# Submission to the

# EQC Public Inquiry

**Submission 2 of 9**

---

## Control Over Natural Disaster Fund (NDF)

---

| | |
|---|---|
| Submission Date: | 20th May 2019 |
| Submission Reference Number: | One (1) of Nine (9) |
| Submission Version Number: | 1.2 |
| Author: | Cam Preston |
| | EQCfix.NZ Steering Committee Member |
| | Accountant |

# Submitted Documents

The following documents are submitted to the Inquiry. They are in the folder titled S2_20190520_Submission_Control Over NDF and S2_20190520_Submission_Control Over NDF _ EQC Board Minutes (note this has already been submitted but has been included in this Submission pack as a reference).

### *S2_20190520_Submission_Control Over NDF*

| | | | |
|---|---|---|---|
| Annual Reports | 17/05/2019 3:58 p.... | File folder | |
| Balance Sheet 2012 | 14/05/2019 7:05 p.... | Adobe Acrobat D... | 35 KB |
| Balance Sheet 2015 | 14/05/2019 7:05 p.... | Adobe Acrobat D... | 39 KB |
| Balance Sheet 2018 | 14/05/2019 7:04 p.... | Adobe Acrobat D... | 421 KB |
| Graphs for ILVR | 14/05/2019 7:06 p.... | Microsoft Excel W... | 481 KB |
| Item 3 - Memo - Revised estimates of ND... | 14/05/2019 7:07 p.... | Adobe Acrobat D... | 2,833 KB |
| Memo on EQC funding issues - Sept 2011 | 14/05/2019 7:03 p.... | Adobe Acrobat D... | 648 KB |

### *S2_20190520_Submission_Control Over NDF _ EQC Board Minutes*

| | | | |
|---|---|---|---|
| 28.04.2011 Minutes after complaint | 28/02/2019 11:24 a... | Adobe Acrobat D... | 877 KB |
| Board Minutes 27 October 2011 | 28/02/2019 11:24 a... | Adobe Acrobat D... | 161 KB |
| Enclosure - Board Minutes June 2016 - 17 | 28/02/2019 11:24 a... | Adobe Acrobat D... | 6,399 KB |
| Item 1 - Board Minutes 2012 (1) | 28/02/2019 11:24 a... | Adobe Acrobat D... | 7,352 KB |
| Item 1 - Board Minutes 2013 | 28/02/2019 11:24 a... | Adobe Acrobat D... | 7,792 KB |
| Item 1 - Board Minutes 2014 (1) | 28/02/2019 11:24 a... | Adobe Acrobat D... | 6,191 KB |
| Item 2 - Board Minutes 2015 (1) | 28/02/2019 11:24 a... | Adobe Acrobat D... | 5,150 KB |
| Item 3 - Board Minutes 2016 (1) | 28/02/2019 11:24 a... | Adobe Acrobat D... | 2,577 KB |
| Item_1_-_Board_Minutes_2010 (1) | 28/02/2019 11:24 a... | Adobe Acrobat D... | 2,302 KB |
| Item_2_-_Board_Minutes_2011 (1) | 28/02/2019 11:24 a... | Adobe Acrobat D... | 5,090 KB |

### *Google Drive Links*

The links in this document refer to the documents provided above.

### *Change Control Register*

#### *Version 1.2 | 24th May 2019*

- Title Page, added Accountant
- All Pages, updated footer, read "Title Page of Submission", now reflects title of report.
- Change control register added.

# Table of Contents



| | | | |
|---|---|---|---|
| Annual Reports | 17/05/2019 3:58 p.... | File folder | |
| Balance Sheet 2012 | 14/05/2019 7:05 p.... | Adobe Acrobat D... | 35 KB |
| Balance Sheet 2015 | 14/05/2019 7:05 p.... | Adobe Acrobat D... | 39 KB |
| Balance Sheet 2018 | 14/05/2019 7:04 p.... | Adobe Acrobat D... | 421 KB |
| Graphs for ILVR | 14/05/2019 7:06 p.... | Microsoft Excel W... | 481 KB |
| Item 3 - Memo - Revised estimates of ND... | 14/05/2019 7:07 p.... | Adobe Acrobat D... | 2,833 KB |
| Memo on EQC funding issues - Sept 2011 | 14/05/2019 7:03 p.... | Adobe Acrobat D... | 648 KB |



| | | | |
|---|---|---|---|
| 28.04.2011 Minutes after complaint | 28/02/2019 11:24 a... | Adobe Acrobat D... | 877 KB |
| Board Minutes 27 October 2011 | 28/02/2019 11:24 a... | Adobe Acrobat D... | 161 KB |
| Enclosure - Board Minutes June 2016 - 17 | 28/02/2019 11:24 a... | Adobe Acrobat D... | 6,399 KB |
| Item 1 - Board Minutes 2012 (1) | 28/02/2019 11:24 a... | Adobe Acrobat D... | 7,352 KB |
| Item 1 - Board Minutes 2013 | 28/02/2019 11:24 a... | Adobe Acrobat D... | 7,792 KB |
| Item 1 - Board Minutes 2014 (1) | 28/02/2019 11:24 a... | Adobe Acrobat D... | 6,191 KB |
| Item 2 - Board Minutes 2015 (1) | 28/02/2019 11:24 a... | Adobe Acrobat D... | 5,150 KB |
| Item 3 - Board Minutes 2016 (1) | 28/02/2019 11:24 a... | Adobe Acrobat D... | 2,577 KB |
| Item_1_-_Board_Minutes_2010 (1) | 28/02/2019 11:24 a... | Adobe Acrobat D... | 2,302 KB |
| Item_2_-_Board_Minutes_2011 (1) | 28/02/2019 11:24 a... | Adobe Acrobat D... | 5,090 KB |

# Discussion

## Background

Please refer to a recent media article for background on this issue:

https://www.stuff.co.nz/the-press/110674808/plunder-how-the-bill-for-the-canterbury-earthquakes-was-passed-on

### Corporatisation of EQC -1988/89

The Earthquake and War Damages Amendment Act 1988 legally separated EQC from the Crown, in order to put EQC on a 'commercial' footing, in line with privatisation initiatives elsewhere.

Arguably the most important change was to the method of the Crown Guarantee from "grant" or "advance" (loan) to simply "grant".

This opened the gateway for the Minister of Finance (who retained the power to direct EQC) to direct EQC to both:

1. pay the Crown $1.475 billion (in nominal terms) of capital from the Natural Disaster Fund (NDF) between 1989 and 1995 (even after 'advance' was reintroduced in the 1993 Act):

| Year | *Millions Paid to Crown* |
|---|---|
| 31/03/1989 | *$239* |
| 31/03/1990 | *$240* |
| 31/03/1991 | *$265* |
| 31/03/1992 | *$244* |
| 30/06/1993 | *$267* |
| 30/06/1994 | *$103* |
| 30/06/1995 | *$117* |

2. give Treasury the administrative power and access to EQC's NDF, which resulted in the entire NDF being invested in government bank accounts and stock (Treasury/RBNZ).

The effect of this was to remove EQC's control over both its levy stream and capital. This draining of the levy income and liquidity control over retained capital was described by EQC's Chair as "**inter-generational theft**".

EQC's 'under funding for the next big natural disaster (such as Canterbury) was likewise described by the Chair as "a monster lurking in the shadows".

### 1998 EQC Amendment Act – EQC side-lined permanently

Tension continued until 1998 when Parliament passed legislation formalising the Crown's control over the NDF (and arguably inter alia EQC operational responses), formalising the loss of control by EQC.

