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Reflections on the hours clause and ex gratia payments when dealing with catastrophic losses

By André Fredette

Wordings are crafted based on prior losses and incidents. However, while we hope they will be sufficient for future losses, it always seems there are new events which either test the wordings or present situations that were not anticipated.

Another fact of life is that the larger the catastrophe the more unanticipated events occur which challenge both primary insurance wordings and reinsurance contract wordings.

The recent flood losses in Alberta and Toronto are examples of how situations that occur can cause problems outside of the contract wordings.

In looking at the hours clause the situation is not too bad. Most hours clauses on reinsurance contracts are fairly standard. An occurrence has an hours limit of 168 hours (7 days) other than windstorm, hail, tornado, hurricane, strike, and civil commotion, which have 72 hours. Windstorm, hail, tornado, hurricane, strike, civil commotion can be split into two events if they last longer than 72 hours. There is then a second net retention on the treaty. The same applies for forest fire which has 168 hours. However flood, which has 168 hours, cannot be split into two events if it lasts more than 168 hours.

In Alberta and Toronto the flooding losses occurred within 168 hours. Even if some of the homes in Alberta remained flooded for several weeks the initial damage ►

Inside this issue:

Flood mitigation in Alberta

By Paul Kovacs
Executive Director, ICLR

How can we reconcile record high disaster damage in Canada this year, with reports by the United Nations and others that the risk of disaster loss and damage in Canada is among the lowest in the world? Will Alberta invest in flood mitigation?

The World Risk Index is a 2012 United Nations' report assessing the risk of disasters around the world. Canada ranks 150th of the 171 countries studied. In contrast Japan is ranked 16, the United States 127, the United Kingdom 139 and Germany 146.

The risk of loss and damage from flood, storms and earthquakes is identified as very low in Canada, Northern Europe, and the Middle East. The highest disaster risk is found in Africa and South-East Asia; including Japan, Bangladesh and the Phillipines.

Among developed countries, the three nations with the greatest frequency and severity of flood, storm and earthquakes are Japan, Chile and the Netherlands. The three developed countries found in the United Nations research to have made the most progress in reducing the risk that natural hazards result in disasters are Japan, Chile and the Netherlands. The residual risk remains a concern in each country, but the findings show that experience with natural hazards is a critical driving force to secure action to reduce the risk of future loss and damage. Japan, for example, ranks first in terms of disaster risk reduction, nevertheless the residual risk remains very high, ranking 16th in the world.

The United Nations report that Canada's progress in reducing the risk that natural hazards result in disaster damage and losses is lower than most industrial nations. Tools to reduce the risk of loss and damage are well known, and widely available. Some countries, like Japan, Chile and Netherlands, choose to more aggressively invest in disaster risk reduction. Other countries, like Canada, choose to invest less in disaster risk reduction, in part because we have less exposure to flood, storms and earthquakes.

Political interest and public support for risk reduction are greatest as the emergency response efforts shift into rebuilding and reconstruction. Rebuilding is completed quickly following smaller events, and the community soon shifts its focus to other issues. In contrast, reconstruction extends over many years following major disasters, also sustaining interest in risk reduction. Experience shows that disaster risk reduction efforts are most likely to take place during the period of twelve to twenty-four months following a major disaster.

Record high flood losses this year in southern Alberta are supporting strong interest in flood mitigation and disaster risk reduction. This includes proposals to build berms, floodways, and prohibit new construction in the floodway. Current political interest and public support for flood mitigation is strong in Alberta but will decline with time.

Record high losses this year from sewer backup and other urban flooding in Ontario has not generated similar political and public support for investments in risk reduction. Insurance companies are assessing the increasing frequency and severity of water damage claims, and some municipal governments are assessing their stormwater management systems, but there appears to be little engagement from the provincial government or the general public.

There is strong agreement about the proven actions that can be applied to reduce the risk of loss and damage from natural hazards. The recent ICLR paper on best practices to reduce the risk of riverine and urban flood damage in Alberta (see page 7), for example, details options for flood mitigation.

