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Catastrophic Natural Events and the Impact on Insurance

Prepared by Angela Kos, Brownlee LLP

Presented by Angela Kos, Brownlee LLP



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CATASTROPHIC NATURAL EVENTS AND THE IMPACT ON INSURANCE

Prepared by Brownlee LLP
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On May 3 and 4, 2016, Fort McMurray, Alberta underwent the largest evacuation in the history of Alberta. Approximately 88,000 residents were evacuated. As of May 18, 2016 assessment of the damage to the community found that of 19,244 structures assessed, 1,921 were destroyed, 17,156 were approved for occupation, 121 were limited to restricted use, 39 were unsafe to occupy and 7 were still to be inspected.¹

The Fort McMurray fires are just the most recent occurrence of a catastrophic insurance event in Canada. With the increased frequency of extreme weather and related catastrophic events in Canada, there has been increased public and media attention on the cost of insurance and extent of coverage for personal property insurance. The current trend of more frequent and severe weather and natural events seems to be here to stay. As such, there is a growing emphasis on the insurance industry's responsibility to ensure that consumers understand their property and casualty coverage, as well as obtain appropriate coverage for their risks, while ensuring that property and casualty insurance remains attainable and affordable. The response of the insurance industry to catastrophic events to date, as well as anticipated steps in the future, remain hot topics for the public and the industry.

Extreme Weather and the Responding Insurance Claims

Property damage caused by severe weather is now the leading cause of property insurance claims and exceeds fire damage in some areas of the country. The Insurance Bureau of Canada's 2013 Report states that:

- Damage caused by severe weather has emerged in recent years as the leading cause of property insurance claims and now exceeds fire damage in some regions of the country;
- Payouts from extreme weather have more than doubled every 5-10 years since the 1980's;
- The largest Canadian catastrophic loss remains the 1988 Quebec/Ontario ice storm which involved \$2 billion in insured losses (although it is anticipated that the 2016 Fort McMurray fires may exceed this loss).²

The increase in insured losses from natural catastrophes has been increasing gradually over the last 30 years. For each of the past six years, IBC reports that there have been near or above \$1 billion in payouts in Canada. In 2012, losses were approximately \$1.2 billion; in 2013, losses reached a historic high of \$3.4 billion due to the floods in southern Alberta and Toronto.

¹ <http://www.alberta.ca/release.cfm?xID=41776B85DAE7F-C0F6-C84E-6D5B0D3C26C65211>

² [http://www.ibc.ca/en/Need More Info/Facts Book/documents/IBC-Facts-2013.pdf](http://www.ibc.ca/en/Need%20More%20Info/Facts%20Book/documents/IBC-Facts-2013.pdf)



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Comparatively, insured losses typically averaged \$400 million a year over the 25 year period between 1983 and 2008.³

Swiss Re, one of the world's largest reinsurers and a leader in addressing the effect of a changing climate on the insurance industry, calls the increasing insurance losses over the past 30 years "a clear trend." According to Swiss Re, several factors are causing the rise in insurance losses: "This increase is principally a result of higher population densities, a rise in insurance density in high-risk areas and the high vulnerability of some modern materials and techniques. Given these trends have been constant, we assume that natural hazard losses will continue to rise."⁴

The Fort McMurray Fires

The 2016 wildfire in Fort McMurray is expected to cost insurance companies an anticipated \$3.58 billion, making it the most expensive catastrophic event for insurers in Canada. This is approximately twice the amount of the most recent natural disaster in Canada, the 2013 southern Alberta floods, which cost \$1.7 billion in insurance claims. Thousands of people impacted by the wildfire have filed claims, including more than 27,000 personal property claims, with the average claim being \$81,000; 12,000 auto insurance claims, averaging \$15,000 per claim and more than 5,000 commercial insurance claims averaging over \$250,000 per claim.⁵

IBC vice-president Bill Adams has said that it is too soon to know entirely what impact the Fort McMurray wildfire will have on policy costs. Although the impact on policy costs are uncertain, one thing is clear: the devastating impact of the wildfire follows a pattern of increasingly regular catastrophic events occurring across Canada, particularly in Alberta; seven of the 10 most expensive catastrophes in Canadian history have occurred in Alberta over the previous decades.

