

The Treasury

Treasury Advice Related to Modernising the EQC Act Information Release

December 2021

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Treasury Report: Modernising the Earthquake Commission Act: Financial Disclosures and Powers

Date:	4 December 2020	Report No:	T2020/2886
		File Number:	TY-2-1-17

Action sought

	Action sought	Deadline
Hon Grant Robertson Minister of Finance	None	N/A
Hon Dr David Clark Minister Responsible for the Earthquake Commission	Agree to the recommendations in this report	18 December 2020

Contact for telephone discussion (if required)

Name	Position	Telephone	1st Contact
Craig Fookes	Principal Advisor, Earthquake Commission Policy Team	[39]	[35] ✓
Helen McDonald	Manager, Earthquake Commission Policy Team		

Minister's Office actions (if required)

Return the signed report to Treasury.

Note any
feedback on
the quality of
the report

Enclosure: No

Executive Summary

This report provides advice on the process by which the key financial settings within the Earthquake Commission (EQC) statutory insurance regime could be reviewed, set, and disclosed. These settings, which include the \$150k cap on insurance and annual insurance premium, determine the scope of cover provided and the extent to which property owners should pay for the cover that they receive.

This report is intended to be read alongside our companion report entitled “*Modernising the Earthquake Commission Act: Institutional Arrangements*” (T2020/3143 refers), which discusses the purpose and objectives of the EQC scheme.

The report recommends:

- i. The introduction of a **regular review period** for key EQC financial settings, including the EQC insurance cap and premiums to avoid these settings falling out of date. We recommend a maximum review period of five years.
- ii. A requirement that the Government publish a funding strategy within a forward-looking funding and risk management statement (“**funding statement**”). The proposed funding statement, based on a similar statement prepared by the Minister responsible for the ACC, would disclose the Governments funding strategy and would also provide a strategic contextual framework for annual financial decisions taken by the EQC Board.
- iii. That the EQC Act 1993 (the ‘**Act**’) be amended to include a **statutory insurance basis for EQC insurance premiums**. As EQC insurance premiums are a form of compulsory levy, we recommend the Act should specific a statutory basis for premiums to better align with the Legislation Design Advisory Committee (LDAC) guidelines.
- iv. That EQC premiums be set with respect to a set of statutory **pricing considerations and disclosure requirements** to inform the public of the current basis for EQC premiums. We propose that the pricing considerations should enable the Minister Responsible for the Earthquake Commission (MREQC) to consider the: cost of the EQC insurance scheme; the risks to the Crown; and the impact of levy changes on the affordability of natural disaster cover.
- v. The introduction of an **option for the EQC to seek public funding** should the Board or the Minister require that EQC contribute to whole-of-government processes within the disaster response and/or resilience space.

The proposed process in points i, ii, and iii above seek to:

- address public concerns about the fairness of levies, funding of the EQC, and past transfers to the Crown;
- reduce the current reliance of the EQC Act upon Ministerial directions in favour of softer direction setting instruments that could better support a delegation to EQC Board; and
- encourage consistency in decision making via a requirement that the Minister and EQC exercise their powers consistent with a medium-term funding strategy disclosed in the Government’s funding statement.

Recommended Action

We recommend that you:

- a **note** that our companion report entitled “*Modernising the Earthquake Commission Act: Institutional Arrangements*” (T2020/3143 refers) provides advice on the EQC’s purpose and objectives
- b **note** this paper provides advice on additional financial disclosures on the basis of the EQC’s current financial structure, but, if EQC’s structure is reformed, the recommended changes could still be implemented, with limited modifications, to reflect any broader institutional changes

Regular review of key financial settings

- c **note** that the EQC’s levy rates and insurance cap have not been subject to regular review, which creates a risk that key financial settings could fall out of date before a natural disaster occurs
- d **agree** that the EQC’s key financial settings, including the insurance premium and EQC insurance cap, should have a maximum review period of five years

Agree/disagree.

Public disclosures within a regular funding and risk management statement

- e **note** that the Treasury has identified a need for additional public disclosures to explain how levies are set and the Government’s strategy to fund or address any projected shortfall in the Natural Disaster Fund (NDF) relative to expected cost of a natural disaster
- f **agree** that the Government publish and table in Parliament a funding and risk management statement following each review of the EQC scheme’s key financial settings (i.e. no less frequently than every five years)

Agree/disagree.

- g **agree** that the funding statement should disclose financial information including the projected costs of the scheme, operational costs, the Government’s financing strategy, and the allocation of the risk from a whole-of-Crown perspective, along with any guidance provided to the EQC Board (e.g. strategic financial guidance as to the management of the NDF)

Agree/disagree.

