

# IAG Submission on New Zealand's Future Natural Disaster Insurance Scheme

## Proposed changes to the Earthquake Commission Act 1993

11 September 2015

# 1. Introduction

- 1.1 This submission is a response by IAG New Zealand Group (IAG) to the New Zealand Treasury's discussion document "*New Zealand's Future Natural Disaster Insurance Scheme: Proposed changes to the Earthquake Commission Act.*"
- 1.2 IAG welcomes the opportunity to work with the government on developing a framework for natural disaster insurance that maintains the ability of New Zealanders to access affordable, effective natural disaster insurance and improves their claims process.
- 1.3 Our comments relate specifically to the government's proposals concerning the ongoing role of the Earthquake Commission (EQC) in offering contents insurance, proposed amendments to siteworks cover, and the claims management process. We also offer our insights into the likely impacts to IAG business from the proposed amendments, including the potential effect on consumer premiums, and provide comment on the timeframes we believe are required for implementation of the proposed amendments.
- 1.4 IAG has also contributed to the substantive submission made by the Insurance Council of New Zealand (ICNZ) which we endorse. The views in that submission are indicative of the broad consensus amongst the industry regarding the bulk of the government's proposals.
- 1.5 IAG's contacts for matters relating to this submission are:

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## 2. General Comments

- 2.1 New Zealand is a nation that is vulnerable to natural hazards. Our relatively young geography and climate change risk means that we are subject to volatile seismic activity and climatic conditions. Consequently, New Zealanders face a number of potential natural hazards including earthquakes, flooding, hydrothermal activity, landslips, storms, tsunamis, and volcanic eruptions.
- 2.2 New Zealand sits third in the world behind just Bangladesh and Chile in terms of exposure to natural catastrophes when assessing expected annual losses to GDP. That exposure is clearly evident in the devastating Canterbury earthquakes that New Zealand experienced in 2010 and 2011. With the estimated Canterbury rebuild programme expected to reach \$40 billion, the earthquakes provide an illustration of how a successful natural disaster insurance scheme is crucial to New Zealand's ability to meet the challenge of recovering from natural hazards. Population growth and increased residential development will only increase the importance of all New Zealanders being able to access affordable insurance cover to meet these challenges.
- 2.3 Despite New Zealand's high level of property insurance penetration, IAG believes the Earthquake Commission (EQC) is a fundamental element of New Zealand's natural disaster insurance framework. The EQC retains an ability to provide more affordable insurance cover through a combination of pre-funding (via the National Disaster Fund), a high reinsurance excess, community rated levies, the absence of having to generate a commercial return, and sitting outside the Reserve Bank of New Zealand's solvency standards. It ensures New Zealanders can access affordable disaster insurance cover.
- 2.4 We support the government's themes underpinning this review and note that the proposed amendments reflect a number of the lessons learned by the wider insurance sector from the Canterbury earthquakes. At its core, our business is focused on helping to make the world a safer place, and we are committed to ensuring New Zealanders have the ability to protect themselves and rebuild damage to their home and contents arising from natural disasters.
- 2.5 We believe amending the current natural disaster framework will establish significant efficiencies within the current claims process and ultimately deliver better outcomes for those New Zealanders impacted by natural disasters. The key lesson to be taken from the experience of Christchurch is that the duplicate handling of claims must be eliminated. This is important on many fronts, but the two most significant are:

- Improved responsiveness for the policyholder by providing the service through which they bought their policy
- Reduction of costs which ultimately leads to ongoing affordability and accessibility of insurance

2.6 The government's proposal in relation to claims handling is a good start but must go further to ensure claims are managed by private insurers.

### 3. Discussion of Proposals

#### Proposal 1

*That the purpose of the EQC Act be to establish a Crown-owned natural disaster insurance scheme for residential buildings in New Zealand that:*

- *supports, complements and is closely coordinated with the provision of effective private insurance services to the owners of residential buildings*
- *recognises the importance of housing in supporting the recovery of communities after a natural disaster*
- *supports improved resilience of New Zealand communities and an efficient approach to the overall management of natural hazard risk and recovery in New Zealand*
- *contributes to the effective management by the Crown of fiscal risks associated with natural disasters*

*Do you agree that these purposes are appropriate and complete?*

3.1 IAG sees the EQC in its current form as having three distinct roles: (1) acting as a fund to protect New Zealanders when land and property damage occurs from a natural hazard; (2) funding first-class and world-leading research on natural hazards and seismology; and (3) acting as a claims manager for New Zealanders affected by natural disasters. We support the EQC maintaining the first two of these roles.

