New Zealand Local Government **Insurance Market Review**

Prepared for Local Government New Zealand

Craig Stobo

We are.
LGNZ.

December 2013

“We can’t solve problems by using the same kind of thinking we used when we created them.”

Einstein

CONTENTS

Biography
Craig Stobo

Craig Stobo was educated at Waitaki Boys High School (Milner Prize), Otago University (BA Hons First Class in Economics) and Wharton Business School, University of Pennsylvannia (Advanced Management Programme).

He has worked as a diplomat, economist, investment banker and also as CEO and Executive Vice President for BT Funds Management. He Chaired the Government review of the taxation of investment income which led to the PIE managed fund tax regime which underpins Kiwisaver; Chaired the Government review of financial services exports which led to tax changes necessary for New Zealand to become a funds domicile and Chaired the Establishment Board of the Local Government Funding Agency (LGFA) prior to its incorporation on 1 December 2011.

He is currently an independent director and Chair of the LGFA, AIG Insurance New Zealand Ltd, Precinct Properties New Zealand Ltd, and OCG Consulting Ltd.

Craig also has directorship and private equity interests in financial services and other businesses, and provides consultancy services to businesses and the New Zealand Government.

Summary

The Christchurch earthquakes have shaken the provision of insurance products and services to New Zealand local authorities. The business models of the three sector-owned entities Civic, LAPP and Riskpool have been severely tested as a result of this and the leaky homes liabilities. In some cases the latter entities may not survive the current reinsurance arbitration process.

The price and extent of insurance provision for local authorities have changed, created extra costs, and has forced a deeper examination of risk profiles, risk assessment practices and risk mitigation techniques including alternatives to existing risk transfer solutions. Finally, the consequences of weaknesses in co-funding arrangements with the Crown for natural disaster recovery requires a rethink on ratepayer/taxpayer risk sharing.

Despite this turmoil New Zealand local authorities are in a strong position to move forward if they can work together. The underlying principles for options and my recommendation are as follows:

1. In my discussions on insurance it is very clear that the bigger issue for local authorities is their access to skills and expertise to think about and manage risk, not just the purchase of insurance which tends to be the last risk mitigation option.
2. Local authorities face similar sets of asset and liability risks and therefore have enormous opportunities to benefit from economies of scale if they can work together. They should use their asset and liability risk homogeneity and size to their advantage including identifying, owning and leveraging their intellectual property, including seeking innovative products and services for their benefit.Pooling risks doesn't have to mean pooling scarce local authority capital in a local authority-owned insurance company/mutual to fund risk mitigation. Councils have limited capital to insure other councils' misfortunes. Insurance markets are also changing. The key is to think smarter about self-reliant sustainable resilient solutions including the most efficient pathway from local authority needs to stable global reinsurer support.
3. The 60/40 per cent co-funding arrangement with the Crown for underground infrastructure damage caused by a natural disaster has no basis for its formula, incentivises councils to avoid self-reliant risk management outcomes and creates funding uncertainties for both parties. This needs to change.

Options

I have detailed options for change from the status quo in my Review. Three of these options are recommended for their economic sustainability.

The three recommendations

1. Encourage councils to spend more resources on risk profiling, risk management and risk mitigation to improve self-reliance and resilience. Identify, own, share and leverage this information to reduce the costs of poor information.
2. Create a local authority-owned Agency to replace the current local authority owned insurers. It is **not** an insurance provider which competes with insurance companies. It should provide expertise on risk profiling, risk management and risk mitigation. Local authority data is its intellectual property which it must own and control. It uses its exclusive negotiating role and collective buying power to negotiate insurances on behalf of all local authorities but settles via individual contracts. The Agency's balance sheet is therefore "capital light." It actively seeks product, service and insurance contract innovation. It works with Crown agencies such as EQC and GNS. It builds strong global relationships with local and global insurers/reinsurers. It is funded by annual premium-related service fees from councils and the Crown. It is owned by councils and the Crown.
3. The 60/40 per cent natural disaster co-funding arrangement with the Crown for material damage to underground infrastructure is removed in return for set dollar insurance layers comprising self-insurance, commercial insurance and taxpayer support in return for Crown funding assistance for the Agency. This will encourage greater council self-reliance and use of the Agency.

Recommended next steps

Convene a working group meeting of like-minded councils to assess the Agency initiative. Specifically, representatives of all the Local Authority Shared Service (LASS) type entities, plus Auckland, Wellington, Christchurch and Dunedin City Councils. National Council has to be a funding sponsor and champion. If required I would be interested in assisting LGNZ to take the next step.

