The Treasury

Earthquake Commission (EQC) Act Review Submissions Information Release

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In preparing this Information Release, the Treasury has considered the public interest considerations in section 9(1) of the Official Information Act.

Submission: Proposed changes to the Earthquake Commission Act 1993

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Overview

Given the multiple problems with the dual insurer model exposed during the Christchurch rebuild, the review needs to imaginatively rethink the purpose of EQC. An ideal solution is for the EQC to stop offering first loss cover, and for the government to require all private insurers to provide disaster cover as part of house insurance at the fixed price nationally, and then to require those private insurers to arrange adequate excess-of-loss reinsurance. These private insurers would be able to deal with the routine quake claims at little extra cost to their admin systems. Bare land could be covered via new products created by private insurers but backed by the EQC. The EQC could aid by arranging that reinsurance for those insurers unable to arrange it at an attractive cost, or those with insufficient expertise.

The EQC should instead focus on building expertise in financial re-insurance arrangements, on funding earthquake and building science to reduce loss, and on researching and preparing post-disaster management.

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?

EQC needs to be focused on:

(i) Ensuring NZ has a high rate of natural disaster insurance
(ii) Ensuring that rebuilds after natural disasters is effective and timely
(iii) Providing expertise in the management of natural disasters
(iv) Ensuring that central government is not exposed to demands to resolve high rates of social distress after a disaster due to a high number of uninsured households

Section 3.3 states that without the EQC NZ would have low rates of insurance against catastrophic loss. However no analysis or evidence is given to support this, apart from a fascicle comparison of insured rates from recent disasters. In fact no other country has a structured natural disaster insurance scheme so table 1 merely compares a structured scheme to unstructured schemes. There is no analysis of the merits of alternative structured schemes. Correlation is not causation.

The only argument offered for EQC first–loss cover is that it causes our high levels of natural disaster insurance cover, and thus avoided the impact of ad hoc government funding. However little analysis or evidence is given to support this.

In fact the EQC cover of the first $115,000 of house losses, or even the recommendation of $230,000, is a low proportion of the average house value in an area like Christchurch, so if additional private cover was not available then householder losses would be crippling. It is the private insurance held which paid for the losses above the EQC cap which saved Christchurch. Requiring private insurers to provide second-loss cover, rather than first-loss does not reduce the risk of private insurer bankruptcy.

So the key question is the link between EQC cover and high rates of private house insurance. This casual link is not explored in the report, a significant failing by report authors.

One casual link offered is that EQC can provide an initial cover of natural disaster first - insurance cover cheaper than private insurers could. No evidence or analysis is offered apart from an argument that setting a uniform rate across the country enables NZers in high risk areas to have their premiums subsided by NZers in low risk areas. There is also no policy backing for this cover, as a similar argument could be made for a government body to offer NZers a first block of income insurance cover, which would help solve our abysmal underinsurance rates on personal risk insurance.

The prime reason for low rates of natural disaster cover in California and elsewhere is actually that it is offered as a luxury additional option to customers, not as an integral part of every policy. Given that natural disasters are a low incidence event, time discounting and the likelihood of govt help, means that customers naturally decline to buy. This causes a culture of choosing not to buy. In some countries, like Norway, natural disaster cover is compulsory, and correspondingly very high rates of cover are achieved. Even in France, where insurance cover is voluntary, it's compulsory inclusion in house cover ensures coverage rates are high. There is no causal link between the existence of a first cover regime and high rates of disaster cover. Therefore the EQC first-cover can be replaced by a law requiring all private insurers to offer natural disaster cover as an inherent, non-separately-priced, part of their house insurance product, and by ensuring insurers develop a stand-alone product.

This could require that insurers price this on an actuarially even basis across the country, though there is a sound policy basis for differential pricing based on regional risk and restrictions on new housing areas.

The main difficulty with a private insurer first–loss requirement is that natural disasters have a capacity to impact on a high number of insured clients at the same time, and thus cause company bankruptcy. However given that NZ house rebuild costs vastly exceed even the proposed $230k first loss cover, the current arrangement still exposes private insurers to all losses above the fixed sum, which are uncertain and unlimited. The proposed arrangement means that all NZ insurers could go bankrupt given a disaster of sufficient size.

