

The Treasury

Treasury Advice Related to Modernising the EQC Act Information Release

December 2021

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Treasury Report: Confirming Objectives and Scope of Review of EQC Act

Date:	30 July 2020	Report No:	T2020/2370
		File Number:	TY-2-1-17-2

Action sought

	Action sought	Deadline
Hon Grant Robertson Minister Responsible for the Earthquake Commission (None)	Agree or provide feedback on the recommendations in this report regarding the objectives and role of EQC, and proposed exclusions from the scope of the review of the EQC scheme.	6 August 2020

Contact for telephone discussion (if required)

Name	Position	Telephone	1st Contact
Steve Cantwell	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: Confirming Objectives and Scope of Review of EQC Act

Executive Summary

The purpose of this report is to seek decisions from you on the high-level objectives and scope of the review of the Earthquake Commission Act 1993 (the EQC Act). The objectives and scope issues explored in this report have cross-cutting implications across multiple streams of advice. Your decisions will therefore help ensure that future advice on the reform of the EQC Act is correctly focussed. The analysis and the judgements in this report regarding your interests draws on your feedback and decisions on previous reporting.

Government policy interests- why does EQC exist?

The usually policy rationale for schemes like EQC is that natural disasters can inflict large losses of wellbeing and living standards on affected communities. If those communities are uninsured, demands for government support from those affected communities, can combine with the charity and humanity of unaffected communities and Government leaders to create irresistible pressures for ad-hoc government support. This has fiscal costs, and can discourage future investment in insurance and risk management by homeowners. The EQC scheme short-circuits this process by creating an environment in which disaster insurance take-up rates are very high, due to it being affordable and widely available.

Policy objectives to guide review of the EQC Act

The policy objectives included in the recommendations draw on objectives provided in previous advice, modified to reflect your feedback. We also include a specific objective to reflect the role of the review of the EQC Act in the Government response to the Public Inquiry into EQC.

Defining EQC's role in a future EQC Act

We seek your agreement that the future EQC Act include a clear, principles-based legislative mandate so EQC can support whole of government efforts and adapt as required. This is in part for good legislative design reasons. EQC's operating environment, demands and challenges are unpredictable, so the EQC Act needs to be adaptable.

Exclusions from scope of evolutionary review of EQC Act

You have previously indicated that you prefer an evolutionary reform of the EQC Act. We seek confirmation of what matters you consider to be outside the scope of an evolutionary reform. Unless you indicate otherwise, we propose to retain these features in future advice on the Bill, and do no significant reporting or advice on these issues.

The seven proposed exclusions are specified in the recommendations. The collective effect of choosing to retain these features would be to retain the EQC scheme in broadly its current form (that is, a natural disaster insurance scheme that attaches to private insurance policies and provides capped cover on residential property).

Recommended Action

We recommend that you:

Policy objectives to guide review of the EQC Act

- a **agree** that the below list accurately captures your policy objectives for the future EQC scheme and EQC Act: help create the right conditions for high levels of homeowner disaster insurance, including through supporting availability and affordability of insurance, and facilitating better public understanding of property risks and insurance,
2. minimise the potential for property owners to experience socially unacceptable distress and loss in the event of a natural disaster,
 3. support an efficient approach to the overall management of natural disaster risk and recovery, that contributes to New Zealand's long-term preparedness and resilience, both nationally and across regions,
 4. contribute to the effective management by the Crown of fiscal risks associated with natural disasters; and
 5. respond to the recommendations of the Public Inquiry into the EQC that have been identified as being addressed through the review of the EQC Act (Cab DEV-20-MIN-0116 refers).

Agree/disagree.

Defining EQC's role in a future EQC Act

- b **note** the Public Inquiry recommended that the EQC Act include more legislative guidance regarding EQC's role and functions, including a purpose statement
- c **agree** that the future EQC Act include a clear, principles-based legislative mandate so EQC can support whole of government efforts and adapt as required.

Agree/disagree.

Exclusions from scope of evolutionary review of EQC Act

- d **agree** that we will not provide advice on alternative design options for the following design elements of the EQC scheme and Act:
1. EQC cover being first-loss cover (i.e. EQC takes the first loss in the event of a damaging event, with the private insurer picking up losses beyond the EQC cover as required);
Agree/disagree.
 2. Access to EQC cover being determined by compulsory attachment to qualifying private insurance policies on the relevant property;
Agree/disagree.
 3. EQC premiums being collected by private insurers and passed to EQC;
Agree/disagree.

4. The EQC scheme being focused on only residential property (although we will provide advice on boundary issues such as MUBs, land cover, definitions, technical changes and so on);

Agree/disagree.

