

# Future Availability of Flood Insurance in the UK

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A report on legal aspects of the solutions adopted in Australia, Iceland, the Netherlands, New Zealand and Turkey, with conclusions

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# Foreword

Insuring against natural catastrophes is a complex matter. Catastrophes may be unforeseen, as was the case with the Christchurch earthquakes, and the problem thereby raised is to seek to resolve novel questions by reference to wordings not designed to deal with the points that have arisen and often of some antiquity. Wordings may be adjusted after the event, but of course that does not help to settle outstanding claims. Alternatively, catastrophes may be readily foreseeable, as is the case with the Queensland flooding and the flooding in England. The issue here is quite different. Insurers may be unwilling to insure at all, or may agree to do so only on terms which are unacceptable to consumers. The State will then be called upon to intervene, and may respond in a number of ways: agree to act as insurer of last resort (or reinsurer) on a commercial basis, as under the UK's Reinsurance (Acts of Terrorism) Act 1993; specify the minimum content of policies (as effected in Australia by the 2012 amendments to the Insurance Contracts Act 1984 (Cth)); or negotiate some sort of accord with insurers. As regards flooding, the UK insurance industry agreed for some years to provide cover to houses built on flood plains despite the almost inevitability of flood damage, but on the understanding that steps would be taken to reduce the risk of flooding. Those agreements expired in the middle of 2013. This excellent and timely report considers the range of possibilities open to governments in dealing with natural catastrophes and also the recent history of flood insurance in the UK. It is full of ideas based upon comparisons with other jurisdictions, and is a most valuable document for those seeking to design future policies. The team should be congratulated on this excellent piece of work

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# Preface

This report was produced by researchers at the University of Southampton thanks to a grant provided by Public Policy@Southampton. The purpose of the project has been to look into the legislative and regulatory models employed in various jurisdictions in the search for a model that could be transposed to the UK. This involved looking at the legislation applicable in several jurisdictions and determining whether the model chosen there would be a plausible fit for the UK. Unlike New Zealand, the UK is subject to the constraints of EU law. This was not a given: unlike Turkey, the UK has reasonably good insurance penetration in many segments of society. Many factors had to be considered.

Our research took unexpected directions as we learned about the historical developments and the models tried and tested in jurisdictions such as Iceland and the Netherlands. Indeed, this report is the first to write about the new Turkish model as recently legislated, the Icelandic model and the proposal for new regime and the insurer covering flood risk in the Netherlands. It is also the first to produce a comprehensive report on the New Zealand model.

The report will provide some food for thought for the development of a flood insurance model for the UK. The ultimate solution cannot be achieved by purely legal and regulatory means, but will have to take into account further factors such as economic and budgetary matters, psychological patterns of behaviour and administrative law.

A short list of thanks is in order. The authors would like to thank PublicPolicy@Southampton for the funding opportunity to carry out the research leading to this report. Dr Ozlem Gurses' contribution was instrumental to the original bid for research funding. Lisa Then's support to the project has been invaluable.

The authors take equal credit – and blame – for the contents of this report, which seeks to reflect the law as it stood on 24 June 2013. The measures announced on 27 June are not discussed in this version of the Report.

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Thames barrier flood defence

# Future Availability of Flood Insurance in the UK

## Introduction

### The Statement of Principles

Regulation of flood protection in the UK is a historical phenomenon that can be traced back to 1531 when Henry VIII introduced the Statute of Sewers governing land drainage. Historically, however, cover for flood risk was not generally offered by the insurance industry due to insufficient data to determine the relevant premium.<sup>1</sup> It was not until the beginning of the 20<sup>th</sup> century that flood hazard became an insured risk under a comprehensive contents policy, though it was still predominantly an excluded risk within the household insurance market.<sup>2</sup> Thereafter, each consumer was usually presented with an option to include flood cover in a building policy at an additional premium, yet a request to that effect was often treated with suspicion.<sup>3</sup> It was widely believed that only those property owners who were the most exposed to the risk would be interested in purchasing flood insurance. Such adverse selection was best avoided by the insurance industry.<sup>4</sup> At the time of the Lynmouth Flood<sup>5</sup>, virtually none of the properties affected had a policy covering the peril of flood in place.<sup>6</sup>

On 1 August 1961, the UK government entered into what became known as ‘The Gentleman’s Agreement’ with the British Insurance Association (BIA)<sup>7</sup> and Lloyd’s of London.<sup>8</sup> It was a response to a request made by the State during the course of an investigation into the feasibility of establishing a ‘National Disaster Fund’. In fact, at that time, a section of the insurance industry did not wish to offer flood cover at all, claiming it was the responsibility of the government.<sup>9</sup> In the wake of the flooding which affected a large part of southwest England, pressure was put upon the government to deal with the widespread unavailability and unaffordability of insurance against such risk.<sup>10</sup>

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<sup>1</sup> See C Walford, *The Insurance Cyclopaedia* (Charles and Edwin Layton, London 1876).

<sup>2</sup> See NW Arnell *et al*, “Flood Insurance and Extreme Events: the Role of Crisis in Prompting Changes in British Institutional Response to Flood Hazard” (1984) 4 *Applied Geography* 167, 169.

<sup>3</sup> See *Stone and Cox Accident Insurance Yearbook* (Stone and Cox, London 1965).

<sup>4</sup> See B Supple, *The Royal Exchange Assurance: a History of British Insurance 1720-1970* (Cambridge University Press, Cambridge 1970).

<sup>5</sup> On 15 and 16 August 1952, a storm of tropical intensity broke over southwest England, affecting, in particular, the village of Lynmouth.

<sup>6</sup> See HC Deb 11 November 1960, vol 629, cols 1406-1438.

<sup>7</sup> In 1985, the BIA together with several other insurance trade associations formed the ABI to represent the whole industry.

<sup>8</sup> See HC Deb 1 August 1961, vol 645, cols 138-140W.

<sup>9</sup> See NW Arnell *et al*, “Flood Insurance and Extreme Events: the Role of Crisis in Prompting Changes in British Institutional Response to Flood Hazard” (1984) 4 *Applied Geography* 167, 172.

<sup>10</sup> See HC Deb 15 December 1960, vol 632 cols 607-670.

On the following day, a statement issued by the two entities appeared in the national press.<sup>11</sup> It contained detailed information regarding the commitment made by the insurance industry with respect to the provision of flood insurance. Flood cover for residential property, as an element of a comprehensive household policy, was made more widely available at an additional rate of 3d per £100 of cover. Consequently, the basic rate for a comprehensive household policy increased from 2s 3d to 2s 6d per £100 of cover. However, the right not to provide flood insurance was reserved with respect to property located in “areas where the risk of flood [was] greater than normal”. It was also stipulated that the terms and conditions of each policy issued would vary depending on the particular circumstances. Therefore, contrary to the popular misconception, the arrangement did not guarantee the availability of flood insurance to any residential property, no matter what the risk.<sup>12</sup> It is also wrong to assume that the BIA together with Lloyd’s undertook to offer flood cover, except where continual, regular flooding was unavoidable, in which case provision of insurance would be withheld or premium would be loaded to reflect the higher risk.<sup>13</sup>

It was later argued that the decision to make flood insurance widely available was influenced by the fear among the insurance industry that introduction of the ‘National Disaster Fund’ would correspondingly reduce demand for catastrophe cover on the private market.<sup>14</sup> It could also be seen as a response to the threat of a possible nationalisation of the insurance market by the then Conservative government.<sup>15</sup>

Following the Great Flood in September 1968, which hit southeast England, yet another call was made for a ‘National Disaster Fund’.<sup>16</sup> The Labour government of the day rejected the motion, claiming that “the taxpayer is entitled to expect the individual to insure his own property and not to rely on private contributions or Government compensation in the event of loss or damage”.<sup>17</sup> In addition, the desire to avoid any sort of financial liability on behalf of the government was an important factor in dismissing the idea.<sup>18</sup>

Subsequently, a relatively minor flood which occurred in August 1970 in Walsall triggered a further proposal for a collective insurance scheme against the risk of flood, albeit of a different nature.<sup>19</sup> It was, however, promptly dismissed as impracticable and at variance with the notion of a competitive market.<sup>20</sup> In response to the suggestion, Michael Heseltine, the Under-Secretary of State at the Department for the Environment, stated

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<sup>11</sup> See, for instance, *The Times*, 2 August 1961.

<sup>12</sup> cf D Crichton, “UK and Global Insurance Responses to Flood Hazard” (2002) 27(1) *Water International* 119, 127; HC Deb 26 March 2013, vol 560, cols 1520-1547.

<sup>13</sup> cf R Salthouse “Lessons to be learned from the autumn 2000 flood disaster in the UK” (2002) 17(1) *Insurance Research and Practices* 64, 71.

<sup>14</sup> See *Financial Times*, 20 September 1968.

<sup>15</sup> See JW Hadmer, *Flood Insurance and Relief in the US and in Britain* (Centre for Resource and Environment Studies, Australian National University, Canberra 1990). See also *Daily Telegraph*, 1 December 1979. Maurice Harold Macmillan was Conservative Prime Minister at the time of the inception of “The Gentleman’s Agreement”.

<sup>16</sup> See *Financial Times*, 20 September 1968.

<sup>17</sup> See HC Deb 13 October 1969, vol 788, cols 42-43W.

<sup>18</sup> See NW Arnell *et al*, “Flood Insurance and Extreme Events: the Role of Crisis in Prompting Changes in British Institutional Response to Flood Hazard” (1984) 4 *Applied Geography* 167, 174.

<sup>19</sup> See HC Deb 27 November 1970, vol 807, cols 859-868.

<sup>20</sup> *ibid*.

“[d]amage to private property from flooding can, like that caused by fire and the more generally accepted household perils, be covered by insurance *at very little extra cost*. It is the Government’s view that the cost of insuring their property should be met by householders themselves and not by the taxpayers”.<sup>21</sup>

Despite the commitment of the insurance industry to make flood insurance more widely available, the penetration rate for that type of risk remained low throughout 1960s.<sup>22</sup> There is a natural human tendency to close the mind to the risk of the unpleasant which constitutes an impediment to achieving widespread insurance coverage against the risk of flood, which may be expressed in the well-documented hierarchy of denial:

- it is not going to happen;
- if it does happen, it will not affect me;
- if it does happen to me, it will not be too bad; and
- if it does happen to me and it is bad, there is nothing I can do.<sup>23</sup>

The penetration rate for flood insurance nevertheless began increasing steadily, in part due to a publicity campaign pursued by the insurance industry.<sup>24</sup> By the end of 1970s, the vast majority of households in the UK had flood cover in place.<sup>25</sup> The Gentleman’s Agreement was amended on two occasions, in 2000 and 2002, each time following significant flooding which revealed the government’s underinvestment in flood defences.<sup>26</sup> In 2005, the commitment was updated and renamed ‘The Statement of Principles on Provision of Flood Insurance’. It was most recently revised in 2008.<sup>27</sup>

Under the current arrangement, the insurance industry pledged to continue to offer flood cover to existing domestic property at significant flood risk. It is, however, not an unconditional promise. In exchange the government undertook to reduce the risk of flooding for those properties below ‘significant’ within five years.

It may be argued that in practice the Statement of Principles does not achieve the intended aim. It is emphasised in the document that neither premiums charged nor policy terms will be affected by the agreement and as a result will reflect the actuarial level of risk. Therefore, although the insurance industry pledged to continue to offer flood cover to existing property, it is by no means obliged to

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<sup>21</sup> See HC Deb 10 November 1971, vol 825, col 154W.

<sup>22</sup> See NW Arnell *et al*, “Flood Insurance and Extreme Events: the Role of Crisis in Prompting Changes in British Institutional Response to Flood Hazard” (1984) 4 Applied Geography 167, 173.

<sup>23</sup> See D Middleton, “The Role of the New Zealand Earthquake Commission” (2001) 16(2) The Australian Journal of Emergency Management 57, 58-59.

<sup>24</sup> See HC Deb 13 October 1969, vol 788, cols 42-43W.

<sup>25</sup> See NW Arnell *et al*, “Flood Insurance and Extreme Events: the Role of Crisis in Prompting Changes in British Institutional Response to Flood Hazard” (1984) 4 Applied Geography 167, 175.

<sup>26</sup> See further A Hall, “A Unique Agreement: a Historical Perspective on the Creation and Breakdown of ‘The Gentleman’s Agreement’ for Flood Insurance in the UK”, available at <[http://www.academia.edu/1855287/A\\_Uneak\\_Agreement\\_A\\_historical\\_perspective\\_on\\_the\\_creation\\_and\\_breakdown\\_of\\_the\\_Gentlemans\\_Agreement\\_for\\_Flood\\_Insurance\\_in\\_the\\_UK](http://www.academia.edu/1855287/A_Uneak_Agreement_A_historical_perspective_on_the_creation_and_breakdown_of_the_Gentlemans_Agreement_for_Flood_Insurance_in_the_UK)> (accessed 26 June 2013).