3.2 It is right for the purpose of the Act to reflect that the private market is the primary source of disaster insurance in New Zealand, and that the role of the EQC is to help that market maintain the high levels of protection it provides homeowners. We believe the proposed purpose accurately reflects the future role of the EQC which we believe is to act as a first-loss, site-specific reinsurer for New Zealanders who suffer from a natural disaster. We address this point in greater detail in our discussion of Proposal 17.

3.3 New Zealanders stand to gain a number of benefits from having a natural disaster insurance scheme that complements and is closely aligned with the private insurance sector, and we are pleased to see this recognised within the purpose of the Act. Greater co-ordination between private insurers and the EQC will reduce unnecessary double-handling of claims and ultimately lead to better policyholder experiences.

3.4 The ability to return people to their homes is vital to a community's ability to recover from a natural disaster and it is imperative that this is reflected in the

proposed purpose of the Act. However, we do not believe that the EQC's most efficient manner of doing this is by acting as a claims manager, a point we address in greater detail in our discussion of Proposals 6 and 17.

- 3.5 We congratulate the EQC on the world-class work it undertakes on research and education relating to natural disasters and seismology within New Zealand. This must remain a core responsibility of the EQC as it underpins New Zealand communities' abilities to continually strengthen their resilience and manage future natural hazard events.
- 3.6 A natural disaster insurance scheme that manages Crown risks is fundamental to New Zealand's ability to meet the financial challenges associated with natural disasters. The Canterbury earthquakes have illustrated just how significant those challenges can be to New Zealand. We are fortunate to maintain an extremely high rate of private house insurance and also public insurance through EQC cover that automatically triggers when private house insurance is taken out. This structure allows all players including private insurers, the government and residents and businesses, to reduce their financial exposure to natural hazards.

### **Proposal 3**

*That EQC building cover continue to be available to residential buildings and dwellings in non-residential buildings.*

*Do you agree that EQC building cover should continue to only be available to residential buildings and dwellings in non-residential buildings?*

- 3.7 IAG supports the proposal that EQC building cover be available to residential buildings and dwellings in non-residential buildings.
- 3.8 Housing pressures in major New Zealand cities such as Auckland are seeing an increasing number of New Zealanders choosing to consider differing accommodation arrangements. As a consequence, more New Zealanders are choosing to live in mixed-use buildings and we believe it is important that they continue to be afforded the same statutory benefits from a natural disaster scheme as other New Zealand homeowners. As such, we do not see the merits of imposing an artificial barrier in the form of a portion of the building that must be residential before EQC cover is available.

## Proposal 5

*That EQC building cover be extended to include siteworks and the main access to the building.*

*Do you agree that EQC building cover be extended to include siteworks and the main access to the building?*

- 3.9 IAG disagrees with the proposal that siteworks be included as part of building cover offered by the EQC. We support the position of the ICNZ in its submission.
- 3.10 Being able to pool money from a variety of sources without restriction on how it is used would be beneficial in crafting a repair or rebuild solution for an affected homeowner. However combining siteworks and house cover in a single pool creates two problems: underinsurance and cost shifting.
- 3.11 Natural disasters cause substantial and unpredictable damage to land which is further enhanced by the variable nature of New Zealand's geology. This often results in land needing significant and costly remediation before work can commence on repairing homes. The combination of siteworks and building cover funding as proposed by the government risks natural disaster insurance funding being exhausted on complex siteworks. This will inevitably leave New Zealanders exposed to the risk of underinsurance.
- 3.12 Under the sum insured insurance model, homeowners are responsible for establishing the appropriate level of insurance cover they require. IAG assists its policyholders in assessing this level of cover through the provision of online calculators, but the policyholder retains ultimate responsibility for the level of cover they choose to have. The government's proposal to combine siteworks and building cover would therefore place a requirement on homeowners to accurately forecast the level of siteworks they are likely to require should a natural disaster occur when they are establishing their sum insured. Furthermore, the additional cover that homeowners may require will come at a cost that some New Zealanders may be unable to sustain, resulting in some homeowners being knowingly underinsured. Such a circumstance raises the difficult question of how insurers can treat claims when those knowingly underinsured seek to utilise a cover they have not fully paid for.
- 3.13 We believe expecting homeowners to forecast their likely siteworks in establishing their total cover is unrealistic given the lack of data and variable nature of natural hazards and New Zealand landscapes. A scenario could occur, for example, where a natural disaster occurs in Wellington and cover provided

