

IN CONFIDENCE

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Briefing to the Public Inquiry into the Earthquake Commission

Title	Estimating EQC's financial liabilities
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Contents

Context.....	3
Executive summary	3
Estimating expected final costs	4
Independent actuarial assessment of EQC’s insurance liabilities.....	4
How is the actuarial assessment reached?.....	5
How has the estimate of Canterbury liability changed over time?	5
How is the uncertainty of reopened claims incorporated into actuarial estimates?	8
How do the changes in expected financial liabilities impact on the Crown’s guarantee liabilities under section 16 of the Earthquake Commission Act 1993?	10
Does the absence of a “full and final” settlement provision limit EQC’s ability to settle claims? .	11

Figures

Figure 1: Canterbury earthquakes: gross claim payments include claims handling expenses (actual and future central estimate).....	7
Figure 2: Canterbury earthquake: estimated gross ultimate incurred claims and claims handling expenses – movement in central estimate: 30 June 2018 to 31 December 2018	8
Figure 3: Estimating the inflow of future reopened claims	9

Estimating EQC's financial liabilities

Context

- 1 This briefing responds to questions raised by the Public Inquiry Chair in a recent meeting with the Earthquake Commission's (EQC's) Chair and Chief Executive. Specifically, questions were raised with respect to:
 - a how EQC estimates the expected final costs of events such as the Canterbury earthquake sequence and Kaikōura earthquake?
 - b what is the impact of reopened Canterbury claims on EQC's estimated liability?
 - c how do the changes in expected financial liabilities impact on the Crown's guarantee of EQC's liabilities under section 16 of the Earthquake Commission Act 1993? and
 - d what impact does the absence of a "full and final settlement" provision in the Earthquake Commission Act 1993 have on EQC's ability to settle claims?

Executive summary

- 2 EQC engages independent actuaries to estimate EQC's insurance liabilities every six months. The role of the independent actuaries is to estimate the final or 'ultimate' cost of each earthquake event. This is common practice in the private insurance industry, and provides key information for EQC's financial statements and ongoing financial forecasts, reinsurers and the Crown (including for the section 16 Crown guarantee). Assumptions as to the future level of reopened building claims are currently one of the principal sources of uncertainty within the actuarial valuation. Since December 2016, a separate provision for reopened claims has been included in actuarial estimates.
- 3 EQC has a specific statutory obligation to settle claims "*...to the extent to which it is liable under [the] Act*".¹ The absence of a "full and final" settlement, as provided by private insurers, does not affect EQC's ability or willingness to make payments to settle claims. It does, however, mean that EQC's final liabilities are not known for some time, particularly in an event as large and as complex as the Canterbury earthquake sequence. Ultimately, the final cost of the Canterbury earthquake sequence will not be known until the final claim is settled and closed.

¹ See section 29(2), Earthquake Commission Act 1993.

Estimating expected final costs

Independent actuarial assessment of EQC's insurance liabilities

- 4 Since 2011, EQC has engaged independent professional actuaries to produce an estimate of EQC's insurance liabilities. EQC's insurance liabilities include:
 - a Outstanding claims liabilities – which relate to the future direct and indirect claims costs and reinsurance recoveries for claims incurred up to the date of the assessment; and
 - b Premium liabilities – which relate to the future net claims costs and administration and reinsurance expenses for future claims arising from unexpired risks as at the date of the assessment.²
- 5 Although not required by the Earthquake Commission Act 1993, undertaking an actuarial valuation of insurance liabilities is consistent with practice by private-sector insurance companies across all of their lines of business (and is a requirement of their license under the Insurance Prudential Supervision Act 2010), and by the Accident Compensation Corporation.
- 6 Currently, EQC engages independent actuaries Melville Jessup Weaver to estimate EQC's claims liability and associated reinsurance assets every six months. Melville Jessup Weaver's valuation assumptions and results are documented in their Insurance Liability Valuation Report. The actuarial valuation results in that report form a key part of EQC's financial statements and ongoing financial forecasts, including those in EQC's Annual Report. The actuarial results are audited by the Auditor-General as part of EQC's Annual Report.
- 7 The Treasury also reviews the assumptions that underpin the valuation as these have a direct impact on EQC's forward looking financial forecasts. As EQC's Natural Disaster Fund has now been drawn down, the ongoing financial impact of Canterbury and Kaikōura liabilities has been a critical input in estimates of the Crown's potential liability under section 16 of the Earthquake Commission Act 1993.³ Since November 2018, EQC has called on \$125 million (excluding GST) from the Treasury under the Crown's section 16 guarantee.