<sup>27</sup> For the text of the revised Statement of Principles, see <<https://www.abi.org.uk/~media/Files/Documents/Publications/Public/Migrated/Flooding/Statement%20of%20principles%20England.ashx>> (accessed 26 June 2013).

render the policy affordable for each consumer. Although the premium for the insurance cover may be reasonable taking into account the income of the household concerned, the terms of the policy may stipulate for a large deductible to be borne by the consumer in the event of flood damage. Should this be the case, the insured will be left with a substantial portion of the damage occasioned by the natural disaster to cover by himself. Finally, the Statement of Principles does not apply to property built after 1 January 2009. The rationale behind this qualification was to discourage construction on flood plains. Since development on flood plains continues,<sup>28</sup> the issue of availability and reasonable affordability of flood insurance for such properties remains a major challenge.

The Statement of Principles was originally due to expire on 30 June 2013. On 16 May 2013, members of the Association of British Insurers (ABI) voluntarily agreed to continue the commitment until 31 July 2013, pending the outcome of the negotiations between the ABI and the Department for Environment, Food and Rural Affairs (DEFRA) regarding the future availability of flood insurance in the UK.<sup>29</sup>

The authors of this study are not privy to the negotiations that have been taking place between the ABI and DEFRA for an arrangement to follow the Statement of Principles. However, we understand from general news reporting that the idea of the industry is to set up a pool to secure future availability of flood insurance in UK, provisionally entitled ‘Flood Re’.<sup>30</sup> It is also our understanding that the government was asked to provide a temporary overdraft facility to pay claims in the early years of the scheme before sufficient fund is built up. Based on publicly available evidence,<sup>31</sup> the aim of ABI appears to be to establish a not-for-profit insurance fund. Flood insurance, as a part of a comprehensive household policy, would be provided by the fund to each property in the UK where accessing such cover in an open market would be problematic. Other properties would continue to be covered by the industry on the private market. Flood insurance for those properties covered by the pool would be provided at a set price that could be varied by council tax band. Should a claim for flood damage be made by an owner of a property which is part of the pooling arrangement, the fund would then reimburse the insurance company concerned to meet the cost of the claim.

<sup>28</sup> See, for instance, Environment Agency, *Development and flood risk in England annual monitoring report 2010-2011*, available at <[http://www.environment-agency.gov.uk/static/documents/Research/120501\\_DFR\\_2010-11\\_Final\\_v3.pdf](http://www.environment-agency.gov.uk/static/documents/Research/120501_DFR_2010-11_Final_v3.pdf)> (accessed 26 July 2013). Analysis of the law related to planning permissions is beyond the scope of this report and has been conducted elsewhere. See, in particular, M Pitt, “Learning Lessons from the 2007 Floods”, *The Pitt Review*, 25 June 2008, available at <[http://webarchive.nationalarchives.gov.uk/20100807034701/http://archive.cabinetoffice.gov.uk/pittreview/\\_/media/assets/www.cabinetoffice.gov.uk/flooding\\_review/pitt\\_review\\_full%20pdf.pdf](http://webarchive.nationalarchives.gov.uk/20100807034701/http://archive.cabinetoffice.gov.uk/pittreview/_/media/assets/www.cabinetoffice.gov.uk/flooding_review/pitt_review_full%20pdf.pdf)> (accessed 26 July 2013); EP Evans *et al.*, “An Update of the Foresight Future Flooding 2004 Qualitative Risk Analysis”, *The Pitt Review*, June 2008, available at <[http://webarchive.nationalarchives.gov.uk/20100807034701/http://archive.cabinetoffice.gov.uk/pittreview/\\_/media/assets/www.cabinetoffice.gov.uk/flooding\\_review/evidence/foresight\\_report%20pdf.pdf](http://webarchive.nationalarchives.gov.uk/20100807034701/http://archive.cabinetoffice.gov.uk/pittreview/_/media/assets/www.cabinetoffice.gov.uk/flooding_review/evidence/foresight_report%20pdf.pdf)> (accessed 26 July 2013); and D Crichton, “Flood Plain Speaking”, *The Chartered Insurance Institute*, 11 March 2012, available at <<http://www.cii.co.uk/knowledge/claims/articles/flood-plain-speaking/16686>> (accessed 26 July 2013). See also ABI and NFF, “Guidance on Insurance and Planning in Flood Risk Areas for Local Planning Authorities in England”, report, 27 March 2012, available at <<https://www.abi.org.uk/~media/Files/Documents/Publications/Public/Migrated/Flooding/ABI%20NFF%20Guidance%20on%20Insurance%20and%20Planning%20for%20Local%20Planning%20Authorities.ashx>> (accessed 26 July 2013).

<sup>29</sup> See <<https://www.abi.org.uk/~media/Files/Documents/Publications/Public/Migrated/Flooding/ABI%20Flood%20Letter%20to%20Owen%20Paterson.ashx>> (accessed 26 June 2013).

<sup>30</sup> The name is based on the model of Pool Re, on which more in the following.

<sup>31</sup> See ABI, *Flood Funding*, written evidence submitted by the ABI to the Environment Food and Rural Affairs Committee, 18 February 2013, available at <<http://www.publications.parliament.uk/pa/cm201213/cmselect/cmenvfru/writev/flood/m07.htm>> (accessed 26 June 2013).

In order to guarantee the solvency of the fund, each insurance company would make an annual contribution based on their level of premium income in the form of a levy raised from insurance premiums collected. Payment into the fund would supplement the income accumulated from the flood-related element of premiums from the high-risk properties participating in the scheme. In the event that the fund is not large enough at the time of being called on for the first time to cover a major natural catastrophe, there would be a deficit to be met. It is our understanding that the government was asked to provide an overdraft facility to back the pool in the early years of the operation.<sup>32</sup>

Nick Starling, Director of General Insurance at ABI, commented:

“[t]he Government has indicated it will not provide any temporary overdraft facility for the insurance industry’s not for profit scheme, which makes it very difficult for it to go ahead. As a result, negotiations have hit an impasse”.<sup>33</sup>

It was against that background that we started the research for this report, to see what solutions would be available if the negotiations between ABI and DEFRA were unfruitful.

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<sup>32</sup> See, more generally, oral evidence taken by the Environment Food and Rural Affairs Committee in relation to flood funding, available at <<http://www.parliament.uk/business/committees/committees-a-z/commons-select/environment-food-and-rural-affairs-committee/inquiries/parliament-2010/flooding/>> (accessed 26 June 2013).

<sup>33</sup> See ABI, “ABI Statement on Flood Insurance”, press release, 26 November 2012, available at <<https://www.abi.org.uk/News/News-releases/2012/11/abi-statement-on-flood-insurance.aspx>> (accessed 20 July 2013).



Australia provide a single definition  
of the concept 'flood'.

# Case study 1: Australia

## Introduction

Australia is plagued by a multitude of natural disasters, including floods, bush fires and droughts. In particular, the Queensland floods have provided some dramatic television images over the last few years with Brisbane repeatedly flooded. Although operating a purely private market approach toward flood insurance, Australia is known for generous ex-post disaster relief assistance made available to those adversely affected by natural hazards.<sup>34</sup> In particular, the Australian Government Disaster Recovery Payment (AGDRP) is a one-off payment to provide immediate, short-term financial relief to the section of the population who suffered at least one type of qualifying harm, including major damage to or total destruction of the residential property.<sup>35</sup>

Dissatisfaction among the public with the treatment received from the insurance industry following the Queensland Flood in 2011 prompted the government to reconsider the approach to flood insurance. As discussed below, the response was to provide a single definition of the concept ‘flood’. Although insurers are not obliged to offer coverage against the risk of flooding, if they wish to do so, the statutory definition provided must be used. It ought to be noted at the outset that Australia as an insurance jurisdiction is considerably more reform friendly than England and Wales, having introduced a comprehensive Insurance Contracts (IC) Act in 1984<sup>36</sup> which also provides an excellent background against which to legislate for specific measures.

## Definition of “flood” in Australia

### Background

The original text of the IC Act 1984<sup>37</sup> did not contain any definition of the word ‘flood’. Nor was there any definition of ‘flood’ within the initial version of the Insurance Contract Regulations 1985.<sup>38</sup> The Insurance Council of Australia (ICA) produced a standard definition of the term which quickly became widely adopted by the insurance industry as an exclusion to the cover offered. ‘Flood’ was thereby defined as:

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<sup>34</sup> For information about recovery assistance following a disaster and the recent history of disaster relief in Australia, see <<http://www.disasterassist.gov.au/>> (accessed 26 June 2013). See also <<http://www.humanservices.gov.au/customer/subjects/flood-assistance>> (accessed 26 June 2013) for information with respect to flood assistance specifically.

<sup>35</sup> See section (a)(3) of Schedule 2 to the Social Security (Australian Government Disaster Recovery Payment) Determination 2013 (No. 3), as amended, made under section 1061L(2) of the Social Security Act 1991.

<sup>36</sup> Interestingly, the IC Act 1984 and the accompanying Insurance Contracts Regulations 1985 introduced standard terms and conditions for prescribed general insurance contracts, including household policies. ‘Flood’ is a named insured peril in the standard cover. However, insurance companies are permitted to exclude that risk from the standard cover provided that they ‘clearly inform’ the prospective policyholder of the alteration made. As a matter of fact, insurers have largely continued to exclude ‘flood’ ever since.

<sup>37</sup> The revised Act is available at <[http://www.austlii.edu.au/au/legis/cth/consol\\_act/ica1984220/](http://www.austlii.edu.au/au/legis/cth/consol_act/ica1984220/)>, accessed 16 June 2013.

<sup>38</sup> Available at <[http://www.austlii.edu.au/au/legis/cth/consol\\_reg/icr1985329/](http://www.austlii.edu.au/au/legis/cth/consol_reg/icr1985329/)>, accessed 16 June 2013.

“[t]he inundation of normally dry land by water escaping from the normal confines of any natural watercourse or lake whether or not altered or modified, or any reservoir, canal or dam”.<sup>39</sup>

A call for a standard definition of ‘flood’ was also made by the Australian Securities and Investments Commission (ASIC) in *Report 7: Consumer understanding of flood insurance* published in June 2000.<sup>40</sup> In August 2002, the Department of Transport and Regional Services delivered on behalf of the Council of Australian Governments (COAG) a report entitled *Natural Disasters in Australia: Reforming Mitigation, Relief and Recovery Arrangements*.<sup>41</sup> Recommendation 66 suggested that COAG should develop a single national definition of natural hazards, including water damage.<sup>42</sup> However, the recommendation was not implemented.

Thereafter, ICA attempted on various occasions to introduce a definition that would be universally accepted across the industry, particularly due to the blurring of the distinction between ‘flood’ and ‘storm’. Notably, following the Hunter Region and Central Coast flooding in June 2007, ICA sought authorisation from the Australian Competition and Consumer Commission (ACCC)<sup>43</sup> of an agreement between ICA’s members to adopt, on a voluntary basis, a common definition of ‘inland flood’ which read:

“the covering of land that is not normally underwater by:

- water that overflows or escapes from a naturally occurring or man made inland watercourse (such as a river, creek, canal or storm water channel) or water pool (such as a lake, pond or dam), whether it is in its original state or it has been modified; or
- water released from a dam whether it be accidentally released or intentionally released to control, mitigate, regulate, or otherwise respond to excess water; or
- water that cannot drain or run off as a result of water that is overflowing or escaping from an inland watercourse or water pool preventing the escape of water”.<sup>44</sup>

<sup>39</sup> See Mason AJ, *The History of Flood Insurance in Australia*, 14 September 2011, 6, available at <[http://www.ndir.gov.au/content/commissionedpapers/2011/Flood\\_Insurance\\_Aus.pdf](http://www.ndir.gov.au/content/commissionedpapers/2011/Flood_Insurance_Aus.pdf)> (accessed on 20 March 2013). It is a paper commissioned by the Australian government for the purpose of National Disaster Insurance Review which commenced on 4 March 2011 and published a final report on 14 November 2011. For more information with regard to the NDIR, see <<http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2011/039.htm&pageID=003&min=bris&Year=&DocType=o>> and <<http://www.ndir.gov.au/content/Content.aspx?doc=home.htm>> (accessed on 20 March 2013).

<sup>40</sup> Available at <[http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/floodreport.pdf/\\$file/floodreport.pdf](http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/floodreport.pdf/$file/floodreport.pdf)> (accessed on 22 March 2013).

<sup>41</sup> Available at <<http://unpan1.un.org/intradoc/groups/public/documents/apcity/unpan024728.pdf>> (accessed on 22 March 2013).

