

The Treasury

Treasury Advice Related to Modernising the EQC Act Information Release

December 2021

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Clarifying Statement

In relation to page 18, paragraph 73:

The entities consulted on report T2020/3719 (refer paragraph 73) provided feedback on the recommendations that were relevant to their respective mandates.

Information Withheld

Some parts of this information release would not be appropriate to release and, if requested, would be withheld under the Official Information Act 1982 (the Act).

Where this is the case, the relevant sections of the Act that would apply have been identified.

Where information has been withheld, no public interest has been identified that would outweigh the reasons for withholding it.

Key to sections of the Act under which information has been withheld:

- [25] 9(2)(b)(ii) - to protect the commercial position of the person who supplied the information or who is the subject of the information
- [26] 9(2)(ba)(i) - to protect information which is subject to an obligation of confidence or which any person has been or could be compelled to provide under the authority of any enactment, where the making available of the information would be likely to prejudice the supply of similar information, or information from the same source, and it is in the public interest that such information should continue to be supplied
- [27] 9(2)(ba)(ii) - to protect information which is subject to an obligation of confidence or which any person has been or could be compelled to provide under the authority of any enactment, where the making available of the information would be likely otherwise to damage the public interest
- [33] 9(2)(f)(iv) - to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials
- [34] 9(2)(g)(i) - to maintain the effective conduct of public affairs through the free and frank expression of opinions
- [35] 9(2)(g)(ii) - to maintain the effective conduct of public affairs through protecting ministers, members of government organisations, officers and employees from improper pressure or harassment
- [38] 9(2)(j) - to enable the Crown to negotiate without disadvantage or prejudice
- [39] 9(2)(k) - to prevent the disclosure of official information for improper gain or improper advantage

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Treasury Report: Modernising the Earthquake Commission Act: Aligning with the Crown Entity Framework

Date:	10 March	Report No:	T2020/3719
		File Number:	TY-2-1-17

Action sought

	Action sought	Deadline
Hon Grant Robertson Minister of Finance	note the contents of this report	None
Hon Dr David Clark Minister Responsible for the Earthquake Commission	agree to the recommendations within this report which seek to consolidate the EQC's current status as a Crown agent	18 March 2021

Contact for telephone discussion (if required)

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

Treasury Report: Modernising the Earthquake Commission Act: Aligning with the Crown Entity Framework

Executive Summary

This report responds to your requests:

- for advice on targeted changes to the Earthquake Commission (“EQC”) structure discussed in our report *Modernising the Earthquake Commission Act: Institutional Amendments* (T2020/3143 refers)
- clarification of *recommendation p* in our report *Modernising the Earthquake Commission Act: Financial Disclosures and Powers* (T2020/2886 refers), which sought agreement to the provision for public funding if EQC takes on non-core duties in support of wider Government objectives.

Modernising the Earthquake Commission Act 1993 (the “Act”) to align the safeguards around the use of public money with other similar public entities

The Act requires modernisation to improve its consistency with best practice for arm’s length public entities managing funds on behalf of the Crown (referred to as Crown Financial Institutions or CFIs).

While the EQC is a Crown agent, its statutory framework was enacted at a time when the Government anticipated the removal of compulsory insurance cover and EQC competing as a commercial insurer.

This background has led to the incorrect categorisation in the Act of EQC levies as a premium – a form of commercial revenue. The Legislation Design and Advisory Committee (LDAC) statutory guidelines relating to the management of compulsory levies (a form of tax) differ from those that apply to commercial revenue, which is normally voluntary in nature.

For this reason, other public agencies collecting and holding dedicated public funds on behalf of the Crown (or the public) are normally subject to specific statutory requirements relating to accounting for the use of public levies.

Differentiating the Natural Disaster Fund from the EQC’s operational assets

This paper recommends amendments to require the EQC to apportion insurance costs, track, and report the levies that it collects and manages via the Natural Disaster Fund (NDF) on behalf of the Crown.

While other Crown entities’ Acts separate the entity from the funds they hold on behalf of the Crown or public, the EQC Act does not financially differentiate between the EQC (the entity) and the NDF. Levies/premiums are treated in a similar way to commercial revenue (that is, they are the property of the EQC and may be paid to the Crown as “*dividends*”).

The Act also specifies that all EQC assets are legal property of the NDF. Operational assets that are not available to pay claims (for example, fixed assets, intangibles, desks, or computers) are owned and are reported as being part of the NDF (a ‘financial’ fund).

We recommend three changes that will require the EQC to specifically track and report insurance-related costs and levy payments into and out of the NDF. In practice, the EQC already has well-developed internal accounting systems that can track the relevant expenditure and apportion costs for reinsurers. We recommend changes to:

- separate the ownership of operational assets (or other non-insurance revenue/costs) so they are not reported as part of the *financial* resources held within the NDF
- require EQC to maintain an account of NDF assets (that is levies) and their use over time, and
- require publication of appropriate financial information for the NDF (there are similar *provisions* in the Accident Compensation Act 2001).

These changes align the Act with the normal reporting required for assets held on behalf of the Crown and provide the necessary transparency around the collection of compulsory levies.

Converting the Crown's shareholding in EQC into contributed capital within the NDF

The Act specifies that the Crown holds \$1.5 billion of shares in EQC.

The Crown shareholding was provided to allow the EQC to act as a commercial insurer should deregulation have occurred. As such, the EQC is the only Crown agent that is capitalised by way of shares and share capital.

