5. INSURANCE COVER FOR THE COUNCIL'S BUILDINGS AND CONTENTS

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The purpose of this report is to consider a possible alternative method of insuring the Council's buildings (excluding housing stock), structures, plant (excluding motor vehicles), and chattels (excluding artworks).

In June 2002, officers reported to this Committee that they had started to investigate the possibility of moving towards a largely self-insurance regime. Below is an extract from the 2002/03 Insurance Renewal report prepared for the Strategy and Finance Committee in June 2002:

> *"The other possible alternative to consider is to move to a largely self insurance regime, to build up a fund to cover larger losses, and to insure for only the catastrophic losses. Staff have started a stream of work to investigate that approach, and will report the conclusions from that work to the Strategy and Finance Committee later in the calendar year. Such a move would be a significant change, and require careful consideration of the risks and advantages."*

The overseas insurance markets are still feeling the flow-on effects from several years of poor financial results, including those following the events of 11 September 2001. As a result insurers' capacity to offer cover has been significantly reduced, thereby lessening competition within the market. The New Zealand insurance market has followed that experienced overseas and means that there is only one insurer in the New Zealand market that will provide insurance for the Council's buildings, structure, chattels etc (ie material damage).

The material damage premiums paid by the Council during 2002/03 totalled $1,430,930 – this represents 77.1% of the total insurance premiums paid during 2002/03 (total $1,855,660). The material damage policy provides cover for the Council's buildings, structure, plant (excluding motor vehicles), and contents (excluding the art works at the New Art Gallery). At the time of renewing the insurance policies last year, Council officers obtained a quote for the material damage policy with an excess of $100,000, the premium saving was $113,709 (the current excess for this policy is $2,500). The Council's claims history over the past three years has been on average $319,578 – the option of increasing the excess to $100,000 was not cost effective.

The alternative material damage cover Council officers are currently investigating would involve the Council significantly increasing its level of self insurance and capping the upper limit of the sum insured – this method of insuring is referred to as 'first loss cover'. In order to determine at which level the upper limit should be capped the Institute of Geological and Nuclear Sciences (IGNS) were engaged to conduct a desktop exercise to assess the potential losses to the Council-owned buildings that would result from earthquake, volcano, and tsunami risks.

IGNS estimates the potential earthquake losses from an earthquake located on the Porters-Grey fault to be between $12 million and $25 million. The report prepared by IGNS has been peer reviewed by Mr David Hopkins, of David Hopkins Consulting Ltd. Mr Hopkins has recommended that the IGNS figures be increased to between $18 million to $38 million.

The Council's insurance covers expire on 30 June 2003 (4pm). Council officers have requested the Council's insurance broker to obtain a quote from the insurance market for 'first loss cover' with an excess of $5 million and the upper limit capped at $100 million (figures would be on an annual aggregate basis, not per claim). Furthermore, a quote will be obtained based on the traditional full sum insured method as insured in previous years. The housing stock has been excluded from this exercise as earthquake insurance cover is provided by the Earthquake Commission which does not make it cost effective to change.

Losses suffered above the $100 million and below the $5 million would be an uninsured risk which the Council would need to fund. To manage losses that fall below the $5 million figure it would be necessary to continue charging the business units the current level of insurance premiums until a $5 million fund was established. It would take several years to establish a $5 million fund - this would depend upon the savings achieved by moving to a 'first loss cover'. A process would also need to be devised for business units to have their claims paid from this fund.

The major advantage of ‘first loss cover’ is that it will limit the ongoing increases in premiums as experienced over the past few years with the insurer being exposed only to major losses. This type of cover will reduce the cost of insurance significantly, although whether it is cost-effective remains to be seen. The major disadvantages of the ‘first loss cover’ are that if the Council suffers an aggregate loss exceeding the capped upper limit figure or incurs a large loss below the $5 million before a fund is established to cover such a loss then the Council will be uninsured for these amounts. The Council needs to consider whether it is prepared to take this level of risk.

While the desk exercise conducted for the Council to establish the level at which the insurance should be capped has been significantly increased to limit the likely exposure, the Council would clearly have an exposure to damage exceeding $100 million. While the risk of that is remote, it is a risk that the Council would need to be prepared to take if it wants to reduce its insurance costs. If the damage did exceed $100 million, the Council would need to fund or borrow for the additional reinstatement costs at a time of significant stress for the whole community. Automatic reinstatement at the same level of cover can be purchased in case of a second event occurring within the same year.

In respect of the Council establishing a fund to cover losses up to $5 million some provision would need to be made for meeting the difference between the $5 million and the amount currently available in the fund. The Council could resort to the use of other reserve funds if the claims in any year exceeded the established insurance reserve but if this occurred the other reserves need to be replenished as soon as possible if the Council is to be put back to a financial position as before the event, which would be the case if the insurance was fully placed externally. An alternative would be to progressively increase the amount of first loss cover to approximate the amount of reserve able to be established in any one year.

Another issue to be considered if the Council was to accept the first $5 million of losses is that when there is a claim for a significant amount, even if the fund were sufficient to cover it, the fund would need to be replenished over a moderately short period of time and this would place an extra operating cost on the Council. The main issue to be considered is whether the Council is prepared to accept the risks associated with having a large excess and having a cap on the upper limit of the sum insured. All of these issues will need to be considered in the light of the savings achieved and the Council accepting higher levels of risk.

Unfortunately, it is not possible yet to provide details of the premiums for 2003/04 and comparison with the traditional insurance cover as quotes from the insurance market will not be received until the middle of June. However, indications are that insurance premiums for 2003/04 based on the traditional method will increase between 15-25% (ie between $285,000-$475,000). Budget provision has been made for a 25% increase in insurance premiums for 2003/04. With the Council’s insurance covers due for renewal on 30 June 2003 a decision will have to be made before 30 June as to whether it is both practical and cost effective for the Council to insure on a ‘first loss cover’ basis.

If the Committee wishes to further explore these issues it is suggested that a subcommittee be formed to decide whether or not to insure the Council’s buildings, structures, plant (excluding motor vehicles), and contents (exclude artworks) on a ‘first loss basis’ as discussed above. The subcommittee’s decision will need to be based on the cost savings verses the increased risk exposure to the Council.

Recommendation: That a subcommittee comprising Councillors James and Wright be appointed with delegated power to decide whether the ‘first loss‘ method of insuring the Council’s buildings should be implemented.