

The Treasury

ECO-24-SUB-0099: Natural Hazards Insurance Act – Funding and Risk Management Statement Information Release

August 2024

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Cabinet Document Details

Title: **Cabinet Paper ECO-24-SUB-0099: Natural Hazards Insurance Act: Funding and Risk Management Statement**

Date: **19 June 2024**

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Office of the Associate Minister of Finance
Chair, Cabinet Economic Policy Committee

Natural Hazards Insurance Act: Funding and Risk Management Statement

Proposal

1. This paper informs Cabinet about my proposal to issue the first Funding and Risk Management Statement (FRMS) for the Natural Hazards Commission Toka Tū Ake (the Commission)¹. The paper also informs Cabinet about the outcome of Minister of Finance's review of two Ministerial Directions issued to the Commission related to the investment of the Natural Hazard Fund (the Fund).
2. The FRMS is required by Section 136 of the Natural Hazards Insurance Act 2023 (the Act) and must be in place when the Act comes into force on 1 July 2024. It provides transparency for how financial settings and levy settings are determined, and how the cost of claims will be shared between the Fund and the Crown.

Relation to Government priorities

3. The FRMS aligns with the Government's commitment to managing natural hazard risks and promoting community resilience.

Executive Summary

4. The Act will take effect from 1 July 2024, replacing the Earthquake Commission Act 1993. The updated legislation aims to mitigate the impact of natural hazards on communities, manage the financial risk to the Crown, and facilitate the arrangement of reinsurance by the Commission.
5. The FRMS is a public disclosure document, which is required to be reviewed at least every five years. Its contents, as set out by the Act, include the financial settings and levy settings of the Natural Hazards Insurance Scheme (the Scheme), financial projections, methodologies and assumptions based on those or other proposed settings, fiscal and economic policy considerations, investment guidelines, and the Commission's function.
6. The first FRMS does not review the financial settings and levy settings, but the projections signal underfunding of approximately 34% over the first five years. I have decided to undertake a review of financial settings and levy settings, now that the necessary regulations are in place.

¹ The Earthquake Commission Toka Tū Ake will go by the Natural Hazards Commission Toka Tū Ake under the Natural Hazards Insurance Act 2023 from 01 July 2024. I refer to *the Commission* throughout this Cabinet Paper.

7. The FRMS sets out the Government’s funding and financing strategy prior to the review. The FRMS highlights the Government's commitment to transparent fiscal management and community resilience in the face of natural hazards. While the current statement maintains the current levy settings, future financial settings and levy settings reviews will be essential to ensure the Scheme's long-term sustainability.

Background

8. The Act represents the culmination of a long-running review of the Earthquake Commission Act 1993 that was first announced in 2012. The Act draws lessons learned about the operation of the legislation in response to the Canterbury earthquakes and other events.

9. The Act will come into force from 1 July 2024, with the purpose to:

- reduce the impact of natural hazards on people, property, and the community,
- contribute to the management of the financial risk to the Crown of providing natural hazard cover, and
- enable the Commission to arrange reinsurance or other risk transfer products, including for Crown risks beyond those covered in the Act.

10. The inaugural FRMS is required to be in place when the Act comes into force. It is then subject to review at least every five years. It provides public disclosure for how financial settings and levy settings are determined, how risk is shared between the Fund and the Crown, and requirements relating to Crown balance sheet exposure. The Act sets out the required contents of the document (Table 1).

Table 1: Content of the FRMS

| Sections | Description |
|--|--|
| Financial Settings and Levy Settings | The current financial settings and levy settings and any proposed changes to them. |
| Financial Projections | Estimates of the costs of providing hazard cover, the Fund amount, and the financial implications of any proposed changes to financial settings and levy settings. |
| Methodology and Assumptions | The methodologies and assumptions used by the financial projections. |
| Policy Considerations | The Minister’s policy considerations during the preparation of the FRMS. |
| Risk Allocations and Government Strategy | The current and projected allocation of risk between the Crown and the Fund, along with the Government’s strategy to reduce or finance any deficiency in the Fund. |

| Sections | Description |
|-----------------------|--|
| Investment Guidelines | The guidelines for the investment and management of the Fund, determined by the Minister, subject to consultation with the Commission. |
| Commission's Function | Copies of current Ministerial directions and letters of expectation given by the Minister to the Commission concerning its functions under sections 129(b) and 129(d) of the Act (to manage the Fund and arrange reinsurance or other risk transfer products, respectively). |