### The effect on the Canterbury Sequence Response

EQC attempted to call on the Guarantee in 2011, when it was over $1 billon insolvent, but was denied funding by the Crown on the traditional and generally accepted accounting principle of balance sheet solvency, and instead an irregular "cashflow" treatment was adopted.

Treasury and the Minister of Finance instructed EQC to "concentrate on cost control" instead of their negative equity position.

While private insurers have seen their initial loss estimates increase (creep) dramatically over the Canterbury recovery period, for some reasons EQC's has reduced, refer Figure 1:

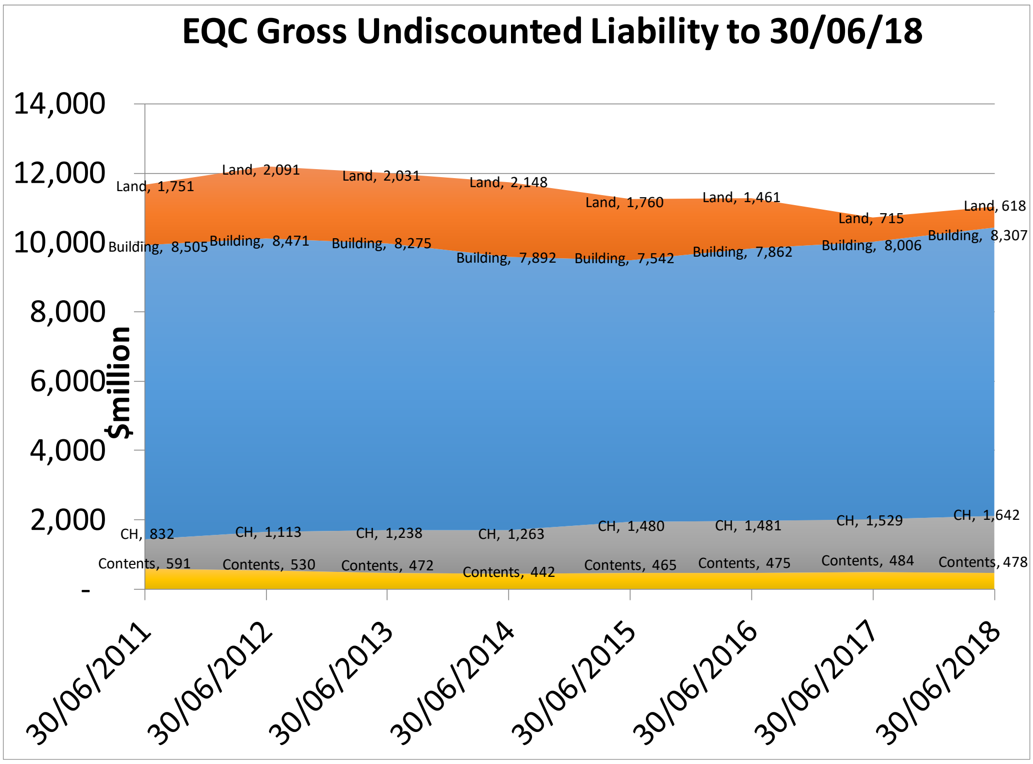



**Figure 1: A chart showing the reduction in EQC's loss estimates.**

## Conclusion

Calculations completed by EQCFix.NZ show the size of the Natural Disaster Fund on 30 June 2010 would have been a conservative $9.6 billion, as opposed to the $5.63 billion as at 30 June 2010 had the Crown not ‘plundered’ the NDF from 1988 to 1996.

While EQCFix.NZ understands the legal and accounting actions behind the reforms from 1988 to 1998, our concern is what the underlying motivation was for this ‘corporatisation’ and whether ‘independence’ from the Crown was, in reality, the opposite of what was achieved. Therefore, we ask in who’s best interests (politicians or homeowners) most influenced the operational decisions were by (and on behalf of EQC) in Canterbury from the 2010-11 event sequence?

For example, we question to what extent the Crown and political control over the NDF dictated operational decisions of EQC such as a “Managed Repair Programme” as opposed to cash settlement post the Canterbury Earthquake sequence, when combined with the overarching Crown fiscal position and global economic conditions in 2010 and 2011.

As alluded to by EQC itself in 1997, a valid question is whether the NDF is mythical or not.

We also wonder to what extent the EQC, being in a negative equity situation since 22 February 2011, has affected its operational response to claim outcomes? Especially given EQC’s overall total estimate of the cost of the Canterbury earthquake as fallen between 2011 and 2018, which is in stark contrast to all other insurers’ liability developments (‘loss creep’) in Canterbury.

Ultimately it appears to EQCFix.NZ that EQC was not in control of its own destiny, and decisions made many decades before the Canterbury Earthquake Sequence had already dictated the outcome that was experience by many.

The NDF is a myth, and as a myth it means the only practical use of the EQC is as a ‘social contract’ between the public and the Crown. Whilst this is useful, it opens the question of who holds the power, at a time of each natural disaster, to alter or manipulate that ‘social contract’.

## Document Register

| Document Register | | |
|---|---|---|
| **Title** | **Author(s)** | **Dated** |
| 1. Annual Report of EWDC | EWDC | 31 March 1987 |
| 2. Annual Report of EWDC for the year ended 31st March 1988 | EWDC | 1988 |
| 3. Earthquake and War Damage Amendment Act 1988 (No 142) | NZ Parliament | 1988 |
| 4. EQC First Corporatised Annual Report | EQC | 1989 |
| 5. 1990 Half yearly report of EWDC to 30th September 1989 | EQC/EWDC | 1989 |
| 6. 1991 Half yearly report of EWDC to 30th September 1990 | EQC/EWDC | 1990 |
| 7. EQC 1991 Annual Report | EQC | 1991 |
| 8. EQC 1992 Annual Report | EQC | 1992 |
| 9. EQC 1993 Annual Report | EQC | 1993 |
| 10. EQC 1994 Annual Report | EQC | 1994 |
| 11. EQC 1995 Annual Report | EQC | 1995 |
| 12. EQC 1996 Annual Report | EQC | 1996 |
| 13. EQC 1997 Annual Report | EQC | 1997 |
| 14. EQC 1998 Annual Report | EQC | 1998 |
| 15. 1998 EQC Amendment Act | EQC | 1998 |
| 16. EQC's call on its Guarantee 30th June 2011 | Treasury (COMU) | 11 September 2011 |
| 17. EQC's Canterbury EQ Gross Undiscounted Insurance Liability development | EQC Fix | 19 May 2019 |

# Supporting Documents

## 1. Annual Report of EWDC for year ended 31st March 1987

https://drive.google.com/file/d/1o22w8GhK5Rvn-nncrxhEYZTgVOCvxxrZ/view?usp=sharing

**GENERAL**

During the year the Government commenced a review on how best to provide disaster insurance for New Zealand. The review is to determine if there is a more efficient, effective, and equitable alternative to the existing scheme or what improvements to the present Commission operation will provide for a disaster insurance package appropriate to today's conditions. It is also aware of any interest issues that might be involved and will consider these and alternatives suggested, when the review is complete.

The Commission is concerned that the fund is not currently invested in such a way as to provide for maximum return and it hopes the review will address this.

