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MARTIN JENKINS

Potential funding support for earthquake strengthening

Options for the design of loan schemes to support owners of multi-unit, multi-story residential properties

Final Report

30 November 2018

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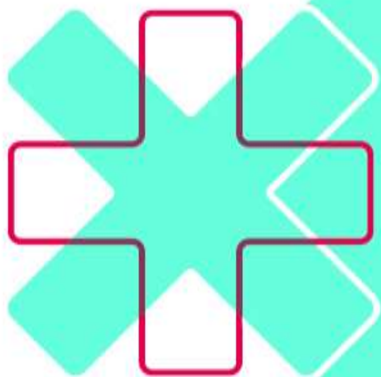

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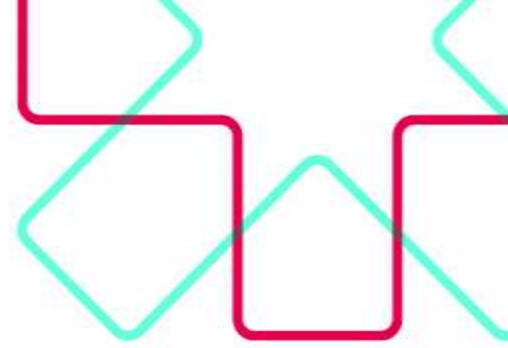

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Preface

This report has been prepared for the Ministry of Business, Innovation and Employment by Nick Davis, Nick Hunn, Nerrissa Wallace and Jennie Marks from MartinJenkins (Martin, Jenkins & Associates Limited).

MartinJenkins advises clients in the public, private and not-for-profit sectors. Our work in the public sector spans a wide range of central and local government agencies. We provide advice and support to clients in the following areas:

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MartinJenkins is a privately owned New Zealand limited liability company. We have offices in Wellington and Auckland. The company was established in 1993 and is governed by a Board made up of executive directors Kevin Jenkins, Michael Mills, Nick Davis, Allana Coulon and Richard Tait, plus independent director Sophia Gunn and chair Hilary Poole.

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Introduction

The 2017 earthquake prone building regime has contributed to the financial pressure on a number of residential property owners

Context

This report provides information in response to a request from the Ministry of Business, Innovation and Employment (MBIE). The findings we present here will be used to inform MBIE's advice to Government about options for the design of a low-interest or suspensory loan scheme for earthquake-prone building remediation.

Background

A revised system for managing earthquake-prone buildings came into force on 1 July 2017 with changes to the Building Act 2004. The regulations introduced a nationally consistent framework for territorial authorities to identify earthquake-prone buildings and for building owners to strengthen them (the Regulations). This system is designed to address the risk posed by building failure in earthquakes and balances protecting people from harm in an earthquake, the costs of strengthening or removing buildings to building owners, and impacts on New Zealand's built heritage. This has significant implications for territorial authorities and building owners.

Concerns around the affordability of remediation of earthquake prone buildings have been raised, especially in relation to low income owners of apartments in multi-storey, multi-owner residential buildings.

In its advice in previous ministerial briefings and Cabinet papers, MBIE considered that the private benefits that accrue from strengthening a building might largely justify these costs. MBIE also considered that it might be too early in the overall span of the revised system to make decisions on whether additional financial assistance for owners of earthquake-prone buildings is required or desired.[1] For the purposes of this report, however, we have been asked to set these concerns aside – and to focus on how financial assistance might be applied in practice, should Ministers wish to proceed with such an approach.

Wellington City Council has also undertaken some preliminary work to consider the pros and cons of introducing targeted financial support to assist and encourage owners of earthquake-prone buildings to carry out remedial work. That work is still in its infancy and to date no policy has yet been formulated and no decisions have been made.

[1] Refer to 1055 17_18 Financial assistance for owner of earthquake-prone buildings, 2989 17-18 Potential Financial Assistance for Earthquake Prone Buildings and 0523 17-18 Earthquake Prone Building Welcome Home Loan Proposal

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Although there is currently some provision of financial assistance to owners of heritage buildings (as part of the Heritage Earthquake Upgrade Incentive Programme), there are concerns that such support is not meeting all the needs of owners. For some time there have been strong calls from residents groups (including from Inner City Wellington and the Body Corporate Chairs Group) for some type of financial assistance to be extended to owners of non-heritage earthquake-prone buildings.

To improve the understanding and inform choices around options for financial assistance, MBIE needs to advise Ministers about options for the design of a low-interest or suspensory loan scheme for earthquake-prone building remediation.

Under the terms of reference for our work, we have assumed that any scheme would focus on properties that are:

- residential only
- in high seismic areas only
- bought before 1 July 2017
- owner-occupied, or owned by an investor
- owned through a body corporate or company share agreement – or through any other type of multi-party arrangement
- owned by someone who would suffer substantial financial hardship if they were made to finance the strengthening of their property without support – including having to sell and vacate their home in the current severely depressed market.

Objectives of work and scope

The objective of this report is to:

- identify and develop recommendations for a low-interest or suspensory loan scheme that would address earthquake-strengthening affordability issues for certain building owners
- understand how this compares to alternative financial schemes (eg. grants) and why this might be a preferred option
- understand the costs to the Crown of a low-interest or suspensory loan scheme for the remediation of earthquake-prone buildings.

Approach taken

The overall focus of our approach is to determine what type of loan scheme can:

- best target the property-owners that genuinely need support
- efficiently solve the affordability issues for those home-owners, and
- provide a practicable and affordable solution for the Crown.

This report is based on our research and analysis undertaken over the period 24 October 2018 to 30 November 2018 – including interviews with MBIE personnel, and representatives of ASB and Westpac

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banks, the Insurance Council of New Zealand, Inner City Wellington and the Body Corporate Chairs Group (representing residential property owners), and Wellington City Council.

We also developed an approach to estimate the costs to the Crown of a potential loan or grant assistance package, drawing mainly on Wellington City Council information on the size of the building stock and the current costs of strengthening.

In this report we collate the results and present the findings, arranged into the following sections:

- Policy objectives
- Eligibility criteria
- Exploring loan scheme options
- Estimated costs to the Crown of support schemes
- Choices for delivery of schemes
- Conclusions

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Policy objectives

Defining the problem, understanding the objectives, and identifying the complexities in the solution

In this section we set out the objectives (which are used to assess the different options for providing financial assistance) we articulate the problem definition and we discuss some of the complex elements that need to be taken into account as part of the solution.

Overarching objectives

For the purposes of our work we have defined three overarching objectives:

1. multi-story, multi-unit residential buildings should be properly remediated within the timeframes set in the Regulations – ensuring that the public safety aims of the Regulations are met
2. members of the public should not be unduly harmed or unfairly affected by the Regulations
3. costs to the Crown should be affordable and any wealth transfers from the taxpayer to property owners should fairly reflect the shared public and private benefits of the strengthening work.

Problem definition

The three objectives listed above are all connected – and satisfying them will necessarily involve a number of trade-offs. This is a complex problem and a solution will need to understand and balance:

- the wide variation in people's individual circumstances and the sort of assistance that would help them best. The solution needs to consider:
  - the immediate financial needs of property owners who can't raise private finance – and that the reasons might be income and/or asset related, or to do with the building itself
  - the needs of owners who can raise finance, but strengthening of their buildings is being held back by those that can't
  - the different literacy and knowledge of the issues that owners will have
- the expected value-gain on properties once they have been strengthened – and who benefits from that gain
- the impact of the underlying long-term increases in property values inherent in the New Zealand property market
- the benefits that accrue to the general public from strengthening of large buildings (for example keeping visitors and those in close proximity to the buildings safe, and ensuring the resilience of emergency and high traffic routes post-earthquakes)

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- the societal value of heritage buildings (partially already addressed in the Ministry for Culture and Heritage's Heritage Earthquake Upgrade Incentive Programme)
- the desire to move quickly to ensure buildings are safe – but the reality, already recognised by the Regulations, that owners need adequate time to prepare for the work
- the importance that New Zealand society has traditionally placed on home-ownership
- the range of seismic risk areas across New Zealand
- the level of strengthening that needs to be completed (now usually driven by insurance requirements as well as by the market)
- the range of costs that might be wrapped up in a strengthening project, including triggering of other regulated costs to meet fire and egress requirements, or whether the work involves general repairs or substantial improvements to the properties.
- the overall costs to the Crown of any financial assistance solution. Such costs will include funding and administrative costs, so with regard to the latter the number of expected recipients will also be a key consideration in scheme design.