- h **agree** that the Minister Responsible for the EQC and the EQC Board should “*have regard to*” (i.e. consider) the funding statement in exercising their respective financial powers under the Act

Agree/disagree.

A statutory basis and disclosure requirements for EQC insurance premiums

- i **note** that the EQC Act does not currently specify a statutory basis for compulsory EQC insurance premiums, which is inconsistent with the *Legislation Design Advisory Committee’s* guidelines for levies

j **agree** that the Act specify that the basis for EQC insurance premiums be to prefund or recover for the Crown the cost of EQC insurance cover and any associated operating costs relating to the discharge of the EQC's insurance functions

Agree/disagree.

k **agree**, to give effect to recommendation j, that the Act should include a set of decision-making considerations that the Minister may "have regard to" and that these should include

i. the financial position of the Government (as guarantor)

Agree/disagree

ii. the impact that EQC premiums will have on the uptake of private insurance cover

Agree/disagree

iii. The benefits for the public of predictable levies (i.e. the need to avoid large annual changes)

Agree/disagree

l **agree** that this list of decision-making criteria could also include cross-references to any other relevant provision within the Act that is relevant to the choice of levy (e.g. the ability to require EQC to pay back historic advances under section 16)

Agree/disagree.

m **agree** that the Minister Responsible for the EQC should disclose the financial projections and other relevant policy considerations that he/she has considered in setting EQC levies within the periodic funding and risk management statement

Agree/disagree.

Additional flexibility as to how the EQC is financed

n **note**, in line with the Inquiry's findings, our companion report entitled "EQC Act Review: Institutional issues" (T2020/3143 refers) recommends a broadening of the EQC's functions to allow it to contribute to whole-of-government initiatives in the disaster response and resilience space

o **note** that charging property owners for non-insurance services would be inconsistent with the proposed insurance basis for levies if this work provides a wider benefit

p **agree** that the Act provide the option to allow for public funding in situations where the Board is not convinced a case for NDF funding exists or in situations where the Government directs the EQC to input into other policy

Agree/disagree.

Subject to wording clarification that this is about supporting input into other public policy inducts as per (n) above.

Helen McDonald
Manager, Earthquake Commission
Policy Team

Hon Dr David Clark
Minister Responsible for the Earthquake
Commission

Treasury Report: EQC Act Review: Financial Disclosures and Powers

Purpose of Report

1. The Government has requested advice on changes to update the Earthquake Commission Act 1993 (the “**Act**”) following the Inquiry into the Earthquake Commission (the ‘**Inquiry**’).
2. This paper is intended to be read alongside our companion report entitled “*Modernising the Earthquake Commission Act: Institutional Arrangements*” (T2020/3143 refers). We recommend that you read this companion report first, given the institutional arrangements report covers the Act’s overarching purpose statement and a set of institutional objectives.
3. This report recommends:
 - introduction of maximum review period of five years for key financial settings, including the cap and/or levy;
 - requirements relating to the public disclosures within a new funding and risk management statement;
 - an amendment to the Act to specify the statutory purpose of and disclosure requirements for EQC insurance premiums; and
 - additional options to provide flexibility as to how EQC is funded, notably with respect to any contribution to any whole-of-government initiatives.

Background and Context

4. The Crown provides natural disaster insurance via the Earthquake Commission Act 1993 (the “**Act**”).
5. EQC insurance is administered by EQC, which acts as an agent for the Crown. While the Board oversees the administration of the scheme, the Minister Responsible for the EQC (‘**MREQC**’) has far ranging financial powers reflecting the uncapped nature of the Crown’s financial exposure. A permanent legislative authority (‘**PLA**’) commits the Crown to cover all costs associated with the scheme. This PLA is sometimes referred to as a “Crown guarantee”.
6. Other Crown Financial Institutions (‘**CFIs**’), such as the Accident Compensation Corporation (ACC), are fully funded from levies and have no formal PLA. The nature and volatility of the risks that the EQC scheme insures and the depletion of the Natural Disaster Fund (‘**NDF**’) following the Canterbury earthquakes highlights an ongoing need to retain the Crown guarantee. The Crown has always anticipated that it may be required to cover the losses associated with large infrequent (i.e. long tail) events and the EQC may face liquidity pressures before levies accumulate.