**Figure 2: Annual Report of EWDC for year ended 31st March 1987**

## 2. Annual Report of EWDC for the year ended 31st March 1988

(see second half of PDF download above for 1998 report)

**EARTHQUAKE AND WAR DAMAGE COMMISSION**
**BALANCE SHEET AS AT 31 MARCH 1988**

| | Note | $000 | 1988 $000 | 1987 $000 |
|---|---|---|---|---|
| Current Assets: | | | | |
| Cash .. .. | | 236,239 | | 160,293 |
| Sundry debtors .. | | 13 | | 1 |
| | | | 236,252 | 160,294 |
| Accruals: | | | | |
| Interest .. .. | | 50,035 | | 39,263 |
| Premiums .. | 3 | 17,224 | | 17,444 |
| | | | 67,259 | 56,707 |
| Investments: | | | | |
| New Zealand Government Stock .. .. | 4 | | 1,570,350 | 1,395,238 |
| Fixed Assets .. | 5 | | 60 | 26 |
| | | | 1,873,921 | 1,612,265 |
| Current Liabilities: | | | | |
| Sundry Creditors .. | | 82 | | 55 |
| GST .. .. | | 1,400 | | 1,046 |
| | | | 1,482 | 1,101 |
| Provisions: | | | | |
| Outstanding claims .. | | 44,903 | | 125,009 |
| Discount on accrued premiums .. .. | | 424 | | 434 |
| Unearned premiums .. | | 52,942 | | 49,581 |
| | | | 98,269 | 175,024 |
| Fund balances represented by: | 6 | | | |
| Earthquake and War Damage Fund .. .. | | 1,697,788 | | 1,378,402 |
| Disaster/Landslip Fund | | 76,382 | | 57,738 |
| | | | 1,774,170 | 1,436,140 |
| Total Funds .. | | | 1,873,921 | $1,612,265 |

**Figure 3: Annual Report of EWDC for the year ended 31st March 1988**

### 3. Earthquake and War Damage Amendment Act 1988 (1988 No 142)

http://www.nzlii.org/nz/legis/hist_act/eawdaa19881988n142305/

**6. Deficiency in Fund**—(1) The principal Act is hereby amended by repealing section 13, and substituting the following section:

"13. If the assets of the Commission (including the money for the time being in the Fund) are not sufficient to meet the lawful claims on the Commission, the Minister shall, without further appropriation than this section, provide to the Commission from the Consolidated Account such sums by way of grant as may be necessary to meet the deficiency upon such terms and conditions as the Minister determines."

(2) Section 123 (b) of the Public Finance Act 1977 is hereby consequentially repealed.

**Comment** – Advance (loan) or Grant removed and replaced with just Grant – provides excuse for Crown to start draining levy income/fund resources

## 4. EQC First Corporatised Annual Report 1989

https://drive.google.com/file/d/1Z9-fc-xhUhaGVCcTfY65NBM2FaiK3BhB/view?usp=sharing

### INVESTMENT

Prior to 1 October 1988, the Commission's assets were administered by The Treasury on behalf of the Crown. Those funds are now vested in the Commission.

Subject to the approval by the Minister of an investment policy, investment decisions will be the function of the Commission. Development of this strategy began during the year. This will inevitably involve, over a period of time, placing a major portion of the investment portfolio off-shore, a move which will further enhance the financial credibility of the Commission.

### COMMISSION FUNDS

A salient feature of the Commission's performance during the year is not only the satisfactory level of its operating surplus, but also the extent to which it has enhanced its ability to meet the financial demands which may be made on it as a consequence of natural disaster.

Nett assets of the Commission as at 31 March 1989 totalled $1.9 billion. Total income for the year was ahead of the previous year, although the payment of an Underwriting Fee to the New Zealand Government and a premium to the Commission's reinsurers restricted the amount of the surplus available for transfer to the Fund.

### RETURN TO SHAREHOLDER

The commercial relationship which now exists between the Government and the Commission requires the payment of an annual fee to cover the Government's underwriting facility, a sum in lieu of tax and a dividend. The aggregate sum paid for this financial year was $239 million.

### MINISTERIAL DIRECTION

The Commission received one written direction from the shareholding Minister pursuant to section 9 of the Earthquake and War Damage Act 1944. This direction related to the Commission's investment policy and also fixed the aggregate amount to be paid to the Crown by way of reinsurance guarantee fee (referred to in this report as the Government Underwriting Fee), payment in lieu of income tax and dividend. A copy is attached to this report as Appendix A.

### MEMBERSHIP OF THE INSURANCE COUNCIL OF NEW ZEALAND INC.

The restructuring of the Commission enabled the informal relationship which existed between the Commission and The Insurance Council of New Zealand Inc. to be formalised with the admission of the Commission to the Council as a full member.

OFFICE OF MINISTER OF FINANCE
WELLINGTON, N.Z.

30 Sept 1988

Mr L B Falck
Chairman
Earthquake and War Damage Commission
P O Box 31342
LOWER HUTT

Dear Mr Falck

As from 1 October 1988 the Earthquake and War Damage Commission becomes an independent Corporation controlling its own finances, appointments and procedures subject to the provisions of the Earthquake and War Damage Act 1944 and its amendments.

Section 8 of the amended Act provides an accountability framework similar to that for the State Owned Enterprises. These provisions will not take effect until 1 April 1989. You have indicated to me on behalf of the Commission their view that I issue general directions to cover the period between 1 October 1988 and the time of the completion of the Statement of Corporate Intent using the powers granted the Minister of Finance under section 9 of the amended legislation. I concur with the Commission's views in this regard.

New section 24(2) of the Act further requires consultations between,the Minister and Board of the Commission with respect to the amount of sums in lieu of income tax to be paid by the Commission. I acknowledge the discussions between Commission representatives and my advisers held concerning these matters prior to the announcements made in the 1988 Budget.

Currently the Commission has net assets in excess of $1800 million. These are invested almost entirely in Government Stock. Whilst it would seem sensible commercial practice that a substantial proportion of these assets be eventually transferred off-shore I wish to be confident that the investment strategy adopted by the Commission is both prudent and appropriate. In order to be assured of these matters it is my intention to involve my advisers in the process of deciding an appropriate investment strategy for the Commission.

2

Accordingly I direct

i that the Earthquake and War Damage Commission is to pay this financial year a sum of $239 million comprising Reinsurance Guarantee Fee, payment in lieu of income tax and dividend. This sum is to be paid in three instalments of $80 million, $80 million and $79 million on or before 25 November, 31 January and 31 March respectively.

ii that the Commission is to continue with the existing investment policy using the Treasury facilities until further notice.

iii that the Commission consult the Treasury in order to determine an appropriate investment policy for the funds now under its control.

It is my intention that directions (ii) and (iii) will be removed as soon as possible and I urge the Board of the Commission to expedite suitable replacement policies, strategies and systems which will meet with my requirements.

Yours sincerely

R O Douglas

**Figure 4: EQC First Corporatised Annual Report 1989**

### 5. 1990 Half yearly report of EWDC to 30th September 1989

(Note Parliamentary Information Services (PIS) haven't provided the full year report as they can't retrieve it, hence and half year only)

https://drive.google.com/file/d/1i8g79ytyorf3koLXXxch93uEPj7sKy8d/view?usp=sharing

## INVESTMENT STRATEGY

The Board continues to discuss with the Shareholding Minister and The Treasury the Commission's proposed investment strategy for the Funds and assets under its control. The Board initiated discussions with the Reserve Bank concerning the reinvestment of funds. The Reserve Bank has indicated that it needs to become involved in these consultations in order to ensure that the final strategy is consistent with the Bank's overall monetary policy guidelines. The Board welcomes this involvement and has advised the Shareholding Minister accordingly. ❖ The Board recently approved with reluctance the investment of maturing funds into short term, non-tradeable securities pending final approval from the Shareholding Minister of the investment strategy. However, developing an investment strategy commensurate with the Commission's risk profile has proven to be more complex than originally thought and more time will be needed to achieve the approval of all parties. ❖ It is hoped that agreement on an appropriate investment strategy will be secured in the next few months so that the Commission may commence overseas placement of a portion of its funds before the end of the calendar year. ❖ Furthermore, until an approved investment strategy is in place, the

Commission's efforts to reduce the Government's contingent liability under section 13 of the Earthquake and War Damage Act have been somewhat hampered. ❖ The Commission intends at the same time as implementing an approved investment strategy to refine its cash management strategy. This is an important reform which will take into account the unique risk exposure faced by the Commission in its role as a specialist natural disaster insurer. The Commission's management and financial consultants will be carefully considering and developing the methodology appropriate to this policy in the next quarter.

