Corp-17-088

Chairperson and Committee Members
AUDIT AND RISK COMMITTEE

27 APRIL 2017

Meeting Status: **Public**

Purpose of Report: For Decision

2016/17 INSURANCE OVERVIEW

PURPOSE OF REPORT

1 The purpose of this report is to provide the Committee with:

- a high level overview of the Council's main insurance cover;
- a high level overview of the Council's potential financial risk exposure/s to rising insurance costs and losses from natural catastrophe; and
- proposed actions to help reduce these financial risk exposure/s.

DELEGATION

2 The Audit and Risk Committee has delegated authority to consider this report under the following delegation in the Governance Structure, Section B.3.

- *ensure that the Council has in place a current and comprehensive risk management framework and to make recommendations to the Council on risk mitigation.*

BACKGROUND

3 The Kāpiti Coast District Council, together with Porirua, Hutt and Upper Hutt City Councils (collectively known as the Outer Wellington Shared Services Insurance Group or OWSS) has been purchasing insurance for their respective assets on a combined basis since 2009. This syndicate was necessary to provide the OWSS with scalability to the benefit of accessing wider domestic and off-shore insurers.

4 Greater Wellington Regional Council (GWRC) self-insures any losses from natural catastrophe to their infrastructure assets. However, in July 2016, GWRC joined the OWSS to insure their above ground assets through the collective. For insurance purposes only, the OWSS Councils and GWRC are collectively known as the Wellington Councils Insurance Group (WCIG).

5 As part of WCIG, the Kāpiti Coast District Council benefits from the expertise and resources made available to it through Aon Insurance Brokers (Aon). For example, this includes extensive asset loss modelling, insurance risk profiling and insurance placements with off-shore insurers.

6 Following several years of reducing insurance premiums, the insurance market has shown signs of tightening. As recommended by Aon, WCIG executed a Long Term Agreement (LTA) for both infrastructure assets (below ground) and above ground assets that secured insurance rates for two years from 1 October 2016 to 1 October 2018.

7 The magnitude 7.8 Kaikoura earthquake event that occurred on the 14 November 2016 was significant with multiple aftershocks continuing across surrounding areas. The Kāpiti Coast District Council did not suffer losses to its infrastructure and above ground assets and did not submit any loss claims to Aon for processing.

8 However, following this event, a number of New Zealand insurers immediately placed a temporary embargo on any new business and any changes to limits and/or deductibles for existing business for all locations between Timaru in the South Island to Napier in the North Island. This embargo still applies to the North Island regions of the Kāpiti Coast, Wairarapa and Greater Wellington area.

9 Excluding residential properties, this event, and the associated aftershocks, resulted in material damage and business interruption to numerous organisations in central Wellington, ranging from small owner operated businesses to large scale central government departments. Typically, this included the immediate loss of access to main buildings and temporary loss of access to ICT infrastructure which necessitated the activation of their business continuity plans.

10 Soon after this earthquake event, business interruption insurance cover gained much media attention. In particular, it was reported to be seemingly worthless to many organisations, due to their high deductibles and lengthy waiting periods before this type of insurance cover became operative.

HIGH LEVEL OVERVIEW OF MAIN INSURANCE COVER

11 The Kāpiti Coast District Council's two most significant types of insurance cover include:

- natural catastrophe damage to infrastructure assets; and
- material damage and business interruption to above ground assets.

<u>Natural Catastrophe Damage to Infrastructure Assets</u>

12 Collectively, the OWSS Group has a sum insured value of $2.27 billion for infrastructure assets. The sum insured value represents the full replacement costs of these assets. Whilst the full replacement cost considers technological advances in construction methods and materials, it assumes no changes in the current levels of service. The Kāpiti Coast District Council's infrastructure assets have a sum insured value of $423.12 million.