As Crown agents manage public funds to give effect to Government policy, the Government would normally deposit public funds in a dedicated account that the Crown entity would manage on its behalf. A statutory framework based around the Crown acquiring additional shares in the EQC in order to contribute to the NDF is dated and administratively costly.

An ability for the Crown to contribute funds to the NDF requires that the EQC have systems in place to track and manage these assets (i.e. the NDF would need to be treated as a defined pool of assets). Providing you agree to establish the NDF as a separate accounting/reporting entity (see above), we recommend that the fixed statutory value of the Crown's shareholding in EQC be written down to its current value (that is zero) and removed. To align with other Crown entities' Acts, we recommend any future contributions by the Crown be treated as contributed capital and held within the NDF.

The permanent legislative authority (i.e. that is the Crown guarantee) in the EQC Act would continue to apply to insurance costs made against the NDF.

Clarifying the purpose of the NDF

As the EQC scheme as a whole benefits the public, the Crown has unconditionally committed to cover the EQC scheme. Claimants are paid regardless of the NDF's value, suggesting the NDF (and its performance over time) exists to partly pre-fund or offset the insurance costs that the Crown has otherwise committed to pay.

Use of a shareholding to indirectly identify the Crown as the owner of a financial fund is unusual. More modern Acts would define the purpose of the fund and the ownership of the assets directly. A removal of the Crown's shareholding, without corresponding changes to define the Crown's rights, would introduce significant ambiguity as to how, when, or whether the Responsible Minister could influence the management of the NDF.

We recommend that you seek authority from Cabinet to amend the Act to ensure the Crown retains its current ownership and rights with respect to the NDF.

Use of NDF Funds – Government

The Act enables the Crown to declare a dividend. As the Crown unconditionally guarantees the EQC, internal transfers from the NDF to the Crown have no economic impact for the public. Claims are paid regardless of the NDF's value. However, the payment of levies as dividends mischaracterises the nature of the transfer and could contribute to underreporting of accumulated EQC levies over time.

Given LDAC expectations that levies bear an appropriate relationship to cost, we recommend changes to better represent how funds are transferred from the NDF to the Crown.

Your current ability to direct the EQC's investment strategy provides sufficient flexibility to allow the Government to transfer resources and/or optimise how it manages risk on its balance sheet. As such, we recommend that you remove the statutory authority to make the following payments:

- **the Minister's ability to declare a dividend** as the transfer of levies should not be treated as a form of *commercial* profit
- **the ability to charge an amount *in lieu of tax*** as provisions introduced to ensure competitive neutrality are no longer required as the compulsory attachment of EQC cover to private insurance policies *was* never deregulated
- **the current charge for the Crown guarantee (section 17)** as the NDF is held to offset the Crown's future insurance costs, suggesting that there is no benefit from the Crown charging the NDF.

Use of NDF funds – public funding and an EQC services agreement

Officials met with you on 10 December 2020 to discuss the Treasury report entitled *Modernising the EQC Act: Financial Disclosures and Powers* (T2020/2886 refers).

You requested that we change *recommendation p* in that report to clarify that public funding would be used to support the EQC's contribution to other priorities. *Recommendation p* in report T2020/2886 stated:

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

Recommendation v in this report seeks agreement to a power that will allow EQC to sign a services agreement that would involve a provision of services to the Crown.

Use of NDF funds – apportionment of costs

You have agreed the EQC should have flexibility to contribute to wider Government priorities and that insurance premiums should only cover the costs of any duties or functions directly relating to provision of EQC insurance.

While public funding may be provided, there is no guidance in the EQC Act as to how the EQC should apportion costs. We have discussed this with LDAC who have recommended that the EQC Act should include guidance as to how costs would be apportioned to align with best practice and modern legislative drafting standards.

We are seeking an indication as to whether section 15 of the Act ("*money payable out of the fund*") should:

- Remain silent as to how costs are apportioned (the status quo) which would allow the EQC Board full *legal* discretion and flexibility as to whether they charge non-insurance costs to property owners (via the NDF) or seek funding from the Government (**inconsistent with Legislation Design Advisory Committee advice**).
- Require that insurance levies may only be used by the EQC to cover insurance claims and any associated operating costs. This would include any education or research that provides a benefit to insured property owners or reduces the estimated future costs of the scheme – a gross benefit test (**the Treasury and EQC's recommendation**), or

- Require that insurance premiums may only cover the cost of claims and associated claims management costs (this would require all costs other than insurance claims to be funded via annual appropriation).

Use of NDF funds – pure scientific research

We anticipate that all of the EQC's current research and education would meet the gross benefit test proposed by the Treasury. The EQC would only have to identify a potential benefit with no requirement that cost/benefit (a net benefit) analysis should be completed.

The EQC currently funds pure scientific research that may have an uncertain pay off, a long payback period, or benefits as a public good for parties other than insured property owners. While theoretical research would normally be publicly funded, research into natural disasters is of significant national interest given the risk New Zealand's geology represents to the community.

We do not support limitations that would discourage EQC investment to further understand geological risks. If you are concerned that attribution of these costs to property owners may be viewed as unfair, we would recommend that you establish a small baseline appropriation to recognise the public benefits that may exist.

