

**SUBMISSION TO THE COMMERCE AND MARKETING
SELECT COMMITTEE
OF THE HOUSE OF REPRESENTATIVES**

DISASTER INSURANCE BILL

**NEW ZEALAND BUSINESS ROUNDTABLE
JANUARY 1990**

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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 interest taken in this topic flows from the importance of establishing an adequate set of policies to mitigate the economic consequences of a major natural 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 Our comments on the Bill are based on an NZBR study, *Disaster Insurance Policy: A Submission to the Associate Minister of Finance*, undertaken in 1989. (A copy of the study accompanies the submission.) It was prepared in response to the Minister's request for submissions on the government's White Paper, *Disaster Insurance Policy*. The essential features of the Bill are similar to those proposed in the White Paper and thus the analysis outlined in our previous study is relevant to the Committee's deliberations.

1.4 The thrust of our submission is that compulsory disaster insurance in respect of most homes has not been justified and that, consistent with the government's general policy on state-owned enterprises (SOEs), the Disaster Insurance Commission of New Zealand (DICNZ) should be privatised at the earliest opportunity.

2.0 The Government's Proposals

2.1 The key provisions of the Bill are as follows:

- the introduction of mandatory disaster insurance cover for the replacement of most homes; and
- the establishment of the Disaster Insurance Commission of New Zealand as the successor to the Earthquake and War Damage Commission and as an insurer of homes and other property against damages due to natural disaster. It would compete with other insurers for such business.

2.2 Under the Earthquake and War Damage scheme, a homeowner can avoid or reduce earthquake and war damage cover and levies by not insuring the property against fire in New Zealand or by understating its value. Where such a property is insured against loss from fire, earthquake and war damage insurance is required up to its indemnity value (which approximates its current fair market value). This would generally be less than the property's replacement value. Thus in respect of homes, the proposal significantly extends the requirement for compulsory insurance against loss from earthquake and certain other kinds of disasters. The exemptions provided for in clause 18 of the Bill are likely to exempt few private homes.

2.3 In respect of property other than homes, the Bill effectively provides for the abolition of compulsory insurance for earthquake and war damage where fire insurance is taken out in New Zealand.

2.4 The Earthquake and War Damage Commission (EQWDC) currently supplies cover for property insured under its scheme. Other insurers write policies in respect of the difference between indemnity and replacement value. Under the Bill private insurers will have a greater opportunity to compete for disaster insurance business in respect of property.

2.5 There is provision in the Local Government Act 1974 for local authorities to require a dangerous building to be repaired or taken down at the owner's expense. This power could be exercised in the event of a natural disaster. The policy incorporated in the Bill is directed at the permanent reinstatement of housing rather than public safety and our evaluation of it has been prepared accordingly.

2.6 These proposals raise the following two main issues on which our submission focuses:

- is compulsory disaster insurance justified?; and
- the role of the Disaster Insurance Commission in the insurance market.

3.0 Is Compulsory Disaster Insurance Justified?

3.1 This question is examined on pages 8 to 14 of the NZBR study. The main points are summarised below.

3.2 The key argument for compulsory disaster insurance, as the White Paper puts it, is as follows:

"Compulsory disaster insurance was favoured because it was felt that the absence of compulsion would lead to two interrelated problems. One is the likelihood of widespread non-insurance among residential property owners, and the resulting disruption to accustomed standards of living following a major disaster. The other is the effect non-compulsion would have on the finances of a Government that felt obliged to assist people with reconstruction."

3.3 In respect of the first point - that individuals would choose not to insure against loss for disaster - we make the following comments:

- The decision to buy insurance is essentially the same as other spending decisions. An individual's preference for accepting or avoiding risk, the likelihood of a loss occurring, the size of

the potential loss and the individual's income are likely to determine the demand for disaster insurance.

- Individuals are continually required to make decisions concerning the wide range of risks which they face every day, for example those involved in travel or work. There is no compelling reason to treat disaster risks differently from other risks.
- There are valid reasons why an optimal level of disaster insurance may be less than full cover and could involve no insurance at all. It is not rational to fully insure against all risks. Homeowners may prefer to bear some of the risk of a disaster themselves rather than buy insurance. They may prefer to diversify their risk by holding a portfolio of assets. In the event of a major disaster they may intend not to fully replace their existing properties. Homeowners may also believe that the cost of insurance is higher than it actually is, because of the difficulties involved in assessing the probability of a natural disaster and the expected loss.
- These factors influencing the decision on whether to buy insurance apply to people throughout the income spectrum. Wealthy individuals may prefer to self-insure rather than be forced to buy insurance. The consumption choices of low income people are already tightly constrained. It may be rational for such people to assume higher risks, especially in respect of events which have a low probability of occurring. The expected cost to households of compulsory insurance is not a trivial amount; it will represent a significant proportion of an annual electricity or telephone bill, for example.

