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New Zealand Productivity Commission
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ICNZ submission on local government funding and financing inquiry (draft report)

Thank you for the opportunity to submit on the draft report on local government funding and financing ('draft report'), which was released on 4 July 2019.

ICNZ represents general insurers that insure about 95 percent of the New Zealand general insurance market, including about a trillion dollars' worth of New Zealand property and liabilities. ICNZ members provide insurance products ranging from those usually purchased by individuals (such as home and contents insurance, travel insurance, motor vehicle insurance) to those purchased by small businesses and larger organisations (such as product and public liability insurance, professional indemnity insurance, commercial property, and directors and officers insurance).

Please contact Andrew Saunders (andrew@icnz.org.nz or 04 914 2224) if you have any questions on our submission or require further information.

Overarching comments

Importance of adaptation

Our submission is focussed on Chapter 8 of the draft report (Adapting to climate change). We note the Paris Agreement of 2015 requires action on both climate change adaptation (risk reduction) and mitigation (greenhouse gas emission reduction). ICNZ considers there should be an equal focus on both issues and it is important to remember the reason mitigation is being addressed is because of the profoundly negative impacts of climate change.

As greenhouse gas emissions are cumulative, some adverse consequences from climate change are already set, such as some further sea-level rise. Regardless of New Zealand's success in achieving greenhouse gas emissions reductions, the country faces significant adaptation challenges resulting directly or indirectly from changes in the climate.

ICNZ supports the strong recognition given to climate change adaptation in the draft report. The focus and funding of climate change issues is all too often solely on mitigating greenhouse gas emissions. When there is consideration of climate change impacts, the emphasis has traditionally been on ex-

post disaster management. Such an approach is totally inadequate and will prove to be economically, socially and environmentally more costly because:

- billions of dollars of local government infrastructure and assets are at risk from sea-level rise, noting that the full cost of exposure (including central government and private sector property) will be in the tens of billions of dollars;
- there is often a mismatch between the resources and capabilities available to local authorities and the scale of their adaptation challenges;
- the central government approach to providing financial assistance to communities affected by natural disasters tends to be ad-hoc, providing little certainty in advance while also risking moral hazard; and
- there is no centrally managed mechanism for funding the costs of climate change adaptation.

The scale of the challenges associated with adapting to the various effects of climate change are such that these cannot be the sole responsibility of local government, though there are important ways in which it can lead adaptation responses. In considering the range of adaptation responses, it is important to acknowledge that while funding is clearly a prominent issue, it is only a part of the solution. The draft report recognises this through its proposal to establish a risk management agency that can provide advice to councils and by calling out the need for aligned legislation that addresses the long-term nature of these issues, to empower appropriate decisions on issues such as planning.

Too often those that take out insurance assume that transferring risks to an insurer removes the risk, when clearly the risk itself is not removed at all. It is important to remember that insurance is only provided for property (not land itself) and so where the land itself is at risk there is a protection gap. This is particularly relevant for lenders as they lend against the combined value of land and property. Where the land itself and therefore the property on it is at risk from climate change effects, for instance from sea-level rise, prudent banks will provide mortgages on shorter terms or not at all. This is likely to have an immediate and significant effect on property prices.

There is also a view that government will always act as a last resort to restore loss from climate change damage, which creates a moral hazard and a disincentive to reduce risks. Clearly there is a wider educational role to address this significant barrier to building resilience. This could be partly addressed if there was greater clarity around climate change risk disclosures on a community, regional, business and national level, done in a consistent and comparable way.

Role of information

It is critical that decision making is underpinned by good quality information at both a community and individual property level. In this context it is important to recognise that climate change will affect different locations and properties in very different ways. Some will face changes over time in the frequency of certain weather related events (e.g. storms, droughts), some will face changes in the nature or extent of events and for properties exposed to sea level rise the impacts will be driven by the speed and extent of sea level rise.

It should be a goal to ensure that all property owners understand the specific natural disaster risks facing their properties (e.g. from flooding, earthquake, landslip etc), both now and in the future, and ICNZ is progressing work in this area. This understanding will help to inform and motivate where action is required by people, businesses and communities. The need for such risk information is not limited to climate change but it is a crucial dimension of it.

It is worth reflecting on some of the key barriers that contribute to today's inadequate support for action on adaptation in the context of funding. Despite the significant need for climate-resilient investment it is simply not given sufficient priority in public funding allocations either at a central or local government level. There is also low awareness of the opportunities for private investors to fund adaptation initiatives and awareness of the investment returns that might be available if opportunities existed. This leads to a lack of financial capital looking to invest, yet it will take a combination of public and private capital to address the funding issue.

