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Preventing Disaster after a Disaster: Lessons for Canada from US Experience

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Key Conclusions

- Insurers and policyholders face several challenges after natural disasters, including some caused by government regulation. After Hurricane Katrina, many victims had insurance against wind damage, which was covered in standard insurance policies, but not flood damage, which was available only through a government program. The split in coverage resulted in payment delays and legal disputes.

- In Canada, a natural disaster capable of causing Katrina-level damage is an earthquake. There is a 30 per cent chance that an earthquake strong enough to cause significant damage will strike southwestern British Columbia in the next 50 years, and a 5-15 per cent chance that a major earthquake will strike southern Quebec or eastern Ontario.

- Provincial legislation makes a distinction between damage caused by earthquakes and damage caused by subsequent fires. The US experience shows that this approach could cause problems for insurers and policyholders.

- Splitting insurance coverage for a natural disaster should be avoided. Allowing insurers to offer comprehensive coverage against damage from the quake and quake-related fires will prevent many of the problems consumers faced following Katrina.

Brief summary

There is a 30 per cent chance that an earthquake strong enough to cause significant damage will strike southwestern British Columbia in the next 50 years, and a 5-15 per cent chance that a major earthquake will strike southern Quebec or eastern Ontario. These quake zones encompass several population centers, including Vancouver, Victoria, Montreal, Ottawa, and Quebec City. If a major quake ever strikes one of these regions, renters, homeowners, and businesses will count on insurance to help them recover and rebuild. However, in addition to the hardships caused by property loss and injury, policyholders may face major impediments to recovery when insurance coverage from a natural disaster is split—a harsh lesson many Americans learned in 2005, after the US Gulf Coast was struck by a series of major hurricanes, including Hurricane Katrina.

The problems that occurred in the aftermath of Katrina demonstrate what can happen when distinctions are made in insurance coverage based on the cause of damage. Many of Katrina's victims had insurance against wind damage, which was covered in standard insurance policies, but not flood damage, which was available only through a government program. The split in coverage resulted in costly payment delays and legal disputes.

Provincial legislation makes a similar distinction between damage caused by an earthquake and damage caused by subsequent quake-related fires. Fire following an earthquake is covered in standard home insurance packages, while earthquake coverage must be purchased separately. Alberta and BC have signaled their intention to maintain this distinction. The US experience shows that this approach could cause unnecessary hardships for insurers and policyholders alike.

The lesson from Hurricane Katrina is clear. Splitting natural disaster insurance coverage should be avoided wherever possible. Allowing insurers to offer comprehensive coverage against damage from a quake and any quake-related fires will prevent many of the problems policyholders faced following Katrina.

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Executive summary

Two regions in Canada have been identified where a major earthquake is likely to cause significant damage: south-western British Columbia, including Vancouver and Victoria; and southern Quebec and eastern Ontario including Montreal, Ottawa, and Quebec City. Damage from an earthquake can result from the ground shaking, or from a fire that is ignited as a result of the earthquake.

Following a disaster, it is important that insurance customers receive their cheques fast to both avoid unnecessary hardship and expedite recovery. However, provincial insurance laws serve as a major impediment to this happening because they make a distinction between insurance coverage for damage caused by the ground shaking and fires that follow from an earthquake. Fire following an earthquake is included in standard home insurance packages while ground shaking coverage must be purchased separately. Alberta and BC have reviewed their insurance legislation and have signalled their intentions of maintaining the distinction, a policy decision that can be expected to create significant unnecessary hardship for victims should an earthquake occur.

The US Gulf coast was struck in 2005 by a series of major hurricanes, including Hurricane Katrina, which was responsible for between 1,300 and 1,500 fatalities and over US$57 billion in insured losses to private insurers and the US government flood insurance program. The problems that occurred in the aftermath of Hurricane Katrina demonstrated what can happen when a distinction is made in insurance coverage based on the cause of damage resulting from the same natural disaster.

In Hurricane Katrina's case, wind damage was covered under standard private home insurance policies, while flood coverage was available separately through a US government program. Many victims of the hurricane had coverage through their private insurance for wind damage but had not purchased separate flood insurance. The separation in coverage exacerbated the costs associated with the storm. These costs included payment delays, court challenges, dispute resolution costs, claims expansion, and disaster relief. For instance, a common problem following the storm was determining the extent of damage caused by wind versus the damage caused by flooding. In many cases, the flood washed away any evidence of damage, leaving only a slab where a house had once stood.