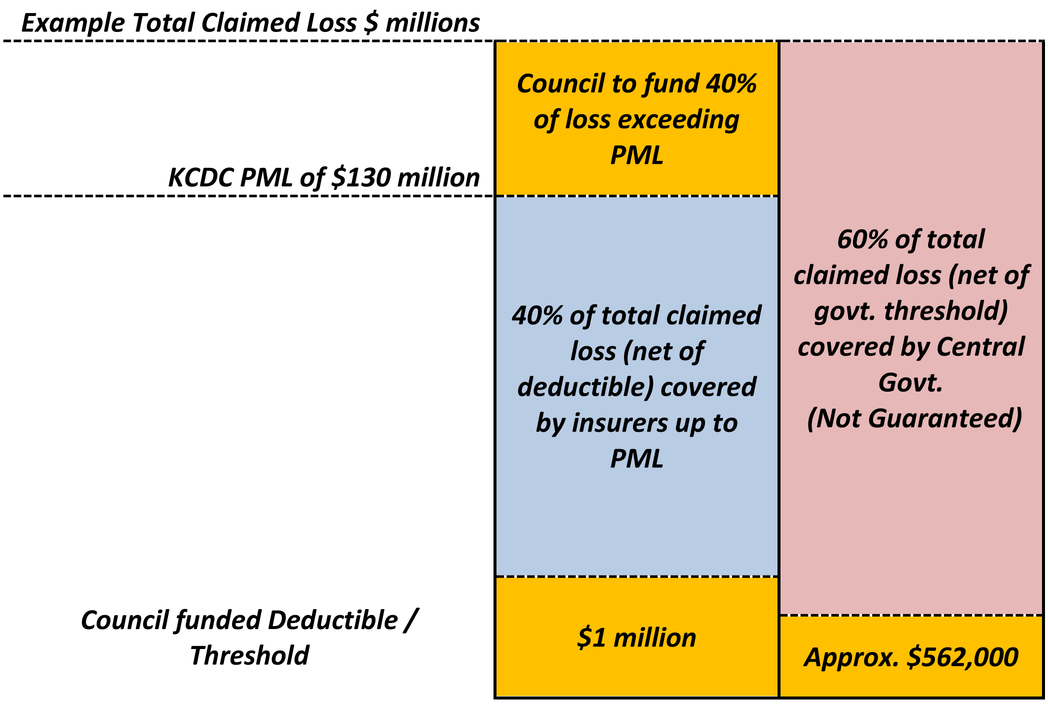
13 Following extensive loss modelling and analysis, Aon has best estimated that an extreme earthquake event for the WCIG would be a magnitude 7.5 event on the Wellington fault that would likely result in a probable maximum loss (PML) of $635 million across the Wellington Region (excluding GWRC infrastructure assets). Whilst the majority of these losses are expected to occur in the Hutt Valley, losses of up to $30.20 million are estimated to occur across the Kāpiti District.

14 Aon extended this loss modelling and best estimated that an extreme earthquake event for the Kāpiti Coast District would be a magnitude 7.4 event caused by a rupture of the Ohariu fault and would be centred in Paraparaumu. This would likely result in a PML of $130 million for the Kāpiti Coast District Council.

15 Consequently, the OWSS has purchased natural catastrophe to infrastructure assets insurance cover with a Group Limit of $600 million per insurance renewal period (12 months). This includes maximum insurance cover of $130 million for the Kāpiti Coast District Council, with a $1 million deductible per claim per event.

16 Central government currently support local government by way of a 60/40 funding split for damage caused to infrastructure assets from natural catastrophe. This means that for each qualifying event, total insured losses suffered by the Kāpiti Coast District Council that exceed a threshold of 0.0075% of the District's Net Rateable Value, will be 60% funded by central government. At the time of writing this report, the central government threshold for the Kāpiti District was approximately $562,000, based on the rateable land value of the Districtwide General Rate, net of rural zone differentials.

17 The residual risks of natural catastrophe damage to infrastructure assets are managed by insurance. This means that for each qualifying event, total insured losses suffered by the Kāpiti Coast District Council that exceed a threshold of $1 million, will be 40% funded from the OWSS insurers, up to the PML of $130 million. Up to 40% of losses exceeding the PML will need to be fully funded by the Kāpiti Coast District Council. This is explained by way of a diagram and examples below:



Example Total Claimed Loss	40% Insurer Funding up to PML (above Deductible)	60% Central Government Funding up to total claimed loss (above Threshold)	Net cost to Council
$750,000	-	$112,800	**$637,200**
$130,000,000	$51,600,000	$77,662,800	**$737,200**
$175,000,000	$51,600,000	$104,662,800	**$18,737,200**

Material Damage and Business Interruption to Above Ground Assets

18 The WCIG has a total sum insured value of $1.37 billion of above ground assets. Unlike natural catastrophe damage to infrastructure assets, the sum insured value provides for the estimated cost of replacement to the same levels of service and additional costs due to business interruption.

19 From their loss modelling analysis, Aon has best estimated that a region-wide maximum credible earthquake event could result in material damages of up to $485 million across the Wellington Region. Accordingly, the WCIG has purchased material damage and business interruption insurance cover with a combined Group Limit of $600 million. This includes a sum insured value of $232 million for the Kāpiti Coast District Council's above ground assets.

