

FILE



Canterbury Earthquake Recovery Authority

To Minister of Finance
Minister for Canterbury Earthquake Recovery

Subject Transaction design issues relating to the Crown's offer to insured, red-zone residential property owners

Action required Discuss recommendations with Minister of Finance/Minister for Canterbury Earthquake Recovery and advise CERA of options to progress by 1 August

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Advisor, Recovery Strategy, Planning & Policy

withheld under
section 9(2)(a)

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- 2 Note that first Cabinet paper on transaction design discussed whether the property owner should be responsible for covering EQC and private insurance excesses prior to settlement but no recommendations were agreed.
- 3 Agree that the Crown bears the EQC dwelling excess but property owners bear the consequences of choosing an insurance policy that contains an excess for earthquake claims.

Agree/disagree
Minister of Finance

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- 4 Note that Cabinet has agreed to adjust a property's purchase price by any insurance payments made where these have not yet been spent on remediation works.
- 5 Note that no decision has been made on whether property owners are able to settle with their insurance company and then subsequently accept the Crown's Option 1 to receive a top-up payment.

- 6 **Agree that property owners cannot accept the Crown's Option 1 offer if they settle with their insurance company after receiving the letter of offer.**

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- 7 **Note that Cabinet has agreed that either a deposit of \$50,000 will be paid where the settlement date is less than six months from the date of agreement, or a prepayment of up to 50 percent of the purchase price is offered where the settlement date is more than six months from the date of agreement.**

- 8 **Agree to amend the decision [CAB Min (11) 27/13 refers] to be "... either a deposit of the lesser of 50 percent of the purchase price less any insurance payments already made and \$50,000 is paid where the settlement date is less than six months from the date of agreement..." to account for properties whose payment from the Crown is less than \$50,000.**

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- 9 **Agree to amend the decision [CAB Min (11) 27/13 refers] to state "... a prepayment of up to 50 percent of the purchase price less any insurance payments is offered..." to clarify that this deposit is up to 50 percent of the total Crown payout.**

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- 10 **Note that Cabinet agreed that "property owners be required to continue their insurance until the earliest of the expiry of their policy (ie at the end of the month or year, depending on the policy) or settlement", which allows property owners to choose not to renew their insurance policy.**

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- 12 **Note that some property owners may have used incorrect house size information from their ratings valuation to inform their insurance policy. When this is lower than the actual house size, the property is underinsured.**

- 13 **Agree that underinsured property owners who have relied on information from the council to inform their insurance policies be exempt from a reduction in the purchase price offered, if the underinsurance is due to factual errors in the RV.**

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Minister of Finance

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14 Agree to discuss these recommendations with the Minister for Canterbury Earthquake Recovery/Minister of Finance and advise CERA on the options you wish to progress.

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15 Agree that CERA will prepare a Cabinet paper for Cabinet on 1 August which gives Joint Ministers (Minister of Finance and Minister for Canterbury Earthquake Recovery) Power to Act on any matters to finalise the transaction process, the sale and purchase agreements, and related communications.

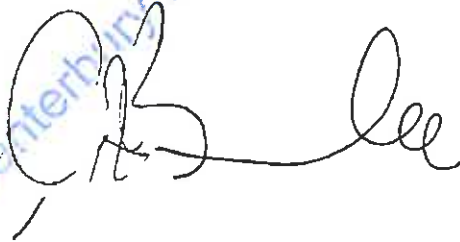
Agree/disagree
Minister of Finance

Agree/disagree
Minister for Canterbury Earthquake Recovery

16 Note that you may wish to take a paper to ACE outlining the decisions you made under this delegation after 18 August.



Hon Bill English
Minister of Finance



Hon Gerry Brownlee
Minister for Canterbury Earthquake Recovery

Released by the Minister for Canterbury Earthquake Recovery

Purpose of report

- 1 This paper discusses further transaction design issues relating to the Crown's offer to purchase insured, residential properties in Christchurch's red zones.

Background

- 2 On 23 June, Cabinet announced a package to support insured, residential property owners whose houses are located in the red zone [CAB Min (11) 24/15 refers]. Under this package, the Crown has offered to purchase these properties at the 2007 ratings valuation. Property owners can choose either to:
 - Option 1: Receive a Crown payout for the land and dwelling, and the Crown takes assignment of the benefits of all insurance policies.
 - Option 2: Receive a Crown payout for the land and the Crown takes assignment of the benefits of land policy. The property owner settles with their insurance company for the dwelling.
- 3 On 18 June, Cabinet considered the design of this transaction including any adjustments to the purchase price, the form and type of additional support provided by the Crown, and issues relating to the implementation of the transaction [CAB Min (11) 27/12 and CAB Min (11) 27/13 refers]. Cabinet also authorised the Minister of Finance and the Minister for Canterbury Earthquake Recovery to have Power to Act to take decisions on any minor and technical issues that arise in relation to these decisions.