Terms of reference for the review

1. To analyse and assess the insurance market in New Zealand insofar as it affects the provision of insurance products and services to the local authorities.
2. Provide advice on the state of the market, its conditions and the consequent risks and threats facing local authorities.
3. Analyse and assess local authorities risk profiles and advise on their insurance needs.
4. Advise on the insurance arrangement options available to local authorities.
5. Make recommendations to the National Council of Local Government New Zealand (LGNZ) on actions LGNZ should take or promote to ensure that appropriate and economically sustainable risk protection is in place to protect the interests of local authorities.

Methodology

My methodology involved the following research:

- Meetings with the Crown and Crown agencies to determine the Crown's perspective on local authority insurance. This included The Treasury, Office of the Auditor General (OAG), Department of Internal Affairs and the Earthquake Commission. In particular, the OAG reports "Insuring Public Assets" and "Managing Public Assets" should be read in conjunction with this Review.
- Meetings with selected councils to determine insurance issues from their different perspectives. This included Auckland, Wellington City, Christchurch City, Dunedin City, Queenstown Lakes District, and Waitaki District Councils.
- Meetings with entities that offered insights into different collective insurance business models. This included Health Benefits Ltd (for New Zealand DHBs), and the Australian local authority insurance businesses Statewide Mutual in NSW and Local Government Risk Services in South Australia.
- Meetings with the Chairs of Civic, LAPP and Riskpool. Meetings with the Board of Riskpool and CEO of Civic.
- Meetings in New Zealand and Sydney with all major global insurance brokers and insurers/reinsurers who have had an interest in local authority insurance in New Zealand.
- Meetings with subject matter experts in Australia and New Zealand.

The meetings are listed in Appendix 1.

A survey on insurance was sent to all local authorities for their comments. Thirty eight replied and are listed in Appendix 2. This did not extend to CCOs and is out of scope of this Review. The results are only summarised in this Review due to commercial sensitivities. The survey questionnaire is attached to this Review as Appendix 5.

Research into insurance issues and markets was conducted. The publication "Assuring and Enduring, Fifty Years of Civic Assurance-Tested by Time and Disaster" was excellent background reading.

I am indebted to all participants in this Review for their time, cooperation given freely and frank views. This Review attempts to capture those views. I apologies for any errors or omissions.

My potential conflict of interest as Chair of AIG Insurance in New Zealand was disclosed at these meetings.

Findings

1. To analyse and assess the insurance market in New Zealand insofar as it affects the provision of insurance products and services to the local authorities

The insurance market has changed considerably on several levels over the last few years. This is already well documented in the OAG Report "Insuring Public Assets." I won't repeat their findings here. The following captures issues that lead to this Review's options and recommendations.

a) Undercapitalised insurers have struggled with major event risks such as the Christchurch earthquakes and weathertight homes. ANSVAR has exited the market. AMI has been broken up and sold. LAPP has paid out and is seeking capital contributions. Riskpool only provides insurance now where reinsurance is available. Civic has limited freedom to operate as an insurer with a provisional licence only from the RBNZ due its arbitration with its reinsurers, and a sub-prime credit rating. Note 24 of Civic's 2012 annual accounts discloses the potential solvency issues.

b) Civic's product offering restrictions from 2011 resulted in its clients becoming distressed buyers in a more expensive market. Local authorities have moved to use brokers directly or through regional collective structures to gain access to expert advice and stable commercial insurance.

c) Commercial insurers/reinsurers are demanding more information about insurance risks and being more selective in their offerings.

d) Premiums and deductibles have increased but some stabilisation is occurring now. The global catastrophe environment in 2013 has been benign to date. It is therefore unlikely that there will be premium increases or restrictions in capacity in the reinsurance sector in the near future. Appendix 3 details premiums written by the insurance industry. The OAG report provides more detail on public asset insurance conditions. My survey also indicates the extent of premium increases for local authorities were variable by region and insurance type, with earthquake risk in the Canterbury and Wellington regions being the most problematic drivers of premium change. Finally, there was some deterioration in cover obtained (ie policy exclusions).

e) As a result of premium increases new entrants have come into the market such as Berkshire Hathaway. Despite earlier doubts some councils have been able to get underground infrastructure insurance from global insurers/reinsurers.

f) The Crown has expressed its concerns over the open ended nature of its contingent liability to its 60/40 per cent co-funding of natural disasters under Clause 26 of the Civil Defence Emergency Plan. All councils have expressed a desire for the Crown to continue to use taxpayers' funds to support a natural disaster in their locality. Some councils may unduly rely on their participation in LAPP to access the Crown's funding under this formula rather than pursue sustainable alternatives.