5. EQC building and land covers be retained (although we will advise on the configuration and coverage of both building and land cover); and

Agree/disagree.

6. EQC continuing to be a Crown Entity.

Agree/disagree.

- e **note** that we consider that the above exclusions will not impede the review of the EQC Act addressing the relevant recommendations of the Public Inquiry. We will advise you if this assessment changes.

Helen McDonald
Manager, Earthquake Commission Policy Team

Hon Grant Robertson
Minister Responsible for the Earthquake Commission

Treasury Report: Confirming Objectives and Scope of Review of EQC Act

Purpose of Report

1. The purpose of this report is to seek decisions from you on the high-level objectives and scope of the review of the EQC Act. Your decisions on these cross-cutting issues will help ensure that future advice on the reform of the EQC Act is correctly focussed.

Background

2. Treasury has to date provided a range of reports on EQC, its role, and potential scope of changes to the EQC Act (T2019/2590 and T2020/1766 refer), and reporting on insurance market trends and dynamics more generally, including EQC's role and its potential use as a tool to address current policy concerns (T2019/2234 and T2019/2933 refer). The analysis and the judgements in this report regarding your interests draws on those reports, and your feedback and decisions on them.

Analysis

Government policy interests - why does EQC exist?

3. In order to advise you on the future configuration of the EQC scheme, we need a shared understanding of the Government's specific interests in the provision of disaster insurance.
4. EQC is part of the Government machinery for dealing with natural hazard risk. New Zealand manages natural hazards as part of an "all hazards – all risks" approach to national security.¹
5. From a Living Standards Framework perspective, EQC supports housing resilience, directly supporting financial and physical capital, and indirectly supporting human and social capitals (due to the benefits from resilient housing and community recovery). We see the government's overarching objective with regard to natural disasters being to minimise the impact of preparing for, and recovering from, natural disasters on the intergenerational living standards of New Zealanders.
6. At a high level, the EQC scheme and role should be whatever configuration and design best supports that overarching objective. EQC will meet this requirement when its involvement results in better living standards outcomes than is achieved by other competing options for supporting natural disaster resilience, e.g. entirely private provision.

EQC only covers some assets...

7. EQC currently covers only some classes of assets, i.e. residential buildings and land, against natural hazards. Other major asset classes, including commercial, industrial and primary sector buildings, are entirely covered by private insurers. In addition, EQC cover is capped, so residential property also has significant private insurer involvement.

¹ Page 7, National Security System Handbook, DPMC, New Zealand Government, August 2016
T2020/2370 Confirming Objectives and Scope of Review of EQC Act

8. This mixed model of private and Crown insurance raises an obvious question – what are the guiding principles in designing the scope of EQC’s coverage?

...as EQC coverage is strongly shaped by political-economy judgements...

9. The traditional policy analysis is that the individuals and businesses are best-placed to manage their own risks, and should be left to do so, unless that imposes costs on others. International evidence suggests that in the absence of an intervention like EQC, the take-up of natural disaster insurance by homeowners is low, especially in higher-risk areas. Demands from large numbers of uninsured homeowners for government taxpayer-funded assistance following natural catastrophes often prove irresistible.
10. In these circumstances, post-disaster ad-hoc government support then feeds expectations of future government post-disaster assistance, further weakening homeowner incentives to insure.
11. The traditional overriding policy rationale of the EQC scheme is therefore to avoid the need for an *ad hoc* intervention after a major event. The scheme achieves this by encouraging high levels of insurance uptake. The high levels of uptake reduce uninsured community losses to levels which do not provoke irresistible demands for post-disaster ad-hoc government support. We have previously described this objective as “minimising the potential for unacceptable distress and loss” (as unacceptable losses create the imperative for an ad-hoc government response).

...while also contributing to wider disaster resilience and recovery objectives.

12. Although this is primarily a political-economy rationale, it also directly supports higher wellbeing, as it achieves its political-economy goals by reducing to socially acceptable levels the natural disaster losses of affected individuals and communities. This supports important broader government disaster resilience and recovery objectives by ensuring that sufficient capital will be available for communities to rebuild and/or recover after a major natural disaster.
13. In this analysis, the core policy goal of the EQC scheme is to create the right conditions for very high levels of homeowner disaster insurance. Several features of the EQC scheme combine to achieve this: namely the compulsory attachment of EQC cover to private insurance fire policies on residential property; affordable premiums (including for higher-risk areas and properties); and by EQC taking on most of the natural disaster risk, private insurer top-up cover on disaster risk can remain ubiquitous and affordable.

This framing explains many features of the existing scheme...