Experience is one of the most important factors driving differences in local and national efforts to apply this knowledge to reduce the risk that natural hazards become disasters. The risk of flood, storms and earthquakes in Canada is low relative to most countries in the world, but we did experience large losses this year. Efforts are underway to bring flood mitigation to Alberta, and will reduce the risk of future flood damage and losses. But political interest and public support for flood mitigation will decline over time. The next twelve to twenty-four months will be an important period to determine to extent of actions taken. **CT**

occurred during the first week.

Places like Thailand, which had floods two years ago, were much more problematic as the floods lasted 2-3 months and many reinsurance contracts did not have aggregate caps to limit the number of losses.

In Canada, so far hours clauses have been sufficient for the situation.

When we turn to ex gratia claims we have a much more slippery problem. We will look at ex gratia payments from the perspective of excess of loss contracts (property cat treaties and property per risk treaties).

I would like to start with a quotation from the Reinsurance Course book C47 2001 Edition from the Insurance Institute of Canada, Chapter 5 Page 4: **"**Ultimate Net loss Article: *The term 'ultimate net loss' shall mean the sum or sums paid or payable by the Insurer in settlement of losses* ***for which the Insurer is liable*** *after making deductions for all recoveries and salvages, including recoveries from other reinsurances, whether recovered or not, and shall include all adjustments and litigation expenses arising from the settlement of losses.*

"This defines what a loss is made up of for the purpose of applying the treaty. Note that the insurer must be ***liable*** *under the terms of the original policy. This is to eliminate an "ex gratia " payment – a settlement made for commercial reasons by the insurance company where there is no coverage or only doubtful coverage under the policy. For example, such a payment might be made to placate a very good agent or insured. But that is a business matter and not properly the subject matter of non-proportional reinsurance."*

In non-proportional treaties one might see the following clause: *"The Reinsurer will follow the judgement of the Company as to whether any loss comes within the terms of the original policy. The Company shall under no circumstances commit the Reinsurer to ex-gratia settlements (i.e. where the Company is not liable) without first consulting the Reinsurers and obtaining their written consent."*

So plainly any ex gratia payments on non-proportional property treaties are excluded and can only be included with the permission of the reinsurer.

However, things are not as clear on proportional property treaties such as quota share treaties. Again to quote the Reinsurance Course book C47 by the Insurance Institute of Canada, Chapter 4 page 8: *"Occasionally, a claim will be presented to the insurance company and there may be some doubt whether it is covered by the policy. However, the company may feel that it would prefer to pay the claim for commercial reasons, that is, to maintain the relationship with a good agent. Such* ***ex gratia*** *payments are also recoverable from the reinsurer under pro rata reinsurance treaties."*

When I read this I was surprised as I had assumed ex gratia losses were also excluded from proportional covers but in speaking with former colleagues, I learned there have been some cases where ex gratia claims are covered. Below are two examples taken from different wording contracts.

Example 1

"*The Cedent shall investigate and settle, or defend all losses and claims recoverable hereunder, including ex gratia payments, alone and the Reinsurer undertakes not to contest such payments or settlements. The Cedent may offer to the Reinsurer an opportunity to be associated jointly with the Cedent in a loss which involves or is likely to involve this Agreement, at the Reinsurer's own expense."*

Example 2

"The Ceding Company shall settle all losses, other than ex gratia payments, and the Reinsurer undertakes not to contest such settlement. With respect to ex gratia payments, the Ceding company shall be able to make such payment without previously obtaining the approval of the Reinsurer up to an aggregate limit per occurrence of CAD$ XXXXX (100% Quota Share). However, it is understood that for the portion of ex gratia payments in excess of this amount, the agreement of the Reinsurer is required."

Coverage for ex-gratia payments is rarer today but there are some cases.