<sup>42</sup> *ibid.*, 100.

<sup>43</sup> The ACCC was made responsible for administering the Trade Practices Act 1974, now the Competition and Consumer Act 2010, in 1995. It can grant immunity from the application of the competition provisions of the legislation if it is satisfied that the benefit to the public from the conduct outweighs any public detriment. It is a standard procedure for the ACCC to conduct a public consultation process to assist it to determine whether a proposed arrangement results in a net public benefit. For more information, see <<http://www.accc.gov.au/>> (accessed on 21 March 2013).

<sup>44</sup> See ACCC, *Determination. Application for authorisation lodged by Insurance Council of Australia in respect of an agreement between its members to adopt, on a voluntary basis, a common definition of “inland flood”*, 3 September 2008, available at <<http://www.accc.gov.au/content/trimFile.phtml?trimFileDialog=Do8+88443.pdf&trimFileFromVersionId=842063&trimFileName=Do8+88443.pdf>> (accessed on 21 March 2013).

Following a public consultation, the definition tabled by the ICA was ultimately rejected by the ACCC on the grounds that:

- “the proposed common definition introduces new terminology, expands established concepts and seeks to diminish the doctrine of proximate cause”;<sup>45</sup> and
- “the [...] definition, by potentially increasing consumer confusion, may inhibit the ability of consumers to make informed choices leading to an increased risk that consumers may obtain cover which is inappropriate for their needs”.<sup>46</sup>

Subsequently, having recognised that there were approximately 20 definitions of ‘flood’ in use within the industry<sup>47</sup>, ICA suggested categorisation of flood risk into three broad categories based on market practice<sup>48</sup>:

- A. stormwater/rainfall runoff/flash flooding: high intensity, short duration storms producing localised flooding;
- B. riverine/inland flooding/flooding: inundation caused by watercourses or catchments overflowing their banks due to long duration rainfall over large areas;
- C. actions of the sea/sea level rise/storm surge: Inundation caused by movement of seawater.

Risk described in category A was recognised to be covered by most insurance policies. Risk referred to in category B was said to be included in some insurance contracts, with many expressly excluding that type of event. Nevertheless, regardless of whether it was included or excluded, the definition of that kind of risk varied greatly depending on the insurance provider. Only a few insurance policies were found to cover the risk described in category C.

The Australian Securities and Investments Commission noted that:

“[t]he terminology in policy documentation can be confusing. The use of technical terms, differing definitions for common words (including the word ‘flood’), and technical meanings for otherwise commonly used words (such as ‘watercourse’) might not be understood by consumers”.<sup>49</sup>

Speaking in the House of Representatives, former Assistant Treasurer and Minister for Financial Services and Superannuation, Bill Shorten stated:

“[a] standard definition of flood will reduce consumer confusion regarding what is and is not included in insurance contracts. It will also avoid situations where neighbouring properties in the same street, affected by the same flood event, receive

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<sup>45</sup> ibid., 26.

<sup>46</sup> ibid. See also ACCC, *Standard flood definition raises too many uncertainties*, media release, 3 September 2008, available at <<http://www.accc.gov.au/media-release/standard-flood-definition-raises-too-many-uncertainties>> (accessed on 21 March 2013).

<sup>47</sup> See Parker L, *Awash with worry*, The Age, 29 September 2010, available at <<http://www.smh.com.au/money/planning/awash-with-worry-20100928-15uop.html>> (accessed on 22 March 2013).

<sup>48</sup> See Treasury, *Reforming flood insurance – Clearing the Waters*, April 2011, 3, available at <[http://archive.treasury.gov.au/documents/1995/PDF/clearing\\_the\\_waters\\_april2011.pdf](http://archive.treasury.gov.au/documents/1995/PDF/clearing_the_waters_april2011.pdf)> (accessed on 20 March 2013).

<sup>49</sup> ASIC, *Report 7: Consumer understanding of flood insurance*, June 2000, 9, available at <[http://www.asic.gov.au/asic/pdfib.nsf/LookupByFileName/floodreport.pdf/\\$file/floodreport.pdf](http://www.asic.gov.au/asic/pdfib.nsf/LookupByFileName/floodreport.pdf/$file/floodreport.pdf)> (accessed on 21 March 2013).

different claims assessments because the policies covering them use different definitions of flood".<sup>50</sup>

Notwithstanding the pressure to introduce a standard definition of 'flood', some observed that:

"[w]hile there is no doubt that the attributes of any standard definition will affect the affordability and availability of policies adopting that standard definition, the mere presence of the standard definition will not remedy the issues of policy coverage".<sup>51</sup>

## The definition solution

Pursuant to section 37B(2) of the IC Act 1984, in a prescribed contract<sup>52</sup> the word 'flood' is to be given the meaning afforded to it by the relevant regulation.

For the purpose of section 37A of the IC Act 1984, Regulation 29C of the IC Regulations 1985 provides for the following to constitute a "prescribed contract of insurance":

- a. home building insurance in respect of destruction of or damage to a home building, where the insured or one of the insureds is a natural person;<sup>53</sup>
- b. home contents insurance in respect of loss of or damage to the contents of a residential building where the insured or one of the insureds is a natural person, but does not include a contract that provides insurance cover only or primarily in respect of specified personal effects;<sup>54</sup>
- c. insurance contract that combines home building insurance and home contents insurance;
- d. contract that provides insurance cover in respect of destruction of or damage to a strata title residence;<sup>55</sup>
- e. contract that provides insurance cover in respect of the loss of the equipment, stock, inventory or premises of a small business;<sup>56</sup>
- f. contract that provides insurance cover in respect of damage to the equipment, stock, inventory or premises of a small business.

For the purpose of such contracts, Regulation 29D of the IC Regulations 1985 defines 'flood' as

"the covering of normally dry land by water that has escaped or been released from the normal confines of any of the following:

- a. a lake (whether or not it has been altered or modified);

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<sup>50</sup> The Hon Bill Shorten, MP, Assistant Treasurer and Minister for Financial Services and Superannuation, House of Representatives Hansard, 23 November 2011, 23.

<sup>51</sup> Lu A, Johnson J, Harris Ch, "Clearing the muddied waters of flood insurance" (2011) 26(4) Australian Insurance Law Bulletin 50, 52.

<sup>52</sup> 'Prescribed contract' is defined by section 34 of IC Act 1984 as "a contract of insurance that is included in a class of contracts of insurance declared by the regulations to be a class of contracts in relation to which this Division applies."

<sup>53</sup> See Regulation 9 of the IC Regulations 1985.

<sup>54</sup> See Regulation 13 of the IC Regulations 1985.

<sup>55</sup> For the definition of 'strata title residence', see Regulation 29A of the IC Regulations 1985.

<sup>56</sup> For the definition of 'small business', see Regulation 29B of the IC Regulations 1985.

- b. river (whether or not it has been altered or modified);
- c. creek (whether or not it has been altered or modified);
- d. another natural watercourse (whether or not it has been altered or modified);
- e. a reservoir;
- f. a canal;
- g. a dam.”

Any other form of the word ‘flood’ will have a corresponding meaning.<sup>57</sup> In accordance with section 37B(3) of the IC Act 1984, the meaning of ‘flood’ set out in the IC Regulations 1985 will be applicable to the prescribed contract even if the meaning of the word provided by the contract (or by a notice or other document or information given by the insurer in relation to the contract) is different from the meaning set out in the IC Regulations 1985.<sup>58</sup> Although highly unlikely, an insurer may still provide a wider definition than the one contained in the IC Regulations 1985.

A revision of the IC Regulations 1985 made by the IC Amendment Regulation 2012 (No 1) will become effective on 19 June 2014.<sup>59</sup> If prior to that date an insurer decides to rely on the IC Regulations 1985, as amended by the IC Amendment Regulation 2012 (No 1), in relation to a contract that provides insurance cover, the Regulations, as amended, shall apply.<sup>60</sup> Needless to say, the legislation does not operate retrospectively. Therefore, it will only apply to any prescribed contract of insurance entered into and any flood event occurring after 19 June 2012.<sup>61</sup>

## Definition of ‘flood’ in England and Wales

On 2 August 1961, R.L. Barnett, Director General of the BIA, stated that the insurance industry had agreed on a standard definition of ‘flood’. It was held to mean:

“[d]estruction or damage caused by the escape of water from the normal confines of any natural or artificial watercourse (other than water tanks, apparatus or pipes), or lake, reservoir, canal, or dam or inundation from the sea”.<sup>62</sup>

This definition became widely used within the industry, but did not feature in every policy of insurance covering the risk of flood. It was not until almost 40 years later that a court of law for the first time ascribed meaning to the term ‘flood’.

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<sup>57</sup> See section 37B(2)(b) of the IC Act 1984.

<sup>58</sup> It is worth noting that initially the ICA proposed a right for the insurer to derogate and amend the definition under the “usual terms” section of the IC Act 1984 in order to maintain competition and consumer choice – see ICA, *10-Point Plan To Tackle Disasters*, media release, 27 January 2011, available at <<http://www.insurancecouncil.com.au/issues-submissions/issues/10-point-plan-to-tackle-disasters>> (accessed on 22 March 2013).

<sup>59</sup> See Regulation 41(1) of the IC Regulations 1985, which states that the amendments introduced do not apply for the period of two years from the date the IC Amendment Regulation 2012 (No 1) commenced. According to Regulation 2 of the IC Amendment Regulation 2012 (No 1), the regulation commenced on the day after it had been registered, i.e. 19 June 2012.

<sup>60</sup> See Regulation 41(2) of the IC Regulations 1985.

<sup>61</sup> See section 37A(2) and section 37(A)(3) of the IC Act 1984.

<sup>62</sup> See The Guardian, 2 August 1961, 11. See also AR Doublet, “Storm, Tempest and Flood” (1966) 63 Journal of the Chartered Insurance Institute 17, 18.

In *Computer & Systems Engineering plc v John Lelliott Ltd*,<sup>63</sup> an employee of a subcontractor dropped a steel purlin shearing through and breaking off a pipe which was part of the installation of fire protection sprinkler system. As a result, 1,600 gallons of water were discharged causing substantial damage to the plaintiff's property. It was held by the Court of Appeal that the incident was neither a 'flood' nor a 'bursting of pipes or apparatus' within the meaning of the 1980 Joint Contracts Tribunal Standard Form of Building Contract. Lord Justice Beldam, delivering the leading judgment, stated:

"In the present case the words 'storm, tempest and flood', are followed by 'bursting or overflowing of water tanks, apparatus or pipes'. This express reference to risks associated with and emanating from an installation used for the collection, storage and distribution of water, generally located in premises, reinforces the restrictive meaning to be given to the word 'flood', for if inundation from any source or cause was encompassed by the word 'flood', no content would remain for the words which follow. [...] [T]here have been many cases in which flooding of premises and damage originating from a natural downpour have been contributed to by a blockage of drains, downpipes or culverts due to fault on the part of the contractor. Moreover in my view since the risks associated with water tanks, apparatus or pipes are expressly confined to bursting or overflowing, any flooding of the premises from water emanating from such an installation was intended to be confined to an occurrence of that nature".<sup>64</sup>

Accordingly, his Lordship proposed the following definition of 'flood': the invasion of property by a large volume of water caused by a rapid accumulation or sudden release of water from an external source, usually but not necessarily confined to the result of a natural phenomenon such as a storm, tempest or downpour.<sup>65</sup> Beldam LJ however, expressly confined that definition to the context of the 1980 JCT Standard Form of Building Contract.

In *Young v Sun Alliance and London Insurance Ltd*,<sup>66</sup> a property was insured against loss, destruction or damage from "storm, tempest or flood" and "escape of water from or frost damage to any water, drainage or heating installation". Water ingress occurred in the lavatory on the ground floor. Ineffective remedial work was carried out and the problem reoccurred. Water accumulated in the room to a depth of three inches. It was subsequently discovered that there was a natural source of water beneath the floor and the issue was resolved by the installation of a pump. Lord Justice Shaw stated:

"[...] it seems apparent that what the policy was intending to cover, whatever may be the colloquial use of the word 'flood' in common parlance, were three forms of natural phenomena which were related not only by the fact that they were natural but also that they were unusual manifestations, certainly of those phenomena: that is to say, 'storm' meant rain accompanied by strong wind; 'tempest' denoted

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<sup>63</sup> [1991] 54 BLR 1.

<sup>64</sup> [1991] 54 BLR 1, 9.

<sup>65</sup> [1991] 54 BLR 1, 10.

<sup>66</sup> [1997] 1 WLR 104.

an even more violent storm; and ‘flood’ was not something which came about by seepage or by trickling or dripping from some natural source, but involved ‘a large movement, an irruption of water’, as one of the definitions in the Oxford Dictionary puts it. The slow movement of water, which can often be detected so that the loss threatened can be limited, is very different from the sudden onset of water where nothing effective can be done to prevent the loss, for it happens too quickly.

