EARTHQUAKE COMMISSION
Kōmihana Rūwhenua

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Briefing to the Public Inquiry into the Earthquake Commission

Title	Managing Risk – Premiums, Reinsurance and the Natural Disaster Fund
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Managing risk – Premiums, reinsurance and the Natural Disaster Fund

Purpose

1 The purpose of this briefing is to set out a high level description of the Natural Disaster Fund administered by the Earthquake Commission (EQC), the premiums collected by EQC from private insurers, and the reinsurance obtained by EQC.

2 This briefing also covers:

a the history and current legal framework of the Natural Disaster Fund;

b the process by which EQC collects premiums from private insurers;

c the history of EQC's approach to reinsurance, and its current reinsurance programme;

d the investment of the Natural Disaster Fund, including an overview of the Ministerial directions that have guided the investment settings;

e the terms of the Crown guarantee under section 16 of the Earthquake Commission Act 1993 in the event of any deficiency in the Natural Disaster Fund;

f EQC's risk financing strategy; and

g some suggestions as to future focus regarding the above matters.

Executive Summary

3 One of the functions of EQC under the Earthquake Commission Act 1993 is "to administer the [Natural Disaster] Fund and, so far as is reasonably practicable, protect its value, including by the investment money held in the [Natural Disaster] Fund."[1] By the time of the first Canterbury earthquake in September 2010, the Natural Disaster Fund had grown to just over $6 billion in accumulated investment assets. This provided significant funding to meet the unprecedented and unanticipated costs of the Canterbury earthquake sequence.

[1] See section 5(1)(c), Earthquake Commission Act 1993.

4 EQC manages a significant proportion of its potential financial risk by purchasing reinsurance in the international insurance market. The importance of the management of New Zealand's relationships with reinsurers cannot be over-emphasised in the context of New Zealand's ability to respond to future disasters.

5 The Fund is to be used to pay certain obligations of EQC, which are summarised as follows:[2]

a insurance claims admitted or sustained against EQC;

b any whole or partial refunds of premiums to private insurers;

c costs associated with EQC's reinsurance;

d funding for research grants made by EQC;

e costs incurred in campaigns to increase public awareness and education about EQC and the Natural Disaster Fund (including research and education in relation to preventing natural disaster damage);

f money required to be paid by EQC to the Crown in relation to money borrowed from the Crown under section 16 of the Earthquake Commission Act 1993 (described in paragraph 49 below);

g dividends payable to the Minister,[3] sums provided to the Crown in lieu of income tax,[4] and EQC's annual fee to the Crown in relation to the Crown's obligation under section 16 of the Earthquake Commission Act 1993 (sometimes referred to as the section 16 Crown guarantee);[5] and

h staff salaries, remuneration and allowances, and other overheads incurred, or other money payable, in the performance of EQC's functions (including under a Ministerial direction[6]).

[2] See section 15, Earthquake Commission Act 1993.
[3] See section 9, Earthquake Commission Act 1993.
[4] See section 10(2), Earthquake Commission Act 1993.
[5] See section 17, Earthquake Commission Act 1993.
[6] The position in relation to any money payable by EQC as a consequence of a Ministerial direction is subject to discussions at the time the direction is issued. For example, the costs incurred by EQC in complying with the Ministerial direction issued in May 2017 in relation to the Edgecumbe flood, were reimbursed by the Crown and the Whakatane District Council.

6 EQC has been the subject of numerous Ministerial directions as to the policies, standards and procedures for the investment of the Natural Disaster Fund.[7] These Ministerial directions have principally focused on the following issues:

a specifying the financial products that EQC is permitted to invest in (including setting caps or restrictions on the maximum percentage of the Natural Disaster Fund that may be invested in certain financial products);

b establishing processes for the prudent management of investments, including the development and continual review of the Statement of Investment Policies, Standards and Procedures;[8]

c establishing the risk settings for the Natural Disaster Fund[9] and certain targeted rates of return and other financial objectives;[10] and

d restricting the ability to hedge currency and interest-rate exposures (which currently cannot proceed without prior Ministerial approval).[11]

7 Within the context of EQC's current legislative framework and operating environment there are a number of areas for future focus regarding the Natural Disaster Fund, premiums and reinsurance including:

a the ongoing development of EQC's loss modelling capability;

b improving the linkages between EQC's loss modelling capabilities and the development and management of EQC's risk financing strategy; and

c the importance of EQC's ongoing investment in its reinsurance relationships.

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[7] See *Briefing to the Public Inquiry into the Earthquake Commission - Ministerial Directions since 1 January 1994*, dated 13 March 2019, paragraphs 42 to 44.

[8] See Ministerial direction to the Earthquake Commission effective 1 November 2001, https://gazette.govt.nz/notice/id/2001-go7946. See also *Briefing to the Public Inquiry into the Earthquake Commission - Ministerial Directions since 1 January 1994*, dated 13 March 2019 – Appendix, Direction #4.

[9] Previously, investments have been required to be calculated so that there was a 1 in 4 chance over any ten year period that the rate of return will be less that Crown's cost of borrowing, and a 1 in 30 chance that the Fund will incur an investment return of less than negative 2% in any one financial year (see footnote 54).

[10] See Ministerial direction to the Earthquake Commission effective 27 July 2015, https://gazette.govt.nz/notice/id/2015-go4515. See also *Briefing to the Public Inquiry into the Earthquake Commission – Ministerial Directions since 1 January 1994*, dated 13 March 2019 – Appendix, Direction #15.

[11] See Ministerial direction to the Earthquake Commission effective 27 July 2015, https://gazette.govt.nz/notice/id/2015-go4515. See also *Briefing to the Public Inquiry into the Earthquake Commission – Ministerial Directions since 1 January 1994*, dated 13 March 2019 – Appendix, Direction #15.

8 Underpinning the ongoing development of the Natural Disaster Fund will be the continuation of EQC's close working relationship with the Treasury. There will be five key areas of focus over the coming 12 to 18 months:

a develop further a shared understanding of the Crown's risk appetite and the role EQC plays in meeting some of the Crown's contingent liabilities arising from natural disasters;

b manage efficiently any payments made to EQC under the section 16 Crown guarantee;

c incorporate lessons from EQC's experiences into further policy and legislative reform, including any recommendations from the Public Inquiry;

d agree on the key parameters for EQC's medium-term investment strategy; and

e incorporate regular reviews of the financial limits set out in the Earthquake Commission Act 1993 into the shared work programme between the Treasury and EQC.

Brief overview of Natural Disaster Fund

History of the Natural Disaster Fund

9 In 1944, following the 1942 Wairarapa earthquakes, the War Damage Commission (established in 1941 when New Zealand faced a threat of war damage) was renamed the Earthquake and War Damage Commission.

10 Under the Earthquake and War Damage Act 1944, the existing War Damage Fund was transferred to a new Earthquake and War Damage Fund under the control of the Earthquake and War Damage Commission. Property (both commercial and residential) insured against fire was insured against both earthquake and war damage, with premiums paid into the Earthquake and War Damage Fund whenever a fire policy was made.[12]

[12] See *Initial Briefing for the purposes of the Inquiry - History of the Earthquake Commission*, dated 26 October 2018, page 2.

11 Later, a separate 'Disaster and Landslip Fund', within the broader Earthquake and War Damage Fund, was established under the Earthquake and War Damage Regulations 1984.[13] All money paid out in respect of the land cover introduced in the Earthquake and War Damage (Land Cover) Regulations 1984 was paid out of the Disaster and Landslip Fund.[14]

12 From 1 January 1994 the Earthquake and War Damage Fund was renamed the Natural Disaster Fund. The Disaster and Landslip Fund was amalgamated into the Natural Disaster Fund.[15]

13 Under the Earthquake Commission Act 1993, the Natural Disaster Fund comprises:[16]

a the funds inherited from the Earthquake and War Damage Fund and the Disaster and Landslip Fund;[17]

b all money in bank accounts established by EQC; and

c all investments and other assets of EQC.