The reason I dwell on ex gratia claims is that flood coverage for residential properties is non-existent in Canada. As a result, when large flood losses occur, there is pressure from both consumers and governments for insurance companies to pay for flood claims which are normally excluded from the policy. Flood claims are typically mixed with sewer backup claims. As policy wordings vary in how they define loss, exclusions, deductibles, policy caps etc. there is a great amount of confusion in the general public. Whatever the insurance industry doesn't cover will put pressure on the provincial government to make up the difference. Therefore, there is great pressure on insurance companies to take a liberal view on adjusting flood/water damage claims.

Some companies have decided to provide ex gratia claim payments from their own net retention without seeking recoveries from reinsurers. In other cases the insurers may not have been as forthcoming.
Up till now reinsurers have focused on getting accurate data on Earthquake exposure as ►

the big loss potential. This will continue. However, going forward, given the severity and frequency of flooding/water damage claims, reinsurers will ask for more information. Typical questions will focus on:

- Data on commercial risks with flood insurance, aggregate exposure.
- Flood maps for commercial risks.
- Flood maps for areas with large residential exposure. T.I.V. in flood areas.
- Policy wordings, deductibles, policy caps for water damage etc.
- Claims adjustment policy.
- Remediation policy.

The flood/water damage problem will not go away as we still do not have a government/industry coverage solution unlike other countries such as the U.S.A., England, France , Germany and many others.

As a result the industry problem will continue and neither customers nor governments will be satisfied.

In a related matter, the pressure to pay claims that were not anticipated, covered or priced for by the policy wording sets a dangerous precedent in the event of a future serious earthquake loss. While some companies may today pay ex gratia claims in order to retain reputation or market share, the size of a large earthquake loss would make such course of action unlikely as it would probably exhaust reinsurance coverage and drive the company into insolvency. **CT**

Note: I would like to thank friends and former colleagues listed who either helped or provided useful advice in completing this article: Charles Campisi, Robin Darby, Rob Finnie, Harold Hopf, Sergio Metallo, George Socha and David Wilmot.

André Fredette recently retired as Senior Vice President and Chief Agent for CCR.

ICLR holds successful urban/basement flood symposium

More than 130 insurance professionals, municipal water experts and others attended ICLR's 2nd Urban/basement flood symposium, held September 19 at the Toronto Region Board of Trade.

A number of municipal water and wastewater experts from various cities presented on their respective experiences with heavy rainfall events that lead to basement flooding, and some of the measures that have been taken and will be taken going forward to minimize the risk of a repeat.

Speakers included water experts from the City of Ottawa, City of Windsor, City of Winnipeg, City of Hamilton, City of London, City of Kitchener and City of Welland.

Additional speakers including Professor Ted Kesik from the John H. Daniels School of Architecture, Landscape and Design at University of Toronto;

and Christine Zimmer, Senior Manager, Watershed Protection and Restoration, Credit Valley Conservation.

The keynote speech was delivered by Murray Pound, President of Goldseal Homes, Carstairs, Alberta, who delivered "Damage is in the Details: Build better now or bail later."

Slide decks from the event can be downloaded at http://www.iclr.org/symposium2013.html **CT**

Mission creep

With the factors leading to increasingly more expensive catastrophe years not liable to change for the better anytime soon, large losses for Canadian insurers are now the 'new normal'. However…

By Glenn McGillivray
Managing Director, ICLR

Over the last few years, Canadian property and casualty insurers have experienced unprecedented claims costs due to natural catastrophes. The Institute for Catastrophic Loss Reduction (ICLR) now considers large loss catastrophe years to be the 'new normal' for Canadian property and casualty insurers.

Canadian carriers paid out $1 billion for each of 2009, 2010, 2011 and 2012. Actually, in the case of 2011, insurers significantly more than that. Even with the wildfire in Slave Lake, Alberta removed, insurers still paid out $4 billion in natural catastrophe claims since 2009. With Slave Lake in, the total is closer to $5 billion in catastrophe claims paid over the last four years. And this says nothing of 2013, which will go down as the most expensive year, by far, for catastrophe losses in Canada.

These numbers represent just the sum of those events that meet or exceed Property Claims Service (PCS) Canada's $25 million claims threshold. Not included are many smaller events that fall under this minimum and those everyday, run-of-the-mill weather-related losses which, at present, no single system captures.