This bankruptcy is normally offset by insurance companies purchasing 'excess-of-loss reinsurance'. One difficulty is that this reinsurance cover can be expensive to obtain at a reasonable price, which would push up client premiums. This is why AMI purchased 'fixed-sum-reinsurance' instead, and went bankrupt after losses exceeded their capital plus the fixed amount of reinsurance. This difficulty would be worse for smaller insurers as they have lower client diversity and a thus higher potential percentage of loss. The area is also quite technical and smaller insurers may lack skill. Thus local companies could be at a competitive disadvantage.

Treasury has tried to solve this by requiring insurers hold enough capital or reinsurance to survive a 1 in 1,000 year event. This requirement doesn't solve modelling risk or the above purchasing and expertise difficulties. It disadvantages smaller insurers' and thus discourages market entrants. It is also very costly, which pushes up insurance premiums and is only secure if actuaries' estimate of the size of the most extreme event holds true. Given our current lack of knowledge of long duration events, this modelling risk is insolvable – the Chch fault-line was only evident after the event. Thus the proposed EQC arrangements do not remove the bankruptcy risk from NZ insurers and thus from the NZ taxpayer.

Given the introduction of fixed value insurance, the next disaster will impact on government funds more than the Chch quake because (i) householders do not include demolition and other costs in their estimates, (ii) rebuild costs naturally rise sharply during a large disaster. These mean that a disaster involving capped insurance policies will create heavy cash-flow costs on families and lead to ad hoc calls on govt funds. The reserve arrangements are thus inefficient, costly and unnecessary.

The current first-loss EQC arrangement thus likely increases insurance costs and doesn't directly cause high rates of catastrophe insurance cover. Yet there is no justification for the EQC to be involved in quakes which are smaller than disasters, as private insurers can handle routine years. There is only justification for EQC to be involved in the infrequent large loss events.

A superior option could be for the government to require all private insurers to provide replacement disaster cover as part of house insurance at the fixed price on a regional or national basis, and then to require those private insurers to arrange adequate excess-of-loss reinsurance. These private insurers would be able to deal with the routine quake claims at little extra cost to their admin systems. Bare land could be covered via new products created by private insurers but backed by the EQC. Non-residential buildings should be included in these arrangements as there is still the chance of insurer bankruptcy due to these.

The EQC could then focus on facilitating or arranging that reinsurance for those insurers unable to arrange it at an attractive cost. International capital markets have developed in a way not imagined when EQC was first created. The government's size and sovereign rating would enable it to buy this cheaper than most private insurers could. EQC could build expertise in this area, and offer the expertise to smaller insurers, who are handicapped by the current requirement that they arrange their own reinsurance. This would also enable the removal of the 1 in 1,000 year capital requirements, which would further reduce premiums. An alternative to reinsurance would be the use of products such as 'cat bonds', which could be issued far cheaper and easier by the EQC than by private insurers. These are currently and bizarrely banned from use.

Thus the EQC scheme should be changed to a 'second-insurer' arrangement, with the default arrangement that private insurers cover this by re-insurance if possible, or via the EQC if not. The EQC should pass on all this residual risk to international markets, if possible.

The value of EQC's existence is the aspects of its roles in Chchc which arise on an ad hoc basis. EQC can be reduced to a small group of specialists, who could focus on regulating private insurer disaster cover, on building expertise in financial re-insurance arrangements, on funding earthquake and building science, and on researching and preparing post-disaster management. EQC, for example, should have been preparing for Cera's job, and should oversee and regulate the work of private insurers during a rebuild.

The current proposals are unimaginative, do not get to grips with core issues, and leave government exposed to a high level of unnecessary loss from the next disaster.

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?

Non-residential buildings should be included in my proposed arrangements as there is still the chance of insurer bankruptcy due to these, and therefore government being forced to pick up the cost. EQC should, however, restrict its second cover here to facilitating reinsurance at cost.

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?

There is no justification for this cover- EQC should exit.

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.

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?

This needs to be clarified if there are multiple events, such as occurred with Chch, so it is clear that only one excess will be used, even if multiple events occur.

How will homeowners access EQC insurance cover?

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?

