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## **CHRISTCHURCH EARTHQUAKE - WHO PAYS THE FOUR BILLION DOLLAR DAMAGE BILL?**

*By John Sloan*

The Christchurch earthquake will result in the largest insurance loss in New Zealand with the total damage bill being estimated at four billion dollars but the split between insured and uninsured losses is not yet clear. The brunt of residential claims will be borne by the Earthquake Commission (EQC) with all other insured claims falling on private insurers. Just who pays for damage to roads, bridges, underground pipes or other infrastructural assets is unclear due to the varied Governmental and Local Governmental authorities involved and their separate insured or self insured arrangements.

Although the ultimate repair, replacement and consequential losses are estimated at four billion dollars due to the logistics involved it will take some time before the bulk of the insurance proceeds start to flow into the Christchurch economy.

One overseas catastrophe modelling firm (AIR Worldwide) has estimated the damage bill as between 4 and 6 billion dollars.

### **Damaged homes and their contents**

If a house is insured EQC pay for repairs up to \$100,000 with the private insurers "topping up" for any excess but limited to the total sum insured on the home which may be a problem if the home is underinsured when the final repair or replacement bill is known. If a home is insured on an "indemnity value" basis (that is depreciated value) there could be problems with the private insurer's contribution. But no such difficulties should arise if the home is insured for its current replacement value.

For instance, if a home (or separate flat, farm residence or an apartment) is insured for \$300,000 and repairs are estimated at \$200,000 then EQC pay \$100,000 and the private insurers \$100,000.

But if a home is insured for \$200,000 and is a total loss with a replacement cost of \$300,000 then EQC pay \$100,000 with the private insurers paying \$100,000 leaving the homeowner underinsured for the balance.

For houses insured on a replacement basis the cover is essentially to rebuild "as is, as new" but subject to the maximum sum insured. If anyone wants a bigger and better home they must pay the extra.

EQC cover land underneath and within 8 metres of a home but private insurers do not include land in their "top up" coverage. EQC provide limited (depreciated value) cover for retaining walls and bridges on residential properties and up to 60 metres of accessways, but private insurers

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rarely provide top up cover for such assets. EQC also insure internal swimming pools, but not external ones.

Contents are insured by EQC for \$20,000 any one home and, again, private insurers provide the "top up cover" to their sum insured limit. Once more, EQC apply certain limits for their contents coverage.

In both cases the EQC cover is plus GST, which is about to increase making it more costly for them and insurers.

Neither EQC or private insurers are permitted to apply "average" to penalise under-insurance of homes or their contents.

If people have to vacate their homes any alternative accommodation costs are usually insured by their contents insurances up to an agreed limit for such costs.

If anyone thinks that they can abandon their home and not rebuild will find out that they cannot claim the total amount insured as a "walk away" payout.

Early comment has been made on people who will be uninsured and the usual estimate is that 15% of the population are uninsured, primarily for their belongings rather than houses.

EQC do not cover motor vehicles which must be commercially insured to obtain earthquake cover.

### **All other property**

All non residential property can only be insured for earthquake damage by private insurers. Commercial/industrial/farm buildings are usually insured against earthquake damage as are machinery, plant, stock in trade, office contents, computers and all other tangible property.

The insurance on buildings in the course of construction always includes earthquake insurance. People or businesses who thought their property would never become an absolute total loss all at one and insured for a portion of the total value may find themselves underinsured in the same manner as the owners of the World Trade Center did when they insured their twin towers for 50% of the total value only to see it totally destroyed.

If the insurance is on a current and updated replacement value basis then there should be no problem but where property is insured on an indemnity value (depreciated) basis problems will emerge if insurers will not pay on a "new for old" basis but insist on the client paying for what is termed "betterment". Where machinery or plant is insured on an indemnity value basis the same basis of claims settlement provisions will apply.

Stock is generally insured for the value to replace it on the shelf with the profit element being insured by any business interruption policy.

Again, the insurer's maximum liability is the sum insured or any specific policy sub limits.

Problems can occur when clients themselves establish the sums insured and roll them over each year to avoid premium increases. They can also underestimate the allowance needed for demolition and removal of debris costs which, as Christchurch experience will prove, can be very costly.

Another problem recognised by valuers is that, after a disaster such as this earthquake, the costs of materials can rapidly increase as can the charges of contractors and the like who are in immediate demand. The valuations and sums insured should have recognised this "surge demand" reality which compounds inflationary increases. Fees for architects, engineers and surveyors are generally included in property policies.

If building owners who have sustained a total loss of their property want to rebuild a different type of building if they are insured on a replacement value basis can normally do so as long as the insurers agree.

If they do not rebuild at all then all they will get paid is the pre-damage indemnity or market value of the building.

Problems can occur with the destruction of undamaged property to facilitate repairs but a well arranged policy should cover this factor. A related difficulty is just at what point is a damaged building deemed beyond economic repair and has to be demolished.

Under replacement value insurance, a destroyed building can be replaced on another site as long as the insurers agree but subject to the sum insured or other policy limitations. A different type or usage or construction may also be permitted but subject to the same provisions.

Most commercial insurance policies include a progress payments clause enabling such payments to be made when validated.

The application of earthquake claims deductibles (that is where the client pays the first amount of a claim) will probably prove to be a nasty surprise for some Christchurch businesses. Up until recently, earthquake claims deductibles were based as a percentage of the actual claim, for instance a 5% deductible meant that for a \$100,000 claim the client paid \$5,000.