The Institute estimates that severe weather costs for Canadian insurers now exceed $2 billion a year when losses from extreme events are combined with smaller loss events.

Makings of a trend

When Canadian insurers experienced back-to-back billion dollar catastrophe loss years in 2009 and 2010 – the first time ever for consecutive billion-dollar losses in this country – many carriers began to ask, at least internally, whether this was the start of a trend or just a short-lived anomaly.

When considerably more than $1 billion was paid out in 2011 due to extreme weather and wildfire – the first time ever that Canadian insurers experienced three consecutive billion-dollar years – carriers began to reach outside their companies to ask if a new order was, indeed, taking shape.

With 2012 being the fourth consecutive year for billion-dollar weather-related losses in Canada, ICLR went on the public record as saying that large losses are, indeed, the way it's going to be for the Canadian insurance industry going forward and the numbers generated this year serve to solidify that statement.

ICLR does caution, however, that while we consider the trend toward larger weather-related losses to be the 'new status quo,' this does not mean that Canadian insurers will experience billion-dollar losses every year. Rather ICLR is simply stating that while there will continue to be good years and bad years for such losses, large-loss years will no longer be the rarities they were just a few years ago.

Only twice prior to 2009 did Canadian insurers pay out $1 billion or more in severe weather claims in a single year. The first was 1998 - the year of the Ontario/Quebec ice storm. The roughly $2 billion in claims tallied from that event made it the costliest insured natural catastrophe in Canadian history. The second year was 2005, when $1 billion in claims were recorded, largely due to the August 19 rainfall event in the Greater Toronto Area (GTA).

To what do we owe this displeasure?

So why billion-dollar losses, and why now?

On the surface it may appear as though the trend towards more expensive catastrophe years for Canadian insurers 'just happened.' However, analysis of available data shows that insured losses from severe weather have been moving in a steady upward direction for more than four decades and have been on course to exceed the 'magic number' of $1 billion for some ►

time.

ICLR believes that the 'drive to $1 billion' can largely be attributed to 'creep' in three key areas: Growth in concentration of values, particularly in Canada's largest cities; degradation of Canada's infrastructure; and more large storms. All three work in one way or another (and often in tandem) to worsen the impact of severe weather events.

None of the changes in these three factors happened overnight. But over time, they changed in increments – or crept - in such a way that when comingled with extreme weather and wildfire, ensure that large losses are now the norm.

Additional exacerbating factors that are making extreme weather events more expensive in Canada include: the rising cost of basement flooding as homeowners finish lower levels of houses more lavishly (eg. with laminate or hardwood floors, drywalled walls and ceilings, pot lights, expensive furniture and electronics, and high efficiency furnaces, to name a few); building in dangerous places like on coastlines and in the Wildland Urban Interface (WUI); and weak public policy measures for building codes, landuse planning and municipal by-laws.

None of the three factors – values, infrastructure and climate, or the additional exacerbating factors – are likely to change for the better in any meaningful way anytime soon, so the drive to larger and larger loss years for Canadian insurers is expected to continue.

What can insurers do?

The mistake would be to view natural disasters as inevitable and ring our collective hands as an industry, doing nothing more but pulling out the corporate cheque book a little more often. As ICLR strongly maintains "natural hazards needn't be disasters."

For more than 15 years, the Institute has been working on behalf of Canada's p&c industry to identify actions that could lessen the adverse impact of natural hazards on life and property.

ICLR was established by Canada's insurers at Western University (formally the University of Western Ontario) to provide a forum for leaders in the disaster safety research community to work directly with insurance leaders to better understand the factors contributing to the alarming trend of increasing damage due to natural hazards, and to champion actions to build resilience to disasters. Through it's call of 'science to action', the Institute has been working on four main peril areas – wind, water, wildfire and earthquake – using four main 'yardsticks' to measure success: Quality research; Effective partnerships; Industry education; and Consumer awareness.

