REGULATORY IMPACT STATEMENT

INCREASE TO THE EARTHQUAKE COMMISSION'S LEVY

Disclosure statement

This Regulatory Impact Statement has been prepared by the Treasury.

It provides an analysis of options to raise the level of the Earthquake Commission's (EQC) levy to an appropriate amount and reduce fiscal risk on the Crown.

There is significant uncertainty around seismological risk in New Zealand and we have not based our analysis on a full actuarial forecast of EQC's future liabilities. However, it is clear that the EQC's levy is too low and is not currently reflecting the cost of providing cover. The low level of the levy is also exposing the Crown to fiscal risk, in both the short and long term, which needs to be managed given the Government's current fiscal position.

To better reflect cover costs, to allow the EQC to be operationally sustainable and so that the National Disaster Fund (NDF) can be built up again, the levy needs to rise. To wait until we have better information exposes the government to ongoing fiscal risk and places the ongoing sustainability of the EQC in jeopardy. The level of the levy can be fine tuned during the planned review of the EQC.

The policy options discussed in this RIS do not affect areas that the government has stated require a strong case before regulation is considered.

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5 October 2011

Status quo and problem definition

Status quo

The Earthquake Commission (EQC) was set up to provide residential insurance against natural disaster.

The coverage provided by the EQC is paid for by households via a levy applied to the premiums households pay for their home fire insurance.

The EQC has been set up as a self funding entity and the levy should be set at a level which reflects the cost of the EQC providing the cover it does.

The current levy is set at 5 cents per $100 of cover (excluding land which has no premium) which results in an annual cost for most households of $69. In total, the levy generates income of around $86 million per annum for the EQC.

The EQC manages its risk exposure via undertaking self-insurance and purchasing reinsurance on the international market. Self-insurance involves the EQC using some of the levy income to build up a pool of assets that can be used to meet claims in the event of a disaster. This pool of assets is referred to as the Natural Disaster Fund (NDF).

As at 30 June 2010, the NDF stood at around $6 billion and the EQC held reinsurance of $2.5 billion. Reinsurance was costing EQC around $39 million per year. EQC also had annual business as usual costs (BAU) of around $59 million per year[1]. BAU costs include the EQC operating costs and costs to meet "normal" claims that occur during the year. Although levy funding of $86 million was not able to cover the total annual costs of around $98 million, the NDF was generating significant income for the EQC ($377 million in 2009/10) and so the EQC had a significant surplus overall.

However, with the liabilities generated by the claims related to the Christchurch earthquakes, all the assets in the NDF are now likely required to meet these claims. In fact, as at 30 June 2011, there were not enough assets in the NDF to meet all the expected claims and the EQC will have liabilities exceeding its assets by $1.156 billion. The Crown is ultimately liable for any shortfall in the EQC finances under the guarantee in section 16 of the Earthquake Commission Act 1993 (section 16). The rundown of the NDF will occur over several years as claims are paid out, over which time the income generated by the NDF will also drop away. With current settings it is forecast that the government will have to provide cash of around $1200million into the EQC.

[withheld - s9(2)(b)(ii)]

The current levy is now significantly below BAU costs, with no ability to meet self-insurance "costs" (i.e. having spare cash to rebuild the NDF).

[1] Excluding the Crown underwriting fee of $10 million. This inter-Crown transaction is not relevant for this analysis.

Problem definition

Without changing the status quo (e.g. the levy), insurance holders will not be being charged a levy that represents the cost of the EQC providing natural disaster coverage to them. EQC will not be operationally sustainable and the government will be fiscally exposed to claims under the section 16 guarantee it gives the EQC (which is a particular problem given the current fiscal pressure on the government).

Objectives

The objectives are:

- to ensure that the levy is set at a level that covers the long term cost of EQC providing natural disaster coverage in NZ.
- To reduce the fiscal risk faced by government under EQC's section 16 guarantee.

Regulatory impact analysis

As indicated by the problem definition, the levy needs to be increased. However, this raises two questions. When should it be raised and by how much?

When should the levy be raised?

There are broadly three options:

- Option 1: Put the levy up as soon as legally possible (28 days after the regulations have been signed by the Governor General)
- Option 2: Wait until the completion of the review of the EQC that the Minister of Finance is intending to have carried out
- Option 3: Put the levy up after giving the insurance industry several months notice.

