The Treasury

Earthquake Commission (EQC) Act Review Submissions Information Release

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Submission on proposed changes to the EQC Act 1993

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Scope of submission

This submission is made in response to the Ministers' invitation to make submissions on the proposed changes to the EQC Act 1993.

All the submissions relate to question 23 in the response form relating to 'other issues'.

I generally support the detailed proposals set out in questions 1 – 22 of the standard response form, with the exception of those relating to 'the cap'. These would no longer be relevant if my submissions are accepted.

Qualifications

My qualification for making a submission is broad experience including:

- As local MP, facilitating many claims after the Edgecumbe earthquake;
- Chair of EQC;
- Director of NZI;
- Major part of design of catastrophe insurance schemes for Turkey and Romania under World Bank projects;
- Consulted internationally on applications of DFA to catastrophe insurance;
- Led Review of the Response to the Christchurch earthquake of 22 February 2011.

Summary

The proposed changes in the EQC scheme are for the most part sensible improvements and I support them. Unfortunately they do not deal with two of the significant weaknesses which were demonstrated after the Canterbury earthquakes.

These are the effect of the scheme being ***excess of loss*** (which brings in the cap), and the lack of any proposal to improve information flow to claimants. Unless these two issues are dealt with, EQC will remain fatally flawed.

Moreover the transfer to insurers of some responsibility for settlement of EQC claims introduces significant conflict of interest for insurers. This can only be mitigated if unless insurers have some "skin in the game" in all the claims they settle.

These problems can be dealt with, and the scheme much improved, by two significant changes: a basic change in the sharing of risk between EQC and insurers; and the establishment of an independent information sharing agency.

The 'Cap' and Robin Hood

The 1993 reform of EQC brought major benefits. Without its changes, the claims arising from the Canterbury earthquakes would have been important almost impossible to settle.

The 1993 Act required losses to be shared between EQC and insurers in a different way than prior to that time. The excess of loss over the EQC cap was left to insurers (or left uninsured). The purpose of the cap was to exclude the Crown from insuring the more expensive houses, whose owners could presumably afford to buy earthquake insurance from insurance companies.

In fact, because the premium is a fixed sum for all houses worth over the cap, the cap has a regressive effect. Unlike Robin Hood, it favours the rich against the poor. After a major earthquake, large mansions are much more likely than are small cottages to get a claim pay-out of the full

amount of the cap. Thus while rich and poor put the same amount into the scheme through the fixed premium, the rich are likely to get much more out of the scheme after a disaster.

Alternative ways of sharing the risk between EQC and the Crown are discussed below.

The 'cap' and Christchurch

The cap caused major problems in settling claims after the Canterbury earthquakes. These were of several kinds:

- For many claims it took years before a decision was made as to whether EQC or an insurer was responsible for settling the claim. Small claims were clearly the responsibility of EQC and were dealt with by EQC. Very substantial losses were clearly the responsibility of insurers and were passed to insurers by EQC without major investigation. But with a large number of claims, it was not clear until after substantial investigation that the claim exceeded the cap. Thus an insurer could not start work on such a claim until investigation of the claim was completed by EQC and the claim handed over to the insurer.
- A cap applied separately to losses from damage caused by each of the several major earthquakes. It was thus necessary to estimate the damage caused by each of the events, in most cases after all of them had occurred. An accurate attribution of losses to each event is impossible unless the damage is assessed before subsequent events occur. Hence the allocation of losses between EQC and insurers depended on which if any of the events was considered to have caused a loss in excess of the cap. This led to considerable uncertainty and delay in claim settlement.
- As well as causing hardship to homeowners and Christchurch, these uncertainties have had a significant effect on insurers and their relationship with reinsurers. Nearly 5 years after the first earthquake, the losses being claimed from reinsurers are still being revised upwards. This uncertainty and ongoing revision of losses is anathema to reinsurers and has a significant effect on their attitude to pricing reinsurance cover in future.

A risk sharing structure which does not involve excess of loss (i.e. a cap) is clearly desirable.

The alternative to a cap

The alternative structure to excessive loss cover is a ***proportional cover***. This is a standard arrangement used in the insurance industry, especially for larger risks and in reinsurance.

It would involve EQC and insurers sharing all losses according to a fixed proportion. The proportion could change over the years by agreement between the Crown and the industry and be implemented by Order in Council have. Either EQC or insurers would settle claims according to an arrangement made in advance.

Proportional cover would give greater certainty to both insurers and reinsurers and hence help keep premiums down.

The risk to the Crown could be set at the equivalent level to a scheme involving a cap. The risk would be modelled using a DFA model as has been done by EQC for 20 years.

Why wasn't proportional cover used originally in 1993?

In consultations prior to the 1993 Act, the draft proposal for a cap created considerable discussion within EQC and the industry. Most of the Board of EQC favoured proportional cover. The industry favoured a cap. I myself considered that an excess of loss scheme with a cap was the most desirable in the circumstances of the time.