Recommended Action

We recommend that you:

- note** that modern legislative standards require that compulsory levies bear an appropriate relationship to the cost of the functions that they fund, which informs the accountability and transparency requirements for other Crown entities managing funds at arm's length on behalf of either the public and/or the Crown
- note** that the statutory design of the Natural Disaster Fund (NDF), Crown shareholding in the Earthquake Commission (EQC), and reporting requirements that apply under the EQC Act do not align with modern drafting standards and/or established best practice for comparable Crown entities

Reclassifying the compulsory EQC "premium" as a levy

- agree** that the EQC "premium" should be relabelled as a "levy" to align with common practice, which is for legislation to specify the nature of the revenue collected

Agree/disagree.

Differentiating the Natural Disaster Fund from the EQC's operational assets

- note** that, while the NDF is commonly presented to the public as a financial fund, the Earthquake Commission Act 1993 (the Act) specifies that the EQCs operational assets (e.g. fixed capital, furniture, or IT equipment) are legally owned by and are held within the NDF
- agree** to remove section 13(3) of the Act which specifies that EQC's non-financial operational assets and liabilities (e.g. plant and equipment) are held within the NDF

Agree/disagree.

- f **note** while the NDF will continue to held by the EQC, this change ensures the fund can be tracked as a defined pool of financial assets that is held to pay insurance claims
Agree/disagree.
- g **agree** that the Act should require that the EQC maintain a standalone record of EQC levies, insurance costs, and any other charges made against the NDF to establish a public record of the NDF's current value and historic use
Agree/disagree.
- h **agree** that the Act should require that the EQC publish in its financial statements appropriate financial data for the NDF (that is on an individual basis) to publicly report the accumulated balance of levies and any information relevant to the allocation of costs to the NDF.
Agree/disagree.

Aligning the Crown's relationship to the NDF and EQC

- i **note** the Act specifies that the Crown owns \$1.5 billion in shares in EQC, which was introduced to allow for the removal of compulsory insurance cover and the commercial sale of EQC residential insurance
- j **note** the shareholding model is obsolete as the insurance market was never deregulated and that the Crown does not own shares in any other Crown agent as these entities normally hold and manage public funds to give effect to Government policy
- k if you agreed to differentiate the NDF (recommendation e), **agree** we recommend that the fixed statutory value of the Crown's \$1.5 billion shareholding be reduced to its current value (that is zero) and removed;
Agree/disagree
- l **agree** the EQC Act be amended to allow the Government to directly contribute capital to the NDF without a need to buy and sell shares in the EQC;
Agree/disagree
- m **agree** the Crown should have the ability to withdraw any further funds that it voluntarily contributes to EQC insurance costs (i.e. contributed capital) providing the fund has sufficient resources to repay;
Agree/disagree.
- n **note**, following conversion of the Crown's shareholding, that the Crown's relationship to EQC (the entity) will continue to be defined by the current Crown agent framework laid out within the Crown Entities Act 2004
- o **note** the Crown entity statutory framework does not define the Crown's relationship to ring-fenced financial funds held within the NDF, suggesting removal of the Crown shareholding would introduce significant ambiguity as to how, when, or whether the Responsible Minister could determine the management of the NDF

- p **agree** that your Cabinet paper should seek approval that the Amendment Act clearly retain, reflect, or preserve the Crown's current interest (or rights) as the ultimate owner of the NDF (and associated insurance liabilities) to ensure the Crown can clearly continue to influence its risk and/or the management of funds within the NDF

Agree/disagree.

- q **note**, should you agree to *recommendation p*, officials will work with Parliamentary Counsel Office (and other agencies) and will report back as to how this would normally be reflected in the Act (for example, via a purpose statement or similar explanatory provision)

Use of NDF Funds by the Government

- r if you agree to remove the Crown's shareholding (recommendation k), **agree** that the power for the Minister to declare a dividend (section 9) be narrowed to only allow for repayment of funds contributed to the NDF by the Crown (that is, the Crown can no longer pay levies paid by the public to itself in the form of a dividend)

Agree/disagree.

- s **agree** the power to charge an amount *in lieu* of tax (section 10(2)) be removed as the residential insurance market was never deregulated and the EQC does not need to compete on a competitively neutral basis

Agree/disagree.

- t if you agreed the Crown should continue to own the NDF (recommendation q), **agree**, that the charge the Crown receives for the PLA in section 17) should be removed as it amounts to the Crown charging itself for a guarantee

Agree/disagree.

Use of NDF funds by the EQC – a services agreement

- u **note** that you have requested a revised version of *recommendation p* in our earlier report entitled *Modernising the EQC Act: Financial Disclosures and Powers* (T2020/2886 refers), which we have included as *recommendation v* (below);

- v **agree** that the EQC Act should be amended to allow the EQC to enter into a services agreement with the Government in exchange for public funding to pay for any services that do not meet the criteria for funding from the NDF (*note that a similar power has been provided to the Accident Compensation Corporation under section 271 of its Act*)

Agree/disagree.

(e.g. services for non-insured when an event occurs & EQC is best-placed to respond for scale or other reasons)

Use of NDF funds by the EQC – Apportionment of insurance and non-insurance costs

- w **note** that, while you have agreed that EQC insurance levies should only cover the cost of insurance, section 15 of the Act ("*money paid out of the fund*") allows the EQC to charge non-insurance costs to the NDF

- x **note** the Legislation Design Advisory Committee has reviewed the current section 15 ("*money paid out of the fund*") and have indicated that the current discretionary framework that does not specify how insurance and non-insurance costs will be apportioned is inconsistent with best practice

- y **indicate** whether section 15 of the EQC Act (“*money paid out of the fund*”) should:
- i. remain silent as to how costs are apportioned (the status quo) which would allow the Board full legal discretion and flexibility as to whether they charge non-insurance costs to the NDF (**inconsistent with Legislation Design Advisory Committee advice**)

Agree/~~disagree~~.