For these reasons (and others discussed in our study) arguments relating to under-insurance should be viewed sceptically. Individuals and financial institutions involved in mortgage finance have incentives to consider whether disaster insurance cover is appropriate in particular circumstances. We believe most New Zealand financial institutions would require insurance as a condition of a loan. There is no sound basis for determining,

in a centralised and prescriptive fashion, an optimal insurance strategy for a diversity of individuals, properties and contingencies.

3.4 The related argument advanced in the White Paper for compulsory insurance - that the government would be obliged to meet uninsured private property losses in the event of a disaster - is also, in our view, an invalid reason for the proposal contained in the Bill.

3.5 The proposition is apparently based on the unproven assertion that, in the absence of a compulsory scheme, the government would meet the loss or a large proportion of it. While governments have, in the past, contributed to losses sustained in natural disasters, including droughts, no systematic study has been undertaken of the extent to which such assistance compensated for the losses incurred by private property owners. (The assistance has often been provided in non-transparent ways, for example through tax concessions, which limit their applicability and value to some property owners.) We suspect that such assistance has in fact been modest, with most of the uninsured loss falling on property owners. Overseas experience also points to a similar conclusion.

3.6 More importantly, in the case of a major catastrophe, the costs of civil defence, public safety, health services and emergency aid to victims, together with the costs of restoring government-provided services (for example schools), are likely to be such that generous compensation for private property losses would be inconsistent with broader economic objectives. It does not seem believable that a government would tax a community devastated by a natural disaster in order to reinstate the homes of its wealthiest or even its average-income members. In short, we do not accept that the government could afford to be anywhere near as generous as implied in the White Paper.

3.7 In our view, individuals ought to be responsible for decisions on whether to insure their properties for loss from disasters and on the level of such insurance. The type of thinking behind the compulsory insurance provision is reminiscent of what has been labelled the 'nannying' or 'fuss-pot' state. The government may have a role in providing information on the risks of a natural disaster if it has superior information on such risks. Beyond this, the government's role is to provide regular safety net

assistance. In the event of a disaster, this would involve health care, accident compensation and welfare benefits, including emergency housing assistance.

3.8 We also submit that the government should grasp the opportunity to establish a credible policy with regard to disasters, thereby setting the constraints within which private provision for disasters can be made. In this regard, acceptance of the perceived belief that the community would expect the government to compensate them for most of their property losses is inconsistent with the policy approach adopted in other areas where the conventional wisdom has been overturned. If the government made clear that its responsibilities in the the event of a disaster would be limited to those listed in the previous two paragraphs, we believe people or their agents would be in a position to make rational decisions on their own needs.

3.9 The welfare costs arising from compulsory insurance appear to have been excessively discounted. These would be considerable with any compulsory insurance scheme. This is, for example, one reason why a compulsory social insurance approach was not favoured in the government's review of national superannuation. The welfare costs involved include the following:

- distortions of consumption patterns. Spending on items which are of higher priority to homeowners would need to be reduced in order to pay for compulsory insurance;
- the resource cost involved in the administration of, and compliance with, the scheme;
- the unpleasantness of being told what to do by an agent beyond one's control; and
- constraints on the terms and conditions on which insurance is offered as a consequence of the DICNZ's role in the market. As noted in the government's Discussion Paper, the Earthquake and War Damage scheme has reduced the range of contracts

available in New Zealand. It can be expected that the DICNZ will have a similar effect on the market for disaster insurance.

These costs can be expected to be significant while the economic benefit is at best doubtful.

3.10 In summary, we submit that the government has not established a valid case for compulsory disaster insurance in respect of most homes. Most countries exposed to natural disasters, for example Japan and the United States, do not require compulsory disaster insurance of homes. We recommend that the provision imposing compulsory disaster insurance on homeowners be deleted from the Bill.