7. While EQC is a Crown agent, the institution has a mixed corporate form that continues to bear a resemblance to a state-owned enterprise. On the basis of the current mixed institutional structure, the Minister Responsible for the EQC (“MREQC”) has the followings powers:
 - under the Crown Entities Act 2004, the MREQC may direct the EQC¹ and add additional functions² that are consistent with the entity’s objectives and/or functions;
 - as guarantor and shareholder, the MREQC may direct EQC as to how the NDF is managed with specific authority to take into account the Government’s financial position³; and
 - as the sole shareholder, the MREQC may review the EQC premium⁴ that is set via Order in Council, declare a dividend⁵, require payments in lieu of tax⁶, and may also determine the charge for the section 16 Crown guarantee⁷.
8. There is no statutory requirement that the EQC scheme be fully financed and the Government may cover any shortfall via a grant with no further need for an appropriation.
9. As the scheme covers infrequent large risks, the powers of the Minister and the Board must be exercised consistently over an extended period of time to effectively anticipate and manage risk. While the NDF and reinsurance largely met the costs of the Canterbury and Kaikoura earthquakes, key scheme settings set by the Government (e.g. the levy) had not been reviewed for an extended period of time.

Additional financial disclosures and public confidence

10. While the Crown guarantee should be sufficient to support public confidence, public disclosures have historically focused on the NDF in relation to the payment of claims. As the value of the NDF declined, the public became concerned that claims may not be honoured or could be treated differently.
11. Public financial or accounting disclosures fulfil a specific purpose and are currently structured around EQC (the institution). There are no current requirements to disclose scheme-based estimates from a whole-of-Crown perspective. The current value of the NDF, the estimated or possible future costs of a natural disaster, and the expected share of risk (or cost) between the NDF, Crown, and reinsurers are not reported in any structured or systematic way.
12. Our companion *Institutional Arrangements* report discusses the public concern that has existed about EQC’s (currently unstated) objectives and the *alleged* unfair treatment of claims. The financing of the scheme and Government’s historic financial drawings have both been criticised in several high-profile media articles.
13. The Inquiry’s report noted that “*some people suggested that, in administering claims, EQC has a particular focus on constraining settlement payments in order to lessen the call on the Crown Guarantee*” but noted “*that they did not see any evidence of a specific focus on avoiding the need to draw on the Crown Guarantee*”. Notwithstanding this, the report did discuss the priority placed upon constraining cost. The report noted

¹ refer section 103 of the Crown Entities Act

² refer section 112 of the Crown Entities Act

³ refer section 12 of the Act

⁴ refer section 36 of the Act

⁵ refer section 9 of the Act

⁶ refer section 10(2) of the Act

⁷ refer section 17 of the Act

consistency with “*general concerns I heard about an undue emphasis on constraining settlement costs following the Canterbury earthquakes.*”⁸

14. The media and the Inquiry have also questioned whether the Government directly or indirectly encouraged a more aggressive approach to claims management to reduce fiscal costs. The Inquiry’s report noted “*others expressed concern about the potential ability of governments to “plunder” the Natural Disaster Fund by requiring the payment of dividends, sums in lieu of tax and fees.*”
15. While the Government has not taken a dividend since the mid-1990s, previous governments have directed the EQC to invest in Government bonds. These transactions sought to better manage risks centrally upon the Crown balance sheet. While the Crown guarantee suggests that these transactions have no economic impact on claimants, the Inquiry recommended that “*Under the Public Finance Act 1989 any future attempt to transfer funds from EQC to the Government would have to take place transparently.*”⁹
16. We have split our response into two parts:
 - our companion *Institutional Arrangements* report provides advice on clear claimant-focused institutional objectives (e.g. the fair treatment of claims) and we are seeking an indication of whether you would like advice on changes to the EQC’s institutional structure, which may, among other things, provide a better basis for financial disclosures¹⁰;
 - this report provides advice on additional disclosures to improve information as to how the EQC is financed from a whole-of-Crown perspective.
17. The proposed disclosure of additional financial information, including the process by which the Crown would disclose its financial strategy, represents an improvement to the current statutory framework. This work is not motivated by any failure by the Government or EQC to meet current statutory disclosure requirements.
18. The overriding objective of both pieces of work is to provide information that explains the scheme from a different perspective. The recommendations in this report consider changes that communicate:
 - how EQC levies are set to establish that they are fair; and
 - that sufficient Crown or NDF finance will always be available to fairly settle EQC insurance claims.
19. Our goal is to refocus public attention on the Crown’s unconditional guarantee by better communicating the purpose that the NDF plays acting as a full or partial pre-funding mechanism. The NDF offsets a cost that the Crown is otherwise committed to pay.
20. Notwithstanding the NDF’s core purpose, the public have an interest as to how levies are collected and set. The EQC’s premiums are collected as a form of compulsory levy, which creates a public interest in clear and accurate disclosures around the NDF. These public expectations around the management of levies also inform the advice on institutional reform in our companion *Institutional Arrangements* report. Among other things, we have recommended that the EQC separate and report the EQC’s operational assets separate from accumulated levies held within the NDF to improve transparency for the public.