2. Provide advice on the state of the market, its conditions and the consequent risks and threats facing local authorities

State of commercial providers

No major broker or commercial insurer/reinsurer met who is a provider to the sector wishes to pull out. Rather they are or want to be highly engaged and wish to see the sector evolve. Some, such as Berkshire, have entered the market as premiums have risen. Many have insurance capacity and have offered innovative ideas for the sector. As the OAG insurance report outlines, historical patterns show that while insurance costs rise sharply after the event, they also show that, relatively soon after, insurance costs plateau and fall. However, insurance for material damage risks from earthquakes is clearly being repriced. This represents a change from perceived to revealed risk, and can be expected to be a structural feature of insurer risk selection going forward. My view is that commercial capacity and changes to the cost of insurance by themselves do not represent a threat to local authorities' ability to manage risk.

Appendix 4 lists the current RBNZ licensed insurers in New Zealand relevant to the sector.

State of local authority owned insurance providers

a) Civic Assurance

Civic Assurance's financial challenges are clearly laid out on page 42 of the OAG insurance report. The matters referred to by OAG that need to be resolved are detailed in Civic's 2012 Annual Report. It currently has a provisional licence from the regulator RBNZ, has been assigned a sub-prime credit rating and therefore cannot provide the services needed by local authorities. It has attempted to provide insurance via another non-regulated structure but the council survey indicates it has not met with support from members. Its offer of shares to members to recapitalise remains open. Its future is tied to winning the arbitration with reinsurers, regaining a full insurance licence, getting an acceptable rating and recapitalising.

The company's core business is as an insurer. After retained earnings and calls on capital it turns to the global market for reinsurance. In that sense it is like any other local insurer. However, it does have differences. It has paid rebates to premium contributors. Its major asset is Civic Assurance House on Lambton Quay. (The asset does not provide diversification from the risks Civic is attempting to manage in my view). Civic relies heavily on its CEO who is accountable across the three sector owned entities – Civic/LAPP/Riskpool.

Importantly, the insurance market Civic operates in is changing. Commercial insurers are able to provide competitive products and services to local authorities without the need for capital calls. The needs of local authorities are shifting to advice on risk management solutions. Civic is at risk of becoming an undifferentiated insurance provider.

b) The Local Authority Protection Programme Disaster Fund (LAPP)

LAPP's genesis, development and its future prospects are also clearly laid out on page 42 of the OAG insurance report. It is a not for profit non-taxable discretionary mutual charitable trust with Civic Assurance as manager. It commenced operations in response to the Government's shift in 1991 to fund only 60 per cent of affected underground local infrastructure above a threshold laid out in section 26 of the Guide to the National Civil Defence Emergency Management Plan. Eligibility for the 60 per cent is subject to the following:

- "the local authority has adequately protected itself through asset and risk management including mitigation, where appropriate, and the proper maintenance of infrastructure assets; or
- the local authority has made sound financial provisions (such as the provision of reserve funds, effective insurance or participation in a mutual assistance scheme with other local authorities) to a level sufficient to ensure the local authority could reasonably be expected to meet its obligation to provide for its own recovery."

Clearly LAPP has "done its job" (funding the Christchurch rebuild-subject to its insurance payout from Civic), but no local authority expected the scale of the disaster and the size of the LAPP payout. The survey captures concerns over the size of contributions required for the LAPP rebuild, and its discretionary status. Consequently, many members have exercised their rights to withdraw from LAPP next year (while still retaining the option to cancel that right). Members are seeking and getting alternative solutions to LAPP. LAPP's future is therefore not clear.

Currently, if local authorities did nothing else but gain LAPP (or another mutual) membership then the Crown is obliged to fund 60 per cent as per the Guide. In my view, this reduces councils' incentives to consider other risk mitigation solutions. LAPP's current problematic rebuild also means that it is not clear that a member local authority can 'reasonably be expected to meet its obligation to provide for its own recovery." Requests for clarity from the Crown on this by one local authority have met with a response that does not provide any certainty.

It is timely to reconsider why both the Crown and local authorities believe that the 60/40 formula is appropriate following lessons learnt after Christchurch. There is a policy hazard here. If LAPP does provides co-funding security for a council, then both the Crown and LAPP have theoretically unlimited liabilities (ie tied to the unknown size of the next disasters). However, LAPP does not necessarily have the same resources to recapitalise post event as the Crown since it relies on scarce local authority capital before a reinsurance layer. Some councils are just now unwilling to fund someone else's disaster.

c) Riskpool

Riskpool is a mutual liability fund started in 1997. Its genesis lies in councils individually being unable to get liability cover at the right price. Civic owns the shares of the Trustee for Riskpool. Following the court rulings on leaky buildings liability, Riskpool can no longer offer this insurance and its members are on notice for capital calls if required. Riskpool has recently put in place a three year reinsurance programme and does not offer insurance outside of this reinsurance (ie no future council-funded capital layer).