Recent Catastrophic Claims in Alberta – The 2013 Floods versus the 2016 Fires

While the insurance claims arising out of the Fort McMurray fires are expected to exceed prior total losses from catastrophic events, the impact on the insurance industry as a whole is likely to be less significant than experienced following losses such as the 2013 floods in southern Alberta.

Unlike the 2013 southern Alberta floods, the costs associated with the wildfire destruction will largely be borne by insurance companies. At the time of the 2013 floods, insurance could not be purchased for overland flooding losses (where water enters a home through doors and windows). Subsequently, although the flood caused \$6 billion in damages, insurance providers were only forced to pay out \$1.7 billion, leaving government agencies to contend with the remaining costs⁶. Comparatively, most home and business insurance policies cover fire damages; additionally, if residents have to leave their homes because of a mandatory evacuation order, most home and tenant's insurance policies will additionally provide coverage for reasonable additional living expenses for a specified period of time.

³ http://www.ibc.ca/en/Need_More_Info/Facts_Book/documents/IBC-Facts-2013.pdf

⁴ http://www.ct.gov/cid/lib/cid/app4_natcaten2006.pdf

⁵ <http://www.rcinet.ca/en/2016/07/08/fort-mcmurray-wildfire-costliest-natural-disaster-in-canadian-history/>

⁶ <http://www.theglobeandmail.com/report-on-business/fort-mcmurray-wildfire-damage-to-cost-36-billion-insurance-bureau/article30788517/>

The Response of the Insurance Industry to Catastrophic Losses

What are catastrophic losses and how, historically, have insurers accounted for them? IBC defines catastrophic losses as insured losses from natural disasters that total \$25 million or more.⁷ These losses can range from wildfires to tornadoes to flooding. However, even seemingly innocuous weather occurrences, such as hail, can constitute a catastrophic loss; in July of 2016, a convective thunderstorm occurred in Alberta, causing \$260 million in insured losses. There was tennis-ball hail and wind up to 110 kilometers, resulting in extensive auto and housing damage.⁸

It is a common perspective that the insurance industry has done very little from a regulatory perspective to handle claims arising from catastrophic events. While those affected by catastrophic losses may experience some benefit from on-site claims teams being made available to process losses or deductibles being waived, there is less of an understanding of the long term adjustments insurance companies are making to deal with catastrophic losses.

Insurers have historically remained well capitalized in the face of catastrophic events by adapting pricing, refining the coverage offered and developing tools to anticipate future costs. These tools include managing geographic risks by carefully deciding which consumers to insure, apply an explicit “cat load” when setting the price of homeowners’ insurance policies to consider claims settlement costs resulting from natural disasters and diversifying catastrophic risk through the purchase of reinsurance.⁹ Coverage specific to natural catastrophes, when available, typically vary from insurer to insurer with respect to how much is available and the limits of coverage.

These differences in coverage help to explain why and how the insurance industry may react, depending on the type of catastrophic event that occurs. As previously noted, many consumers carried insurance for fire damage. Fewer consumers carry full coverage for all potential types of water losses. As such, a higher number of consumers found themselves without sufficient coverage, or any coverage, following the 2013 Southern Alberta floods than are expected in the wake of the Fort McMurray fires.

There are a number of potential events that may lead to water losses. Insurance claims related to water damage typically arise as a result of sewer back up or rising overland water (ie. from melting of significant snow fall or rainfall). While coverage in Canada for sewer back up has been available for a number of years, coverage for rising water events has only recently been introduced to the market place. Further, despite coverage for sewage back up being made available, many consumers are typically unaware of the need to add the same as an endorsement to their homeowners’ policy.

Coverage for overland flooding was largely unavailable for Canadian residential properties until 2015, largely in response to an increase in flood events in recent years. In particular, the industry was reacting to the 2013 Southern Alberta floods and the 2013 rainfall in Toronto. These

⁷ http://assets.ibc.ca/Documents/Facts%20Book/Facts_Book/2015/FactBook-2015.pdf

⁸ <http://www.paramountinsurance.ca/blog/65-alberta-takes-the-cake>

⁹ <http://www.pacicc.com/publications/pages/publications/WIF%20Natural%20Disasters.pdf>



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flooding events brought to the forefront the public's expectation that home insurance provided comprehensive protection, including more regularly occurring events such as floods.

