THE EARTHQUAKE & WAR DAMAGE COMMISSION — A LOOK FORWARD (AND A LOOK BACK)

This paper was presented at the 1992 IPENZ Conference
in Christchurch by

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I am pleased to have this opportunity to speak this morning about the Earthquake & War Damage Commission. The invitation to do so was originally extended to our Chairman, Ian McLean, but subsequent to his acceptance he has found it necessary to ask that I take his place. Throughout this paper there will be expressions of opinion. These reflect my own personal view and do not necessarily reflect the view of the Commission or indeed that of other Commissioners. As an introduction may I remind you of the occasion when a somewhat illiterate Irish peasant was appearing before a High Court judge in relation to a civil claim. His counsel was in full flight when the judge interrupted and asked "Mr Brown. Has your client never heard of the dictum......."de minimus non curat lex"?" "Quite the contrary Your Honour", responded Mr Brown, "I am advised by my client that it is the principal topic of conversation in the small village where my client lives." I cannot say the same about the affairs of the Earthquake & War Damage Commission.

The affairs of the Commission - now more frequently referred to as EQC - are certainly not generally the principal topic of conversation except on rare occasions. It is possibly the least understood of all government agencies. That may be, but EQC nevertheless has, since its beginnings, had a significant role in offering a measure of security to property owners who suffer loss as a result of natural disaster, and should there at some future date be a major seismic or volcanic event, EQC will be one of the principal sources of finance for reconstruction.

THE BEGINNING

Just as the Napier earthquake led to a review of building design and construction standards, so the Masterton earthquake of 1942 resulted in the establishment of a statutory scheme of disaster insurance in this country. The perils to be covered by the scheme were earthquake and war and the empowering legislation, the Earthquake & War Damage Act, came into force on 1 January 1945.

The Act made provision for the setting up of a Fund to be known as the Earthquake & War Damage Fund and the scheme was to be financed by a mandatory level, payable with respect to all property insured against loss as a consequence of fire.

The amount of the levy was set at that time at the equivalent of 5 cents per $100 of insured value. The levy remains at that level today. The Act further imposed on insurance companies the obligation to collect the levies on behalf of the Commission.

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Since that time EQC cover has been extended to other perils, and property covered by a policy of fire insurance is generally covered by EQC for loss as a consequence of earthquake, volcanic and geothermal activity, tsunami and landslip. Land under and around dwellings is also covered.

Cover is limited to the indemnity sum insured or the actual indemnity value - whichever is the lesser. If the Fund is unable to meet the claims which may arise, the Act provides that this deficiency be made good by way of grant from the Consolidated Fund. The Act was administered by the State Insurance Office which provided, on secondment, most of the staff and accounting services, whilst Treasury determined and administered investment policy.

No-one has yet attempted to look back on the first 40 years of the Commission's existence and this is certainly not an attempt to do so. I believe I can make a reasonable appreciation of that period and my first reaction would be that little was asked of the Commission over that time, but what was asked of it was done well. It saw itself possibly more as part of the "system", administering an act of parliament than as a part of the insurance industry. It was nevertheless a low cost operation and the annual cost, including discounts payable to the insurance companies, was some 3% of premium income.

After 40 years (31 March 1985) the Fund totalled approximately $1.274 billion, and at 31 March 1988, the last year in which accounts were drawn up in accordance with the original Act, the Fund totalled approximately $1.773 billion. (As at 31 March 1991, shareholders funds totalled $2.14 billion).

THE BEGINNINGS OF CHANGE

In the early 80s the Commission addressed the matter of its resources and its liabilities and, with respect to the last, asked the N.Z. National Society for Earthquake Engineering to carry out a study to determine "Losses Due to a Catastrophic Earthquake". At about the same time the Commission canvassed the international reinsurance market for the purpose of enhancing its resources. The first quotations received by the Commission were seen as "too high" and the matter was deferred.

It was again taken up after receipt of the NZNSEE study and whilst the reaction as to cost was the same, it was nevertheless apparent that the resources of the Commission were meagre compared with the likely cost of a major earthquake and, on the basis that the implications of this went far beyond the affairs of the Commission, wrote accordingly (in 1986) to the then Minister. Pending a reply, the Commission negotiated a reinsurance contract for $1 billion with an excess of $1 billion. At the same time also, there occurred a major earthquake in the eastern Bay of Plenty, drawing attention to the limited resources available to the Commission. In 1988 came the reply to the Commission's letter.

1988 AND ALL THAT

In July the then Labour Government made known its intention to introduce change and issued a discussion paper setting out a changed philosophy regarding the role and functions of the Commission. The principal reason for change was said to be the costs which the state would be called on to bear following an earthquake of disastrous proportions in a densely populated area, more particularly Wellington. Although the paper reflected the then Government's philosophy of "level playing fields" and the establishment of "a competitive market", its credibility was dependent on the validity of two assertions:

i) that claims against the Fund could, as a consequence of a major disaster, total $20 billion compared with its resources of some $3 billion including reinsurance; and

ii) that up to 20% of domestic property in New Zealand is not insured and owners of such property would have great difficulty in becoming re-established if they suffered major loss.