Comment

- 4 This briefing covers matters subsequently raised by the lawyers drafting the sale and purchase agreements relating to the transaction design decisions considered on 18 June. These issues are:
 - Who bears the EQC and private insurer's excesses?
 - Can a property owner who has already settled one or more insurance claims still accept Option 1 (and get a top-up for the difference)?
 - What size deposit should be paid when the settlement is less than \$50,000?
 - Can property owners voluntarily cancel their insurance policy prior to settlement with the Crown?
 - Should there be an adjustment when house size is understated in insurance policies?
- 5 While you are authorised to resolve minor and technical issues relating to the transaction design decisions, you may wish to consider taking a paper to Cabinet to note your decisions on some of these issues. This delegation does not include other issues such as who bears the EQC and private insurer's excesses. The approval process for these decisions is discussed further at the end of this report.

Who bears the EQC and private Insurer's excesses?

- 6 The first Cabinet paper on transaction design [CAB Min (11) 27/12 refers] discussed whether the property owner should be responsible for covering EQC and private insurance excesses. However, no recommendations were agreed in relation to this policy.
- 7 As discussed in the Cabinet paper, the Crown has three options:
- Excess payout Option A: Adjust the purchase price on settlement so that the property owner bears the dwelling excesses.
- Excess payout Option B: Adjust the purchase price on settlement so that the Crown bears the dwelling excesses.
- Excess payout Option C: Adjust the purchase price on settlement so that the Crown bears the EQC dwelling excess but the property owner bears the private insurance excess.
- 8 Option A preserves insurance rights more accurately so property owners bear the dwelling excesses that they agreed to when purchasing their dwelling insurance (or which were imposed by the EQC Act).
- 9 Option B allows property owners to receive the purchase price less any actual cash received, so their total payment (including any EQC or insurance payouts) will be equal to the purchase price.
- 10 Option C is a compromise: the Crown bears the EQC dwelling excess but property owners bear the consequences of choosing an insurance policy that contains an excess for earthquake claims. This is the option supported by the Minister for Canterbury Earthquake Recovery in the Cabinet.
- 11 Although discussed in the previous paper, a decision on this was not made in the earlier Cabinet papers, therefore you have not been delegated Power to Act in relation to this decision. As discussed below, we recommend that you seek Power to Act for Joint Ministers to consider this and other unresolved issues required to finalise the transaction process, the sale and purchase agreements, and related communications

Can a property owner who has already settled one or more insurance claims still accept Option 1 (and get a top-up for the difference)?

12 On 18 June, Cabinet agreed to adjust a property's purchase price by any insurance payments made where these have not yet been spent on remediation works. However, no decision was made on whether property owners are able to settle with their insurance company and then subsequently accept the Crown's Option 1 to receive a top-up payment.

13 The Crown has three options:

Settlement Option A: Allow property owners who have settled with their insurance company still accept Option 1

- Settlement Option B: Do not allow property owners who have settled with their insurance company after receiving the Crown's offer to accept Option 1
- Settlement Option C: Do not allow property owners who have settled with their insurance company after the announcement of the Crown's offer on 23 June to accept Option 1
- 14 In situations where property owners have already settled with their insurance company and wish to accept Option 1, the Crown will not have a claim to settle with the insurance company. As long as insurance companies pay property owners an appropriate value for claims, there will be no financial disadvantage to the Crown when property owners settle prior to accepting the Crown's offer. However, property owners will have no incentive to ensure that they receive an appropriate payout from insurers when the Crown will top-up their payout to RV. At the same time, insurance companies will have an incentive to minimise their costs and therefore the claims they pay out. Consequently, the Crown could face a higher cost if a significant number of property owners settle with the insurance companies then seek to accept Option 1.
- 15 Some property owners may have settled with their insurance companies before the Government announced its red zone package. Other property owners may settle before receiving the offer from the Crown or, if they are currently located in the orange or white zones, before being classified as a red zone property. These property owners will have been acting in good faith and should not be penalised by not being able to accept Option 1. However, the purchase price offered to these property owners will be net of any insurance payments received, where these have not yet been spent on remediation.
- 16 We recommend that property owners who have settled with their insurance companies be able to accept Option 1, but only if they settled any claims prior to receiving a written offer from the Crown (Option B above).
- 17 What size deposit should be paid when the settlement is less than \$50,000?
- 18 On 18 July, Cabinet:
- noted that payment of a deposit is a common feature of a residential conveyance transaction; and
 - agreed that either a deposit of \$50,000 will be paid where the settlement date is less than six months from the date of agreement, or a prepayment of up to 50 percent of the purchase price is offered where the settlement date is more than six months from the date of agreement.
- 19 Since this decision, we have discovered that some of the properties in the red zone have a land value of less than \$50,000. If these land owners were to accept Option 2, the Crown would be paying a deposit greater than the total payment agreed.
- 20 We recommend that this decision is amended to be "... either a deposit of the lesser of 50 percent of the purchase price less any insurance payments already made and \$50,000 is paid where the settlement date is less than six months from the date of agreement..." to account for properties whose land value is less than \$50,000

- 21 The Cabinet Minute also states that the deposit will be a prepayment of up to 50 percent of the purchase price is offered where the settlement date is more than six months from the date of agreement. As discussed above, the purchase price should be adjusted to account for any insurance payments. When the property owner has received significant insurance payments and chooses a long settlement period, they could receive a deposit that is more than half of the total payout.
- 22 We recommend that you agree to amend the above decision to state "... a prepayment of up to 50 percent of the purchase price less any insurance payments is offered..." to clarify the intention that this deposit is up to 50 percent of the total Crown payout.