² Melville Jessup Weaver, *Earthquake Commission Insurance Liability Valuation as at 31 December 2018 Final Report*, 25 March 2019, section 2.4.1, https://www.eqc.govt.nz/sites/public_files/documents/ILVR/Insurance_Liability_Valuation-Dec%202018.pdf.

³ See *Briefing to the Public Inquiry into the Earthquake Commission: Managing Risk – Premiums, Reinsurance and the Natural Disaster Fund*, dated 5 July 2019, paragraphs 49 to 62.

How is the actuarial assessment reached?

- 8 The process of estimating the claims liability involves EQC working closely with independent actuaries Melville Jessup Weaver over a number of months to assist with the determination of appropriate data and assumptions. The role of the independent actuaries is to estimate the final or 'ultimate' cost of each earthquake event, based on the data and historic trends, knowledge of the earthquakes, the exposure, claims development patterns from other insured events and actuarial techniques. Melville Jessup Weaver presents its findings and key assumptions to the EQC Board which, in turn, accepts these as part of the sign-off process.
- 9 At the time when the first estimate of the insurance liabilities was carried out in 2011, EQC had undertaken a large number of assessments after the September 2010 earthquake, but due to ongoing aftershocks, few actual repairs had been finalised. The actuarial valuation therefore provided key information for EQC, reinsurers and the Crown, including to help understand the potential cost of settling claims.
- 10 Court cases relating to the extent of cover provided by EQC under the Earthquake Commission Act 1993, including apportionment and what forms of land damage are covered under the Earthquake Commission Act 1993, are reflected in the actuarial assessment of EQC's liability. For example, the 2014 declaratory judgment on land⁴ enabled EQC's actuaries to refine the estimated costs relating to land settlements.
- 11 EQC's obligation is to make sure that customers receive their full entitlement. As more claims are settled, the actual claim settlement amounts drive changes in the liability estimate, not the other way around. Ultimately, the final cost of the Canterbury (and Kaikōura) earthquakes will not be known until the final claim is settled and closed.⁵
- 12 The results of this process are externally assessed annually by the Auditor-General and are regularly reviewed and discussed with the Treasury as part of its ongoing monitoring of EQC. The actuarial estimates are also scrutinised by international reinsurers who have the right to inspect and audit EQC's processes and accounts.

How has the estimate of Canterbury liability changed over time?

- 13 Generally, as the claims settlement process advances, the actuaries have more data with which to estimate the final cost of claims. However, with the Canterbury earthquake sequence, there are considerable uncertainties presented by the level of reopened claims, ongoing litigation and the potential cost of financial reconciliation discussions between EQC and private insurers.