20 Losses suffered to above ground assets that are not caused by natural catastrophe trigger a deductible of $50,000 per claim per event. This means that losses below $50,000 will need to be fully funded by the Kāpiti Coast District Council.

21 Losses suffered to above ground assets by natural catastrophe/s trigger a deductible of 5% of the site sum insured, with a minimum Group deductible of $100,000 (capped at $20 million) per claim per event. For example, the Coastlands Aquatic Centre has a sum insured value of $21 million. This means that in the event of a natural catastrophe loss to the facility, the Kāpiti Coast District Council will need to fund the first $1.05 million of the total insured loss before claiming from the insurers. Any losses in excess of the $232 million in aggregate will need to be fully funded by the Kāpiti Coast District Council.

Potential Financial Risks

22 It is not economically possible to fully protect the Council against all losses from unforeseen events. Instead, for affordability, the Council best manages its risk exposure by ensuring it has insurance cover in place. In this context, it is therefore important to fully understand the Councils potential financial risk exposures.

<u>Changes to Long Term Agreement (LTA) Rates</u>

23 As already noted, the OWSS/WCIG has executed a two-year rate agreement for both infrastructure assets and above ground assets. The main advantage of this was to best protect or hedge the WCIG against the trend of rising insurance premiums.

24 However, the OWSS/WCIG agreed that at the expiry of the first period of insurance on 1 October 2017, the insurers are entitled to review the terms and conditions, including premium rates and deductibles, if any of the following occurs:

- There has been any material change in the risk;
- The incurred insured claims under the policy exceed 50% of the net written premium received for the first period of insurance;
- There is a reduction in insurers' reinsurance facilities or substantial alterations to the terms and conditions of reinsurance previously offered to insurers.

25 Aon has recently advised the OWSS/WCIG that substantial New Zealand reinsurance occurs in March 2017 and June 2017. Consequently, likely changes to the LTA will only be known in June 2017.

26 Notwithstanding this, WCIG was advised that New Zealand insurers are adopting different positions regards LTA rates, with three main insurers signalling premiums in Wellington to now be based on more expensive technical rates (i.e. insurer's general rates derived from their own loss modelling) This would result in premium increases ranging from 25% to 500% (depending on engineering reports and/or compliance with National Building Standards). In addition, they are also looking to remove capped deductibles on losses to above ground assets caused from natural catastrophe.

27 Aon further advised that the London property insurance market has incurred large losses from New Zealand catastrophes over the last six years. Consequently, premium increases ranging from 10% to 15% are possible and preservation of LTA rates will be dependent on the loss ratio of incurred insured claims to net premiums not exceeding 50%.

<u>Central Government Review of 60/40 Funding Split for Natural Catastrophe to Infrastructure Assets</u>

28 In 2016, central government initiated a review of their 60/40 funding split which is being led by Treasury. There has been very limited input from or direct involvement with the local government sector. Promised public consultation in 2016 was postponed several times.

29 Potentially, central government could withdraw completely from the current 60/40 funding split for natural catastrophe damage to infrastructure assets. More information is required from Central Government to fully understand their intentions and the consequential impacts thereof.

Multiple Deductibles and Capped Claim Settlements

30 The Council has a $1 million deductible per event for losses to infrastructure assets caused by natural catastrophe. An event is deemed to be a single loss or series of losses incurred during a continuous 72 hour period. Multiple natural catastrophe events to infrastructure assets will give rise to millions of dollars of deductibles that will need to be fully funded by the Kāpiti Coast District Council.

31 Losses to above ground assets caused by natural catastrophe trigger a deductible (subject to minimum and maximum limits) based on 5% of the site sum insured value for each above ground asset per event. A natural catastrophe event could result in losses to multiple above ground assets which will give rise to millions of dollars of deductibles that will need to be fully funded by the Kāpiti Coast District Council.

32 As was shown with the Christchurch earthquakes, there is a possibility of multiple events within an insurance year. If this occurs, it creates multiple instances of claims and associated deductibles.

Insurance Reinstatement Costs

33 AON have recently advised the WCIG that reinstatement of natural catastrophe damage to infrastructure assets insurance and/or material damage and business interruption insurance for above ground assets would be charged at the same premium as the initial insurance renewal. However, Aon warned that, to reflect higher risk, it was highly likely that insurers would increase the costs of insurance cover for subsequent insurance renewals at the renewal date.

ACTIONS TO REDUCE FINANCIAL RISKS

34 In October 2016, Kāpiti Coast District Council's insurance cover was considered to be adequate. Now, these emerging potential financial risks need to be fully considered to best inform the next insurance renewal period from 1 October 2017 to 1 October 2018.