3.11 Clause 14 of the Bill provides that homes are generally to be insured at 'replacement' value. The term replacement is not defined in the Bill and detailed rules relating to its calculation are to be prescribed by regulation. Even if the White Paper arguments for government intervention cited in paragraph 3.2 were to be accepted, we fail to see how they would constitute a basis for requiring compulsory insurance at replacement value. If the Bill's provision for compulsory disaster insurance is proceeded with, we submit that the amount of insurance required should be reduced to the amount required to afford a minimum level of basic housing. This might be generally defined as the lesser of the current market value of a basic modular unit or the current market value of the property. Homeowners could, if they wished, take out additional insurance.

4.0 The Role of the Disaster Insurance Commission in the Insurance Market

4.1 A curious feature of the Bill is that it does not fully apply the government's general policy on SOEs, including privatisation, to the DICNZ. This contrasts with the recent decision to offer the State Insurance Office for sale. The businesses of the DICNZ and the State Insurance Office are similar and the same approach should logically be taken to each. Furthermore, in other countries disaster insurance business is generally written by private sector firms. These observations raise the question of

why a straightforward privatisation approach has not been adopted in the case of the DICNZ.

4.2 The provision of insurance services is not a natural public sector function. The efficiency of insurance (and other) markets can be impaired by the activities of SOEs operating in the industry. Such entities create special problems because they do not face the same incentives and disciplines as privately-owned businesses.

4.3 The explicit backing of the DICNZ by taxpayers (provided for in clause 12 of the Bill) places it in a preferred position in competing with private sector insurers. Prior to taking out disaster insurance, consumers need to assess whether the insurer is in a sufficiently sound state to meet its obligations if called upon to do so. Clearly SOEs (such as DICNZ, EQWDC and the State Insurance Office) have a special advantage in that they have an explicit or implicit government guarantee. While a charge for the guarantee (as provided for in clause 13) would help even up the competitive position of the DICNZ and other insurers, the value of the guarantee is likely to be difficult to quantify.

4.4 It is most unlikely that an insurance business restricted to disaster risk in New Zealand would emerge in a competitive market. The limited scope to diversify such risks within New Zealand and the transactions costs of reinsurance could be expected to preclude this. New Zealand disaster risk might be diversified by insuring similar and other risks overseas and, to a lesser extent, by insuring other risks in New Zealand. If the DICNZ were to engage in offshore insurance business (as the Bill may permit), this would accentuate the problems of monitoring its performance and of the DICNZ's government guarantee. It is not envisaged that the DICNZ would insure New Zealand risks other than those arising from natural disasters. To the extent that the DICNZ is less able than other insurers to diversify exposure, its risk premium would be higher and therefore its prices should be higher. Such a form of insurance would be inefficient.

4.5 It should be noted that monitoring the performance of an SOE in the disaster insurance market is likely to be unusually onerous. Because of the uncertainties, risks and premium levels are especially difficult to establish and apparent profits over long periods of time may mask the real risk of

claims exceeding the available assets. In view of these problems, it is particularly important that market disciplines apply to insurers in the disaster insurance industry.

4.6 The Bill provides for the DICNZ to be both a participant in the disaster insurance market and the chief regulator of the market. The government's general policy on SOEs has recognised the need to separate such functions in order to clearly identify objectives. We see no grounds for departing from this approach in the case of the DICNZ.

4.7 Even if compulsory insurance in respect of residences were accepted, this does not require an SOE to write insurance contracts. The case for the DICNZ to write contracts has not been established in either the Discussion Document or the White Paper. It would be necessary to demonstrate both that compulsory insurance is justified and that cover is best provided by a government insurer. The concerns expressed above suggest that it is unlikely that a valid case for government participation in the insurance market could be established.

4.8 We submit that there are no valid grounds for government provision of insurance services. Furthermore, the difficulties involved in establishing a competitively neutral environment and in monitoring the performance of SOEs engaged in the insurance market suggest that they should be privatised. The first step would be to place the DICNZ on a competitively neutral footing to the furthest extent possible and then to privatise it at the first opportunity.

5.0 Conclusion

5.1 The onus is on the government to demonstrate that the benefits of compulsory insurance for the replacement of most homes outweigh the costs involved. We do not believe that this test has been met. We submit that compulsory disaster insurance of most homes should not proceed. At most, the level of insurance required should not be greater than that required to provide a basic level of housing.

5.2 We also submit that the proposals relating to the DICNZ are inconsistent with the government's general policy on SOEs. The DICNZ should be placed on a competitively neutral basis with other insurers by, for example, separating regulatory and commercial activities, and it should be privatised at the earliest opportunity.