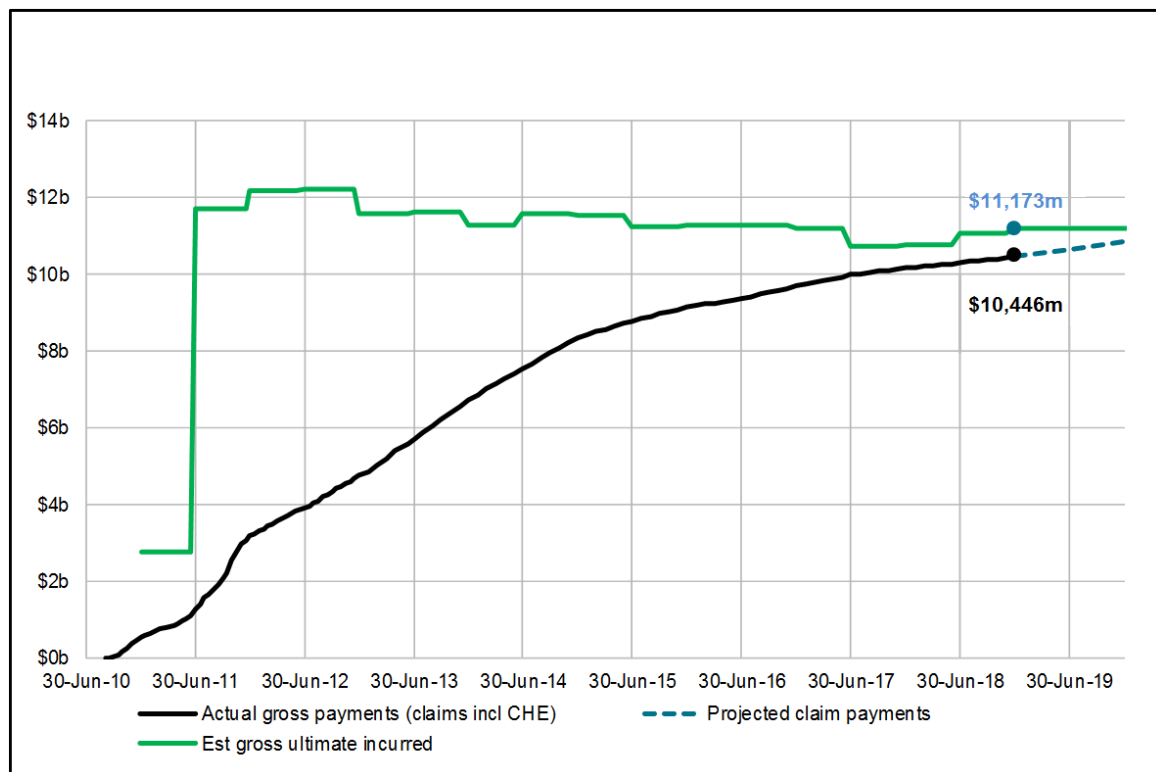
⁴ See *Briefing to the Public Inquiry into the Earthquake Commission: Canterbury Land Programme*, dated 24 May 2019, paragraphs 107 to 128.

⁵ See *Briefing to the Incoming Minister Responsible for the Earthquake Commission*, dated October 2017, https://www.eqc.govt.nz/sites/public_files/documents/BIM-2017.pdf.

- 14 There is inherent uncertainty in any estimation of insurance liabilities. Estimates of liabilities are based on assumptions and deviations from estimates are normal and to be expected. The estimates are therefore a probability statement rather than an absolute judgement.⁶ Every six-monthly insurance liability valuation involves a reassessment of the key underlying assumptions, including an analysis of the actual claim experience over the previous six months and any other new information that has emerged over the period.
- 15 Given the inherent uncertainty, particularly at the beginning of the Canterbury earthquake sequence, it is standard actuarial practice to include risk margins in the valuation results, to increase the probability that the calculated provision does in fact cover the final cost.
- 16 EQC's Board currently adopts a risk margin based on a probability of sufficiency of 85% (that is, based on the actuarial models, the provision should be adequate in 85% of cases and inadequate in 15%). Prior to June 2013 the risk margin was based on a probability of sufficiency of 75%, but this was adjusted upwards when the expected (mean) outstanding claims reduced but became more uncertain due to an increased possibility of litigation. As we progress through claim settlements, a greater part of the ultimate cost becomes known and a smaller part is unknown, so the dollar value of the risk margins tends to reduce.
- 17 The graph below shows how the estimate of gross ultimate cost of Canterbury claims in the Insurance Liability Valuation Report has changed over time, against cumulative claim payments (inclusive of claims handling costs, with projected values shown as a dotted line). This shows that since June 2011, estimates of the ultimate liability have remained relatively consistent, particularly given the scale of the events.

