New Zealand's Future Natural Disaster Insurance Scheme

Proposed changes to the Earthquake Commission Act 1993

Discussion Document

July 2015

THE TREASURY
Kaitohutohu Kaupapa Rawa

New Zealand Government

Erratum: *Table 4: Impact of different excesses on EQC claims numbers and costs* was updated on 15 July 2015 to incorporate results of more recent modelling. The modelling results originally summarised in Table 4 were from 2014. That was done to better align the information in Table 4 with the other tables in chapter 8, which already drew on that more recent modelling.

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Ministers' foreword

An EQC scheme that helps keep home insurance affordable and supports community recovery after natural disasters

New Zealand is a seismically active country. Our communities are exposed to the perils that come with this, namely earthquakes, volcanic and hydrothermal activity and tsunami. We also regularly suffer from landslips, storms and floods as a result of our weather and geography. When these perils strike, affordable, widely held home insurance is critical to how individuals and communities recover.

By international standards New Zealand homeowners carry high rates of catastrophe insurance. The EQC scheme is a major reason for this. EQC provides homeowners with a significant block of insurance cover against natural disasters that is affordable and costs the same nationwide. This keeps total premiums for insurance covering these perils affordable for most homeowners.

The Canterbury earthquakes are the most destructive natural disaster to have hit New Zealand since European settlement. They have severely tested individuals, families, communities, businesses and local and central government. They have also tested EQC and other insurers. However, EQC's work has significantly contributed to how well homeowners and communities have recovered.

EQC has completed almost 70,000 home repairs, settled more than 500,000 claims and paid out over $8.5 billion. It has also supported wider Government recovery efforts through its work on assessing land and its suitability for habitation, remediating land, carrying out urgent repairs and replacing chimneys and open fires with clean heating devices.

This review of the EQC Act draws on lessons from the Canterbury earthquakes as well as broader lessons from how the Act has been applied since it came into force in 1994.

The Government has developed a number of reform proposals for discussion. These are designed to: ensure the EQC scheme remains focussed on insuring homes; resolve the difficulties experienced in Canterbury with the interaction of land and building cover; better integrate EQC and private insurers' claims handling processes; and ensure the ongoing financial sustainability of the scheme.

We also propose keeping EQC's role in supporting research and education about New Zealand's natural hazards and how to reduce their impact. This work helps build community resilience by reducing the loss and disruption caused by natural hazards.

We believe the proposals in this document, if implemented, will better position homeowners, EQC and private insurers to plan for and recover from future natural disasters. We welcome public submissions on these proposals. Ministers will carefully consider all submissions before making decisions on a reform package. That package will then form part of a Bill which we expect to introduce to Parliament in early 2016.

Hon Gerry Brownlee
Minister Responsible for the Earthquake Commission

Hon Steven Joyce
Associate Minister of Finance

1. Submissions

This document sets out the Government's proposals for potential changes to the Earthquake Commission Act 1993 (the EQC Act). We invite interested parties to make **written submissions** on these proposals.

1.1. How to have your say

We have included questions about each of the proposals in boxes throughout this document. The proposals and questions are also summarised in the Appendix.

You can make your submission using the submission template available at: http://www.treasury.govt.nz/publications/reviews-consultation/eqc. Submitters can open and save their own copy of that template, make submissions on any of the proposals they wish, and email it to us at Submissions.Eqcreview@treasury.govt.nz

We strongly prefer submissions utilising the submission template. If you cannot do that you may email or write to us. To help with our analysis please clearly indicate which proposal and question numbers your submission is responding to. Our email address is Submissions.Eqcreview@treasury.govt.nz. Our postal address is:

Review of EQC Act
The Treasury
PO Box 3724
Wellington 6140
NEW ZEALAND

The deadline for submissions is 5.00pm on Friday 11 September 2015

1.2. Next steps

Officials will analyse all submissions after the closing date. The views expressed in the submissions will be taken into account when the final proposals are developed and considered by the Cabinet.

The Government intends to develop a Bill for introduction to Parliament in early 2016. The general public will be able to comment on the Bill during the select committee review process.

1.3. For further information

Website: http://www.treasury.govt.nz/publications/reviews-consultation/eqc

Email: Submissions.Eqcreview@treasury.govt.nz

Phone: +64 4 472 2733

1.4. Official Information Act 1982

Submissions are subject to the Official Information Act 1982 (OIA). Please set out clearly with your submission if you have any objection to any information in the submission being released under the OIA, and in particular, which part(s) you consider should be withheld, together with the reason(s) for withholding the information.

Grounds for withholding information are outlined in the OIA. Reasons could include that the information is commercially sensitive or that you wish personal information, such as names or contact details, to be withheld. An automatic confidentiality disclaimer from your IT system will not be considered as grounds for withholding information.

We will take your objections into account when responding to requests under the OIA.

Any personal information you supply in the course of making a submission will be used by the Treasury only in conjunction with the matters covered by this document. Please clearly indicate in your submission if you do not wish your name to be included in any summary of submissions that we may publish.

1.5. This document is not financial advice

None of the information in this document should be construed as financial advice. Readers should contact a qualified advisor if they have a question about their own insurance arrangements.

2. Terms used in this document

Term	Meaning
average annual loss	The modelled long-run average annual claims liability of the current or alternative EQC schemes.
capped insurance	Insurance with a maximum dollar amount per event.
catastrophe insurance	Insurance to protect against natural disasters such as earthquakes, floods and volcanoes.
Crown	Crown means the Sovereign in right of New Zealand, all Ministers of the Crown and all departments. It does not include Crown entities (including EQC) , Offices of Parliament or other entities in which the Crown has an interest.
EQC	The Earthquake Commission.
EQC Act	Earthquake Commission Act 1993.
excess	This is the amount a person making an insurance claim contributes towards the cost of the claim. The amount for EQC claims is specified in the EQC Act. EQC only pays for the losses above this amount.
first loss/second loss	A first loss insurance scheme covers the initial loss (after any excess). EQC is in practice the first loss insurance provider for natural disasters and private insurers provide cover for the second loss, which are losses above the first loss covered by EQC.
fiscal risk	In this context, risks imposed on the New Zealand government by natural disasters. EQC claims are one of those risks.
fiscally sustainable	That EQC scheme revenue is sufficient to meet its own expected costs and risks, and any fiscally unsustainable risks are appropriately reinsured.
full replacement	An insurance policy that replaces an insured item with a similar new item, or provides the insured the funds to do so.
hazard risk management	This is the process that includes the following steps: hazard risk identification; risk analysis; risk evaluation; and risk treatment.
hazard risk mitigation	This is the undertaking of measures to reduce the risks from natural hazards, such as strengthening buildings against ground shaking from earthquakes.
indemnity value	The current value of an item, taking into account its age and condition at the time of loss or damage.
Ministerial directions	Directions made under section 12 of the EQC Act.
monetary cap	The maximum dollar amount paid out per event under capped insurance.
NDF	Natural Disaster Fund.

Term	Meaning
premium	This is the money that must be paid for your insurance policy. You automatically have EQC cover if you have a current private insurance policy for your home or contents that includes fire insurance. Depending on the type of cover you have, your premium is usually made up of the insurance company's premium which goes to your insurance company, the Earthquake Commission levy, the Fire Service levy, and GST.
reinstatement	To return to a former state or condition.
reinsurance	A process whereby one entity (the reinsurer) takes on all or part of the risk covered under a policy issued by an insurance company in consideration of a premium payment. In other words, it is a form of an insurance cover for insurance companies.[1]
replacement value	The cost of replacing an item, without taking into account its age and condition at the time of loss or damage.
Responsible Minister	The Minister of the Crown responsible for the EQC.
risk financing instruments	Products or solutions that provide funds to cover the financial effect of unexpected losses experienced by a firm, entity or government. Traditional forms of risk finance include insurance (risk transfer), retention by way of reserves (often called self-insurance) and risk pooling.
risk transfer	The undertaking of measures to transfer risks from one party to another, such as property insurance.
siteworks	Work on a building site, including earthworks, preparatory to, or associated with, the construction, alteration, demolition, or removal of a building (section 7 of the Building Act 2004).
sum insured	An insurance policy that replaces an insured item with a similar new item, or provides the insured the funds to do so, unless this costs more than a specified amount (the sum insured) in which case the sum insured is paid.

[1] http://economictimes.indiatimes.com/definition/reinsurance

3. Summary

3.1. Background to Review

New Zealand governments have provided insurance against natural perils since 1945. The current EQC scheme has existed since 1993. The earthquakes in Canterbury since 4 September 2010, and especially 22 February 2011, have tested EQC, and its insurance scheme, to the limit. As part of the policy response to these events, in 2012 the Government announced a legislative review (the Review) of the Earthquake Commission Act 1993 (the EQC Act).

The Review is a lessons-learned exercise. Although it was prompted by the Canterbury events, it also draws on lessons from the 22 years the current scheme has been in operation. The Review is also forward looking. This means any resulting changes will only apply to future events. The Review will not change any claims entitlements from events that have already happened.

As the Review is a legislative review of the EQC Act, it only addresses issues and sources of difficulty that can be traced to that Act. There are a number of other Acts that also influence the response to and recovery from natural disasters. These include the Civil Defence Emergency Management Act 2002, the Resource Management Act 1991 and the Building Act 2004. This Review will not address difficulties and challenges which have emerged as a result of the application and interaction of other legislation, including natural hazard legislation, particularly in Canterbury.

Similarly, there are many valuable lessons to be drawn from the Canterbury events about managing and processing complex insurance claims. These relate to both EQC, specifically, as well as the wider insurance industry. Where these lessons can be captured by amending the Act, they have been picked up in the proposed changes in this document. However, there are a number of lessons that will need to be addressed by changing the operational practices and processes of both EQC and private insurers. The Review cannot address these.

Finally, when embarking on reviews following major events, it is important to avoid solutions aimed at addressing particular challenges from the last event. These can have narrow application in future events. Instead, the aim is to capture lessons in a way that will serve New Zealanders well in unknown future events.

3.2. The EQC scheme

The EQC scheme currently provides EQC cover for insured residential property damaged by earthquake, volcanic eruption, hydrothermal activity, landslip, tsunami or fire caused by natural disaster. Maximum cover for each event is up to $20,000 + GST for personal property (contents) and $100,000 + GST for each dwelling.

EQC land cover is complex but primarily relates to land under and within 8 metres of an insured dwelling and any appurtenant structures (such as garages), as well as certain retaining walls, bridges and culverts. Land cover also includes damage caused by a storm or flood. The cover is typically limited to the value of one of three measures – the damaged area, the minimum lot size allowed by the District Plan in that location or 4,000 square metres – whichever is the smallest. If there are damaged retaining walls, bridges and culverts, their indemnity value is added to the limit of the cover.

As well as its insurance functions, EQC is responsible for research and education about natural disaster damage, methods of reducing or preventing that damage and the insurance cover it provides.

In Canterbury, the Government expanded EQC's role through a series of Ministerial directions and decisions. These included designing and supervising land remediation works beyond the scope of the EQC scheme and providing engineering advice to the Government for wider policy purposes. EQC has also assumed a social assistance role through measures such as the urgent repair work and chimney replacement programmes which provided clean heat solutions.

3.3. EQC's value

Internationally, private markets for catastrophe insurance tend to be marked by low rates of insurance uptake and fluctuations in supply of this type of cover. This results in significant levels of under-insurance or non-insurance among property owners. Table 1 below shows New Zealand's very high rates of disaster insurance, compared to other countries affected by destructive earthquakes since 1980.

The Government believes that without something like the EQC scheme, many homeowners would be under-insured or uninsured against catastrophe risks[2]. The experience elsewhere in the world is that, in that situation, governments provide ad hoc assistance to those homeowners after large natural disasters. This creates risks and uncertainty for homeowners, insurers and governments.