by the EQC is exhausted on complex siteworks activity for a policyholder whose home is built on hilly terrain. The policyholder's top-up from private insurers, as stipulated in their sum insured, falls short of the cost of rebuilding their home. The homeowner is then left needing to cover any shortfall which could in many cases be significant and well beyond their means to fund through savings or additional lending against the property. This could leave some New Zealanders unable to repair their home or secure a new home. This is inconsistent with the intentions of the Act.

- 3.14 We also oppose the proposed combination of siteworks and building cover on the basis that once EQC funding is exhausted, it effectively shifts costs onto the private insurer without a means for insurers to recuperate those costs. We currently offer cover for standard foundation works, capped at \$25,000, alongside cover for specified features such as retaining walls. Our ability to offer more extensive coverage is limited by our inability to accurately model future costs arising from natural hazards and the level of siteworks required. We therefore lack the ability to establish a fair pricing scheme, made further difficult by the proposed extension of building cover to include reinstatement of the main access-way and retaining walls.
- 3.15 Consequently, we believe the proposal to combine funding for siteworks and building cover will lead to perverse outcomes in the form of New Zealanders being less protected from natural disasters. This is clearly not the intention of the Act.
- 3.16 Should the government proceed with this proposal, private insurers would likely face two options: (1) undertake modelling based on 'worst case scenarios' which could see insurance premiums artificially inflated on the basis of imprecise forecasts; or (2) alter insurance policy wordings to achieve the same results as ring fencing the siteworks component of the EQC home cover which may expose insurers to legal risks. We note that any price increases will reduce the affordability of private sector insurance and leave more New Zealanders financially exposed to adverse events. This contradicts the purpose of the proposed changes to New Zealand's natural disaster insurance framework.
- 3.17 With private insurance and EQC cover capped, and the cost of repair or reinstatement capped by economic value, there is likely to be a shortfall in insurance funding for some New Zealanders. The overarching question for the government through this review process is therefore who should bear the cost of that shortfall.



- 3.18 We believe a more appropriate solution than that proposed is for siteworks to remain separate from the building cover offered by the EQC, with building cover reduced from the proposed \$200,000 to \$150,000 and siteworks capped at the economic value of the land. This would remove the potential for underinsurance and cost shifting.

**Proposal 6**

*That EQC no longer offer residential contents insurance.*

*Do you agree that EQC should no longer offer residential contents insurance?*

*For insurers, what do you anticipate the impact would be on premiums your company charges for residential contents insurance if EQC no longer offered residential contents insurance?*

- 3.19 IAG supports the proposed change that the EQC no longer offer residential contents insurance.
- 3.20 We do not view contents insurance as a core responsibility of the EQC as outlined in the proposed purpose of the Act, and believe the EQC should instead concentrate its efforts on better assisting those communities recovering from natural disasters by acting as a first-loss site-specific reinsurer for homes (we address this in greater detail in our discussion of Proposal 17).
- 3.21 New Zealand's private insurance industry currently offers widespread private insurance cover, with IAG providing 830,000 households' contents insurance through the State, AMI, NZI and Lumley brands and through its banking partners. We do not believe the EQC is presently providing any affordability or capacity benefits that warrants its continued provision of contents cover, and instead consider there is capacity for the private insurance sector to extend its current contents insurance offerings to all New Zealanders. Private insurers are easily able to provide the cover available in contents policies currently offered by the EQC and we believe this change will lead to a smoother process for policyholders who will gain greater clarity on their claims from having a single point of contact for their insurance matters.
- 3.22 Accurately defining the impact on consumer premiums from the proposed amendments is extremely difficult and the numbers we have provided are based on initial best-attempt modelling. We caution that a more detailed analysis will occur before any actual prices are established and flow into the market, which will likely cause changes to the figures provided.