It is because the word ‘flood’ occurs in the context it does, that I have come to the conclusion that one must go back to first impressions, namely, that it is used there in the limited rather than the wider sense; that it means something which is a natural phenomenon which has some element of violence, suddenness or largeness about it”.<sup>67</sup>

Lord Justice Lawton for his part asserted that ‘flood’ must be something different from ‘escape of water’ since the two are kept separate from each other in the wording of the policy. His Lordship continued:

“I agree with Shaw L.J. that the essence of ‘flood’ in ordinary English is some abnormal, violent situation. It may not necessarily have to be sudden, but it does, in my judgment, have to be violent and abnormal. This seepage of water through a rise in the water level was not violent, and it was not all that abnormal; it was the sort of incident which householders sometimes have to suffer as a result of ‘rising damp’”.<sup>68</sup>

Lord Justice Cairns had no doubt that an ordinary man could call such an event a “flooded floor”. Nonetheless, his Lordship opined that whether it was properly a ‘flood’ within the meaning of the policy was “very largely a question of degree”. It seemed right to the judge that a ‘flood’ involved a large quantity of water. Consequently, Cairns LJ concluded that “water 3 in. deep in a room 6 ft. by 4 ft. would [not] be regarded by any normal person as a flood”.<sup>69</sup>

In *Rohan Investments Ltd v Cunningham*,<sup>70</sup> heavy rain fell and accumulated on the roof of the claimant’s property while he was away, eventually finding a way into the house. Damage occurred in the form of ingress of water some 3-4 inches deep. An insurance policy provided cover against “storm, tempest or flood” and “escape of water from [...] fixed water tanks, apparatus or pipes”. Lord Justice Walker emphasised the importance of achieving a measure of uniformity in construction of a standard wording describing a common peril. His Lordship added, however, that the meaning of ‘flood’ proposed by Beldam LJ in *Computer & Systems Engineering plc v John Lelliott Ltd*<sup>71</sup> “is not to be construed as if it were a statutory definition in an Act of Parliament”.<sup>72</sup> Commenting on the line of case law discussed above, Walker LJ asserted:

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<sup>67</sup> [1997] 1 WLR 104, 107.

<sup>68</sup> [1997] 1 WLR 104, 108.

<sup>69</sup> ibid.

<sup>70</sup> [1999] Lloyd’s Rep IR 190.

<sup>71</sup> Above.

<sup>72</sup> [1999] Lloyd’s Rep IR 190, 191.

“It is to be noted that the facts in both the *Young* case and the *Computer & Systems* case were fairly unusual. Nor, it seems to me, can Beldam L.J. have intended to lay down any precise test for a large volume of water or for its rapid accumulation. It must be, as Cairns L.J. said in *Young*’s case, very largely a question of degree and the size and character of the insured premises may have to be considered”.<sup>73</sup>

A similar conclusion was reached by Lord Justice Auld LJ, who emphasised that it is the water which entered and caused damage that is important, not the area or depth of flooding outside.<sup>74</sup> His Lordship also contended that in considering whether there was a sufficiently large quantity of water to constitute a flood the size of the property affected relative to the amount of water should be taken into account.<sup>75</sup> In addition, Auld LJ observed:

“[a]s to the naturalness of the phenomenon, I share Beldam L.J.’s caution in *Computer Systems* in so confining the origin of the accumulation giving rise to a flood causing damage to property. I doubt the relevance of the precise cause of that accumulation, notwithstanding the association of the word ‘flood’ with storm and tempest common in such policy conditions. A flood is no less a flood, whatever its originating cause”.

The judgment of the High Court in *The Board of Trustees of the Tate Gallery v Duffy Construction Ltd*<sup>76</sup> is said to have put discussion about the definition of ‘flood’ to rest.<sup>77</sup> Mr Justice Jackson, having carefully reviewed previous case law, stated that earlier judicial decisions on the meaning of ‘flood’ constitute valuable and helpful guidance. He went on to say that such advice must be read having regard to the context in which the word appeared and the factual background giving rise to the dispute in the particular case; one should not treat any past decision as laying down a rule of law in respect of the definition of ‘flood’ in every insurance policy.<sup>78</sup> Moreover, in construing a term such as ‘flood’ in an insurance policy “the court must endeavour to do so in a manner which gives separate content to each term or phrase used by the draftsman”.<sup>79</sup>

In considering whether the unwelcome arrival of water upon property can properly be held to be a ‘flood’, it is therefore relevant to consider:

- a. whether the source of the water was natural;
- b. whether the source of the water was external or internal;
- c. the quantity of water;
- d. the manner of its arrival;

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<sup>73</sup> ibid.

<sup>74</sup> ibid.

<sup>75</sup> [1999] Lloyd’s Rep IR 190, 192.

<sup>76</sup> [2007] EWHC 361 (TCC); [2007] Lloyd’s Rep IR 758.

<sup>77</sup> David Crichton, *Flood Plain Speaking*, media release, 11 March 2012, available at <[http://www.cii.co.uk/media/2233858/flood\\_plain\\_speaking\\_3rd\\_ed.pdf](http://www.cii.co.uk/media/2233858/flood_plain_speaking_3rd_ed.pdf)> (accessed on 5 April 2013).

<sup>78</sup> See n 35, [37].

<sup>79</sup> ibid.

- e. the area and character of the property upon which the water was deposited;
- f. whether the arrival of that water was an abnormal event.<sup>80</sup>

It can be seen that there is currently no uniform common law definition of ‘flood’ in England and Wales. The proposition put forward by Beldam LJ in *Computer & Systems Engineering plc v John Lelliott Ltd* was confined to the context of a particular standard form construction contract.

There is nevertheless a statutory definition of ‘flood’. The Department for Environment, Food and Rural Affairs (DEFRA) issued the Flood Risk Regulations 2009,<sup>81</sup> implementing Directive 2007/60/EC of the European Parliament and of the Council of 23 October 2007 on the assessment and management of flood risks (the ‘Flood Directive’). Regulation 2(1) defines ‘flood’ as “any case where land not normally covered by water becomes covered by water”.<sup>82</sup> Regulation 2(2) was not strictly necessary in light of the text of the Directive, but its adoption was aimed at ensuring that the cause of the flood is irrelevant for the purpose of determining its existence. Importantly, Regulation 2(3) (a) excludes from the definition of ‘flood’ “a flood from any part of a sewerage system, unless wholly or partly caused by an increase in the volume of rainwater (including snow and other precipitation) entering or otherwise affecting the system”. Article 2(1) of the Directive had made such an exclusion permissible.<sup>83</sup> The Regulations notably also excluded a flood caused by a burst water main,<sup>84</sup> although no provision for such derogation was made in the Directive.

## Comments

Within the confines of the present project we have had not sought to investigate what the market reaction would be if government unilaterally imposed a single definition of the concept ‘flood’. This would require acquiring a statistically significant amount of market information and subjecting it to an accurate assessment of various hypothetical or uncertain factors such as the lobbying powers of important insurance industry representatives. We have instead provided an overview of the legal sources and definitions of the concept flood in the law of England and Wales and have noted that there is currently no single definition of ‘flood’ in the law of England and Wales: other than the EU Directive definition which is not designed for insurance or contractual purposes and in any case not uniformly implemented.

As noted, Australia is a considerably more reform friendly insurance jurisdiction than England and Wales. The comprehensive Insurance Contracts Act 1984 provides an excellent background against which to legislate for specific measures. The Law Commissions’ work on insurance contract law reform in UK is not expected to result in comprehensive insurance contract legislation – English law will remain governed by a complex mixture of case law, the Marine Insurance Act 1906 and financial services regulation. This means that even if the market could be brought onside with a single

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<sup>80</sup> ibid.

<sup>81</sup> SI 2009 No. 3042

<sup>82</sup> It is worth noting that the text of the Directive itself contained a reference to “*temporary* covering by water of land not normally covered by water” (emphasis added).

<sup>83</sup> Article 2(1) of the Directive stated that the definition of “flood” “*may* exclude floods from sewerage systems”, thus leaving the ultimate decision to each Member State (emphasis added).

<sup>84</sup> See regulation 2(3)(b) of the Flood Risk Regulations 2009.

definition, it would be difficult to find the right way to enact that definition. The Marine Insurance Act 1906 or issue-specific, context-less legislation or case law would certainly be the wrong vehicles, and therefore a regulatory measure (through the Financial Conduct Authority Handbook) would probably be the only available solution. One way or another, such a measure would expose the body public to EU insurance competition regulation.

The chapter has discussed the Australian measure of creating a single definition of floods for the home insurance market. The purpose of the measure is to help ensure that houses in the same street or neighbourhood experience the same treatment following a flood. For insurers, a common definition ought to have the virtue of making both underwriting and claims processes more predictable.

Standardisation of the definition of ‘flood’ may be considered of benefit to both the insurance industry and the consumers. Having the certainty of a common meaning given to the term that would apply across the field is likely to intensify, in particular, premium competition for insurance cover. On the other hand, such an achievement might meet the expectation of the insureds, reinforcing social justice through equal treatment.

It is, nonetheless, submitted that a common definition of ‘flood’ is necessarily inflexible. Should the insurer prefer not to contract on the basis of the standard definition, the only available course of action will be to refuse cover. No scope for adjustment was left by the legislature. Consequently, the insurance industry might lose otherwise sound business. However, it will undoubtedly be the consumer who will suffer the most due to the inability to obtain flood insurance on the market purely because of the insurer to issue a policy containing the definition prescribed for by the IC Regulations 1985. As noted by Derrington Q.C., “the only reasonably efficient area of expected benefit of standardisation would be in those cases where the insurer has agreed to provide flood cover”.<sup>85</sup> A uniform definition of the concept of ‘flood’ therefore does not on its own guarantee that flood insurance will be available to the consumer market at affordable prices.

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<sup>85</sup> See D Derrington, “Flood Insurance”, Australian and New Zealand Insurance Law Tracker, Issue 10, February 2011, available at <[http://www.floodcommission.qld.gov.au/\\_\\_data/assets/pdf\\_file/0014/9122/Hon\\_Desmond\\_Derrington\\_QC\\_Flood\\_insurance.pdf](http://www.floodcommission.qld.gov.au/__data/assets/pdf_file/0014/9122/Hon_Desmond_Derrington_QC_Flood_insurance.pdf)> (accessed 20 June 2013).



Aerial view of the residential area of the suburb of Milton during the Brisbane Flood of 2011.

# Case study 2: The Netherlands

## Flood risk in the Netherlands

Due to the fact that roughly 24% of the Dutch territory and 64% of the Dutch population are located below the sea level, the risk of flooding in the Netherlands is immense. Statistically, 65% of the GDP is generated on land situated either below or not higher than 6m above the sea level. *Watersnoodramp* (English, literally, ‘flood disaster’), also known as the North Sea Flood, was a major flooding in the southwest of the Netherlands caused by a heavy storm that occurred on the night of 31 January 1953 and the morning of 1 February 1953. It is estimated that as a result of the disaster 1,835 people were killed, an area of 1,650 km<sup>2</sup> was submerged,<sup>86</sup> almost 10,000 buildings were completely destroyed, and approximately 47,300 properties were damaged. Economic damage totalled nearly 10% of GDP. Unfortunately, the risk of flooding was not covered in the vast majority of standard household policies. Therefore, damage occasioned by the North Sea Flood was compensated on a limited scale.<sup>87</sup>

## The historic cartel and binding decision

Consequently, on 17 November 1955, the Dutch Association of Insurers (DAI)<sup>88</sup> issued a binding decision concerning the insurability of the flood risk which prohibited coverage of damage caused by a flood which was the consequence of the collapse or overflowing of any dike, quay, lock or other dam, irrespective of whether the flood was a consequence or result of an event covered by insurance policy in question. By virtue of the cartel agreement, every insurance company operating in the Netherlands was thus forbidden from providing a flood cover. It was widely thought that ‘flooding’ could not be considered an uncertain event. Hence, the DAI decided that ‘flood risk’ was technically uninsurable. Bearing in mind that the insurance industry considered flood risk to be uninsurable anyway, the need for such a decision might be questioned. DAI defended the decision before the European Commission emphasising the unique situation in the Netherlands, where almost the entire territory is affected by the risk of flooding,<sup>89</sup> whereas in other countries only certain regions are susceptible to such damage. Unlike in other countries, the option was not available to the Netherlands government of responsibly imposing solidarity on the entire population.

On 13 April 1992, an earthquake measuring 5.4 on the Richter scale occurred near the city of Roermond in Limburg province. The majority of those affected by the disaster was not aware of the fact that earthquake damage was customarily excluded from a standard household policy.<sup>90</sup> In fact, such a risk was regarded as altogether uninsurable due to the effect of a binding decision with

<sup>86</sup> Total area of the Netherlands is 41,543 km<sup>2</sup>.