⁸ Page 66.

⁹ Page 66.

¹⁰ The EQC and the NDF are currently reported as a single entity.

Regular review of key financial settings

21. Despite substantial changes to the scheme
 - the EQC insurance levies were unchanged between 1944 and 2012.
 - the EQC insurance cap was not reviewed between 1993 and a 2019.
22. The lack of regular review was partly attributable to the infrequent nature of the financial risks that EQC faces and a period of geological inactivity. In the absence of large claims events, the NDF had become very large prior to 2011. In the absence of clear pricing principles or reviews, the EQC and Ministers did not consider the funding of the scheme or potential changes to other key financial settings.
23. We recommend that the Act specify maximum review periods for the EQC insurance levy, the cap, and other key financial settings to ensure that these settings take into account developments and remain up to date.
24. Specification of a timeframe requires a balance between administrative overhead verses the risk that the premiums may no longer support the Crown's financing strategy.
25. We recommend a maximum review period of five years for premiums, the cap, and other key financial settings. This allows for more frequent review if desired.

Public disclosures within a regular funding and risk management statement

26. We recommend that the Minister Responsible for EQC publish a funding and risk management statement following each review of key financial settings. While we have proposed changes, this requirement is based upon a similar statutory requirement that exists with respect to the ACC.
27. The EQC covers very long dated risks in an area where the science is developing rapidly. The overriding benefit of a structured regular disclosure is that it would require officials to review and discuss the schemes funding, consider its adequacy, and tender advice to the Government on options to address any shortfall.
28. Public disclosure as to how EQC is financed also has the following three benefits:
 - a published financial strategy provided from a whole-of-Crown perspective could support public confidence;
 - a medium-term financial strategy could act as the basis for a delegation to the Board as a funding strategy acts as context for the annual use of financial powers to ensure consistency over time; and
 - the statement could form the basis for public disclosures relating to any guidance provided to the Board.

Improved public disclosures as to how the scheme is funded

29. While the EQC publishes annual financial reporting for EQC (the entity) the Act does not require any public disclosures on the NDF or as to how the insurance scheme (as a whole) is financed. Annual accounting data is based on the current financial strength of the EQC. This accounting data does not project future or potential natural disaster costs, disclose any potential future shortfall, or communicate the Crown's funding

strategy as to how this shortfall should be financed or addressed over an extended period of time.

30. The purpose of a public disclosure would be to inform media commentary by communicating the Crown's future funding and risk management strategy to support public confidence. A statement could communicate:
- that EQC levies are fair given our current understanding of the science relating to natural disaster risk; and
 - the sources of finance (including Crown funding) that will be used to pay insurance claims if they were arise at a time when the NDF is depleted.

A guide for annual financial decisions, such as the purchase of reinsurance, and the exercise of other financial powers provided by the Act

31. We have recommended that both the Minister and the Board "*have regard to*" the funding statement when exercising their financial powers.
32. Periodic discussion involving forward-looking projections of the potential costs and future revenue of the scheme could provide strategic context for the Board's decisions. The Crown's funding strategy could also inform Ministerial decisions as to whether he/she should declare a dividend or alter the charge EQC pay for the Crown guarantee.
33. While the Minister may already direct EQC to give effect to Government policy, directions are legally binding and significantly reduce the scope for Board discretion. The proposed funding statement is intended to act as a soft direction-setting alternative to Ministerial directions. However, a funding statement cannot entirely replace the need for directions. Binding directions may still have a role adding functions or requiring action within crises.

Statutory disclosures of guidance provided to the EQC Board alongside the Crown's financial strategy

34. The final proposed purpose of the funding statement would be to publish any financial guidance provided to the Board alongside disclosures as to the potential impact on the EQC's funding. The funding statement would, for example, require the Government to disclose the financing demands for the Crown if it were to direct the EQC to invest entirely in New Zealand Government debt.

Process requirements

35. Given the public interest and historic concern, we recommend that the Crown's financing strategy be published.
36. We recommend that:
- the MREQC should table in Parliament a funding and risk management statement providing financial projections as to how the EQC scheme is financed and an indication as to how risks have been shared;
 - the funding statement align with and disclose the outcomes arising from the regular five yearly reviews of the cap, levy, and other significant financial settings (refer above); and
 - the MREQC and the Board should "*have regard to*" the funding statement before exercising their financial powers under the Act.