The lesson from Hurricane Katrina is clear. Splitting natural disaster insurance coverage should be avoided where possible. There are circumstances where this may not be avoidable, such as where a peril is uninsurable. However, this is not the case for earthquake risk in Canada. Allowing insurers to offer comprehensive coverage against damage from both the ground shaking and the fire following will avoid the problems that home and business owners faced en masse following Katrina.

Introduction

After a major natural disaster strikes a densely populated area, prompt payment of insurance claims plays a critical role in the area's recovery, for the wider economy generally, but particularly for individual families. For instance, insurance payments help homeowners with their immediate shelter costs and the expense of reconstructing their homes; they also enable businesses to quickly repair their buildings and restock their supplies. Insurance companies face several challenges in meeting claims after a disaster. One is dealing with the sheer number of individual claims that happen at the same time. Another is limited access to the disaster area because of damage to roads, bridges, and other infrastructure. One further and unnecessary problem may be created by regulation that makes disputes between insurers and consumers more—and not less—likely after a major disaster. Thus, policymakers need to ask themselves what policies should be in place to ensure the insurance industry plays as effective a role as possible in assisting the region's speedy recovery by reducing any obstacles to prompt payment of claims.

When hurricanes, including Hurricane Katrina, struck the U.S. Gulf coast in 2005, many victims of the storm had insurance against wind damage, which was covered in standard private insurance policies, but not flood damage, which was available only through a US government program. Both perils caused significant damage. The split in coverage resulted in problems after the hurricane struck, including delays in insurance payments and disputes between insurers and their customers as to whether damage costs were covered under insurance policies.

In Canada, a natural disaster capable of causing a comparable scale of damage to Hurricane Katrina is a major earthquake.

Provincial insurance legislation makes a distinction between earthquake damage caused by the ground shaking and the damage caused by any subsequent fire ignited by the earthquake (fire following an earthquake).[1] This study will examine the fallout in the US from Hurricane Katrina on insured losses, and what lessons can be drawn for insurance earthquake coverage in Canada where provincial legislation has resulted in separate insurance coverage for ground shaking and for subsequent fire. The first section describes the risks of a major earthquake happening in Canada. This is followed by a review of the insured losses resulting from Hurricane Katrina and the problems

1 Earthquakes under water can trigger another peril: tsunamis. Tsunamis are waves generated by a sudden displacement of water. The areas in Canada most prone to tsunamis are the west coast of the Queen Charlotte Islands (recently renamed Haida Gwaii) and the west coast of Vancouver Island (Kovacs, 2010).

that were caused by the distinction between wind and flood damage. The third section discusses the current status of provincial insurance legislation. The fourth section examines whether the distinction made between fire-following and ground shaking insurance coverage under provincial insurance legislation could be problematic after an earthquake based on the experiences encountered after Hurricane Katrina. The conclusion follows.

The earthquake risk in Canada

An earthquake occurs when rocks break and slip along a fault in the earth. Earthquakes are caused by the slow deformation of the outer portions of the earth's outermost layer of crust.

While earthquakes occur across much of Canada, there are two regions where a major earthquake is likely to cause significant damage. Kovacs (2010) states that that there is at least a 30 percent chance that an earthquake strong enough to cause significant damage will strike south-western British Columbia in the next 50 years, a region that includes Vancouver and Victoria. There is a 5 to 15 percent chance that a damaging earthquake will strike southern Quebec or eastern Ontario in the next 50 years, a region that includes Montreal, Ottawa, and Quebec City.

The Munich Reinsurance Company of Canada commissioned a study, published in 1992, to assess the impact of a 6.5 magnitude earthquake located near Vancouver (Kovacs, 2010). The study estimated economic losses of between CA$14 and CA$32 billion (CA$20 and CA$42 billion in today's dollars) with insured claims predicted to be between CA$7 and CA$13 billion (CA$10 and CA$18 billion in today's dollars).

Ground shaking and fire following

Damage from an earthquake can result from the ground shaking, or from a fire that ignites as a result of the earthquake. Damages from fires following an earthquake can be quite severe because broken gas mains fuel the fires, water supplies used to fight the fires are curtailed, and fire engines may not be able to travel on blocked roads (OSFI, 1998).