- ii. be amended to require that EQC levies and the NDF may only cover insurance claims and, in addition, any associated operating costs, including any relevant education or research, which the Board expects to either provide a benefit to insured property owners or reduce the estimated future costs of the scheme – a gross benefit test (**the EQC and the Treasury’s recommendation**),

~~Agree~~/disagree.

or

- iii. require that insurance premiums may only cover the cost of claims and associated claims management costs (**not recommended**).

Agree/~~disagree~~.

Use of NDF funding – pure scientific research

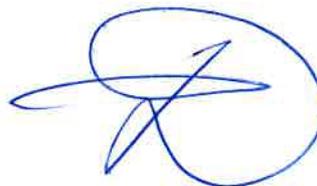
- z **note** that all EQC’s current research and education would meet the proposed gross benefit test (refer *recommendation y(ii)* above) including pure scientific research that would normally be publicly funded as a public good

- aa if you agree that levies should cover insurance costs that provide a benefit for the scheme (y(ii) above) **indicate** whether you would like to receive advice before the Act enters into force on establishing a small nominal EQC baseline to recognise the public benefit and/or address the perceived fairness issues that may arise if only property owners were charged for pure science research

Yes/~~no~~.

[EQC should continue current approach in my view. D.]

- bb **note**, should you agree to the recommendations in this report, the EQC and the Treasury will report back on the final wording for the Cabinet recommendations necessary to give effect to the proposed accounting and structural changes within EQC (i.e. removal of its shareholding);



Helen McDonald
Manager, Earthquake Commission Policy Team

Hon Dr David Clark
Minister Responsible for the Earthquake Commission

22/3/21

Treasury Report: Modernising the Earthquake Commission Act: Aligning with the Crown Entity Framework

Purpose of Report

1. This paper discusses minor statutory amendments that seek to modernise the Earthquake Commission Act 1993 (the EQC Act) to: improve reporting; consolidate the EQC's status as a Crown agent; and align the institutional arrangements for the Natural Disaster Fund (NDF) with standard requirements relating to the management of dedicated public funds held at arm's length to the Crown.
2. The content of this report responds to your request:
 - for advice on targeted changes to the Earthquake Commission discussed in our report *Modernising the Earthquake Commission Act: Institutional Amendments* (*recommendation bb* in T2020/3143 refers); and
 - that we provide wording revisions to *recommendation p* in our *Financial disclosures and powers* paper (T2020/2886 refers), which sought agreement to a framework for public funding in situations where the EQC contributes to other Government priorities.

The scope of analysis

3. In providing this advice we have not reviewed the Earthquake Commission's ("EQC") current status as a Crown agent within the Crown entity framework as the previous Minister Responsible for EQC agreed to exclude changes in entity status from the terms of reference for this review (T2020/2370 refers).
4. Our advice on the NDF has taken an "*evolutionary*" approach that takes the existence of the NDF as a given. The approach taken is to align accountability arrangements with other similar dedicated funds held and managed at arm's length to the Crown.

Background

5. The EQC scheme is a first-loss insurance scheme that provides coverage for residential properties against damage arising from natural disasters. The scheme continues to run as a statutory insurance scheme that is administered by the EQC.
6. This section of the report discusses the historical background explaining why the EQC Act retains aspects of the state-owned enterprises (SOE) framework, for example, the EQC has a shareholding minister. The remainder of the report focusses on the potential changes you could consider to modernise the EQC Act to better align with the Crown entity framework.

EQC was restructured to align with aspects of the state-owned enterprise framework to allow for deregulation

7. The EQC's current statutory framework sought to allow for deregulation in the late 1980s. The amendments anticipated that EQC insurance cover would eventually become voluntary and that the EQC would eventually compete on a competitively neutral commercial basis. The changes to the EQC Act made at this time included:

- the EQC was given ownership of the NDF to align its institutional structure with insurance reserves earned by commercial insurers
- the Crown received shares and provided paid in capital (\$1.5 billion)
- the Minister gained the right to declare a “*dividend*”
- the Minister was given the power to require the EQC to pay an amount “*in lieu*” of tax to ensure competitive neutrality, and
- the EQC was required to pay a charge for the Government guarantee to address the competitive benefit that it may obtain.