Money paid into the Natural Disaster Fund

14 The Earthquake Commission Act 1993 provides that money from three sources is payable into the Natural Disaster Fund:

a the proceeds of any premiums and other money payable to EQC (as described in paragraphs 63 to 79 below);[18]

b any fines and penalties recovered under the Earthquake Commission Act 1993 or the regulations under it;[19] and

c all other money lawfully paid into the Natural Disaster Fund.[20]

15 All money payable (or paid) into the Natural Disaster Fund, and all debts and other money owing to EQC, are EQC's property. EQC has a right of recovery in respect of those sums.[21]

[13] See Regulation 11, Earthquake and War Damage Regulations 1984.
[14] See Regulation 7, Earthquake and War Damage (Land Cover) Regulations 1984.
[15] See section 13(2), Earthquake Commission Act 1993.
[16] For the purposes of this briefing, references to the "Fund" generally mean all liquid funds and investments of EQC which are available to settle insurance claims and to meet other obligations of EQC (i.e. it does not include the physical and intangible assets of EQC, although these form part of the Fund for the purposes of the Earthquake Commission Act 1993).
[17] See section 13(1) and (2), Earthquake Commission Act 1993.
[18] See section 14(1)(a), Earthquake Commission Act 1993.
[19] See section 14(1)(b), Earthquake Commission Act 1993.
[20] See section 14(1)(c), Earthquake Commission Act 1993.
[21] See section 14(2), Earthquake Commission Act 1993.

Money paid out of the Natural Disaster Fund

16 The Fund is to be used to pay certain obligations of EQC, which are summarised as follows:[22]

a insurance claims admitted or sustained against EQC;

b any whole or partial refunds of premiums to private insurers;

c costs associated with EQC's reinsurance;

d funding for research grants made by EQC;

e costs incurred in campaigns to increase public awareness and education about EQC and the Natural Disaster Fund (including research and education in relation to preventing natural disaster damage);

f money required to be paid by EQC to the Crown in relation to money borrowed from the Crown under section 16 of the Earthquake Commission Act 1993 (described in paragraph 49 below);

g dividends payable to the Minister,[23] sums provided to the Crown in lieu of income tax,[24] and EQC's annual fee to the Crown in relation to the Crown's obligation under section 16 of the Earthquake Commission Act 1993 (sometimes referred to as the section 16 Crown guarantee);[25] and

h staff salaries, remuneration and allowances, and other overheads incurred, or other money payable, in the performance of EQC's functions (including under a Ministerial direction[26]).

More about the Natural Disaster Fund

17 The Fund is all of EQC's property that, at any time, is represented by balances in bank accounts and other investments and assets (whether or not those assets and investments are able to be immediately liquidated into cash).

[22] See section 15, Earthquake Commission Act 1993.
[23] See section 9, Earthquake Commission Act 1993.
[24] See section 10(2), Earthquake Commission Act 1993.
[25] See section 17, Earthquake Commission Act 1993.
[26] The position in relation to any money payable by EQC as a consequence of a Ministerial direction is subject to discussions at the time the direction is issued. For example, the costs incurred by EQC in complying with the Ministerial direction issued in May 2017 in relation to the Edgecumbe flood, were reimbursed by the Crown and the Whakatane District Council.

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18 The Fund is the property of EQC and legally is separate from the Crown's money and investments. Subject to any Ministerial directions, the Natural Disaster Fund is under the control of EQC, but may only be used for the purposes summarised in paragraph 16 above.

19 Aside from Ministerial directions that restrict or limit the investment of the Natural Disaster Fund, there are few legislative restrictions on the way in which EQC can invest the Natural Disaster Fund. EQC is subject to exemptions from various restrictions in the Crown Entities Act 2004, such as restrictions on borrowing and on acquisition of financial products.[27] The exemptions provided to EQC are consistent with other Crown Financial Institutions, such as the Government Superannuation Fund Authority and the Accident Compensation Corporation. The investment of the Natural Disaster Fund (including Ministerial directions) is discussed in paragraphs 33 to 44 below.

20 EQC's net financial position is consolidated as part of the Crown's balance sheet. This also includes, as part of the notes to the Crown's Financial Statements, details setting out the Crown's unquantifiable contingent liability arising from the section 16 Crown guarantee.[28] Under section 16 of the Earthquake Commission Act 1993, if EQC's assets (including the Natural Disaster Fund) are insufficient to meet its liabilities, the Minister is required to provide, by way of grant or advance, funding sufficient to meet the deficiency (see paragraphs 47 to 50 below).

Exemption from Anti-Money Laundering legislation

21 The Anti-Money Laundering and Countering Financing of Terrorism Act 2009 places obligations on New Zealand's financial institutions and casinos to detect and deter money laundering and terrorism financing.

22 EQC has been granted an exemption from the Anti-Money Laundering and Countering Financing of Terrorism Act 2009.[29] Exemptions are issued on a five-yearly term, with the current exemption being granted on the basis that:

a the risk of money laundering / terrorist financing associated with EQC's business activities is low;

[27] See section 100, section 160(1)(d) and Schedule 1, Crown Entities Act 2004. See also section 13(5), Earthquake Commission Act 1993).
[28] See *Financial Statements of the Government of New Zealand for the year ending 30 June 2018,* page 112, Note 25: *Contingent Liabilities and Contingent Assets* https://treasury.govt.nz/sites/default/files/2018-10/fsgnz-year-jun18.pdf
[29] See letter from Associate Minister of Justice (Hon Aupito William Sio) to the Earthquake Commission, *Ministerial Exemption: The Earthquake Commission*, dated 23 July 2018. The exemption is issued pursuant to section 157(6)(b) of the Anti-Money Laundering and Countering Financing of Terrorism Act 2009. The exemption came into force on 23 July 2018 and expires on 30 June 2023.

b EQC, in the absence of an exemption, would be subject to an undue regulatory burden;

c renewing EQC's exemption is unlikely to affect third-party reporting entities; and

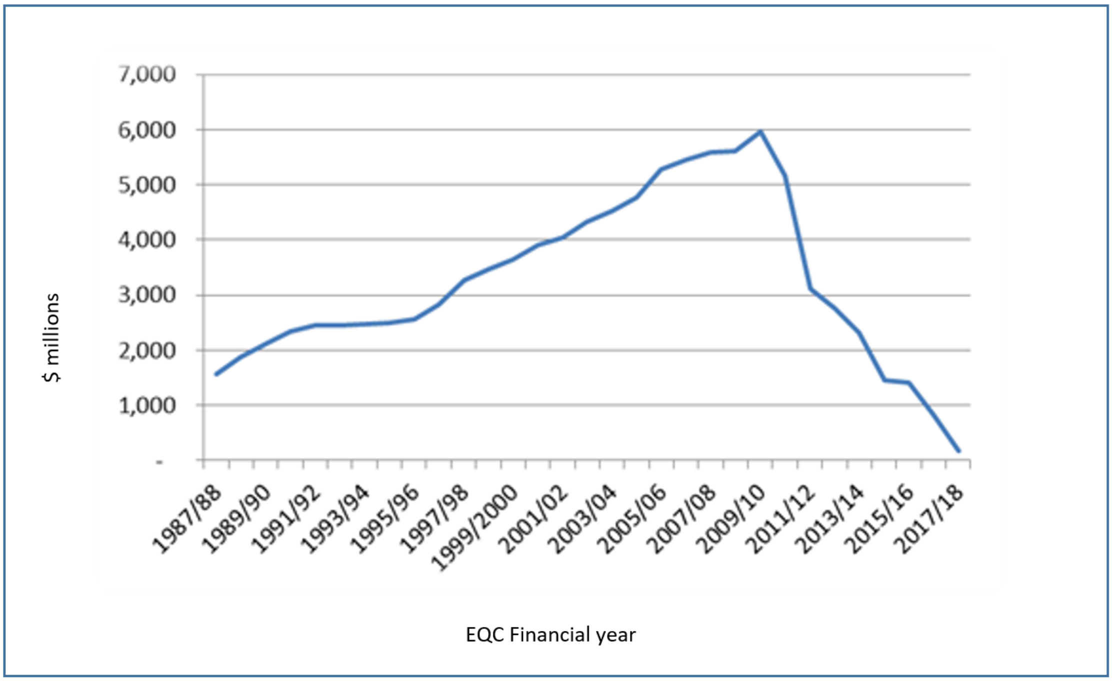
d there have been no material changes to EQC's business activity since the previous exemption was granted.