RMS (2006) describes the ground shaking and fire following damages from the 1906 San Francisco Earthquake. Ground shaking damage included wooden houses torn off their foundations, masonry buildings crumbled, and brick chimneys collapsed. Sixty fires were reported in downtown San Francisco and it took three days to suppress them, during which 28,000 properties were destroyed.

The Institute for Catastrophic Loss Reduction commissioned a study in 2001 that provided an estimate of the fire damage in Vancouver that would follow a major earthquake; its estimates for various earthquake disaster scenarios ranged from CA$1 billion to CA$9 billion (Kovacs, 2010).

The Hurricane Katrina case

Hurricanes are tropical storms associated with heavy rains and high winds. In August 2005, Hurricane Katrina hit the US Gulf Coast region, seriously affecting Louisiana, Mississippi, and Alabama. Hurricane Katrina was different from other hurricanes because of the extensive flooding that resulted from the record storm surge (abnormal rises in sea level) and the breaching of three levees that protected New Orleans from Lake Pontchartrain and the Mississippi River (King, 2008). The storm resulted in between 1,300 and 1,500 fatalities (Hartwig and Wilkinson, 2010).

The hurricane was the costliest in US history. It caused an estimated US$41.1 billion in private insurance losses and a further US$16.1 billion in losses from flooding insured by the National Flood Insurance Program, a program operated by the US government (Hartwig and Wilkinson, 2010).

Following the storm, significant questions were raised over insurance coverage. An in-depth discussion shows how these issues exacerbated the costs associated with the storm. The costs included payment delays, court challenges, dispute resolution costs, claims expansion, and disaster relief. The disputes over coverage centred around the cause of the damage: was it wind or water?

Wind versus water

The damage caused by hurricanes is a result of either strong winds or flooding. While standard US home insurance policies provide coverage against storm damage, these policies exclude damage from surface water, including storm surges caused by hurricanes. Flood insurance is available through a US federal program, the National Flood Insurance Program. The federal program was created in 1968 in response to the rising cost of taxpayer-funded disaster relief for flood victims and the increasing amount of damage caused by floods (Hartwig and Wilkinson, 2005). The program makes federally-backed flood insurance available for residential and commercial properties in communities that agree to adopt and enforce floodplain management ordinances to reduce future flood damage. Fewer than 20 percent of homeowners in coastal Mississippi purchased flood insurance prior to Hurricane Katrina, whereas upwards of 60 to 80 percent of homes in some Louisiana parishes had flood coverage (Hartwig, 2007).

The distinction between coverage provided by private insurers and that provided by the federal program created a significant problem for homeowners and their insurers subsequent to Katrina as they tried to determine whether the damage was covered

by insurance. The Government Accountability Office (2008) notes that determining the extent of the damage caused by each peril can be difficult; that leads to disputes between policyholders and private insurers and delays in the payments that property owners need for day-to-day living and rebuilding expenses. The GAO report cites the unprecedented damage from the 2005 hurricanes, including Katrina, which led to disputes between policyholders and insurers over the extent of what damage would be covered under a homeowner's policy when both high winds and flooding occurred.

The coverage disputes in the aftermath of Katrina took two forms. Regulators and policyholders challenged the validity of the exclusions to flood damage. As well, there were disputes over whether wind or flooding was the cause of specific damage.

a) Legal challenges to exclusions

Regulators and policyholders challenged exclusions in the courts over both their validity and whether they applied to the specific developments following from Hurricane Katrina. On September 15, 2005, Mississippi Attorney General Jim Hood filed a lawsuit against five insurers alleging that the flood exclusions they had written into homeowner policies were void and unenforceable because they violated public policy, were unreasonably favourable to insurers, and were ambiguous (Mealy's Litigation Report, 2005). The Attorney General also argued that the exclusions violated the Mississippi Consumer Protection Act and Mississippi common law, which mandate that full coverage be provided if the proximate and efficient cause of the damage (i.e., hurricane wind) is covered under the policy even if other non-covered causes also contributed to the loss. In other words, if some damage was caused by wind and further damage was caused by flood, all the damage should be covered by the insurance policy. The suit was dismissed in December 2008 on the basis that the Attorney General never had the standing necessary to pursue the matter (O'Brien, 2009). Prior to the decision, three of the five insurance companies agreed to settlements.