35 The Kāpiti Coast District Council can of course do nothing to reduce these potential financial risks and look to fund any uninsured losses from new borrowings. This is not recommended by Council Officers. Instead, the following actions are recommended to the Committee for endorsement:

Create a self-insurance fund

36 Clearly, the Kāpiti Coast District Council is exposed to potentially significant financial risk in the event of losses caused by a natural catastrophe. Whilst the Council cannot anticipate these loss events, it can however plan to mitigate its financial risk exposure to uninsured losses by way of a self-insurance fund.

37 A self-insurance fund would be established to offset uninsured losses incurred from loss events that fall below Council's deductibles. Based on the Council's deductibles and the trend of uninsured losses over the past few years, it would be prudent for the Council to have a self -insurance fund of at least $2 million.

38 As part of the Draft 2017/18 Annual Plan, the Council is consulting on gradually building a self-insurance fund and is proposing to initially rates fund $150,000 for uninsured repairs and maintenance costs caused directly from unforeseen loss events.

39 In addition, the Council is also proposing to also include a self-insurance fund budget of $250,000 in the 2017/18 planned capital works programme for asset renewals caused directly from unforeseen loss events. If required, this would be funded from borrowings. Otherwise, the $250,000 budget allocation would be carried over to the following financial year and may be gradually increased over time.

<u>Complete Regular Loss Modelling, Insurance Valuations, Risk Profiling and a Resilience Strategy</u>

40 To ensure that the Kāpiti Coast District Council is properly insured loss modelling and insurance valuations for both infrastructure assets and above ground assets should be completed with sufficient regularity to ensure accuracy of the Kāpiti Coast District Council's PML sub-limits for both types of insurance cover.

41 Insurance risk profiling should also be completed with sufficient regularity to ensure the accuracy of the Kapiti Coast District Council's likely business interruption costs for both types of insurance cover.

42 As noted above, New Zealand Insurers are now looking to set premiums based on technical rates. Quality submissions to underwriters with detailed loss modelling, survey reports and an asset resilience strategy are vital to attract differential (cheaper) pricing from the markets. The WCIG is currently in discussions with AON to undertake an asset resilience strategy for the Groups infrastructure assets.

<u>Explore changes to Multi Option Line of Credit Facility (MOCL)</u>

43 The Kāpiti Coast District Council currently has a $20 million MOCL. This enables the Council to immediately access to $20 million of new borrowings, if required.

44 For the Kāpiti Coast District Council, losses to infrastructure assets exceeding $130 million in aggregate will need to be self-funded. Additionally, losses to above ground assets exceeding $232 million in aggregate will need to be self-funded.

45 If central government withdraw from their 60/40 funding split, as an alternative to increasing insurance capacity it is recommended that Council Officers explore increasing this MOCL to an amount sufficient enough to "self-insure" any insurance capacity shortfalls up to 100% of the PML for natural catastrophe damage to infrastructure assets

<u>Explore Alternate Insurance Procurement Strategies</u>

46 Clearly the 14 November earthquake event in Kaikoura has resulted in a perception of increased risk for the Wellington Region. With regards to the WCIG, the Council is the geographical outlier and is completely separate in terms of both water supply and transmission power supply.

47 Over the next six months, the Kāpiti Coast District Council will explore whether continued involvement in WCIG creates a higher risk weighting than is appropriate with associated higher premiums.

CONSIDERATIONS

Policy considerations

48 There are no policy considerations arising from this report.

Legal considerations

49 There are no legal considerations arising from this report.

Financial considerations

50 There are no financial considerations in addition to those already covered in this report. The infrastructure assets resilience strategy can be funded from existing 2017/18 budget underspends. No new money is required.

Tāngata whenua considerations

51 There are no Tāngata whenua considerations in this report.

SIGNIFICANCE AND ENGAGEMENT

Degree of significance

52 This report has a low level of significance and no engagement is required.

RECOMMENDATIONS

53 That the Audit and Risk Committee notes the Council's potential financial risk exposure/s to rising insurance costs and losses from natural catastrophe.

54 That the Audit and Risk Committee recommends to Council the establishment of a self-insurance fund as part of the 2017/18 Annual Plan.

55 That the Audit and Risk Committee endorses completion of regular loss modelling, insurance valuations, risk profiling and an infrastructure asset resilience strategy, with a report back to this Committee.

56 That the Audit and Risk Committee endorses the proposal for Council officers to explore options for further mitigating insurance costs and potential losses.

Report prepared by	**Approved for submission**	**Approved for submission**
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