

# THE GOVERNMENT'S ROLE AND RESPONSIBILITIES IN DISASTER INSURANCE

## 1.0 Introduction

- 1.1 This submission is made on behalf of the New Zealand Business Roundtable (NZBR), an organisation of chief executives of major New Zealand business firms. The purpose of the organisation is to contribute to the development of sound public policies which reflect overall New Zealand interests.
- 1.2 The NZBR has participated in recent reviews of New Zealand's disaster insurance arrangements because of the importance which it attaches to the establishment of an adequate set of policies to mitigate the economic consequences of a major disaster. Risk management techniques such as disaster insurance form part of this set of policies. Because the resources committed to disaster insurance are substantial, and are currently channelled in large part through a state insurer, the efficiency of the insurance market and the performance of insurance organisations in it are significant public policy issues.
- 1.3 Previous submissions were made to the former associate minister of finance on the White Paper, *Disaster Insurance Policy*, and to the Commerce and Marketing Select Committee of the House of Representatives on the Disaster Insurance Bill.
- 1.4 The thrust of the present submission is that the government's proposals to allow a competitive and voluntary market for disaster insurance in respect of property other than residential property is desirable. The move to relax the requirement for homeowners to buy disaster insurance if they insure their homes against the risk of loss from fire is also a step in the right direction. In contrast, we believe that further consideration should be given to the following aspects of the proposal:
  - (i) The appropriate role for the government in respect of disasters;
  - (ii) The desirability of competition in the supply of disaster insurance to homeowners; and, most particularly,
  - (iii) The role and organisational form of the Earthquake and War Damage Commission (or its successor).

The remainder of this submission focuses on the above areas where we believe improvements should be made.

## 2.0 IS COMPULSORY INSURANCE OF RESIDENTIAL BUILDINGS JUSTIFIED?

- 2.1 Under the proposals, homeowners who buy fire insurance in New Zealand would also be required to insure their properties with the Earthquake and War

Damage Commission (EQC) against loss from a natural disaster. The sum to be insured would be the lesser of the property's indemnity value or \$72,000. The latter represents around two-thirds of the average value of houses (Annex two of the paper refers). The EQC would be the sole provider of such insurance and it is to charge a flat premium, regardless of the risk characteristics of the particular property (e.g. its location on a fault line or in a low risk locality).

- 2.2 As far as residential buildings are concerned, this proposal represents a minor relaxation of the present compulsory scheme. Currently, homeowners are required to insure their properties for their indemnity value (without limit) if they buy fire insurance in New Zealand. Thus, where homes have an indemnity value greater than \$72,000 (excluding land and certain improvements, such as garages), the owners would be able to choose whether to insure their additional investment and from whom that insurance would be purchased. However, we suspect that most homeowners will be unaffected by the proposal as the indemnity value of many properties is unlikely to exceed \$72,000. Because houses in high risk areas such as Wellington tend to have a higher value than the average New Zealand house, the proposal will result in a lower ratio of insurance cover to indemnity value in high risk areas than in other areas. This would be a perverse outcome.
- 2.3 In our submission to the former Associate Minister, we examined the question of whether compulsory insurance was justified (see pages 8 to 14 of that submission). In paragraph 4.26 we expressed a sceptical conclusion and suggested that the government had not shown that the benefits of compulsory insurance outweighed the costs involved.
- 2.4 The key arguments advanced in the paper for compulsory disaster insurance in respect of residential property are, first, that the state has some responsibility for homeowners who could not look after themselves in the event of a disaster and, secondly, that the commercial insurance market may not be able to provide disaster insurance for all residential property (paragraphs 16 and 17 of the paper refer).
- 2.5 These arguments are not compelling. The paper does not provide an analysis which shows that the cost benefit test has been met. While there is a free-rider problem associated with disaster insurance (as with many other activities), this problem can be contained by a clear policy statement on the extent of government assistance in the event of a disaster; by limiting that assistance to civil defence services, initial emergency accommodation assistance (e.g. in halls, schools and tents); and, beyond that, by the availability of the government's existing means tested welfare assistance. If such a policy were adopted, communicated and implemented as situations arise, (such as storms and floods), we believe that the residual free-rider problem would not be of sufficient magnitude to justify the level of compulsory insurance envisaged in the current proposal. The paper itself downplays the free-rider argument and points out that uninsured property owners would not rank high in claims for government assistance.
- 2.6 We are sceptical that private insurance markets would not respond to the community's demand for disaster insurance cover. Furthermore, should the