Taking the objectives and trade-offs into account, we have summarised the problem definition for this work as:

> *How can we best encourage the owners of multi-unit, multi-story residential buildings in high risk zones to meet the Regulations for the sake of private and public safety – even if one or more of the part-owners cannot afford the cost of earthquake strengthening?*
>
> *In doing this, how do we:*
>
> – *assist owners of residential properties to access funds to undertake earthquake strengthening work required by legislation, if those owners cannot otherwise access a private loan?*
>
> – *reduce the incidence of what might be seen as unfair financial consequences (such as vulnerable people being forced to sell their home at a severely depressed price)?*

In determining a solution, there will be a need to exercise judgement across the various dimensions described above. In the following section we consider the eligibility for assistance across the key dimensions of choice.

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Eligibility criteria

Determining eligible properties, eligible owners – and the level of assistance

Eligibility can be determined on two primary levels.

- What **properties** meet the criteria to be considered for assistance?
- In those properties, which **owners** meet the hardship criteria for assistance?

Once eligibility is established, the questions then become:

- **How much** assistance should be given up front? Should assistance only apply to the statutory strengthening level (34% NBS), or should it fund a higher level, and should it fund other associated building costs incurred at the time? What portion of the building cost (if any) should stay with the owner?
- **How** should assistance be given – for example by grant, loan, subordinated loan, interest or other subsidy, or through a combination of ways?

Qualifying properties

As noted earlier, for the purposes of this report we have assumed that a number of the choices around the qualification of properties have already been determined. These are:

- **Property type:** support applies only to multi-unit, multi-story residential properties. It does not apply to commercial or industrial properties or to single residential homes or very small jointly owned residential properties.
- **Property ownership – own or rent**: support applies to both owner-occupiers and owner-investors.
- **Location (based on seismic risk):** support is provided in high seismic risk zones only.
- **Timeframe:** support only applies to properties purchased prior to the commencement of the Regulations (1 July 2017), based on the presumption that purchasers after that date should have had full knowledge of the Regulations and the impact on their property.

Two other property-based choices remain within the design of the scheme. These are both costed as separate scenarios in the 'Costs to the Crown' section of the report.

- **Property ownership – joint arrangements:** support could be provided to all or some of body corporate, company share or other types of joint ownership (such as cross-leases of shared properties).

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- **Location – priority:** support could be provided only to properties that are in priority zones, which have been identified as high traffic areas or are important emergency routes post-earthquakes. The rationale for this would be that the Regulations could have impacted the priority properties much more than other properties. In Wellington, for example, the owners of priority-designated buildings have generally faced a decrease in the timeframe for their strengthening from 15 years (under the old regulations) to 7.5 years (under the current Regulations). Other non-priority properties have generally remained under their original timeframes of 15 years[2]

Qualifying owners – measuring hardship

Inability to service a loan

Our problem definition considers that those in need will not have had access to private funding – which for practical purposes means through one of New Zealand's commercial banks.

A pre-requisite for financial assistance, and one of the measures of hardship, could therefore be the presentation of a verified letter from the owner's bank that they are ineligible for a bank loan, or for an extension of their existing loan – and the reason behind that decision. This would serve two purposes. First, it shows that third party funding is not currently available[3]. Second, the letter would give some information (to be supplemented with further information from the owner) on where the owner's financial difficulties might lie. For example, they could be income related, asset related, or for reasons to do with the state of the building, or the future marketability of the unit.

Income and asset testing

A second pre-requisite for financial assistance could be the requirement for the owner to show that they have low income and assets.

For this report we have not determined the scale of income or assets that would be used in the test. However, we note that such tests already exist in a number of areas, including, for example, in the Council Housing application process run by Wellington City Council.

As noted earlier, the financial circumstances of owners will be varied – and the ideal solution will differ accordingly. For example:

- an owner may have good income, but have insufficient equity in their property (or any other assets) and cannot get a loan – but could service one if they could
- another owner may have a fully committed fixed income, with no assets other than their property. In that case, they could not service a loan or any interest on a loan
- a third owner might have insufficient income to service a loan, but significant assets other than their residential property. If such assets could be sold to pay for refurbishments, a person may not meet the hardship criteria

[2] There were a range of excep ions to the standard 15 year timeframe under the old regulations, but the bulk of properties were following a 15 year timeframe.

[3] Our discussions with banks indicated their strong desire to help their exis ing customers. Our view is that a letter from the owner's current bank would be sufficient evidence for this step of the process, and the scheme would not require multiple letters from a range of banks.

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More specifically, we asked Inner City Wellington and the Body Corporate Chairs' Group to provide some real-life examples of hardship, taken from their interactions with property owners in Wellington. Such examples included:

- *a retired pensioner; whose entire savings has been sunk into purchasing their apartment; and who has insufficient income to afford any special levies for strengthening their building*
- *a solo parent living in an apartment; working part-time; and with no spare income to pay for strengthening*
- *an owner whose apartment has been reviewed as being less than 33% NBS; where the value of the unit has plummeted; and whose current mortgage is close to or in excess of the remaining equity. The owner's bank will not lend any more funds to pay for strengthening*
- *an owner who has to undertake earthquake strengthening but has to be out of their apartment for a minimum of 12 months while the work is undertaken. The owner can't afford the cost of strengthening on top of the cost of 12 month's rent on the new apartment, the costs of levies on the existing apartment, and the cost of their existing mortgage*
- *an owner who sought a loan from their bank to fund their earthquake strengthening, but the bank wouldn't give the full amount needed because of the lack of clarity on the new value of apartment once it had been strengthened*
- *an owner who sought a loan but the bank indicated that they were not currently funding into the apartment market for strengthening.*
- *a building that has been charging special levies to build a fund to pay for strengthening, based on the original pre-Regulations timeframe, but which is likely to have its timeframe reduced as it is on an emergency transport route – and where there are 6 out of 34 owners who may now be around $70,000 short of their funding target.*

In some of the examples above, measurement issues could arise with regard to the owner's financial and other assets, particularly where properties are held in trusts. A decision would need to be made whether to look through the owners' trusts when considering hardship and eligibility criteria.

New Zealand citizens/residents

Lastly, ownership eligibility criteria might also include whether the owner is a permanent resident, New Zealand citizen or a new arrival who has submitted an application for permanent residence or refugee status. Wellington's Council Housing scheme uses such criteria.

How much assistance should be given up front?

This question relates to the amount that would be provided up front by the Crown for the building works. A second question – how much should be repaid – is covered in the next section 'Exploring loan scheme options'.

The options for Crown funding, running from lowest cost to highest cost, are as follows:

1. fund only the cost of strengthening to the statutory requirement of 34% NBS

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2 fund all costs of strengthening, but only if the higher standard is the only feasible solution or is needed for insurance

3 fund all strengthening costs as above, plus other regulatory requirements triggered by the work (such as fire and disability requirements)

4 fund the above, plus incidental improvement works completed at the same time as the strengthening works

5 fund the above plus any more comprehensive improvements to the buildings.

MBIE has already provided preliminary advice with respect to the above in the Briefing to Ministers dated 14 June 2018. That advice supported the level of funding described in step 3 above, and we concur with that advice. Our discussions with the Insurance Council confirmed that in most cases buildings will need to be strengthened to 67% or more in order to secure insurance.

Our wider discussions also confirmed that those owners that are in real hardship will need support for all capital works on the buildings, so for the scheme to be successful it would need to cover all unavoidable costs. Such costs will include strengthening to a level that would satisfy the insurers, as well as meeting the costs of complying with the building code provisions relating to means of escape from fire, and access and facilities for persons with disabilities.

Our discussions with banks, and with Inner City Wellington and the Body Corporate Chairs Group, highlighted that when work is being undertaken on a property there are considerable risks around the preliminary estimates of the costs of strengthening and associated work. In many cases, it is not until the work is underway that the true nature of the problems are revealed, and, like many building projects, the costs can increase significantly over the course of the work.

When administering the scheme, the Crown would need to allow for substantial contingencies around the initial cost estimates for the individual projects, so that the work does not become unaffordable during the construction period and the financial assistance package continues to meet the objectives of the scheme

The cost estimates in this report include the costs of all consented works, which will include all costs at least up to step 3 above.

How should assistance be given?

This question relates to whether assistance is to be by way of a grant, a subsidised loan, or an unsubsidised suspensory loan. This discussion is covered in the following section 'Exploring loan scheme options'.

Retrospective assistance

MBIE's preliminary advice to Ministers also considered whether assistance should be provided retrospectively to owners who have already complied with strengthening requirements but have arguably been subject to hardship. MBIE's advice was that discretion could be applied where hardship could be clearly demonstrated.