Deregulation did not occur and the EQC was established as a policy focused Crown agent

8. A review of the EQC conducted in the early 1990s, prior to the deregulation of the market, concluded that a more efficient and competitive EQC would grow its business, which would increase (not decrease) the Crown’s contingent liability.
9. The public discussion document released at that time also noted that the “*underlying objective of the Government in relation to natural disasters must be to reduce the distress caused, in so far as it is within its capacity, and to do so in an effective and efficient manner as possible*”.
10. The Government decided not to proceed with deregulation of residential cover and the EQC was designated a Crown agent in 2005. Crown agents must give effect to Government policy when directed to do so.
11. Changes were made at this time to limit the Crown’s liability (for example, removing indemnity cover for commercial properties and capping residential cover). In light of the Crown’s fiscal objectives, the Government maintained control of the risks it underwrites (via the EQC Act), the pricing of cover (premiums/levies via regulations), and EQC’s statutory insurance duties remained administrative rather than commercial in nature.¹

The Inquiry has suggested that the EQC could play an even more significant public role supporting the development of policy

12. Within New Zealand, the experiences from the 2010 and 2011 Canterbury earthquake sequence and subsequent insurance market developments have highlighted the continued importance of publicly-provided natural disaster insurance. The Public Inquiry into EQC (the Inquiry) noted that the EQC’s insurance functions had been interpreted narrowly, suggested that the EQC had social responsibilities, and recommended that EQC could contribute to the development of policies in other areas.
13. In response to the Inquiry’s findings, you have agreed (T2020/3143 refers) that the EQC Act should include:
 - a purpose statement and organisational objectives that provide additional mandate flexibility to allow the EQC to play a more significant (non-insurance) public role, contributing to community resilience or supporting a response to a natural disaster, and
 - provision for public funding given insurance levies should not cover non-insurance costs.

¹ The EQC’s function is to “*administer the insurance against natural disasters provided under this Act*” section 5(a).
T2020/3719 Modernising the Earthquake Commission Act: Aligning with the Crown Entity Framework

Problem definition

14. While the EQC is currently a Crown agent funded from compulsory levies, certain outdated aspects of its current statutory framework and relationship to the Crown continue to be based upon provisions that were introduced to preposition the EQC to eventually become a commercial entity.
15. While EQC's operational practice generally conforms with best practice, the current statutory framework and basis for reporting requires modernisation to align with the standard statutory framework that applies to other Crown agents. These omissions are most acute with respect to how public funds within the NDF should be treated.

Ambiguity around the EQC's purpose and statutory mandate

16. As noted, the EQC may have previously interpreted its role as an insurer too narrowly, prompting the Inquiry to recommend that the EQC should play a more significant public role in future. Removing obsolete commercial clauses would further consolidate the EQC's status as a Crown entity/agent whose role is to give effect to government policy.

Recognition that EQC "premiums" are either a fee or a levy

17. The history that gave rise to the current Act has led to the incorrect definition of the EQC's income as a "premium", which is a form of commercial revenue.
18. Commercial revenue arises from the voluntary sale of goods and services. However, in practice, EQC premiums are collected as a compulsory charge against private insurance policies. The compulsory nature of the charge suggests that the EQC premium could be defined as either a fee or a levy. A fee is charged for monopolistic public services (for example a passport charge). A levy is a compulsory charge to pay for a function that benefits a specific group.
19. The compulsory nature of the EQC levies and/or lack of any viable alternative creates an obligation to the public. These funds are:
 - normally subject to specific accounting and reporting requirements, and
 - where they are dedicated for a specific purpose (they are hypothecated) and held at arm's length to the Crown, they are normally managed separate from the funds of the entity that collects and/or manages them.

A lack of differentiation between the EQC and funds held on behalf of the Crown is not consistent with best practice

20. As the EQC Act treats EQC levies as premiums (commercial revenue), the EQC Act does not enforce any separation between the EQC and the assets that it holds on behalf of the Crown. The EQC formally 'owns' the NDF and the Act specifies that all EQC assets, including operational assets such as furniture, form part of the NDF (section 13(3)).
21. The reclassification of EQC premiums as a levy suggests that the EQC Act should provide additional guidance as to how these levies should be managed and/or reported. A dedicated, ring-fenced fund can operate in a range of different ways. This report has sought to clarify the legal basis for accounting, disclosure, and reporting.

The statutory controls around the use of levies or Crown funds should align with best practice

22. In line with the *Legislation Design Advisory Committee (LDAC)*'s guidance, you have agreed that EQC levies should be calculated to cover the cost of EQC natural disaster insurance.

23. The basis for the EQC levy and permissions under the Act as to how these levies may be spent are not currently aligned. While you have agreed that EQC levies may only cover the cost of insurance, section 15 of the EQC Act allows the EQC to use levies to pay for its insurance and non-insurance duties.
24. The Treasury has received advice from LDAC that leaving the allocation of costs to the EQC Board may not be consistent with best practice. LDAC advised that:
 - legislation should lay out how levies are determined
 - there should be a proper relationship between the levy amount charged and the particular function concerned, and
 - levies should only be imposed if it is appropriate for a certain group to contribute money for a particular purpose.
25. The apportionment of levies has not been an issue historically because, as the Inquiry notes, the EQC has interpreted its role narrowly and has focused on its insurance duties. Your agreement that the EQC Act should allow for an EQC contribution to wider whole-of-government processes suggests a need to consider how costs are apportioned to ensure levies do not unfairly charge property owners.

Accountability to Parliament

26. The EQC Act currently allows the Government to fund other non-insurance related duties from the NDF, which (in a statutory sense) undermines the principle that there should be no spending without an appropriation from Parliament. You have agreed that the EQC's overriding objective should be broad ("*to reduce the impact of natural disasters on land and buildings*"). Additionally:
 - under section 112 of the Crown Entities Act, the Responsible Minister may add additional EQC functions that are consistent with the EQC objective listed above
 - the EQC may currently pay from the NDF any costs arising from its functions including new functions added under section 112, and
 - the Act includes a permanent legislative authority (PLA) allowing the Crown to pay any shortfall in the EQC's assets with no further need for an appropriation (section 17).
27. This set of statutory clauses could, theoretically, allow for any new discretionary function that reduces the impact of natural disasters on land or buildings to be funded via the NDF/PLA.