Table One:

Option on when to put up the levy.	Costs	Benefits	Net Impact
1.Put up the levy as early as legally possible	Policy holders will face higher insurance premiums earlier than any other option. Insurance providers may face costs having to rush through system changes.	Achieves the objectives at the earliest possible time. Policy holders will be being charged the actual costs of coverage, and they will not be being subsidised by government (tax payers). Reduces the fiscal risk that the Crown faces under section 16 more than the other options (due to the EQC collecting more revenue sooner).	**Small positive**
2.Wait until the EQC review	The completion of the review could be some way off, so this would result in the levy being too low for an extended period of time. It will exposure the Crown to more fiscal risk. Government will be subsidising policy holders over this time.	The levy can be based on more complete information – there is less risk that the long term cost is incorrectly priced. Policy holders have lower premiums for a longer period of time.	**Negative**
3.Increase the levy in early 2012	Some of the benefits listed under option 1 will be lost.	Insurance companies will be able to make the system changes in a timelier manner, reducing the cost to them and reducing administrative burden on them, during what is a busy time.	**Slightly more positive then option 1**. (As long as the levy increase can occur fairly quickly - giving the insurance sector some time seems reasonable).

By how much should the levy be increased?

The following table shows the financial impacts of different levy rates based on the current EQC model and settings [withheld - s9(2)(b)(ii)]

Table Two:

Levy change	Levy per $100 of coverage (cents)	Annual Cost to household ($)	Expected call on the Crown ($ millions)*	Coverage after 25 years ($ billions) – from point of repayment expected call on Crown*	Approximate Size of NDF after 25 years ($ billions) – from point of repayment expected call on Crown*
Status Quo	5.0	69	1200	2.5	0.00
100%	10.0	138	800	3.5	1.0
120%	11.0	152		4.5	2.0
200%	15.0	207	490	9.0	6.5
300%	20.0	276	23	14.5	12.0

*These figures represent point estimates that lie within a confidence interval and indicative in nature given the inherent uncertainties. [withheld - s9(2)(b)(ii)]
. [withheld - s9(2)(f)(iv)]

The continuum of potential levy rates can broadly be broken down into three groups:

- The status quo and very small levy increases which do not allow the NDF to be rebuilt in a reasonable time.
- Those levy rates that allow the NDF to be rebuilt in a reasonable time.
- Those levy rates that rebuild the NDF very quickly.

The range for reasonable time was taken to mean rates that would return coverage to roughly 50% and 150% of pre-Christchurch levels 25 years after the NDF begins to be rebuilt. This corresponds to levies around 10-20 cents.

Table Three:

Option	Objective: Levy matches cost	Objective: Reduce fiscal risk	Cost	Benefits	Net Impact
Status quo 5cents	No	No	Does not allow the EQC to be operationally sustainable. Does not result in insurance holders paying the true cost of their cover. Results in the Crown (and thus taxpayers) having to provide continued financial support to the EQC.	Insurance holders face lower premiums as they are effectively subsidised by the tax payer.	**Negative**. Pricing below cost is not economically efficient and the government is not in the fiscal position to readily absorb it.
10-20cents	Yes	Yes	Home insurance holders have to pay higher premiums. Exacerbates inequalities in the current scheme[2].	Home insurance holders paying fairer price. Lowers the fiscal risk the Crown is exposed to.	**Positive**. Correct pricing and reduced fiscal risk for the Crown, outweighs the negatives of higher prices for policy holders and increased inequalities (which can be looked at in the EQC review).
>20cents	No	Yes	Home insurance holders paying too much for coverage. Significant inequalities.	Quickly reduces fiscal risk to the Crown.	**Negative**. Pricing above cost is not economically efficient.

As a starting point the levy should be increased to allow the EQC to meet its ongoing BAU and reinsurance costs [withheld - s9(2)(b)(ii)]

levy needs to be set at a rate which allows the NDF to be rebuilt over time. To achieve this the levy will also include a component to cover the "cost" of self-insurance. This component needs to be covered for the levy to be a true reflection of the actual cost of

[2] EQC's coverage is regressive because the EQC cover has generally the same limit for all households, yet has a higher probability of being called upon for houses of high value (i.e. it is easier to do $100,000 of damage to a house worth $2 million than to a house worth $300,000). Increasing the levy will mean that lower value households will pay a higher percentage of their house value towards insurance which they have a lower probability of calling on. The fact that the levy is not applied to land cover further contributes to this inequality.

the EQC providing natural disaster cover. However, we do not want to set the levy too high, or we may be overcharging.