Many councils surveyed do not want to be the "last man standing," have withdrawn from Riskpool and obtained satisfactory insurance from the commercial sector. What was a virtue for some councils with Riskpool (collective risk sharing) has become a collective liability (long tail calls on capital).

While the commercial sector may be meeting liability insurance needs (and without capital calls) they may not be able to advocate for the sector, and ensure that case law does not develop with precedents that adversely affect all councils. Riskpool has played an important role in this regard.

Local authority response

The changes to insurance market conditions have resulted in a number of different responses by local authorities:

- Agreed to accept higher premiums/deductibles/exclusions because the council policy requires full insurance, ie a passive transaction approach;
- Decided to the alter the extent of insurance cover (from full replacement to fire only loss or indemnity or demolition costs); and increased deductibles to keep costs down;
- Expressed unwillingness/uncertainty to support Civic/LAPP/Riskpool. Various reasons have been given including cost, service, a conflicted business model, and the presence of alternative suitable products and services;
- Asked the Crown if LAPP in its current state would meet the eligibility criteria for 60/40 co-funding assistance;
- Moved/moving to source advice/insurance from brokers/commercial insurers directly or through regional collective structures eg Waikato Local Authority Shared Services (LASS), Bay of Plenty LASS, Wairarapa collective, Wellington cooperative, Canterbury CFOs and Top of the South;
- Have commenced reviews of risk management;
- Christchurch City Council announced it was undertaking a formal review of a number of issues related to the Council's insurance led by an independent barrister; and
- LGNZ has commissioned a Review of the Insurance Market for Local Authorities.

Local authority risks and threats

a) Local authority risk management

Local authorities are required to maintain essential services to their communities including the continuous provision of the three waters and roading. The risks that have to be managed are disorderly disruption to essential services and the funding of repair and/or replacement in a timely manner. Councils also have to protect themselves from potential liabilities incurred in performing council services.

Councils do have asset management plans which record the condition of infrastructure and buildings which informs repairs, renewals and therefore future capital expenditure. However my survey indicates that these are recorded in different types of software and in some cases do not link to risk mitigation strategies or depreciation schedules.

Councils do not have uniformly complete policies on their risk appetite, risk management and risk mitigation. They lack resources to consider these issues and may view insurance as the panacea to risk mitigation which is managed in the annual budget negotiation round by confirming that cover is in place at the same or less premium than the previous year. I am very concerned about what councils don't know.

So in some senses this Review has a Terms of Reference which focuses at the last step in the risk mitigation process, ie risk transfer (insurance) when the bigger issue is councils' capacity to consider risk appetite/profiles, risk management opportunities and risk mitigation techniques.

For example, no council surveyed could confirm that they had had a clear mandate with their communities on their appetite for risk. Conversations are needed on what infrastructure is essential to be reinstated first in a disaster setting and therefore should attract priority management and funding today. That might be three waters infrastructure, but not community halls and sports facilities for example.

Secondly, there is a lack of uniform consideration of risk management techniques to reduce risks of asset or service non-performance. Fire alarms, security patrols, refusing to permit unsuitable development, sale and leaseback structures, and asset leasing; or pushing back on legislation which might lead to onerous liabilities for councils are examples of the use of management skills that can reduce risk for ratepayers without paying insurance premiums while still delivering services to communities.

Thirdly, there needs to be consideration of risk mitigation through pre event and post event funding structures which links appetite for risk with asset management plans and councils' balance sheets. This really does build council self-reliance and community resilience to withstand unforeseen shocks. Put simply, once risk management solutions are in place, what resources are required to fund unforeseen damage to assets the community views as essential?

These resources could come from:

- Specific cash reserves for this purpose;
- The sale of assets. The Christchurch City Council public response to the prospect of asset sales has so far been politically difficult. In hindsight that may have been an easier decision if leadership had been able to have a public conversation on broader choices to fund disasters. Councils also need to consider the benefits of asset diversification. Owning assets that are tagged for sale in the event of a disaster that could themselves be subject to the same disaster affecting essential services seems reckless portfolio concentration in hindsight;
- Building spare debt funding capacity (ie councils could fund well within their debt covenants, and/or use LGFA to gain access to the LGFA's AA+ credit rating which builds a contingency for funding disasters); and finally
- Risk transfer ie insurance. But councils could consider smarter consideration of tradeoffs between premiums, deductibles and exclusions, types (ie full replacement, indemnity, fire loss only, demolition costs only),and purchasing recovery cost insurance before asset insurance can be paid out. New ideas for the sector should be considered.

b) Local authority threats

My study of insurance for the sector indicates that threats can be broken down into two types – external and internal.