The reasons were these:

- the proposed cap of $100,000 was expected to cover nearly all damage to dwellings at that time. For most claims the cap would not come into play, and it would thus have little impact on claim settlement;
- at that time the insurance industry was absorbing a transfer from EQC of a large amount of commercial risk, and this was straining its capacity to adjust claims and to obtain reinsurance;
- the reinsurance industry was just emerging from a very hard market, reinsurance was difficult to obtain in sufficient quantities, and in the interest of New Zealand it was prudent for EQC to continue to use the reinsurance facilities available to it;
- DFA modelling was in its infancy and calculations of the sharing of risk between EQC and insurers were not adequate.

The final decision was made by the Minister who issued a directive to EQC that the cover would be subject to a cap with the excess of EQC losses covered by insurers.

The situation is very different now as compared with 1993. The insurance industry in New Zealand is much stronger, and availability of reinsurance is significantly increased. DFA modelling to assess the risk to the Crown is now well developed and robust. There would seem to be little barrier to restructuring the EQC scheme to base it on proportional cover rather than excessive loss.

Why proportional cover would be better

If proportional cover were in place with a prior arrangement between the industry and EQC as to handling claims, claimants would only have to deal with one entity and there would be no uncertainty as to who is managing their claim. When multiple events cause losses, there would be no need to allocate the damage to each specific event. Reinsurers could have more confidence in the exposure of both EQC and insurers and hence reinsurance rates would not be increased because of uncertainty.

With proportional cover, insurers would be better placed to resist pressure from their customers to spend EQC money freely when settling claims.

If a transition of more cover to insurers proved to be desirable and in the interest of householders, the Crown and insurers, such transition could be readily made.

Proportional cover would give greater certainty to both insurers and reinsurers and hence help keep premiums down.

It must be emphasised that insurers as well as EQC need to lift their game in the settlement of claims after major disasters. Whether or not the insurance industry performed better or worse than EQC, neither did nearly well enough to satisfy the needs of their customers. Such an improvement in performance is necessary regardless of whether excess of loss or proportional cover is used. However improved performance by insurers would be even more important if they take over any part of the EQC responsibility of receiving claims, settling claims and rebuilding.

Why audit of insurers isn't enough to mitigate conflict of interest

If insurers are to take bigger part in handling claims then basic issues of motivation need to be dealt. Claimants always expect their own insurance company to look after them. This applies particularly when the funding of claims is by EQC rather than the insurer. It is very much in the insurers' interest to keep their customers happy and not see them lost to another insurer. Hence there is a strong incentive to be generous with EQC funds. Thus the duty of insurers to act as a responsible agent for EQC is in conflict with the commercial imperative of taking care of their own customers.

When dealing with thousands of earthquake claims it is very difficult to audit the accuracy of assessments of loss and the cost of repairs. That the estimation of loss and the cost of repairs is

difficult after major earthquakes has been shown time and again in Christchurch. What is more, audit needs to be after the event, and it is of course not possible to inspect the original damage.

Hence audit and monitoring are a weak tool to mitigate the conflict of interest of insurers when they settle claims on behalf of EQC without carrying any of the risk themselves. Another mechanism is necessary.

Information

One of the frustrating problems faced by claimants in Christchurch has been the inability to obtain information as to progress on their claims from EQC, and (to perhaps a lesser extent) from insurers. EQC did not appear to have a system which enabled claimants to readily find out what is happening with their claims. Many used the Official Information Act but this is a clumsy and inappropriate tool for finding ongoing information about a process like claim settlement. A multitude of bodies exercise some supervision, or provide appeal regarding EQC or insurers' action (or lack of it). None seemed to be equipped to resolve the information issues arising from the Canterbury earthquakes.

The Discussion Document does not appear to address the issue of poor information systems. Indeed, with claim settlement process being even more divided between insurers and EQC (with insurers receiving claims and passing them on to EQC), information flows to claimants are likely to be made more difficult.

A major change needed in order that claimants can be continuously kept informed as to the progress of their claim.

In the past insurers have been reluctant to give EQC detailed information about their own portfolios for fear that their competitors would obtain information of competitive value.

One possibility is the establishment of a separate information agency both to hold information about the earthquake insurance cover flowing from each insurer, to keep claimants informed as to progress of the claims, and to exercise discipline over EQC and insurers with respect to information to claimants. This would focus more on provision of adequate systems than resolving disputes over the handling individual claims.

In the USA the Insurance Information Institute carries out some of these functions, as does the ICNZ here. Substantially more is needed is needed in to manage and facilitate information flows after major disasters.

My recommendation is for a cooperative body with governance by representatives of EQC, insurers and reinsurers. Such a body would require considerable development in consultation with consumer interests and the insurance industry.

Conclusion

The changes proposed in the Discussion Document would deal with many of the problems demonstrated by the Canterbury earthquakes. They are however fatally flawed in that the excess of loss structure of cover involving a cap is continued. A change to proportional cover would significantly improve claim settlement and at the same time enable the insurance industry to play a greater role in dealing with claims. The Discussion Document has a major gap in that it does not deal with an adequate information or claimants. Managing the flow of information may need a small separate agency to be set up.

11 September 2015