14. This view has also informed past decisions on the coverage of the EQC scheme. In this view the coverage of the scheme should be whatever it needs to be to forestall widespread demands for ad-hoc post-disaster government support, and no larger.
15. The decisions to exit EQC from all non-residential property from 1993 (EQC used to cover commercial, industrial and rural property too) and, more recently, to exit EQC from residential contents cover, reflected judgements that future governments would be able to resist demands to provide ad-hoc post-disaster assistance to owners of the assets that were no longer being covered by EQC. In the case of EQC exiting commercial and industrial property, the pre-1993 judgement proved correct when tested in a series of earthquakes from 2010-2016. Conversely, EQC land cover was introduced following what was seen as unacceptable outcomes for homeowners following the 1979 Abbotsford landslide that destroyed, or forced the relocation of, 69 houses.

...and emphasises post-disaster durability in scheme design.

16. Lastly, an implication of the EQC scheme's purpose being to address a political-economy problem is that, while policy analysis can help inform decision-making, there is no "right" technocratic answer regarding the coverage of the scheme. Scheme coverage hinges on political judgements about how future disaster-affected communities and governments will be willing to share losses and risks.
17. A key question Ministers should ask of any future scheme design is whether Ministers judge it to likely to be robust to post-disaster political economy pressures for extension. In balancing the risks, an EQC scheme coverage that is too extensive is likely less damaging than coverage that is too parsimonious. The former transfers, for a premium, risks to the Crown that might be successfully carried by insurers, while the latter risks policy failure by not retaining the necessary conditions to keep high rates of insurance coverage in the target population, and so avoid pressure for ad-hoc post-disaster extension.

Insurance Supply

18. The above discussion focused on the demanders of insurance (i.e. homeowners). The EQC scheme also has two-way interactions with the supply side of the insurance market.
19. On one hand, the EQC scheme improves the supply and availability of private top-up disaster insurance. EQC taking a large tranche of disaster risk helps make it attractive for private insurers to continue to offer all-risk residential insurance policies without disaster exclusions. On the other hand, insurance market conditions affect the EQC scheme's success – a scheme that achieves its policy goals at one point in time may no longer do so if market conditions change, for reasons outside of the EQC scheme, in ways that increase non-insurance or under-insurance.
20. Changes in insurance market conditions are of current policy interest. Considering insurance industry dynamics and the merits of alternative non-EQC intervention options would be a much longer-duration and more ambitious project than the current review of the EQC Act. Therefore, for the purposes of the review of the EQC Act, we intend to consider insurance market supply issues only to the extent that they are relevant to the EQC Act. In particular, we expect that analysis of insurance market pricing and margins will help inform our advice as to whether increasing EQC caps on building cover would improve insurance affordability and availability in high-risk areas. This could inform next steps on addressing any broader insurance market issues that fall outside the EQC Act.

Policy work on broader insurance market issues regarding consumer understanding of property insurance pricing and availability will progress through a separate stream of advice.

Our understanding of your objectives for EQC and related insurance work

21. The previous Minister Responsible for the EQC (the Hon Dr Megan Woods) accepted advice that the review seek to achieve an EQC Act that supports the following policy objectives:
 1. minimise the potential for property owners to experience socially unacceptable distress and loss in the event of a natural disaster;
 2. support an efficient approach to the overall management of natural disaster risk and recovery, both nationally and across regions;
 3. contribute to the effective management by the Crown of fiscal risks associated with natural disasters; and

4. that, in achieving the above three objectives, the future 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.
22. We also previously provided you with advice on potential objectives for the broader work on property insurance markets (T2019/2234 and T2019/2933 refer). In response to that advice, you asked for further advice on options that:
 - a facilitate **better public understanding** of insurance (e.g. costs, availability, and risk-factors) and property risks to help people manage their risks and promote confidence in the insurance market, and
 - b ensure that property insurance is **affordable and available** and appropriately contributes to New Zealand's **long-term resilience** (i.e. the 4Rs – reduction, readiness, response, recovery) against all natural hazards, including hazards exacerbated by climate change.
23. Lastly, the review of the EQC Act is the vehicle for the Government addressing 14 of the recommendations of the Public Inquiry into the EQC (Cab DEV-20-MIN-0116 and T2020/1766 refer). Our advice will need to address all these recommendations.
24. We intend to draw on the above understanding of your objectives in the development of our advice on the review of the EQC Act. Do you consider that the above section provides an accurate and complete overview of your objectives?

Key question: does this section accurately capture your high-level objectives for this work?