## DISASTER INSURANCE INDUSTRY REFORM

Although the fine detail of the shape and function of the Earthquake and War Damage Commission in the impending deregulated disaster insurance market is yet to be determined, the Commission has been active in preparing for the new environment as far as is possible in the circumstances. ❖ Planning has proven difficult in the absence of the introduction of the new legislation. ❖ A special task force has been formed to consider and prepare plans for the changes. ❖ In the meantime, the Commission continues to carry out effectively its day-to-day activities and claims management, consistent with its obligations under the Earthquake and War Damage Act and Regulations.

**Figure 5: 1990 Half yearly report of EWDC to 30th September 1989**

### 6. 1991 Half yearly report of EWDC to 30th September 1990

https://drive.google.com/file/d/1ptBELnQxctz_B8e4lhH-qldamf43rfjZ/view?usp=sharing

## BALANCE SHEET AS AT 30 SEPTEMBER 1990

| | $(000) | $(000) |
|---|---|---|
| Shareholders Funds | | |
| Issued and Paid-up Capital | | 1,500,000 |
| Reserves | | |
| - Earthquake Fund | 401,641 | |
| - Disaster Landslip Fund | 115,532 | |
| - Retained Earnings 30/9/90 | 120,351 | 637,524 |
| | | 2,137,524 |

The Commission paid an aggregate of $240 million in Crown fees for the year ended 31 March 1990.

The Board of the Commission believes the current level of Crown fees paid inhibits adequate fund growth. Finding an equitable basis for each element of Crown fees relies on balancing the requirements of the Shareholder for a return on funds used, and the need for the fund to grow so as to enhance the Commission's ability to meet its financial liabilities at the time of a major disaster.

## Claims

Whenever there is a disaster for which the Commission has an insurance responsibility, the Commission's disaster management plan is implemented. Broadly, this involves using a toll-free number and bringing in extra staff, if necessary, to receive claims. The prime mission in claim settlement is to settle and pay as rapidly as possible. All claims are settled on a cash basis either directly to the claimant or to a mortgagee of a property, depending on the amount payable. Rarely does the Commission authorise repair work or get involved in rebuilding.

**Figure 6: 1991 Half yearly report of EWDC to 30th September 1990**

## 7. EQC 1991 Annual Report

https://drive.google.com/file/d/1VlMOoewZ7ha09opTlMpkWEHZIxS_PxsL/view?usp=sharing

The Board takes this opportunity to publicly express its thanks to the retiring Chairman, Mr Lloyd Falck, who has been a member of the Board since 1987 and Chairman since 1988.

A new Chairman, Mr Ian McLean, has been appointed from 1 June 1991.

### CROWN FEES

EQC paid $265 million in Crown fees - 222% of annual premium, 61% of gross income. The Commission's performance objective in the Statement of Corporate Intent states that the parties will work towards establishing commercial formulae for the calculation of Crown fees. This would regularise the Commission's commercial obligations to its shareholder and reflect the financial exposure of the Fund.

The Commission's reinsurance programme provides a $1 billion offset in the event of a major disaster. Therefore, the likely net EQC claims liability following a single major disaster lies between $2.6 and $4.8 billion (the total would be higher if two or more disasters affected different regions), of which the Fund could meet approximately $2.2 billion. The remainder would be a call on the Crown pursuant to section 13 of the Earthquake & War Damage Act 1944.

The Crown's potential exposure has, therefore, increased in recent years, even though inflation in property values and construction activity have slowed. This is due to the size of payments made by the Commission to the Crown and the current investment strategy, which provides sub-optimal returns to the Commission.

### INVESTMENT POSITION

Despite legal ownership of the Fund being vested in the Commission, the Fund has continued to be administered by the Treasury in accordance with a direction issued in 1988 by the previous Minister. It was understood that full management and control of the Fund was to be transferred to the Commission when an investment strategy for the off-shore placement of funds was developed on agreed objectives.

**Figure 7: 1991 Annual Report**

## 8. EQC 1992 Annual Report

https://drive.google.com/file/d/14U9puhH20gXSdxJBAeOnrnYCrInx6tFU/view?usp=sharing

Crown fees, at an aggregate $244 million, whilst lower than the $265 million paid in 1990/91, took a larger share of the Commission's 1991/92 income. The net surplus of $93,181,000 was allocated to the Earthquake & War Damage fund and the Disaster Landslip fund, resulting in shareholder funds increasing to $2,232,522,000.

While fees paid to the Crown are kept at this level, the funds of the Commission cannot grow to a size sufficient to cover a major disaster or to reduce the Crown's liability.

This was a disappointing consequence of the Commission's powerlessness to manage a fund of which it has legal ownership. Its control is theoretical, rather than practical. In the meantime, the Minister's direction that the fund remain invested according to current policy, i.e. in Government stock and Treasury bills, remained in force.

It is of growing concern that while restraints on the Commission's ability to manage its funds continue and Crown fees remain at a significantly high level, the Commission's ability to achieve its corporate objectives, which are to be in a position to pay claims in the event of a major disaster and to reduce the Crown's contingent liability, will be frustrated.

I support the Board's concern at the lack of significant growth of the fund.

**Figure 8: 1992 Annual Report**

## 9. EQC 1993 Annual Report

https://drive.google.com/file/d/1moRepSIxOv3hDjtBr98aJGPeSymVXEIy/view?usp=sharing

Under its Act, the Commission's payment of claims is guaranteed by the Crown. Because of this government guarantee, all claimants can expect to be paid after even the largest disaster - no Government could afford to welsh on legal obligations of this kind.

But a large call on the guarantee would add to all the other expenditure the Government would face after a catastrophic disaster and after the disaster all New Zealanders would suffer more financially than if proper preparation had been made.

The unfunded liability of the Government to EQC is like a monster lurking in the shadows, waiting to pounce when catastrophe strikes.

The unfunded liability of the Government to EQC is like a monster lurking in the shadows, waiting to pounce when catastrophe strikes.

Successive governments have made progress in dealing with the Government's other unfunded obligations, and while attempts have been made to grapple with the Commission's exposure, it was only in this current financial period that the Commission's liabilities started to fall.

Despite these problems created by reliance on the government guarantee, the earthquake insurance scheme operated by the Earthquake & War Damage Commission over the past 50 years has had major positive features. The scheme has been a base on which the insurance industry has been able to provide earthquake insurance cover of a quality and at a price unmatched anywhere in the world. After the reforms have taken effect, the industry should be able to continue to provide high quality, relatively inexpensive cover for homes and their contents.

While governments have continued to spend money derived from Earthquake & War Damage levies, either through fees or through borrowing the money, the bill for catastrophes is handed on for payment to those living at the time of the disaster and beyond. This can fairly be described as inter-generational theft.

### *Changed Role of EQC*

The changes being made are based on a discussion paper released by the then Associate Minister of Finance, Hon Doug Kidd, in July 1991.

The first step in the reforms was the start of a period of four years during which the Commission will phase out from coverage of commercial property. This change was made possible by an amending regulation. The detail and mechanisms of the cover to be provided during the phase-out period were determined primarily by negotiation between the Commission and the insurance industry. The negotiations were carried out in a good spirit but were indeed tough, and involved major input from both the industry and the Commission in order to produce a workable system.