In early 2012, ICLR's Board of Directors asked for an action plan to guide the Institute's research and outreach efforts for the next three to five years. The plan was written by ICLR's Insurance Advisory Committee, and outlines specific actions for reducing the risk of loss from wind, water, wildfire and earthquake.

The plan for each of the four hazards includes a comprehensive review of potential actions, including the importance of increased investment in public infrastructure, working with municipal officials to change local by-laws and planning, influencing new home design and construction, and building public awareness of actions to reduce the risk of loss.

Three critical elements of ICLR's new 'research to action' plan are: Partner with municipalities to advance homeowner basement flood risk reduction efforts; Promote best practices to enhance the resilience of *existing* homes to damage from water, wind, earthquake and wildfire; and, Work with builders to champion resilient design and construction of *new* homes.

Canada's property and casualty insurers continue to actively support and champion ICLR's loss reduction research program. In addition, individual companies can leverage the many resources and tools that have been made available to them, including ICLR's new basement flood mitigation website basementfloodreduction.com; 'How to' and information videos on ICLR's YouTube Channel; and its series of 'Protect Yourself' booklets dealing with basement flooding; severe wind; wildfire, snow & ice and, soon, earthquake and overland flood.

ICLR's way forward is ambitious but critical to confront the 'new normal' of large losses that has taken hold in Canada, through research to identify best practices for loss reduction.

Most loss and damage is preventable if emerging findings are applied. **CT**

New publication

Best practices for reducing the risk of future damage to homes from riverine and urban flooding

A report on recovery and rebuilding in southern Alberta

Flooding in southern Alberta in June 2013 resulted in four fatalities and unprecedented damage to property. Premier Alison Redford met in late July with the Insurance Bureau of Canada and a number of insurance industry CEOs to discuss recovery and rebuilding. The Bureau asked the Institute for Catastrophic Loss Reduction in August to prepare this report on actions the Government of Alberta could take to reduce the risk of flood damage to homes in the province.

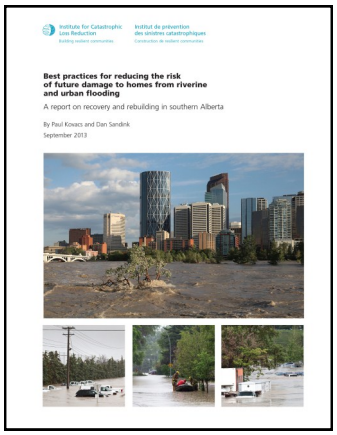
The tragic losses in southern Alberta have opened a window of opportunity over the next 12 to 24 months for the Government of Alberta and other stakeholders to take action to reduce the risk of loss from flooding, tornadoes, wildfires and other perils. The Institute's research program on best practices for reducing the risk of loss from natural hazards demonstrates that most disaster damage can be prevented through the application of existing and emerging knowledge about building disaster resilient communities.

Best practices to prevent and reduce the risk of loss from riverine flooding are well known, and have been tested around the world for several decades. Prohibition of development in zones of flood risk, investments in structural flood defence and a variety of other tools are available to eliminate or reduce the expected loss from riverine flooding. The foundation for riverine flood management involves a clear determination of acceptable risk of flood damage.

Best practices for reducing the risk of urban flooding have emerged over the past 25 or 30 years and are distinct from actions to reduce the risk of loss from riverine flooding. The frequency and severity of urban flood damage is determined by factors that include rainfall patterns, lot level actions by property owners and the state of the local sewer infrastructure. Every household connected to the storm or sanitary sewer system is at some risk of loss. Best practices to reduce the risk of urban flood damage include lot level actions by property owners and public investments in sewer systems.

This paper sets out 12 recommendations on actions the Government of Alberta can take to reduce the risk of flood damage to homes.

The paper can be downloaded at www.iclr.org **CT**



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Mission
To reduce the loss of life and property caused by severe weather and earthquakes through the identification and support of sustained actions that improve society's capacity to adapt to, anticipate, mitigate, withstand and recover from natural disasters.

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