⁶ Melville Jessup Weaver, *Earthquake Commission Insurance Liability Valuation as at 31 December 2018 Final Report*, 25 March 2019, section 9.1, https://www.eqc.govt.nz/sites/public_files/documents/ILVR/Insurance_Liability_Valuation-Dec%202018.pdf.

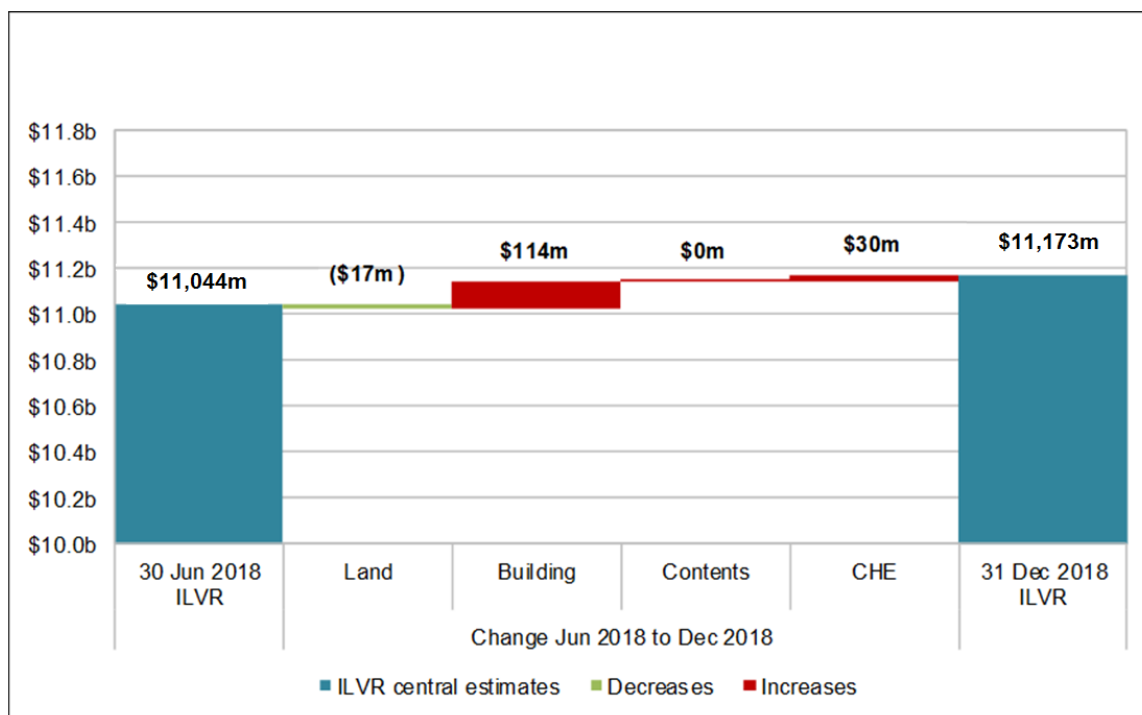
Figure 1: Canterbury earthquakes: gross claim payments include claims handling expenses (actual and future central estimate)⁷



- 18 With every six-monthly report, the actuaries provide commentary on the changes since the previous Insurance Liability Valuation Report, including how actual costs have compared to the previous assumptions and where new sources of certainty (or uncertainty) have arisen.
- 19 The drivers behind the increase in the gross ultimate cost, from \$11.044 billion in June 2018 to \$11.173 billion in the December 2018 Insurance Liability Valuation Report, are presented in a waterfall graph below (noting that the vertical axis is truncated). This increase relates largely to an increased estimate for building claims, from additional expected costs coming out of financial reconciliation discussions with private insurers. The figures represent the central estimate of the Insurance Liability Valuation Report (that is, the expected value before the addition of any risk margin to allow for variability from the central estimate). This provides important information to management and other readers on the sources of the change in the projections over time.