Analysis

The first FRMS has not involved a review of the financial settings and levy settings

11. In making the FRMS, I am required under section 137 of the Act to review the adequacy and appropriateness of the financial settings and levy settings. I am not required to review the financial settings and levy settings when making the first FRMS.²
12. Therefore, the FRMS I propose to publish on 1 July 2024 will be based on the current financial settings and levy settings. Cabinet agreed [ECO-24-MIN-0009] that the current rate of EQC premium of 16 cents of cover per \$100 of the EQCover amount, up to a maximum of \$480 (\$552 incl. GST) will continue to apply upon commencement of the Act.

The first FRMS includes a section on the Investment Guidelines

13. Under the Act, the Commission is responsible for investing the Fund, having regard to the amounts to be paid out of the Fund and as required by any direction provided by the Minister and the FRMS.
14. The Minister of Finance agreed to revoke the existing Ministerial Directions related to the investment of the Fund. I propose to include the requirements from the Ministerial Directions related to the investment of the Fund into the FRMS.
15. Principles from the Ministerial Directions have been incorporated where they remain relevant. This includes the expectation for the Commission to develop a Statement of Investment Policies, Standards and Procedures for the Fund that aligns within the *Investment Guidelines*, and the expectation that the Commission invests the Fund in a manner that can be liquidated in a timely manner to support claims costs.
16. The Minister of Finance consulted with the Commission on the proposed revocation of the two Ministerial directions related to investment of the Fund. Including an *Investment Guidelines* section within the FRMS makes the two Ministerial directions no longer necessary.

² Per clause 13 of Schedule 1 of the Act

Cost-of-living Implications

17. The FRMS is not expected to have any cost-of-living implications. The levy rate is the same as the existing levy rate.

Financial Implications

The modelling to support the first FRMS shows that the current levy settings are insufficient

18. The Commission's initial modelling indicates current levy settings do not sufficiently fund the expected cost of the Scheme. The analysis indicates that the Scheme is currently underfunded by approximately 34% over the first five years.
19. The Crown guarantee can be provided by a loan or a grant. Any loan should be provided with confidence that the Scheme can repay within a reasonable timeframe and without creating undue volatility in levies after a claims event. This requires levies to be risk-reflective or for the Crown to absorb an agreed level of risk for any setting of levies below the risk-reflective amount.
20. Any shortfall in levy income presents a risk for Crown funding now and restricts the build-up of assets in the Fund. This can create a higher need for reinsurance, which is a net cost to the Scheme, or require future generations to absorb levy increases.

The level of risk borne by the Crown is relatively high

21. There is currently a low Fund balance (NZD\$350 million) and ongoing claims costs from past events pose a significant risk. According to the Commission's modelling, there is a 28% probability of needing to draw on the Crown guarantee by 2028 and 35% by 2029. The Commission currently organises for reinsurance for any event greater than NZD\$2 billion.
22. At present, the current levy settings and modelling outcomes have shown that the primary cause of the levy insufficiency is the increase in the risk costs, which is led by the change to the National Seismic Hazard Model. The Crown bears a relatively high level of risk and, it is the cost of claim payments for new events over the next five years will be met by the Crown under the proposed settings.
23. Under section 112 of the Act, the Crown can provide financial support by way of loan or grant. This applies in the case of the assets of the Fund being insufficient to pay the amounts forecast to be due and payable out of the Fund under section 111 of the Act in any upcoming 12-month period.