<sup>87</sup> See V Bruggeman, *Compensating Catastrophe Victims. A Comparative Law and Economics Approach* (Kluwer Law International, London 2010), 363.

<sup>88</sup> Dutch: Verbond van Verzekeraars. See generally <<https://www.verzekeraars.nl/Paginas/Home.aspx>>.

<sup>89</sup> Report from the Commission to the Council and the European Parliament on the operation of Regulation 3932/92 concerning the application of Article 81, paragraph 3, of the Treaty to certain categories of agreements, decisions and concerted practices in the field of insurance, available at <<http://aei.pitt.edu/4659/1/4659.pdf>> (accessed on 14 June 2013).

<sup>90</sup> See V Bruggeman, *Compensating Catastrophe Victims. A Comparative Law and Economics Approach* (Kluwer Law International, London 2010), 364.

respect to earthquake and volcanic eruption damage. The insurance industry established an *ad hoc* fund for the purpose of compensating victims of the natural catastrophe and the binding decision was subsequently abolished.

Shortly thereafter, discussion took place between the government and the insurance industry in the forum of a special working group with the aim of creating an insurance pool to compensate the damage caused by natural disasters. Nevertheless, development of a comprehensive regime was halted because the insurance industry was not prepared to participate in the pool to the extent required for it to be viable. On the other hand, the government initially did not perceive itself capable of providing the necessary financial support for such a pool, whether in the form of fiscal exemption for the accumulated fund or guarantee for the amount on top of the pool capacity. Following the Meuse Flood in December 1993,<sup>91</sup> the Ministry of Finance together with the Ministry of the Interior expressed willingness to contribute to the solvency of the pool but the extent of the potential government engagement in the model was considered insufficient and the demand for flood insurance among the Dutch population was considered low. It was estimated that only 14% of those eligible for the cover to be provided by the pool would actually be interested in purchasing it. That said, scarce demand for private market flood insurance could credibly be attributed precisely to the prospect of *ad hoc* compensation by the government.<sup>92</sup>

In January and February 1995, flooding struck the province of Limburg.<sup>93</sup> The Dutch government soon entered into a covenant with the DAI for the purpose of establishing a compensation fund for natural catastrophes. The solvency of the pool was to be ensured by a charge levied on each contract of standard household (fire) insurance. The Raad van State (the Council of State), consisting of the Advisory Division and the Administrative Jurisdiction Division,<sup>94</sup> despite acknowledging the obligation placed upon the government by Article 21 of the Constitution to ensure habitability of the land, advised against the enforcement of the covenant.<sup>95</sup> It was thought unreasonable to obligate each property owner to contribute toward the flood insurance pool especially as some might not actually be at risk.<sup>96</sup> The government decided to reject the idea of a natural disaster damage compensation fund.

The binding decision related to flooding was withdrawn because of internal political pressure and fear of action by the European Commission against the Netherlands for violation of

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91 It is estimated that the total damage caused by the Meuse Flood amounted to EUR 115 million (approximately, GBP 97.7 million). See M Kok and A Barendregt, “Verantwoordelijkheid en Aansprakelijkheid bij Wateroverlastschade”, Directoraat Generaal Water, HKV Lijn in Water 2004.

92 For support of this argument, see S.E. Harrington, “Rethinking disaster policy” (2000) Regulation—The Cato Review of Business and Government 40.

93 It is estimated that the total damage caused by that flooding reached EUR 65 million (approximately, GBP 55.2 million) See M Kok and A Barendregt, “Verantwoordelijkheid en Aansprakelijkheid bij Wateroverlastschade”, Directoraat Generaal Water, HKV Lijn in Water 2004.

94 See further <<http://www.raadvanstate.nl/>>.

95 See R. B. Jongejan and P. Barrieu, “Insuring Large-Scale Floods in the Netherlands” (2008) 33 The Geneva Papers on Risk and Insurance 250.

96 See Report from the Commission to the Council and the European Parliament on the operation of Regulation 3932/92 concerning the application of Article 81, paragraph 3, of the Treaty to certain categories of agreements, decisions and concerted practices in the field of insurance, available at <<http://aei.pitt.edu/4659/1/4659.pdf>> (accessed on 14 June 2013).

Commission Regulation (EEC) No 3932/92 of 21 December 1992.<sup>97</sup> It was altered into a non-binding recommendation, leaving each insurer free to extend cover to flood risk.

The Dutch example conceivably proves that the underlying condition for insurability of a catastrophic risk is a competitive insurance market that offers a wide range of differentiated products as a reaction to a corresponding demand. Lack of insurance coverage was the result of an anti-competitive arrangement devised by the insurance industry. Although no robust study of the market demand for flood insurance was conducted at the time of the binding decision being in force, the examples of the catastrophe risk policy offered by Amsterdam's Euro-Lloyd<sup>98</sup> and, more recently, the stand-alone flood insurance product introduced by Neerlandse<sup>99</sup> arguably demonstrate such a demand. Therefore, as asserted by Professor Faure

"[i]nstead of a direct government intervention the first adequate reaction of government should therefore be to guarantee an adequate competition policy, also with respect to insurance markets. Otherwise uninsurability may, as the Dutch case shows, simply be the result of a cartel agreement".<sup>100</sup>

## Disaster fund

On 25 May 1998, the *Wet Tegemoetkoming Schade bij Rampen en Zware Ongevallen* ('WTS')<sup>101</sup> was adopted with the intention to abandon the practice of providing an *ad hoc* response to each natural disaster. It came into effect on 12 June 1998. It was based indirectly on the Belgian Act of 12 July 1976 concerning the compensation of damage caused to private property by natural disasters. On 1 October 2010, the WTS was amended.<sup>102</sup> It is now referred to as the *Wet Tegemoetkoming Schade bij Rampen*.<sup>103</sup> Arguably, the rationale behind the WTS is that a natural catastrophe might lead to a damage of such an extent as cannot be borne by each individual household affected itself. According to the preamble to the WTS, the legislation is

<sup>97</sup> Commission Regulation (EEC) No 3932/92 of 21 December 1992 on the application of Article 85 (3) of the Treaty to certain categories of agreements, decisions and concerted practices in the insurance sector. Now: Commission Regulation (EU) No 267/2010 of 24 March 2010 on the application of Article 101(3) of the Treaty on the Functioning of the European Union to certain categories of agreements, decisions and concerted practices in the insurance sector.

<sup>98</sup> According to the content of the policy, the insured would receive only 25% of the quantum of the claim submitted. Customarily, the premium for the cover provided was dependent on the location and amounted to an average of EUR 150 (GBP 127.30). See V Bruggeman, *Compensating Catastrophe Victims. A Comparative Law and Economics Approach* (Kluwer Law International, London 2010), 368.

<sup>99</sup> See <<http://www.lloyds.com/news-and-insight/news-and-features/environment/environment-2013/lloyds-supports-unique-flood-solution-in-the-netherlands>> (accessed 15 June 2013). For the terms and conditions of the policy, see <<http://neerlandse.nl/>> (accessed 15 June 2013). It is worth noting that only an owner of a property located on a floodplain can purchase a policy covering the flood risk.

<sup>100</sup> MG Faure, *Financial Compensation in Case of Catastrophes: a European Law and Economics Perspective*, Metro Institute, Maastricht 2004, available at <[http://www.hertig.ethz.ch/LE\\_2004\\_files/Papers/Faure\\_Financial\\_Compensation\\_Catastrophes.pdf](http://www.hertig.ethz.ch/LE_2004_files/Papers/Faure_Financial_Compensation_Catastrophes.pdf)> (accessed 15 June 2013).

<sup>101</sup> English: Compensation for Damage by Disasters and Serious Accidents Act.

<sup>102</sup> Detailed discussion concerning the extent of the amendment is beyond the scope of this report.

<sup>103</sup> English: Compensation for Damage by Disasters Act. See Article 15 of the WTS. For the text of the WTS, see <[http://wetten.overheid.nl/BWBRO009637/geldigheidsdatum\\_15-06-2013](http://wetten.overheid.nl/BWBRO009637/geldigheidsdatum_15-06-2013)> (accessed 15 June 2013).

“a structural arrangement upon which the state provides compensation to those who incurred a cost in preventing or limiting damage and to those who suffered damage which is the immediate and direct consequence of a freshwater flood, an earthquake or another catastrophe of at least equal order”.

In essence, a victim of a ‘freshwater flood’,<sup>104</sup> an ‘earthquake’<sup>105</sup> or a ‘disaster’<sup>106</sup> of at least equal order has a right to receive compensation for the direct and immediate damage suffered and/or the cost of any preventative/mitigating measure incurred as a result of the catastrophe,<sup>107</sup> provided that it occurred within the ‘damage area’.<sup>108</sup> Saltwater flooding is not under the direct scope of application of the WTS, as it was thought that the potential damage could exceed the capacity of the fund.<sup>109</sup> Nonetheless, the government might declare such damage to be within the ambit of the WTS through a royal decree as ‘a disaster of at least equal order’.<sup>110</sup> It should be borne in mind that a citizen will not be entitled to the compensation under the legislation if *inter alia*

- the damage and/or the cost of any preventative measure incurred was/were reasonably insurable,
- compensation for the damage and/or the cost was or could have been obtained in any other way,
- the damage and/or the cost were caused by the own fault of the victim, or
- the victim did not take adequate measures to prevent or minimise the damage or the cost.<sup>111</sup>

The amount of money available for the purpose of compensating the victims of a given disaster is in principle limited to approximately EUR 500 million (GBP 424,732,500).<sup>112</sup> The maximum compensation recoverable under the WTS is to be established, in form of a percentage, on each occasion by a ministerial order, taking into account the nature and the magnitude of the catastrophe concerned.<sup>113</sup>

It is worth noting that the WTS is a system of financial aid granted by the government, with a set maximum annual commitment, to those suffering from the occurrence of a disaster. It is not an insurance programme. It should thus be considered as nothing more than a structured approach of the State to *ex-post* response to a catastrophe. Article 21 of the Dutch constitution might be said to be the reason for the State assuming the responsibility for providing disaster relief. Equally, since the government is in charge of dike maintenance, it may be thought to be liable for damage occurring

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<sup>104</sup> For the definition of ‘freshwater flood’, see Article 1(b) of the WTS.

<sup>105</sup> For the definition of ‘earthquake’, see Article 1(c) of the WTS.

<sup>106</sup> For the definition of ‘disaster’, see Article 1 of the *Wet Veiligheidsregio’s* (English: Security Regions Act - SRA), available at <[http://wetten.overheid.nl/BWBRO027466/geldigheidsdatum\\_15-06-2013#](http://wetten.overheid.nl/BWBRO027466/geldigheidsdatum_15-06-2013#)> (accessed 15 June 2013).

<sup>107</sup> For the exhaustive list of categories of damages and expenses recoverable under the legislation, see Article 4(1) of the WTS.

<sup>108</sup> Only damage eventuated within the ‘damage area’ will be compensated. Such is to be determined by a ministerial order in the event of a disaster occurring. See Article 1(d) of the WTS.

<sup>109</sup> V Bruggeman, *Compensating Catastrophe Victims. A Comparative Law and Economics Approach* (Kluwer Law International, London 2010), 368.

<sup>110</sup> See Article 3 of the WTS.

<sup>111</sup> See Article 4(3) of the WTS.

<sup>112</sup> See J.F. de Groot, “Na de ramp. Een beschouwing over de toepassing van de WTS” (2004) 5 Overheid en Aansprakelijkheid 141, 148.

<sup>113</sup> See Article 6 of the WTS. See also V Bruggeman, *Compensating Catastrophe Victims. A Comparative Law and Economics Approach* (Kluwer Law International, London 2010), 369.

as a result of inadequacy of the flood defence system. Furthermore, solidarity among the Dutch citizens could be yet another reason for financing compensation through the tax revenue or issuing debt.<sup>114</sup> Risk diversification over the entire population as well as future generations is likely to have a marginal impact upon an individual citizen.<sup>115</sup>

Nonetheless, the WTS might be criticised on several grounds. Lack of clear criteria for ensuring a uniform implementation of the WTS on each occasion is a major drawback of the Dutch model for dealing with the aftermath of a natural hazard. Even a structured approach to *ex-post* disaster compensation such as the WTS might create uncertainty. If an event does not amount to a ‘disaster’, as defined in Article 1 of the SRA, the WTS will not be applicable.<sup>116</sup> Regrettably, the definition of ‘disaster’ in Dutch law is far from being unambiguous. For an event to be classified as a ‘disaster’ it would have to a) cause a severe distortion of public safety, in the course of which life and health of a number of people or large material interests are being threatened or are damaged, and b) require a coordinated effort of various services or organisations in order to suppress the threat or limit the harmful effects.<sup>117</sup> Accordingly, whether a particular catastrophe will attract the application of the WTS would invariably be a matter of subjective interpretation of the minister concerned.