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Our view is that, while a retrospective approach might provide a measure of equality for current and previous owners, the complexity inherent in dealing with such cases would make such a system inoperable. Financial decisions generally need to be made, rightly or wrongly, based on information available at a given point time. Trying to look back and decide what should or shouldn't have happened after the fact would be fraught with difficulty. For those reasons, we suggest that any assistance scheme is forward looking only.

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Exploring loan scheme options

The Crown can provide assistance through grants, subsidised loans or unsubsidised loans

Design features of a financial assistance scheme

In Table 1 we outline the key features that we would expect to see in a well-designed financial assistance scheme.

These are grouped into two themes, which broadly align with the overarching policy objectives we have set for the scheme:

- **Efficacy:** criteria to ensure the financial support arrangement is effective and efficient in bringing about the benefits. That means the scheme best achieves the objectives to ensure multi-story, multi-unit residential buildings meet the Regulations to ensure public safety, and that members of the public are not unduly harmed by the Regulations, or otherwise unfairly affected.
- **Fiscal risk:** criteria to ensure the lending of moneys does not bring about undue risk for the Crown. Which means that the scheme best achieves the third objective – that costs to the Crown are affordable and any wealth transfers from the taxpayer to property owners fairly reflect the shared public and private benefits of the strengthening work.

Table 1: Desirable features of a financial assistance scheme

Type	Feature	Description
Efficacy	Encourage strengthening work to be undertaken as soon as practicable and within statutory timeframes	The mechanism needs to genuinely provide a pathway to speed up earthquake strengthening.
	The solution targets and unblocks the financial constraint so that owners in hardship can contribute to strengthening their building	The mechanism needs to provide a real solution to affordability for people who meet eligibility criteria. People who otherwise couldn't afford the work are provided a solution that meets their particular need, whether that is lack of income or insufficient equity with which to access a loan.
	The scheme is cost effective and easy to set up and administer	The administrative costs of the loan scheme needs to be minimised and expenditure should be in proportion with the size of the opportunity and the risk. Administration needs to be efficient to ensure benefits are not lost through transactional costs. The administration needs to avoid unnecessary complexity and red-tape to help owners understand their obligations under the scheme and the implications on the future value of their units. The administration also needs to be able to scale up or down over time and be designed to stand the test of time.

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Type	Feature	Description
Fiscal risk	The scheme is affordable	The scheme
	Minimise fiscal risks to the Crown	Any scheme will entail costs and/or risks to the Crown. The extent and type of cost and risk will vary depending on the option agreed and may fall at different times (for example, when a unit is sold, or on expiry of a term loan).
	The scheme is affordable and wealth transfers are understood and managed	Crown does not unreasonably subsidise owners by unnecessarily transferring significant wealth from public good to private benefit. Eligibility criteria will be critical in ensuring there is minimal wealth transfer and in managing perceptions.
	Risk of setting a precedent	The scheme will not set unwanted precedents for subsidising other earthquake-related claims or changes in regulations more generally. .

The potential assistance schemes (subsidised loans, suspensory loans and grants) are described in the sections below – then assessed against the key design features. The delivery options (through banks or the Crown) are discussed later in the 'Choices for delivery of schemes' section on page 31.

Financial assistance options

Subsidised low-interest loan

This type of financial assistance would be based on a traditional bank loan, but where the interest rate paid by the eligible property owner is reduced below the market rate. The Crown would make up the difference, paying the part of the interest cost not paid by the owner. If the loan was to be managed through a commercial bank, it is possible the bank would also require the Crown to guarantee the loan – mainly because the owner would not have passed the bank's eligibility criteria without Government assistance.

The main challenge with this type of solution is that it still requires the owner to have a relatively high level of financial strength – in particular, sufficient uncommitted income to repay the monthly loan principal as well as any portion of un-subsidised interest. Our discussions with representatives of the owners indicate that the people most in need of assistance are those with no (or very little) un-committed income – and those people still won't be able to afford to strengthen their units even with such a scheme.

From the Crown's perspective, there will be a transfer of wealth from the taxpayer to the owner – for the amount of the subsidy. There will also be administration costs for both the Crown and the banks, over the term of the loan.

Suspensory loan

A suspensory loan could be subsidised or unsubsidised. In an unsubsidised suspensory loan the lender would advance the funding, but repayment of principal and interest would be suspended until the end of the loan. Interest would be capitalised and also repaid at termination, so that the lender is fully compensated for the use of their funds. Hence, there is no subsidy.

In a subsidised suspensory loan, the repayment of principal and interest would also occur at the end of the loan, but there would be some form of subsidy such that the owner did not pay the full market

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rate of interest (or all of the principal). The amount of the subsidy would be a direct transfer of wealth from the lender to the owner.

Under both types of suspensory loan, the term of the loan will be critical factor in whether the scheme meets the policy objectives. From an owner's perspective, a suspensory loan will certainly help them to meet their regulatory obligations to strengthen the building, but their key concern after that will be whether they can repay the loan on the termination date.

A loan that terminates when the owner voluntarily chooses to sell their property (or it terminates on the death of the owner) would provide the least financial risk for them. On the other hand, a fixed term loan (and particularly one with a very short term) would mean that the owner would need to re-finance the loan or be faced with selling their property to repay the principal and accumulated interest.

Some owners might find that the strengthening of their building will increase the value of their unit – to a point where they would then be able to obtain a loan from a commercial bank. However, we suspect that situation would be rare. More likely, and particularly for those people with low fixed incomes, is that owners will still be unable to obtain third party funding on the termination of their suspensory loan. In that case, the owner would most likely be forced to sell their property to repay the loan.

In some respects, a fixed term loan will just be shifting the current problem out to the loan termination date. Then again, by that time the owner will have a strengthened building and a much more saleable asset than they currently have, and some capital gains would also be expected over the term of the loan. If a loan scheme is to be pursued, a suspensory loan has some appealing features – but these issues surrounding the choice of termination date are likely to require further policy discussions with MBIE and Ministers.

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The administration costs would therefore fall to the Crown, for as long as the scheme was open. For loans that only terminated on sale of the property or death of the owner, there could be a very long tail of loans, eventually for a very small number of applicants.

Grants

Grants involve a simple up-front payment to the eligible recipient, so the body corporate or other group of owners can proceed with the strengthening work.

The amount could be set in a range of ways, including:

- covering the full cost of the building works
- providing the minimum required to enable the eligible recipient to gain access to a commercial loan (only likely to be relevant for a few owners)
- a flat amount for all recipients
- a scaled structure depending on hardship measures.

From the property owner's perspective, the key advantage of a grant is that it doesn't need to be repaid. The biggest risk is that it isn't big enough and the owner is still unable to afford their share of strengthening costs.

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The main advantage of a grant scheme for the Crown is its simplicity, certainty (including its short timeframe) and its low administrative costs. The downsides are the potentially high cost of the grants (and the explicit wealth transfer to the owners) as well as the risk that grants that are too low and do not meet the objectives of the scheme.

Evaluation against objectives and desirable design features

In Table 2 we summarise the evaluation of the subsidised loans, suspensory loans and grants – against the scheme objectives and the desired design features.

Table 2: Alignment of government support options with key design features (HIGH, MEDIUM or LOW alignment)

Design features and scheme objectives	Grant	Subsidised loan	Suspensory loan
Strengthening can be undertaken as soon as practicable and within statutory timeframes	**HIGH** As long as grants are large enough to fund the strengthening and associated costs.	**LOW** Loans need to be high enough to fund the strengthening and associated costs, but repayment schedules are likely to mean owners can't commit to drawdown the loan.	**HIGH** As long as loans are large enough to fund the strengthening and associated costs.
The solution targets and unblocks the financial constraint so the owner can contribute to strengthening the building	**HIGH** As long as grants cover all costs.	**LOW** As the requirement for repayments will not help one of the key target groups, those with low fixed incomes.	**HIGH** If the loan term is at the discretion of the owner (on voluntary sale or death). **MEDIUM/LOW** If the term is fixed and the owner is not in a position to re-finance upon termination.
The scheme is administratively cost effective and easy to set up and operate	**HIGH** Grants would be the simplest form of scheme to administer, and run over the shortest timeframe.	**MEDIUM** Higher cost and over a longer period than grants, possibly involving both the Crown and banks. Costs will finish at the end of the final loan.	**MEDIUM / LOW** Medium if loans are fixed term. Low alignment if loans have no fixed term, but are only linked to voluntary sale (or death of the owner).
The scheme is affordable and wealth transfers are understood and managed	**LOW** Alignment will be low if large grants are needed to provide sufficient funding so as to meet the objectives. Smaller, more affordable grants are unlikely to solve the main problems of affordability for those in most hardship.	**MEDIUM** This will depend on the level of government subsidy. A balance will need to be found between managing government fiscal risk and providing enough support to enable a recipient to access a loan to progress work.	**HIGH** A non-subsidised suspensory loan can be fully repayable and fiscally neutral to the Crown – while still providing the needed finance for strengthening.