The Commission was also heavily involved in the preparation of the Bill which implements the rest of the reforms. At the end of the reporting period the Bill was before the Finance and Expenditure Select Committee and has since been enacted.

Under the new regime, the Commission will continue to provide disaster insurance cover for dwellings and their contents up to the "cap" of $100,000 plus GST for dwellings, and $20,000 plus GST for domestic contents. That cover will continue to be automatic when a dwelling is insured for fire with a commercial insurer.

Since the cover will be provided on a replacement rather than an indemnity basis and will relate to the first amount of the damage, the quality of the insurance provided by EQC to homeowners will be significantly better than in the past.

The effect of the change is that the Commission's liabilities will substantially reduce over the next three and a half years, and from 1 January 1997 it will only cover dwellings and contents (up to the caps).

### *Investment Performance*

Returns from the investment portfolio for the 15-month period ending 30 June were in line with the benchmarks adopted by the Commission. Results are as follows:

| | |
|---|---|
| **NZ Government Bonds** | |
| EQC | 15% |
| CS First Boston Government Stock Index | 15.2% |
| **NZ Government Index Linked Stock** | |
| EQC | 13.5% |
| CS First Boston Index Linked Index | 10.9% |
| **NZ Treasury Bills** | |
| EQC | 8.7% |
| CS First Boston 90 Day Bank Bill Index | 8.8% |

The combined investment return earned by the Disaster Fund over the period was 13.4%.

### *Financial Statements*

The Public Finance Amendment Act 1992 resulted in the Commission becoming a Crown Entity with a financial year ending each 30 June. EQC's balance date was previously 31 March, hence these financial statements cover a 15-month period.

**Figure 9: 1993 Annual Report**

**10. EQC 1994 Annual Report**

https://drive.google.com/file/d/1Bnksv00S7z6IzRjO2mANV4BhwNPtYfha/view?usp=sharing

# *Managing Financial Risk*

The business of EQC is dealing with the risk arising from disasters, but like anyone else who owns assets, it faces financial risks as well.

At the time the Earthquake & War Damage Commission was formed in 1944, investment risk in government agencies was handled according to the old "Post Office Savings Bank mentality" of depositing funds "safely" somewhere within the Government.

In the past, when depositors put money into the government owned POSB, they were protected against credit risk, but lost much money through their exposure to other risks. In the same way, EQC has faced no credit risk, but has carried huge exposure to other risks.

These include interest rate risk, currency risk and liquidity risk.

# *Probability of Ruin and the EQC Corporate Model*

In my report last year I indicated that the "probability of ruin" for the Commission was high. That assessment was somewhat misunderstood.

For the sake of the record there is good news and bad news.

The good news is that EQC has about the right level of resources to meet the predicted cost of its target event - the largest event with a return period of less than 2,000 years - an earthquake of magnitude of 7.5, of intensity X, centred near Wellington. Thus we do expect to have the finances to deal with the monster.

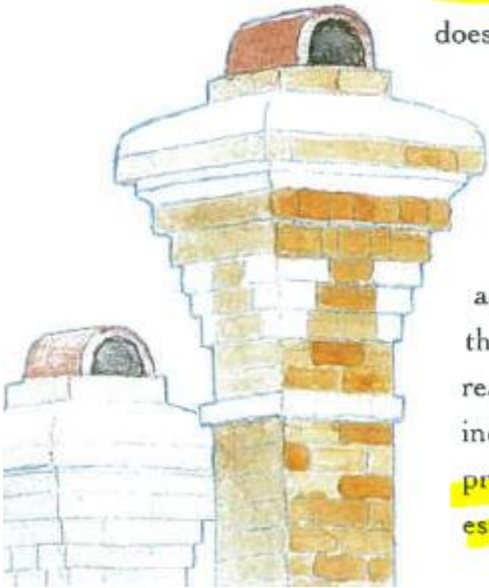
However, with existing resources and current policies we could not expect to have resources to meet claims arising from that monster and its smaller brothers and sisters occurring in the decades preceding and following.

# *What the EQC Accounts Don't Show*

The Chairpeople of most organisations often devote part of their annual reports to proclaiming the accuracy of the accompanying financial statements.

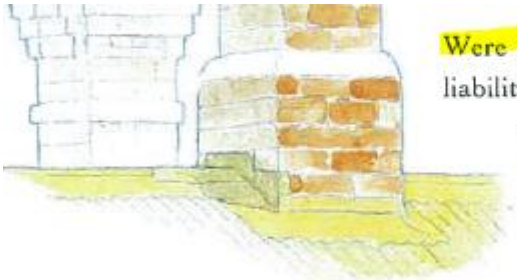
It is my duty to do the opposite.

The financial statements of EQC do show, to the best of their ability, a true and fair position of the financial results for the year and the financial position at year end, under current financial reporting and accounting standards.



But using these standards, the accounts do not accurately describe the economic situation of the Commission, nor does the reported level of shareholder's funds indicate that EQC is solvent without the Crown guarantee.

The sharp point is that EQC faces liabilities in the form of future claims arising from large earthquakes which cannot be reflected in the accounts. Large earthquakes are certain to occur, their frequency and magnitude can be predicted with reasonable accuracy, and only the date and time of individual earthquakes is unpredictable. Hence the probabilities of different levels of claims can be estimated with a reasonable degree of confidence.



Were EQC a life insurance company facing similar liabilities, it would be required to bring to account the present value of these expected future claims, and to make provision accordingly in its reserves to meet these claims. Life insurance companies do this by using an actuarial valuation which takes into account probabilities and the time value of money. In the valuation the expected level of claims for each future year is calculated, and those liabilities are then discounted back to today's values. The actuary computes the liabilities on conservative assumptions so that there is a high degree of certainty that the level of reserves will be adequate.

To measure EQC's level of solvency, an actuarial assessment is also required, but the techniques used need to be different from those used for life insurance companies. Different techniques are necessary because EQC's liabilities arise from many earthquakes with a small level of claims (about $10m or less a year), a few large earthquakes, and occasionally a disastrous earthquake costing $1 billion or more. Thus the situation is quite different from life insurance where the risk is spread and averaged over many lives.

---

no dividend paid in other years.

The analysis shows that a fund of $5 billion is needed to achieve a long term probability of ruin low enough (about 5%) for EQC to be considered to be fully solvent without having to rely on the government guarantee for its solvency. A level of $4 billion would give a long term probability of ruin of 10%, at which stage it would be considered to be barely solvent.

If EQC were fully solvent, its balance sheet in economic terms would read as follows:

| | |
|---|---|
| **Assets** | |
| Investments and Cash | $5 billion |
| **Liabilities** | |
| Claims and Assets Fluctuation Reserve | $5 billion |
| **Shareholder's Funds** | 0 |

As of now, EQC has assets of $2.4 billion. On an economic basis and valued as a going concern with the EQC scheme continuing, EQC shareholder's funds at present are in deficit to the extent of $2.6 billion. (In calculating this figure the model assumes that reinsurance is purchased whenever funds are depleted by disasters. While such reinsurance would enable claims to be met, EQC could not pay dividends and remain solvent while its shareholder's funds are in deficit).

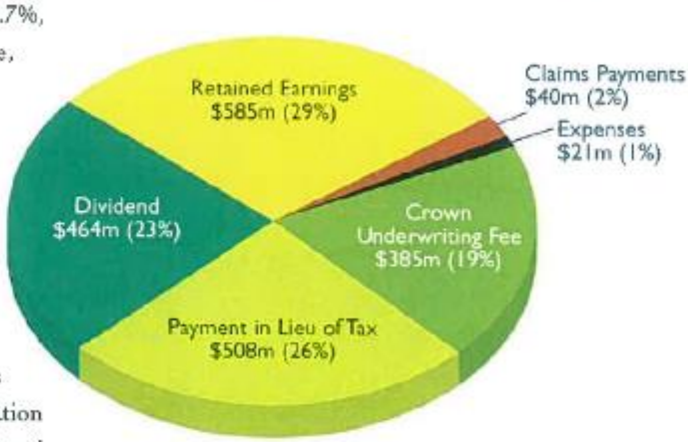
The Commission is seeking better ways to report in its financial statements on its actual economic situation. This should be made easier as the current emphasis on solvency and contingent liabilities (as in the Companies Act (1993)) brings further development of accounting standards.