## Current developments

Currently, the DAI is in the process of developing a scheme of insurance against flood risk. The *Autoriteit Consument & Markt* (ACM)<sup>118</sup> raised an objection to the proposed pool in relation to compliance with competition law. Consultation conducted by the DAI will result in a report, to be published in August 2013, detailing the suggested mechanism for dealing with the insurance of flood risk.<sup>119</sup> Perhaps, the probable cost of such a scheme will constitute a major obstacle to the success of the initiative. Bearing in mind the impact of the climate change upon the flood risk, the value of property at significant risk of flooding will be increasing exponentially in the absence of further considerable investment in flood defences by the State. It is understood that the Dutch government would prefer a market solution that is both transparent and affordable rather than a model of compulsory flood cover tied to a standard household policy.

While the former would incentivise risk prevention and mitigation of the potential loss, the latter could hinder risk awareness and maintain a misleading sense of security among the public. Nevertheless, there are powerful arguments that only the latter solution is capable of addressing the problem of flood insurance in a country such as the Netherlands. The main factor responsible for the technical uninsurability of the flood risk on the private market in the Netherlands may well be the

<sup>114</sup> It is worth noting that an EU Member State is permitted to run a government deficit exceeding 3% of GDP when it was caused by an “unusual event outside the control of the Member State” that had “a major impact on the financial position of the general government”. See Article 2(1) of Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure, as amended by Article 1(2)(a) of Council Regulation (EU) No 1177/2011.

<sup>115</sup> See, generally, E Michel-Kerjan and N Marcellis-Warin, “Public-Private Programs for Covering Extreme Events: The Impact of Information Distribution on Risk-Sharing” (2006) 1(2) Asia-Pacific Journal of Risk and Insurance, 21. See also K.J. Arrow and R.C. Lind, “Uncertainty and the Evaluation of Public Investment Decisions” (1970) 60(3) American Economic Review 364.

<sup>116</sup> See Articles 1(b), 1(c) and 3 of the WTS.

<sup>117</sup> See Article 1 of the SRA.

<sup>118</sup> English: Authority for Consumers and Markets. For further information, see <<https://www.acm.nl/>> (accessed 16 June 2013).

<sup>119</sup> See F Nyman, “Flood: a Dutch Obligation”, Insurance Insight, 11 April 2013, available at <<http://www.insuranceinsight.com/insurance-insight/news/2260762/flood-a-dutch-obligation>> (accessed 16 June 2013).

danger of adverse selection.<sup>120</sup> Insufficiency of risk spreading might indeed affect the equilibrium provided by the Law of Large Numbers.<sup>121</sup>

## Comments

It can be argued that a State might be under an express or implied obligation to ensure that the citizens are able to occupy own property without an undue burden being placed upon them. Be that as it may, Article 21 of the Dutch Constitution explicitly imposes on the government a duty to safeguard the habitability of the land. It was construed by the Council of State as requiring the administration to guarantee some sort of post-disaster relief to those affected.<sup>122</sup> Hence, the enactment of the WTS was considered to be a necessary development. Needless to say, availability of insurance which would compensate the victims in the event of a natural hazard occurring might be seen as an alternative, though perfectly legitimate measure of discharging that obligation.

Although the UK does not have an entrenched constitution, a corresponding duty might be found elsewhere. Article 7(2) of the Flood Directive requires a Member State to establish appropriate objectives for the management of the flood risk. Particular emphasis is to be put on “on the reduction of potential adverse consequences of flooding for human health, the environment, cultural heritage and economic activity, and, if considered appropriate, on non-structural initiatives”.<sup>123</sup> It was suggested that the provision might be construed so as to require the government concerned to provide indemnity to the public against damage or loss suffered as a result of flooding.<sup>124</sup> Such indemnity could be in the form of insurance. With respect, bearing in mind the general objective of the Flood Directive,<sup>125</sup> it is inconceivable that provision of insurance against the risk of flood was contemplated by the draftsmen to constitute a part of the flood risk management plan. It was rather the need to eliminate or at least minimise the threat of displacement of people and damage to the environment caused by flooding that laid the foundation of the Flood Directive.

Availability of public aid following a catastrophe might discourage both the uptake of insurance and damage prevention, constituting “a governmentally subsidised incentive to take on risk”.<sup>126</sup> In particular, the scheme provides no deterrent against property development on flood plains.<sup>127</sup>

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<sup>120</sup> See, generally, K.J. Crocker and A Snow, “Background Risk and the Performance of Insurance Markets under Adverse Selection” (2008) 33(2) *The Geneva Risk and Insurance Review* 137.

<sup>121</sup> For a detailed treatment of that issue, see ME Yaari, “A Law of Large Numbers in the Theory of Consumer’s Choice under Uncertainty” (1976) 12 *Journal of Economic Theory* 202; M Rothschild and J Stiglitz, “Equilibrium in Competitive Insurance Markets: An Essay on the Economics of Imperfect Information” (1976) 80 *Quarterly Journal of Economics* 629; and, more recently, Ch Gollier, “Some Aspects of the Economics of Catastrophe Risk Insurance”, CESifo Working Paper No 1409, February 2005, available at <[http://www.cesifo-group.de/ifoHome/publications/docbase.html?docbase.query=%22Some%20aspects%22&docbase.currentPage=21&docbase.facet\\_publishYear=2005](http://www.cesifo-group.de/ifoHome/publications/docbase.html?docbase.query=%22Some%20aspects%22&docbase.currentPage=21&docbase.facet_publishYear=2005)> (accessed 17 July 2013).

<sup>122</sup> See above.

<sup>123</sup> Article 7(2) of the Flood Directive was implemented in the UK by regulation 27(3) of the FRR 2009. Both the Environmental Agency and the lead local flood authority of the relevant area are responsible for preparing the flood risk management plan. See regulations 25 and 26 of the FRR 2009. For the definition of ‘lead local flood authority’, see regulation 7 of the FRR 2009.

<sup>124</sup> See J Morgan and M Stallworthy, “Indemnifying against flood loss in a changing environment” (2013) 33(2) *Legal Studies* 239, 244.

<sup>125</sup> See Preamble of the Flood Directive.

<sup>126</sup> See W Botzen and J van den Bergh, “Insurance Against Climate Change and Flooding in the Netherlands: Present, Future, and Comparison with Other Countries” (2008) 28(2) *Risk Analysis* 413, 417.

<sup>127</sup> See, in particular, R Schwarze and G Wagner, “In the aftermath of Dresden. New directions in German flood insurance” (2004) *Geneva Papers on Risk and Insurance* 154.

Previous history of the government granting relief to the victims of natural catastrophes might create a severe moral hazard. According to the expected utility model,<sup>128</sup> a non-zero probability of post-disaster compensation substantially reduces consumer willingness to purchase insurance<sup>129</sup> and to adopt cost-effective mitigation measures.<sup>130</sup> As a result, effective individual and collective risk management is discouraged.<sup>131</sup> Risk differentiation by private insurance companies is said to be much more effective in achieving that aim.<sup>132</sup> Equally, existence of a State-funded disaster relief scheme negatively affects the desire of the market to develop sound insurance solutions addressing the flood risk.<sup>133</sup> As noted by Professors van den Bergh and Faure, “compensation of catastrophic loss by governments makes it harder for insurance markets to function and market failure becomes a self-fulfilling prophecy as a result of misguided regulation”.<sup>134</sup>

The availability and/or the extent of post-disaster funding may be dependent upon the political will of the government concerned and public pressure. The WTS arguably provides an arbitrary and subjective answer to the problem of flood insurance.<sup>135</sup> Research has shown that a government might be more inclined to grant a substantive compensation shortly before a general election.<sup>136</sup> On the contrary, within the private market the decision to honour an insurance policy in the event of a damage or loss is purely a matter of contract law. In addition, the existence of public compensation is an impediment to the development of a flood insurance product on the private market.<sup>137</sup> Since such disaster relief is financed through an additional tax or reduced public investment (expenditure cuts), the WTS might also hinder the economic development of the country. Consequently, there are significant incentives for seeking an alternative method of dealing with the damage caused by flooding.

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<sup>128</sup> See J von Neumann and O Morgenstern, *Theory of Games and Economic Behaviour* (3<sup>rd</sup> edition, Princeton University Press 1953), available at <<http://archive.org/stream/theoryofgamesando30098mbp#page/n5/mode/2up>> (accessed 17 June 2013).

<sup>129</sup> See, however, H Kunreuther, “Mitigating disaster losses through insurance” (1996) *Journal of Risk and Uncertainty* 177, where it is argued that there is no empirical evidence that people refuse to secure private insurance coverage because of relying upon *ex-post* government relief. Still, such an argument is more persuasive in the context of a purely *ad hoc* compensation than within the realm of a predetermined structural disaster response mechanism such as the WTS.

<sup>130</sup> See, for instance, R.B. Jongejan, *How safe is safe enough? The government's response to industrial and flood risks*, Doctoral Thesis, Delft University of Technology 2008, 109-110, available at <[http://repository.tudelft.nl/assets/uuid:o32f5b9a-d38d-4boe-83b1-7685198fba6c/jongejan\\_20081010.pdf](http://repository.tudelft.nl/assets/uuid:o32f5b9a-d38d-4boe-83b1-7685198fba6c/jongejan_20081010.pdf)> (accessed 17 June 2013).

<sup>131</sup> See A Endres, C Ohl and B Rundshagen, ‘Land unter! Ein institutionenökonomische Zwischenruf’ (2003) 29 *List Forum für Wirtschafts und Finanz Politik* 284.

<sup>132</sup> See GL Priest, “The government, the market, and the problem of catastrophic loss” (1996) *Journal of Risk and Uncertainty* 219.

<sup>133</sup> See RA Epstein, “Catastrophic response to catastrophic risks” (1996) *The Journal of Risk and Uncertainty* 287.

<sup>134</sup> See R van den Bergh and M Faure, “Compulsory Insurance of Loss to Property caused by Natural Disasters: Competition or Solidarity?” (2006) 29(1) *World Competition* 25, 32.

<sup>135</sup> See, more generally, MW Downton and RA Pielke, “Discretion Without Accountability: Politics, Flood Damage and Climate” (2001) 2(4) *Natural Hazards Review* 157.

<sup>136</sup> *ibid.*

<sup>137</sup> See n 29, 416.



Storm surge barrier in Zeeland, Netherlands.  
Build after the storm disaster in 1953.

# Analysis: competition law concerns

## Australia: a single definition

The Australian unified definition was scrutinised by the Australian Competition and Consumer Commission (ACCC). Given that the UK insurance market is subject to EU competition rules, we found that it would be important to consider whether a single definition adopted by the industry itself and perhaps also made mandatory by law or other measure would be likely to pass muster under EU rules.

Under EU Competition law, two competition issues would arise if a common definition of flood was to be adopted in the UK: firstly, if that definition were to appear in common standard policy conditions adopted by the market, its validity would need to be assessed under Art. 101 TFEU, which prohibits forms of horizontal co-operation between undertakings occupying the same position in the production/distribution chain. Secondly, would a new definition of flood create a ‘new risk’ which could be subject to joint coverage by insurers under Art. 6 (1) of the current block exemption Regulation?<sup>138</sup>

### **Definition of Flood and Standard Policy conditions: an assessment under Art 101 TFEU**

In the past,<sup>139</sup> cooperation on the design of policy forms was generally considered acceptable as it was deemed to facilitate price comparisons for consumers.<sup>140</sup> Considering that the supply of insurance services traditionally lacks transparency, in granting a block exemption<sup>141</sup> the Commission took into consideration that non-binding standard policy conditions allegedly procured efficiencies for insurance undertakings and could have benefits for consumer organisations and brokers.

Exactly as with any kind of service industry, consumers need to have access to information in order to determine which service provider is most suitable for them. Information deficiencies are theoretically capable of impairing the functioning of the market, leading to ineffective results.<sup>142</sup> A block exemption relating to the standardisation of policy conditions was therefore considered the correct regulatory response to this alleged market failure.<sup>143</sup>

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<sup>138</sup> Commission Regulation (EU) No 267/2010 of 24 March 2010 on the application of Article 101(3) TFEU to certain categories of agreements, decisions and concerted practices in the insurance sector (OJ L 83/1, 30.3.2010).

<sup>139</sup> See Commission Regulation (EEC) No 3932/92 of 21 December 1992 on the application of Article 85 (3) of the Treaty to certain categories of agreements, decisions and concerted practices in the insurance sector, 1992 OJ L 398/7, and Commission Regulation (EC) No 358/2003 of 27 February 2003 on the application of Article 101(3) of the Treaty to certain categories of agreements, decisions and concerted practices in the insurance sector.