Therefore, I propose the first FRMS maintains the financial and levy settings, and I have decided to review financial settings and levy settings

24. With the levy settings regulations passed³, I can now undertake a review of the current financial settings and levy settings in accordance with section 139(1)(b) of the NHI Act. This decision underscores my commitment to ensuring that the financial mechanisms underpinning the scheme are both adequate and appropriate.
25. The NHI Act requires financial settings to be reviewed alongside levy settings. In undertaking a review, I may have regard to a range of statutory criteria, including the potential impacts of any changes on insured individuals, fire insurers, the Crown, and other affected parties, as well as the availability, affordability, and uptake of catastrophe insurance for residential buildings.⁴
26. The land and building caps were reviewed as part of the NHI Act, and the building cap came into effect for policies renewing from October 2022. As part of the financial settings review, I will take into account that the impact of these recent changes on natural hazard insurance uptake and affordability needs a longer period of assessment, and that Treasury are continuing to monitor pricing and availability.

Legislative Implications

27. The FRMS is issued under section 136 of the Natural Hazards Act 2023. As soon as practicable after the FRMS is made, it must be presented to the House of Representatives, and the Commission must make it available on its website. The FRMS is included as an Appendix.

Impact Analysis

28. An Impact Analysis is not required for this paper.

Regulatory Impact Statement

29. A Regulatory Impact Statement is not required for this paper.

Climate Implications of Policy Assessment

30. A Climate Implications of Policy Assessment is not required for this paper.

Population Implications

31. There are no specific population implications. A resilient Fund supports an affordable Scheme, enabling homeowners to access insurance.

³ On 27 May 2024, Cabinet agreed to make regulations for the purpose of section 116(2) of the NHI Act to continuing the current rate of EQC premium (16 cents per \$100 of EQC/NHI building cover) as the rate of the NHI Act scheme levy charged on fire insurance policies, and specifying how an insurer must pay the levy to the Commission [CAB-24-MIN-0188 refers].

⁴ Section 140(c) of the NHI Act.

Human Rights

32. The proposals in this paper are consistent with the New Zealand Bill of Rights Act 1990 and the Human Rights Act 1993.

Use of external Resources

33. The Treasury did not engage any external resources in the development of the advice this paper.

Consultation

34. The following agencies were consulted on this Cabinet paper: the Earthquake Commission. The Department of Prime Minister and Cabinet has been informed.

Communications

35. A press release will be posted on the Beehive website once the FRMS is in place.
36. The Commission will publish the FRMS on its website www.eqc.govt.nz.

Proactive Release

37. This paper will be proactively released within 30 business days of decisions being confirmed by Cabinet, subject to amendments as appropriate under the Official Information Act 1982.

Recommendations

38. I recommend that the Committee:
 - 38.1 **note** that I am informing Cabinet of my proposal to issue the FRMS and the Minister of Finance's agreement to revoke the two Ministerial Directions related to investment of the Natural Hazard Fund (the Fund).
 - 38.2 **note** that the first Funding and Risk Management Statement (FRMS) is due to be published by 1 July 2024, as mandated by Section 136 of the Natural Hazards Insurance Act 2023 (the Act). It ensures transparency in cost-sharing, communicates the Crown's financial strategy, and serves as a public disclosure document, requiring periodic review at least every five years.
 - 38.3 **note** that my decision to make the first FRMS will be based on current financial settings and levy settings, including maintaining the existing levy rate of 16 cents per \$100 of EQCover.
 - 38.4 **note** the Natural Hazard Insurance Scheme (the Scheme) is currently self-funding its business-as-usual claims. However, the development of the FRMS has indicated that the current levy rate is insufficient to cover the expected costs of the Scheme over time. Initial modelling indicates a shortfall of approximately 34% over the first five years.

- 38.5 **note** that inadequate funding, combined with a depleted Fund balance and persistent claims costs from previous incidents, presents a substantial risk.
- 38.6 **note** that the Crown has an obligation to provide funding for the Scheme, by way of loan or grant, when the assets of the Fund are not sufficient, outlined in section 112 of the Act.
- 38.7 **note** that, with the first levy regulations now passed, I have decided to undertake a review of the financial settings and levy settings in accordance with section 139(1)(b) of the NHI Act.

Authorised for lodgement

Hon David Seymour
Associate Minister of Finance