In the past, even if a loss was not specifically covered by a policy, insurance companies have often provided coverage in the event of catastrophic losses. For example, in 2013, insurance providers reversed their decision to deny Calgary residents flooding claims after neighboring homes with various insurance providers received different levels of coverage for repairs due to the type of water damage that homeowners experienced. Companies such as TD Insurance and RBC Insurance Service subsequently agreed to cover some of the flooding damage. Subsequently, insurers worked to expand coverage available for property loss due to flooding. This being said, coverage available for floods continues to be rather limited. For example, some policies provide coverage for accumulation of water including significant rainfalls that enter properties. Other policies limit flood coverage to tsunamis, tidal waves or rising of a body of water. Policies can further limit coverage when water damage is a consequence of another natural disaster, such as earthquakes or hail.

These differences in coverage are brought to the forefront following catastrophic losses and, unfortunately, may be the first time that consumers are made aware of limits of coverage under their particular policies. Ultimately, as the frequency of events requiring large payouts increases, insurance companies will likely be less motivated to provide coverage if it is not specifically afforded for under a policy.

In addition to expanding coverage available, the increased frequency in flood events have led insurance companies to revisit risk assessments. In this respect, efforts have been made to update flood zone mapping, calling for increased awareness for consumers who are at risk to be identified and provided with access to appropriate insurance coverage.

While most insurers do not have specific coverage or exclusion for wildfire, there is also no specific definition of wildfire within the insurance industry. However, damages caused by fire are covered as part of the standard multi-peril policy. Of course, due to drier weather throughout the year and increased winds, the risk of wild fires and the potential for insurance payouts significantly increases. Prior to the 2016 Fort McMurray fires, the most significant wildfire related event in Canada was the Slave Lake Fire. That fire cost more than \$700 million in insured losses.

It is still too early to determine the long term impact of the Fort McMurray wildfire with respect to policy premiums. In a recent Edmonton Journal article, IBC director of media and digital communications Steve Kee expressed the uncertainty felt by both insurers and insureds alike, saying "it's too early to tell the exact level of damage on the ground, but we can say that no one event will lead to an automatic increase in premiums...individually, insurers are going to make those decisions".¹⁰ Ultimately, although consumers may make decisions about which policies they choose, it is ultimately up to insurance companies to determine their own exposure to catastrophic events. This will involve insurers obtaining access to risk modelling tools and accurate data related to wildfires across Canada. While the terms of policies may not necessary

¹⁰ <http://edmontonjournal.com/business/local-business/fort-mcmurray-fire-damage-not-act-of-god-insurance-bureau-of-canada>



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be altered, the cost of obtaining property insurance in areas prone to wildfires will undoubtedly increase.

Anticipated Responses in the Face of Increasing Catastrophic Events

What is clear is that coverage for natural catastrophe-related events varies from insurer to insurer. As such, when events such as the Fort McMurray wildfires occur, the effect on each individual policy holder may vary drastically. Many consumers do not have a full understanding of their coverage or of coverage available.

Moving forward, there is an increased likelihood that insurers will more predominantly turn to risk sharing in an effort to diversify their risk. This may include reinsurance with respect to specific geographic locations to minimize the risk in the case of a catastrophic event. Alternatively, insurers may look to increase deductibles on high risk losses.

Ultimately, the availability of insurance coverage for catastrophic losses is a significant factor for consumers, particularly those in a high risk area. As consumers typically become aware of the extent of, and limits of, their coverage when faced with a disaster, there is an increased need for the industry to take steps to bring consumer's attention to the coverage available.

Realistically, insurers are not the only parties responsive to catastrophic losses. The responses of the various levels of government are important considerations in assessing the ongoing role of insurers in responding to catastrophic losses. For example, in 2016, the Regional Municipality of Wood Buffalo passed a motion to refund a portion of property taxes for the time residents have been away from their home, meaning everyone would get approximately one month's worth of residential tax credit for the evacuation. Individuals whose communities remain uninhabitable, or those whose homes were destroyed by the wildfire, would receive even more money back. Council is also contemplating removing a restriction on development permits. Additionally, the CRA can allow taxpayers to file their tax returns late in the event of extraordinary circumstances such as floods or wildfires. It is clear that, as Fort McMurray begins to rebuild, both insurance companies and government bodies will be vital in its development.