As a means of overcoming these problems, the paper proposed that legislation be introduced to:

(i) provide for compulsory insurance of domestic property, such property to be covered for replacement cost of a "notional" house, this to be so irrespective of whether the property was insured against fire.

(ii) permit insurers engaged in the provision of fire and marine insurance to offer earthquake insurance, this in furtherance of a political philosophy and a fond belief that the contingent liability of the state could thus be transferred to the international reinsurance market.

The Minister invited public comment on the proposals and those received were referred to a committee appointed by the Minister, comprising 2 representatives of the insurance industry and an officer of Treasury. The proposals were not well received by those who responded to the Minister's invitation and the Committee reported unfavourably. The Minister, however, chose to accept the minority view of the Treasury official and, as a consequence, the Disaster Insurance Bill was introduced to Parliament in late 1989 and referred to a Select Committee of the House. To be fair, EQC was, during the discussions on the Paper, not as well informed as it might have been on the two major issues, that of the Maximum Probable Loss (MPL) of a major disaster and the level of domestic insurance - and its early submissions were not well founded.

By the time the Select Committee met, EQC was well informed and was able to put forward together with the Insurance Council, cogent and persuasive arguments on almost all the contentious issues.

An appreciation of a more credible event in the Wellington area indicated an MPL no greater than $5 billion and a study of the extent of insurance on residential property suggested that some 96% of all such property is indeed covered by insurance. The Commission expressed concerns on other aspects of the Bill, the inordinate cost of carrying out its monitoring role and also the lack of any provision for prudential control over the insurance industry. Again, neither Treasury nor the Minister were persuaded but others were, and the Bill was finally dropped from the Government's legislative programme. It languishes still in the Select Committee, never having been reported back to the House.

I now have to turn the clock back a little as while this was going on, legislation had been introduced (on Budget night), effecting major change to the Earthquake & War Damage Act. With the thought perhaps that the Government's contingent liability would in future rest comfortably with the international reinsurance market, the discussion paper had suggested that the EQC fund should not be permitted to grow other than at a rate comparable to the inflation rate. With this firmly in mind, the amending legislation provided that the Commission pay:

(i) a dividend
(ii) a sum in lieu of tax
(iii) a guarantee fee

It was intended that the "fee" be penal in nature to encourage the Commission to extend its reinsurance, a thought which could only emanate from the well intentioned but not the well informed.

The EQC reinsurance programme was already thought in the market to be the largest catastrophe reinsurance programme in the world and well established insurers were at or near the limit which they would write for any single insurer. Moreover, both the price and availability of reinsurance fluctuates according to the market and the recent experience of disasters world-wide. As a consequence of this change, EQC has paid into the public coffers approximately $700 million over the past 3 years. The same budget legislation made changes to the capital structure of the Commission and I will refer to that matter later in this paper.

FURTHER PROPOSALS FOR CHANGE

Neither the demise of the Bill in mid 1990 nor the impending election deterred those intent on change and EQC was again subjected to scrutiny, this time by an international firm of insurance brokers, acting through its NZ office. The findings could hardly be described as memorable although comment made with respect to the assets of the Commission were taken

up by Treasury and subsequently reappeared in a later discussion paper to which I will shortly refer. Within a short time of the change of Government in late 1990, the incoming Minister in charge of EQC announced that the Disaster Insurance Bill would not proceed in its then form. In mid 1991, he released a further paper, "*The Government's Role and Responsibilities in Disaster Insurance*". The principal reasons for change were stated to be:

i) The underlying objective of the Government in relation to natural disasters must be to reduce stress.

ii) The resources of the state will inevitably be limited in dealing with the aftermath of a natural disaster,

iii) The Government's actions in making prior arrangement against disaster should complement, not replace, the actions of private parties in making their own insurance arrangements.

The underlying philosophy was that the Government does have a responsibility to make sure that people are housed after disasters and that it is prudent to make arrangements in advance. On the other hand, commercial enterprises should be expected to make their own provisions for recovery.

The paper considered 3 areas of change -

- the nature and extent of EQC cover;
- the structure of EQC;
- investment policy.

Again, there has been the opportunity for submissions and these generally supported the principles, if not the detail, of the proposals. We understand that the Minister should soon be in a position to announce firm decision on the new regime. The proposals in the discussion paper, together with changes that may be made as a result of the submissions, are as follows:

THE NATURE AND EXTENT OF EQC COVER

1. Residual Property

The mandatory provisions of the present legislation would remain but would only apply to "the principal place of residence". Cover would be limited and the proposed cap is $72,000 based on indemnity value and cover on contents would be limited to $10,000. Owners of property seeking a higher level of cover would be required to arrange this through an insurance company. The principle of a "cap" is not in dispute and although the proposed figure would cover two-thirds of all residential property, the Commission would like to see this increased to at least $100,000.

The Commission has not always found the concept of indemnity a comfortable one even as it relates to residential property, particularly when NZ courts shy away from a useful definition. This not only creates problems in determining how much the insured should be paid, but also in the apportionment of liability between EQC and the insurance companies where (as in most cases) excess of indemnity cover is bought from insurance companies. The Commission accordingly prefers that cover be related to replacement. The level of the "cap" will be regularly reviewed.