Can property owners voluntarily cancel their insurance policy prior to settlement with the Crown?

- 23 Ensuring that property owners maintain insurance until they settle with the Crown is ideal to appropriately place the risk of further earthquakes on insurers and the EQC. However, some property owners will not be able to do so if their insurance company declines to renew their policy. To take this into account, Cabinet agreed that "property owners be required to continue their insurance until the earliest of the expiry of their policy (ie at the end of the month or year, depending on the policy) or settlement".
- 24 As stated in the Cabinet Minute (CAB Min (11) 27/13), property owners will be able to choose not to renew their policies even when their insurance company is willing to do so. This will leave the properties uninsured between policy expiry and settlement as property owners will have no incentive to insure their buildings once they have accepted the Crown's offer. While there might be minimal value left in the dwellings to insure, maintaining insurance cover for these properties keeps public liability (e.g. the house falling down and damaging neighbouring properties) and EQC cover. Maintaining insurance may also increase the amount that Crown receives from insurers in the event of further damage.
- 25 We understand that many insurance companies are offering reduced cover for these properties which covers public liability and are sufficient to get EQC cover. This will reduce the cost of premiums to property owners.
- 26 We recommend that the Cabinet Minute is amended to ensure property owners to maintain private dwelling insurance until settlement unless their insurer declines to renew their policy. This will prevent property owners from opting out of insurance policies.

Should there be an adjustment when house size is from their Ratings Valuation and is understated in insurance policies?

- 27 In some cases, a property's Rating Valuation (RV) may be based on an incorrect house size, leading to an incorrect valuation. In an earlier decision on purchase price offered to the underinsured, Cabinet agreed that the purchase price offered will be the RV reduced pro rata by the percentage underinsured, where the property is underinsured by more than 20 percent (CAB Min (11) 27/12). This decision covers those property owners who have underinsured their properties for a variety of reasons, including stating an incorrect floor size. But some of these property owners may be underinsured

because of incorrect house size information in the RV, which they received from the local council, rather than intentionally underinsuring.

- 28 The Crown has two options for property owners who have underinsured because of an incorrect house size listed in their RV:

Option A: Treat as underinsured and therefore reduce the purchase price on a pro rata basis relative to the percentage that the property is underinsured, where the property is under-insured by more than 20 percent.

Option B: Do not reduce the purchase price.

- 29 You may wish to consider an exemption from this adjustment for property owners who are underinsured because of incorrect information that they received from an official source (local or central government) in their insurance policy. These property owners trusted that the information provided by local or central government was accurate and used it as the basis of their insurance policy. We expect that only information on a property's RV, which is sourced from the local council, will impact on insurance policies.
- 30 Without an exemption to the underinsurance policy, some property owners may have their purchase price increased to adjust for an incorrect information in the RV and then decreased on a pro rata basis because they are technically underinsured (i.e. they were insured for less than 80% of the adjusted RV).
- 31 House size should be correct in most properties and the 20 percent threshold included in the earlier decision will protect property owners where there is a minor discrepancy in house size from that listed in the ratings valuation. However, there may be some properties where the actual house size is significantly different from that listed in the RV. For example, where an extension has been added but not yet updated in the RV or where the house size was incorrectly entered into the records when the house was built.
- 32 As only a small number of properties are likely to be unintentionally underinsured, the fiscal impact to the Crown is likely to be small, but enabling such adjustments may have significant benefits to some property owners.
- 33 As these property owners have relied on information from the council to inform their insurance policies, we recommend that they be exempt from a reduction in the purchase price offered if the underinsurance is due to factual errors in the RV.

Next Steps

- 34 We recommend that the Minister for Canterbury Earthquake Recovery and Minister of Finance discuss and agree the recommendations in this report.
- 35 The letters of offer are being sent to property owners on 18 August. Therefore it is important that outstanding decisions relating to the transaction design are finalised promptly. We recommend that you seek Power to Act for Joint Ministers (Minister of Finance and Minister for Canterbury Earthquake Recovery) on any matters to finalise the transaction process, the sale and purchase agreements, and related communications until 18 August to enable this to happen. CERA will prepare a Cabinet paper seeking this delegation.

- 38 You may wish to take a paper to ACE outlining the decisions made under this delegation after 18 August. Please advise CERA if you would like such a paper prepared.

Recommendations

It is recommended that Ministers:

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