Table 1: Ten costliest earthquakes worldwide 1980 – 2014

Ordered by percent of loss insured[3]

	Date	Event	Affected Area	Losses, in Original Values		Percent of Losses Insured
				Overall $US m	Insured $US m	
1	13.6.2011	Earthquake	New Zealand	2,700	2,100	78%
2	4.9.2010	Earthquake	New Zealand	10,000	7,400	74%
3	22.2.2011	Earthquake	New Zealand	24,000	16,500	69%
4	17.1.1994	Earthquake	USA: CA, Northridge	44,000	15,300	35%
5	27.2.2010	Earthquake, tsunami	Chile	30,000	8,000	27%
6	11.3.2011	Earthquake, tsunami	Japan: Tohoku	210,000	40,000	19%
7	20/29.5.2012	Earthquake (series)	Italy	16,000	1,600	10%
8	26.12.2004	Earthquake, tsunami	Indonesia, Indian Ocean	10,000	1,000	10%
9	17.10.1989	Earthquake	USA: CA, Loma Prieta	10,000	960	10%
10	17.1.1995	Earthquake	Japan: Kobe	100,000	3,000	3%

2 Global reinsurers have noted that New Zealand has very high catastrophe insurance coverage rates (see Lloyd's *Global Underinsurance Report,* compiled by the Centre for Economics and Business Research Ltd, October 2012).

3 Data sourced from Munich Re download centre for statistics on natural catastrophes at http://www.munichre.com/

Therefore, EQC appears to perform a valuable role in helping support unusually high, perhaps uniquely high, rates of catastrophe insurance among homeowners. However, the Canterbury events generated a raft of challenges for EQC, some of which could be addressed by changing the EQC Act. As EQC's insurance cover is set out in legislation most of those changes relate to the EQC insurance scheme itself.

3.4. Preferred reform package

The Government has developed a preferred reform package. The purpose of this discussion document is to seek feedback on that package from the public and other interested stakeholders. Five themes underpin the package.

Themes of preferred reform package

Effectiveness – addressing tensions and inconsistencies with the Government's objectives for natural disaster insurance and natural hazard risk management more broadly eg, exiting contents cover if this can be adequately provided by the private insurance market.

Simplification – removing unnecessary complexity to make scheme easier to implement and improve outcomes for customers eg, clarifying the purpose of the scheme in legislation.

Alignment – removing or minimising inconsistencies and perverse incentives within the EQC scheme, and between EQC cover and private cover eg, making coverage for land damage more consistent with the approach taken by private insurers, while also providing additional cover to claimants who need to move elsewhere if it is not feasible to rebuild on the original site.

Sustainability – ensuring the scheme remains financially viable and can respond appropriately to changes within the broader insurance, reinsurance and property markets eg, establishing sound pricing principles and requiring periodic reviews of monetary caps, excesses and premiums.

Connecting EQC and Insurers – recognising the dual insurance model and ensuring EQC and private insurers work effectively together and with the customers' best interests in mind eg, requiring EQC claims to be lodged with the claimants' private insurers.

There are nine key proposals in the preferred reform package.

- **EQC claims to be lodged with private insurers:** this would require claimants to lodge EQC claims with their private insurer. Private insurers would then authenticate these claims. Depending on the agreed arrangements insurers would pass the claim onto EQC for further processing, or complete some or all of the remaining management of the claim on EQC's behalf.

- **Building cover to include siteworks:** EQC building cover would include additional siteworks associated with repair or reinstatement of the building and access to it. This would involve land works, including tasks such as testing the soil and geotechnical engineering assessments, levelling, cutting and filling the land and installing retaining walls needed to support or protect the building. This is intended to better align with private insurer practice in commercial claims, and, as some of these works currently fall within EQC land cover, remove a problematic overlap between land and building cover.

- **Monetary cap on building cover to be increased to $200,000 + GST:** this is intended to reflect the inclusion of siteworks in the building cover and to help ensure private second loss cover continues to remain affordable for homeowners.
- **EQC land cover to apply only where rebuilding is not practicable*:*** EQC land cover would be paid only if it were not practically or economically feasible to rebuild on the site. If the dwelling could be repaired or rebuilt on site no separate land cover would be paid, and only building cover (including siteworks) would apply. This is intended to bring greater clarity to the scheme's coverage and to refocus land cover on the scheme's core goal of protecting homes.
- **Scheme terms and conditions to be better aligned internally and with usual insurer practice:** this is intended to reduce frictions within the scheme and between EQC cover and private second loss cover.
- **A standard building claims excess of $2,000 to apply:** at present EQC excesses on building claims range from $200 to $1,000 per claim. As they can be a percentage of the claim they often cannot be finalised until the final cost of a claim is known.
- **EQC to no longer provide contents insurance:** the Government, industry and consulted community groups agree EQC should not provide contents insurance.
- **EQC premiums to reflect the costs of running EQC and the costs and risks of the EQC scheme; monetary caps, prices and excesses to be reviewed at least every five years:** the current EQC Act has no legislated premium pricing principles or review provisions. The Government believes that adding these would improve the scheme's sustainability.
- **Natural Disaster Fund and Crown guarantee to be retained:** the Natural Disaster Fund, in combination with the Crown guarantee, gives homeowners and industry confidence that EQC has the resources to meet its obligations.

3.5. Impact of proposed changes for homeowners

Claims experience

Many factors shape the experience that claimants have following a natural disaster. These include the size, complexity and duration of the event, organisational capability and plans, the sometimes significant time taken to resolve legal, technical, regulatory and engineering uncertainties, and, in the case of EQC, the quality of interaction between EQC and the claimant's private insurer.

This Review focuses on those factors that can be improved by making changes to the EQC Act. The proposals in the preferred reform package are intended to work together in the following ways to improve the experience for claimants.

- **EQC's exit from contents insurance:** claimants would deal with private insurers on all contents claims. EQC's exit would eliminate claimant uncertainties between their EQC and private insurer contents claims, and help EQC focus on claims for damage to homes.

- **Including more siteworks in enhanced EQC building cover:** this would largely remove claimant uncertainties caused by the interaction between building and land cover.

- **Higher caps on EQC building cover:** this will reduce the interaction between EQC and private insurers on over-cap claims by about two-thirds. Over-cap claims have been a major point of friction and uncertainty for claimants in Canterbury.

- **Limiting land cover to situations where rebuilding is not practicable:** this greatly improves claimant certainty about what EQC covers, as all EQC claims would be building claims, apart from situations where rebuilding on the original site is not possible. Homeowners would no longer be able to make claims in situations where the land has suffered damage that has not caused damage to the house itself, for example undulations to land around the house.

- **Requiring claimants to lodge their EQC claim with their private insurer:** this will reduce uncertainty for claimants and is expected to improve their claims experience. Insurers will need to validate the claimant's status before forwarding the claim to EQC, thus reducing the current information churn between the claimant, EQC and insurers. If this claims lodgement proposal works as intended, and agreements are reached between EQC and insurers, insurers will over time take an even greater role in the claims management process.

- **Technical improvements in drafting core elements of the legislation:** this should improve the experience for claimants by increasing clarity about what the EQC scheme covers.

Coverage

Under these proposals homeowners would see several changes in EQC cover. EQC would exit contents insurance. Building cover would cover more repairs, including siteworks for the building and access ways, as well as the access way itself. At present EQC covers land under access ways, but not the artificial surface of the access way itself eg, a concrete drive. This would be an extension of cover. EQC also currently provides cover on some bridges, culverts and retaining walls as part of its land cover. But this cover is capped. The cap for a land claim is based on land value, plus an indemnity value for each damaged retaining wall, bridge or culvert. The indemnity value based cap can result in lower payouts than replacement value cover would. Under the new proposal, cover for retaining walls, bridges and culverts would be on a replacement value basis and will come within the same cap as the buildings and siteworks.

The proposal is to restrict cover for land repairs to siteworks only, and to provide separate land cover only in situations where rebuilding is not practicable because of extensive damage to the land. As the proposed new scheme focuses on repair and reinstatement of homes, it is intended that the new scheme would not cover subsidence of the land resulting in increases in flooding or liquefaction vulnerability. However the scheme would continue to cover any physical damage to the building caused by the same event that caused the increase in vulnerability. Similarly, as long as the building continues to be insured by EQC, the scheme would continue to cover damage to the building from any subsequent events weeks or even decades later.

Insurance premiums

The proposed changes are expected to have a modest impact on insurance premiums. EQC would no longer charge the $30 annual premium on contents. Preliminary modelling suggests risk-pricing the EQC premium, combined with increasing the building cap to $200,000, would increase the maximum EQC annual premium on building cover by about $50.

During consultation in 2013, a large insurer told officials they estimated the proposed changes would reduce private property insurance premiums by about $100 a year and increase private contents premiums by about the same amount. These estimates are subject to large uncertainties.

4. Introduction

4.1. Motivation for the Review

The present form of national disaster insurance in New Zealand was established by the Earthquake Commission Act 1993 (the EQC Act). The 2010/11 Canterbury earthquakes have been the first major test of the insurance scheme created under the EQC Act.

The Government has decided to review the EQC Act in light of the lessons learned from the Canterbury earthquakes and other recent natural disasters. The purpose of the Review is to identify areas where the scheme has not delivered on policy expectations and where change to the Act is needed.

While the Government's proposals have been influenced by the experience of the EQC scheme in Canterbury and other events, the Review is not intended to be a direct performance assessment of EQC staff or operations in Canterbury or other recent natural disasters. The Review's focus is on legislative change.

4.2. Relationship to past and current claims

The Review is forward looking. It will not affect the status or entitlements of any past or current EQC claims, including outstanding claims from the 2010/11 Canterbury earthquakes. Any new legislation resulting from this Review will not apply retrospectively, which means existing claims will be settled in accordance with the current Act. This includes claims in Canterbury for land with increased vulnerability to liquefaction (ILV) and flooding (IFV), which EQC are working to resolve. Further, the Review will not in any way affect the timing or process for addressing existing claims.

4.3. Scope of the Review

The Government is seeking to achieve the following objectives through the Review:

- support the contribution of a well-functioning insurance industry to economic growth opportunities in New Zealand
- minimise the fiscal risk to the Crown associated with private property damage in natural disasters
- support an efficient approach to the overall management of natural disaster risk and recovery
- minimise the potential for property owners to experience socially unacceptable distress and loss in the event of a natural disaster.

The Review will cover the following matters.

What EQC insures: **the structure and extent of EQC cover**	Which layer of loss (first loss/second loss) should be covered? Which types of natural disasters should be covered? How should multiple events be treated? Which types of property should be covered: - residential? - non-residential (commercial, not for-profit)? Should the scheme cover land/buildings/contents? What types of limits, caps and excesses should the scheme have? Should the scheme be mandatory or voluntary?
How EQC prices its insurance	Should the EQC premium be risk-based? If so, should it be a uniform premium reflecting national risk, or have some finer level of pricing which better reflects particular regional or policy holder risks? What revenue collection mechanism should the EQC use?
Institutional design	What roles and expectations should the Crown have of EQC? This includes: - research capabilities and information - hazard risk management - claims management and settlement - scope of independence or Ministerial direction. What structure or institutional form should the EQC take?
The financial management of the Crown's risk exposure	What is the Crown's risk preference? How should the risk be financed? This includes: - the size and composition of the Natural Disaster Fund - alternative risk financing instruments.

The terms of reference for the Review are available from the Treasury website: http://www.treasury.govt.nz/publications/reviews-consultation/eqc

5. Context

5.1. Why is the Government involved in natural disaster insurance?

EQC provides capped insurance to home owners against a limited range of natural hazards. All other property insurance is provided by private insurers. This includes cover for commercial, industrial and agricultural property against the hazards that EQC covers homeowners for. A good question to ask is why the Government is in the residential property insurance business at all. The answer is that without something like EQC, many homeowners would be under- or uninsured. Governments would probably provide ad hoc assistance to these homeowners after large natural disasters, creating risks and uncertainty for homeowners, insurers and governments.

EQC's predecessor, the Earthquake and War Damage Commission, was established in 1945, partly in response to the slow rates of repair following the 1931 Napier and 1942 Wellington earthquakes.

Providing insurance to enable damaged homes to be repaired continues to be a major rationale for retaining EQC. Internationally, private markets for catastrophe insurance tend to be marked by low rates of insurance uptake and fluctuations in supply of this type of cover. This results in significant levels of under-insurance or non-insurance among property owners. For instance, only around 10 percent of California homeowners have earthquake insurance, despite California being very seismically active. In Japan, 25-30 percent of homeowners have earthquake insurance. It is worth reflecting on the position Canterbury homeowners and the Government would have been in if 30 percent or less of earthquake affected homeowners had earthquake insurance.