<sup>140</sup> See Patricia M. Danzon, *The McCarran-Ferguson Act: Anticompetitive or Procompetitive?*, above, p.28. On this point see also M. Faure, “*Insurance and competition law: balancing the conflicts*”, available at the following link: <<http://www.nottingham.ac.uk/business/cris/papers/Grif%20-%20Michael%20Faure.pdf>> (accessed on 3 July 2011).

<sup>141</sup> A Block Exemption Regulation is an exemption in a business line or industry, which debars organisations in the industry from some business activities in order to create competition.

<sup>142</sup> See M. Faure, “*Insurance and competition law: balancing the conflicts*”, above, p. 11. On this point see also Patricia M. Danzon, “*The McCarran-Ferguson Act: Anticompetitive or Procompetitive?*”, above, p.28.

<sup>143</sup> See M. Faure, “*Insurance and competition law: balancing the conflicts*”, above, p. 11.

As from 24 March 2009, the scenario is radically different. The current Regulation<sup>144</sup> represents a weighty rebuttal of the above approach and the end of the block exemption in this area. The Regulation does not regard standard policy conditions as a sufficiently sector-specific feature to merit special treatment by way of block exemption coverage. The Commission believes that insurance undertakings should be capable of assessing whether co-operation on standard terms is competition law compliant on the same basis as companies in other sectors.<sup>145</sup>

In the meantime, it needs to be emphasised that the relatively recent removal of standard policy wording from the comfort zone of a block exemption has introduced an element of legal uncertainty for the industry, which now has to assess the competition law sensitivity of each standardisation agreement.<sup>146</sup>

The rationale for this radical change of policy appears to be that in the absence of a block exemption for standard terms, competition would supposedly be enhanced because insurers could supply a greater variety of policies. In the past, the *raison d'être* for the block exemption for standard policy conditions had been criticised for being erroneous both in formulation and in the proposed remedy.<sup>147</sup> In particular, the claim that consumers are not capable of assessing standard insurance contracts is perhaps formulated in excessively generic terms.

It would be convenient to consider different classes of insurance. In case of mass consumer insurance, for instance, it has been correctly noted that policies containing sharply drafted exclusion clauses, the implications of which can only be assessed by a specialised lawyer, may be difficult for consumers to understand.<sup>148</sup>

On the contrary, according to economic doctrine, in the field of business and industrial insurance, the commercial awareness of this group of customers should mean that they require no specific legal protection.<sup>149</sup> Since the problem therefore seems to arise mainly in relation to non-commercial, consumer insureds, it has been argued that the repeal of the block exemption should have been confined to this area and that the role of insurance brokers could be emphasised as a means of consumer protection.<sup>150</sup>

Clearly this was not the intention of the Commission which, with Regulation 267/2010, envisaged a complete repeal of the block exemption related to standard policy conditions. The rationale for

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<sup>144</sup> Commission Regulation (EU) No 267/2010 of 24 March 2010 on the application of Article 101(3) TFEU to certain categories of agreements, decisions and concerted practices in the insurance sector (OJ L 83/1, 30.3.2010).

<sup>145</sup> Guidelines were expected to be issued but there is as yet no sign of them.

<sup>146</sup> As recently happened in connection with the abolition of the Council Regulation (EEC) No 4056/86 OJ L 378/4, 22/12/1986, which provided a block exemption for the maritime sector, the Commission will issue guidelines in order to help insurers verify the validity of their agreements on policy conditions *vis-à-vis* Art. 101.

<sup>147</sup> On this point see M. Faure, "Insurance and competition law: balancing the conflicts", above, p. 15.

<sup>148</sup> *Ibid.*, at p. 12.

<sup>149</sup> *Ibid.*

<sup>150</sup> See M. Faure, "Insurance and competition law: balancing the conflicts", above, p. 12. A competitive supply of insurance brokers could indeed assist consumers in finding an insurance policy that fits their preferences as far as premium and policy conditions are concerned. The Commission itself recently emphasised that insurance brokers have increased their role in most Member States, and that the role of insurance brokers can be used to strengthen the bargaining position of consumers, acting as a countervailing force to the increased bargaining power of large insurers and reinsurers. See the Commission's *Business Insurance Sector Inquiry Final Report* of 25 September 2007, available at: [http://ec.europa.eu/competition/sectors/financial\\_services/inquiries/final\\_report\\_annex.pdf](http://ec.europa.eu/competition/sectors/financial_services/inquiries/final_report_annex.pdf)(accessed on 1 July 2011).

this decision was to be found in the assumption that the use of standard policy conditions was not a peculiarity of the insurance industry and thus did not deserve special consideration.

Although standard policy conditions are in common use in the insurance sector, they do give rise to competition concerns. On a general level, problems occur whenever an association of undertakings imposes on its members an obligation to use common terms and conditions of sale and purchase. This inevitably has an impact on competition as in the first place it limits the freedom of the undertakings involved to provide conditions which vary from the one imposed upon them. Most importantly, consumers may also be harmed by such practices as their choice of service providers is inevitably narrowed down.

Standard policy conditions are less likely to have a detrimental impact on competition where members of the association of undertakings retain the freedom to adopt different conditions if they wish to do so. The freedom to implement diverse conditions was an essential condition for the block exemption. Standard policy conditions can still have an adverse effect on competition if a large proportion of the insurance undertakings adopt the same policy conditions. In such a case, the theoretical freedom to adopt different standard policy conditions does not represent a safety net since customers may be left with little or no choice in practice.

### **Introducing a definition of ‘flood’**

The repeal of the block exemption for standard policy conditions has created a scenario where the compliance of agreements between insurance undertakings with Article 101(3) TFEU must be assessed on a case by case basis through ‘self-assessment’ procedures. On the basis of Art 101(3), individual exemptions will be granted if specific conditions apply: agreements on standard policy conditions will qualify for exemption insofar as they create efficiencies that outweigh the restriction of competition, consumers obtain a fair share of those benefits, there are no less restrictive means of achieving the efficiencies, and competition is not eliminated altogether.

In order to be consistent with Art 101(3), an association of insurance undertakings that adopts a common definition of ‘flood’ in standard policy conditions will have to be able to demonstrate that its member undertakings concerned are permitted to deviate from the agreement and provide alternative conditions.

If that definition were to be introduced by statute, its validity would be consistent with EU competition law, provided that the rationale for a common definition of ‘flood’ to be enacted via a statutory provision lies with consumer protection. The idea of a common definition of flood would have to be designed to avoid confusion for consumers, who would otherwise be unable to understand the exact extent of the insurance policy. Nevertheless, it is submitted that in order to comply with the EU competition regulatory framework, apart from a common definition of flood, insurers should retain the freedom to provide alternative conditions for their flood policies.

For instance, an agreement binding only on specific pre-determined terms related to flood and which were to leave the freedom to provide diverse conditions in relation to other matters would be likely to benefit from an individual exemption. Conversely, agreements which do not confer any degree of freedom to provide alternative conditions will be considered anticompetitive unless beneficial

for consumers. Under such circumstances, individual exemption may be granted to standardisation agreements which result in particularly confusing policy conditions becoming more accessible for consumers.<sup>151</sup>

In order to pass the competition test enshrined in Art 101(3), the introduction of a standard definition of ‘flood’ is permissible only if it will ultimately be beneficial to consumers. In the case of flood insurance, it does appear that the ultimate rationale for the introduction of this common definition is grounded in the consumer-protection related need to avoid having a confusing range of definitions of the same concept. As noted in the above, the Australian Securities and Investments Commission once noted that:

“[t]he terminology in policy documentation can be confusing. The use of technical terms, differing definitions for common words (including the word ‘flood’), and technical meanings for otherwise commonly used words (such as ‘watercourse’) might not be understood by consumers.”<sup>152</sup>

Speaking in the House of Representatives, former Assistant Treasurer and Minister for Financial Services and Superannuation, Bill Shorten stated:

“[a] standard definition of flood will reduce consumer confusion regarding what is and is not included in insurance contracts. It will also avoid situations where neighbouring properties in the same street, affected by the same flood event, receive different claims assessments because the policies covering them use different definitions of flood”.<sup>153</sup>

If accepted, such an assessment ought to suffice for an exemption under Art 101(3) TFEU. If therefore the insurance sector were to agree – without government interference – on a single definition of the concept ‘flood’, it is not unreasonable to expect that an exemption could be permitted under Art 101(3) TFEU. By the same token, a common definition to be introduced by statute should be considered to be compliant with EU competition rules.

### New definition of flood and co-insurance

The current block exemption regime retains the block exemption for pools that cover ‘new risks’ and for other pools subject to certain market share thresholds.

In line with the previous regime, pools covering new risks are exempted for a period of three years, regardless of the participants’ market share<sup>154</sup>. The risk must be genuinely new or, exceptionally, can also be a risk the nature of which, on the basis of an objective analysis, has changed so materially that

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<sup>151</sup> After the decentralization process of the enforcement of the EC competition rules introduced by Regulation 1/2003 on the implementation of the rules on competition laid down in Articles 81 and 82 of the Treaty (OJ 2003 L 1/1), the Commission is no longer the only body entitled to grant individual exemption. National competition authorities and national courts are also currently involved in checking the validity of co-operation agreements *vis-à-vis* Art. 101(3) of the Treaty. The burden of proof is high and lies on the applicants.

<sup>152</sup> ASIC, *Report 7: Consumer understanding of flood insurance*, June 2000, 9, available at <[http://www.asic.gov.au/asic/pdfib.nsf/LookupByFileName/floodreport.pdf/\\$file/floodreport.pdf](http://www.asic.gov.au/asic/pdfib.nsf/LookupByFileName/floodreport.pdf/$file/floodreport.pdf)> (accessed on 21 March 2013).

<sup>153</sup> The Hon Bill Shorten, MP, Assistant Treasurer and Minister for Financial Services and Superannuation, House of Representatives Hansard, 23 November 2011, 23.

<sup>154</sup> *Ibid.*, Art. 6 (1).

it is not possible to know in advance what subscription capacity is necessary in order to cover such a risk.<sup>155</sup> The concept of risk changed on the basis of objective criteria is new and will have to be further elaborated. Nevertheless, this new concept may represent an important tool for the Commission in order to assess the effective necessity of the coverage of specific risks through pools. This begs the question whether the introduction of a new common definition of ‘flood’ would mean that flood insurance could be categorised as ‘new risk’ within the meaning of Regulation 267/2010. The answer to that question is important, as a pooling arrangement offering the co-insurance or co-reinsurance of new risks can be exempted for a limited period of time without a market share threshold,<sup>156</sup> which in turn could enable large insurers to provide joint coverage of floods without being concerned by their market share/size.

Under Regulation 267/2010, risks which did not previously exist should be considered as new risks<sup>157</sup>. Clearly, this is not the case with flood insurance which has been in existence for a very long time. However, in exceptional circumstances, a risk may be considered as a new risk where an objective analysis indicates that the nature of the risk has changed so materially that it is not possible to know in advance what subscription capacity is necessary in order to cover such a risk. If, in light of the more and more frequent flood episodes in recent times affecting the UK, the insurance industry is capable of providing evidence of difficulties in foreseeing subscription capacity for flood insurance, the definition of ‘new risk’ under Regulation 67/2010 might be fulfilled. Such a claim could be enhanced by the introduction of a new definition of ‘flood’ as a cathartic element indicating an evolutionary stage of flood insurance.

### **Joint co-operation in the absence of a ‘new risk’**

If the new definition of flood insurance will not be interpreted as giving rise to a ‘new risk’, joint co-operation might still be possible, but only if specific conditions are met. If under the previous regime market share thresholds were considered in relation to the turnover of the pool, under Regulation 267/2010, the possibility of benefiting from exemption in terms of joint coverage of flood insurance will depend on the turnover of all participating companies on the relevant market, regardless of the fact that the turnover is achieved inside or outside the pool<sup>158</sup>. This narrows down the scope of application of the exemption considerably. The new scenario would be particularly delicate for larger insurers providing flood insurance, because uncertainty inevitably arises in relation to the calculation of market shares for all undertakings participating in the pool.

Under Regulation 67/2010, consumers can benefit effectively from pools only if there is sufficient competition in the relevant markets in which the pools operate. The condition of ‘sufficient’ competition should be regarded as being met when the market share of a pool remains below a given

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<sup>155</sup> *Ibid.*, Art. 1(6) b.

<sup>156</sup> *Ibid.*

<sup>157</sup> *Ibid.*

<sup>158</sup> *Ibid.*, Art. 6 (3) c.

threshold<sup>159</sup> and therefore can be presumed to be subject to actual or potential competition from undertakings which are not participating in that pool.