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Minimise ongoing fiscal risks to the Crown	**HIGH** No lasting risk	**MEDIUM** Crown is exposed to credit risk over the term of the loans.	**LOW** Crown is exposed to credit risk over the term of the loans – and risks would be considerably higher for loans with no fixed term. Some risk there would be calls to convert loans to grants at termination.
Minimise risks of setting a precedent	**LOW** The simplicity of a grant means it could easily be seen as a precedent Crown assistance in other areas of financial hardship.	**MEDIUM** Some risk that a simple loan scheme could set a precedent for government assistance in other areas of financial hardship	**LOW** The specific nature of the scheme means it is less likely to set a precedent for other areas of financial hardship.
Overall comments	The simplest and most effective solution, with the lowest long-term risks – but also the most costly if it is implemented in a way that would meet the objectives. If the costs and the wealth transfer were acceptable to the Crown, this would be the preferred solution.	This scheme is more complex to administer than a grant scheme with a high probability that it will not help those who need it most. The least preferred option.	Preferred loan-based option This scheme would enable progress on strengthening buildings and avoid unnecessary wealth transfer from the taxpayer to private citizens. However, it would be complex to administer, and there are complications around the term of the loans that may cause future issues for the owners, or force future policy decisions on what happens at the end of the term.

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Costs to the Crown of the support options

Estimating the fiscal costs of different financial assistance schemes

In this section we summarise our approach and present the results from our modelling of the fiscal costs to the Crown of a grant scheme, an interest subsidy and a suspensory loan.

General assumptions

The calculations are based on the following general assumptions:

- all support is targeted at the owners of multi-story, multi-unit residential units, in high seismic risk zones across New Zealand
- costs are calculated separately for Wellington (where we have had access to very good data on the number and status of EPBs) and for the rest of the high-risk earthquake zones across New Zealand (where data is very limited)
- strengthening costs have been estimated separately for buildings based on three categories of primary construction material:
  - unreinforced masonry
  - timber framing
  - concrete/steel
- the estimated costs per square meter of building work have been based on a sample of 46 Wellington buildings (containing 196 apartments/units) that have been strengthened over the past five years, and which are representative of the types of buildings for which support is expected to be offered (i.e. excluding very small jobs and very large commercial work)
- the per-square-meter costs have been cross-checked and validated against (inflated) estimates of strengthening costs developed by MBIE in 2012 as part of the preliminary regulatory work.

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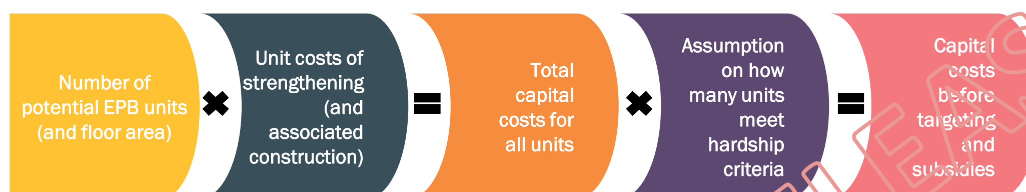
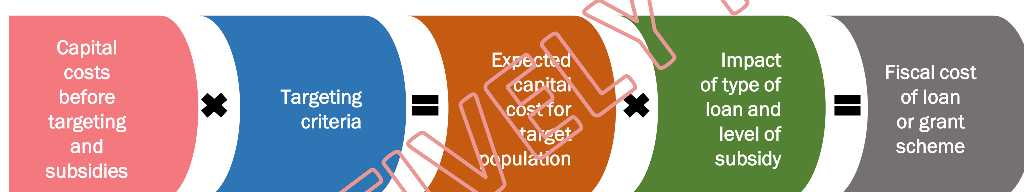
Overview of costing methodology

Our methodology is described in two stages – comprising the following key steps:

Stage 1 – determine the estimated capital costs for strengthening residential buildings for those in hardship – before considering targeting and subsidies



Stage 2 – determine targeting criteria, type of financial assistance and level of Crown subsidy (if any) – and calculate the expected fiscal cost



The steps in stages 1 and 2 are described in the following tables, which also include information on the data sources and calculation methodologies – and the results.

Stage 1 – capital costs before targeting and subsidies – description and data sources

Stage 1 – key steps	Description – Wellington buildings	Description – rest of NZ buildings
Number of potential units (and floor area)	• From Wellington City Council (WCC) we obtained their most current list of all earthquake prone buildings that were either residential and/or body corporate / company share units. This data showed: – the property address – whether the building was residential or non-residential – whether the building was body corporate / company share or another type of shared ownership (such as a cross-lease)	• We identified the current high-risk towns and cities of New Zealand using the latest Z-factors recorded by MBIE. High risk areas are those with a Z-factor of 0.3 or greater, and there are 21 such districts in New Zealand (including Wellington) with multi-story, multi-unit residential buildings[4]. • Current data was not available for the number of EPBs outside of Wellington because most areas are still gathering the information. We therefore used as our main data source the Quotable Value building information provided to MBIE for the 2012 cost benefit

[4] The high risk areas with relevant residential buildings are: Buller District, Central Hawkes Bay District, Christchurch City, Gisborne District, Grey District, Hastings District, Hutt City, Kapiti Coast District, Manawatu District, Marlborough District, Masterton District, Napier City, Palmerston North City, Porirua City, Queenstown Lakes District, Rangitikei District, Upper Hutt City, Waimakariri District, Westland District, Whakatane District and Wellington City.

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Stage 1 – key steps	Description – Wellington buildings	Description – rest of NZ buildings
	– the number of units in the building – year of construction – the year by which the building currently needs to be strengthened (which will change for some buildings following consultation in 2019, but will remain unchanged for most buildings) – the predominant construction material – number of stories – floor areas – heritage status – whether the building was on a high traffic and/or an emergency route (and therefore subject to a reduced timeframe for strengthening). • With each building identifying its floor area and type of construction, we were able to separately calculate costs for each unit (using the costs described in the next section). **WELLINGTON SUMMARY** • **128 residential buildings** • **1,013 units** • **Average size of unit 126m2** **Across all New Zealand including Wellington: the units are 59% concrete/steel, 34% URM and 7% timber construction.**	modelling of potential changes in the building legislation. • The QV data provided the building age, which we used as a proxy for being a potentially earthquake prone building. There are two age bands where buildings are likely to be earthquake prone, with the steps defined by significant changes in building construction policy. These age bands are pre-1935, and 1935 to 1976. • The methodology to estimate the number of EPBs used the ratio of Wellington's actual EPBs divided by the potential EPBs from 2012 - for both building numbers and floor areas. (No data was available for numbers of units). The ratios derived from Wellington were applied to the 2012 data for each of the other high risk areas in New Zealand, using different ratios for pre-1935 and 1935-1976 buildings. • This derived an estimate of actual EPBs (and floor areas) in each of the high risk regions, by type of construction material. **REST OF NZ SUMMARY** • **88 residential buildings** • **248 units** • **Average size of unit 126m2**
Costs of strengthening and associated construction	• WCC provided a second dataset of 224 buildings where earthquake strengthening has already been undertaken and where costs for the consented works was available. Using this dataset, it was possible to extract 48 buildings that provided current costs as well as floor areas for the consented works, so that a representative cost per m2 could be calculated. Minor works were excluded (under $10,000), as were very small and very large works, such as chimney works, demolitions and large commercial projects. The resulting data provided a reasonable selection of properties of a similar type to the residential buildings that still need to be strengthened and which are part of this project. • We compared the WCC data to the estimates of costs prepared for the 2012 EPB regulatory work, inflated to current dollars. The 2012 results were largely consistent with the current WCC-derived costs – and provided some added comfort around using the current costs. • We note that the WCC data includes all costs that were lodged on the building consents, so they may also include costs to upgrade the statutory fire and egress requirements, as well as some betterment of the properties. It is also not clear how much strengthening (the % of NBS) was carried out. • However, on the basis that insurers now require high levels of improvement, and the property market is also driving higher levels of improvement, we have assumed that recent strengthening would be towards the higher end of the scale – and therefore comparable to the type of work we expect owners to undertake in future.	