insurance market be unable to absorb the risk, in the absence of price controls, the government should be particularly careful about stepping in because there may be valid economic reasons for such an outcome. We suspect that some of the concerns expressed by existing insurers on this point are essentially designed to limit competition, not just in the provision of disaster insurance but more particularly in the provision of general insurance to homeowners.

- 2.7 It should also be noted that the current proposal will bear more heavily on people who are less well off. They will tend to own lower-valued houses which will be insured compulsorily, while those with more valuable houses will have some choice and they may be better placed to insure their property offshore, thereby avoiding entirely the compulsory levy. As is the case now, some less well-off people may be forced to forgo fire insurance, which they would prefer to buy, in order to avoid the unaffordable cost of disaster insurance on the indemnity value of their house.
- 2.8 The foregoing arguments have even greater force in relation to the compulsory insurance of household contents. Any suggestion that the government has a social responsibility in respect of items such as floor coverings, light fittings and appliances would not stand up to close scrutiny. Similarly, we do not accept that the private market does not have the capacity to insure the first \$10,000 of household contents.
- 2.9 While we are unconvinced of the arguments for compulsory insurance of residential properties, if the government wishes to adopt this course we would suggest a lower ratio of insurance to the value of the house, say 50 percent, differentiated on a regional basis, with no compulsory insurance for household contents.

### **3.0 COMPETITION IN THE SUPPLY OF DISASTER INSURANCE**

- 3.1 If the government were to decide that some minimum level of compulsory disaster insurance should be imposed on homeowners, it could achieve that objective by regulation without also needing a state agency to provide such insurance. Thus the continued provision of compulsory disaster insurance cover by the EQC, without competition up to a regulated level of coverage, requires separate justification. We submit that adequate justification is not provided in the paper.
- 3.2 There is a wealth of information which shows that monopolies provide low quality services to consumers, that their product range is limited, that they are unresponsive to genuine complaints from consumers, that their costs are excessive and that they do not innovate as much as firms subject to competition. Furthermore, state-owned monopolies are subject to the additional disadvantage of weak monitoring by their owners which accentuates these problems. For these reasons, we are opposed to the proposition that the provision of compulsory disaster insurance should remain a state monopoly. We also believe that this would result in greater risks than necessary being assumed by taxpayers, thereby defeating one of the original objectives for reviewing the EQC scheme.

- 3.3 A flat rate of premium is also undesirable. It could only be sustained by a monopolist. The chief disadvantages of a flat rate are that it impairs the incentive for households to undertake optimal amounts of damage prevention (such as steps designed to minimise the risk of damage in the event of a disaster) and distorts location decisions. It will tax homeowners in low risk areas and subsidise those that face the largest risk of loss from a disaster.
- 3.4 There are no valid equity or social grounds for a flat rate levy nor would the cost of implementing an appropriate system of risk rating be excessive. If the government wished to assist some homeowners on social grounds, it should direct such assistance to people in need. A needs-based approach would be unlikely to include many homeowners.

#### **4.0 THE ROLE OF THE EARTHQUAKE AND WAR DAMAGE COMMISSION**

- 4.1 The paper argues that the proposed changes in the provision of disaster insurance mean that the EQC would not be a commercial participant in the insurance market and that it would not be constrained by the disciplines of meeting rate-of-return objectives. Its structure would be changed to what is claimed to be a more suitable one for the delivery of "social services". As a consequence, its risks are to be managed as part of the Crown's general reserves.
- 4.2 This aspect of the proposal, which is discussed on pages 11 to 15 of the paper, appears to be based on the seriously flawed analysis presented in the Marsh and McLennan report. At a most basic level it is abundantly clear that disaster risks have no place in a national reserves portfolio. The risk to be managed is stochastic (random) and of relatively long duration. Such risks require long duration assets to be matched against them to hedge the risks. Few long-lived assets which would be unaffected by a disaster are available in New Zealand. On prima facie grounds a diversified asset mix is required to hedge the risk undertaken.
- 4.3 The shortcomings of the Marsh and McLennan report are as follows:
- While noting that the EQC's monopoly had distorted the market for disaster insurance, the report failed to consider the implications of its conclusions for the efficient functioning of the disaster insurance market.
  - The report failed to analyse the nature of the EQC's liabilities and the risks inherent in them and thereby deduce the nature of the assets required to appropriately manage those risks. As a consequence it suggests that the risk be covered by Crown borrowings when a disaster occurs and by a loose consideration of the level of foreign reserves held. In this regard, the report is simply out-of-date with contemporary private sector risk management practice.