3.23 WITHHELD

3.24 WITHHELD

**Proposal 7**

*That the monetary cap on EQC building cover be increased to \$200,000 + GST*

*Do you agree with the proposed increase in the building cap to \$200,000 + GST?*

*Do you have strong views on the merits of a \$150,000 + GST cap versus a \$200,000 + GST cap?*

*For insurers, what do you anticipate the impact would be on premiums your company charges for residential property insurance if the proposals in this document regarding changes to building cover were implemented?*

3.25 As noted in our comments on Proposal 5, IAG does not support the concept of bundling the funding for siteworks and building cover. We recommend that siteworks and building cover remain separate, with siteworks capped at the economic value of the land and building cover capped at \$150,000 + GST.

3.26 We emphasise that accurately defining impacts on consumer premiums from the proposed amendments is extremely difficult and the numbers we have provided are based on initial best-attempt modelling. We caution that a more detailed analysis will occur before any actual prices are established and flow into the market which will likely cause changes to the figures provided.

3.27 WITHHELD

3.28 WITHHELD

**Proposal 11**

*That EQC has a standard claims excess of \$2,000 + GST per building claim.*

*Do you agree that EQC's building claims excesses should be standardized and simplified to a flat dollar amount – if yes, do you agree that \$2,000 + GST is the appropriate claims excess on building claims?*

- 3.29 IAG supports simplifying the building claims excess through a flat rate charge. We are interested in learning more detail on the calculations used to establish the proposed fee of \$2,000 + GST and believe the government could explore aligning this with current industry excess payments.
- 3.30 We believe it is important that claims excesses are set at an appropriate level that both encourages homeowners to mitigate risks for themselves and encourages good risk behaviours amongst New Zealanders.
- 3.31 We would not want to see a situation evolve where the excess is set at such a level that minor claims overwhelm processing teams at the expense of more substantial EQC claims. It is also crucial that the claims excess be set at a level that is affordable for the average New Zealand family and ensures those who suffer from a natural disaster can return to their homes as quickly as possible.
- 3.32 The claims excess must also preclude families from feeling compelled to wait until their home has, for example, more than \$2,000 worth of damage before lodging their claims, which prevents insurers from making early interventions. We note the associated risk of smaller issues under the excess developing into larger problems that carry greater long-term financial costs. That potential escalation of costs contradicts the proposed purpose of the natural disaster insurance scheme which is to contribute to the Crown's effective management of fiscal risks associated with natural disasters.

**Proposal 17**

*That all EQC claims be lodged with claimant's private insurers.*

*Do you agree that EQC claimants should be required to lodge all EQC claims with claimant's private insurers?*

- 3.33 IAG supports the proposal that all EQC claims be lodged directly with a policyholder's private insurer. We also recommend that private insurers manage claims on behalf of the EQC, establishing the EQC as a first-loss, site-specific reinsurer. We believe this is the single most important change the government can make to the current EQC model, and will provide a better experience for the policyholder. We note this also aligns with the proposed purpose of the natural disaster insurance scheme.
- 3.34 Under the current operating model, New Zealanders lodge their claims with the EQC and are required to wait while the EQC verify policyholders have a valid

home insurance policy with private insurers. The policyholders separately lodge a claim with their private insurer who liaises with the EQC to ascertain whether the claim is over the EQC cap, at which point the insurer can commence work on processing the claim. We believe the government's proposed amendment will streamline this process and remove the often lengthy interplay between private insurers and the EQC before claims are verified and commence.