23 The previous exemption noted that payments into and out of the Natural Disaster Fund are carefully prescribed by statue. The money in the Natural Disaster Fund is only able to be paid out in the event of a natural disaster or as otherwise permitted by the Earthquake Commission Act 1993. On this basis, there is effectively no risk that proceeds of crime can be cleansed through the Natural Disaster Fund.[30]

Development of the Natural Disaster Fund

24 By the time of the first Canterbury earthquake in September 2010, the Natural Disaster Fund had grown to just over $6 billion in accumulated investment assets. The following graph provides a summary of the Natural Disaster Fund's growth from 1988 to 2010 and its subsequent reduction to meet the costs of the Canterbury and Kaikōura earthquakes.

Figure 1: *Investment assets held by the Natural Disaster Fund since 1988*



[30] Minister of Justice (Hon Judith Collins), *Ministerial Exemption: The Earthquake Commission*, dated 22 April 2013.

DIVIDENDS PAID FROM THE NATURAL DISASTER FUND

25 As noted at paragraph 16g above, at the Minister's discretion (including as to the amount), EQC can be required to pay the Crown a dividend out of the Natural Disaster Fund in respect of any financial year.[31] This dividend is different to the annual fee that EQC pays to the Crown in respect of the section 16 Crown guarantee.[32] The process for the payment of a dividend to the Crown is set out in section 9 of the Earthquake Commission Act 1993.

26 Over the eight year period between 1989 and 1996, the Crown received over $491 million from EQC in the form of dividends. Annual reports from that period stated that the dividend payment was calculated as being 50% of the surplus of the Natural Disaster Fund following payment of:

a payment in lieu of taxes; and

b the annual fee in relation to the section 16 Crown guarantee.

27 Over the same period the Crown also received payments in lieu of taxes (as provided for in section 10(2) of the Earthquake Commission Act 1993) of over $575 million. These payments were calculated as 33% of EQC's surplus after payment of the annual fee in relation to the section 16 Crown guarantee.

28 The table below provides a summary of the payments made by EQC to the Crown in the 1988/89 to 1995/96 financial years with respect to the annual fee in relation to the section 16 Crown guarantee, payments in lieu taxes, and dividends.

29 Since the 1997/98 financial year, the section 16 Crown guarantee fee has been set at $10 million per annum and has not been subject to any further reviews.

[31] See section 9, Earthquake Commission Act 1993.
[32] See section 17, Earthquake Commission Act 1993.

Figure 2: *Payments made by EQC to the Crown 1988/89 - 1995/96*

$ million	1988/89	1989/90	1990/91	1991/92	1992/93	1993/94	1994/95	1995/96	Total
Annual fee, s16 Crown guarantee	80	80	60	60	75	30	25	20	430
Payment in Lieu of Tax	100	100	107	91	95	36	46	0	575
Dividend	59	60	98	93	97	37	47	0	491
Total	**239**	**240**	**265**	**244**	**267**	**103**	**117**	**20**	**1,495**

Note: Some numbers in the table will not add due to rounding.

30 It is not clear from records available why the government stopped seeking payments in lieu of tax and regular dividend payments beyond the 1994/95 financial year.

Special Dividend

31 In 2001 the Waihi mining stope collapsed causing damage to a number of residential dwellings. The Waihi damage was not covered by the Earthquake Commission Act 1993. However, the Crown:

a agreed to provide compensation for residential home owners as if the damage was covered by the Earthquake Commission Act 1993; and

b provided EQC with $1.3 million to cover the cost of the ex-gratia payments made to the affected Waihi homeowners.[33]

32 The Crown had not required a dividend payment from EQC for some years, but in 2002 the Crown sought and received a special dividend of $1.3 million. The $1.3 million dividend from EQC was equal to the amount received by EQC from the Crown to fund the Waihi claims.

[33] See *Briefing to the Public Inquiry into the Earthquake Commission - Ministerial Directions since 1 January 1994* dated 13 March 2019, paragraphs 13 to 15.

Investment of the Natural Disaster Fund

33 One of the functions of EQC under the Earthquake Commission Act 1993 is "to administer the [Natural Disaster] Fund and, so far as is reasonably practicable, protect its value, including by the investment money held in the [Natural Disaster] Fund."[34] As noted in paragraph 19 above, there are few requirements under the Act on how EQC is to carry out this function. In practical terms, the Board invests in accordance with the Statement of Investment Policies, Standard and Procedures[35]. The current Statement addresses a series of matters (including investment classes, benchmarks and standards) as set out in the 2015 Ministerial direction on the investment of the Natural Disaster Fund[36].

34 Since the Canterbury earthquake sequence (and in particular since the 2015 Ministerial direction), management of the Natural Disaster Fund has focused on ensuring that EQC has sufficient resources to meet its cash flow requirements as they fall due.

35 As discussed in the Briefing on *Ministerial Directions since 1 January 1994*, EQC has been the subject of numerous Ministerial directions as to the policies, standards and procedures for the investment of the Natural Disaster Fund.[37] These Ministerial directions have principally focused on the following issues:

a specifying the financial products that EQC is permitted to invest in (including setting caps or restrictions on the maximum percentage of the Natural Disaster Fund that may be invested in certain financial products);

b establishing processes for the prudent management of investments, including the development and continual review of the Statement of Investment Policies, Standards and Procedures;[38]

c establishing the risk settings for the Natural Disaster Fund[39] and certain targeted rates of return and other financial objectives;[40] and

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[34] See section 5(1)(c), Earthquake Commission Act 1993.
[35] Earthquake Commission, *Statement of Investment Policies, Standards and Procedures,* dated June 2017, https://www.eqc.govt.nz/sites/public_files/documents/Policy/EQC%20SIPSP%202017.pdf.
[36] See Ministerial direction to the Earthquake Commission effective 27 July 2015, https://gazette.govt.nz/notice/id/2015-go4515. See also *Briefing to the Public Inquiry into the Earthquake Commission – Ministerial Directions since 1 January 1994*, dated 13 March 2019 – Appendix, Direction #15.
[37] See *Briefing to the Public Inquiry into the Earthquake Commission - Ministerial Directions since 1 January 1994*, dated 13 March 2019, paragraphs 42 to 44.
[38] See Ministerial direction to the Earthquake Commission effective 1 November 2001, https://gazette.govt.nz/notice/id/2001-go7946. See also *Briefing to the Public Inquiry into the Earthquake Commission - Ministerial Directions since 1 January 1994*, dated 13 March 2019 – Appendix, Direction #4.

d restricting the ability to hedge currency and interest-rate exposures (which currently cannot proceed without prior Ministerial approval).[41]

Past Ministerial directions as to the investment of the Natural Disaster Fund

36 Up until 2001, EQC was only able to invest in New Zealand Government bonds. In November 2001, the Minister of Finance issued a Ministerial direction allowing EQC to invest the Natural Disaster Fund on a prudent, commercial basis and in doing so, manage and administer the Natural Disaster Fund in a manner consistent with:

a best practice portfolio management;

b maximising return without undue risk to the Natural Disaster Fund as a whole; and

c avoiding prejudice to New Zealand's reputation as a responsible member of the world community.

