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Minister of Finance and Minister Responsible for the EQC
Executive Wing
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Hon James Shaw
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Nicola Willis MP
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Dear Ministers, Members of Parliament and Rev Stephen King,

Issues Raised at a Public Forum held at St Peter's 18 August 2020

Thank you, Stephen, for organising the forum that examined seismic strengthening regulations, insurance and the Unit Titles Act and for enabling remote attendance as well as a providing a record of what was said. I have distributed this recording to our member insurers and reinsurers here and overseas who provide the capital to support New Zealand's risks.

As you know, the Insurance Council has participated in the 2019 Mayoral Taskforce and attended several public forums including with body corporates to explain in some detail what has influenced insurance pricing and the non-insurance issues that need to be addressed to reduce seismic risk and support the affordability and availability of insurance. ICNZ and individual members have also engaged with The Treasury openly and constructively to improve understanding of (re) insurance markets and pricing, so well-informed advice is provided. I had a sense from the meeting that there was a tripartite will across the political candidates to address the issues. We are very willing to engage with you collectively if that were the case or individually if that is your preference to address any issues in more detail.

It is important that responses to the situation are proportionate, carefully thought through with the full facts and wider context, address the actual risk and do not create unintended consequences or set expectations with apartment owners that cannot ultimately be delivered on. Some commentary at the meeting suggested that there are relevant issues that may not be well understood and there were factual errors that we would like to correct.

Better understanding of earthquake risk

The 2010-11 Canterbury earthquakes, the 2013 Seddon earthquakes and the 2016 Kaikoura earthquake resulted in a much better understanding of seismic risks and potential losses from such events in the future. It was rightly pointed out there have been significant increases in earthquake premiums over the past 10 years. That is because insurers' understanding of risk prior to the Canterbury earthquakes was based on modelling at the time that grossly underestimated potential losses. In effect, premiums at that time were significantly under-pricing the underlying risk, so a price adjustment to better reflect actual risk was inevitable.

For example, in February 2012, the State-owned Earthquake Commission's home insurance levy tripled from $69 to $207 including GST. Insurers' premium rates also increased as did reinsurance rates. In the commercial property sector, earthquake insurance deductibles, the amount the insured must meet before insurance payments are triggered, generally moved from 5% of the insured loss to 5% of the sum insured. This results in different outcomes for apartment owners who pay for a complex risk, an apartment block, vis-à-vis an owner of a stand-alone house where the deductible is significantly lower and can be adjusted higher by the insured at their choice.

Experience from the Canterbury earthquakes demonstrated the damaging losses from multiple events in a built urban environment and included insights into the impact of widespread liquefaction of soft soils. As you know, many buildings in central Wellington are located on reclaimed land where water once lapped Lambton Quay. This is extremely soft soil and highly vulnerable to liquefaction.

It was claimed at the meeting that insurers base their underwriting decisions for a commercial property on where it is located in a postal code area. This is incorrect. Insurers use geocodes, which are sets of longitude and latitude of a physical address, and plot these on soil maps to inform exactly what type of soil a property is located on. Postal codes cover many blocks of streets and varying soil types. They also rely on information about the date of the building's construction (as an indicator of structural resilience reflecting building standards operative at the time), as well as the height of a specific building and the material used in its construction amongst other things like the state of wiring, plumbing and fire protection. Insurers may also take into consideration the state of adjacent properties too as the collapse of less resilient buildings may affect more resilient ones In the context of climate change, flood events, and coastal inundation, insurers are able to access flood maps that provide a level of granularity down to 5mx5m in urban areas and 8mx8m in rural areas. Various inundation scenarios can be over-layed across property portfolios to show the relative risks of individual properties.

It is possible the reference to postal codes arose from a misunderstanding. Some insurers may run stocktakes on all their property risk aggregates in one location on a regular basis so they understand exposure and match to their reinsurance treaty arrangements. This is not an underwriting exercise, but necessary to ensure alignment to agreements with reinsurers who provide the bulk of the capital support should there be a catastrophic event.