⁷ Melville Jessup Weaver, *Earthquake Commission Insurance Liability Valuation as at 31 December 2018 Final Report*, 25 March 2019, section 5.1.3, https://www.eqc.govt.nz/sites/public_files/documents/ILVR/Insurance_Liability_Valuation-Dec%202018.pdf.

Figure 2: Canterbury earthquake: estimated gross ultimate incurred claims and claims handling expenses – movement in central estimate: 30 June 2018 to 31 December 2018⁸

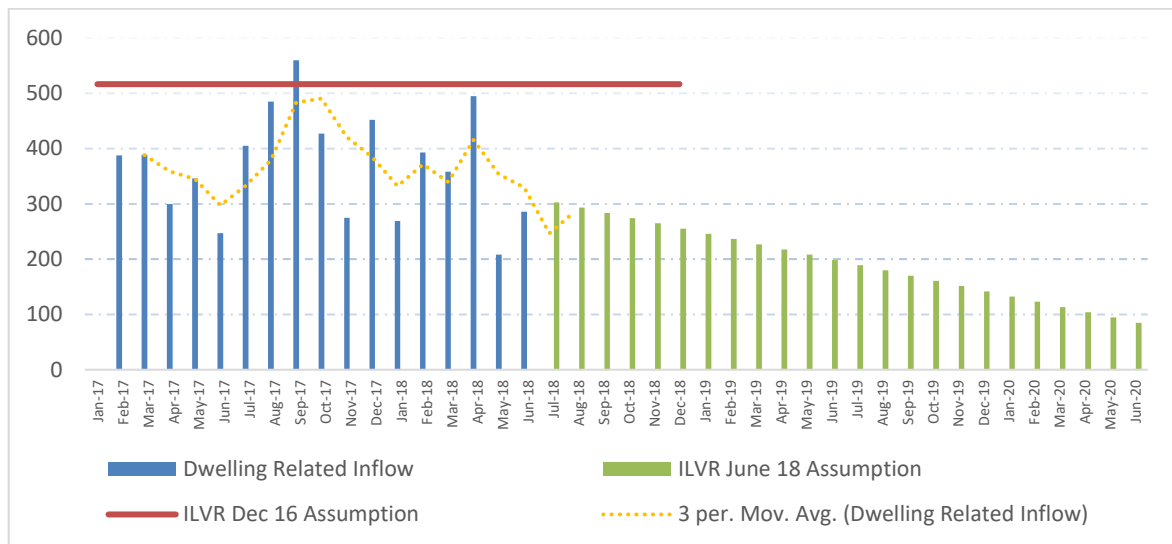


How is the uncertainty of reopened claims incorporated into actuarial estimates?

- 20 In recent years, one of the principal sources of uncertainty within the actuarial valuation has been the assumptions as to the future level of reopened building claims. As these claims cannot be known until they have been lodged with EQC, there is more uncertainty in their frequency and cost.
- 21 In December 2016, EQC made a separate provision for reopened claims, assuming a constant inflow of just over 500 reopened claims per month through to December 2018. Reopened claims were assumed to cost an average of \$10,000, based on the limited information available at that time for completed reopened claims. The December 2018 timeline was in line with expectations at the time that the Canterbury claim payments would be fully completed by then.
- 22 In the June 2018 valuation, the decision was made to extend the tail of claims beyond the initial end point of December 2018. A longer tail of reopened claims was therefore forecast at a reducing rate. This is shown in green on the graph below (**Figure 3**). This longer tail increased the estimated cost of this provision.

⁸ Melville Jessup Weaver, *Earthquake Commission Insurance Liability Valuation as at 31 December 2018 Final Report*, 25 March 2019, section 1.4.6, https://www.eqc.govt.nz/sites/public_files/documents/ILVR/Insurance_Liability_Valuation-Dec%202018.pdf.