When there are large numbers of under-insured or uninsured property owners, the experience elsewhere in the world is that governments feel compelled to provide financial assistance to affected households. When a disaster occurs in that environment, homeowners face large, often personally catastrophic, losses. Homeowners' fortunes then depend on the uncertainties of ad hoc government assistance packages. And governments are exposed to the fiscal and policy risks of funding those assistance packages.

Ad hoc assistance packages for property owners can encourage the assisted and other owners to not buy insurance against those hazards, generating larger future risks for homeowners and governments.

A scheme like EQC can eliminate that dynamic, benefiting homeowners, insurers and the Government. In return for paying their EQC premiums, homeowners are no longer reliant on uncertain ad hoc government assistance following a natural disaster. Instead they have the certainty of a legislated right to catastrophe insurance with pre-established terms, backed by a Crown funding guarantee.

Homeowners in higher risk areas also benefit from EQC's flat-rate pricing structure, which keeps private insurance premiums affordable nationwide. That in turn helps keep national homeowner take-up rates of insurance against natural hazards very high – perhaps the highest in the world. That is of direct benefit to homeowners and private insurers.

The high rates of private insurance take-up also greatly reduce the risk that the Government will be called on after a natural disaster to provide assistance to uninsured homeowners.

Although the Government is required to provide the resources to pay EQC claims, homeowners pay the Government for this service when they pay their EQC premium. In contrast, ad hoc assistance packages expose the Government to large unfunded fiscal risks. A natural disaster insurance scheme is ultimately fairer for the taxpayer and provides more certainty for affected homeowners than the alternative of successive assistance packages offered to homeowners after natural disasters occur.

Once established, an organisation like EQC can perform other useful roles supporting broader Government and community interests. For example, the recent move of private insurers from providing 'full replacement' to 'sum insured' policies could have important implications for overall levels of private property natural disaster insurance cover. Although the move simply reflects a realignment of the New Zealand market with common international practice, it may result in high levels of underinsurance if homeowners do not consider the full range of costs associated with repairing property following a natural disaster when deciding on the sum insured value.

While the EQC scheme cannot compensate for inadequately set private insurance cover, it can play a key role in helping avoid underinsurance by providing homeowners with the necessary information to make better decisions about natural disaster insurance cover and hazard risk management more broadly.

EQC also plays a critical role in transferring natural hazard financial risk by reinsuring scheme risks internationally, funding research into natural hazards and mitigating damage, educating homeowners, establishing repair programmes and so on.

5.2. How does the EQC scheme work?

Types of perils covered

EQC insures residential buildings, residential land and personal property (contents) against earthquake, natural landslip, volcanic eruption, hydrothermal activity and tsunami. It insures residential land against storm and flood. It also insures against fire resulting from any of these natural disasters.

Cover and limits of cover

The cover and limits of EQC cover for each natural disaster event are typically as follows.

- **Building**: the replacement value of rebuilding or repairing up to $100,000 + GST, less excess.
- **Contents**: replacement or indemnity value (depending on the policy wording of the fire insurance coverage) up to $20,000 + GST, less excess.

- **Land**: the lower of the value of damaged land (as described in section 19 of the EQC Act) or the cost of repairing the land to its pre-event condition less excess.[4]

Pricing and financing

EQC insurance cover costs 15 cents + GST for every $100 of private home or contents fire insurance. EQC revenue is collected by each homeowner's private insurer and passed on to EQC. Before the cost was tripled from five cents in 2012 it had been unchanged, per dollar of cover, since the scheme's inception in 1945.

The maximum premium payment, per year, for one home and its contents is $180 + GST. This will give the maximum cover of $100,000 + GST for the home, $20,000 + GST for contents and the value based cap amount of the residential land. This amount of insurance is available for each event of natural disaster damage.

EQC's obligations have been managed through a number of financial instruments:

- an accumulated reserve called the Natural Disaster Fund (NDF) – the fund totalled $5.6 billion at the time of the Canterbury earthquakes and will be exhausted by the cost of those earthquakes
- a reinsurance programme totalling several billion dollars at the time of the Canterbury earthquakes
- a backstop Crown guarantee to be called upon if the EQC's reserves and reinsurance lines are exhausted.

EQC's functions

As well as its insurance functions, EQC is responsible for research and education about natural disaster damage, methods of reducing or preventing damage and the insurance coverage it provides.

In Canterbury, the Government has decided to expand EQC's role through a series of Ministerial directions and decisions. EQC's expanded roles include project managing a large proportion of the residential rebuild, designing and supervising land remediation works beyond the scope of the EQC scheme and providing engineering advice to the Government for wider policy purposes. EQC has also assumed a social assistance role through measures such as the urgent repair and winter heat programmes.

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[4] Land cover is restricted to the insured owner's land holding and comprises only:

- the land under the building
- the land within 8 metres of the building
- the main access way up to 60 metres from the building and land supporting it (but not artificial surfaces like concrete or asphalt that cover the access way)
- bridges and culverts within those areas
- retaining walls within 60 metres of the building that are necessary for the support or protection of the building or the insured land.

5.3. What have we learned about the EQC scheme from Canterbury?

During this Review the Treasury has invited a range of stakeholders involved in earthquake recovery efforts to tell us what they have learned about how the EQC scheme has operated in Canterbury. These stakeholders include Government agencies, local authorities, insurers, reinsurers, banks, brokers and community representatives.

Overall, these stakeholders support retaining the EQC scheme. They believe EQC has contributed to New Zealand's high rates of residential insurance against natural disasters and see this as an important strength that needs to be preserved in the future.

These stakeholders strongly support EQC's involvement in research and education. Many feel EQC has played a critical role in supporting the growing understanding of natural disaster risk in New Zealand, and used this knowledge effectively in communicating and building relationships with global reinsurance markets.

Many of these stakeholders also support the Government decision for EQC to manage the repair or rebuild of damaged property in Canterbury rather than settle by cash payments. They believe this will lead to a better quality building stock and support the ongoing insurability of the affected areas.

There are, however, areas for improvement. Three key themes have emerged from the feedback we have received to date.

- The EQC scheme operates on a **dual insurance model**, in which both EQC and private insurers share the insurance obligations for individual properties. Many stakeholders believe the way in which the dual insurance model has operated in Canterbury has created unnecessary cost, confusion and complexity.
- EQC faces **institutional challenges** in a major claims event. Most of the time EQC is managed as a small financial institution handling relatively few claims on a business-as-usual basis. In a major claims event, however, EQC must greatly scale up its operations, creating a range of challenges and risks.
- Key aspects of the EQC scheme require **clarification**. All stakeholders identified the provisions relating to land cover as an area requiring particular attention.

The Government recognises these concerns and has sought to address them in the proposals in this document.

6. Issues and proposals

6.1. Purpose

What is the purpose of the EQC scheme?

The EQC Act lacks a clear statement of its purpose. The Legislative Advisory Committee's *Guidelines on Process and Content of Legislation* emphasise the importance of having purpose provisions in legislation.

> *Purpose provisions are of key importance given the injunction in section 5(1) of the Interpretation Act 1999 that enactments are to be interpreted in light of their purpose ... if the Act confers powers on persons or institutions those powers should be exercised consistently with the purpose so stated.*[5]

The EQC Act does not currently include a clear purpose statement. This absence has created uncertainty about how best to interpret some of the Act's provisions.

In many cases, it is not possible to resolve such uncertainty by changing or clarifying individual provisions. While there are certainly areas in the Act where the scope of cover could be specified with greater precision, it is not possible to prescribe entitlements in a way that completely avoids the need for judgement calls. Such judgements need to be informed by an unambiguous statement in the Act about the policy interests that sit behind the law.

The Government believes the EQC Act needs a purpose statement that will cover matters such as:

- the purpose of the insurance provided under the Act
- how the insurance provided under the Act is expected to relate to and interact with private insurance services
- the extent of EQC's roles in the context of disaster recovery.

The exact wording of the purpose statement will need to be determined during the drafting of the Bill. For discussion, however, the Government proposes the following statement:

That the purpose of the Act is to establish a Crown-owned natural disaster insurance scheme for residential buildings in New Zealand that:

- supports, complements and is closely coordinated with the provision of effective private insurance services to the owners of residential buildings
- recognises the importance of housing in supporting the recovery of communities after a natural disaster
- supports improved resilience of New Zealand communities and an efficient approach to the overall management of natural hazard risk and recovery in New Zealand

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5 http://www.pco.parliament.govt.nz/lac-chapter-3a

- contributes to the effective management by the Crown of fiscal risks associated with natural disasters.

During consultations, some stakeholders suggested the list of functions should be expanded to allow EQC to play a role in natural hazard mitigation, either by funding mitigation works or carrying out mitigation works itself. The proposed purpose statement is intended to be broad enough to permit, but not require, EQC participation in natural hazard mitigation projects.

Proposal for discussion

1 That the purpose of the EQC Act be to establish a Crown-owned natural disaster insurance scheme for residential buildings in New Zealand that:

- supports, complements and is closely coordinated with the provision of effective private insurance services to the owners of residential buildings
- recognises the importance of housing in supporting the recovery of communities after a natural disaster
- supports improved resilience of New Zealand communities and an efficient approach to the overall management of natural hazard risk and recovery in New Zealand
- contributes to the effective management by the Crown of fiscal risks associated with natural disasters.

What do you think?

1a Do you agree that these purposes are appropriate and complete?

1b If not, what changes would you suggest, and why?

6.2. Coverage

What types of perils will EQC cover?

The Government proposes that EQC continue to insure against the following perils:

- earthquake
- natural landslip
- volcanic eruption
- hydrothermal activity
- tsunami
- storm and flood (residential land only).

EQC would continue to insure against fire resulting from any of these natural disasters.

There would continue to be no cover for any consequential loss that is not a direct result of the natural disaster. This includes loss by theft, vandalism, loss of profits or business interruption.

Proposal for discussion

2 That EQC continue to insure against the following perils: earthquake, natural landslip, volcanic eruption, hydrothermal activity, tsunami, and storm and flood (with, in the case of storm and flood, only residential land being covered).

What do you think?

2a Do you agree that EQC should continue to provide cover against the same perils as it currently does?

2b If not, what changes would you suggest, and why?

What types of property will EQC insure?

The core purpose of the EQC scheme is to ensure homeowners are able to put a roof over their heads after a natural disaster strikes. On this basis, the scheme provides a block of flat-rate natural disaster cover that is affordable, and it reduces private insurers' exposure sufficiently to keep private second loss cover affordable for most homeowners. Owners of more expensive property are expected to use either private insurance or their own financial resources to meet the costs of reinstating that housing.

The Government proposes that EQC continue to provide cover for buildings that are used only or mainly for private residential purposes (or are intended for such use and occupation). Under this approach, rental accommodation, holiday homes for individual households and retirement villages would continue to be insured under the EQC Act.

The scheme would *not* cover residential buildings that are commercially run accommodation, such as hotels, boarding houses, serviced apartments, nursing homes, rental holiday accommodation or campgrounds.

The current scheme covers any dwelling, including dwellings that are contained buildings that are primarily non-residential (such as apartments, in primarily commercial or industrial buildings).

The Government's preferred proposal is to continue to provide EQC building cover for such dwellings. However, it is intended to not extend separate land cover to these buildings in situations where rebuilding is not practicable because of damage to the land

The Government proposes that the threshold will operate in a similar way to the current Act. A building will only be considered to be a residential building if the total floor area of residential living spaces constitutes at least half of the total floor area of the building.

The Government does not propose to extend EQC cover to bare land, buildings under construction or non-residential property.

Proposal for discussion

3 That EQC building cover continue to be available to residential buildings and dwellings in non-residential buildings.

What do you think?

3a Do you agree that EQC building cover should continue to only be available to residential buildings and dwellings in non-residential buildings?

3b If not, what forms of accommodation or living arrangements do you think should be added or removed, and why?

Proposal for discussion

4 That EQC land cover only be available for land associated with residential buildings. Therefore, dwellings in non-residential buildings would not receive any EQC land cover.