In order to identify climate change exposures, there needs to be greater use made of frameworks such as that of the Task Force on Climate-related Financial Disclosures (TCFD). By drawing on quality scientific data and employing such frameworks, councils (and businesses) can estimate the impact of climate change and integrate them into long-term strategies. The resources and expertise to carry out this work are limited, so the establishment of a well-resourced centre of expertise to support councils would be critical. Such an initiative would both increase expertise while avoiding duplication and should be particularly helpful for smaller councils. Taking clear steps to quantify the financial cost of inaction, or inadequate measures to adapt, will help to facilitate the creation of financial products that are attractive to private capital to help fund risk reduction initiatives.

Risk reduction

While we support much of the draft report and the recommendations for greater central government support, pre-event risk reduction, and incentives to reduce long-term costs, we consider it should be more conclusive about the approach that needs to be taken to reduce climate change risk. There is scope for wider society to bear some of the costs of adapting to climate change, however, clear price signals need to be given to reflect risk and these should not be so muted as to prevent action. We caution using the idea of social insurance as a concept to underpin responses to climate change for various reasons. These include that some kinds of losses are highly foreseeable now and that the same physical effects will likely result in costs and losses for both individuals/families and businesses as well as for local and central government.

Policies need to minimise moral hazard and we also support a focus on minimising long term costs. It will be important that Government carefully considers and formalises a principles-based approach to any taxpayer funding of climate change adaptation measures, including where relevant coastal retreat. The aim of this should be to reduce risky investments and moral hazard, allow for as orderly a transition as practicable, and ensure the costs of climate change are shared equitably across the existing population and intergenerationally. We are also mindful the absence of a clear approach from government creates uncertainty for local government and others and may prevent or limit sensible adaptation measures being taken now and also increases moral hazard in some situations. History also shows that central government often ends up funding the response to disasters and so the absence of an upfront approach in this area does not necessarily reduce the long-term risks to taxpayers associated with the effects of climate change.

While we cannot control the forces of nature, we can reduce their impact significantly by building our capacity to withstand and recover from natural disasters. This is achieved by identifying and planning ahead on how to adapt or mitigate, in order to reduce the risks we face. Numerous studies show that investment in those measures before disaster strikes saves much more than trying to pick up the cost afterwards. Government should also support local government in promoting the measures needed to attract investment, so adaptation is funded through public-private arrangements. Assistance and incentives from central and local government should be focused on assisting those most vulnerable to adapt and reduce their risk.

Reducing risks also helps to keep insurance available and affordable. High levels of insurance cover in turn benefits society by sharing the risk and reducing the costs individuals, businesses, and local and central government would otherwise have to meet, as well as improving an economy's ability to recover after a disaster. It is important to remember that New Zealand is one of the most vulnerable countries in the world to the impact of natural disasters for an economy of our size (largely due to earthquake risk). A 2018 Lloyd's report rated New Zealand as having the second highest level of annual expected losses as a percentage of GDP.¹

Given New Zealand's exposure to natural disasters it is critical that it maintains access to international risk-capital to support both private insurers and the Earthquake Commission (EQC). Proactive efforts to reduce risks and increase the swiftness of response and recovery are a welcome step in this regard. It is critical to reduce the risks from climate change as if the risks become too great, insurance will likely become unaffordable or unavailable. The consequences of this can be severe, so taking steps earlier, when they are often less costly, is vital to enable risks to continue to be transferred through insurance.

We see merit in the use of adaptive pathways and support reform and alignment of the legal framework for the *Resource Management Act 1991* and the *Building Act 2004* to ensure that appropriate account is taken of existing and evolving natural hazard risks in planning and building decisions. We also agree that it is necessary for legal frameworks to be amended to give councils more backing and knowledge to do the right things in land-use planning and infrastructure investment.

As well as taking proactive steps the simplest action is to stop investing in and/or consenting new assets and infrastructure that are inherently vulnerable to climate change risks, particularly given the value of vulnerable infrastructure is already high.² Governments and public authorities play a crucial role in enhancing resilience and adaptation measures and so to enable an affordable transfer of risk to the insurance sector a holistic approach to adaptation involving central and local government will be necessary.

Innovative funding mechanisms

Given the massive costs of reducing risks from climate change to vulnerable infrastructure and communities, innovative financing options are going to be required to support investments in resilience and risk reduction. There is a need to identify the long-term risk based on credible scenarios, conduct cost-benefit analysis of investment to ensure net benefit of investment on an NPV basis and develop financial products that monetise the value and provide funds for up-front investment. Innovative approaches that seek to incentivise resilience, make funds available, and also provide an insurance element to manage risk include³:

- Insurance-Linked Loan Packages – Concessional loans from public bodies with integrated resilience conditions.

¹ A world at risk, Closing the insurance gap, October 2018, available from <https://www.lloyds.com/news-and-risk-insight/risk-reports/library/understanding-risk/a-world-at-risk>.