Consolidation as a Crown Agent

28. We recommend that you consolidate the EQC's current status as a Crown agent with minor changes to recognise your decisions relating to the EQC's mandate and funding.

The Crown agent framework provides sufficient flexibility to implement your decisions

29. While we have not reviewed the EQC's current designation as a Crown agent, the Crown agent framework is sufficiently flexible that it can support the broad statutory mandate that you have agreed. Crown agents have a close association with the Government and are required to give effect to Government policy when directed to do so.

The proposed changes in this report work as a package

30. The changes recommended in this report need to be considered as a package. While some clauses, such as rights to dividends, are obsolete, these clauses indirectly define a relationship that exists between the Crown and the NDF.
31. The removal of the Crown's shareholding requires supporting changes to address the ambiguity that would arise around the correct use of directions and/or other financial powers relating to the NDF. While the Crown's relationship to the EQC (a Crown agent) is otherwise clearly defined under the Crown Entities Act 2004, the Crown's relationship to the NDF must currently be indirectly inferred from the fact that the Crown owns the NDF as the sole shareholder for the EQC.
32. The Crown's relationship to dedicated funds is normally defined more directly within dedicated entity-specific legislation. To define the relationship between the Crown and the NDF, the EQC Act must:
 - define or differentiate the fund from the EQC (the entity) in some way
 - identify the purpose of the fund to inform its future use, and
 - specify the rights with respect to the use of money held within the NDF.
33. The following sections of this report cover differentiation, the purpose of the NDF, and access to NDF funds.

Differentiating the Natural Disaster Fund from the EQC's operational assets

34. While the Acts of other Crown entities separate the entity from the funds that they hold on behalf of the Crown or public, the EQC Act does not financially differentiate between the EQC (the entity) and the NDF.
35. Levies/premiums are treated in a similar way to commercial revenue (that is, they are the property of the EQC and may be paid to the Crown as "dividends"). Conversely, the EQC Act also currently specifies that all assets of the EQC are owned by the NDF (section 13(3) – "*Natural Disaster Fund*"). This suggests that the clearly operational EQC assets that are non-financial and cannot be used to pay claims are reported as part of the NDF. Examples include fixed assets, bank accounts, office furniture, computers, or cell phones.
36. We recommend amendments to the EQC Act to:
 - **Remove operational EQC assets** from the NDF insurance fund to ensure the reported balance only includes financial assets that are actually available to pay insurance claims.
 - Require that the EQC **maintain an account for the NDF** that records the assets and liabilities of the fund with a record of all deposits and withdrawals to pay for EQC's insurance related activities, including claims management, risk financing, or relevant research and education.
 - Require that the Act publish **separate reporting for the NDF** to align with the standard Crown entity requirements for dedicated funds held on behalf of the Crown.
37. A clear legal definition specifying what assets the NDF holds represents the minimum possible intervention necessary to meet established best practice. A clear pool of assets and a record of their use would:

- meet the requirements under the Records Act 2005, that requires records be held in an accessible form
 - support further financial disclosures by the Government demonstrating that EQC levies bear an appropriate relationship to cost, and
 - form the basis for standard safeguards applied to other Crown entities managing dedicated funds on behalf of the Crown and/or public.
38. The proposed amendments to the Act are unlikely to have significant operational impacts. The EQC already has well-developed internal accounting systems that can apportion claims costs for reinsurers. Maintaining a 'nominal account' to track flows into and out of the NDF would not require significant system upgrades.

Defining the Crown's relationship with the NDF and EQC

Conversion of the Crown's shareholding into contributed capital held within the NDF

39. The Act specifies that the Crown owns \$1.5 billion in shares within the EQC. The EQC shareholding is a statutory construct that is obsolete as the Crown does not own shares in any other Crown agent.
40. Providing you agree to separate the NDF and EQC's assets (discussed above), we recommend that the book value of the Crown's shareholding be written down to its current financial value (that is zero) and removed. As the reported value for the EQC will not change, there is no fiscal impact from this change.
41. Removing the requirement that the Crown acquire additional shares in the EQC to allow the Crown to contribute capital to the NDF would modernise the current statutory arrangements and would also reduce administrative costs. The Government can contribute directly to the NDF without the need to buy and sell shares.
42. To simplify future contributions made by the Crown, we recommend the Act include a new framework for "*contributed capital*". Allowing the Crown to contribute to the NDF and request withdrawal of its funds would align with other legislation. The ability to withdraw contributed capital would not apply to compulsory levies or any grants or advances paid under the Crown Guarantee.
43. The Crown does not need to own shares in other Crown agents, as Crown agents apply financial resources to promote the Government's policy objectives. Contributions made by the Crown would normally be recognised as '*contributed capital*' held within a dedicated fund or notional account that the entity manages on the Crown's behalf.
44. The next two subsections discuss how a removal of the Crown's shareholding would affect the Crown's relationship or rights with respect to the EQC and the NDF.