2. Commercial Property

EQC cover on commercial property will be progressively withdrawn. An introduction date has yet to be announced but the paper proposes that in the first year thereafter, EQC cover be limited to 66% of indemnity value, 33% the following year and beyond that time would no longer be available.

The mandatory levy has long been a controversial issue with the commercial sector and there have been many attempts to develop insurance policies which effectively limit the insured sum on which the EQC levy is calculated or otherwise avoid it entirely by placing cover off-shore. This has unfortunately involved the Commission in complex and expensive litigation. The Privy Council recently ruled on a matter which first came to the attention of the Commission in the early 80s, and in doing so upheld the Commission's interpretation of the Act. This will be an embarrassment to a number of companies. The ink on Their Lordship's decision was barely dry before a variation of this type of policy emerged, designed again to limit the amount of the EQC levy. The Commission has no option under the existing legislation but to challenge these practices but it is a wasteful and unnecessary use of resources. I welcome change which will obviate the need for practices which can best be described as questionable.

The Eastern Bay of Plenty earthquake gave rise to the largest insurance claim yet in this country, in excess of $100 million. The "Bay Milk" case highlighted the problems associated with the concept of indemnity as the basis for EQC cover where cover in excess of indemnity is carried by a private insurer. Subsequent litigation was expensive and the need to have the matter decided in Court led to great uncertainty and inconvenience to all parties. The prospect of ever having another "Bay Milk" on the books in the future can only lead to further enthusiasm for change.

3) Motor Vehicles

Motor vehicles will no longer be covered by EQC.

4) War Damage

War damage cover will cease.

5) Prudential Control

There are no proposals for any statutory form of prudential control over the insurance industry beyond those which at present exist - a $500,000 bond. My greatest concern is that it reflects an extension of the concept of "caveat emptor" into an industry in which no other OECD country sees it to be appropriate.

THE STRUCTURE OF THE COMMISSION

The proposals relating to this matter might be seen as simply technical, but they could have a major impact on the long-term effectiveness of the new regime. If control in all significant aspects returns to the Treasury, then one can expect the same failures as occurred in the past with departmental management of commercial or semi-commercial activities. While the direct impact on policy-holders may not be discernible in the short term, their ultimate interest lies in having the most efficient scheme possible.

INVESTMENT POLICY - "THE FUND"

The paper proposes that the EQC fund be managed as part of the Crown's overall reserves. In simple language this means that instead of registered securities in one form or another, the Government would in effect issue to EQC promissory notes or IOUs. In other words they would see the Commission income as their own and would endeavour to borrow, at the appropriate time, whatever amount was required to meet the claims which might arise from a natural disaster. The notion of a Fund would be preserved by an entry in the Government accounts.

Except perhaps at the very beginning, no Government has made any real endeavour to give any credibility to the Fund. Its assets are all held in New Zealand in either Government Stock or Treasury Bills. That this is so has been the subject of frequent criticism, one of the more recent critics being Treasury itself. This only goes to show that there are sections within Treasury who never talk to each other as the Commission's investment policy has been established and administered by Treasury since the beginning. Our great concern is the fact that these assets are held wholly as kiwi dollar instruments. Until about 1983, approximately 10% of the Fund was domiciled off-shore but for reasons best known to the then Minister of Finance these funds were repatriated. The Commission is hopeful that the Government will accept a proposal that all the future cash surplus be invested off-shore. Should this not be so, a future Minister of Finance will undoubtedly view with great disfavour the decisions taken in the 80s and 90s as he/she endeavours to finance the rebuilding of a devastated city.

In a somewhat covert manner, the character of the Fund was changed in 1988 when, in the budget legislation at that time, the Commission became a "Body Corporate" with a capital of $1,500 million, held in the name of the Minister of Finance and deemed to have been subscribed and paid for in full from the Fund. What has in the past been perhaps loosely called the "Fund" must now more correctly be referred to as shareholders funds. This can lead to an element of farce, and a prime example is the suggestion put to the Commission by Treasury some 2 years ago, that the Commission might like to consider increasing the levy, not because of any greater perception on the part of Treasury of the risks carried by EQC, but for the purpose of enhancing the return on shareholders funds.

CONCLUSION

This is an appropriate point to conclude this review of the Earthquake & War Damage Commission. There are many matters which I have not addressed, that of differential rating is a topic in itself. My objective was to bring before you matters which are relevant to your interests but of which you may not be aware. I certainly do not wish to leave the impression that I am opposed to change. Along with other Commissioners, I have, at times, found it extremely difficult to accept that the changes proposed adequately address the problem to which they are directed. As the changes outlined in this paper take effect, the Government's contingent liability will be reduced and possibly extinguished. The obligation with respect to the "Fund" itself will remain.

It would not be appropriate to conclude this address without acknowledging the contribution which members of your Society make to the work of the Commission. The Commission is very conscious of the expertise you can bring to bear on matters in which we share a common interest, and appreciates the manner in which your members respond to both our formal and our informal requests for assistance.