The external threats could come in the form of more insurance market disruption due to more natural disasters including earthquakes, floods and tsunamis. This disruption could occur due to these events happening in New Zealand or overseas since local premiums are affected at the margin by the global costs of reinsurance. Councils' response should be to put in place risk profiling, risk management and pre event and post event funding mechanisms described above to increase their self-reliance and sustainability. In addition, they need to ensure that they arrange their insurances with strong stable global insurers/reinsurers.

The internal threats relate to the way the sector has organised its sector-owned insurance structures and their own internal processes.

Councils can't currently use Civic when councils' investment policies require a minimum credit rating of A or better from their insurer. The ability of Civic to resume its normal business activities is, according to Civic's directors "uncertain." Fundamentally, as the Notes to the 2012 Financial Statements of Civic state "the resolution of the reinsurance issue is necessary to enable the Company to restore its claims payable rating of A- or better." Furthermore, the Notes state that "the validity of the going concern assumption on which the financial statements are prepared depends, inter alia on limiting the Company's net outstanding claims liability to $6.6m."

It is clear from the survey responses that continued council support for LAPP is uncertain. I am not able to determine what minimum level of membership, and therefore contributions, is required to ensure LAPP is viable. If it is not viable, then councils who have relied on LAPP to meet the eligibility criteria for 60 per cent taxpayer funding of infrastructure disasters will have to seek alternatives. The level of council preparedness for this latter outcome is of some concern."

The Crown is wary about its contingent liability under the 60/40 per cent arrangement, which enables ratepayers to access taxpayer funds when councils could be more self-reliant. The National Council of LGNZ should take this opportunity to renegotiate the sector's relationship with the Crown in the event of natural disasters.

Councils have not put in place processes to consider the full suite of risk management and mitigation options available to them. Possibly councils are therefore over-insured.

The counterpoint to this is that council asset valuations for insurance purposes are estimated on an Optimised Replacement Cost (ORC) under normal operating conditions. However, reinstatement costs are more than ORC following a major disaster. These reinstatement costs include access costs in remote areas, higher labour and material costs, professional fees and claims administration. Possibly then councils are underinsured.

"What concerns me is not the way things are, but rather the way people think things are."

Epictetus

3. Analyse and assess local authorities risk profiles and advise on their insurance needs

As discussed above, my research indicates that council risk profiles/risk appetites are absent or not well documented across the sector. This makes it hard to analyse and assess actual profiles. The important conclusion is that this work needs to be done.

In discussions with large private businesses the identification of risk and elimination or reduction in risk through good management has resulted in much lower insurance costs. However, the following list of insurance types and desire for low deductibles purchased by councils indicates an astonishing breadth of insurable activities and probably a risk averse industry/organisational culture:

- material damage to property (above and below ground);
- crime;
- fine arts;
- forestry;
- forest and rural fire costs;
- standing timber;
- marine;
- motor vehicles;
- employee liability;
- statutory liability;
- public liability;
- general liability;
- trustee liability;
- professional indemnity;
- fidelity guarantee;
- personal accident;
- airport owners and operators;
- hanger keepers;
- harbour masters;
- wreck removal;
- punitive damages;
- contract works;
- hall hirers;
- life insurance;
- business interruption;
- civil defence costs;
- election costs; and
- machinery breakdown.

The list of insurances indicates to me that councils may not be thinking about risk appetite, risk management, and risk mitigation alternatives before seeking insurance. In addition, there needs to be more consideration given to funding the coverage of emergency or reinstatement costs following a disaster. As detailed earlier council officers have expressed concerns to me that their biggest issue is the availability of resources to consider risk and implement cost effective remedies – not just an insurance solution. Third party risk advisors are provided with valuable Intellectual Property (IP) data and are paid for the consequent advice while global insurance brokers are beginning to move from insurance placement to more holistic advice. There is a risk of divide and rule here, where councils are not driving contractual negotiations from a position of IP strength. A local authority supported vehicle with these specialist skills who understands the sector's needs could fulfil this role very effectively.

When choosing insurance, councils need a strong stable insurer or insurers who will honour the insurance contract sum when required for a premium at a reasonable price. Insurers should offer innovations such as rolling reinstatement insurance to provide budget certainty or parametric insurance alternatives. Catastrophe bonds are another potential avenue for risk transfer. Councils do not necessarily want to be in a mutual fund which requires unforeseen capital calls particularly when it funds someone else's disaster. And they do not necessarily want to own an insurance company to deliver stable insurance products.

Councils want great service from specialist claims support management that balances legal support with member input on claims.

Councils need to engage with the Crown and solve the uncertainty over the 60/40 per cent co-funding arrangements for infrastructure damage due to natural disasters. It would be my preference to move away from the 60/40 per cent obligation to an agreed sum insurance tower structure whereby councils self-insure up to a dollar threshold; councils have access to funds/purchase insurance for the next layer based on (for example) maximum probable loss and the Crown agrees to fund the excess top layer. Membership of a mutual such as LAPP should no longer automatically mean eligibility for taxpayer funding. This would assist in incentivising councils to manage their risks.