The Crown agent framework defines the Crown's relationship to the EQC

45. As noted above, the Crown's shareholding indirectly defines the relationship between the Crown and the EQC and/or the NDF. Removal of the Crown's ownership/share held in the EQC is not problematic as the Crown's relationship to the EQC (the entity) is already adequately defined by the standard Ministerial powers, including powers of direction, authorised by the Crown Entities Act 2004 and the EQC Act 1993.
46. We are not proposing any secondary changes to respond to the proposed removal of the Crown's shareholding.

The Crown's ownership and rights with respect to the NDF should be defined

47. While the Crown Entities Act 2004 defines the relationship between the Crown and the EQC, the Crown's interest in the NDF is indirectly defined by the shares it holds in EQC. We recommend that the Act directly recognise the Crown's current rights and interests as the legal owner of the NDF².
48. The EQC Act specifies that the Crown will pay all of the costs arising from the EQC insurance scheme with no further need for an appropriation (via the PLA or Crown guarantee). As a result, the use of NDF funds, or the performance or under-performance of the NDF over time affects the Crown's future costs, but there is no implication for claimants (the public).
49. As the Crown currently owns the NDF and bears all the risk relating to its performance over time, we recommend that the Act clarify that the fund is owned by the Crown. A failure to define this beneficial interest introduces significant ambiguity as to how, when, or whether the Responsible Minister could influence the management of the NDF.³
50. The Treasury has considered other solutions based on the Accident Compensation (ACC) Act 2001, which conceptually passes beneficial ownership of ACC financial assets to the public. However, while the ACC Act requires that the ACC hold levies "as if" in trust on behalf of the public, the ACC scheme also passes all of the risks of the scheme back to the public. The ACC scheme is not government guaranteed and the ACC Act requires that that levies increase to cover any annual deficit in the scheme.
51. Unlike workplace accidents natural disasters are large, uncertain, infrequent, and highly correlated. While catastrophe risk schemes abroad do resemble the ACC model, we do not support removal of the EQC guarantee or steps to pass all solvency risk back to insured property owners. Evidence from overseas schemes suggests that applying the ACC approach to insuring catastrophe risk may contribute to very low levels of insurance uptake⁴.
52. At this point we recommend that that you seek authority from Cabinet to make amendments to the Act necessary to clearly retain or reflect the Crown's current interest (or rights) as the owner of the NDF. This will ensure the Crown continues to determine how NDF funds are managed.
53. The Crown's interest could be reflected in a range of different ways within the EQC Act. Should you agree, officials will seek advice from the Parliamentary Counsel Office (PCO). At the time of writing, we are exploring a purpose statement, explanatory provision, or deposit in a Crown account.

Use of NDF funds

Targeting how the Crown may influence or access the NDF

54. The PLA (the Crown Guarantee) ensures that transfers within the Crown have no economic impact for claimants and/or the public. Given the Crown has the liability it should have the right to access the NDF and/or determine how EQC manages its risk

² While the Act does not specify that the Crown owns the NDF, this can be clearly inferred by the current Act. The NDF is part of the EQC, which the Crown owns as the sole shareholder. The Minister may currently withdraw the NDF as a dividend and the Minister's ability to direct the management of the NDF was clarified to allow the Minister to Act in the Crown's interest (i.e. he/she is not bound solely by the purposes of the Act).

³ For example, whether investment directions could consider the risks to the Crown or investment interests of claimants.

⁴ The California Earthquake Authority must be fully funded and is not guaranteed. Concerns about solvency risk and the cost of CEA cover contribute to very low levels of insurance uptake in California. While insurance uptake is over 90% in New Zealand, around 10-20% of Californian homes are insured against natural disaster in California.

over time. Notwithstanding this, we recommend the removal of some Ministerial powers to ensure that transfers to/from the Crown recognise the underlying nature of the transaction.

55. We propose (refer table one) that the Government’s powers with respect to the NDF be based around the current investment directions that allow the Minister to direct the EQC as to how the NDF should be managed (refer to section 12 of the current Act). This suggests other obsolete clauses, such as dividends or amounts in lieu of tax, could be removed. These clauses sought to ensure competitive neutrality should the insurance market have been deregulated.

Table One: Summary of recommended changes:

Recommendation	Explanation
We recommend removal of the Minister’s power to declare a dividend (s9).	Payment of a levy to the Crown as a “dividend” mischaracterises the nature of the transfer. Levies should not exceed the cost of the service they fund, suggesting levy funded entities should not pay dividends.
We recommend removal of the Minister’s power to require a payment of an amount in lieu of tax (s10(2)).	This clause is obsolete as payment of tax was intended to ensure competitive neutrality, if the insurance market was deregulated.
Should you agree that the NDF is a Crown owned fund, we recommend the removal of the charge (s17) for the (s16) Crown guarantee.	The NDF is charged an annual fee for the Crown guarantee. The guarantee was introduced to encourage competitive neutrality.
We recommend that the power allowing the Minister to direct the EQC as to its direction strategy (s12) be retained.	The Minister may direct the EQC on investment and management of the NDF. Previous Governments have directed the EQC to invest in Government debt.
We recommend a new power allowing the Government to contribute capital or require repayment of historic contributions or advances.	The Government could invest and/or require repayment of funds that it voluntarily deposits in the NDF. This power would not affect the treatment of compulsory EQC levies or any grants or payments made under the Crown guarantee (s16).

56. Providing that the Act is amended to clarify that the NDF is held for the Crown’s benefit (i.e. to offset its future insurance costs), we also recommend the removal of the current charge for the Crown guarantee (section 17). A charge to the NDF for the Crown guarantee adds unnecessary complexity.