What do you think?

4a Do you agree that EQC land cover should only be available for land associated with residential buildings?

4b If not, what coverage of land cover would you prefer, and why?

Extending building cover to include more siteworks and main access way

A major lesson from the Canterbury earthquakes is that EQC cover for land damage is complex and, initially, was poorly understood. This created uncertainty and delays for EQC, insurers and homeowners.

The Government proposes to better align EQC building cover with private insurer practice in commercial claims, and the Building Act, so that building cover includes any siteworks that are needed to repair or replace the building.

Siteworks are land works including tasks such as testing the soil and geotechnical engineering assessments, levelling, cutting and filling the land and installing retaining walls needed to support or protect the building. Including siteworks as part of the building cover rather than land cover better reflects the engineering reality. This is, that siteworks and foundation works form one integrated engineering solution to providing an appropriate building platform.

EQC building cover would also apply to the main access way to the residential building. Therefore, it would apply to all works, including siteworks, needed to repair or reinstate the building or access to it.

If there were debris on the land, EQC would remove the debris to the extent needed to repair or rebuild the building.

Including siteworks in building cover would mean that any land damage that does not need to be repaired as part of repairing or reinstating the building would no longer be covered by the EQC scheme. Increased vulnerability to liquefaction and flooding are examples of damage that would no longer be covered by the scheme. However as long as the building has EQC cover at the time of the damaging event, any physical damage to the building from a peril covered by the scheme would be covered, both if that damaging event was the event that caused the change in vulnerability, or was a subsequent event weeks or decades later.

Proposal for discussion

5 That EQC building cover be extended to include siteworks and the main access to the building.

What do you think?

5a Do you agree that EQC building cover be extended to include siteworks and the main access to the building?

5b If not, what do you think should be done instead, and why?

EQC to no longer provide contents insurance

The Government proposes to *remove* residential contents cover from the EQC scheme. Delivering contents cover strains EQC's ability to cope with major claims events. Contents claims can be numerous and require disproportionate resources during the recovery phase. As a result, providing contents insurance impacts on EQC's ability to focus on its core housing responsibilities.

In consultations, private insurers indicated they were willing and able to extend their contents insurance products to include natural disaster risks. Therefore, the Government expects private insurers will be able to offer adequate cover for residential contents after EQC withdraws from the market.

Proposal for discussion

6 That EQC no longer offer residential contents insurance.

What do you think?

6a Do you agree that EQC should no longer offer residential contents insurance?

6b If not, what level of contents cover do you think EQC should offer, and why?

6c For insurers, what do you anticipate the impact would be on premiums your company charges for residential contents insurance, if EQC no longer offered residential contents insurance?

Please note the information in section 1.4 regarding the Official Information Act.

How much insurance will EQC offer?

The value of the building cap needs to be revised. At present, the maximum amount EQC will pay under residential building cover is $100,000 + GST.

The EQC scheme has led to high rates of insurance cover among homeowners by providing a block of low-cost insurance to the residential insurance market. High rates of cover, in turn, mean more homeowners are protected against natural disaster risk. And fewer homeowners will be likely to seek compensation for natural disaster damage outside of the EQC scheme.

The current building cap has not been adjusted since 1993. This means the value of the cap in *real* terms ie, adjusted for inflation, has reduced substantially. As a result, EQC is carrying less, as a proportion of total residential building exposure, while private insurers are carrying more.

Since the Canterbury earthquakes, private insurance premiums have increased substantially, particularly in regions such as Canterbury and Wellington. Higher risk regions and properties are expected to face further increases in premiums in the coming years, as insurers become better at pricing individual risks. Ongoing price rises will be unaffordable for some homeowners and are likely to result in lower rates of insurance cover in higher risk areas. For this reason, the Government believes the value of the building cap is now too low and should be raised.

Increase the building cap to $200,000 + GST

Deciding on the right value of the cap calls for a series of judgements about the insurance market's capacity to continue to offer affordable cover, the risks facing the Government and the role of the state in making good private losses.

Generally, increasing the value of the cap will increase the direct cost of the scheme. But it will reduce the implicit risks associated with the natural disaster liability (notably the risks of unfunded extensions to the scheme following a disaster).

Private insurers, through their industry body the Insurance Council of New Zealand, proposed retaining the current building cap of $100,000 + GST. That is in the context of the current configuration of building and land cover. If the Government's preferred proposal for reconfiguring building and land cover is adopted (Proposal 5), the $100,000 + GST cap would need to be increased, perhaps up to $150,000 + GST, to adjust for including siteworks and access ways in the enhanced building cover.

The insurers' proposal shows a willingness to keep insuring their current housing exposure, despite the large claims of recent years. The Government welcomes this, and the confidence it implies in the New Zealand residential insurance market.

The Government has also carefully considered the question of the appropriate building cap. Given the enhanced building cover, it sees a case for increasing the cap to $150,000 + GST or $200,000 + GST. An increase to $150,000 + GST would broadly match the insurers' proposal and, of the two options, would result in the smallest increase in explicit fiscal risks for the Government and the largest private insurer contribution to future claims.

However, as EQC charges the same premium nationwide and private insurer premiums are risk-rated, the $150,000 option would also result in the highest private premiums in higher risk areas. In consultations, insurers told us that private premiums in higher risk areas were likely to continue to increase over time, as insurer risk models became more sophisticated and competitive pressures led insurers to adopt increasingly individualised risk-based pricing.

On balance, the Government prefers the larger increase, to $200,000 + GST. This is because the EQC scheme's flat-rate pricing improves affordability for homeowners in higher risk areas, and is therefore likely to better maintain the high levels of homeowner take-up of natural disaster insurance, which is a central policy objective of the scheme.

The data in Chapter 8 shows the risk of the scheme increases by much less than headline increases in the monetary cap imply. Increasing the monetary cap for building cover to $150,000 + GST increases by under 10 percent the expected average annual loss, and the claims liability associated with a large Wellington event. If the monetary cap is increased to $200,000 + GST these building claims liabilities increase further by less than 5 percent.

Proposal for discussion

7 That the monetary cap on EQC building cover be increased to $200,000 + GST.

What do you think?

7a Do you agree with the proposed increase in the building cap to $200,000 + GST?

7b If not, what cap would you prefer, and why?

7c Do you have strong views on the merits of a $150,000 + GST cap versus a $200,000 + GST cap?

7d If so, what are they?

7e For insurers, what do you anticipate the impact would be on premiums your company charges for residential property insurance, if the proposals in this document regarding changes to building cover were implemented? Please provide this information for a monetary cap for EQC building cover of both $150,000 and $200,000.

Please note the information in section 1.4 regarding the Official Information Act.

Reinstatement of EQC cover after an event

Following the Canterbury earthquakes the High Court determined that EQC cover automatically reinstates in full after every event, so long as the underlying contract of fire insurance is still in force.

Reinstatement on this basis has caused a number of problems in Canterbury. Firstly, it is difficult to precisely apportion damage to specific events, especially in cases where it was not possible to conduct a damage assessment before subsequent shocks caused further damage. Secondly, the apportionment process creates potential incentives for cost-shifting: private insurers can transfer much or all of the cost to EQC if they can demonstrate that each shock caused relatively small amounts of damage ie, below the EQC cap in each event. Equally, EQC can transfer some or much of the cost if it can demonstrate the damage occurred in a single shock, in which case any costs over the cap fall on the private insurers.

The Canterbury experience of multiple events is rare, even by international standards. It is unusual for a series of aftershocks to cause greater levels of damage than the original shock. Nevertheless, the complexity, inevitable uncertainty and delays of the apportionment process mean the Government must consider other models that might better manage multiple events if a similar situation arose in the future.

The Government sees two leading options for the future.

- **The status quo:** accept the current reinstatement model and require EQC and private insurers to develop joint systems and processes ahead of time to deal with apportionment issues, should they arise in future events, or

- **EQC cover reinstates with the renewal of the underlying private insurance policy:** EQC's maximum liability under the building and land cover would not exceed an amount equal to one maximum payment under that cover during each period in which the underlying contract of fire insurance is in force.

On the surface, adopting the alternative reinstatement model is attractive. It would greatly reduce the need for any apportionment. EQC would pay the full costs of accumulating damage in each event until it reached the cap, and pay nothing more until the associated fire insurance contract renewed. It also has lower claims costs for EQC than the current reinstatement model, so is fiscally attractive.

But there are two main arguments against this option mainly to do with fairness.

- **Increased scope to game the system:** the shorter the duration of the private insurance contract, the more frequently EQC cover would reinstate. This would create an incentive for insurers and homeowners to sign brief and recurring fire insurance contracts. This could be prevented by establishing EQC cover on an annual basis, regardless of the length of the underlying fire insurance contract. However, this would disadvantage customers on shorter contracts, who would pay an annual premium EQC cover whenever their insurance contract renewed, potentially resulting in multiple EQC premium payments a year. Avoiding this would require incurring extra administrative and compliance costs to maintain EQC premium payment histories on individual properties and calculate EQC premiums accordingly. This model would also create incentives for customers and insurers to engineer a fire policy renewal once an event occurred. Protecting against this is also likely to increase administration and compliance costs for EQC, insurers and customers.

- **Renewal dates would affect entitlements:** Renewal dates would influence how much EQC cover was available to homeowners and how costs would be shared between EQC and private insurers. For example, if this option had been in force in 2010 an EQC claimant with an annual fire policy that renewed on 1 September 2010 would have been entitled to up to one EQC cap payment over both the September 2010 and February 2011 earthquakes, whereas an EQC claimant with an annual fire policy that renewed on 1 October 2010 would have been entitled to up to two cap payments.

The problems with this alternative approach to reinstatement appear substantial. Attempting to resolve them will create additional complexity and costs and still leave the scheme open to inequities because of different renewal dates. At the same time, apportionment will be less likely to cause major problems if the EQC monetary cap on building cover increases and claims management processes become better integrated between private insurers and EQC.

Therefore, the Government's preferred approach is to maintain the status quo for reinstatement. EQC would continue to insure on an event basis. All damage caused within 48 consecutive hours as the direct result of a natural disaster, other than fire, or damage caused within seven consecutive days as the direct result of natural disaster fire, would constitute a single event.

Proposal for discussion

8 That EQC building cover reinstate after each event.

What do you think?

8a Do you agree that EQC cover should reinstate after each event? If not, what is your preferred alternative, and why?

8b Do you agree with retaining the current definition of an event?

8c If not, what is your preferred definition, and why?

EQC land cover is complex

Currently, EQC land cover is triggered where a residential building is insured under the EQC Act. The provisions relating to land cover are complex and a summary of how they operate is set out below.

Land cover is restricted to the insured owner's land holding and comprises only:

- the land under the house and outbuildings (eg, garage and shed)
- the land within 8 metres of those buildings
- the main access way up to 60 metres from the building and land supporting it (but not artificial surfaces like concrete or asphalt that cover the access way)
- bridges and culverts within those areas
- retaining walls within 60 metres of the building that are necessary for the support or protection of the building or the insured land.

Section 19 of the EQC Act sets a cap on the amount EQC can pay for a land claim. This is based on the value of the land and indemnity value of retaining walls, bridges and culverts.

The first component of the cap is the value, at the site of damage, of the smallest of:

- the area of the insured land that is damaged
- an area of land of 4,000 square metres, or
- the minimum sized area allowed for use of the residential site under the relevant district plan.

Added to the calculated land value is the indemnity value of any insured retaining walls, bridges and culverts that have suffered natural disaster damage.

The two values added together represent the cap, which is the maximum amount EQC can pay for a land claim.

EQC will generally settle a land claim by paying the cost to repair natural disaster damage to the insured land, retaining walls, bridges and culverts, up to the calculated cap amount. It may also carry out the repair itself, or pay loss in value rather than repair cost in some cases.

The complexity of land cover creates a number of problems

The existing EQC land cover is complex and creates complex interactions with building cover. These have been a source of dispute, delay and uncertainty for EQC, homeowners and insurers.

There are three general problems with the way EQC land cover currently works.