Generally, at the federal level, the Disaster Financial Assistance Arrangements (DFAA) program outlines how the federal government should respond to a natural disaster.¹¹ Provinces and territories are responsible for designing, developing and delivering financial assistance to the victims of emergencies and disasters as they see fit, with no restrictions placed on them by the federal government.

Under the DFAA program, provincial/territorial governments can ask the federal government for disaster relief when eligible expenditures surpass \$1 per capita (based on provincial/territorial population). The program sets out guidelines respecting what expenses resulting from a disaster qualify for relief, following a graduated funding formula based on the size of the disaster. Generally speaking, DFAA guidelines stipulate that the federal government will not provide funding to the province to cover costs already insured or *where insurance was available at a reasonable price* but was not purchased. There is nothing in the law, however, preventing the

¹¹ Government of Canada – Guidelines for the Disaster Financial Assistance Arrangements



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federal government from covering any cost it wishes. In theory, however, the DFAA rule against providing aid to those who choose not to purchase insurance is likely to motivate consumers to purchase insurance when available. With the increased frequency of catastrophic events, the limits of the DFAA program are becoming more commonly known.

However, the reaction of governmental agencies to catastrophic events simply emphasizes the role of insurance in managing losses. Insurance effectively transfers the risk away from tax payers, permitting consumers an opportunity to plan ahead to reduce their risk. In addition, when increased insurance funds are available to respond to losses, public funds can be made more readily available for response and recovery efforts.

Canada's insurers participate in the Institute for Catastrophic Loss Reduction (ICLR), a forum for insurers to work more actively with the research community and others to better understand severe weather and options for managing this risk.¹² Moving forward, we can expect consumers to look to insurers to provide products and services that improve disaster resilience, as well as informing the public about emerging risks.

The Insurance Bureau of Canada's (IBC) main response to rising claims, aside from increased premium rates, has been to promote a strategy of prevention. Over the past several years, it has lobbied the federal government to adopt the IBC's Natural Disaster Reduction Plan, which calls for the government to:

- invest in infrastructure a proportionate amount of the funds spent on disaster response and recovery, independently or in conjunction with a national infrastructure program;
- invest 15% of recovery costs in mechanisms to prevent the recurrence of specific extreme events; and
- include risk assessments in every project in which the federal government invests.

In its May 2000 report on natural disasters and the insurance industry, the House of Commons Standing Committee on Finance made recommendations that generally echoed the Natural Disaster Reduction Plan. In response, in 2001 the federal government created the Office of Critical Infrastructure Protection and Emergency Preparedness (OCIEP), which was responsible for addressing many of the concerns raised by the Insurance Bureau of Canada. OCIEP's mandate has since been folded into Public Safety and Emergency Preparedness Canada (PSEPC). This goal of this organization includes, but is not limited to:

- promoting dialogue among Canada's critical infrastructure owners and operators, and fostering information-sharing on threats and vulnerabilities;
- providing a focal point for the Government of Canada's own cyber-incident analysis and coordination efforts, and supporting federal departments and agencies in meeting their responsibilities for protecting their information technology systems and networks;
- promoting other areas of cooperation, such as raising awareness, enhancing education and training, and promoting research and development in the field of information technology security; and
- achieving an appropriate level of national civil emergency preparedness.

¹² www.iclr.org



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PSEPC is also developing a National Disaster Mitigation Strategy, which is “aimed at reducing or eliminating the personal, social, economic and environmental risks and impacts of natural and human-induced disasters.”¹³

Conclusions

For reasons of climate change, economic growth and population growth in areas prone to natural hazards, insurers are likely to face rising claims for payments as the economic cost of natural disasters increases. This reality could have important implications for the viability of insurers, the availability and affordability of insurance to consumers and businesses, and the cost to governments and society.

Governments and the insurance industry have already started to address the problems associated with the increasing severity and frequency of natural disasters, most notably through programs to mitigate the effects of natural disasters. As such the frequency of such risks grow, increased pressure will be put on insurers, working together with governments, to address gaps in coverage to minimize the exposure of the public to such catastrophic events.

¹³ www.publicsafety.gc.ca