It is clear however, that proper actuarial assessment of solvency is required, and that policy decisions should be taken in the light of such assessments rather than on the basis of what current accounting standards permit.

The surplus before Crown fees was $139.3 million; of this $102.69 million or 73.7%, (representing underwriting fee, payment in lieu of tax, and dividend) was paid to the Crown, leaving a net surplus for the year of $36.62 million.

Since EQC became subject to these fees in 1988 it has paid some $1357.8 million in Crown fees. The pie chart (right) illustrates the significance of this amount in relation to other payments and net fund retentions.

Distribution of EQC Income 1988 – 1994



Dear Mr McLean

As a consequence of a directive issued by a previous Minister of Finance in 1988, the Government securities which form part of the EQC Fund, although beneficially owned by the Commission, are registered in the name of the Secretary to the Treasury. The Commission has requested that it be allowed to become the registered owner.

Given recent developments affecting the Commission (Earthquake Commission Act, FBLN agreement, and work done by EQC on investment management), I agree that it is now appropriate to remove this restriction.

I therefore give my approval for the Commission's Government securities to be re-registered in the Commission's name.

However, the requirement to continue with existing investment policy is to remain at present. This will include the securities retaining their non-tradeable classification and funds remaining within the Crown bank account.

I understand that I may soon receive further proposals from the Commission as to the investment of the portion of the Fund not invested in FBLNs. I will review the necessity of retaining restrictions on EQC investment at that time.

Please liaise with the Debt Management Office over the transfer of registered ownership of the securities.

Yours sincerely

Hon B W Cliffe
Associate Minister of Finance

**Figure 10: EQC Annual Report 1994**

## 11. EQC 1995 Annual Report

https://drive.google.com/file/d/100v4L1xo5VliLU7MmQnMbWp7bZtcVu_X/view?usp=sharing

### Key Events

THE 1994/95 YEAR WAS MARKED BY:

- A Government decision not to extract in the near future dividends or payments in lieu of income tax in subsequent years.
- The investment climate remained poor, with consequent adverse effects on the return on EQC's assets.
- The conference, "*Wellington – After the 'Quake : The Challenge of Rebuilding Cities*", turned out to be a remarkable success.

### Government Fees

The Government decision regarding fees will significantly improve the solvency of EQC, and is a most responsible action. In my view, the expedient extracting of fees from EQC within the past decade has made the Crown's balance sheet look better while at the same time building up a bow wave of off-balance sheet liabilities.

## 50 Years of History

### New Act in 1993

In 1991 the then Minister issued a discussion paper on the future of the Commission. The phase-out of commercial cover commenced by regulation, and the Act changing the Commission into its present form was passed in 1993.

The establishment of FBLNs in 1993 marked a significant change in investment policy. Thus, once again a substantial part of EQC funds are invested through the FBLNs in foreign currency assets. Furthermore, the assets of the Commission are now held in the name of the Commission rather than the Secretary to the Treasury, and the passive investment policy of managing to the benchmarks within the agreed parameters is directed by the Commission rather than the Treasury. However, the holdings of New Zealand

Government Stock (and the FBLNs) are classified as "non-tradeable", and no mechanism is laid down for the liquidation of Government Stock when this is required after a major disaster. I understand the Treasury and the Commission will be formalising the mechanism for redeeming such securities during the current year.

When the Earthquake and War Damage Commission was closely linked to State Insurance, it had a very small staff. On becoming a separate organisation, staff levels were kept low and have remained so ever since, with the current total being 12.

Wherever possible, activities are contracted to, or services

## The Next 50 Years

The Minister of Finance has decided to review investment policy and premium structure by 1997. The timing is appropriate.

### Opinion

Under the assumptions and policies described in the accompanying Notes, there is a probability of 29% that over the long term the Commission will be unable to meet its financial obligations without calling on the Crown guarantee.

In our opinion, with this probability of invoking the Crown guarantee, the Commission has insufficient assets to be regarded as solvent on a long term basis.

It is our opinion, again subject to the assumptions and qualifications in the Notes, that the Commission's assets and reinsurance cover are sufficient to meet the maximum probable loss for a major earthquake in the Wellington region over the next financial year. Such an event would deplete the Commission's assets to a level where cover against subsequent major losses could be provided only by recourse to the Crown guarantee.

Craig F Ansley MSc, PhD, FIA, ASA, FNZSA
Frank Russell Company (N.Z.) Limited

October 1995

**Figure 11: EQC Annual Report 1995**

## 12. EQC 1996 Annual Report

(Note pages 2-4 are missing from my copy and I believe these missing pages are relevant and I have re-requested the Annual Report for 1996 from Parliamentary Services to obtain them)

https://drive.google.com/file/d/1OVndN4iBt3xtH_IvwOK0Tnt6nSEWMtM5/view?usp=sharing

The best advice the Commission has received indicates that the Natural Disaster Fund and the reinsurance arranged by the Commission still leave the resources available well short of the size needed to meet the probable liabilities faced by the Commission. In this light it is vital that the key policy issues surrounding the Fund are resolved soon. The 1997 Review is opportune.

I consider that the Review is also an

- To pay all lawful claims on the Commission promptly and fairly.

*Opinion*

Under the assumptions and policies described in the accompanying Notes, there is a probability of 60% that the Commission will be unable to meet its financial obligations without calling on the Crown guarantee.

A key factor in the computation of this figure is the assumption of a future real growth rate of 2% p.a. The effect of varying the growth rate assumption is shown in the figure below. We estimate that the real value of residential property covered by the Commission has increased by 1.8% over the past year, and by an average of 1.9% over the past five years.

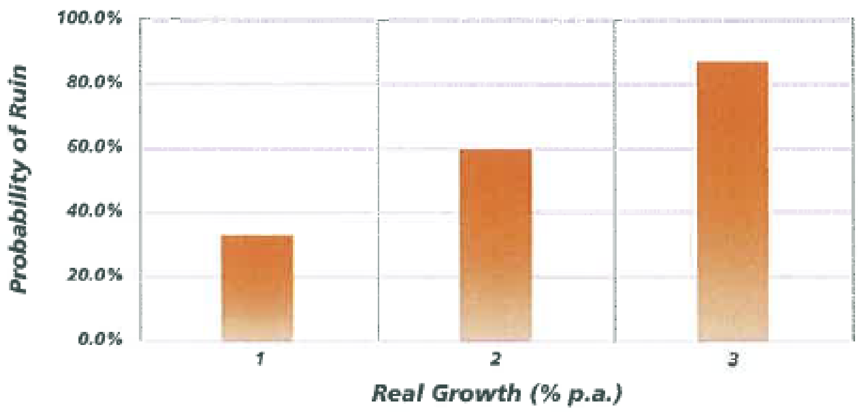



**Figure 12: EQC Annual Report 1996**

**13. EQC 1997 Annual Report**

https://web.archive.org/web/19980703212034/http://www.eqc.govt.nz/ann_rep/chman.htm

From a policy viewpoint some progress was also made. In last year's annual report I noted that there were two key policy issues outstanding concerning the role of the Earthquake Commission and the Natural Disaster Fund it administers. These were:

- **whether there is to be a dedicated Natural Disaster Fund in which premiums are collected and invested to prepare for disaster, and**
- **who should administer the Fund and how best to invest it to serve the interests of premium payers.**

I reported that EQC was looking forward to a proposed review by the Government of EQC's investment strategy and other outstanding issues during 1997.