The Kaikoura earthquake, epicentre 200 kms from Wellington, caused the most insured loss in the capital and most of that loss was to commercial property including several buildings that were constructed this century and well above the New Building Standard (NBS). The NBS is a life safety factor for buildings and not a clear measure of a building's resilience to earthquake damage. Despite this, property owners have clearly been under the impression that strengthening their buildings to a higher NBS addresses structural resilience when this may only be partially true. Sadly, this has resulted in significant investment and the expectation that this would lead to a premium reduction. We have said publicly on many occasions over recent years that the NBS is only a life safety measure, not a measure of structural resilience. We pro-actively repeated those messages again last year to a public meeting convened by the former Mayor, but clearly this was news to some at that meeting. The NBS needs to be redesigned to also reflect structural resilience. This is something we have advocated for some time.

It is fair to say that better communication about risk between insurer and the insured is needed and equally better communication is required between government and building owners about the NBS and precisely what it measures. From the insurers' perspective, we were never consulted prior to the assertion that upgrades to NBS on structures would result in a premium decrease being made. In almost all instances, insurers and likely insurance brokers would not be aware that such investment was occurring until it was completed. However, better two-way information flows must occur between insurers, brokers and the insured. One of the barriers to this is the chain of communication. Insurers are required to communicate directly with brokers, not the end customer in the unit title property or commercial unit. Brokers communicate with body corporate chairs who procure the insurance and it is the body corporate chair that communicates with the unit title owners. This situation is worthy of review specially if individuals are to obtain better information on why their insurance premiums are changing. Local and central government have a role to play in setting expectations here too.

It is noteworthy that the NBS is reviewed and adjusted every ten years or so. Unit title holders that upgrade to today's standard may find the need to invest in a further upgrade a decade later. Those in structures with low NBS today have clearly not upgraded in the past.

A pejorative reference was made at the meeting that internal, non-structural damage to buildings had led insurers to adjust prices even though buildings had been structurally undamaged. One of the learnings from the Canterbury earthquakes was that over 40% of insurance losses in commercial properties resulted from the failure of non-structural seismic restraints. Over the years since, we have been at pains to point out to Parliament and the Government that we believe there is systemic non-compliance with NZS4219 and NZS1170.5 for the installation of these elements that support, ceilings, partitions, glazing, air conditioning, electrical, telecommunications, plumbing and sprinkler systems. An MBIE random survey three years ago of 20 commercial properties identified that 19 were non-compliant with the standard. Nothing has been done to address this issue and the risks remain and as long as they do, they will be factored into the pricing calculation. The 2013 Seddon earthquake resulted in multi-million dollar insured loss and business interruption to the BNZ Centre Harbour Quays four years after it had been built due to the failure of non-structural seismic supports. The Kaikoura earthquake caused this building to subsequently become a total loss.

It is instructive to note that modelling companies upon whom insurers and the EQC rely to inform them of their exposure do not use the NBS as a primary indicator of risk. Rather they rely on the factors I have outlined – location, soil type, period of construction and type of material used. Two of the main suppliers of seismic models for New Zealand revised their models drawing on the Canterbury and Kaikoura earthquakes as well as new information on the risks posed by the Hikurangi Trench subduction zone off the east coast of New Zealand and the Alpine Fault which is overdue to rupture. These faults are capable of releasing megaquakes in excess of M8.0. These models have elevated New Zealand's overall seismic risk significantly and inform insurer and reinsurer understanding of risk.

Regulatory solvency requirements

These models also inform how much capital or reinsurance risk insurers must purchase because they estimate the maximum probable loss a (re)insurer could face from an event. The Reserve

Bank of New Zealand (RBNZ) requires insurers to hold a minimum level of capital to meet the probable maximum loss resulting from a M7.0 earthquake with an epicentre at the Beehive. Insurers though, depending on their appetite for risk, which they must articulate to the RBNZ, may prudently decide to hold more capital or purchase more reinsurance than such an event. The material point being that Wellington's risk is critical to many insurers maximum probable loss calculation that reflects their risk appetite.