Policyholders also challenged insurers in the courts over the exclusions on the basis that hurricane wind was the proximate cause of water damage. A US district court ruled in August 2006 in a case brought against Nationwide Insurance that the exclusions for damage caused by water were valid and enforceable (Robert Redfearn Jr., 2006). However, the court found that provisions that excluded coverage in its entirety when damage was caused by a mix of a covered and non-covered perils were ambiguous. One year later, Nationwide won a ruling in the Fifth Circuit Court of Appeals; the Court held that the provisions were not ambiguous (Mohr, 2007).

In Louisiana, lawsuits were brought on the premise that the proximate cause of damage was not flooding but poorly maintained levees. In April 2008, this issue was ultimately settled by the Louisiana Supreme Court; in a case brought against the Lafayette Insurance Company, the Court ruled that the flood exclusion in the insurer's pol-

icy, which covered a New Orleans apartment building, applied to damages even from a flood caused by breaks in poorly-maintained levees (Reuters, 2008).

Hartwig and Wilkinson (2010) note that insurers ultimately won virtually every major case that was filed against them. However, defending the litigation cost insurers substantial millions of dollars in time and money.

b) Cause of damage disputes

The second kind of dispute was over whether damage was caused by wind or water. Damage under a standard homeowner's policy was only covered if the damage was caused by wind. In these disputes, the insurer commonly found the cause of damage to be water, while the customer contended that the cause was wind. Many of these cases were "slab" claims, where nothing was left of an insured's residence except the foundation upon which it was built. Kenneth Abraham (2007) describes the problem:

> Residents of the coastal areas of Louisiana and Mississippi evacuated their property as Katrina approached. As the hurricane winds came ashore, they brought with them a powerful storm surge that washed away buildings. But which buildings had been destroyed by wind, and which by storm surge, was not always clear. When residents returned after Katrina had passed, they simply found that their homes had been damaged or destroyed. If the damage or destruction was caused by wind, there was coverage. But if the damage or destruction was caused by flood, the insurer arguably had a defence. Vast numbers of claims were therefore dependent on efforts to determine what exactly had occurred while no one was present.

Insurers that had initially denied claims in slab cases or where cause of damage was unclear came under regulatory and court pressure to review those decisions. To settle a class action lawsuit and resolve litigation by the Mississippi Attorney General, State Farm agreed in January 2007 to reopen thousands of Katrina claims (Kern, 2007b). The agreement included a number of conditions. It specified that where only a slab or pier remained, a minimum offer must be made of at least 50 percent of the policy limit for structural damage, and where a claim proceeded to arbitration, State Farm was to pay the costs of the arbiters chosen by both sides.

In April 2007, the Mississippi Insurance Department announced that another company, the Nationwide Insurance Company, agreed to voluntarily re-evaluate Hurricane Katrina slab cases (Mississippi State Insurance Department, 2007b). By the end of 2007, the State Farm and Nationwide re-evaluation programs had resulted in an additional US110 million in additional claims payments being made (Mississippi State Insurance Department, 2007a).

Mediation was extensively used to resolve disputes between insurers and their customers. In Mississippi, the State Insurance Department established the Hurricane Katrina Mediation Program, a non-binding dispute resolution procedure, to facilitate the resolution of claims. By mid-December 2007, over 4,500 mediation requests had been made (Mississippi State Insurance Department, 2007a).

One year following Katrina, approximately 56,000 homeowner claims in Louisiana and Mississippi remained unresolved, representing just over five percent of the total (Insurance Information Institute, 2006). About 20,000 of these claims were being disputed in mediation or litigation. By Katrina's second anniversary, one percent of personal property claims remained unresolved (Hartwig and Wilkinson, 2010).

Claims expansion

After Katrina, state regulators made a determined effort to create coverage for excluded risks, which the insurance industry strongly resisted. While insurers successfully defended themselves in the courts from having flood exclusions overturned, regulatory pressure contributed to insurers proceeding with settlement offers in cases where they had initially determined flood to be the cause of loss. Abraham (2007) notes that the fact that major insurers chose to settle claims *en masse* suggests that the threat of adverse consequences for insurers who did not cooperate created strong incentives for them to settle.

Marshall and Neale (2006) examined what the direct costs to insurers would have been had the flood exclusions been overturned in Mississippi. They estimate the total cost of flood claims would have exceeded US$4 billion—seven times greater than the total premiums collected in the state for property and casualty insurance in 2005. Marshall and Neale also note that the flood loss exposure for which no premium was collected and no reserve established could have led to the insolvency of some companies. As claim payments for insolvent companies are paid through a State Guarantee Fund financed through assessments against insurance companies, a further potential negative impact would be the creation of a domino effect of company insolvencies (Marshall and Neale, 2006).