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Stage 1 – key steps	Description – Wellington buildings	Description – rest of NZ buildings
	• Costs have been calculated by building type as there are significant differences in costs between strengthening of timber and URM buildings. • A further 10% contingency has been added to all costs, to take account of past and future inflationary impacts – and estimation error. STRENGTHENING AND ASSOCIATED COSTS - results URM: $695/m2. Concrete/steel: $543/m2. Timber: $348/m2 (all including 10% contingency)	
Total capital costs for all units	Total costs are calculated by multiplying the floor areas under each construction type by the costs for that construction type. On that basis: Total costs are estimated at $92 million. Made up of $74 million in Wellington (80% of total) and $18 million for the rest of New Zealand (20%). These are the total costs expected to be faced by the building owners – before allowing for any government assistance.	
Assumption on how many meet hardship criteria	Currently there is no readily available information on how many unit owners will be in financial hardship – or how many will seek assistance from a government assistance scheme. Anecdotal evidence indicates a range of 5% to 20% might be expected – with a mid-point for modelling purposes of 12.5%.	
Capital costs before targeting and subsidies	Applying the hardship eligibility assumption to the total capital costs provides an estimate of the total cost of work to be performed on the EPBs that would be part of a Government assistance scheme. This cost is before exercising any targeting (for example excluding non-body corporate or company share owners, or excluding investor owners); and before applying any form of government subsidy (such as an interest subsidy or a full or partial grant). Total costs at 5% eligibility are $5 million ($4 million Wellington, $1 million rest of NZ) Total costs at 12.5% eligibility are $12 million ($10 million Wellington, $2 million rest of NZ) Total costs at 20% eligibility are $18 million ($15 million Wellington, $3 million rest of NZ).	

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Stage 2 – targeting criteria, type of financial assistance and level of Crown subsidy – description and data sources

Stage 2 – key steps	Description and impacts
Capital costs before targeting and subsidies	• Range of $5 million to $18 million for all of New Zealand (based on 5% to 20% hardship eligibility) – as shown in the Stage 1 table above.
Targeting criteria	• The total population used in the capital costs described above include all types of residential owners. These comprise owner-occupiers as well as investor owners (who might be a family member or an unrelated landlord). Our data has not allowed us to estimate the proportion of owner-occupiers vs investors. All estimates therefore include both types of owner. • The total also includes those living in buildings that have body corporate or company share governance arrangements, as well as those with other types of shared arrangements (for example by way of a cross lease). This latter group is quite substantial. In Wellington they comprise 62% of the buildings and 55% of the units. (The difference in percentages is because the buildings for this group are generally smaller than the body corporate / company share buildings, having on average 7 units per building compared to 9). • A third targeting option would be to only provide assistance to unit owners who are on high traffic or emergency access routes – on the basis that they might be the most impacted by the 2017 change in regulations. In Wellington 288 (28%) of the residential EPB units are on high traffic or emergency access routes – but only 188 (19%) of the total have been impacted by the change in regulations in 2017. The other 100 units were are not affected by the change because they already have shorter timeframes to completion than the 7.5 years in the new regulations.
Expected capital cost for target population	• If only body corporate / company share buildings were targeted, the relevant construction costs within the scheme for all of New Zealand would fall from a range of "$5 million to $18 million" to "$2 million to $9 million" – based on 5% to 20% hardship eligibility. • If only priority impacted buildings were targeted, the relevant construction costs within the scheme for all of New Zealand would fall from a range of "$5 million to $18 million" to "$1 million to $3 million" – based on 5% to 20% hardship elig bility.
Impact of type of loan and level of subsidy	• The preceding cost ranges represent the construction costs for the building works for all of the qualifying units. The Crown then has choices about the type of assistance package it might provide – and the fiscal costs are a function of that package. For example: – At one end of the scale, a 100% grant would have a fiscal impact equal to the total costs described above – On the other end of the scale, a suspensory loan with compounding interest could be fiscally neutral for the Crown (assuming the Crown's lending margin compensated for the administration costs of the scheme, and loans were only made to owners with low credit risk). In reality, we expect that the Crown would have some exposure to credit risk, and only some of that would be managed through the setting of the interest rates on borrowings. – Interest subsidies, partial grants and partial repayments of suspensory loans would all have fiscal costs between the two extremes described above.

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Stage 2 – key steps	Description and impacts
Fiscal cost of loan scheme	Using the examples described above, the range of fiscal costs for different types of loan schemes are as follows: **100% grants** • $5 million to $18 million if all eligible residential owners are included • $2 million to $9 million if only body corporate / company share buildings were included • $1 million to $3 million if only affected priority buildings were included **Unsubsidised suspensory loans** • Nil fiscal cost, except for credit risks associated with any owners who are unable to repay the loan (and the accumulated interest) on maturity. The Crown's credit risk will be impacted by a number of factors, including: – the extent of the owner's existing bank or other borrowing (if any) – the likelihood that Crown lending would be subordinate to any third party mortgages – the current loan to value ratio (LVR) on the property, and whether current value has been significantly impacted by the lack of earthquake strengthening to date – the amount of risk the Crown is willing to take on up front, which could be managed using its own lending criteria for the scheme (for example, using current and future LVR analysis for combined Crown and 3rd party lending). **Interest subsidy** • The fiscal impact of an interest subsidy will vary considerably depending on the amount of interest subsidised – as well as the length of the loan and the length of the subsidy. • As an example, using the estimated average cost of remediation for a Wellington apartment ($73,000 per unit[5]), the current average mortgage interest rate of 5.89%[6], and a 10 year loan, the annual interest cost for a single unit would be $4,300 in the first year and an average of $2,600 per year over the term of the loan. Total interest over the term of the 10 years of the loan would amount to $26,000. For a 20 year loan, total interest over the term of the loan would amount to $53,000.

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Suspensory loans – ability to re-pay (and Crown credit risk)

A suspensory loan with compounding interest will result in a significant repayment amount at the end of the loan – and the longer the loan the bigger the capitalised interest that will need to be repaid. This raises the issue of whether the owner would be able to afford to repay the suspensory loan on the sale of the property – and the answer to that question depends on the value of the apartment, and the amount of existing debt.

Currently, the average value of Wellington apartments is around $475,000[7]. The average expected costs of remediation is expected to be around $73,000. Assuming a 20 year loan term, a market interest rate of 5.89% and a conservative 3.1% annual value increase on the property (being half the long run average for Wellington apartments of 6.25% p.a.[8]), an owner with no current debt should be

[5] Using WCC data, remediation costs in Wellington are expected to range from an average of $28,000 for a timber building to around $76,000 for URM and concrete buildings. Overall, 52% of units are expected to cost under $50,000 to remediate and 86% of properties are expected to cost less than $100,000. At he other end of the scale, 31 units spread across 4 buildings (3% of the total) are expected to cost over $250,000 each.

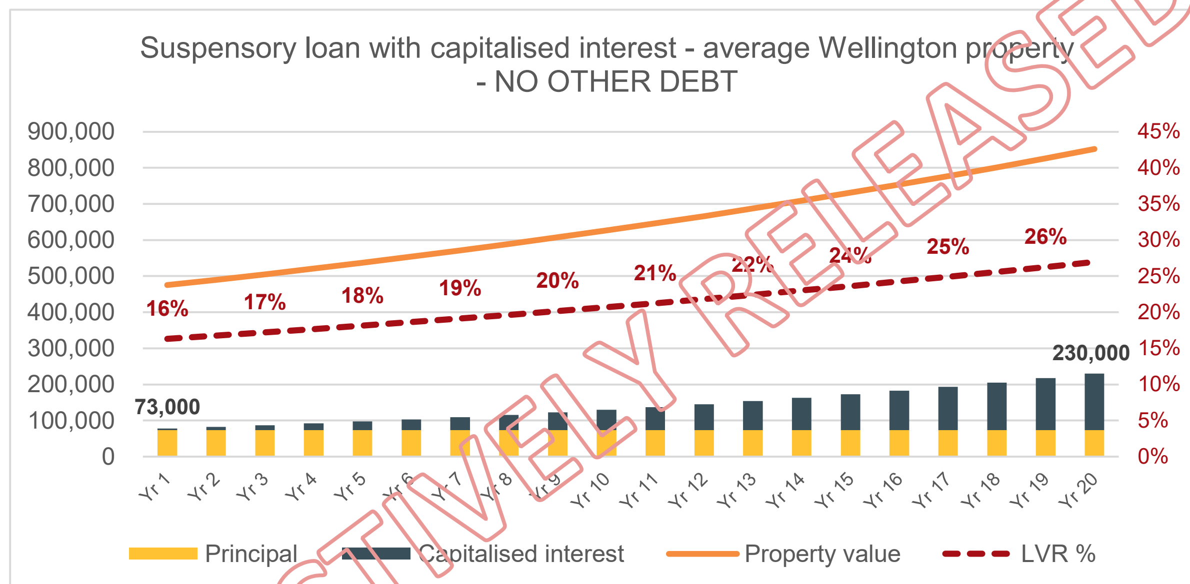
[6] Source: www.mortagerates.co.nz/mortgage-rates.html (accessed 13.11.2018).