It is noteworthy that between 2012-17 insurers were required to progressively increase their probable maximum loss provisioning from a 1:250 year to a 1:1000 year event, the highest we believe in any jurisdiction globally. That too has contributed to costs.

Regulatory interventions

The meeting also heard about potential interventions in the insurance market. One suggestion was an increase to the EQC cap. Whether this would require the entire country to meet the cost of a Wellington solution or a more targeted increase to the cap for apartment dwellers only was contemplated was not clear. However, the point is that an increase in the cap does not address the underlying risk; it simply mutes the price-risk signal and could encourage people to continue to live in less resilient structures. A unit title holder in a low resilient apartment where the market value is well below the replacement value would experience a windfall gain from a total loss in a major earthquake, subsidised by other New Zealanders. It would also incentivise the conversion of low resilient commercial property into residential apartments.

It was also suggested, which is of concern if the point is correctly interpreted, consideration could be given to require insurers to spread their risks to include higher risks in their portfolio regardless of their appetite for risk. Although it is premature to gauge the potential reaction to that, it would be important to ensure that did not discourage insurance and in turn reinsurance support for New Zealand. Reinsurers will not price below the actual risk.

A comment was also made that risk-based pricing was "unfair". Risk-based pricing has of course been a fundamental part of insurance for hundreds of years. The focus on the term in recent years has arisen because better technology and data analytics enables insurers to better understand individual risks at a granular level and therefore to price each more accurately and fairly. It would be unfair to charge lower risk properties more in order to subsidise higher risk ones.

Unit Titles Act

The meeting heard that the Unit Titles Act (UTA) requires property owners to fully insure and that some owners may be non-compliant. It was said lack of earthquake insurance had prevented some apartment owners from being able to sell and had left them "trapped" and unable to pass the predicament on if there were a prospective purchaser. We are very sympathetic to that situation and also to property owners who invest in high levels of seismic resilience, such as base isolation techniques, being legally unable to retain more risk. It is also a fact that lenders on property developments do wish to have their loan secured against insured properties. In California lenders loan on commercial property if it meets a certain level of structural resilience and if that is not met insurance must be obtained.

One issue with the UTA we have raised for almost a decade is the requirement for 100% agreement among the co-owners for the way damage is repaired. This proved a significant stumbling block to recovery in Christchurch with multi-unit buildings and those in cross-lease situations, some of which were cash-settled and not rebuilt.

There are a number of tensions in the current UTA that need addressing. There may be merit in holding discussions with key stakeholders about the way forward. However, it was far from clear at the meeting that all issues will be addressed as there was an indication that piecemeal change may be preferred to a more comprehensive review.

Risk treatment and retaining (re) insurance support

Where risk presents and needs to be managed there is a standard risk management framework to adopt which looks at how to Adapt, Control, Transfer and Avoid the risk. Insurance simply acts as the canary in the mine by indicating through premiums actual risk. Our sector is fully co-operative with the Treasury in explaining how our pricing is derived to provide re-assurance that the price increases have been driven by the understanding of the risk and regulatory requirements. The prices for commercial property earthquake risk in Wellington are now comparable to rates in Japan and California which face similar seismic risks. The adjustments that have occurred over the past decade only serve to reflect how under-priced New Zealand property risk was for many years. A singular focus on trying to suppress insurance price-risk signals or to attempt to force insurers to accept more risk than they deem prudent or sustainable must be avoided. It is vital that a high-risk country like New Zealand continues to attract reinsurance support and the very last thing we should be doing is giving signals that may deter that support.

Insurance should be allowed to signal risk and if affordability issues arise these should be addressed through social policy mechanisms available to the Government as occurs in so many other areas like housing or power supply affordability. There are no quick-fire, sustainable solutions. Indeed, with a similar set of issues presented in the climate change space, there is a need to develop a comprehensive approach to risk management, rather than readily blame the insurance sector and reach for short-term measures.

Yours sincerely

Tim Grafton CMinsD
Chief Executive