Towers Perrin (2005) describes three further problems for insurers, other than the direct costs, that can emerge from claims expansion. First, shareholders may sue the insurer for payment of non-covered claims. Second, policyholders (such as those who, in this case, incurred the extra expense of flood insurance) may launch lawsuits against insurers for failing to appropriately and consistently apply policy language for all customers. Third, precedents are developed that will affect future events.

Regulatory pressure on insurers to settle disputed claims likely added to the cost of insurance and limitations in availability following Hurricane Katrina. Higher costs

and limited availability commonly occur after a major disaster for a number of reasons, including higher reinsurance[2] costs and anticipation of exposure to future losses (McCarty, 2006).

The experience after Hurricane Katrina was no exception. In Mississippi's case, in addition to rate increases, insurers also shifted towards the use of percentages rather than flat deductibles. Mississippi insurers introduced storm percentage deductibles of two to five percent (Marshall and Neale, 2006). Mississippi's residual market (market of last resort) also sheds light on the state's insurance affordability and availability challenges. Mississippi has a wind pool (a facility owned by individual insurance companies) that serves as the market of last resort for coastal property insurance; the pool applied for rate increases in April 2006 for dwellings and commercial property of 397.8 percent and 268.3 percent. Marshall and Neale also found substantial increases in the pool's business volume, an indicator of availability challenges (Marshall and Neale, 2006).

Rate increases and availability challenges occurred in other affected coastal regions, beyond those affected by Katrina. For instance, despite not having had a major storm since 1989, South Carolina experienced problems in coastal areas in 2006 with insurance availability (McCarty, 2006). Insurers were increasing rates by 100 to 200 percent, decreasing coverage by employing percentage deductibles, declining to renew existing policyholders, and discontinuing writing new business in the state. Major insurers also reduced coverage in parts of New York, Connecticut, New Jersey, Rhode Island, Maryland, and Massachusetts (Block, 2010).

While governments and courts exerting regulatory and legal pressure on insurers may result in benefits to those coping with immediate financial losses, ultimately, insurance consumers are adversely affected in both the cost and availability of insurance. Abraham (2007) described the issue:

> But as in any multiple move game, the insurers have not simply taken their medicine and moved on. Rather, their next move has been to cease selling homeowners insurance on coastal properties. This development was at least partly in prospect regardless of how the insurers were treated in the courts. Harsh legal treatment (or the prospect of it), however, undoubtedly exacerbated insurers' reluctance to continue writing coverage on coastal property.
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> In the field of insurance, legal rescue of this sort is thus a double-edged sword. The price that is paid to ensure that current policyholders have insurance for their losses may be that future policyholders find it difficult or impossible to ob-

2 Reinsurance is insurance purchased by an insurer from other insurers. It can help an insurer manage the risk associated with a disaster.

tain coverage at current levels or for current premiums. As a result, coverage becomes scarce and premiums skyrocket. This phenomenon occurred in the 1980s in connection with insurance against liability for pollution, and now it is occurring again in the homeowners insurance market.

State Farm, the largest insurer in Mississippi when Katrina struck, scaled back from Mississippi and made it clear that their withdrawal was a direct result of the actions taken by the state's attorney general. State Farm's general counsel was clear: "The attorney general's actions only further highlight the unpredictable legal and business environment that led to our February decision to suspend writing any new homeowners or commercial property business within the state of Mississippi" (Kern, 2007a).

Federal and state disaster relief

The distinction between wind and flood damage likely contributed to the disaster relief costs incurred by both the federal and state governments.

The Federal Emergency Management Agency (FEMA) operates a program that provides housing assistance after disasters. The assistance includes funding for repair and replacement of homeowner residences not covered by insurance. In the two years following Katrina, FEMA provided US$7.6 billion to households that suffered damage or lost their entire belongings (FEMA, 2007).

Louisiana established a program following the 2005 hurricanes, called the Road Home, which provides financial assistance to homeowners, small rental property owners, and building professionals. Homeowners were required to have owned and occupied their homes as main residences at the times of Hurricanes Katrina and Rita. Homeowners who were uninsured but should have carried insurance (i.e., those who lived in a flood plain but did not have flood insurance) were eligible for the program but their assistance was subject to a 30 percent penalty. Homeowners were eligible for compensation grants up to US$150,000 for damage costs, less compensation received through insurance and FEMA. According to the program's website, as of April 8, 2011, the program had dispersed US$8.74 billion.