37 Among other things, this provision was designed to enable EQC to diversify investments into international equities. The approach was contrasted with the previous types of investment restrictions and previous portfolios of predominately domestic bonds and cash.

38 At the time of the 4 September 2010 Canterbury earthquake, EQC held approximately $1.7 billion in global equities and $4.3 billion in New Zealand Government and bank securities.

Sell-down of certain classes of investments

39 Following the 2010/2011 Canterbury earthquakes, EQC started to sell down its investments to fund the settlement of claims. The initial sell down was conducted approximately in line with each investment's strategic proportional weighting of the Natural Disaster Fund. This meant that the bulk of the initial sell down was New Zealand government stock, which comprised approximately two-thirds of the Natural Disaster Fund.

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[39] Previously, investments have been required to be calculated so that there was a 1 in 4 chance over any ten year period that the rate of return will be less that Crown's cost of borrowing, and a 1 in 30 chance that the Fund will incur an investment return of less than negative 2% in any one financial year (see footnote 54).

[40] See Ministerial direction to the Earthquake Commission effective 27 July 2015, https://gazette.govt.nz/notice/id/2015-go4515. See also *Briefing to the Public Inquiry into the Earthquake Commission – Ministerial Directions since 1 January 1994*, dated 13 March 2019 – Appendix, Direction #15.

[41] See Ministerial direction to the Earthquake Commission effective 27 July 2015, https://gazette.govt.nz/notice/id/2015-go4515. See also *Briefing to the Public Inquiry into the Earthquake Commission – Ministerial Directions since 1 January 1994*, dated 13 March 2019 – Appendix, Direction #15.

40 In November 2011, the EQC Board requested Russell Investment Group Limited to provide proposals in relation to the sale of EQC's assets, particularly global equities. Russell Investment Group Limited recommended that EQC:

a eliminate the equity allocation, and the associated currency risk from the Natural Disaster Fund;

b allocate investments to cash and fixed income only; and

c match the duration of the assets to its liabilities.

41 EQC broadly agreed with the recommendations and undertook a short-term programme to divest its equities, with proceeds being invested in either fixed income or cash.

42 As EQC has continued to pay claims relating to both Canterbury and Kaikōura earthquakes, EQC has liquidated New Zealand government stock or New Zealand bank term deposits as required.

Current Ministerial direction as to the investment of the Natural Disaster Fund

43 The Ministerial direction to EQC on investment of the Natural Disaster Fund effective 1 November 2001 was revoked by the direction effective 27 July 2015. The purpose of the 2015 direction was expressly to ensure that EQC invested the Natural Disaster Fund conservatively and maintained its liquidity to meet claims in the aftermath of the Canterbury earthquakes[42].

44 Currently, EQC is permitted to invest in:

a Treasury bills, government nominal bonds and government inflation indexed bonds traded through the New Zealand Debt Management Office; and

b New Zealand bank bills and deposits held in New Zealand registered banks with a short-term credit rating of A–1, Prime 1 or higher (and, if rated by both Moody's and Standard & Poor's, a higher rating).

[42] See Ministerial direction to the Earthquake Commission effective 27 July 2015, https://gazette.govt.nz/notice/id/2015-go4515. See also *Briefing to the Public Inquiry into the Earthquake Commission – Ministerial Directions since 1 January 1994*, dated 13 March 2019 – Appendix, Direction #15.

Proposed changes to legislative and reporting framework

45 The 2015 Discussion Document proposed changes related to the periodic review of the various financial limits set out in the Earthquake Commission Act 1993, including premiums and caps.[43] Submissions received on the 2015 Discussion Document indicated a broad level of support for the proposals relating to the financial reporting framework.

46 It is expected that the Treasury will look to refresh this policy work as part of the second stage of the review of the Earthquake Commission Act 1993.

Crown support for EQC

47 EQC's current capital structure was established following the announcement of a reform of the (then) Earthquake and War Damage Commission in the 1988 Budget.

48 The first stage of that reform involved:

a restructuring the Earthquake and War Damage Commission; and

b requiring it to pay an annual fee for the section 16 Crown guarantee and, if required by the Crown, a dividend and an amount in lieu of income tax.

The changes were implemented in the Earthquake and War Damage Amendment Act 1988, which came into force on 1 October 1988.

49 Under section 16 of the Earthquake Commission Act 1993, if EQC's assets (including the Natural Disaster Fund) are not sufficient to meet its liabilities, the Minister is required to provide, by way of grant or advance, funding sufficient to meet the deficiency.[44]

50 The Minister is not required to seek any specific appropriation from Parliament to enable the grant or advance, as expenses incurred by the Crown under section 16 are able be met under a Permanent Legislative Authority.[45]

[43] The Treasury, *New Zealand's Future Natural Disaster Insurance Scheme: Proposed Changes to the Earthquake Commission Act 1993*, dated July 2015, https://treasury.govt.nz/sites/default/files/2012-09/eqc-rev-discussion-doc.pdf.
[44] See section 16, Earthquake Commission Act 1993. There was a similar statutory obligation in section 13 of the Earthquake and War Damage Act 1944.
[45] See section 16, Earthquake Commission Act 1993.

Annual fee payable by EQC

51 As noted in paragraph 16g above, EQC is required to pay an annual fee to the Crown, on such date and in such an amount as determined by the Minister from time to time.[46] This fee is in recognition of the section 16 Crown guarantee.

52 It appears that the purpose of the fee – introduced in 1988 – was to encourage EQC to obtain reinsurance for its contingent liabilities instead of simply relying on the section 16 Crown guarantee.[47] When the fee was introduced in 1988, the Government's intention was to charge a fee calculated on the amount of risk the Government was left with. It was expected that fee would be set in advance at a margin above reinsurance costs.

53 This approach was designed to reflect the costs of the implicit guarantee and to ensure that EQC always preferred to reinsure as far as it was possible. For example, since 1997/98 the annual fee for the section 16 Crown guarantee has been set at $10 million per annum. Since 1988/89, EQC has paid $655 million to the Crown in annual fees.

Managing net liabilities

54 In the course of preparing EQC's financial statements for the year ended 30 June 2011, it became apparent that its assets were less than its expected liabilities. That deficiency arose primarily through the analysis of claims arising from the Canterbury earthquake sequence that had occurred at that time, and particularly the quantification of the expected liabilities of EQC in relation to those claims. This exercise was supported by actuarial analysis by EQC's actuaries, Melville Jessup Weaver.[48]

55 The section 16 Crown guarantee ensured that, despite its net liabilities, EQC would be able to pay out on all outstanding claims as EQC approved them. There was an issue however about how the Crown guarantee worked in practice as it had not been called on before.

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[46] See section 17, Earthquake Commission Act 1993.
[47] New Zealand Government, *A Review of Earthquake Insurance: A Public Discussion Paper*, dated 1988, pages 23 and 24.
[48] Melville Jessup Weaver, *Earthquake Commission Insurance Liability Valuation as at 30 June 2011*, dated 6 September 2011, https://www.eqc.govt.nz/sites/public_files/June%202011%20ILVR%20-%20Part%201.pdf.