Investment directions

57. The Minister may direct the EQC as a Crown agent to give effect to Government policy under section 103 of the Crown Entities Act and section 12 of the EQC Act. We recommend that you retain these powers as they are common to other Crown agents.
58. An ability to direct how the NDF is managed allows the Crown to influence the risks that it insures, and provides options as to how this risk is managed on its balance sheet. While EQC has historically viewed itself as a standalone entity, EQC assets and liabilities are fully guaranteed and are also consolidated onto the Crown balance sheet.
59. Removing rights to take levies as dividends and retaining the ability to direct how EQC invests the NDF would ensure that:

- the Crown may continue to access NDF resources (i.e. via a direction to invest in Government debt), and
- any transfer to the Crown would be recognised as a future debt/obligation that the Crown must repay if insurance claims were to arise.

Legal requirements defining how NDF funds may be used

Clarifying our recommendation to provide for public funding

60. In our meeting on 10 December 2020, you requested that we clarify *recommendation p* in our report entitled *Modernising the EQC Act: Financial Disclosures and Powers* (T2020/2886 refers) to clarify that that the public funding would only be provided to support the EQC’s contribution to wider government priorities.
61. The original recommendation sought agreement to a statutory provision authorising the EQC to enter into a service agreement (i.e. contract) in exchange for public funding. *Recommendation u* in this report provides an amended recommendation for you to consider.

Apportionment of costs

62. There is a difference between the scope of the mandate that you have agreed for the EQC and the proposed basis for the EQC insurance levies. While levies cover insurance costs, the EQC may also contribute to other Government priorities.
63. While, in practice, the Crown has historically paid for discretionary public policies,⁵ section 15 of the Act (“*money payable out of the fund*”) authorises the EQC to deduct any costs relating to any of its functions. There is no guidance in the Act as to how costs should be apportioned (that is between the NDF and the Crown).
64. The Minister Responsible for the EQC may also add additional functions to the EQC (as a Crown agent) under section 112 of the Crown Entities Act. These functions must relate to the EQC’s objectives (i.e. “to reduce the impact of natural disasters on land and buildings”) but are not required to be insurance-related.
65. We have consulted the LDAC (refer to paragraph 26) and have identified a need to review section 15. LDAC’s letter to the Treasury on modernising the EQC Act noted in relation to a proposal to leave the allocation of costs between premiums and public funding as a discretion for the Board that:
- “The levy setting process needs to be transparent. There needs to be a clear basis for how the rate of levies is determined. Leaving the allocation of costs to the Board’s discretion may therefore not be best practice”*
66. We are seeking an indication as to whether you would prefer the EQC Act to provide guidance as to how premiums should be used. The options are that the EQC Act could:
- remain silent as to how costs are apportioned (the status quo) which would allow the EQC Board full legal discretion as to whether non-insurance costs may be charged to the NDF (**inconsistent with Legislation Design Advisory Committee advice**)
 - require that the NDF may only cover the provision of insurance, any associated operating costs, and any education or research that is expected to provide a benefit for insured property owners or a reduction in the estimated future costs of the scheme – a gross benefit test (**the EQC and the Treasury’s recommendation**), or

⁵ For example, the Crown paid the EQC to remove silt for uninsured properties in Edgecumbe as it was already performing this function for insured properties.

- iii. require that insurance premiums may only cover the cost of claims and associated claims management costs.

Provision for public funding

67. New Zealand's geography and our exposure to natural disasters informs how the Treasury has considered these options. The infrequent nature and severity of natural disasters supports provision of a degree of flexibility and independence to the EQC Board. This flexibility ensures investments in research occur and that steps are taken to ensure that the public understand the risks.
68. While hard prescriptive spending guidelines (option iii) offer clear benefits over the status quo (option i) in terms of transparency and accountability, a prescriptive test may contribute to the EQC scheme becoming more reactive over time (that is, these requirements may deter future investment that seeks to avoid future costs/loss).
69. The expected benefit test proposed by Treasury (option ii) seeks to exclude activities that primarily benefit the public outside the scheme (for example, the EQC clean-up of silt for uninsured owners in Edgecumbe). While the proposed test provides transparency, an assessment of benefits remains inherently subjective suggesting the Board would retain a significant amount of discretion. The key requirement created is that the EQC would need to continue running robust processes to establish that its research priorities provide a benefit to allow it to prioritise spending.

Public funding for pure science research

70. The EQC currently funds a range of pure scientific or theoretical research that may have an uncertain pay off, a long payback period, or benefits as a public good for parties other than insured property owners.
71. LDAC guidance would normally suggest that theoretical (or pure science) research should be publicly funded as it provides a general benefit. However, research into natural disasters is of significant national interest given the risk that New Zealand's geology represents.
72. We do not support limitations that would discourage further EQC investments to understand geological risks. However, if you are concerned that attribution of these costs to property owners may be viewed as unfair, we would recommend that you establish a small baseline appropriation to recognise the public benefits that may exist.

Consultation

73. The Earthquake Commission (EQC), Public Service Commission (PSC), and Office of the Auditor General (OAG) were consulted on, and were supportive of the, proposals in this paper.
74. The Department of Prime Minister and Cabinet, Reserve Bank of New Zealand, Ministry for the Environment, Department of Internal Affairs, and Land Information New Zealand were provided a copy of this report, but have not provided any comment.