- The boundary between building foundation works and the land works needed to reinstate or replace the dwelling (and therefore between the land cap and the building cap) is disputed.
- The provisions relating to land cover (particularly regarding the area and maximum value of cover, and the treatment of 'appurtenant' structures such as garages and sheds) can result in unintentionally unfair outcomes in some cases.
- There is a need for clearer or revised definitions of key concepts eg, what constitutes land damage and what standard of reinstatement is necessary to satisfy EQC's obligations.

The original EQC scheme did not insure land. Land cover was introduced following the Abbotsford landslip of 1979. The aim was to provide homeowners, whose section was totally lost or unusable, the resources to buy elsewhere. The Government considers that goal is still appropriate.

Therefore, it proposes EQC land cover be simplified to focus on compensating homeowners who need to relocate because their land is so damaged they cannot rebuild on the site of the insured home.

For EQC-insured homeowners who can repair or rebuild on the original site, EQC would only provide the proposed enhanced building cover including siteworks.

Extending EQC building cover to include siteworks and the main access way removes complex interactions between land and building cover, and enables separate land cover to be limited to situations where the site the insured residence is built on is so badly damaged that it is not practically or economically feasible to repair or rebuild the insured property there.

With the proposed approach, if a house can be repaired or rebuilt on site, then all EQC claims will be under EQC building cover. This brings much more conceptual clarity to what land damage is covered and EQC's obligations regarding land damage that has not damaged the building.

Where it is not practical to reinstate a building on site, the current methods for calculating the value of damaged land based on the minimum lot size under the 1993 Act appears broadly appropriate for determining the land compensation amount.

The collective impact of the proposed changes to EQC's land and building cover is complex. It is further complicated by private insurers moving from providing full replacement to sum-insured cover. Compared with the current scheme, future claimants may be advantaged or disadvantaged, depending on the particular details of the damage incurred.

The recent shift by private insurers to sum-insured policies has placed new demands on homeowners to accurately determine the cost of rebuilding their home. Under the current scheme, the separate land cover is paid over and above an insurance policy's sum insured, meaning land repairs do not need to be factored in when that sum is set.

Including siteworks and access ways in the enhanced EQC building cover means estimates of reconstruction costs will also need to consider these factors in determining an appropriate sum-insured value for the home. A further added complexity for home owners is that ideally those estimates would consider potential increments in the costs of siteworks if a future event changed the characteristics of the site, requiring repairs or rebuilds to utilise more expensive engineering solutions than were appropriate before the event. This occurred in Canterbury.

Increasing a home's sum insured so that it includes a risk margin for future increases in repair or rebuilding costs is usually relatively inexpensive. Table 2 below shows online quotes from an insurer for a house in Wellington. An extra $100,000 of cover increases annual premiums by about $45. In the most extreme case quadrupling cover, from $200,000 to $800,000, increases premiums by $270 per annum, or 28 percent.

Table 2: Example of Change in Insurance Premiums as Sum Insured Increases[6]

Insured Value	Annual Premium	Cost of Extra $100K of Cover	% Increase in Premium
$200,000	$972	-	0%
$300,000	$1,014	$42	4%
$400,000	$1,059	$45	9%
$500,000	$1,105	$46	14%
$600,000	$1,151	$46	18%
$700,000	$1,197	$46	23%
$800,000	$1,242	$45	28%

6 From AA Insurance online quote tool at https://www.aainsurance.co.nz/ for a 100m^2 house in Island Bay, Wellington, 2 June 2015

Proposal for discussion

9 That land cover be limited to situations where the insured land is a total loss meaning it is not practicable or cost-effective to rebuild on it.

What do you think?

9a Do you agree that the proposed enhanced building cover, combined with restricting land cover to situations where the site of the insured building cannot be rebuilt on, would resolve, for future events, many of the recent difficulties with the interaction between land and building cover?

9b If not, what is your preferred alternative, and why?

9c Do you agree that restricting land cover to situations where the site of the insured building cannot be rebuilt on is appropriate, given the EQC scheme's focus on providing homeowners the resources to repair, rebuild or re-establish homes elsewhere?

9d If not, what is your preferred alternative, and why?

9e Do you have any concerns regarding the proposed change to the configuration of building cover in light of the move by most insurers to provide sum insured home insurance policies?

9f If so, what is your preferred alternative, and why?

Better aligning EQC and private insurers' standard of repair

In consultations, stakeholders said they would like to see EQC cover more closely reflect insurance industry practice.

In principle, the Government agrees with this view. However, there are many insurance contract wordings, meaning the EQC cover cannot be expected to perfectly match individuals' private cover. Nevertheless, it would be helpful for claimants, EQC and insurers if EQC's standard of repair reflected broad industry practice.

From a legislative perspective this appears to already be the case, although there may be differences within the industry as to how that standard is applied in practice. EQC building cover is for replacement value, with the standard being "to a condition substantially the same as but not better or more extensive than the building's condition when new, modified as necessary to comply with any applicable laws". However, EQC is "...not bound to replace or reinstate exactly or completely, but only as circumstances permit and in a reasonably sufficient manner".

Private insurer provisions regarding the standard of repair often incorporate similar concepts, namely replacement as new, subject to a reasonableness test. This is the standard of repair from a home insurance contract of a large private insurer:

> ***"Replacement condition*** *means what* we *[the insurer] determine is reasonably required to rebuild the home to a building standard or specification similar to, but no more extensive or better than the home's condition when new, using currently equivalent techniques and building materials readily available in New Zealand.* We *will only replicate heritage features if the currently equivalent techniques and/or building materials are readily available in New Zealand."*[7]

[7] https://www.vero.co.nz/sites/default/files/Vero%20Residential%20Home%20Policy_0.pdf

Therefore, EQC's current repair obligation already appears broadly consistent with industry practice. At this stage, the Government has no preferred reform proposal. The Government invites submissions on options for reforming EQC's current repair obligation so that it better maintains (or achieves) a repair obligation that reflects industry practice.

Proposal for discussion

10 That EQC's current statutory repair obligation already appears broadly consistent with industry practice.

What do you think?

10a Do you agree with the Government's assessment that EQC's legislated standard of repair is broadly consistent with current industry norms?

10b If so, do you have views on why EQC's standard of repair is seen as markedly different from current insurance industry norms?

10c If not, do you have suggestions for reforms that you consider would move the EQC standard of repair closer to current insurance industry norms for residential property?

Simplifying EQC's claims excess

The Earthquake Commission Regulations 1993 establish the following excesses for buildings and land.

- **Buildings:** $200 multiplied by the number of dwellings in the building, or 1 percent of the amount payable under the Act, whichever is the greater.
- **Land:** $500 multiplied by the number of dwellings in the residential building which is situated on the land, or 10 percent of the amount payable under the Act, whichever is greater, to a maximum of $5,000.

These excess provisions, particularly for land, are unnecessarily complex, especially when EQC is dealing with large numbers of claims after a major natural disaster.

The Government proposes replacing the current excess provisions with a specified dollar excess for EQC cover.

- **Buildings:** $2,000 + GST multiplied by the number of residential units in the building.
- **Land:** No excess.

Higher average excesses transfer risk from EQC to homeowners and ease the burden on EQC by reducing the number of low value claims. A zero excess is proposed on land claims because as land claims would only arise if a site cannot be rebuilt on, there should be no or very few low value claims. Therefore an excess would serve no purpose.

In determining the value of the excess on building claims, the Government has tried to strike a balance between administrative efficiency, social acceptability and recovery concerns. A higher excess will reduce the number of low value claims and allow EQC, or insurers acting on EQC's behalf, to focus on more serious damage. But if the excess is set too high there may be pressure to reduce it after a large event.

In principle building excesses can range from $200 to $1,000 (being 1 percent of a $100,000 maximum payment) and land excesses can range from $500-$5,000. EQC claims data indicates that in Canterbury the average claims excess on building claims is about $500.

Issues that arose in Canterbury included the need to:

- apportion damage to claims before being able to calculate excess
- know the final value of a managed repair before being able to apportion the claim and calculate excess
- collect the excess by issuing an invoice.

This occurred because there were multiple claims made for multiple damaging events which occurred within a relatively short period of time. This was the first time this had happened on a large scale. This issue may need to be addressed as part of the technical issues that may form part of a future EQC Bill.

Proposal for discussion

11 That EQC has a standard claims excess of $2,000 + GST per building claim.

What do you think?

11a Do you agree that EQC's building claims excesses should be standardised and simplified to a flat dollar amount?

11b If yes, do you agree that $2,000 + GST is the appropriate claims excess on building claims?

11c If not, what would you prefer, and why?

Proposal for discussion

12 That EQC have no claims excess on land claims.

What do you think?

12a Do you agree that EQC should have no claims excess on land claims?

12b If not, what would you prefer, and why?

Regularly reviewing main monetary settings of cover

The Government proposes the monetary caps, premium rates and excesses should be reviewed at least every five years. Regular adjustment will ensure any major change to the real value of EQC cover is the result of deliberate policy choices.

The Government has decided against annually indexing the caps and excesses. Judging the appropriate size of the caps and excesses is not simply a technical exercise. It also requires judgements about insurance market conditions and the role of the state in making good private losses. The need for such judgements points towards a formal policy review rather than automatic indexation.

Since change will impose costs on all stakeholders, less frequent adjustment is desirable, especially in a low inflation environment where the real value of cover is unlikely to erode quickly. On this basis, a maximum period of five years between reviews would seem reasonable.

Proposal for discussion

13 That the EQC Act require monetary caps, premium rates and claims excesses on EQC cover to be reviewed at least once every five years.

What do you think?

13a Do you agree that monetary caps, premium rates and claims excesses on EQC cover should be reviewed at least once every five years?

13b If not, what alternative would you prefer, and why?

Simplified summary of proposed changes to EQC scheme coverage

Scheme Coverage	Current Scheme	Proposed Scheme
Home contents	Maximum of $20,000 (plus GST) of cover	No cover
Residential buildings		
Monetary cap	Maximum of $100,000 (plus GST) of building cover	Maximum of $200,000 (+GST) of building cover
Siteworks	Covered, building or land cover, depending on the circumstances of the damage	Covered, building cover, to the extent necessary for the repair of an insured building or structure, or the main access way
Access to residential building		
Main access way (up to 60 metres)	Covered as part of land cover. Artificial surfaces (eg, concrete drives) not covered	Land under access way covered as part of siteworks Artificial surfaces covered as part of building cover
Bridges and culverts on main access way	Covered, as part of land cover	Covered, as part of building cover
Residential land		
What triggers EQC land cover?	Land must have an insured residential building on it	Land must have an insured residential building on it
What land on the section is covered?	Land within 8 metres of an insured building	The entire section is covered to extent siteworks are necessary
Damage that is an increase in vulnerability to future damage (eg, increased flood or liquefaction vulnerability)	Covered, diminution of value or cost of repair, up to value based land cap Future natural disaster damage covered at the time it occurs	Increase in vulnerability not covered Future natural disaster damage covered at the time it occurs
Damage to land that means it is not practically or economically feasible to rebuild on the site	Covered, a site-specific value-based cap applies	Covered, a site-specific value-based cap applies

Scheme Coverage	Current Scheme	Proposed Scheme
Retaining walls		
Retaining walls within 60 metres, of the insured building which are necessary for the support or protection of the building and main access way	Covered, as part of land cover	Covered, as part of building cover
Claims excesses		
Excess on building claims	The greater of $200 or 1% of the claim (with a $100,000 plus GST cap excesses range from $200-$1,150)	$2,000 excess on all building claims
Excess on land claims	The greater of $500 or 10% of the claim to a maximum of $5,000	No separate excess on land claims
Access to EQC Cover	EQC coverage automatically attaches to residential fire insurance policies	EQC coverage automatically attaches to residential fire insurance policies, or EQC coverage automatically attaches to residential insurance policies for those perils covered by EQC that the insurance policy also covers

6.3. Distribution

How will homeowners access EQC insurance cover?

EQC building and land cover will continue to be attached to private contracts of insurance for residential buildings.

Currently, EQC residential building and land cover is automatically attached to private contracts of fire insurance for residential buildings (as defined in the EQC Act) in New Zealand. The Government believes this approach has supported high rates of catastrophe insurance cover in the residential sector.

The Government has considered alternative ways of distributing EQC cover, such as using local authority rating systems. Such arrangements are likely to be costly and cumbersome so there is not an obvious case to shift from the status quo.