56 In September 2011, EQC engaged with the Treasury and the Minister of Finance on the implications of the deficiency under section 16 – referred to at the time as "negative equity". On 29 September 2011, the Minister of Finance, Hon Bill English, wrote to the Chair of EQC commenting that the Crown recognised its commitments under section 16 of the Earthquake Commission Act 1993.[49] Specifically the Minister commented that:

> *I am writing to inform you that in my view I do not need to take immediate action under section 16. However, you can take comfort in my ongoing commitment to fulfil my obligations under section 16 to ensure EQC can meet all its liabilities as they fall due.*
>
> *I believe the purpose of the Crown guarantee is to provide comfort to those covered by the Act that their claims will be met in the event that EQC has insufficient resources to meet them. Notwithstanding any changes as a result of the review of EQC, the Crown will action section 16 closer to the time when EQC's liquidity considerations need to be addressed.*

Deficiency Funding Deed

57 In line with the Minister of Finance's position from 2011, it was not until 2018 that steps were taken to effect the section 16 Crown guarantee. In September 2018, following ongoing dialogue and exchange of information between EQC and the Treasury, the Crown (acting through the Minister) and EQC entered into the Deficiency Funding Deed. The parties took this step after it was forecast that EQC would shortly exhaust its cash and other liquid assets.[50]

58 The intention of the Deficiency Funding Deed was to establish a contractual framework under which Crown support (in the form of cash grants or advances) could be requested by EQC from time to time to ensure it was able to meet its liabilities. The key elements of the Deficiency Funding Deed are:

a a $50 million operational buffer;

b requiring the reporting of monthly cash-flow projections and other information which would indicate, among other things, when a shortfall was likely to arise; and

[49] Letter from Hon Bill English, Minister of Finance to Mr Michael Wintringham, Chair, EQC, dated 29 September 2011.
[50] See *EQC Deficiency Funding Deed,* dated 18 September 2018, between the Earthquake Commission and Her Majesty the Queen in right of New Zealand acting by and through the Minister Responsible for the Earthquake Commission.

c allowing the Minister responsible for EQC (through Treasury officials) to review the information provided by EQC. Either the Minister could challenge those projections or, by further notice, confirm to EQC his or her agreement that there would likely be a shortfall, and the extent of such a shortfall.

59 A key feature of the arrangements under the Deficiency Funding Deed is to provide a mechanism:

a for Treasury officials to review, monitor and test EQC's assessment of its cash-flows; and

b for the Treasury to be satisfied that a shortfall does, or will, exist before cash is provided to EQC.

60 The Minister retains an overarching discretion to determine the terms and conditions of each payment made under the Deficiency Funding Deed. However, the Minister has delegated authority to the Treasury to manage all payment requests under the Deed.[51]

61 In November 2018, EQC sought the first drawdown against the section 16 Crown guarantee. EQC sought $50 million (plus GST). This drawdown was largely driven by the need for EQC to pay its quarterly reinsurance premium (totalling $47 million) due at the end of November 2018. EQC also sought a further drawdown of $30 million (plus GST) on 1 March 2019 to cover expected shortfalls arising in March 2019.

62 While the Deficiency Funding Deed provides a means for EQC to manage its ongoing ability to meet its obligations, the Deficiency Funding Deed does not limit the application of section 16 of the Earthquake Commission Act 1993.

[51] See Treasury Report to the Minister of Finance and the Minister Response for the Earthquake Commission, *EQC Deficiency Funding Deed*, dated 4 September 2018, Report No: T2018/1373.

Premiums

63 Under the Earthquake Commission Act 1993, premiums are payable to EQC by private insurers who are party to certain designated fire insurance contracts.[52]

Single rate for the entire country

64 When the (then) Earthquake and War Damage Commission was restructured in 1988, the Government intended that the newly structured Commission would be encouraged to set premiums more flexibly to reflect market conditions and the different riskiness of different regions and structures.[53]

65 The Earthquake Commission Act 1993 allows different rates of premiums to be prescribed in different cases.[54] However EQC premiums are currently set at a single flat-rate for the entire country, rather than, for example, reflecting the different levels of natural disaster risk in different parts of New Zealand.

66 In the 2015 discussion document on proposed changes to the Earthquake Commission Act 1993 (2015 Discussion Document),[55] the then Government commented that it intended keeping the current flat-rate pricing model in the revised Earthquake Commission Act 1993. The 2015 Discussion Document highlighted three reasons for this as follows:

a *Risk-differentiated premiums may compromise the goals of the insurance scheme* – Pricing on the basis of earthquake risk would 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 insurance scheme seeks to avoid;

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[52] See section 23(1), Earthquake Commission Act 1993. The types of fire insurance contracts that are currently subject to EQC premiums are set out in sections 18 to 20, namely (i) contracts in respect of residential buildings, and (ii) contracts in respect of contents situated in New Zealand. The premiums payable by private insurers under the Earthquake Commission Act 1993 are sometimes referred to as "levies". But because the legislation uses the term "premiums", we also use that term in this briefing.

[53] New Zealand Government, *A Review of Earthquake Insurance: Public Discussion Paper*, dated 1988.

[54] See section 36(1)(c), Earthquake Commission Act 1993.

[55] The Treasury, *New Zealand's Future Natural Disaster Insurance Scheme: Proposed Changes to the Earthquake Commission Act 1993,* July 2015 https://treasury.govt.nz/sites/default/files/2012-09/eqc-rev-discussion-doc.pdf

b *If an apparently 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* – For example, if, historically, EQC's premiums had been geographically risk-based, 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;

c *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.

Private insurer's obligation to pay premiums to EQC

67 The obligation of private insurers to pay premiums to EQC is established at the formation of the relevant insurance contract.

68 The Earthquake Commission Act 1993 provides that the amount of the premium payable by the insurer to EQC is a debt due by the insured person[56] to the insurer. The insurer may recover such sum from the insured person.[57]

69 In practice, private insurers identify separately the amount of the EQC premium when invoicing for their insurance policies. The insurers recover these amounts from insured persons at the same time as they invoice their own premiums. But as a matter of law, it is the private insurer's obligation to pay the required premiums to EQC.[58]

70 In accordance with section 24(2) of the Earthquake Commission Act 1993, EQC receives certificates from private insurers stating that the private insurer's premium payment is correct. There is no customer-related information provided to EQC at the time premiums are paid by the private insurers.

[56] Under section 2(1) of the Earthquake Commission Act 1993, an "insured person" is a person for the time being entitled to the benefit of the contract of insurance.
[57] See section 23(2), Earthquake Commission Act 1993. Note that, if the insurer does not "carry on business in New Zealand", the debt is deemed payable by the insured directly to EQC.
[58] See section 23(2), Earthquake Commission Act 1993.

71 For any given month, the private insurer's premium payment to EQC for that month is an aggregated payment of all the premiums that the private insurer has become liable to pay EQC during that month. EQC has no visibility of which properties the aggregated premium payment relates to. EQC instead relies on the certificates given by the private insurers to ensure that the premiums paid to EQC cover all of the properties for which a premium has been collected by the insurers in that period. Given the lack of any specific property-level information, EQC has no ability to verify, from the premiums paid by private insurers, which properties are covered or whether the premiums are correctly calculated.

Failure of private insurer or customer to pay premium does not affect EQC claim

72 If:

a the private insurer has not paid an EQC premium due to EQC; and/or

b the customer has not paid the premium due to the private insurer;

that will not affect the customer's EQC claim. This is provided that the contract of fire insurance has not been suspended or cancelled as a result of the non-payment by the customer.