Given the low take-up rates of flood insurance relative to private home insurance, it is likely that some government financial assistance went to homeowners who experienced flood losses who had private home insurance, but not flood coverage. The US government flood insurance program would have experienced losses had these homes had flood coverage, but at least premiums would have been collected to offset some of the losses.

Split coverage and the insurance of Canadian earthquake risk

The developments that unfolded post-Katrina demonstrate how split coverage of insurance against a natural disaster can create significant problems for both insurance consumers and the industry. The inability of private insurers in the US to cover flood risk and the presence of a US government plan for this risk made split coverage unavoidable. However, the problems illustrate why split coverage should be circumvented where possible. In Canada's case, although coverage for earthquake risk does not need to be split as private insurers are prepared to offer comprehensive coverage, provincial insurance legislation has resulted in this happening.

Provincial insurance acts in common law provinces have historically made a distinction between damage caused by fire and damage caused by other perils. For a home or commercial property and casualty insurance policy, a section of the provincial insurance act referred to as "the fire part" would apply to fire damage while another section of the act ("the general part") would cover other damage. A BC consultation paper on that province's Insurance Act explains the history:

> The structure of today's legislation reflects the historical regulation of insurance contracts, when contracts were generally issued for specific types of risks or perils. However, modern insurance contracts often cover a variety of risks (multi-peril) or even all risks. For example, the basic home policy no longer insures consumers only for damage to the home by fire, but also typically covers 14 other perils (including vehicle impact, vandalism, wind and hail, window glass breakage and theft), and may also include a component protecting the homeowner from third party liability in certain circumstances (BC, 2007).

The part of provincial insurance acts that deals with fire includes specific exclusions for risks that are considered uninsurable, such as war or insurrection (BC, 2011). Insurers can place other exclusions into insurance contracts for fire damage. However, an exclusion is not binding on the insured if it is held to be unjust or unreasonable by the courts. In other words, a judge can expand coverage by overturning an exclusion after an event.

The insurance industry has a longstanding preference for offering comprehensive earthquake coverage (BC Ministry of Finance, 2007). In other words, both damage caused by the ground shaking and any fire subsequent to an earthquake would be packaged together. However, because of the historical structure of insurance legisla-

tion, the coverage for fire following an earthquake and that for the ground shaking is prevalently split. Standard all-perils policies include coverage for damage from a fire following an earthquake. Coverage against damage from the ground shaking is available, but must be purchased through a separate rider (an optional add-on to the policy). Insurers are reluctant to exclude risks that are not set out in the Insurance Act because of concerns that a court will overturn an exclusion and allow an insurance claim to succeed, even though the insurer has not collected a premium or set aside reserves to cover the risk (BC Ministry of Finance, 2007).

While coverage for fire following an earthquake is standard for homeowner policies, take-up of the earthquake rider varies across the country. Kovacs (2010) notes that the Insurance Bureau of Canada estimates 60 to 65 percent of homeowners in south-western British Columbia buy earthquake insurance. In contrast, very few homeowners (less than 2 percent) elsewhere in Canada buy earthquake insurance, including those in Montreal, Ottawa, and Quebec City.

The Alberta and BC Insurance Act reviews

Maintaining a distinct part of the Insurance Act for fire ultimately leads to cases where there is ambiguity over which part of the Act applies. In 2003, the Supreme Court of Canada ruled in *KP Pacific Holdings Ltd. v. Guardian Insurance Co. of Canada* that the limitation period under the general part of the BC Insurance Act applied to a fire loss claim rather than the period under the fire part (SCC, 2003). The ruling effectively made the fire part of provincial insurance acts redundant for multi-risk policies.

Alberta and BC initiated reviews of their Insurance Acts in 2005. A key issue for these reviews was addressing the issues raised by the Supreme Court. The reviews prompted these provinces to consider whether to amend the list of exclusions for fire damage. Alberta passed amendments to its Insurance Act in 2008 and BC followed suit in 2009. The amendments in both provinces created one set of provisions applicable to all property contracts. The changes thus eliminated the need to classify the insurance contract as a fire contract or a multi-peril contract. Both provinces amended their acts to move exclusions following fire from legislation to regulation.