However, a feature of the current dual insurance model is a risk-sharing arrangement between EQC and the private insurer. At present, EQC takes on natural disaster risk as a result of a private insurer selling a fire policy. Therefore, there is the potential for the private insurer to impose risks on EQC that they are not exposed to, for instance by selling fire-only policies. This happens relatively rarely as most residential insurance policies sold in New Zealand are so-called “all-risks” policies that cover natural disaster damage.

The Government therefore seeks feedback from submitters on two options:

- that EQC building cover and associated land cover continue to automatically attach to private contracts of fire insurance for residential buildings, or
- that EQC building cover and associated land cover automatically attach to private contracts of insurance for residential buildings on a peril by peril basis; so if a peril covered by EQC is excluded from the private policy, it is also excluded from the EQC cover.

The second option better aligns the EQC and private cover, supporting the *Alignment* and *Connecting EQC and Insurers* themes discussed in section 3.4 *preferred reform package*. The key risk with the second option is that if a peril, say earthquake or volcano risk, becomes very expensive to insure in a part of the country, a decision by the policy holder to drop insurance cover against that risk will result in their also losing EQC cover for that peril. This would undermine a core goal of the scheme discussed in Section 3.3 *EQC's value*, which is to support very high rates of residential insurance cover against natural disasters.

Note that the second option alters only the *perils* covered by EQC in certain circumstances. It does not alter the cover, including land cover, available under the EQC scheme for any covered peril.

Proposals for discussion

14 That EQC cover continues to automatically attach to fire insurance policies on residential buildings, as defined in the EQC Act.

or

15 That EQC cover automatically attach to insurance policies on residential buildings, as defined in the EQC Act, on a peril by peril basis; so if a peril covered by EQC is excluded from the private policy, it is also excluded from the EQC cover.

What do you think?

14a Do you agree that EQC cover should continue to automatically attach to fire insurance policies on residential buildings? Or

15a do you agree that EQC cover should automatically attach to insurance policies on residential buildings, and EQC cover should exclude any natural disaster peril that is excluded from the fire insurance policy it attaches to?

15b If you do not agree with either of these options, what alternative arrangement do you prefer, and why?

EQC will continue to offer 'voluntary insurance' for homeowners at its discretion

There are situations in which homeowners cannot purchase, or do not want to purchase, fire insurance cover for their residential building. In such cases, section 22 of the EQC Act allows EQC, on a voluntary basis, to offer insurance for residential buildings, subject to such conditions as EQC thinks fit.

This appears to be appropriate, serving as a safeguard if homeowners are unable to secure private fire insurance for their homes. At the same time, the discretionary nature of the cover allows EQC to exclude inappropriate risks. The Government proposes to retain EQC's discretion to accept or refuse requests for directly provided insurance cover under section 22.

Proposal for discussion

16 That EQC continue to have the ability, but not the obligation, to directly provide EQC cover to homeowners who request it.

What do you think?

16a Do you agree that EQC should continue to be able, but not be obliged, to directly provide EQC cover to homeowners who request it?

16b If not, what alternative arrangement would you prefer, and why?

6.4. Claims

Current claims lodgement arrangements are complex and inflexible

The EQC Act requires claimants to give notice of damage to EQC within 30 days (extended to three months by regulation) after the natural disaster damage has occurred (Schedule 3, clause 7(2)). Claims must be submitted for every event causing natural disaster damage. The EQC Act does not provide EQC with any discretion to accept the late notification of damage.

EQC and private insurers share claims-handling responsibilities, depending on the type and value of claim. The responsibilities are shared as follows.

Property insured under the EQC Act	Value of claim **less** than statutory caps on EQC insurance cover	EQC
Property insured under the EQC Act	Value of claim **greater** than statutory caps on EQC insurance cover	Both initially, then claimant's private insurer
Property **not** insured under the EQC Act (eg, fences or pools)		Claimant's private insurer

The requirement for claimants to notify damage to EQC, as well as their private insurer, increases cost, complexity and confusion in the notification stage.

- Many homeowners in Canterbury have been unsure about which organisation they should notify.
- Having EQC and a private insurer involved in each claim can create uncertainty about which organisation will handle the claim through to settlement. This is particularly problematic in cases where EQC and the insurer do not agree on the treatment of the claim, leaving the claimant in limbo until the situation is resolved.
- Having two parties involved generates additional cost and delay for properties subject to 'double-handling', including when claims move from under-cap to over-cap.

- EQC and private insurers must match the claims they have separately received with each other, and then with individual properties and claimants. This process can be costly and time consuming, particularly when there are many claims.

The sequence of multiple earthquakes in Canterbury has aggravated the problems associated with claims notification. For example, some homeowners did not submit claims for every event, because they were confused about their obligations, mistaken about when the damage occurred, too distressed to deal with the paperwork, or simply absent and did not become aware of the damage until later. There is no way for them to remedy their omission after the three-month time limit on notification has passed.

Who will handle EQC claims in future?

A common suggestion raised in consultation is that homeowners' private insurer should handle EQC claims. This would limit EQC's claims handling role to funding its share of approved claims. Such arrangements are already permitted under the EQC Act (clause 7(5) of Schedule 3).

There are two main reasons why it could be desirable to outsource the handling of EQC claims to private insurers.

- Claims handling is a core daily function of private insurers. Therefore, private insurers have an existing capability to deal with the large numbers of claims that arise in a major natural disaster. EQC, which deals with relatively few claims on a business-as-usual basis, does not.

- Assigning EQC claims handling responsibilities to private insurers should simplify the claims handling process.

However, there are risks associated with outsourcing. The claims handling process includes lodgement, validating claims, assessing and costing damage, and settling a claim (repair, rebuild or cash settlement). Outsourcing will need strong safeguards along with appropriate audit processes to ensure the desired outcomes for customers and EQC.

If EQC was not involved in these processes there is a risk it would not have the capacity to undertake other activities, beyond a narrow insurance focus, to contribute to the recovery and the community. For example, in Canterbury, EQC:

- facilitated emergency repairs

- identified, in the course of its rapid assessment work and other customer engagements, households with vulnerable occupants and/or those needing temporary accommodation support

- implemented the Winter Heating Programme as well as chimney replacement and insulation initiatives.

The geophysical and technical data collected throughout the settlement process has also been extremely valuable in ongoing research of hazard risk mitigation and management.

Before agreeing to any outsourcing arrangement, the Government will need to have confidence in five main areas, that:

- there are robust audit and accountability mechanisms to manage the financial costs and risks of outsourcing claims handling
- there are clear agreements about the quality of service provided to EQC claimants, as well as ongoing accountability arrangements
- there are robust arrangements between EQC and private insurers for sharing relevant customer and claims data in a timely and secure way
- the insurance industry has the ongoing capability and quality of preparation to manage future events, particularly large scale events
- there are appropriate and robust arrangements, either with insurers or elsewhere, to replace any loss of adaptability or flexibility in natural disaster response as a result of EQC no longer directly participating in claims handling.

Some of these areas, such as data sharing, may require legislative support. Insurers are likely to also need confidence on some of the above issues, as well as others, before being prepared to take on a larger claims management role. These matters can only be resolved to the satisfaction of all parties through detailed discussion and agreements. Attempting to capture those agreements in an Act or regulation would create an excessively prescriptive and unwieldy legislative environment for EQC and insurers. For this reason, the Government does not intend that the EQC Act *require* EQC to outsource all claims handling.

Instead, the legislation would continue to *allow* claims handling responsibilities to be outsourced. The Government would also invite EQC to begin discussions with private insurers to see if it were possible for EQC to develop contractual arrangements that were mutually acceptable to all parties.

An impediment to insurers handling EQC's claims in Canterbury was the lack of pre-existing systems and processes for insurers and EQC to work together. This was, in part, due to insurers believing there would be relatively few over-cap claims; therefore such systems were not required.

The Government sees this as a significant gap in preparedness. While good systems now exist, there is a risk that they will fall into disuse as memories fade in the long quiet times, most likely lasting decades, between large claims events.

Therefore, the Government proposes that the EQC Act require claimants to lodge EQC claims with their private insurer. Private insurers would need to validate these claims. Depending on the agreed commercial arrangements, insurers would then pass the claim onto EQC for further processing, or complete some or all of the claims management on EQC's behalf.

The Government considers that legislatively requiring EQC claims to be lodged with the claimant's private insurer sends a strong signal to EQC and private insurers that the Government expects EQC and insurers to work closely together to improve the claims experience for claimants, while avoiding overly detailed and prescriptive legislation on the claims handling process.

The Government expects that lodging EQC claims with private insurers would result in business-as-usual systems, processes and ongoing claims handling contacts being developed between insurers and EQC. This would help insurers to move into other areas of claims management if acceptable arrangements can be agreed.

Insurers have indicated to the Government they would like more certainty than this proposal provides and wanted to be fully responsible for the entire claims handling process. The Government has significant reservations about extending the proposed legislative requirement further into the claims management process.

The Government has two key concerns.

- Legislation cannot guarantee that EQC and private insurers would be able to reach an arrangement that worked for all parties. Using legislation to force the parties together, even if they considered the resulting arrangements to be unworkable or not in their interests, would create unacceptably high risks for future claims handling.
- Outsourcing arrangements should be able to evolve as time passes and best practice changes. Enshrining a particular approach in legislation would freeze the arrangements in place for a period of time, creating the risk that they would become increasingly outdated and inappropriate.

Until any new contractual arrangements have been agreed, EQC would continue to handle under-cap claims passed on by claimants' insurers. In the interim, this would not prevent EQC and insurers, collectively or individually, developing or formalising protocols to make claims handling arrangements work better.

Insurers have indicated to the Government that they do not want to take over processing land claims. Insurers do not insure land separately from building cover and so have no expertise or systems for processing stand-alone land claims. Therefore, whatever deeper arrangements might be reached for processing building claims, EQC land claims lodged with insurers would likely always be passed onto EQC for assessment and settlement.

Proposal for discussion

17 That all EQC claims be lodged with claimants' private insurers.

What do you think?

17a Do you agree that EQC claimants should be required to lodge all EQC claims with claimants' private insurers?

17b If not, what alternative arrangement would you prefer, and why?

Extend deadline for reporting claims

The Government proposes retaining the current timeframe of three months for reporting claims to encourage timely notification, but amending the Act to allow EQC to accept claims made after three months, unless doing so would prejudice EQC. This approach is based on the provisions of the Insurance Law Reform Act 1977 which applies to private insurers.

The Government also proposes applying an absolute time limit of two years for notification to ensure the claims process is not open ended.

> **Proposal for discussion**
>
> 18 That the current three-month time limit for claims notification be retained, but EQC be able to accept claims up to two years after an event, unless doing so would prejudice EQC.
>
> **What do you think?**
>
> 18a Do you agree that the current three-month time limit for claims notification should be retained, but EQC should be able to accept claims up to two years after an event, unless doing so would prejudice EQC?
>
> 18b If not, what alternative arrangements would you prefer, and why?

6.5. EQC premiums

How much will EQC insurance cost?

As this is a legislative review, the focus in this section is on establishing the appropriate legislative framework and principles for establishing and reviewing EQC premiums, not determining what particular rate EQC premiums should be set at.

Homeowners currently pay a single-rate premium of 15c per $100 of insurance cover (excl. GST). EQC revenue is collected by each homeowner's private insurer and then passed on to EQC.

These pricing arrangements, and the structure of the single-rate premium established in the Earthquake Regulations, raise two concerns for the Government.

- The EQC Act does not require EQC's premiums to reflect the costs and risks that the scheme imposes on the Government. As EQC has an unlimited Government funding guarantee, the risks of the EQC scheme are ultimately borne by the Government.
- EQC premiums are almost never changed. The premium rate first established in 1945 remained unchanged, per dollar (or pound) of cover, for over 65 years. In 2012 it was then tripled in response to the losses generated by the Canterbury earthquakes. Proposal 13, that the scheme's monetary caps, excesses and premiums be reviewed at least every five years, addresses this concern and so this is not considered any further here.