In fitting in which my suggested re-insurance arrangements, EQC should not have any customer contact. However EQC could require that insurers provide customers with the opportunity to offer natural disaster cover separate from fire cover, which EQC could explore offering via rates payments or other avenues.

EQC needs to have regulatory powers to oversee customer service by private insurers during disasters. EQC should also facilitate the development of natural disaster only cover, to be offered via private insurers.

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?

The current dual first/ second cover arrangement proved a disaster during the Christchurch for several reasons;

(i) the EQC pre-quake was set up to handle the small number of routine claims. The Christchurch quake forced them to expand from about 30 staff to over 1800, with a large number needing unusual technical skills, as well as creating new administrative systems. Thus the EQC didn't have the systems of staff to cope for at least 18 months.

(ii) all claims had to be screened by the EQC, so private insurers could not proceed until the scarce EQC staff had screened customers. As claim costs rose or fell depending on circumstances, the number the private insurers had to deal with fluctuated, especially as many initial assessments proved wrong. Private insurers were thus not able to use their greater capacity until much later in the process.

The current first cover set-up ensures that when large disasters happen the EQC will never be ready, given their small staff size during non-crisis periods. EQC will always be totally unprepared for large disasters given their infrequent nature. We would still suffer from the two insurer problem which is the cause of a lot of current problems. This cannot be solved without moving to my second cover/ reinsurance scheme.

Yet it is inefficient for private insurers to act as EQC's agents for the numerous small claims which will occur between the infrequent large disasters. They will have to pay for this administration cost by loading claims to EQC, who will have to judge whether that loading is fair. This will involve extra EQC staff, and unsolvable administrative arguments. Insurance costs will rise for no obvious gain.

Handling a major disaster is easier for private insurers to deal with as they are in general large world-wide companies employing thousands of staff, who have the necessary skills. Thus they simply have to fly in staff or remotely use foreign staff. EQC, by contrast, was forced to try to try to poach them from existing insurers or use expensive contractors.

The proposed insurer first scheme does not solve any issue as in normal times the insurer hands on the 70% of small claims to EQC, while adding cost. During a large disaster the EQC would still have to deal with thousands of claims and private insurers would have to handle a large percentage of claims which they do not ultimately pay for. Since the EQC is directly liable for costs, they will still have to independently assess all claims, as they do now. The proposed arrangement which will push up premiums by adding to double handling while failing to solve the core issues.

My proposed solution short-circuits this complexity by making all claims only private insurer, thereby ensuring they are only handled once, assessed once, with no liaison between two insurers required. EQC's only role would be to regulate private insurer response quality.

If the Report's proposed dual insurer model is adopted, with only the insurer having customer contact, then many legal issues arise around liability. These revolve mainly around there being two contracts and two payment processes involved. This means that during a complex natural disaster the EQC cannot in actuality escape customer contact. For example if there is a question of possible non-disclosure wrt the private insurer contract then that cannot under law also apply to the EQC contract. The issue would need to be dealt with separately. Similar considerations apply around rebuild/cash choices, assessment details, etc.

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?

My suggestion will require EQC to monitor private insurer response times during a crisis and publically report. The EQC then needs powers to fine or otherwise punish insurers who unduly delay claims.

There needs to be longer notification leeway during large natural disasters as people's lives are disrupted, they may leave the city or be travelling, etc. The 'three month' also depends on arbitrary definitions of which of many quakes caused the damage.

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

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?

The concept of using a savings fund to prepare for infrequent needs of uncertain size is a concept derived from a time before the development of international financial markets. Under my scheme EQC would primarily act as a facilitator of reinsurance. However these may be a role for issuing reinsurance or cat bonds on behalf of insurers. Reinsurance markets are problematic as it can be difficult to access cover for longer than 3 years. The use of longer instruments like Cat bonds allows access to the style of long term funds suited to an infrequent event like major earthquakes. The growth in size of sophistication of these kinds of products means that a slow building fund like the Natural Disaster Fund is inappropriate. Its only purpose would be as a backup to any residual risk left from a temporary inability to place more appropriate financing.

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?

The EQC needs or be a lot more flexible in its financing. Financial markets are changing and legislation needs to allow scope for this. My suggestion is that developing skills in facilitating risk refinancing become part of EQC's core functions.

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?

I will be submitting a detailed report at a later stage.