In return for negotiating this, the Crown would assist in funding local authority risk management.

> *"Information gaps are filled by premiums."*
>
> Chief of Risk, Fonterra

4. Advise on the insurance arrangement options available to local authorities

Local authorities have the following (non-exclusive) options available to them:

a) Self insurance

Councils need to more actively embrace risk profiling, risk management and risk mitigation, including the selection of funding techniques and insurance condition tradeoffs (premiums, deductibles, exclusions). A more detailed review is needed on the current state of the commonality of methodologies of determining asset criticality, asset valuations and its link to risk mitigation including insurance, followed by consistent continuous improvement programmes. This builds self-reliance and resilience.

b) Councils can continue to individually go directly to commercial insurers via local brokers

Councils get tailored solutions, executive accountability and imposes a degree of budgetary discipline. But there is no leverage to drive down premiums, deductibles and exclusions. There is a strong asymmetry of insurance expertise.

c) Regional initiatives to go direct to commercial insurers via brokers

Councils get similar insurance solutions based on their proximate geographic location. There is more leverage from a larger grouping. The asymmetry of expertise is better since councils can invest in skills.

d) Let the current shareholders of Civic, LAPP and Riskpool determine the future of these entities

I have already expressed my views on the challenges that Civic and LAPP now face. Riskpool is now effectively a broker intermediary to global reinsurers.

e) Actively evolve the mutual model

Galvanise the sector to recapitalise Civic, LAPP and support Riskpool but under a single, independently governed and appropriately skilled Board; and reconsider internal vs external management structures. Sell Civic Assurance House.

Statewide Mutual in NSW and the South Australian local government mutual structures have got strong local and/or state government support with elected local government directors to the schemes, and managed by externally managed insurance specialists (Jardine Lloyd Thompson in both cases). These schemes have a strong focus on workers' compensation which is mitigated in New Zealand by ACC. Without the workers' compensation liability schemes the balance of insurance provision for local authorities in Australia is considerably smaller. Like my view on equivalent structures in New Zealand, I believe their members could benefit from skilled independent professional directors who should focus on the value delivered by the manager (eg through monitoring service level agreements in the case of an external solution).

(An iteration of this option is to consider the move of the entity to become a captive insurer in an overseas jurisdiction such as Singapore, where there are attractive incentives to relocate this type of business. This has been discounted as politically unsuitable for LGNZ).

The success of this option then is entirely dependent on New Zealand local authorities willingness to make capital contributions. However, it is difficult for them to assess the future net benefits of membership ie paying potentially lower net premiums than commercial insurers vs potential capital calls. At this stage, I don't believe that enough support will be forthcoming.

f) Change the business model. The Local Government Insurance Agency (LGIA)

Councils should shift their focus from controlling insurance provision through ownership and then competing with insurers, to controlling the ownership of their Intellectual Property (IP) and working with domestic and global insurers. In this case, their IP is their risk profiles, risk management plans and risk mitigation solutions. With control of their data they should use their economies of scale to reduce the costs of risk mitigation solutions as they have successfully done with debt funding through LGFA. If all councils were to delegate risk advisory and insurance contract negotiations to a council-owned LGIA then LGIA could commence using common sector expertise and size to benefit individual councils. LGIA could evolve from the current sector entities Civic/LAPP/Riskpool. Or LGIA could be independent of, or a part of LGFA.

Key risk advisory functions provided by LGIA could include:

- risk assessment/analytics/modelling;
- asset and liability risk register compilation (eg in RMS format for reinsurers understanding);
- placement negotiation (local insurer and overseas reinsurer);
- placement (by type and tenor);
- claims operations; and
- claims advocacy.

According to reinsurance advisory specialist, Guy Carpenter, there are four fundamental components in the pricing of an insurance contract:

- expected loss;
- volatility loading (primarily to allow for the cost of capital);
- expenses; and
- investment returns.

Two of the components – volatility load and expenses – are reduced by increasing the amount of business within a programme. By purchasing insurance for all councils on a combined basis ie a single insurance contract protecting each council, councils receive a technical pricing advantage. In addition, the LGIA would have greater negotiating power, not just on price, but deductibles, reinstatement, and exclusions. Clearly the Agency would have to develop generic standard contracts specific for the sector but endorsed by each council (but that is what occurs now with standard borrowing tenors for councils using the LGFA). And then there is the opportunity to market "NZ Local Authority Inc" risk to strong global insurers and seek innovation.

The LGIA should also look after claims support including legal advice.