Ensuring the scheme meets its expected costs

One of the objectives of the Review is to minimise fiscal risk arising from private property damage in natural disasters. Aside from the Government's strong interest in managing any large fiscal risk, a fiscally sustainable scheme is more likely to give homeowners, insurers, reinsurers and policy makers confidence that the scheme is sustainable and will endure.

To help achieve this, the Government proposes introducing a pricing principle into the legislation. This would require the total revenue collected from the premium to be enough, over time, to fully compensate the Crown for the expected costs of the risks imposed by the scheme and the costs of EQC performing its functions. This would include administering the EQC scheme, purchasing reinsurance or other risk transfer products, and being responsible for research and education about the scheme, natural disasters, their damage and mitigation.

There might be some occasions when the Government decided it was not appropriate to price on a risk-adjusted basis. For example, there might be a step change in the level of pricing when the underlying catastrophe model was updated or replaced, and the Government might wish to phase the pricing changes in over time.

The legislation would allow the Responsible Minister to depart from this pricing principle, as long as the reason for the departure was clear as was the intention to return to this principle over time. This approach draws on the principles of responsible fiscal management established in the fiscal responsibility provisions of the Public Finance Act 1989.

EQC's advisors have made a preliminary estimate of a flat rate EQC building premium, under current terms and conditions, for indicative purposes. The resulting indicative premium for $200,000 of building cover is approximately $200 per annum, compared with a current EQC premium for $100,000 of cover of $150 per annum. If the proposed $2,000 claims excess also proceeds this increase would approximately halved. As the proposed claims excess reduces expected claims costs, it puts downward pressure on EQC premiums.

As this is a legislative review its focus is the design of future legislation determining the pricing of EQC cover. This review is not a pricing review and does not attempt to precisely determine what EQC premiums should be in future.

Therefore this estimate is only indicative, and not the result of a full actuarial pricing exercise or full engagement with relevant global capital providers. It does not take account of potential changes in external capital markets or local loss events which could increase or decrease costs, potentially significantly. Future premium pricing would also need to reflect yet-to-be-made decisions on a range of other factors. These include the future size and cost of EQC's reinsurance programme, the strategy for rebuilding the Natural Disaster Fund, and EQC's future budget for natural hazard research, education and mitigation. Nevertheless, the results suggest the proposed pricing principles appear unlikely to, on their own, substantially change EQC premiums.

Proposal for discussion

19 That the new EQC Act contain pricing and transparency principles requiring the scheme to adequately compensate the Crown for its expected costs and risks.

What do you think?

19a Do you agree that the new EQC Act should contain pricing and transparency principles requiring the scheme to adequately compensate the Crown for its expected costs and risks?

19b If not, what alternative arrangements would you prefer, to ensure the scheme's future financial sustainability, and why?

Allow but do not require differentiated EQC premiums

While the scheme as a whole should meet its costs, there are secondary decisions about how these costs should be distributed across individual homeowners. Should homeowners pay different prices, depending on the risk profile of their property or where their property is located?

At one extreme, the status quo, EQC premiums could charge one price nationwide. Alternatively premiums could be set on a geographical basis (using units such as hazard zones or local authority boundaries) or on a house-by-house basis (using risk factors such as the age or construction of the building or the underlying soil types).

Section 36(1)(c) of the EQC Act already permits, but does not require, differentiated pricing. The Government proposes retaining this enabling approach in the legislation. However, it also intends keeping the current flat-rate pricing model in the new Act. There are three reasons why it has reached this view.

- Risk-differentiated premiums may compromise the goals of the scheme. Pricing on the basis of earthquake risk will result in significant increases in premiums in some parts of New Zealand. The experience in other countries suggests homeowners faced with significant increases in premiums will choose not to insure and instead seek assistance from the Government after a natural disaster. This would create the very under-insurance problem the EQC scheme seeks to avoid.

- If an ostensibly low risk area makes a large claim on EQC's resources, risk-differentiated premiums may be seen as unfair, provoking a return to flat-rate premiums. If, historically, EQC had had geographically risk-based premiums, EQC premiums for Christchurch would have been about a quarter those of Wellington. Yet claims from the Canterbury earthquakes will entirely exhaust the Natural Disaster Fund.

- The current state of catastrophe modelling does not allow comprehensive pricing of the perils covered by EQC. There are gaps in modelling for land risks, as well as for building damage from the non-earthquake perils covered by EQC. This is due to gaps in data and scientific understanding that are unlikely to be filled in the short to medium term.

Proposal for discussion

20 That the current legislative flexibility to charge flat-rate or differentiated EQC premiums be retained.

What do you think?

20a Do you agree that the current flexibility to charge flat-rate or differentiated EQC premiums should be retained?

20b If not, what alternative arrangement would you prefer, and why?

20c Do you agree with the Government's intention to continue charging EQC premiums at a universal flat rate?

6.6. Financing

How will EQC finance its risk?

EQC's current financing arrangements raise concerns about efficiency. EQC currently finances its risk through a savings vehicle, the Natural Disaster Fund (NDF), and a programme of reinsurance purchases. EQC can also call on a backstop Crown guarantee if its reserves and reinsurance lines are exhausted.

In reality, EQC is managing the NDF on behalf of the Crown, which bears all residual risks through the Crown guarantee.

These financing arrangements raise two concerns from an efficiency perspective.

- Finance theory suggests the most efficient approach to financing would be to close the NDF and instead finance natural disaster risk centrally through the Treasury. This is because, for low-probability high-impact risks, it is more efficient to pool resources against a diversified portfolio of risks, rather than create a range of ring-fenced funds for different risks.
- There is a need to ensure EQC appropriately manages the NDF and its reinsurance purchases as an agent for managing Crown risk on behalf of the Government.

The Government proposes retaining the NDF. The main reason for doing so is that this best reflects industry and community understanding of EQC as a premium-funded insurance scheme. This is likely to increase acceptance of EQC premiums reflecting the costs and risks associated with the scheme, and support EQC's engagement with the insurance and reinsurance industry.

The Government believes the benefits associated with keeping the NDF are likely to outweigh any financing efficiencies associated with closing it. Also, these efficiencies are less than they appear. From a Crown perspective, NDF investments in New Zealand government stock are already transferred to the Debt Management Office where they are managed centrally. Therefore, retaining the NDF also gives future governments the flexibility to adjust the mix of central government and EQC management of the fund's resources, by adjusting the NDF's investment mandate.

Retaining the NDF also preserves maximum policy flexibility for the Crown. The NDF investment portfolio can be adjusted as policy thinking about the optimal financing strategy for the fund evolves.

In retaining the NDF, provisions for the fund and how it is managed may be updated to reflect insights from legislation covering Crown Financial Institutions, established since the 1993 EQC Act.

Proposal for discussion

21 That the Natural Disaster Fund be retained in broadly its current legislative form.

What do you think?

21a Do you agree that the Natural Disaster Fund should be retained in broadly its current legislative form?

21b If not, what changes would you like to see considered?

More flexible approaches to financing risk, for EQC and the Crown

The EQC Act currently provides for EQC to purchase reinsurance. It does not mention other types of risk financing instruments, such as catastrophe bonds. Allowing for other types of instruments may support a more efficient risk financing strategy.

The Government wants EQC to explore alternative risk financing instruments, where these offer a more efficient approach. To explicitly provide for this, the Government proposes that the new EQC Act will state that EQC may purchase other types of risk financing instruments.

There is also an opportunity for other state sector entities to take advantage of EQC's existing involvement in risk financing. It is intended the Act will clarify that EQC may buy reinsurance and other risk financing instruments on behalf of other state sector entities, if so directed by the Minister. This would be a facilitating provision. It would allow, but not require, the Crown to take more advantage of EQC's existing risk financing relationships, if Ministers saw value in this in the future.

Under such an arrangement, EQC would not insure the assets of other departments, agencies and entities. Instead, it would be able to act as an agent on their behalf. The costs of these activities would be recovered from the departments and agencies concerned, not from EQC premium revenue or the NDF.

Proposal for discussion

22 That the Act enable EQC to use other forms of risk transfer, in addition to traditional reinsurance.

What do you think?

22a Do you agree that the Act should enable EQC to use other forms of risk transfer, in addition to traditional reinsurance?

7. Technical issues

Any future new EQC Act will include many technical changes that are not discussed in this document. Interested stakeholders, including the public, will have an opportunity to comment on all proposed changes of any proposed new legislation as part of the select committee process that a new EQC Bill would be subject to.

Technical issues that may potentially form part of a future EQC Bill include:

- more closely aligning with industry practice EQC's ability to deny or cancel insurance cover, deny claims and recover payments improperly paid out
- reviewing the circumstances in which EQC may pay claims to people with insurable interests in the damaged property, but who are not the insured person
- considering requirements for the assignment of claims and settlement with the person the claim is assigned to
- reviewing the effective date at which the value of cash settlement should be determined
- specifying the application of excesses when multiple claims are made on one or more events within a relatively short time
- updating EQC's currently far reaching salvage rights to better balance the interests of EQC, the insured and insurers
- redefining volcanic eruption as volcanic activity more broadly
- addressing the *Canterbury Earthquakes Royal Commission* recommendation 94, namely that "Section 32(4) of the Earthquake Commission Act 1993 should be amended to allow for disclosure of information that may affect personal safety"
- defining when the site that an insured building is on is eligible for a land claim as it is either not practicable or cost-effective to repair or rebuild on the site
- inclusion of provisions to facilitate area-wide repairs or off-site works, where that is the most economical solution to meet EQC's repair obligations
- Consideration of what will constitute an appurtenant structure
- transitional arrangements to bring the new scheme into force.

Other feedback

23a Are there any issues not discussed in this document that you would like to bring to the Government's attention at this stage?

23b What submissions would you like to make on those issues?

8. Impacts of proposals on fiscal risk

How do proposed changes to the EQC scheme affect the scheme's risk?

The Government's preferred reform package has a number of elements. Each element has its own effect on risks associated with the EQC scheme.

- Enhanced building cover increases scheme risk; while some of this increase in cover is a transfer from existing land cover, other elements, such as artificial surfaces on driveways, are new.
- Increasing the monetary cap on building cover increases scheme risk.
- Restricting land cover to situations of total loss of land reduces scheme risk.
- No longer providing contents cover under the scheme reduces scheme risk.
- Standardising EQC excesses on building claims at $2,000 + GST per claim reduces scheme risk.

For a given residential building, these changes represent transfers of risk to or from private insurers or homeowners.

EQC can model its expected claims liability under different scheme designs and event scenarios. The analysis below shows the modelled claims costs to EQC of what is dubbed the 'Wellington reference event'. This is EQC's probable maximum loss event, the event that will inflict the largest modelled loss within a given timeframe. For EQC that is a large (magnitude 7.5) Wellington earthquake, which has an expected return period of about once every 860 years. A 50th percentile loss is the average (median) expected loss. A 95th percentile loss means the modelled loss is less than this figure 95 percent of the time. So, for practical purposes, it can be considered a worst case estimate.

The system can model changes in monetary values (eg, excesses and caps, including a zero cap for contents), but not changes in the quality of cover being provided. Therefore, the figures below model the scheme cover as it currently is, so do not include the effects of the enhanced building cover, nor the restriction of land cover to situations where the site of the insured building cannot be built on.

Table 3 show's EQC's modelled building claims in a Wellington reference event (a single event with no aftershocks). The expected loss (50th percentile) liabilities are in bold type. The following features are worth noting.

- The 95th percentile cost estimates are about double the 50th percentile estimates ie, the worst case estimate is about twice as costly as the best guess estimate.
- The bulk of liability is incurred at low caps.
- Increasing the monetary cap from $100,000 + GST to $200,000 + GST reduces private insurers' modelled share of the liability by about two-thirds.
- The exposures are large, potentially warranting risk transfer through reinsurance or other means.