² A recent NIWA report found that in regard to coastal flooding exposure at present-day mean sea-level "A usually-resident population of just over 72,000 occupies the exposed land. More than 49,000 buildings with a \$NZD 12.5 B replacement value are also exposed". A rise in sea levels of 0.6m more than doubles the replacement value of exposed property to \$26.2 B. Refer to *Coastal Flooding Exposure Under Future Sea-level Rise for New Zealand*, prepared for The Deep South Challenge, August 2018.

³ Refer to the following document for more information on these concepts - Innovative Finance for Resilient Infrastructure (Lloyds 2018) (https://www.lloyds.com/~media/files/news-and-insight/risk-insight/2018/dfid/innovativefinance_final_web.pdf).

- Resilience Impact Bonds – A bond with outcome-based repayments focused on resilience and social goals.
- Resilience Bonds – A catastrophe bond (cat bond) where bond coupon payments are reduced when resilience measures are implemented.
- Resilience Service Companies – An entity that invests in upfront resilience measures in exchange for a share of future insurance premium savings.

Specific and technical comments on the draft report

We have the following specific comments to make on the content of Chapter 8 of the draft report:

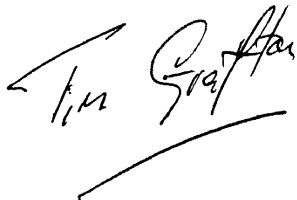
- We agree one of the critical factors with climate change is that risks are evolving and changing, however, we question the comparison to earthquake risk being unchanging as the understanding of earthquake risks are constantly evolving due to events and/or research (refer bullet point on page 210 and Finding 8.2 on page 222). Inclusion of this comparison is unnecessary and so we suggest it is removed.
- With regard to “insurance will be of limited help” on pages 224-225 – we note that while insurance is not suitable for managing risks that are not uncertain (e.g. inundation from sea level rise) it will remain critical in regard to losses that remain uncertain (e.g. storm damage) so long as the losses being incurred are not so frequent and significant as to make it unaffordable. Also, as discussed below, insurers are increasingly drawing on models in underwriting risks.
- With regard to the second to last paragraph on page 224, the reference to the insurance of council’s infrastructure assets should be to their four waters assets (e.g. freshwater, stormwater, sewage and flood protection) as the 60/40 funding split referred to is limited to these types of assets.
- In relation to Finding 8.4 and the discussion that precedes it on page 225. We agree that properties at growing risk from sea-level rise, river-plain flooding or other types of climate-change hazard could become increasingly uninsurable and this will largely be because the losses are not unforeseen (e.g. they can become certain over time if caused by sea level rise). We disagree however that this will be because it is not possible to calculate the chance of loss either mathematically or through experience due to the novel, uncertain and dynamic character of climate-change. While insurance was historically experience based, it is increasingly becoming based on forward looking models. Weather risk modelling continues to be further developed and explicitly looks at what the weather will be like in the future when considering present day risks, because historical experience has already become a less valid guide and will become increasingly so over time. It is also important to consider that climate change will create different kinds of risks over time. For example, coastal inundation resulting from sea level rise has an inevitability and predictability to it that does not necessarily apply to non-coastal flooding risks, which might be affected in less linear and obvious ways over time depending on the location.
- In relation to the top bullet point on page 226, we note that in the case of recent natural disasters, general insurers have funded a significant proportion of the total costs (e.g. \$21 billion so far from insurers to their private and commercial customers in Canterbury, much of this provided through reinsurance arrangements, with another \$3.5-4 billion into EQC from reinsurers also).

- In relation to the bottom bullet point on page 226, we note that in the case of leaky homes, the financial assistance package was 1/4 central government, 1/4 local government, and 1/2 homeowners, rather than 1/3 for each.
- With regard to the top bullet point on page 232. Rather than saying “Private insurance is available, and, for residential property and land, it is supplemented by the EQC cover”, it would be more accurate to say “Private insurance is available, and for residential property its provision is supported by the EQC cover applying to the first \$150,000 of property loss in relation to specified natural disasters”. The EQC cover in relation to land could be described separately.
- While noting that it is not a recommended option in the draft report, we consider there are strong reasons to not amend the legislative manage of the EQC so that it becomes responsible for pre-disaster funding (as is discussed on page 233). This would represent a radical change to the role of EQC given the completely different purpose (pre event resilience funding vs providing an amount of cover to complement private insurance coverage in relation to certain natural disaster losses) and the limited scope of EQC cover (only for residential property and related land and only for certain types of damage, notably not flood damage in regard to property) not aligning with the required scope of such a task. It would be much more appropriate to create a new structure than to try and adapt EQC to such a purpose.

Conclusion

Thank you again for the opportunity to submit on the draft report. If you have any questions, please contact our Regulatory Affairs Manager on (04) 914 2224 or by emailing andrew@icnz.org.nz.

Yours sincerely,



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