap should be increased as part of the residential property insurance work.

Review Objective Two: *contributes to the effective management by the Crown of fiscal risks*

38. While EQC insurance cover is intended to be fully funded through actuarial fair levies, changes to the scheme may have fiscal implications.
39. While we proposed four objectives, the EQC scheme has the most direct influence with respect to social loss (objective one) which defines the level of fiscal risk for the Crown (objective two)². The EQC scheme's influence on other factors, such as the retail cost of insurance, is less direct.
40. There is no '*right*' EQC cap. The social loss and fiscal objectives may theoretically be balanced by seeking the minimum possible EQC cap necessary to ensure that insurance uptake remains high. Notwithstanding this, some homeowners will rationally choose to self-insure, which introduces a degree of subjectivity as to how much loss (i.e. underinsurance) is "*acceptable*" and as to what the correct cap should be.
41. There is also significant uncertainty as to the final impact a change to the cap may have. The impact of the cap will depend on public perceptions and on industry dynamics. Our previous advice (T2014/2145) noted the effects of a low monetary cap may be more damaging than a high cap. A cap that is too high misallocates risk away from insurers to the Crown, whereas a cap that is too low has real world effects on longer term community resilience and recovery after a disaster.

Review Objective Three: *to support an efficient approach to the overall management of natural disaster risk and recovery, both nationally and across the regions*

42. We anticipate that the Inquiry will provide recommendations as to how the Commission interacts with industry and wider Government in supporting a post-crisis response. These recommendations may be operational or technical in nature, but some may require changes to the Act.

² This EQC's gross exposure may be pre-funded or reinsured, which would reduce the Crown's net exposure.

43. In considering changes to the Act, a review should consider the EQC institution's comparative advantage as demonstrated within the wider Government response to the Canterbury quakes. A significant lesson from Canterbury has been that a recovery from a natural disaster involves uncertainty and may take a significant amount of time. The operation of private markets following a catastrophic loss may be impaired and construction services could be constrained by capacity. Earthquake repairs can be complicated by skilled labour shortages, land damage, engineering challenges, consent processes, and modifications to improve building standards.
44. The Canterbury quakes have also shifted policy debate in two key ways:
- first, the focus of recent public debate has shifted from access to adequate ex-post insurance funding to place a stronger focus on the resilience of society and its infrastructure ex-ante, and
 - second, the challenges around the Canterbury rebuild raise questions as to how a future Government should respond and the degree of flexibility they may require to expedite a recovery.

Review Objective four: *that, in achieving the above three objectives, the future of the Act both reflect lessons from previous events, and positions EQC to support government and national preparedness, mitigation and response to future natural disasters, including those exacerbated by climate change.*

45. As noted, a number of other policy reviews are underway, which may have implications for a review of the EQC scheme. Objective four recognised the need to apply lessons from past events while considering trade-offs between different areas of policy to ensure consistency.
46. We are preparing advice on the implications of climate change for the EQC and you will receive advice on the accessibility and affordability of residential property insurance in April.