During the year the Minister of Finance advised EQC that Cabinet had decided that, given recent investment policy discussions and written exchange between EQC and The Treasury, the 1997 review had in effect taken place. Any further policy work undertaken during 1997 was to be based on the understanding that the Minister of Finance sets EQC's investment policy.

We were also notified that the Government intended introducing legislation to address some of the issues surrounding the Fund. After year end a Bill was brought forward seeking to strengthen the powers of the Minister of Finance to determine the investment policy of EQC.

These decisions remove much of the uncertainty which has surrounded the management of the Fund in recent years. That is pleasing. However, I do remain concerned that an investment policy which limits the ability of EQC to invest the Fund will not result in the best outcome for premium payers.

EQC's Crown Guarantee allows me to give an assurance that all legitimate claims will be met. Current Government policy makes it far more likely than not that the guarantee will be called upon at some point. Both this expense and that of reimbursing the Natural Disaster Fund, which has almost all been borrowed by Government, will fall upon taxpayers, who are predominantly those New Zealanders who have already paid premiums to EQC.

**Figure 13: EQC Annual Report 1997**

### 14. EQC 1998 Annual Report

**https://web.archive.org/web/19991105224453/http://www.eqc.govt.nz/ann_rep/chman.htm**

In my report last year, I referred to the Government's intended legislation designed to give the Minister of Finance the explicit power to determine the investment policy of EQC.

The Amendment Bill finally became law on 27 March 1998 and consequently cleared up the uncertainty there had been about the investment roles and responsibilities of EQC on one hand and the Minister on the other.

The Commission's investment of $1,000 million dollars in Foreign Bond Linked Notes (FBLNs) had been caught up in the debate about who could do what and why. This investment was made in 1993 and essentially replicated the investment performance (in local currency terms) of the major bond markets - USA, Japan, France, Germany, and the UK.

Aside from portfolio diversification benefits, the investment in FBLNs provided significant protection against the likelihood that both the NZ Dollar and NZ Government Bond investments would fall in value following a large natural disaster in New Zealand. However a ministerial direction had prevented the Commission from managing the associated currency risk and this had increased the volatility of EQC's investment returns.

Finally, following a further ministerial direction received on 2 June, the FBLNs were liquidated on 3 June and the proceeds reinvested back into New Zealand government securities.

EQC's management continues to develop and fine-tune its arrangements to meet the demands of a major disaster. Linked to this is the work underway to make New Zealanders more aware of the risks and what can be done about them and about the role of EQC. Actions taken to mitigate against loss are also actions for reducing demand on the Natural Disaster Fund itself.

Because of this, the commissioners during the year approved Stage Two of a communications programme, Stage One of which was completed during the year and is reported on more fully in the General Manager's report. Stage Two will feature television and print advertising and information distributed to every household in the country.

During the period of my appointment as chairman, I have had occasion to consider carefully the characteristics of EQC and the service it is providing - protection to all New Zealanders at a reasonable cost. It is clear no other country provides such a service. There are suggestions from some quarters that the activities of the Commission could be better handled by the commercial sector.

However, in my opinion, the interests of all

**Figure 14: EQC Annual Report 1998**

## 15. 1998 EQC Amendment Act

http://www.legislation.govt.nz/act/public/1993/0084/latest/DLM306745.html#DLM306745

**12 Directions by Minister**

(1) In directing the entity in accordance with section 103 of the Crown Entities Act 2004, the Minister must, if practicable, first consult with those persons likely to be affected by the direction.

(1A) The Minister may, in giving any written directions in relation to the exercise of the Commission's functions under section 5(1)(c) or section 5(1)(d), or both, take account not only of the objects and policy of this Act, but also of 1 or more of the following matters:

(a) the Crown's current and possible future overall financial position, having regard to the requirement in section 16 to grant or advance public money to meet any deficiency in the Commission's assets to meet its liabilities:

(b) the Crown's current and possible future overall financial position, taking into account the interests of the Crown in the bodies referred to in section 27(3)(a) to (f) of the Public Finance Act 1989:

(c) the Commission's current and possible future overall financial position.

(1B) Without limiting subsections (1) and (1A), written directions may specify detailed requirements or prohibitions, or both, to which the Commission must give effect in exercising its functions under section 5(1)(c) and section 5(1)(d).

(2) *[Repealed]*

(2A) *[Repealed]*

(2B) *[Repealed]*

(3) *[Repealed]*

(4) Every direction given under section 9 of the Earthquake and War Damage Act 1944 (as substituted by section 3 of the Earthquake and War Damage Amendment Act 1988) and in force on the commencement of this Act shall be deemed to have been given under section 103 of the Crown Entities Act 2004.

Section 12(1): substituted, on 25 January 2005, by section 200 of the Crown Entities Act 2004 (2004 No 115).
Section 12(1A): inserted, on 27 March 1998, by section 2 of the Earthquake Commission Amendment Act 1998 (1998 No 9).
Section 12(1A): amended, on 25 January 2005, by section 200 of the Crown Entities Act 2004 (2004 No 115).
Section 12(1A)(b): amended, on 25 January 2005, by section 37(1) of the Public Finance Amendment Act 2004 (2004 No 113).
Section 12(1B): inserted, on 27 March 1998, by section 2 of the Earthquake Commission Amendment Act 1998 (1998 No 9).
Section 12(1B): amended, on 25 January 2005, by section 200 of the Crown Entities Act 2004 (2004 No 115).
Section 12(2): repealed, on 25 January 2005, by section 200 of the Crown Entities Act 2004 (2004 No 115).
Section 12(2A): repealed, on 25 January 2005, by section 200 of the Crown Entities Act 2004 (2004 No 115).
Section 12(2B): repealed, on 25 January 2005, by section 200 of the Crown Entities Act 2004 (2004 No 115).
Section 12(3): repealed, on 25 January 2005, by section 200 of the Crown Entities Act 2004 (2004 No 115).
Section 12(4): amended, on 25 January 2005, by section 200 of the Crown Entities Act 2004 (2004 No 115).

**Figure 15: 1998 EQC Amendment Act**

## 16. EQC's call on its Guarantee 30th June 2011

https://drive.google.com/file/d/1obnQ1qrNRLk2tKAsI1wURhOujzadOetk/view?usp=sharing

3. These discussions have come about because EQCs new actuarial valuation of their future liabilities will result in EQCs accounts as at 30 June 2011 showing its liabilities exceeding its assets by $1.156 billion i.e. a negative equity position.

**Treasury Report:** Crown Guarantee of the Earthquake Commission

**Purpose**

1. The purpose of this report is to inform you of a difference in opinion between Treasury and the Earthquake Commission (EQC) over whether the Crown guarantee should be triggered. Treasury's view is that there is no imminent requirement to carry out action under the guarantee and that you should send a letter to the EQC stating this. The reason for proactively sending a letter to EQC now is largely to avoid this issue becoming a distraction to more important areas of focus for the EQC Board, such as cost control.