Figure 3: Estimating the inflow of future reopened claims⁹



- 23 While the number of reopened claims has been broadly at the assumed level or lower, the average financial cost has been significantly higher than assumed (\$25,000 actual compared to the \$10,000 assumption). It is likely that the initial assumption was based on reopened claims that were simpler to resolve. The complexity of reopened claims settled post-December 2016 has been greater, hence a higher average cost.
- 24 As at June 2019, reopened claims remain one of the most difficult elements to model. EQC is undertaking a number of initiatives to assist Melville Jessup Weaver in understanding the drivers, potential numbers, and cost of reopened claims.
- 25 Melville Jessup Weaver is currently looking to estimate the future level of reopened claims based on:
- a the actual level of reopened claims experienced over recent months;
 - b a reactive approach to reopened claims, that is EQC waits for customers to reopen claims, rather than an allowance for EQC to conduct proactive sampling of repairs;
 - c mapping of areas where future reopened claims with a material cost may occur, based on looking at damage to other properties in those areas; and
 - d an assumption that the level of reopened claims will reduce as time progresses, especially with EQC focusing on completing quality settlements for current reopened claims.

⁹ Earthquake Commission Board paper, *Acceptance of the June 18 Draft ILVR*, dated 27 July 2018.

How do the changes in expected financial liabilities impact on the Crown's guarantee liabilities under section 16 of the Earthquake Commission Act 1993?

- 26 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 of Finance is required to provide, by way of grant or advance, funding sufficient to meet the deficiency.¹⁰
- 27 On 18 September 2018, EQC and the Crown signed the EQC Deficiency Funding Deed which set out the terms and process under which EQC can access funding from the Crown under section 16 of the Earthquake Commission Act 1993. The purpose of the Deficiency Funding Deed was to ensure an effective and efficient mechanism for EQC to draw down on public funds so that it can meet its financial obligations as they fall due.
- 28 The Deficiency Funding Deed specifies the nature of information required by the Treasury from EQC to ensure that the Treasury is able to undertake a robust assessment of EQC's financial need and provide funding in a timely manner. The Deficiency Funding Deed also provides a number of safeguards for EQC and the Crown including:
- a provision of a \$50 million financial buffer so that the Natural Disaster Fund balance does not have to reach \$0 before EQC can trigger the Crown's guarantee; and
 - b clarity on the roles and responsibilities of the Minister in determining the appropriate terms and conditions of any Crown payment under the Deed.
- 29 The financial forecasts that underpin EQC's cashflow requirements are based on the latest Insurance Liability Valuation Report prepared by Melville Jessup Weaver. Changes to the underlying actuarial assumptions and the financial outcomes resulting from these have a direct impact on EQC's forecast cashflow requirements and therefore the potential call on the Crown under section 16 of the Earthquake Commission Act 1993.
- 30 Since November 2018, EQC has drawn down \$125 million (excluding GST) under section 16, in three separate tranches. Whilst EQC's financial position is forecast to improve substantially over the coming few years, it is expected that EQC will make further calls on the section 16 Crown guarantee over the coming year. For that reason, in May 2019 the Chair of EQC wrote to the Minister Responsible for the Earthquake Commission seeking a twelve month extension to the current Deficiency Funding Deed. Based on our discussions to date with Treasury, we do not anticipate that there will be any substantive challenges in renewing the Deed on the same terms and conditions as are currently in place.

¹⁰ See section 16, Earthquake Commission Act 1993. There was a similar statutory obligation in section 13 of the Earthquake and War Damage Act 1944.

Does the absence of a “full and final” settlement provision limit EQC’s ability to settle claims?