Hence we are left making a judgment in the 10c-20c range, which appears to represent the most appropriate level of the levy. This judgment largely comes down to how quickly the government wants to see the NDF rebuilt and the amount of fiscal risk it wants to be exposed to, balanced with a desire not to put too sharp an increase on policy holders.

The various costs and benefits are shown in the table below.

Table Four:

Costs of higher levy	Benefits of higher levy
Higher financial impact on Households who hold home insurance. Increases the risk that the levy is set too high (in particular reinsurance costs may come down). Exacerbates inequalities in the current scheme.	Less financial impact on government and thus tax payers. Less chance that EQC will make a call on government under section 16. Less chance that EQC's financial position will result in fiscal pressures on the Crown. NDF will build up quicker, resulting in less time over which the government is exposed to the financial risk of another large nature disaster. Decreases the risk that the levy is set to low.

Consultation

The EQC has been consulted. EQC supports an increase in the levy as an interim measure, pending a review of the EQC scheme, including coverage and funding. EQC notes that the increase is not based on full actuarial forecasts of future liabilities.

The Insurance Council of New Zealand (ICNZ) has been consulted, and has requested that any levy increase be signaled four months in advance to limit the administrative costs to insurers.

Conclusions and recommendations

When should the levy be raised...

The levy should be raised as soon as possible, while taking into some account the costs that insurance companies would face if they had to rush through system changes at a time when the insurance industry is under other pressures (i.e. option 3).

How much should the levy be increased by...

Treasury's judgment, when subjectively balancing the cost and benefits in table 4, came to the view that the levy should be set at 11 cents.

The Minister of Finance's judgment was that 15 cents was a better balance between costs and benefits. In particular the Minister of Finance thought the benefits at the margin were higher, in particular the benefit of further reducing the risk of a call on the guarantee and rebuilding the NDF quicker.

Treasury's recommended levy rate of 11 cents would leave the Crown exposed to more short term fiscal risk and provides quite a slow build up of the NDF if current reinsurance costs persist over the longer term. In the short term an 11 cents levy would not likely be enough to prevent EQC from making a call on the Crown under section 16. In the longer term, the NDF would have built up to around $2 billion after 30 years[3], which is still less then what it was before the Christchurch earthquakes.

A 15 cent levy will reduce the amount of the EQC's call under the guarantee (assuming no additional major natural disasters in the short to medium term), and should then allow the NDF to be built up to pre-Christchurch levels in around 30 years[3].

Both 11 cents and 15 cents should be closer to the true cost of EQC cover (once a full actuarial analysis has been carried out) than with the status quo.

Test of reasonableness of levies in the 11-15c range.

This analysis has been carried out assuming the current setting for the EQC,
[withheld - s9(2)(b)(ii)]

While the reinsurance cost may subside over the next few years, it certainly gives us comfort that a levy in the range of 11c-15c is not likely to be over pricing the cost of providing coverage in New Zealand.

Even if reinsurance costs over the next few years fell back to pre-Christchurch levels, with a levy set at 15 cents the NDF will still take around 25 years[3] to be rebuilt (which is by no means an unjustifiably rapid build up).

Comparison to other insurance rate rises

A percentage increase of the scale proposed is considerably larger than the types of price increases being put in place by private insurers at the moment. Private house and contents insurance is forecast to increase by substantially less during the coming year than the EQC levy increase (20-30% versus 200%). This is not surprising given the differing nature of the risk covered by the private market and the EQC. The EQC covers the first loss from any event (from $0 up to its coverage limits – which covers much of the risk), and as such, should be more sensitive to perceived risk and cost

[withheld - s9(2)(f)(iv)]

increases. Private premiums are also buffered and diversified by pricing associated with coverage beyond the EQC's scope; for example, burglary, fire and flood. An increase now would be the first time the EQC levy has been increased since the Earthquake Commission Act was passed in 1993, whereas private insurance pricing is revisited much more frequently.

Implementation

The rate of the levy is set by clause 3 of the Earthquake Commission Regulations 1993. We will work with the ICNZ over any implementation issues.

Monitoring, evaluation and review

The Minister of Finance is planning a review of the EQC that could fine tune the levy.

EQC will continue to monitor its liabilities and report changes to the Treasury.