Defining EQC's Role in a Future EQC Act

25. A strategic question for the review is what should future legislation envisage for EQC's role, beyond the core functions of administering the scheme and its associated finances.
26. The Public Inquiry into EQC made the following recommendations regarding legislative role and mandate:
 - "1.1.1 Provide a mandate in legislation for EQC (or another appropriate agency) to coordinate the residential insurance response to ensure housing recovery following a natural disaster, including setting roles and responsibilities, monitoring performance and requiring assistance from other government agencies.*
 - 1.1.3 Determine how a managed repair programme might be initiated and executed should it be required and whether EQC should be the lead agency to conduct the programme. If not, then specify EQC's role in a managed repair and rebuild programme. As part of this, review the discretion in Schedule 3 of the EQC Act enabling EQC to manage the replacement or reinstatement of properties.*

1.2.1 Consider inclusion of a purpose statement and set of principles in the EQC Act that will guide the discharge of EQC's responsibilities as an insurer with a social responsibility to claimants."

27. We anticipate providing advice recommending that the EQC's role, responsibilities and mandate be clarified in the future EQC Act through the inclusion of a purpose statement and set of principles.
28. As outlined earlier, EQC's role should be whatever leads to EQC best supporting the broader government goal of minimising the impact of preparing for, and recovering from, natural disasters on the intergenerational living standards of New Zealanders. This includes supporting the Crown's balance sheet through the purchase of reinsurance.
29. Disaster response and recovery are inherently unpredictable and uncertain environments. From a legislative perspective, we consider that the EQC Act should provide a clear, principle-based legislative mandate for EQC to provide natural disaster, insurance and risk management expertise into wider government and national disaster risk management, preparedness planning, risk sharing, and post-disaster response and recovery activities.
30. Regarding Inquiry recommendation 1.1.1, this approach would result in a clear, principle-based legislative mandate for EQC that would enable, but not require, EQC to perform this role.
31. Regarding recommendation 1.1.3, a principles-based legislative mandate regarding managed repair would avoid progress on the Bill becoming dependent on the Government making a firm decision on the lead agency for future post-event housing managed repair programmes. This NEMA-led work stream is expected to take one to two years, with an initial report due in December 2020, so the results of this process will not be known in time to be reflected in a mid-2021 Bill (T2020/2426 refers).
32. If you agree to our proposed approach, we will provide further advice on potential purpose statements and associated principles. Initial discussions between Treasury and EQC indicate that both agencies support clear, principles-based legislative statements regarding EQC's role. It is unclear at this point in time how closely agency views will align regarding the substance of all provisions. We expect to work collaboratively on this and will report to you in due course.

Key question: do you agree to the future EQC Act including a clear, principles-based legislative mandate so EQC can support whole of government efforts and adapt as required.

Exclusions from Scope of Review

33. You have indicated that you envisage an evolutionary review of the EQC scheme. As reported previously, introducing an EQC Bill in July 2021 requires all substantive policy decisions to be made by you before Christmas.
34. We understand that by "evolutionary" you mean that the core features and characteristics of the current scheme be retained, while being improved and modernised. We have identified a number of key design features of the current scheme that we consider are likely outside the scope of this framing of an evolutionary review.

Therefore we propose to retain these features in future advice on the Bill, and do no significant reporting or advice on these issues, unless you request it.

35. The collective effect of choosing to retain these features would be to retain the EQC scheme in broadly is current form (that is, a natural disaster insurance scheme that attaches to private insurance policies and provides capped cover on residential property). The design features we propose to not provide advice on alternative design options are:
- EQC cover being first-loss cover (i.e. EQC takes the first loss in the event of a damaging event, with the private insurer picking up losses beyond the EQC cover as required);
 - access to EQC cover being determined by compulsory attachment to qualifying private insurance policies on the relevant property;
 - EQC premiums being collected by private insurers and passed to EQC;
 - the EQC scheme being focused on only residential property (although we will provide advice on boundary issues such as MUBs, land cover, definitions, technical changes and so on);
 - EQC building and land covers be retained (although we will advise on the configuration and coverage of both building and land cover); and
 - EQC continuing to be a Crown Entity.
36. We consider that the above exclusions will not impede the review of the EQC Act addressing the relevant recommendations of the Public Inquiry. We will advise you if this assessment changes.
37. We seek your confirmation or feedback on these exclusions. We can provide more advice on any of these issues if you wish.

Key question: do you agree with the above six issues being excluded from the current review of the EQC scheme and Act? If not, what issues do you want more advice on?

Next Steps

38. We have recently reported on the high-level process for delivering an EQC Bill by July 2021 (T2020/1766 refers). The next three reports we intend to provide will cover:
- advice on options for the future coverage of EQC scheme,
 - EQC land cover and
 - EQC hazards exacerbated by climate change.

Consultation

39. The Earthquake Commission, Reserve Bank, Department of Internal Affairs, and National Emergency Management Agency were consulted on drafts of this report. The Department of Prime Minister and Cabinet was also informed.