A statutory basis and disclosure requirements for EQC insurance premiums

A statutory basis for premiums

37. The compulsory nature of EQC “*premiums*” suggests that they are a levy. The *Legislation Design Advisory Commission* (LDAC) guidelines suggest:
- that the empowering statutory provisions for levies should state the basis for fees and procedures by which they are set;
 - fees and levies must bear a “*proper relationship*” to the cost of providing the service, implicitly capping the levy at cost recovery;
 - Parliamentary authority is required to go beyond cost recovery, although care needs to be taken to avoid a levy becoming a tax; and
 - while levies can be set by the Executive, a tax should be set by the Parliament.
38. As the Act does not specify a basis for premiums, we recommend that the Act be amended to specify that premiums may prefund or recover the cost of EQC insurance cover and any associated operating costs relating to the provision of EQC natural disaster insurance.

Pricing considerations - disclosure as to how the EQC premiums have been set

39. The statutory insurance basis for premiums creates a cap on levies at the level required to recover costs. However, in practice, the Government may choose not to fully recover the costs of EQC insurance.

Should the Crown have flexibility around cost recovery

40. The correct settings for EQC premiums may be subjective given the uncertainty around actuarial estimates of the future cost of a natural disaster. This uncertainty and competing policy objectives for the scheme suggest that the Government should have flexibility as to how it sets premiums. The scheme, for example, seeks to encourage uptake of insurance, requiring a high premium could be self-defeating.
41. Given the LDAC guidance that a levy should bear a proper relationship to cost, the Minister could choose to undercharge, but would not be able to deliberately overcharge over an extended time period to protect or benefit the Crown.

Public disclosure

42. The sections above recommend that the Government should review levies at least every five years. As the share of risk between the Crown and property owners may have intergenerational implications, we recommend that the Government disclose within the funding and risk management statement the financial estimates and/or supporting policy considerations underlying the current choice of EQC premiums.

Managing the risk of judicial review

43. Ministers may also face judicial review for considering ‘*irrelevant*’ matters that do not relate to the purposes of the relevant Act. Section 12, for example, was amended in 1998 to put beyond doubt that the Minister (as guarantor and shareholder), when directing the EQC with respect to the NDF, could consider both the Crown’s and the EQC’s financial position.

44. We recommend the Act also provide a set of broadly worded pricing considerations to clarify that the Minister may consider other factors¹¹. We recommend that the Minister be able to also consider:
- the financial position and interests of the Crown given the scheme is fully Government-guaranteed;
 - the overall cost of private insurance or other factors affecting accessibility and/or affordability of insurance given the scheme also seeks to support the uptake of private insurance cover; and
 - the desirability for the public of both consistency and predictability in EQC premiums over time.

Preparation of a final list of pricing considerations

45. If Cabinet were to support this recommendation, the Treasury will work with the Parliamentary Counsel Office to develop the specific wording for a final set of statutory pricing principles. This list may include other clauses cross referencing other parts of the draft Bill. The Government can, for example, seek to recover historic advances paid out under the s16 Crown Guarantee via changes to the levy.

Flexibility as to how the EQC is financed

46. The Inquiry recommended:
- that the EQC be provided a stronger obligation to support claimants and in some cases the community;
 - have capacity to contribute to other areas of policy in the disaster management or resilience space;
 - participate in whole-of-government initiatives in the disaster recovery or resilience space.
47. The scheme is currently primarily funded via insurance premiums/levies. Charging a discrete set of property owners for the full cost of general policy activities that contribute to wider Government policy priorities may not be seen as fair.
48. The Treasury reports covering the review of the Act have not sought to define the EQC's priorities or the work that should be undertaken to support claimants or the wider community. To give effect to the Inquiry's recommendations we have defined EQC's mandate broadly to provide flexibility. A final decision as to EQC's annual priorities in this space would be agreed within the Statement of Intent.
49. To further support the recommendations of the Inquiry, we recommend that the Act be amended to provide additional funding flexibility to allow for the provision of public funding. We recommend that the Act include the option for EQC to enter into a service agreement based upon a similar option provided to the ACC. A service agreement would allow the Government to purchase services from the EQC in situations where:
- the Board requests funding on the basis that activities or advice is deemed tangential to the research or education required to reduce insurance liabilities over time; or

¹¹ This is not currently a problem as the EQC Act does not state any basis for levies. Alignment with modern standards, which require a basis for compulsory charges and levies, introduce a risk of review. We will consult Parliamentary Counsel Office on the specific wording, but in general terms a Minister may legitimately consider factors recognised by the Act.

- the Government requests or directs that the EQC contributes to a wider whole-of-government initiative.

Consultation

50. The Earthquake Commission and Legislation Design Advisory Commission (LDAC) were consulted in drafting this report.