73 EQC pursues recovery of any premium due from the private insurer to it through a separate process.

Amount of premium

74 The premium amount is set out in regulations made under the Earthquake Commission Act 1993.[59] The current premium, in respect of every applicable insurance contract, is 20 cents per every $100 of the amount to which the property is insured, generally calculated by reference to yearly periods of insurance. Where the period of insurance is not in years, this amount is pro-rated and rounded to the nearest five cents.[60]

[59] See section 23(1), Earthquake Commission Act 1993.
[60] See Regulation 3, Earthquake Commission Regulations 1993.

75 The premium amount has increased over time as follows:

a the original premium was set at one shilling per £100 of the amount insured in the 1940s (decimalised in 1967 at five cents per $100);[61]

b an increase from five cents to 15 cents per $100 of the amount insured from 1 February 2012;[62]

c an increase from 15 cents to 20 cents per $100 of the amount insured from 1 November 2017.[63]

76 Notably, the premium did not increase with the introduction of residential land cover in 1984. There was and continues to be no separate or additional premium for the residential land cover provided under the Earthquake Commission Act 1993.

77 The rationale for the increases in premium rate that occurred in 2012 and 2017 was in each case to charge a price that better reflected the expected long run costs and financial risks of the insurance scheme.[64]

78 In addition, a key consideration underpinning the changes to EQC's premiums in 2017 was to carefully balance the following two policy objectives:

a ensuring the EQC scheme is financially sustainable over the medium to long-term; and

b maintaining New Zealand's current high rate of residential insurance.[65]

79 During 2016, EQC sought advice from a number of providers on the following issues, which also influenced the Government's decision to increase premiums from 1 November 2017:[66]

a an estimation of EQC's probable maximum loss, expected average annual losses and the financial tools to manage these; and

b premium adequacy and retail insurance price elasticity, (that is, whether an increase in EQC premiums would result in fewer homeowners purchasing residential insurance).

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[61] See Regulation 7(1), Earthquake and War Damage Regulations 1944.
[62] See Regulation 4, Earthquake Commission Amendment Regulation 2011.
[63] See Regulation 5, Earthquake Commission Amendment Regulations 2017.
[64] See Cabinet Paper, *Increasing the Earthquake Commission's Levy*, dated October 2011, https://treasury.govt.nz/sites/default/files/2018-02/cabmem-10oct11.pdf.
See also Cabinet Paper, *Earthquake Commission (EQC): Proposed EQC Premium Rate Increase*, dated May 2017.
[65] See Cabinet Paper, *Earthquake Commission (EQC): Proposed EQC Premium Rate Increase*, dated May 2017. See also New Zealand government media release, *EQC levy increase to prepare for future disasters,* dated 26 May 2017, https://www.beehive.govt.nz/release/eqc-levy-increase-prepare-future-disasters
[66] Advice was sought from Aon Benfield, GNS Science, Taylor Fry and Sapere Research Group.

Retention of a proportion of the EQC premium by private insurers

80 EQC allows private insurers to retain 2.5% of the total amount of premiums collected on behalf of EQC. The aggregate cost of this 2.5% retention across all private insurers is currently approximately $10 million per annum.

81 In essence, this is to provide compensation to the private insurers for administration and costs associated with collecting EQC premiums. In recent years, this premium retention has been reviewed to determine whether the rationale for retaining the discount remains, but no change has been made.

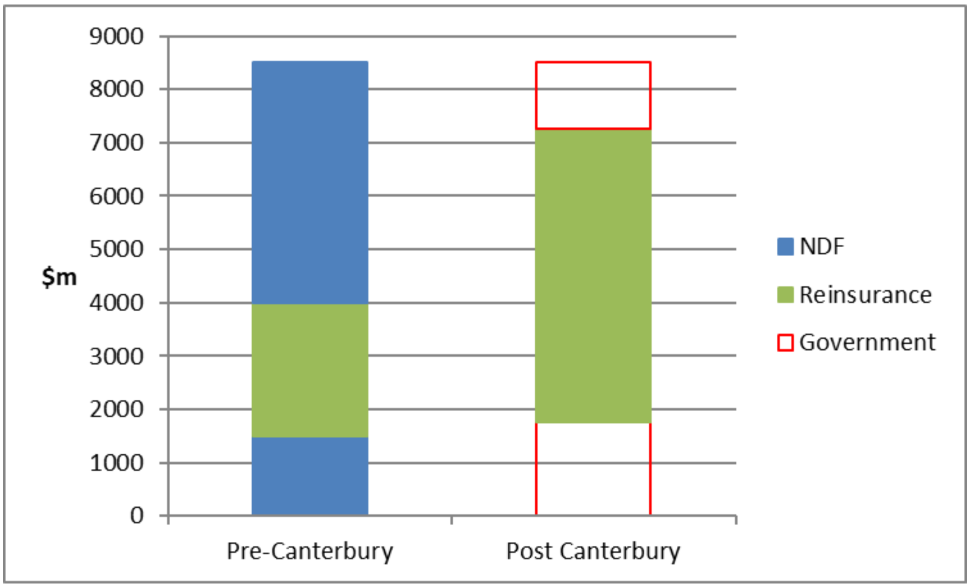
Reinsurance

82 EQC manages a significant proportion of its potential financial risk by purchasing reinsurance in the international insurance market. Reinsurance – insurance for insurers – enables insurance companies to share risk. Through its reinsurance programme, EQC transfers a proportion of the Crown's contingent liability to international financial markets. This means that additional financial resource is available to EQC (coming from international financial markets, in addition to the Natural Disaster Fund or Crown funding) for settling claims in the event of a major natural disaster.

83 Under the current reinsurance programme, EQC must meet the first $1.75 billion of claims before it can draw upon its reinsurance contracts. EQC's annual reinsurance programme is one of the largest in the world.

84 **Figure 3** below provides an illustration of the contribution that reinsurance plays in allowing EQC to meet its claims obligations, and how the sources of funding available to EQC in the event of a major natural disaster have changed since the Canterbury earthquakes. The figures used are illustrative and show the substantial increase in EQC's reinsurance programme since 2010. They also show the depletion of the Natural Disaster Fund and the increased reliance on the section 16 Crown guarantee. Until the Natural Disaster Fund is rebuilt, if a major natural disaster occurs then claims below the level at which reinsurance is available (currently $1.75 billion) will have to be satisfied by the Crown under the section 16 Crown guarantee.

Figure 3: *EQC's sources of funding to meet claims pre-Canterbury earthquakes and current*



85 EQC's reinsurance programme is negotiated annually with reinsurance contracts renewing from 1 June. The renewal represents the end point of a nine month process in which EQC works closely with its external reinsurance brokers. In this process, EQC seeks to secure sufficient cover to meet a significant proportion of EQC's possible financial needs in the wake of a substantial natural hazard event.

86 EQC looks to balance a number of factors to ensure that its reinsurance programme:

a takes account of the Crown's views on risk;

b is affordable and provides value for money for the premium paid; and

c is placed with counterparties that meet a high threshold for financial security.

87 EQC is required to obtain reinsurance in respect of the whole or part of the insurance provided under the Earthquake Commission Act 1993.[67] Reinsurance is the single largest annual operating cost incurred by EQC. In 2017/18, for example, the cost of EQC's reinsurance premiums ($168 million) represented just over 54% of EQC's total revenue.[68]

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[67] See section 5(1)(d), Earthquake Commission Act 1993.
[68] Earthquake Commission, *Annual Report 2017–18,* page 38, https://www.eqc.govt.nz/sites/public_files/documents/publications/EQC-Annual-Report-2017-18.pdf.