**Figure 16: EQC's call on its Guarantee 30th June 2011**

## 17. EQC's Canterbury EQ Gross Undiscounted Insurance Liability development

### Statement of Financial Position

AS AT 30 JUNE 2012

| | NOTE | ACTUAL 2012 $(000) | BUDGET 2012 $(000) | ACTUAL 2011 $(000) |
|---|---|---|---|---|
| **NATURAL DISASTER FUND** | | | | |
| Capitalised reserves | 9 | 1,500,000 | 1,500,000 | 1,500,000 |
| Retained earnings | 9 | (3,092,074) | 1,952,312 | (2,656,401) |
| **TOTAL EQUITY** | **9** | **(1,592,074)** | **3,452,312** | **(1,156,401)** |

### STATEMENT OF FINANCIAL POSITION

AS AT 30 JUNE 2015

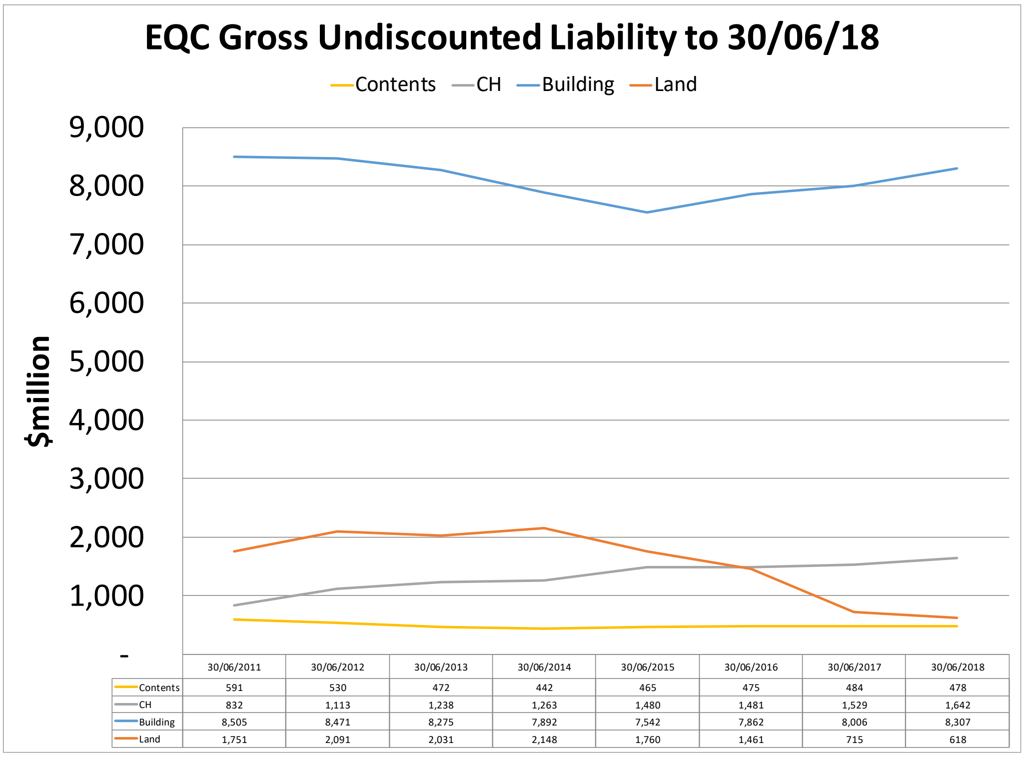
| | NOTE | ACTUAL 2015 $(000) | BUDGET 2015 $(000) | ACTUAL 2014 $(000) |
|---|---|---|---|---|
| **NATURAL DISASTER FUND** | | | | |
| Capitalised reserves | 10 | 1,500,000 | 1,500,000 | 1,500,000 |
| Retained earnings | 10 | (1,924,062) | (2,269,281) | (2,581,578) |
| **TOTAL EQUITY** | **10** | **(424,062)** | **(769,281)** | **(1,081,578)** |

https://www.newstalkzb.co.nz/news/politics/eqc-accused-of-bolstering-govt-surplus/

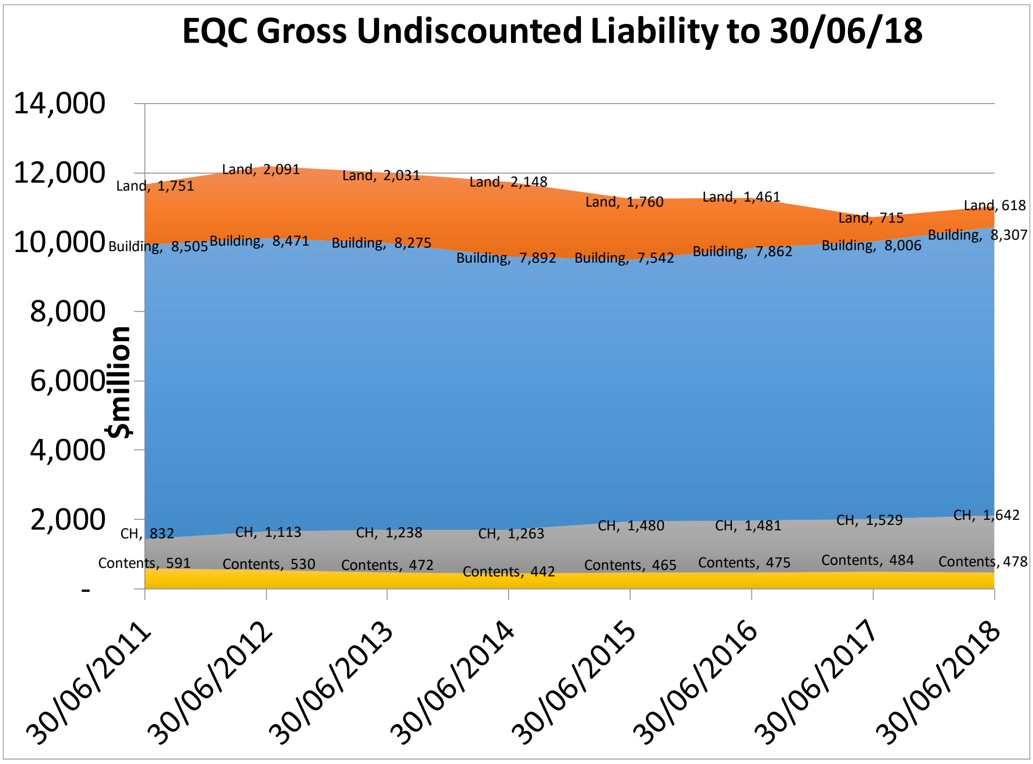
### Statement of Financial Position

AS AT 30 JUNE 2018

| | NOTE | ACTUAL 2018 $(000) | UNAUDITED BUDGET 2018 $(000) | ACTUAL 2017 $(000) |
|---|---|---|---|---|
| **EQUITY** | | | | |
| Capitalised reserves | 11 | 1,500,000 | 1,500,000 | 1,500,000 |
| Retained earnings | | (2,449,501) | (2,115,612) | (2,270,470) |
| **Total equity** | | **(949,501)** | **(615,612)** | **(770,470)** |




| | 30/06/2011 | 30/06/2012 | 30/06/2013 | 30/06/2014 | 30/06/2015 | 30/06/2016 | 30/06/2017 | 30/06/2018 |
|---|---|---|---|---|---|---|---|---|
| Contents | 591 | 530 | 472 | 442 | 465 | 475 | 484 | 478 |
| CH | 832 | 1,113 | 1,238 | 1,263 | 1,480 | 1,481 | 1,529 | 1,642 |
| Building | 8,505 | 8,471 | 8,275 | 7,892 | 7,542 | 7,862 | 8,006 | 8,307 |
| Land | 1,751 | 2,091 | 2,031 | 2,148 | 1,760 | 1,461 | 715 | 618 |




Note – CH = Claims Handling Expenses

Source : EQC Insurance Liability Valuation Reports 2011-2017, EQC Annual Report 2018

**Figure 17: EQC's Canterbury EQ Gross Undiscounted Insurance Liability development**