- 3.35 However, the primary lesson to be taken on by this review is that the duplication and contention within the current dual management of claims has had a large and negative impact on the wellbeing of homeowners and their families. While the bulk of the proposals are sound and will help support the more efficient provision of funds into future disasters, their importance pales when compared with the impact that reformed claims management will have.
- 3.36 We believe greater efficiencies within the claims system can be realised by private insurers managing natural disaster claims on behalf of the EQC with a fee for service. This change would prevent issues currently experienced under the dual-handling claims process where some Christchurch residents experienced up to 16 assessments as both the EQC and private insurers assessed their claims. Similarly, the current scheme imposes additional costs through the involvement of multiple loss adjusters. This duplication leaves policyholders in limbo, contributes to unnecessary delays and in many cases leads to policyholders receiving inconsistent information and experiencing added stress from the claims process.
- 3.37 While we acknowledge natural disaster claims will often require multiple assessments, we consider that universal management of claims by the private sector will result in greater consistency in evaluating damage and faster claims resolution. Furthermore, this amendment has the potential to lower consumer premiums in the long-term as further frictional costs are removed from the current double-handling system. Should the EQC wish, it could still undertake an audit of assessments to ensure it remains comfortable with the assessment process being managed by private insurers.
- 3.38 In order to enable private insurers to manage EQC claims, we believe it is important that a mechanism is established by which private insurers can opt-in to an agreed model for managing EQC claims. We note the government's preference that legislation allow rather than require the EQC to outsource its claims. This would require an agreement between the EQC and insurers. Given the importance that remedying the claims management issues has in responding to the lessons from the Canterbury earthquakes, we suggest that effectively

leaving this change to goodwill is insufficient, and that a firmer and more direct response is needed.

3.39 We believe New Zealanders feel a strong connection with the insurer they choose for their insurance cover, and we are proud of the reputation our State, AMI, NZI and Lumley brands, in addition to our banking partners, have established amongst policyholders. We see our proposed amendment as protecting these reputations from damage currently inflicted by insurers not being the first point of contact for policyholders and not managing their claims. While we acknowledge that managing all EQC claims including those under cap will present a challenge for insurers, particularly given the potential consumer issues with the level of statutory cover provided, we believe the existing natural disaster insurance model already inflicts far more significant damage to the reputation of our brands.

3.40 We do not underestimate the impact our recommendations will have on our business. A natural disaster can place strain on any system but we believe that our existing infrastructure, supply chains, recruitment process and training programmes will enable our business to scale up, and our staff to up-skill, far more quickly than the EQC in order to meet increased demands following a natural disaster. Furthermore, we note that our investment in digital claims lodgements and the ongoing evolution of our digital capabilities mean private insurers are better placed to manage claims lodgements in the event of any natural disaster.

**Proposal 18**

*That the current three-month time limit for claims notification be retained, but EQC be able to accept claims up to two years after an event, unless doing so would prejudice EQC.*

*Do you agree that the current three-month time limit for claims notification should be retained, but EQC should be able to accept claims up to two years after an event, unless doing so would prejudice EQC?*

3.41 IAG supports the three-month time limit for claims notification being retained which we believe will ensure there is an efficient and effective response to a natural disaster.

3.42 We endorse the views outlined on this matter in the ICNZ submission, notably the importance of having this time limit stipulated in legislation which will avoid the undesirable scenario of claims remaining in limbo.

**Proposal 23**

*Are there any issues not discussed in this document that you would like to bring to the Government's attention at this stage?*

*What submissions would you like to make on those issues?*

- 3.43 All money paid out through the EQC should be paid directly to the insurer rather than the homeowner. We believe this will significantly reduce the amount of time and costs associated with insurers securing deeds of assignment and undertaking cost recovery. The direct transfer of funds to insurers will also ensure that payments are available for the specific purpose for which they were provided in the first place, namely repairing or rebuilding the home.

## 4. Implementation Issues

- 4.1 IAG notes that the government’s proposed changes to the Act will require private insurers to make substantial changes to their current systems. While achievable, we caution that an appropriate approach and timeframe for the implementation of these changes is required for a smooth transition. We look forward to working in partnership with the government to establish a timeline that is appropriate for our New Zealand policyholders.
- 4.2 In our view, there are two issues of central importance to the implementation process: (1) how EQC cover transitions from the current model to include the proposed provisions; and (2) the time provided for the necessary operational changes to take effect.
- 4.3 IAG understands that the government is considering a “big bang” approach for the transition of EQC cover. This would ensure New Zealanders do not receive different levels of statutory cover in the event that a natural disaster strikes during the transition period. It would likely prove easier from an administrative point of view for the EQC and the government if this “big bang” were to occur at financial year-end. We have a number of concerns relating to this approach.
- 4.4 A number of existing home insurance policies expressly exclude the ability to make mid-term adjustments to contractual terms, with State Insurance estimated to oversee 500,000 such policies. Under the government’s proposal, these policies would need to be amended ahead of the transition to allow for changes in EQC cover to be reflected via an endorsement to the policy. We believe this double-handling of policy changes would add material costs to private insurers.
- 4.5 Under the current model, commercial material damage policies which attract EQC cover are largely annual single premium contracts. The only way these contracts can currently be adjusted mid-term to reflect the proposed changes to cover and premium is for the policy to be cancelled and rewritten to include new terms. IAG believes this may affect approximately 5,000 existing policies and we do not consider cancelling and rewriting these policies operationally feasible on the basis this may not align with our policyholders’ other business arrangements and will create a significant artificial spike in workloads.
- 4.6 WITHHELD

