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INSURANCE AND REINSURANCE ISSUES ARISING OUT OF NATURAL CATASTROPHES

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2011 saw an unprecedented sequence of natural catastrophes including the Christchurch earthquake, the Japanese earthquake and tsunami and the floods in Thailand. In addition to the devastating loss of life and the impact on local communities, these events have also had a significant impact on the global insurance industry with insured losses estimated at more than US$110 billion. In this article, we will consider the immediate financial impact these events have had on the industry, as well as some of the insurance and reinsurance issues that commonly arise in the context of claims resulting from natural catastrophes.

Financial impact

Insured losses arising from natural catastrophes in 2011 are estimated at US$110 billion, making it one of the most expensive years on record for the insurance industry. Despite the immediate impact these losses had on insurers and reinsurers, the share prices of a number of Lloyd's businesses and European insurers have performed well since and continue to do so in 2012. This is largely down to a combination of much lower catastrophe claims in 2012 and an increase in premiums as insurers and reinsurers look to replenish lost capital from previous years. Catastrophe claims for the period up to the end of May 2012 have been estimated at approximately US$6 billion, compared to a figure of US$75 billion for the same period in 2011. Meanwhile, rates rises of 2-3% have been reported by some insurers, with reinsurance premiums up by as much as 5-10% and further increases expected. In addition, those regions or countries that are now perceived as potentially more exposed to natural disasters than previously, have seen rates increase by as much as 30%.

Whilst the level of insured losses for 2011 was amongst the highest on record at US$110 billion, the total economic losses arising from natural catastrophes are likely to be far higher and are currently estimated at US$370 billion. This means

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that more than two thirds of the total damage caused by these catastrophes are uninsured. This significant "gap" in coverage highlights not only the upward trend in the potential total economic losses arising from these catastrophes, but also an apparent lack of adequate insurance protection in respect of these events. Without adequate cover, it is invariably those who are most vulnerable following such an event, namely individuals, businesses and governments, who ultimately bear the loss.

The level of insured versus uninsured losses can vary significantly between countries, as is clear when contrasting the losses arising from the recent earthquakes in Christchurch and Japan. Despite Japan being considered one of the best prepared nations for earthquakes and tsunamis, of the estimated US$210 billion of total economic losses, total insured losses are estimated at only US$35 billion (i.e. less than 20% of the total losses). Meanwhile, of the estimated US$15 billion of economic losses caused by the earthquake in Christchurch, US$12 billion of those losses (or 80%) are estimated to be insured. As a result, whilst the financing for Japan's recovery is likely to come from the Japanese government, thereby adding to the country's already high fiscal debt, the recovery in Christchurch will rely instead on the settlement of insured losses paid for by the global insurance industry.

Despite the growing awareness of the need for adequate insurance protection for these types of events, it appears the gap between insured and uninsured losses has continued to grow in recent years. As "insurers of last resort", it is normally governments who end up financing a large proportion of the disaster recovery costs. In the past this has typically been done by diverting budgets from

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other areas of government or by increasing taxes, as was the case in Australia following the Queensland floods of 2010 and 2011, where a flood levy was applied to taxable income to help finance the recovery. In the United States, the federal government does not generally budget for future catastrophes and instead largely relied on taxpayers to shoulder the burden of financing the recovery following a disaster. The decision by governments to self-insure in this way can leave them with considerable exposure to natural catastrophes. In addition, not all economies have the ability to act as insurer of last resort in this way. By way of example, total economic losses from the earthquake in Haiti in 2010 totalled US$8 billion, which was the equivalent of 120% of the country's gross domestic product.

In light of the ongoing global financial crisis, some countries may experience difficulties raising the requisite finance following such an event, perhaps due to their already substantial deficits. As a result, it is anticipated that governments in future will need to consider a more efficient and appropriate form of risk transfer to ensure they are adequately protected in advance of a natural catastrophe. This could be in the form of a government managed fund, such as the Natural Catastrophe Insurance Fund in Thailand or ex-ante risk financing, where funds can be secured prior to the event itself through insurance linked securities or cat bonds.