[7] Source: https://relatable.co.nz/2018/10/16/wellington-real-estate-update-october-2018/ (accessed 13.11.2018).

[8] Source: www.interest.co.nz/property (accessed 13.11.2018)

well placed to repay a Crown loan on sale of their property. In Figure 1, we show an example of the "average" home-owner's ability to pay off their suspensory loan – assuming the owner has no current debt.

Figure 1: Example of owner's ability to pay – assuming no other debt



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While on the face of it the interest impact appears onerous (taking the debt from $73,000 to $230,000), the impact of compounding interest should easily be covered by the increase in the value of the property – even when using a conservative estimate of the value increase over time. In the example above, we have halved the long-run average growth in values for Wellington apartments. We have also not allowed for any one-off value uplift on completion of the remediation works, which would most likely provide further headroom between the value of the apartment and the balance of the suspensory loan.

In Figure 2, we show a second example, but one where the home-owner already has considerable debt – an 80% LVR (before Crown lending). We also assume that their current debt will be repaid over the next 15 years.

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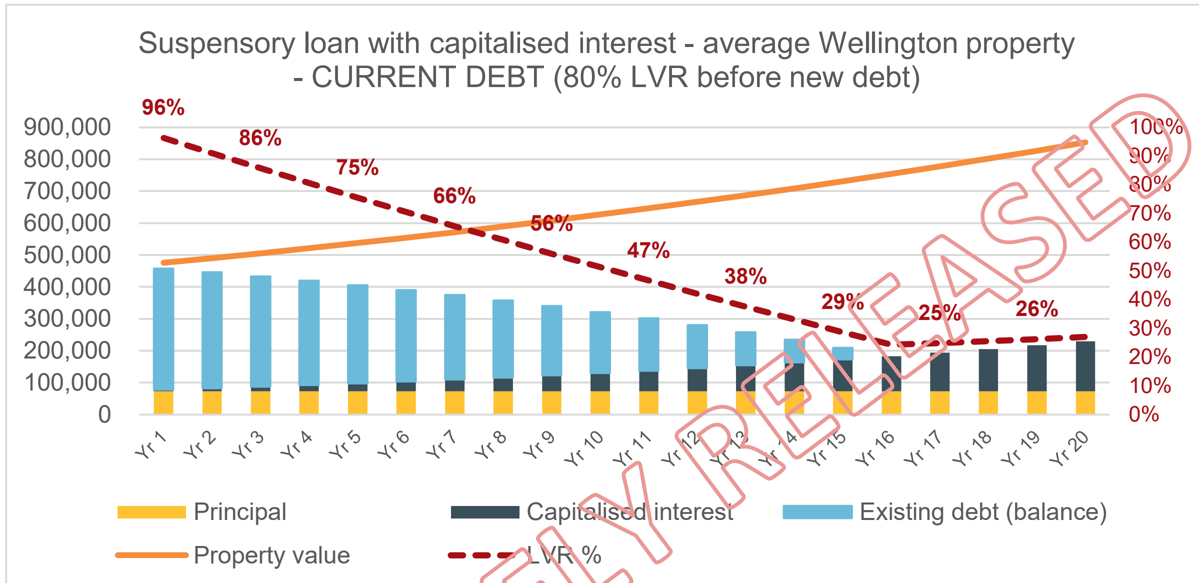
Figure 2: Example of owner's ability to pay – assuming substantial existing debt



In this example, the LVR jumps to 96% on drawdown of the suspensory loan, and it doesn't fall below 60% until Year 9. The credit risk for the Crown will be highest over the early years of the loan – until other debt is reduced and an acceptable total LVR is reached. In the example above, the credit risk is high until Years 7 to 9.

In designing a suspensory loan scheme, the Crown will need to have regard to an owners existing debt, and the existing and future value of their apartment or unit.

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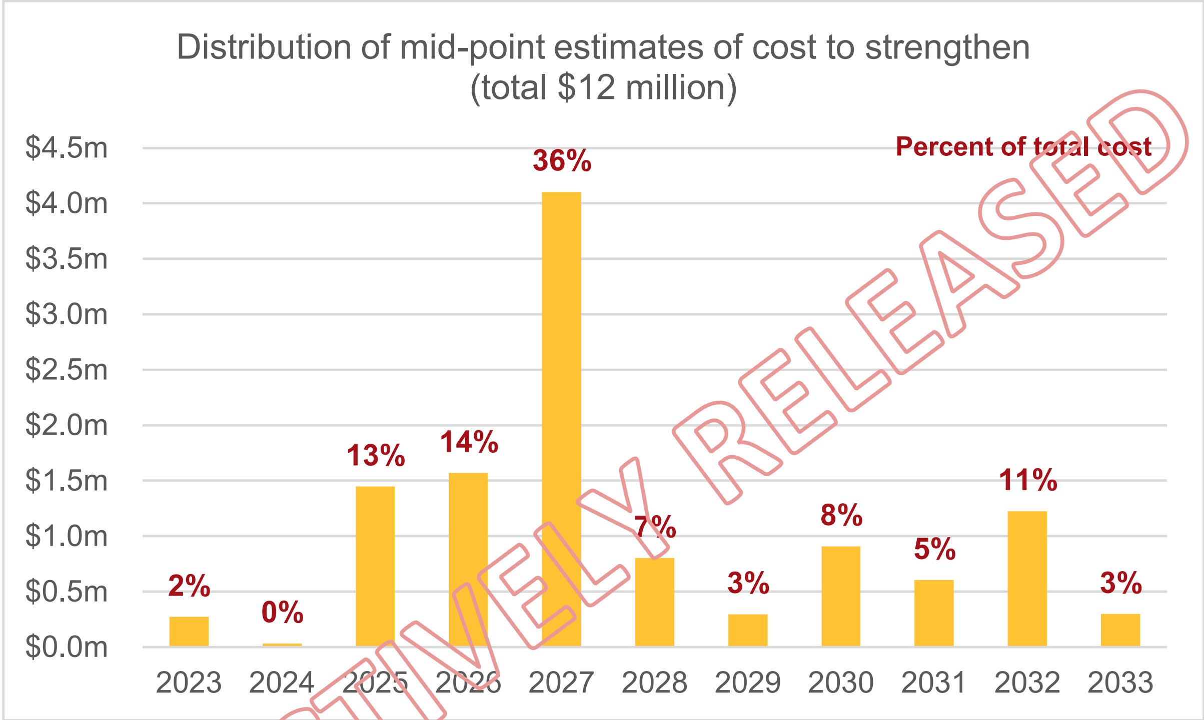
Distribution of costs – timing of Crown payments

All of Wellington's EPB owners have been issued with Notices setting out the date by which their buildings need to be strengthened[9]. Many property owners are motivated to strengthen sooner than the final date, but others will wait until they need to act. Figure 3 shows the distribution of the New Zealand-wide strengthening costs for eligible owners ($12 million total cost, based on 12.5% eligibility) based on the dates of final notices in Wellington.

The expectation is that these dates would be the latest that funding would be needed, with most owners strengthening before these dates if an assistance package was available for those in hardship.

9 Some dates may change following consultation in 2019, but it is expected that the majority of the current dates will remain in force.

Figure 3: Timing of EPB notice expiry – total NZ costs but based on actual Wellington timing



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Summary of results

Table 3 sets out a summary of the costs to the Crown of alternative assistance schemes – and the underlying assumptions that drive the numbers of eligible owners. The remediation costs would be the fiscal cost if they were advanced as a grant – or the amount of principal advanced if assistance was provided by way of a suspensory loan.

Table 3: Summary of volumes and costs

	Buildings	Units	Remediation costs
Volumes and costs before targeting			
Unreinforced masonry	91	432	**$33m**
Timber framed	24	86	**$2m**
Concrete/steel	102	744	**$57m**
Total New Zealand	**216**	**1,261**	**$92m**
Hardship eligibility – mid-point 12.5%	27	158	**$12m**
Hardship eligibility - range (5% to 20%)	11 - 43	63 - 252	**$5m - $18m**
Targeting options			
All units (as above)	11 - 43	63 - 252	**$5m - $18m**
Body corporate/company share only	4 - 17	28 - 114	**$2m - $9m**
Priority affected - only	1 - 5	12 - 47	**$1m - $3m**
Unit and average costs			
Average remediation costs	$427,000 per building	$73,000 per unit	
Strengthening costs by construction type:	URM: $695/m2. Timber: $348/m2. Concrete/steel: $543/m2		

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Choices for delivery of the schemes

Exploring delivery mechanisms and institutional arrangements of who can provide the support to property owners eligible for Crown assistance

For any subsidy or loan scheme, the success will depend, to some extent, on the institutional arrangements (who manages and administers the scheme) and the delivery mechanism (how the scheme is delivered). In each of these areas there are various ways in which a subsidy or loan scheme could be administered, but in all cases it is likely that the scheme will need a coordinated approach across central government, local government and the commercial banking sector.