Alberta has now amended its regulations. Earthquake was not added to the list of exclusions for fire coverage. BC has released a consultation paper which proposes not to add fire following earthquake to the exclusions listed in its regulations. This would thus maintain the status quo in these provinces for split coverage. The BC consultation paper (BC Ministry of Finance, 2010) notes the following reasons for not adding this exclusion:

- Fire losses often entail significant financial loss for individuals and businesses, and limits in fire coverage may result in unexpected and unfair consequences;

- Consumers now covered for fire following an earthquake as part of their basic fire coverage would have no protection from losses arising from fire following earthquakes unless they purchased additional coverage;
- Consumers who purchased additional coverage could find their fire loss coverage significantly reduced due to higher deductibles that apply to earthquake coverage;
- Modern predictive tools have made it possible for the industry to appropriately price, and obtain reinsurance to cover, the risk of fire following earthquake;
- Industry analysis indicates that it adds very little to the cost of insurance to include fire-following earthquake with the ordinary fire coverage in a multi-peril contract.

Earthquake aftermath: What we can expect

The experience in the US following Hurricane Katrina shows that the Alberta and BC government approaches to earthquake risk could have disturbing consequences should a major earthquake occur that leads to significant damages from both fire and the ground shaking.

The most significant concern is that payments of claims to insurance customers will be delayed. Where the cause of damage is not evidently clear, insurance adjusters will need time to assess whether the damage was caused by the ground shaking or fire. Claims may be held up in dispute resolution including court cases where the insurance customer disagrees with the opinion of the insurer and the cause of damage. Delays in payments will result in individual hardship as people will face immediate shelter costs. These delays will also slow the broader economic recovery because it will take longer for people to receive the funds they need to rebuild their homes and businesses.

The same factors that will cause payment delays for insurance customers will also result in an escalation of costs for the industry and its customers (i.e., higher adjustment and legal costs will be passed on to consumers in higher premiums, higher deductibles, or both). Legal disputes might put added strain on the court system and dispute resolution mechanisms such as the General Insurance OmbudService.

There is also a risk that politicians, regulators, and courts will push for claims expansion, as was the case in some American states following Hurricane Katrina. For example, they may attempt to persuade the industry to cover ground shaking damage costs for their customers, even those who chose not to buy this coverage and pay the premium for it. Claims expansion, or even the risk of claims expansion, ultimately results in higher insurance costs for consumers. It also threatens the availability of future coverage, and risks the solvency of insurers.

As Appendix 1 discusses, claims expansion emerged following the 1906 San Francisco earthquake (RMS, 2006). After the earthquake, a number of insurers went bankrupt or withdrew from the market, walking away from their liabilities (RMS, 2006).

Conclusions

Following a disaster, it is important that insurance customers receive their cheques fast to both avoid unnecessary hardship and expedite recovery. The sheer volume of claims and infrastructure damage after a disaster can create challenges for insurers in resolving claims expeditiously and cost effectively. However, public policies that minimize coverage disputes will ease the process.

The lesson from Hurricane Katrina is clear. Splitting insurance coverage for a natural disaster should be avoided where possible. There are circumstances where this may not be avoidable, such as where a peril, such as flooding, is uninsurable. However, this is not the case for earthquake risk in Canada. Allowing insurers to offer comprehensive coverage against damage from the ground shaking and fire following an earthquake will ensure the avoidance of many of the problems that consumers faced *en masse* following Katrina.

Appendix 1: The 1906 San Francisco earthquake and claims expansion

The cost of the 1906 earthquake in San Francisco has been estimated at somewhere between US$350 million and US$500 million, or 1.3 to 1.8 percent of nominal US Gross National Product in 2006 (Odell and Weidenmier, 2004).

Claims expansion following the earthquake was significant. Most fire insurance policies included a "fallen building" clause (RMS, 2006). This stated that if any material part of the building were to fall, except as a result of fire, the policy would immediately cease to cover. Some insurers attempted to deny liability in some claims where damage was caused from a fire that resulted from the earthquake (Odell and Weidenmier, 2004). However, political pressure ultimately prompted the New York Agreement under which most insurers agreed to cover all losses for fire following the earthquake, unless it was proved that the building was totally destroyed by the earthquake (RMS, 2006). RMS (2006) notes that of an estimated US$350 million of insured limits, US$235 million was recovered. Of the 130 companies providing fire insurance in San Francisco, 12 insurers went bankrupt and six European insurers walked away from their liabilities.

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