Table 3: EQC 50th and 95th percentile building damage liability for a Wellington reference event at various building caps

Confidence level	Liability, $ million, at a range of building caps						
	$50k	$100k	$150k	$200k	$250k	$300k	Uncapped
50%	**$3,690**	**$4,854**	**$5,381**	**$5,654**	**$5,800**	**$5,884**	**$5,994**
95%	$6,588	$9,574	$11,093	$11,919	$12,387	$12,658	$13,024
Confidence level	**Capped liability as percentage of uncapped liability**						
	$50k	$100k	$150k	$200k	$250k	$300k	Uncapped
50%	**62%**	**81%**	**90%**	**94%**	**97%**	**98%**	**100%**
95%	51%	74%	85%	92%	95%	97%	100%

Confidence level	Change in liability from current $100,000 cap, $ million						
	$50k	$100k	$150k	$200k	$250k	$300k	Uncapped
50%	**($1,164)**	**$0**	**$527**	**$799**	**$946**	**$1,030**	**$1,140**
95%	($2,986)	$0	$1,518	$2,344	$2,812	$3,083	$3,449
Confidence level	**Change in liability from current $100,000 cap, Percent**						
	$50k	$100k	$150k	$200k	$250k	$300k	Uncapped
50%	**-24%**	**0%**	**11%**	**16%**	**19%**	**21%**	**23%**
95%	-31%	0%	16%	24%	29%	32%	36%

Table 4 summarises the impact of different excesses on building claims. The Canterbury earthquakes have generated over 400,000 building claims for EQC, so these percentage reductions potentially represent tens of thousands of low value claims that would no longer need to be processed by EQC, or insurers acting on EQC's behalf.

Table 4: Impact of different excesses on EQC claims numbers and costs

This table was updated on 15 July 2015 to incorporate the results of more recent modelling. Other tables in this chapter already drew on that more recent modelling.

Excess on building claims	Reduction in reference event number of EQC building claims	Reduction in average annual claims $ million	Reduction in reference event expected liability $ million
$500	3.6%	1.3	19
$1,000	7.8%	4.0	95
$2,000	13.8%	8.6	239
$5,000	28.3%	19.8	632

Table 5 shows EQC's expected annual claims liability (EQC's expected average annual claims paid out over the long run) and expected claims from a Wellington reference event. Because the scheme is exposed to rare but very costly events, the annual expected claims are a small fraction of the worst case loss. Most years, EQC pays out much less than the average annual claims.

The key feature worth noting is that reductions in risk from changes to contents cover and claims excesses are substantial; about $900 million in a Wellington reference event. A package incorporating an increase in the building cap to $200,000 + GST, combined with these changes, is modelled as reducing scheme risk by about $100 million, or about 1.6 percent. Given the uncertainties of such models we interpret the impact of this package on scheme risks as likely to be broadly risk neutral.

Table 5: Fiscal impacts of potential reform options

	Expected annual claims liability $ million					Expected liability, Wellington reference event $ million				
	Building cap					Building cap				
	$100k	$150k	$200k	$250k	Uncapped	$100k	$150k	$200k	$250k	Uncapped
Expected claims	$118	$128	$133	$136	$139	$5,585	$6,106	$6,380	$6,531	$6,725
Change from status quo										
Building cap changes	$0	$10	$15	$18	$21	$0	$521	$795	$947	$1,141
Exit contents	-13.74	-13.74	-13.74	-13.74	-13.74	-661	-661	-661	-661	-661
$2,000 excess	-8.6	-8.6	-8.6	-8.6	-8.6	-239	-239	-239	-239	-239
Impact of combined changes	**($22)**	**($12)**	**($7)**	**($5)**	**($1)**	**($899)**	**($378)**	**($104)**	**$47**	**$241**

To help submissions on the modelled elements of the scheme design, these tables also include data on options other than the Government's preferred reforms.

Appendix 1: Proposals and questions for submitters

What is the purpose of the EQC scheme?

Proposal for discussion

1 That the purpose of the EQC Act be to establish a Crown-owned natural disaster insurance scheme for residential buildings in New Zealand that:

- supports, complements and is closely coordinated with the provision of effective private insurance services to the owners of residential buildings
- recognises the importance of housing in supporting the recovery of communities after a natural disaster
- supports improved resilience of New Zealand communities and an efficient approach to the overall management of natural hazard risk and recovery in New Zealand
- contributes to the effective management by the Crown of fiscal risks associated with natural disasters.

What do you think?

1a Do you agree that these purposes are appropriate and complete?

1b If not, what changes would you suggest, and why?

What types of perils will EQC cover?

Proposal for discussion

2 That EQC continue to insure against the following perils: earthquake, natural landslip, volcanic eruption, hydrothermal activity, tsunami, and storm and flood (with, in the case of storm and flood, only residential land being covered).

What do you think?

2a Do you agree that EQC should continue to provide cover against the same perils as it currently does?

2b If not, what changes would you suggest, and why?

What types of property will EQC insure?

Proposal for discussion

3 That EQC building cover continue to be available to residential buildings and dwellings in non-residential buildings.

What do you think?

3a Do you agree that EQC building cover should continue to only be available to residential buildings and dwellings in non-residential buildings?

3b If not, what forms of accommodation or living arrangements do you think should be added or removed, and why?

Proposal for discussion

4 That EQC land cover only be available for land associated with residential buildings. Therefore, dwellings in non-residential buildings would not receive any EQC land cover.

What do you think?

4a Do you agree that EQC land cover should only be available for land associated with residential buildings?

4b If not, what coverage of land cover would you prefer, and why?

Extending building cover to include more siteworks and main access way

Proposal for discussion

5 That EQC building cover be extended to include siteworks and the main access to the building.

What do you think?

5a Do you agree that EQC building cover be extended to include siteworks and the main access to the building?

5b If not, what do you think should be done instead, and why?

EQC to no longer provide contents insurance

Proposal for discussion

6 That EQC no longer offer residential contents insurance.

What do you think?

6a Do you agree that EQC should no longer offer residential contents insurance?

6b If not, what level of contents cover do you think EQC should offer, and why?

6c For insurers, what do you anticipate the impact would be on premiums your company charges for residential contents insurance, if EQC no longer offered residential contents insurance?

Please note the information in section 1.4 regarding the Official Information Act.

How much insurance will EQC offer?

Proposal for discussion

7 That the monetary cap on EQC building cover be increased to $200,000 + GST.

What do you think?

7a Do you agree with the proposed increase in the building cap to $200,000 + GST?

7b If not, what cap would you prefer, and why?

7c Do you have strong views on the merits of a $150,000 + GST cap versus a $200,000 + GST cap?

7d If so, what are they?

7e For insurers, what do you anticipate the impact would be on premiums your company charges for residential property insurance, if the proposals in this document regarding changes to building cover were implemented? Please provide this information for a monetary cap for EQC building cover of both $150,000 and $200,000.

Please note the information in section 1.4 regarding the Official Information Act.

Reinstatement of EQC cover after an event

Proposal for discussion 8 That EQC building cover reinstate after each event.
What do you think? 8a Do you agree that EQC cover should reinstate after each event? If not, what is your preferred alternative, and why?
8b Do you agree with retaining the current definition of an event?
8c If not, what is your preferred definition, and why?

EQC land cover

Proposal for discussion 9 That land cover be limited to situations where the insured land is a total loss meaning it is not practicable or cost-effective to rebuild on it.
What do you think? 9a Do you agree that the proposed enhanced building cover, combined with restricting land cover to situations where the site of the insured building cannot be rebuilt on, would resolve, for future events, many of the recent difficulties with the interaction between land and building cover?
9b If not, what is your preferred alternative, and why?
9c Do you agree that restricting land cover to situations where the site of the insured building cannot be rebuilt on is appropriate, given the EQC scheme's focus on providing homeowners the resources to repair, rebuild or re-establish homes elsewhere?
9d If not, what is your preferred alternative, and why?
9e Do you have any concerns regarding the proposed change to the configuration of building cover in light of the move by most insurers to provide sum insured home insurance policies?
9f If so, what is your preferred alternative, and why?

Better aligning EQC and private insurers’ standard of repair

Proposal for discussion

10 That EQC’s current statutory repair obligation already appears broadly consistent with industry practice.

What do you think?

10a Do you agree with the Government’s assessment that EQC’s legislated standard of repair is broadly consistent with current industry norms?

10b If so, do you have views on why EQC’s standard of repair is seen as markedly different from current insurance industry norms?

10c If not, do you have suggestions for reforms that you consider would move the EQC standard of repair closer to current insurance industry norms for residential property?

Simplifying EQC’s claims excess

Proposal for discussion

11 That EQC has a standard claims excess of $2,000 + GST per building claim.

What do you think?

11a Do you agree that EQC’s building claims excesses should be standardised and simplified to a flat dollar amount?

11b If yes, do you agree that $2,000 + GST is the appropriate claims excess on building claims?

11c If not, what would you prefer, and why?

Proposal for discussion

12 That EQC have no claims excess on land claims.

What do you think?

12a Do you agree that EQC should have no claims excess on land claims?

12b If not, what would you prefer, and why?

Regularly reviewing main monetary settings of cover

Proposal for discussion

13 That the EQC Act require monetary caps, premium rates and claims excesses on EQC cover to be reviewed at least once every five years.

What do you think?

13a Do you agree that monetary caps, premium rates and claims excesses on EQC cover should be reviewed at least once every five years?

13b If not, what alternative would you prefer, and why?

How will homeowners access EQC insurance cover?

Proposal for discussion

14 That EQC cover continues to automatically attach to fire insurance policies on residential buildings, as defined in the EQC Act.

or

15 That EQC cover automatically attach to insurance policies on residential buildings, as defined in the EQC Act, on a peril by peril basis; so if a peril covered by EQC is excluded from the private policy, it is also excluded from the EQC cover.

What do you think?

14a Do you agree that EQC cover should continue to automatically attach to fire insurance policies on residential buildings? Or

15a do you agree that EQC cover should automatically attach to insurance policies on residential buildings, and EQC cover should exclude any natural disaster peril that is excluded from the fire insurance policy it attaches to?

15b If you do not agree with either of these options, what alternative arrangement do you prefer, and why?

Proposal for discussion

16 That EQC continue to have the ability, but not the obligation, to directly provide EQC cover to homeowners who request it.

What do you think?

16a Do you agree that EQC should continue to be able, but not be obliged, to directly provide EQC cover to homeowners who request it?

16b If not, what alternative arrangement would you prefer, and why?

Who will handle EQC claims in future?

Proposal for discussion

17 That all EQC claims be lodged with claimants' private insurers.

What do you think?

17a Do you agree that EQC claimants should be required to lodge all EQC claims with claimants' private insurers?

17b If not, what alternative arrangement would you prefer, and why?

Deadline for reporting claims

Proposal for discussion

18 That the current three-month time limit for claims notification be retained, but EQC be able to accept claims up to two years after an event, unless doing so would prejudice EQC.

What do you think?

18a Do you agree that the current three-month time limit for claims notification should be retained, but EQC should be able to accept claims up to two years after an event, unless doing so would prejudice EQC?

18b If not, what alternative arrangements would you prefer, and why?

Ensuring the scheme meets its expected costs

Proposal for discussion

19 That the new EQC Act contain pricing and transparency principles requiring the scheme to adequately compensate the Crown for its expected costs and risks.

What do you think?

19a Do you agree that the new EQC Act should contain pricing and transparency principles requiring the scheme to adequately compensate the Crown for its expected costs and risks?

19b If not, what alternative arrangements would you prefer, to ensure the scheme's future financial sustainability, and why?

Allow but do not require differentiated EQC premiums

Proposal for discussion

20 That the current legislative flexibility to charge flat-rate or differentiated EQC premiums be retained.

What do you think?

20a Do you agree that the current flexibility to charge flat-rate or differentiated EQC premiums should be retained?

20b If not, what alternative arrangement would you prefer, and why?

20c Do you agree with the Government's intention to continue charging EQC premiums at a universal flat rate?

How will EQC finance its risk?

Proposal for discussion

21 That the Natural Disaster Fund be retained in broadly its current legislative form.

What do you think?

21a Do you agree that the Natural Disaster Fund should be retained in broadly its current legislative form?

21b If not, what changes would you like to see considered?

Proposal for discussion

22 That the Act enable EQC to use other forms of risk transfer, in addition to traditional reinsurance.

What do you think?

22a Do you agree that the Act should enable EQC to use other forms of risk transfer, in addition to traditional reinsurance?

Do you have any other feedback?

Other feedback

23a Are there any issues not discussed in this document that you would like to bring to the Government's attention at this stage?

23b What submissions would you like to make on those issues?