But now some policies apply a "site" deductible where the total sums insured on all property and business interruption coverages are totalled and the claims deductible percentage applied to that total meaning that if the total "site" value is say, \$3,000,000 with a 5% site deductible, the client pays the first \$150,000 of any claim.

One policy exception in a standard replacement value policy may emerge to penalise Christchurch property owners. This is where an authority has issued an enforceable notice to upgrade a building's earthquake resistance and the building is damaged before that upgrading is completed then the insurers will not pay for this cost as the owner was already responsible for meeting that expense anyway.

Yet another problem for some will be that they do not have their policy documents in their possession and will face the experience of their agents or brokers fronting up with the full wording and explaining the full impact of certain critical exclusions and limitations which will deny or reduce the claim they may have thought was fully insured. Tough questions for the agent or broker may eventuate especially if the limitations etc have not been explained in writing or annually revisited.

Many businesses will need to have had their property insurances extended to cover property in their care, custody and control (think panel beaters) even though the earthquake was beyond their control but a force majeure exclusion to liability may be enforceable.

Any other interested parties seeking compensation must be either named in the policy or included by a widely worded "other interests" clause.

Businesses who have insured their contents on a blanket basis, such as "anywhere in New Zealand", may find that arrangement is better than having individual location limits which may prove inadequate.

### **Business Interruption Insurances**

Following a major catastrophe, the consequential losses can be immediate and disproportionate to the property damage. For some business, such as restaurants, the loss is immediate and unrecoverable whilst for others the revenue is deferred rather than lost.

Some service providers, including many Governmental entities, will only require insurance for increased costs of working which can be substantial and unavoidable but many will require insurance for lost profit and payment of continuing overheads.

A classic problem is that it can take some time to prove the reduction in turnover and consequent loss of profit meaning a delay in settling the business interruption claim. In such cases the progress claims payment clause is vital to obtain advance payments.

Businesses who insured their business interruption on an agreed in advance weekly or monthly fixed amount, which is paid promptly, should thank their lucky stars for such a policy.

One complication for business interruption insurances is the selection of what is called the "indemnity period" which is the estimated time to fully recover from the interruption and this can range from, say, 3 months to 24 months or longer. Christchurch businesses will find out that, already, priorities have been established and their business may be well down the list meaning their resumption is delayed with a consequent impact on their loss of profits insurance claim.

If businesses have chosen a short indemnity period this dictates the sum insured so if rebuilding or repair takes much longer an underinsured claim will inevitably result. For those who said "earthquakes don't happen here" or did not contemplate catastrophic damage when selecting their indemnity period may find their business interruption insurance coverage is inadequate.

Tenants who have to vacate damaged premises will be checking their leases to check the conditions applying to any cessation of rent during the period of repair.

Businesses will also find that their business interruption insurance needs to correctly cover payment of wages and salaries to unemployed or underemployed staff. The Government announced that they would subsidise wages, for up to four weeks, to employees of small businesses (up to 20 employees) who were forced out of employment due to the earthquake.

Another coverage businesses need in the insurance is an extension for the interruption to supplies of gas or electricity or water as well as damage to suppliers' or customers' premises including telecommunications.

These "dependencies" are normally included with what is termed "prevention of access" (which happened immediately in the CBD area) but these extensions are invariably limited to a percentage of the total sum insured or may apply a limited time deductible.

Business interruption policies invariably include a claims preparation costs clause which covers accountant's fees to prove any claim and can often include a provision for the client's own staff time in preparing claims. Already the CEO of the Insurance Council, Chris Ryan, has advised businesses to take photographs of all damage and document everything in writing including staff times and all costs incurred to avoid problems months down the track when finalising insurance claims.

One insurance broker predicts that the main problems will arise in the business interruption insurance area although he also reckoned that some property insurances could prove inadequate or nonexistent with heritage buildings likely to present major difficulties for repair. Landlords should have loss of rentals insured themselves.

Incidentally, the local branches of Multinationals who have their insurances arranged on a global basis may find that such policies impose very large claims deductibles which the local branch have to absorb.

### **Infrastructural Property**

As television revealed, the destruction and damage was widespread and will obviously cost hundreds of millions of dollars to repair or replace.

Just who bears the final costs is not clear as some property, such as bridges, may be commercially insured whilst the primary roads are the responsibility of Transit and the local authorities concerned may have a combination of insured and self insured assets plus, possibly, access to the Local Authority Protection Pool which was created to provide a degree of protection for such damage.

So the dollar cost or liability allocation between Central and Local Government is unknown as is the division between commercially insured and self funded losses

### **Insurance Market Impact**

EQC's total reserves exceed five billion dollars and they also have reinsurance protection for catastrophes of this (Christchurch) nature. Consequently EQC can absorb the likely total claims even though they may ultimately seek to review their limits and levies which have remained unchanged since the mid 1990s.

The private insurers will also have their own reinsurance arrangements which may be triggered by this earthquake which means that the final aggregate losses will be spread amongst many overseas insurers and reinsurers.

Just when the Christchurch disaster will be reflected in increased premium rates is unknown but it seems likely as earthquake rates for the South Island have traditionally been much lower than for, especially, Wellington or other areas perceived as being a higher earthquake risk than elsewhere.

Immediately after the earthquake one major insurer decreed that they would exclude earthquake on any new business in the Christchurch region for the next 21 days which created some justified concerns.

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15th September 2010