88 Since 1988, EQC has paid almost $1.9 billion in reinsurance premiums and has received more than $4.2 billion from reinsurers to cover claim costs from the Canterbury earthquake sequence.[69]

Evolution of the EQC reinsurance programme

89 In 1988 the Earthquake and War Damage Commission established a reinsurance programme with an initial placement of $1 billion of reinsurance cover. Placement of reinsurance refers to the way in which a reinsurance programme of this size and complexity is purchased from multiple reinsurers, as opposed to a single reinsurer, or markets.

90 Since 1988 a reinsurance programme has been a core component of EQC's overall risk management strategy. At the time the initial reinsurance placement was made the EQC Board made the following observations in the 1988/89 Annual Report:

> *It has been apparent for some time that the resources to which the Commission has access are limited and a heavy financial burden would be placed on the Government of the day and the people of New Zealand in the event of a major natural disaster. Clearly it is in the national interest that the Government's contingent liability in respect to natural disaster be progressively reduced and eventually eliminated.*[70]

91 Since the initial placement, EQC has continued to develop and expand the reinsurance programme. From the outset of the programme, this has involved a strong relationship with EQC's reinsurance brokers as key conduits to the market. There has also been a significant and consistent investment in relationships with key reinsurance counterparts.

92 In the 1989/90 Annual Report, just one year after the initial placement, the Chair highlighted that adverse storm events in Europe and North America potentially put the renewal of EQC's programme at risk. The EQC Chair commented:

> *Fortunately, the contact made with representatives of the industry by members of the Commission in the course of the year ensured that the Commission's current layer of reinsurance was renewed, albeit at additional cost*.[71]

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[69] Earthquake Commission, *The Natural Disaster Fund,* 28 March 2018 https://www.eqc.govt.nz/about-eqc/our-role/ndf.
[70] Earthquake and War Damages Commission, *Annual Report of the Earthquake and War Damages Commission for the year ended 31 March 1989*, page 5.
[71] Earthquake and War Damages Commission, *Annual Report of the Earthquake and War Damages Commission for the year ended 31 March 1990,* page 8.

Research and Loss Modelling

93 A critical component underpinning EQC's reinsurance programme has been the ongoing investment in research and loss modelling, including the development of the Minerva model. This modelling application combines geographical information, seismic hazard and financial analysis to simulate the predicted number of claims EQC will receive and likely losses as a result of any particular single event.[72]

94 A key enabler of an effective hazard risk management system is loss modelling, which is the ability to effectively price known hazard risks. EQC has provided the reinsurance market a loss modelling analysis of its housing portfolio. Historically, the analysis generated by EQC and related research has demonstrated to international reinsurers that EQC has a current understanding of New Zealand-specific earthquake risks, compared to international models.

95 EQC's modelling analysis has helped reduce uncertainty for reinsurers on the risks that they are covering and has sustained market participation by reinsurers in the aftermath of the Canterbury earthquakes.

Reinsurance Contracts

96 Over time, EQC has also been able to negotiate a number of additional terms and conditions within its reinsurance contracts to reflect some of the specific issues facing EQC. This has in part reflected the development of long-standing, trusting relationships with a number of key reinsurance markets, including the Lloyd's market. 9(2)(b)(ii) [redacted]

[72] See *Briefing to the Public Inquiry: Catastrophe Response Programme 2009/10*, paragraph 60.

9(2)(b)(ii) [redacted]

“TOP AND DROP” COVER

97 Advances in our understanding of earthquake behaviour, particularly in relation to the clustering of large events, also led to further innovations in EQC’s reinsurance programme. In December 2005, the Chair wrote to the Minister responsible for the Earthquake Commission seeking agreement for EQC and its brokers to investigate specific products (e.g., “top and drop” cover) that would respond to the clustering of large events. Top and drop cover provides layers of excess so that, in the event that a loss exhausts a reinsurance limit in a lower layer, unexhausted limits will drop down to respond to subsequent losses.[74] This cover was in place before the first Canterbury earthquake and the contracts in place at the time allowed EQC to access reinsurance cover for the February 2011 earthquake at a substantially reduced deductible.

Continued support for EQC’s reinsurance programme since Canterbury earthquakes

98 The continued successful renewal of EQC’s reinsurance programme since the Canterbury earthquakes provides a signal of the confidence placed by the global reinsurance market in its understanding of New Zealand natural hazard risk.

99 EQC’s reinsurance programme has expanded following the Canterbury earthquake sequence to reduce the exposure created by the depletion of the Natural Disaster Fund to meet the costs of the Canterbury and Kaikōura earthquakes, as shown in Figure 3 above. For example:

a EQC has been able to renew appropriate reinsurance contracts every year since the 4 September 2010 earthquake to ensure EQC can continue providing ongoing cover for New Zealand.

b Pricing for the renewing programme significantly increased following the 2010 earthquake, and reinsurers reviewed their risk appetite for New Zealand exposure resulting in some in the market withdrawing support (while others entered the market) and others reducing the capacity available. Despite this, EQC has been able to increase the cover provided by the reinsurance programme since the September 2010 Canterbury earthquake, when it stood at $2.5 billion;

c During 2017/18, EQC was able to provide additional reinsurance protection against the impact of a significant event by securing $5.55 billion of reinsurance capacity for the 2018/19 financial year. This new cover was up from $4.83 billion purchased in 2017 for the 2017/18 financial year. This additional capacity was purchased to protect the Crown balance sheet by offsetting the low balance in the Natural Disaster Fund; and

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[74] Preferred Reinsurance Intermediaries, Inc., *Reinsurance*, 1996, https://www.preferredre.com/assets/glossary.pdf

d EQC has recently finalised its reinsurance programme for the 2019/20 financial year, with $6.2 billion of reinsurance.

100 Investment by EQC in applied research and modelling to better understand the impact of New Zealand's natural hazards is fundamental to EQC's engagement with global reinsurance markets. As noted earlier, EQC's research and loss modelling analysis has helped reduce uncertainty for reinsurers on the risks that they are covering. The analysis has also sustained market participation by reinsurers in the aftermath of the Canterbury earthquakes.

101 Through EQC's ongoing investment in applied science and public education, EQC is also seeking to increase community resilience to natural disasters, which in turn should be reflected in the price EQC pays for its reinsurance. The balance sheet protection offered to the Crown by EQC's reinsurance programme was highlighted in the Government's 2018 Investment Statement.[75]

Diversification of risk

102 EQC has long signalled interest in exploring opportunities for diversification of the risk transfer programme, whether this be from:

a alternative sources of capital (for example, catastrophe bonds or other insurance linked securities); or

b changes to the terms of our existing programme (for example, privately-placed versus subscription placements or a return to multi-year reinsurance contracts).

103 The 2015 Discussion Document signalled an interest in providing EQC with further legislative flexibility to undertake alternative financial risk diversification opportunities, including alternative sources of capital.[76] There was little direct commentary received in public submissions on the risk financing proposals in the 2015 Discussion Document. EQC expects further policy work will be undertaken on this matter as part of the second stage of legislative reform being led by the Treasury.

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[75] The Treasury, *He Puna Hao Pātiki 2018 Investment Statement – Investing for Wellbeing*, dated 20 March 2018, https://treasury.govt.nz/publications/investment-statement/2018-investment-statement

[76] The Treasury, *New Zealand's Future Natural Disaster Insurance Scheme: Proposed Changes to the Earthquake Commission Act 1993*, dated July 2015, https://treasury.govt.nz/sites/default/files/2012-09/eqc-rev-discussion-doc.pdf.