LGIA funding should be sourced from an annual pro rata service fee charged to councils for LGIA services and to the Crown. The latter is negotiated as part of the revised 60/40 per cent funding of natural disaster damage of council infrastructure.

The establishment costs of the LGIA company's operations would need to be funded by councils and the Crown, but on-going capital should not be required. Councils should expect a reduction in broking costs as the Agency passes lower negotiated insurance premiums directly from the insurers to councils. Councils should experience a reduction in their staff costs as some risk management/insurance functions shift to the Agency. It is not a profit maximising entity but will need to pay a suitable return to shareholders. Service fee revenues should support on-going operations including staffing and capex for data management.

The LGIA should be owned by councils and the Crown. Councils could operate a Shareholder Council to provide coordinated accountability of the Board of LGIA. The Board's directors should be a majority of skilled independent directors. Management could commence with a transparently priced external management model initially with a view to bringing it eventually in-house. Management skills need to be world class and globally credible. The risk data must be owned and controlled by the LGIA.

> *"There are no shortcuts to any place worth going."*
>
> Beverley Sills

g) Natural disaster funding

Make membership of LAPP/council mutuals no longer a condition for Government infrastructure disaster funding. Change funding from 60/40 per cent of loss funding formula to towered dollar limits. The first layer of the tower is council self-insurance, the second layer is commercial insurance (LAPP is classed as a commercial provider) and the top layer is Government funding uncapped. However, the layer thresholds are dollar limits, tied to (for example) advice on maximum probable loss. This incentivises councils to manage their risks and the caps may generate more capacity/lower prices from commercial insurers for councils.

5. Recommendations to LGNZ

In making recommendations to the National Council of LGNZ, on actions LGNZ should take or promote to ensure that appropriate and economically sustainable risk protection is in place to protect the interests of local authorities, I recommend that National Council canvas support from its members for options a), f) and g) above. This must be run in conjunction with option d). National Council must have a contingency plan in place if option d) fails.

Specifically convene a working group meeting of like-minded councils to assess the Agency initiative. Specifically representatives of all the LASS-type entities, plus Auckland, Wellington, Christchurch and Dunedin City Councils. National Council has to be a funding sponsor and champion. If required, I would be interested in assisting LGNZ to take the next step.

Appendix 1:
Insurance industry meetings

- The Treasury, Wellington
- Office of the Auditor-General, Wellington
- Department of Internal Affairs, Wellington
- EQC, Wellington
- Jardine Lloyd Thompson, Auckland
- Jardine Lloyd Thompson, Sydney
- Berkshire Hathaway, Sydney
- Guy Carpenter, Sydney
- PWC, Auckland
- Fonterra, Auckland
- Risk Management Partners, Sydney
- Willis, Auckland
- Highfield Group, Auckland
- Aon, Auckland
- Marsh, Auckland
- Crombie Lockwood, Auckland
- Munich Re, Auckland
- Munich Re, Sydney
- Insurance Council of NZ
- IAG NZ
- Vero Liability Insurance
- Lumley Insurance, Auckland
- AIG NZ, Auckland
- General Re, Auckland
- QBE, Auckland
- Chair of Civic Assurance
- Chair of Riskpool
- Chair of LAPP
- Board of Riskpool
- CEO of Civic Assurance
- Auckland Council
- Wellington City Council
- Christchurch City Council
- Waitaki District Council
- Dunedin City Council
- Queenstown Lakes District Council
- Lloyd and Partners, London
- Health Benefits Ltd, Auckland
- Statewide, Sydney
- Local Government Risk Services, Adelaide

Appendix 2: **Local authority insurance survey**

Responses to the survey were received from the following councils:

- Ashburton District Council
- Auckland Council
- Bay of Plenty Regional Council
- Central Hawke's Bay District Council
- Clutha District Council
- Environment Canterbury
- Greater Wellington Regional Council
- Hamilton City Council
- Hastings District Council
- Hawke's Bay Regional Council
- Kawerau District Council
- Marlborough District Council
- Masterton District Council
- Napier City Council
- Nelson City Council
- New Plymouth District Council
- Opotiki District Council
- Otorohanga District Council
- Palmerston North City Council
- Selwyn District Council
- Stratford District Council
- South Taranaki District Council
- South Waikato District Council
- South Wairarapa District Council
- Tasman District Council
- Tauranga District Council
- Thames-Coromandel District Council
- Timaru District Council
- Upper Hutt City Council
- Waikato Regional Council
- Waimakariri District Council
- Waimate District Council
- Waipa District Council
- Wanganui District Council
- Wellington City Council
- West Coast Regional Council
- Whakatane District Council
- Whangarei District Council

Appendix 3: **Insurance Council of New Zealand insurance premium statistics**

Gross written premiums by business class, $m, years to September.