In considering the practical implementation of a scheme, a key factor is that we expect the numbers of eligible owners across New Zealand to be relatively low – probably less than 250 at the higher end of the scale, and more likely to be nearer to 150 owners. At this level of take-up there are two key impacts:

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- it will be important to ensure that the administrative arrangements are not overly complicated (and that the fixed costs of the scheme are relatively low) as recovery of those costs could only be spread over a small number of owners, and there is a risk that such costs might be as large as the assistance intended to be provided via the scheme.

Institutional arrangements

After discussions with several banks, and with Wellington City Council, we expect that any financial assistance scheme will require central government to take a lead in the management and delivery of the scheme. Commercial Information , there are also some positives to be gained from central government coordination of the scheme. These include

- maintaining transparency around the size and value of the scheme; and
- being better placed to ensure consistency of the scheme across territorial authorities and across individual owners in terms of:
  - the treatment of applications
  - monitoring of grant or loan conditions
  - being able to make policy decisions that may depart from standard commercial terms; and
  - managing any instances of loan default in a way that stays true to the objectives of the scheme.

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In the sections below we review the respective roles of central government, local government and the banking sector.

The nature of central government's role

Given the relatively small size of the scheme, setting up an entirely new entity to administer the scheme is unlikely to be the most effective (or efficient) option. Setting up and administering a new entity would most likely give rise to significant administration costs – in excess of what would be reasonable for a scheme of what might be at most around $5 million to $18 million in value.

It would therefore be preferable if the scheme was embedded in an existing agency – noting that authority for a government agency to lend would first need to be given by the Minister of Finance. We have not identified any equivalent schemes currently operating in the public sector.

However, regardless of where this function sits it will require dedicated resource to manage the following:

- liaison with banks as to how government assistance might be managed, and how a government loan might sit alongside an existing bank loan. As an example, the government may want to mimic certain prudential practices currently used by the banks (including income and/or asset assessments) rather than devising a set of new processes that diverge from common practice
- liaison with local councils to:
  - inform those in high risk areas of the scheme and how it is expected to operate
  - ensure that the work government is funding (either through subsidy, grant or suspensory loan) is progressing according to statutory timeframes and is in compliance with local government regulations
- liaison with unit owners and/or body corporates and company share boards over all aspects of the financial assistance package. In body corporates and company share properties, it is likely that funds will pass through owners and on to the governing body. In some cases, owners may need direct assistance to help manage or coordinate the funding and the work.

The role of local government

As councils are charged with assessing earthquake prone buildings in their areas, they will be the primary source of all information regarding the status of the local building stock, including the timeframes for strengthening.

Local government will continue to exercise all their current functions regarding implementation of the earthquake prone building (and other construction) regulations. They could also take a role in ensuring that funding provided for the purposes of strengthening buildings was being used for that purpose.

As noted above, given the likely size of the scheme it would be inefficient for councils to administer individual financial assistance schemes in their areas. A decentralised model would also increase risks around inconsistency of approach across territorial authorities.

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The role of banks

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Also, if banks were to be used as a conduit for suspensory or subsidised loans, they still need to ensure that the owner can service the loan, and they might also require that Government provides a guarantee for any property owners that have insufficient equity in the property, or otherwise fall outside of the bank's normal approval criteria.

In the unlikely event that banks were to be involved in the administration of a scheme, they already have in place people and processes for dealing with 'business as usual' hardship cases – and loan applications for earthquake-prone buildings could be dealt with in the same way.

Regardless of what scheme might be put in place, banks will still need to satisfy their prudential requirements around responsible lending including the need to ensure a recipient can reasonably service a loan. With that in mind, any new loans that the Government puts in place will need to take into account the recipient's existing bank lending, their available income, and the size and liquidity of their other assets – as well as the mechanisms and restrictions under which the banks will be operating.

Delivery mechanism

The following sections describe the potential delivery mechanisms for subsidised loans, suspensory loans, and grants.

Subsidised loan

Description: Government will pay an interest subsidy allowing owners to borrow from the bank. Government will also become the guarantor for the loan.

The delivery steps can be summarised as follows:

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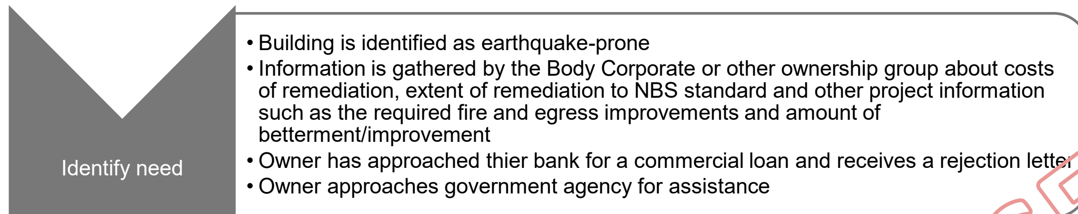

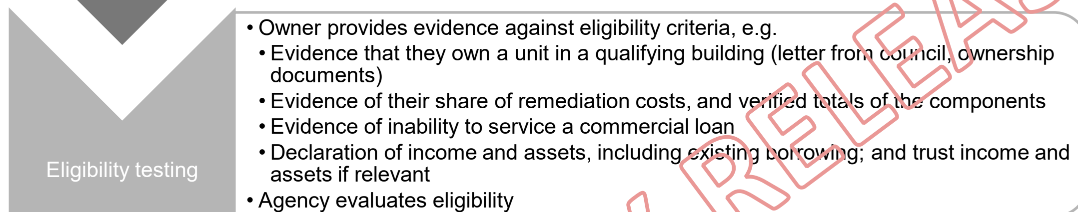

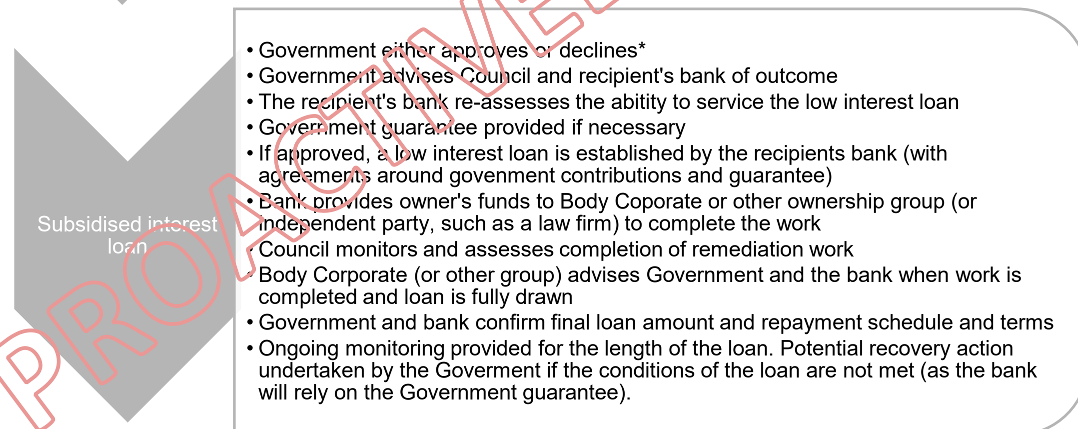

*If the government or bank declines then the onus will be on the Body Corporate to take action to ensure the owners comply with the Regulations. In extreme circumstances, this may require the Body Corporate or the Council to force a sale of the unit.

This scheme could use a similar model to that put in place by the Government to provide financial assistance for leaky homes. Under this model a law firm acts as an agent for the owner. The funding is held in trust and released at appropriate milestones and subject to meeting conditions. This would require the body corporate to provide evidence when certain milestones for the work are completed.