- The report places undue emphasis on the need for liquid reserves in the event of a disaster, thereby under-stating the importance of other characteristics of the portfolio required to hedge disaster risks (e.g. the duration of assets), and the impact on the risk/return trade-off involved with diversification of the portfolio.
- The report gave undue attention to accounting issues, such as the debt to GDP ratio, and implicitly assumed that financial markets are inefficient. For example, it implies that financial market participants and credit rating agencies do not take account of the contingent liability on the Crown as a result of its ownership of the EQC. Given the public debate on disaster insurance arrangements which has taken place since 1988, this is an unsustainable presumption.
- The report correctly identified greater private sector provision of disaster insurance as being desirable and noted that privatisation of the EQC would also be an option, but then dismissed the latter option without serious analysis. We question the validity of the argument advanced for this conclusion. There are many possible ways in which EQC risk could be transferred to private risk takers.
- The report fails to analyse the implications of its approach for the incentives facing the management of the EQC and their accountability, thereby ignoring the lessons from the past poor performance of state agencies and the substantial literature which underlies the worldwide move to the corporatisation and privatisation of state businesses.

4.4 In short, the proposals advanced by Marsh and McLennan represent a return to pre-1970s thinking. They ignore industry practice in approaches to risk management and in the organisation and management of state businesses. The report did note some better options but, for reasons which are not fully explained in the report, it dismissed them.

4.5 In our view the preferred approach would be to adopt the following course of action:

- Implement all steps necessary to ensure that the market for disaster insurance operates as efficiently as possible. This would require low barriers to entry and exit and reform of the EQC so that it operates on a competitively neutral basis.
- Re-examine the case for requiring compulsory insurance of residential properties and household contents. We are sceptical that a compulsory minimum level of cover is justified but if it is imposed we believe a lower limit established on a regional basis (so as not to discriminate against lower housing cost regions) should be applied, and set at a level which would cover an estimated half rather than two thirds of all houses.

- The EQC should be first established on SOE principles and subsequently privatised. Because of special difficulties involved in monitoring entities engaged in disaster insurance activities, there is a case for restricting the business of the EQC to the provision of compulsory insurance (in competition with private insurers in this segment of the market).
- The review of the taxation of insurance activities should be concluded. It should involve the implementation of a regime which, as far as practicable, taxes domestic and foreign insurance activities on a neutral basis.
- Any attempt to raise barriers to entry through the guise of prudential supervision ought to be resisted. We do not think that there are valid grounds for industry-specific prudential regulation, but if the government were to move in this direction the best approach would be to require insurers to be rated as to their claims paying ability by a recognised insurance rating agency.

The grounds for these views are set out fully in our previous submissions.

## 5.0 CONCLUSION

- 5.1 The NZBR believes that the proposals set out in the paper relating to the insurance of non-residential property are desirable and should be implemented. It is of the view, however, that further steps should be taken to enhance competition in the provision of disaster insurance to homeowners. The government's role in the event of a disaster should also be more tightly defined and spelt out clearly as part of a move to a more credible and transparent policy.
- 5.2 In addition, we believe that the section of the paper relating to the organisation of the EQC and the management of its risks is unsound. It draws heavily on the Marsh and McLennan report which is flawed. We believe that standard SOE principles should initially apply and that the EQC should then be privatised. Standard industry approaches to risk and asset management should be used, the EQC's risk should be sold down to private risk takers, as far as possible, and private investment managers with proven performance should be engaged.