- 4.7 The proposed “big bang” approach also raises questions over wash up. We caution that consideration is required to establish how in transitioning from the existing scheme to a new model of natural disaster cover, levies and premiums are reconciled in a way that ensures neither policyholders, insurers, nor the EQC are financially disadvantaged.
- 4.8 Furthermore, we believe there are significant difficulties in implementing the changes from a reinsurance perspective. Reinsurance contracts renew at different points in the calendar year for different insurers, creating an additional layer of complexity in maintaining continuity of insurance cover for New Zealanders.
- 4.9 We believe these issues need to be addressed as part of what IAG expects will be ongoing discussions between the government and industry as these proposals are further developed. We are committed to working in partnership with the government to ensure that these changes are implemented in a fashion that ensures unnecessary complexity and costs are not imposed on insurers.
- 4.10 IAG supports the ICNZ’s call for a long implementation timeframe. From an operational perspective the proposed changes are significant and will include:
- Changing pricing algorithms to reflect changes in cover, levy rates and reinsurance allocations
  - Completing a pricing review of home and contents product portfolios to reflect expected changes in working claims experience
  - Creating new product and claim types to accommodate under-cap EQC claims within private insurer systems and the unique excess, reserving, recovery and accounting treatment they require
  - Changes to underwriting rules to reflect changes in EQC cover
  - Changes to customer collateral and policy documentation
  - The introduction of new claim management procedures and reporting
  - Training of staff
- 4.11 These changes involve considerable time and investment for private insurers, further exacerbated by the operation of several core insurance systems and



within IAG approximately WITHHELD home and contents products. We note by way of comparison that the implementation of previous changes such as the introduction of sum insured home products took just over a year and cost approximately WITHHELD. We believe the proposed changes to the natural disaster insurance framework are significantly larger and more complex.

4.12 We acknowledge that some of the operational requirements outlined above are present in insurers' response to the Canterbury earthquakes. To date, these have necessitated the creation of solutions commensurate with a (albeit large) one-off event. The proposed changes will mean more permanent solutions will be required which may well be different to those that are already in place.

4.13 The timing associated with these changes is complicated by a number of dependencies that will form a critical path within the implementation process. A common feature amongst these changes is the need for clarity and certainty before taking action. We believe complications will include:

- Negotiation lead times for reinsurance programmes triggered by confirmation of EQC cover with the Act passing its Committee stage. A typical six-month lead time could, depending on reinsurance arrangements and renewal timeframes, see anything from 6 to 24 months required for reinsurance changes to be reflected in consumer premiums
- Memorandum of Understanding (MoU) negotiations which will need to be concluded before insurers can reasonably commit to systems changes to enable the management of EQC claims. We suggest these negotiations cannot properly commence until the Act is passed
- Release windows for core insurance systems which provide several challenging constraints. For example, within IAG these changes will be implemented through a process which involves development, testing, capacity assessment, regression and functionality testing, production, production testing, coding and release
- The complexity of communications with policyholders, with private insurers needing to update their policyholders on how the changes will affect their individual policy settings
- The associated surge in policyholder queries to insurer branches and call-centres following the announcement of the proposed changes and further

surges following any advertising campaigns that are run promoting the changes

- 4.14 We believe that together these operational changes and timing constraints necessitate an implementation timeframe of 18-24 months from the passing of an Amendment Bill.

## 5. Conclusion

- 5.1 IAG is committed to working in partnership with the Government to ensure that amendments to the Act provide New Zealanders with a world-class natural disaster insurance framework.
- 5.2 We look forward to discussing the implementation of these proposals as the government further refines them.