Insurance and reinsurance issues

Invariably, given the complex nature of natural catastrophes, issues can arise when insureds come to make claims under their property, business interruption, contingent business interruption, liability and directors and officers' policies. The fact that the potential claims involved are so high means that it is perhaps inevitable that questions will be raised regarding the application of the specific facts (leading up to, during and following the catastrophe) to the relevant insurance or reinsurance policy wordings. In this section we will consider some of the most common questions which may arise in this context.

One of the primary considerations for determining cover under a property insurance policy, and as a trigger to business interruption cover, is the question of what actually constitutes "physical loss or damage". In some cases the term physical loss or damage may be defined in the policy, whilst in others it may be apparent from the context that physical loss or damage has occurred. However, in some circumstances, whether or not the property has suffered physical damage may not be so clear. By way of example, would fear of or an unproven threat of contamination from a damaged nuclear plant constitute physical damage to an insured's premises? In the absence of a definition or a clear understanding between the parties of what physical loss or damage actually means

under the policy, it may ultimately be left for the courts to decide. In doing so, the courts may look at the dictionary definition of the terms and also previous case law to interpret the meaning of the term. The governing law of the policy may also be particularly relevant in determining the actual meaning of the term.

The reason it is so important to determine whether physical damage has actually occurred is because, in most cases, physical loss or damage is the trigger for the business interruption cover under the policy. As a result, it is fundamental to the validity of any business interruption claim to ascertain whether the trigger has been met. The burden of showing the trigger has been met typically falls upon the insured, who must also show that property damage is insured under the policy.

Another important feature of business interruption cover in the context of natural catastrophes, is the determination of what the operative or proximate cause of the business interruption loss was. Typically business interruption policies have a double causation test, requiring the insurer to pay the amount of economic loss "resulting from" the business interruption "in consequence" of the relevant business interruption trigger (usually physical damage). If the loss does not meet either of these tests, the loss would not be recoverable. However, in the context of natural catastrophes where multiple perils may be operating concurrently or in quick succession, it may sometimes be difficult to determine precisely which of these causes was the proximate cause of the loss. This will ultimately be a question of fact. The answer to this question will be relevant if the loss was caused by more than one proximate cause (i.e. concurrent causes). If one of the concurrent causes is insured and the other is not, then the loss may still be covered. However, if one of the causes is insured and the other is expressly excluded, then the loss may not be covered.

In addition to normal business interruption cover, which is typically triggered by damage to the property of the insured, cover can also be extended to circumstances where a business has been interrupted as a result of physical damage to the premises of a supplier or a customer. This type of cover is referred to as contingent business interruption and can be purchased in addition to the normal business interruption cover, typically in the form of "Supplier" and "Customer" extensions. This type of cover may be particularly relevant for businesses which are heavily reliant on other businesses for their ongoing operations, such that damage to the premises of that other party could result in the interruption of insured's business. Whilst this cover has formed part of Industrial Special Risk and All Risk Insurance policies for some time now, the recent catastrophic events in Japan and Thailand have brought the importance of it sharply into focus and has highlighted the vulnerability of certain production processes to interruptions to the global supply chain and the potential losses that can result. Given that the scope of the contingent business interruption cover will ultimately depend on the specific wording of the extension in the insurance or reinsurance policy, it is important that insureds ensure the trigger language in their policies is broad enough and that the cover itself meets their business needs. Insurers and reinsurers meanwhile, may wish to seek to limit their exposure to specific, known contingencies by tightening the language in their policies, reducing the relevant sub-limits, by limiting the range of perils to which the policy responds and/or by implementing all of the above.

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Natural catastrophes can also give rise to liability claims. These could arise in a number of ways and against a variety of different individuals or entities, and could include designers, architects or engineers who were responsible for managing the risk profile of a business and/or its property, to claims against directors of a company whose share price has been materially affected by such an event due to inadequate steps taken by them at a corporate governance level to deal with risk identification, management and transfer. In this respect it should be noted that class actions by shareholders are becoming increasingly common where major catastrophes have affected the share price of a company and where they are seeking access to the company's directors and officers' insurance to recover their losses.

Specific reinsurance issues

In addition to the issues discussed above which arise at the insurance level, it is also important to consider the issues facing reinsurers, since payment of claims at the reinsurance level may be key to payment of the direct insurance claims.