- 31 EQC has a specific statutory obligation to settle claims “...to the extent to which it is liable under [the] Act”.¹¹ EQC closes claims once it is satisfied that the customer has received their statutory entitlement. The Canterbury earthquakes are the first time since EQC’s establishment that there has been such a substantial volume of reopened claims.
- 32 For many years prior to the Canterbury event, EQC asked its customers to sign a document called a “Declaration of Loss”. This Declaration did not seek to prevent further claims, but it provided a useful evidential record that the customer was happy with the EQC settlement at the time it was made.
- 33 In the Canterbury event, EQC did not get its customers to sign Declarations of Loss, however it is not clear from records available why EQC’s position on these changed. In comparison, it is common for private insurers to require their customers to enter into a full and final discharge agreement when accepting the private insurer’s settlement offer for a building claim under an insurance policy. Sometimes, the requirement will be a term of the insurance policy or it may be framed by the private insurer as an offer to settle the relevant claim on terms more favourable than the policy provides.
- 34 Customers, including those customers where an EQC claim has been assigned by a previous owner of the insured property, can therefore reopen a previously settled EQC claim if, for whatever reason, the settlement is insufficient to discharge EQC’s liability.¹² For example, if additional damage is discovered that requires additional settlement to repair the damage, or the settlement amount is insufficient to meet the repair of the scoped damage based on quotes received by the customer.
- 35 In these and other circumstances, customers are able to come back to EQC, and if EQC determines that a further settlement is payable, receive further settlement from EQC, up to the monetary limit (cap) per event, in order to address the physical loss or damage to the insured property.

¹¹ See section 29(2), Earthquake Commission Act 1993.

¹² The nature of natural disaster damage is such that it is difficult in many cases to determine precisely the amount of that damage, and in these cases there will often be genuinely different views about what the correct settlement of the EQC claim should be.

- 36 There are some limitations to this. One is a financial limitation set by the statutory cap per event. The second is a time consideration set out in the Limitation Act 2010, requiring customers to issue legal proceedings or challenge a settlement of claim for each land, building and contents claims from each earthquake. EQC approaches the six-year limitation as running:
- a where an EQC **claim has been settled**, from the date EQC settled that claim;
 - b where an EQC **claim has not yet been settled**, from the date when EQC settles or declines that claim; or
 - c where a **claim is declined**, from the date that EQC declines the claim.¹³
- 37 In 2015, the Insurance Council of New Zealand suggested in its submission on the discussion document on proposed changes to the Earthquake Commission Act 1993 that consideration should be given to providing a statutory basis on which EQC could make “full and final” settlements with customers. Arguments put forward in the ICNZ submission were that the lack of such provision meant that EQC can never close claims.¹⁴
- 38 In early 2017, Treasury sought commentary from EQC in response to the Insurance Council of New Zealand’s submission. We commented that EQC can, and does, enter into full and final settlement agreements with customer in appropriate circumstances, for example an out of court settlement of disputes in litigation.
- 39 We anticipated that seeking or requiring a full and final settlement in all cases could add additional expense to the claims process, particularly for the large majority of claims that would not otherwise be disputed. In these circumstances, customers would need to be confident the settlement reflected their entitlement to be in a position to agree to waive any valuable insurance rights to seek anything further.
- 40 Our view is that there may be some merit in further clarifying the process under which EQC closes claims when it satisfied that the customer has received their statutory entitlement. Our concern is that including a requirement that *all* settlements are “full and final” may unfairly impact upon a customer’s ability to seek further settlement (such as where new evidence came to light) that would have otherwise be covered by the Earthquake Commission Act 1993.

¹³ Earthquake Commission media release, *EQC’s position on Limitations Act* (1 September 2017), <https://www.eqc.govt.nz/news/eqc-position-on-limitations-act>. See also Earthquake Commission webpage *Limitation Legislation*, <https://www.eqc.govt.nz/canterbury-earthquakes/claims-assessment/limitation-legislation>.

¹⁴ Insurance Council of New Zealand media release, *EQC Act must be changed* (11 November 2015), <https://www.icnz.org.nz/media-resources/media-releases/single/item/eqc-act-must-be-changed/browse/22/>.

9(2)(b)(ii)