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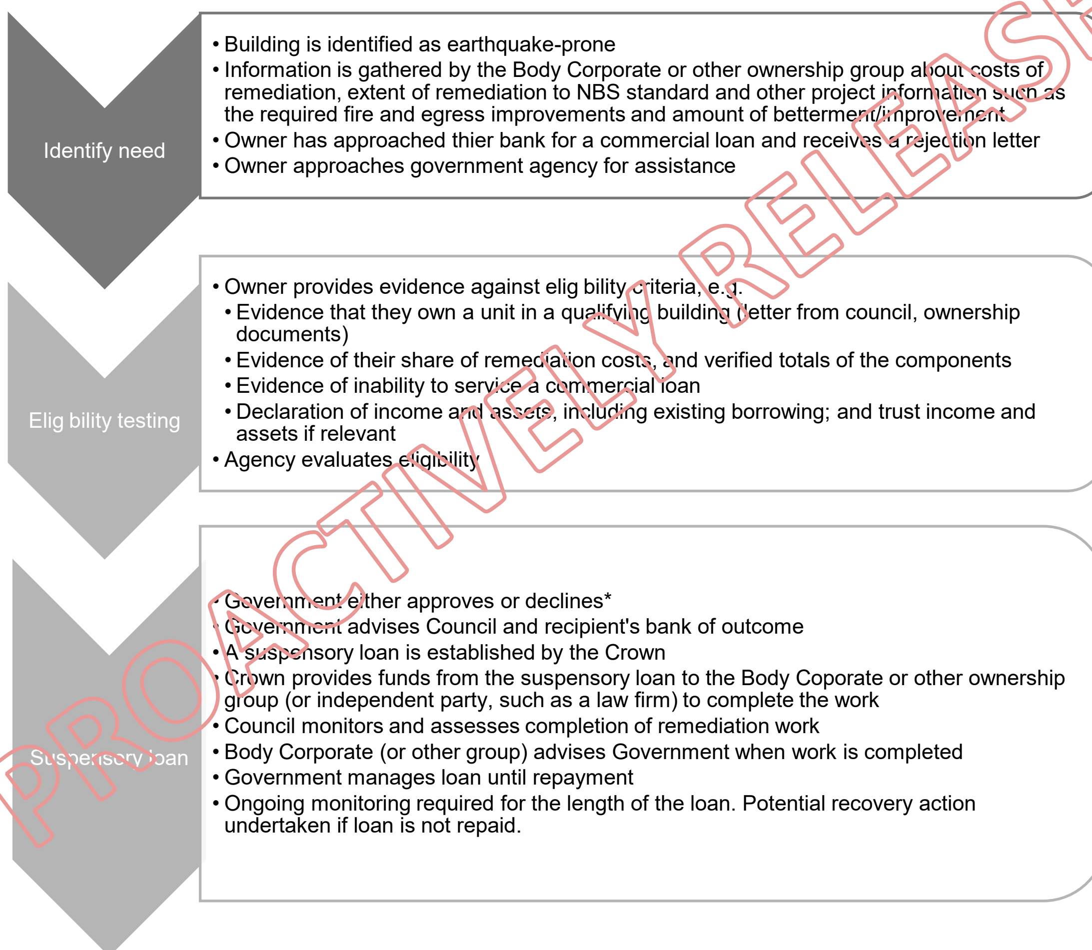
Suspensory loan

Description: Government chooses an end date when recipients pay back all the principal and accrued interest on the loan. This could be based on the voluntary sale of the property, death of the applicant, or based on a fixed-term period for the loan, determined in advance.

The delivery steps for a suspensory loan would be:



*If the government or bank declines then the onus will be on the Body Corporate to take action to ensure the owners comply with the Regulations. In extreme circumstances, this may require the Body Corporate or the Council to force a sale of the unit.

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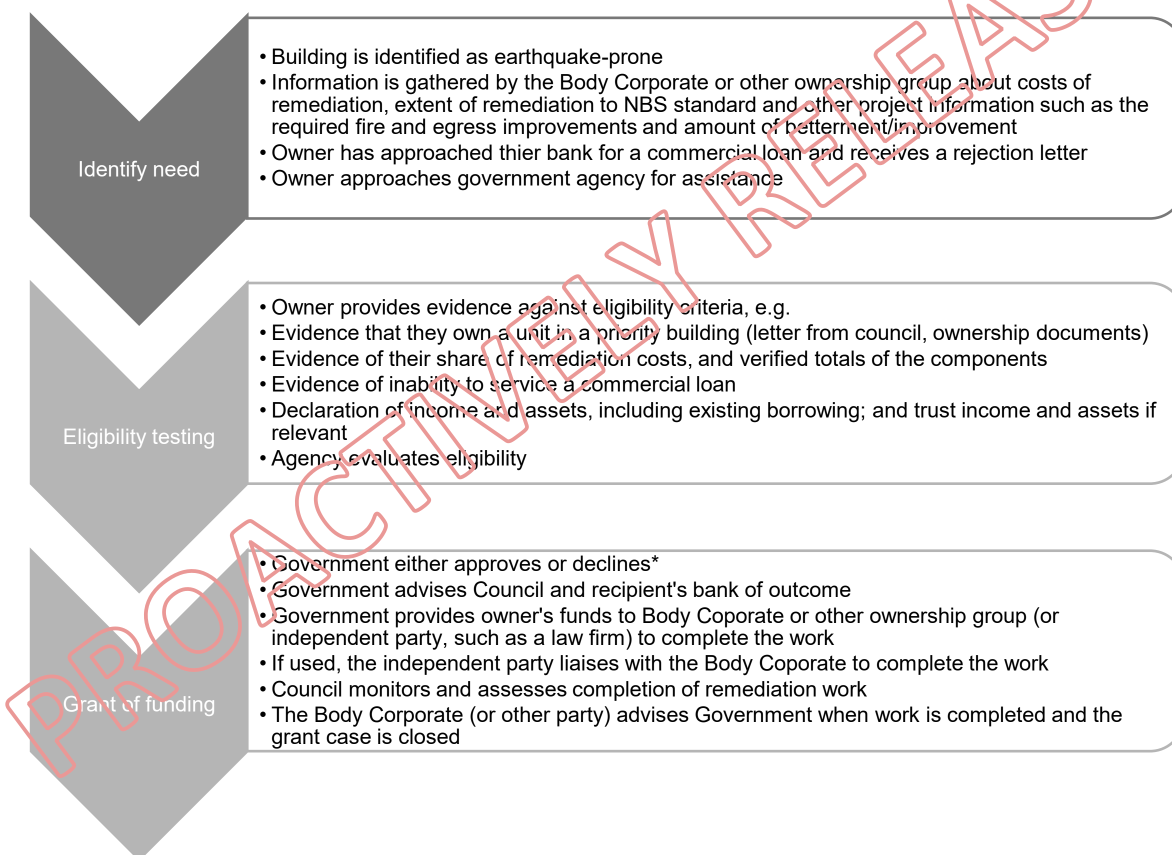
Grants

A grant could follow a similar approach to the Heritage EQUIP model. Under this model an application is made by the owner to a central fund. An application must be made before work begins and all consents and permissions must be in place. A grant would require evidence of financial hardship and inability to receive a commercial loan.

The potential steps for a process to obtain a grant would be:



*If the government or bank declines then the onus will be on the Body Corporate to take action to ensure the owners comply with the Regulations. In extreme circumstances, this may require the Body Corporate or the Council to force a sale of the unit.

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Conclusions

Conclusions on choices for the financial assistance schemes

As noted throughout the report, there are trade-offs to be made when determining the type and shape of a financial assistance scheme.

If a low weighting was placed on the costs and complexities associated with a potentially long tail of loans, then we believe a suspensory loan scheme (with repayment linked to the sale of the property or the death of the owner) would provide the best balance of meeting the needs of owners and minimising costs to the Crown.

However, if the administrative costs and long term risks of a suspensory loan were considered onerous, and the Crown was satisfied with a considerable transfer of wealth to private owners (which can be justified to some extent by the public good aspects of strengthening the buildings), then a grant scheme would be the preferred option.

When considering the costs of administration, as well as the overall up-front cost of the scheme, the preliminary estimates indicate the capital costs of strengthening could be relatively modest – particularly if tighter targeting was adopted.

Table 4: Summary of up-front costs under different targeting assumptions

	Buildings	Units	Remediation costs[1]
Targeting options			
All units	11 - 43	63 - 252	**$5m - $18m**
Body corporate/company share only	4 - 17	28 - 114	**$2m - $9m**
Priority affected - only	1 - 5	12 - 47	**$1m - $3m**

1. Remediation costs could be met by a grant, in which case these cost ranges represent the total fiscal cost to the Crown. If the costs were funded by a non-subsidised suspensory loan, the remediation costs would represent the up-front funding provided by the Crown. Once the loans were repaid, the net costs to the Crown would be nil.

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The administration will therefore fall to central government to manage.

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