	2008	2009	2010	2011	2012
Commercial	441	464	469	502	590
Domestic	766	840	933	1052	1170
Motor	1159	1210	1266	1340	1355
Marine	108	114	126	120	144
Liability	267	280	298	314	340
Earthquake	207	213	220	350	549
Other	306	283	297	296	303
Total	3260	3417	3604	3980	4449

Appendix 4:
Relevant RBNZ licensed general insurers (rated A or better)

- AA Insurance Ltd
- ACE Insurance Ltd
- AIG Insurance New Zealand Ltd
- Allianz Australia insurance Ltd
- AMI Insurance Ltd
- Berkshire Hathaway International Insurance Ltd
- Farmers' Mutual Group
- IAG New Zealand Ltd
- Lloyd's of London
- Lumley General Insurance (N.Z.) Ltd
- Mitsui Sumitomo Insurance Company, Ltd
- QBE Insurance (International) Ltd
- The New India Assurance Company Ltd
- Tokio Marine & Nichido Fire Insurance Company Ltd
- Vero Liability Insurance Ltd
- Vero Insurance New Zealand Ltd
- Zurich Australia Insurance Ltd

Appendix 5: **Survey**

A view from councillors/your community

1. **The Office of the Auditor General New Zealand recently published a paper on "Insuring Public Assets." They stated that there were several questions on councils' risk assessment capabilities that were of interest to them.**

With this background in mind, does your council have an asset and liability risk management policy which inter alia sets out the council's risk "appetite" and whether and how the council's risks might be mitigated by solutions such as insurance?

Yes / No

If **yes**, please attach the policy.

If **no**, is there any other council guidance?

A view from Government

2. **The Crown has a contingent liability tied to the 60/40 per cent formula for funding the replacement of local authority underground and certain flood protection assets should they be materially damaged.**

What do you believe is your council's obligation in order to be eligible for the Crown's 60 per cent share of any potential damage to these assets?

Should the Crown continue to maintain their 60 per cent commitment?

Asset Insurance

3. Do you have an up-to-date inventory of council assets, including where appropriate their age and maintenance schedule, and renewal programme?

Yes / No

If **yes**, what is the management information system that holds these records?

If **yes**, does the inventory record whether assets should not be insured, self insured through available working capital/dedicated reserves, debt funded at the time of damage, insured or require the use of other risk mitigation solutions?

4. Does this asset inventory information link to a depreciation schedule which is summarised in your council's annual accounts?

Yes / No

5. Do you insure below ground and flood protection infrastructure?

Yes / No

If yes, with whom do you insure below ground infrastructure?

If no, are you satisfied that your council is eligible for the Government's 60 per cent contribution to make good in the event of damage to your below ground infrastucture?

6. What is the ratio of your above ground assets/total assets?

7. **What is the ratio of your insured/not insured above ground assets?**

8. **What are your reasons for not insuring assets?**

9. **What was the largest fire and general insurance claim paid out to you in the last ten years, and what risk did it insure?**

10. **How does your council implement asset insurance cover?**

- ☐ Directly with a private insurer
- ☐ Using a broker
- ☐ CIVIC
- ☐ LAPP
- ☐ Other

11. **Please state why you implement this way.**

12. **Please describe your views on recent insurance market conditions as they have affected council insurance needs. This might include a description of changes in premiums, deductibles, renewals, or contract terms; or how it has affected whether the council has changed its insurance cover.**

Local government insurance sector entities – Civic

13. Please state which of the following applies to you

- Your council is a shareholder of Civic

Yes / No

- Your council currently uses Civic for its fire and general insurance needs

Yes / No

If not, why not?

- You have recommended/will recommend to council to commit to recapitalise Civic

Yes / No

Local government insurance sector entities – LAPP

14. Please state which of the following applies to you

- Your council will commit to rebuilding LAPP

Yes / No

If not, why not?

Liability insurance

15. What types of liability risks have you insured in the past year?

16. What types of liability risks do you not insure?

17. What is the largest liability insurance claim paid to you in the last ten years and what risk did it insure?

18. How does council implement public liability insurance?

☐ Direct with a private insurer

☐ Using a broker

☐ Riskpool

19. If you do not use Riskpool for liability insurance, please describe why not?

Other insurance

20. Please describe other insurances taken out and why?

Collective procurement

21. Do you confer/work with other councils on insurance procurement practices?

Yes / No

If so, with whom or in what forums?

Resourcing

22. What full time equivalent council staff work on:

- Risk assessment analysis and risk mitigation?

- Insurance needs identification, procurement and monitoring?

The Future

23. If you could make changes to Civic, LAPP and Riskpool what would they be?

24. Is there a role for local government collective insurance vehicles?

Yes / No

Why?

25. Other thoughts on insuring local government's needs?

We are.
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