Management of reinsurance claims collection

104 The real value of reinsurance is only revealed when recoveries are collected. Done well, this process starts long before a loss occurs, beginning when reinsurance contracts are first placed and continuing through to claim finalisation. It remains true to the time of writing this paper that every dollar requested of reinsurers in respect of the Canterbury earthquake sequence has been recovered by EQC.

105 Collections from EQC's reinsurance contracts were triggered for the first time following the Canterbury earthquake sequence and have played a significant role in meeting EQC's Canterbury claims liabilities. As at 28 February 2019, an estimated 90% of reinsurance recoveries totalling $4.02 billion had been received and subsequently paid out to Canterbury customers, with additional reinsurance expected to be recovered[77].

106 Following the 4 September 2010 earthquake, reinsurers were advised that an event had occurred that would require their financial support. A series of processes was initiated to keep reinsurers updated of progress of assessment of homeowner claims, expectations for financial recoveries from reinsurers following EQC's settlements to their customers, and estimations of the ultimate loss expected of the event.

Ongoing communications with reinsurers

107 EQC's approach to reinsurance has taken on a wider role informing markets of unfolding circumstances during the recovery of an event. EQC plays an important role in balancing popular news and social media reports. It communicates factual developments and activities to the global risk financing community. This aligns with standard reinsurance market practice in the event of catastrophic property losses.

108 EQC and its reinsurance broker invested resource to explain the scientific and engineering attributes of the Canterbury earthquake sequence, as well as the legal and policy analysis that underpinned EQC's response to the events.

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[77] The Treasury, *He Puna Hao Pātiki 2018 Investment Statement – Investing for Wellbeing*, 20 March 2018, https://treasury.govt.nz/sites/default/files/2018-03/is18-hphp-wellbeing.pdf.

109 Given the significance of the Canterbury earthquake sequence, reinsurers instigated visits to New Zealand to familiarise themselves with the events. The visits provided a strong foundation for future reinsurer support both in the claims process and during the following reinsurance renewal cycles. Reinsurer interaction with EQC has included:

a reinsurer briefings, including quarterly updates, event specific information, and the Insurance Liability Valuation Report (i.e., the six monthly actuarial valuation of EQC's liabilities);

b reinsurer meetings in New Zealand, including the audit and inspection of EQC records; and

c regular discussions with the reinsurers that have losses from the Canterbury earthquakes as part of EQC's annual reinsurance renewal processes.[78]

EQC's risk financing strategy

110 EQC's current risk financing strategy is aimed at ensuring EQC has access to the necessary financial resources to meet the potential liabilities arising from the insurance scheme under the Earthquake Commission Act 1993.

111 The risk financing strategy is founded on four elements, being:

a *premium adequacy* – ensuring that EQC's premiums reflect the expected costs of the scheme, including the cost of reinsurance and administration;

b *risk transfer* – ensuring that EQC's risk transfer programme is efficient and effective and takes account of the Crown's overall risk appetite for natural hazard related losses;

c *management of the Natural Disaster Fund* – ensuring that accumulated premiums and other financial assets are managed in line with best practice and relevant Ministerial directions; and

d *Crown support provided under the Earthquake Commission Act 1993* – ensuring that there is a clear understanding between the Crown and EQC on the operation of the Crown's guarantee.

112 EQC carries out its risk financing strategy in accordance with the requirements of the Earthquake Commission Act 1993 and Ministerial directions.

[78] Further detailed information on EQC's reinsurance claims interaction is contained in Aon, *Reinsurance Claims Interaction – Final Report*, dated 25 March 2019. Note that this report is commercially sensitive and confidential.

113 Since 2016, EQC has predominantly focused on three of these elements. This has involved input from a number of specialist external advisors, the Treasury and ultimately with Ministers. The areas of focus have been as follows:

a *Premium adequacy* – In May 2017, Ministers agreed to increase EQC's premiums from 1 November 2017, following work commissioned by EQC and peer reviewed by the Treasury;

b *The section 16 Crown guarantee* – In 2018, the Deficiency Funding Deed was finalised with the Treasury on the operational arrangements underpinning the Crown's liabilities under section 16 of the Earthquake Commission Act 1993; and

c *Annual reinsurance renewal* – For the 2018/19 renewal period EQC secured more than $5.5 billion of reinsurance cover, an increase in capacity of around $700 million from the previous year. In addition, EQC also completed an appointment process for its external reinsurance broker, attracting proposals from five international firms.

114 To date, EQC has worked closely with the Treasury in developing the risk financing strategy, in particular to understand the Crown's risk appetite and the implications of this for EQC. As noted earlier in this briefing, the Crown's financial statements recognise that the Crown has a number of potential or contingent liabilities. One of these is the costs arising from major natural disasters such as earthquakes and other events covered under the Earthquake Commission Act 1993. EQC helps to manage a proportion of the financial risks associated with the Crown's contingent liabilities through its risk financing strategy, including the transfer of substantial risk to international capital markets through EQC's reinsurance programme (see paragraph 82). The role that EQC plays in the management of the Crown's overall balance sheet risk was highlighted in the Crown's 2018 Investment Statement.[79]

115 The final element of the risk financing strategy centers on the management of the Natural Disaster Fund, and in particular how to replenish the Natural Disaster Fund after the Canterbury and Kaikōura earthquakes. This element has not been progressed in any substantive form at this stage. EQC has had some initial discussions with the Treasury but these have not been developed at this point in time. In part, this work is linked to potential legislative changes that may arise from further review of the Earthquake Commission Act 1993.

[79] The Treasury, *He Puna Hao Pātiki 2018 Investment Statement – Investing for Wellbeing*, 20 March 2018, https://treasury.govt.nz/sites/default/files/2018-03/is18-hphp-wellbeing.pdf.

Lessons learned/future considerations

116 Within the context of EQC's current legislative framework and operating environment there are numerous areas for future focus regarding the Natural Disaster Fund, premiums and reinsurance. These include:

a the ongoing development of EQC's loss modelling capability in order to better understand the financial impacts of the natural disasters covered by the EQC scheme. EQC's Board approved a business case in November 2017, that also included consideration of the wider economic impact of natural disasters;

b improving the linkages between EQC's loss modelling capabilities and the development and management of EQC's risk financing strategy. This includes improving EQC's access to private insurer information on premium and exposure information and enhancements to EQC's internal cost control processes; and

c the importance of EQC's ongoing investment in its reinsurance relationships. This includes the need to continue to explore options for alternative sources of risk financing. EQC's long-standing partnership with its reinsurance broker, Aon, provides EQC with ongoing access not only to significant global financial capacity, but also to intellectual capital to assist the Board as it redevelops the Natural Disaster Fund.

117 Underpinning the ongoing development of the Natural Disaster Fund will be the continuation of EQC's close working relationship with the Treasury. There will be five key areas of focus over the coming 12 to 18 months. Specifically, EQC will work with the Treasury to ensure the following matters progress:

a develop further a shared understanding of the Crown's risk appetite and the role EQC plays in meeting some of the Crown's contingent liabilities arising from natural disasters. The Crown's position is an important component of EQC's decisions on its annual reinsurance renewal;

b manage efficiently any payments made to EQC under the section 16 Crown guarantee;

c incorporate lessons from EQC's experiences into further policy and legislative reform, including any recommendations from the Public Inquiry;

d agree on the key parameters for EQC's medium-term investment strategy. It is expected that EQC will begin to accumulate significant surpluses in the Natural Disaster Fund over the coming two to three years as substantial payments from Canterbury and Kaikōura events diminish; and e incorporate regular reviews of the financial limits set out in the Earthquake Commission Act 1993 into the shared work programme between the Treasury and EQC. These financial limits include liability caps and premiums.