A fundamental concern for any reinsurer is that the direct insurance

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claims are being handled effectively and efficiently. In the immediate aftermath of a natural catastrophe there may be limited resources to fully investigate and adjust losses. In addition, access to the damaged property may be difficult in order to assess whether physical damage has actually taken place. Meanwhile, there may be pressure on reinsurers from their local insurers (who are in turn being pressured by Government) to make settlements as quickly as possible under their policies to allow the repair, rebuilding or reinstatement of damaged property to proceed. These settlement requests can often be made at a very early stage of the adjustment process and based on only limited information. If reinsurers do pay claims quickly and without the benefit of all the information, they may have trouble recovering from their own reinsurers if information later emerges suggesting cover had not in fact been triggered. As a result, where reinsurers do have a claims control clause in their reinsurance policy, they may insist on controlling all aspects of the insurance claim, including the investigation, adjustment and settlement of any loss.

One of the most common reinsurance issues to arise when considering claims arising from a natural catastrophe, is the question of the number of occurrences. This can have a significant effect at a reinsurance level, as it will determine how claims can be aggregated, and accordingly when attachment points or limits are reached. In some circumstances the word "occurrence" will be defined in the policy, whilst in other policies the word may not be defined, with no distinction made between "occurrence" and "event" such that they are regarded as the same. An event or occurrence is something that happens at a particular time, at a particular place in a particular way. However, often policies will define an occurrence by reference to something which arises out of an event, such that clearly the two concepts would be different.

Where an event or an occurrence produces multiple instances of loss and damage, as is often the case with a catastrophe, it will need to be considered whether those instances involved such a degree of unity as to justify them being described as a single occurrence. Factors to be taken into account when assessing the degree of unity would include the cause, locality and time of the occurrence. The nature of natural catastrophes and the fact that multiple (separate) causes can be operating at the same time in the same location, presents a number of interesting questions when assessing the degree unity between instances of damage. For example, earthquakes which produce tsunamis and multiple aftershocks can give rise to a number of difficulties in this regard. Floods can also give rise to some interesting questions, especially where the flooding spreads gradually over a large geographical area for an extended period of time. In such circumstances, it may be difficult to determine whether the flooding which caused a loss at one location would be considered the same "occurrence" as flooding which caused a separate loss, in a separate location, a number of days later. Clearly, the answer may depend upon the definition of "flood" (if there is one) and the relevant "aggregating language" in the reinsurance wording.

To negate these uncertainties, reinsurance policies will often include clauses to restrict the interpretation of an "occurrence" or "event" to a specific place or a specific period, thereby expressly requiring certain "unities" to be fulfilled. One example would be to include a "locality clause" which can be used to restrict an occurrence or event to something which happens within prescribed geographical limits. Alternatively or in conjunction with the locality clause, reinsurers could also include an "hours" clause which would specify that all loss and damage of a particular type which happens within a specified period from the initial occurrence would be treated as a single occurrence for the purposes of the reinsurance. The specific period in question can vary in length from (typically) 72 hours to 168 hours and would operate such that any additional loss and damage which happens after that period would count as a new occurrence. Although the purposes of such clauses is to avoid some of the issues which could arise regarding the interpretation of the term "occurrence", often there will also have to be a factual enquiry to determine this, particularly where there may have been multiple instances of loss and damage across a number of occurrences happening sequentially.

Given the often complex structure of multilayer natural catastrophe reinsurance programmes, there will often be a number of different perspectives, each with potentially different interests. Coupled with the level of claims at stake, it is perhaps not entirely surprising that parties sometimes end up in dispute. On multilayer programmes in particular, these different interests can create additional tensions since those reinsurers (or insurers) at the upper levels of a programme might seek to argue that there are multiple occurrences, such that the lower layers are impacted several times and no single loss makes it through to their upper layers. Meanwhile, the lower level insurers/reinsurers may argue for a single occurrence in order to maximise their reinsurance recovery.

Conclusion

The huge losses resulting from the natural catastrophes in 2011 and the myriad of issues that can arise when insureds come to make claims under their insurance and reinsurance policies, serve as reminders to both insureds and insurers of the importance of fully evaluating their potential exposure to natural catastrophes. It also highlights the importance of ensuring that the relevant policy language is sufficiently clear and concise, so that insureds know the cover is adequate for their business needs and insurers can determine precisely the potential scope of the cover they are providing.

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