For the first time, *ad hoc* co-insurance and co-reinsurance agreements will fall outside the application of the block exemption<sup>160</sup>. *Ad-hoc* co-reinsurance agreements on the subscription market, are defined by the Regulation as agreements whereby a certain part of a given risk is covered by a lead insurer and the remaining part of this risk is covered by follow insurers who are then invited to cover that remainder in order either to a) reinsurance mutually all or part of their liabilities in respect of a specified risk category; or b) incidentally accept, in the name and on behalf of all the participants, the reinsurance of the same category of risks.<sup>161</sup> This means that insurance undertakings participating in ad hoc agreements will be fully exposed to the EU competition rules. In order to be legally compliant with EU competition rules, *ad hoc* agreements in flood insurance should, under Art 101 (3) TFEU, contribute to improving the production or distribution of goods or to promoting technical or economic progress, while allowing consumers a fair share of the resulting benefits, whilst not imposing restrictions which are not indispensable to the attainment of these objectives.

*Ad hoc* agreements on joint coverage of flood insurance will need to provide for pro-competitive benefits capable of outweighing their anti-competitive effects. The balancing of anti-competitive and pro-competitive effects is conducted exclusively within the framework laid down by Article 101(3) TFEU, and focuses on four conditions: a) efficiency gains; b) fair share for consumers; b) indispensability of the restrictions; b) no elimination of competition. These conditions are cumulative.

The mere indispensability of *ad hoc* agreements on flood insurance will not suffice as a constitutive element for an exemption. It will be necessary to establish the creation of efficiency gains to be shared by consumers and to prove the retention of a certain degree of market competitiveness. The existence of *ad hoc* agreements on flood insurance could be justified in case of diversification of offers, possibility of different choices and elements of price differentiation which could ultimately lead to consumer savings.

To this end, the introduction of a common definition of flood insurance might become an interesting tool available for insurers involved in ad-hoc agreements for flood insurance. The task for insurers to prove efficiency gains for consumers could indeed be alleviated in the presence of a common definition of terms for flood insurance, as it would be easier to prove the existence of elements of price differentiation vis-à-vis a common definition of flood. Nevertheless, the implications of

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<sup>159</sup> Under Art. 6(3) Regulation 67/2010, where the market share is initially not more than 20 % but subsequently rises above that level without exceeding 25 %, the exemption shall continue to apply for a period of two consecutive calendar years following the year in which the 20 % threshold was first exceeded. Where the market share is initially no more than 20 % but subsequently rises above 25 %, the exemption shall continue to apply for a period of one calendar year following the year in which the level of 25 % was first exceeded. Where the market share is initially not more than 25 % but subsequently rises above that level without exceeding 30 %, the exemption shall continue to apply for a period of two consecutive calendar years following the year in which the 25 % threshold was first exceeded. Where the market share is initially not more than 25 % but subsequently rises above 30 %, the exemption shall continue to apply for a period of one calendar year following the year in which the level of 30 % was first exceeded.

<sup>160</sup> *Ibid.*, Art. 1(5)b.

<sup>161</sup> *Ibid.*, Art. 1(4)a, and Art. 1(4)b.

adopting a common definition of flood on insurance pools needs to be further emphasised. Indeed, a scenario seeing insurers capable of providing flood insurance co-operating horizontally in the form of pools on the basis of a statutory or ‘voluntarily’ common definition of flood would give rise to serious competition concerns, as consumers would be effectively deprived of the possibility to choose among insurers.

Consequently, it is crucial that the insurers party to the pools retain the possibility to provide different policy conditions (apart from the definition of flood); that would be the only way to ensure a certain amount of diversification and competition allowing consumers to choose between different policies.

## The Netherlands: compulsory insurance and ‘uninsurable’ risks

The Netherlands scenario equally gives rise to some interesting competition issues. Several elements contribute to the creation of an intricate competition law scenario in the Netherlands flood insurance sector, namely the possible introduction of a common definition of flood, the imposition of a compulsory flood insurance contribution on the population, and allowing pools as the only possibility to insure a risk which would otherwise be considered technically uninsurable.

In terms of a common definition of insurance to be introduced by statute, the observations made in relation to the Australian and UK scenario remain valid and can be fully applied to the Netherlands scenario. If adopted in order to protect consumers, that common definition would indeed comply with EU competition rules and could be tolerated from a competition perspective. The introduction of such a common definition however also needs to be assessed in conjunction with the two other aforementioned elements, namely rendering flood insurance compulsory, and authorising its coverage through insurance pools.

### Compulsory insurance

It is submitted that the introduction of compulsory flood insurance contributions could be consistent with the EU regulatory framework insofar as it is confined to people living in an area at flood risk. An example of compulsory catastrophe insurance arises under French law, where compulsory catastrophe extension of voluntarily subscribed property insurance contracts was introduced by statute,<sup>162</sup> giving rise to doubts in terms of its compatibility with the EU competition regulatory framework. It is worth emphasising that any legislative measure introducing compulsory insurance may have an adverse effect on competition and create a complex competition scenario, especially if, as we shall discover in the following, that measure is accompanied by the introduction of a common definition of flood, and the specific type of insurance concerned is covered by insurance pools. Such concerns have been taken into account by the Italian Competition Law Authority (‘Consob’), which ruled negatively on the proposal to introduce a compulsory catastrophe extension of fire insurance policies in Italy.<sup>163</sup>

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<sup>162</sup> A detailed description of the French measure can be found in M. Faure and T. Hartlief, (Eds), “*Financial compensation for victims of catastrophes: a comparative legal approach*”, Vienna, Springer 2005.,

<sup>163</sup> Decision of the Italian Antitrust Authority (Autorita Garante della Concorrenza e del Mercato) AS 270 of 20 November 2003, Bulletin nr. 47/2003.

It should be emphasised that the scope of EU competition rules is confined only to the conduct of private undertakings and does not affect legislation adopted by Member States.<sup>164</sup> In case of a legislative measure adopted by a Member State, insurance companies may therefore invoke the State compulsion defence, according to which there is no infringement of the competition rules if a certain anti-competitive action is required by mandatory law.<sup>165</sup>

Nevertheless, in such a case the liability may shift to the State, according to consolidated case law of the European Court of Justice.<sup>166</sup> State legislation which requires compulsory insurance may indeed reduce competition in insurance markets and cause distortions similar to the anti-competitive effects that the competition rules are trying to prevent. In practice, in the area of public-private cooperation, it may be difficult to draw the borderline between State action that has adverse effects on the applicability of EU competition rules and State action dictated by industry considerations capable of conflicting with EU Treaty competition provisions. Although a State was not to explicitly legalise a cartel agreement, the public regulator may be inspired by cartel-like considerations of the insurance industry that favour anti-competitive measures.<sup>167</sup> Hence, intricate questions would arise with respect to the liability for potential infringements of the EU competition regulatory framework of a State that were to introduce such measures.

Even assuming that the adoption of a statutory requirement for compulsory flood insurance is consistent with EU competition rules, the extent of such provision would pose further intricate issues. The natural way forward would seem to be to confine the obligation of taking out flood insurance to people living in an area at flood risk, much like with the main form of compulsory insurance in EU, motor insurance, which is compulsory in EU countries only for persons who drive a vehicle. With liability insurance like motor insurance, it is quite a natural regulatory course to make insurance compulsory only where the insured is in fact engaging in behaviour deemed risky, and to make compulsory a form of insurance that will serve to protect innocent third parties from the results of that risky behaviour. However, flood insurance is property insurance and the benefit of the policy is limited to the insured homeowner.

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<sup>164</sup> See R. Van den Bergh and M. Faure, “*Compulsory Insurance of Loss to Property caused by Natural Disasters: Competition or Solidarity?*” *World Competition* 29(1): 25–54, 2006, Kluwer Law International, at p.7.

<sup>165</sup> *Ibid.*

<sup>166</sup> See, *inter alia*, Case 6/60, *Humblet* [1960] ECR 559, p. 569, Case 39/72, *Commission v. Italy* [1973] ECR 101, para. 11. Case 60/75, *Russo* [1976] ECR 45, para. 9. Case 13/68, *Salgoil* [1968] ECR 453, p. 463; Case 33/76, *Rewe* [1976] ECR 1989, para. 6; Case 45/76, *Comet* [1976] ECR 2043, para. 12; Case C-199/82, *San Giorgio* [1983] ECR 3595, paras. 12–18; Case 179/84, Joined Cases C-6/90 and C-9/90, *Francovich* [1991] ECR I-5357, paras. 31–37, *Bozzetti* [1985] ECR 2301, para. 17; Case C-213/89, *Factortame* [1990] ECR I-2433, paras. 18–22. For an overview of the Mechanisms of Enforcement of Member State liability, see . *Enforcing Community Law from Francovich to Köbler: Twelve Years of the State Liability Principle*. Köln: Bundesanzeiger Verlag, 2004, p. 29–30; Hilson, Ch. The Role of Discretion in EC Law on Non-contractual Liability. *Common Market Law Review*. 2005, 42: 677–695; Schermers, H. G.; Waelbroeck, D. F. *Judicial Protection in the European Union*. Sixth edition. Hague: Kluwer Law International, 2001, p. 540–588; Antonioli, L. Community Liability. *Tort Law of the European Community*. Wien: Springer, 2008, p. 213–240; Hix, J. P. Zur Ausservertraglichen Haftung der Gemeinschaft. *Enforcing Community Law from Francovich to Köbler: Twelve Years of the State Liability Principle*. Köln: Bundesanzeiger, 2004, p. 199–223; Lenaerts, K. Interlocking Legal Orders in the European Union and Comparative Law. *International and Comparative Law Quarterly*. 2003, 52: 887–893; Lenaerts, K.; von Nuffel, P. *Constitutional Law of the European Union*. London: Sweet

and Maxwell, 1999, p. 369–384; Tridimas, T. *The General Principles of EU Law*. Second edition. Oxford: Oxford University Press, 2007, p. 477–497; van Gerven, W. The Emergence of the Common European Tort Law: the EU Contribution—One Among Others. *Enforcing Community Law from Francovich to Köbler: Twelve Years of the State Liability Principle*. Köln: Bundesanzeiger Verlag, 2004, p. 229–236.

<sup>167</sup> See R. Van den Bergh and M. Faure, “*Compulsory Insurance of Loss to Property caused by Natural Disasters: Competition or Solidarity?*” *World Competition* 29(1): 25–54, 2006, Kluwer Law International, at p.12.

It has been claimed that, in spite of its anti-competitive effects, a duty to buy insurance coverage for catastrophic loss imposed on low-risk groups (or even on individuals who are not exposed to the risk) may be justified.<sup>168</sup> The rationale for this would be that without such a duty to insure, only high risks may decide to buy insurance coverage for natural disasters and the risk may become uninsurable at realistic prices. From an insurance perspective, a compulsory catastrophe extension involves a cross-subsidisation of high risks by low risks: this avoids adverse selection and may be justified also on grounds of national solidarity.<sup>169</sup>

Under European law, solidarity has been constructed and categorised as a qualified derogation to the applicability of EU competition rules. According to the case-law of European Courts, competition law has been put aside in order to achieve a high level of social protection in the field of health services and pension schemes<sup>170</sup>. Attempts have been made by authors to extend the scope of the solidarity exception so as to include other needs of the modern welfare State, the argument here being that Citizens may expect State assistance whenever they are in serious difficulties<sup>171</sup>. This would include not only medical treatment in case of illness and the payment of an adequate pension, but also financial assistance in case of harm caused by catastrophes; in each of these cases, the aim of ensuring competitiveness among specific markets may collide with the goal of the welfare State to provide assistance to citizens in serious difficulties.<sup>172</sup>

The underlying rationale for the solidarity argument would be the establishment of a framework for public-private cooperation, whereby statutory actions (such as the introduction of compulsory insurance) are integrated by private players (in our case the insurers), with concerns about anticompetitive effects that such a scenario ignites be addressed in a broader social welfare context.<sup>173</sup>

The introduction of a common definition of flood in conjunction with compulsory flood insurance policies creates a rather worrying competition scenario. This is further underlined by allowing pools for the coverage of flood insurance. It has been established in the above that in the past, the Netherlands authorities declared flood risk virtually uninsurable. The only natural alternative to insurability against flood risks would thus appear to be the permissibility of insurance pools.

Be that as it may, the outcome of that picture would be on the verge of any possible competition threshold tolerance; that scenario would indeed entail compelling consumers to buy flood insurance from pools operating on the basis of a common definition of flood. It is submitted that the only possibility to create such a situation without infringing the EU competition regulatory framework would be by ensuring at the very least a minimum level of competition.

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<sup>168</sup> See R. Van den Bergh and M. Faure, “Compulsory Insurance of Loss to Property caused by Natural Disasters: Competition or Solidarity?” *World Competition* 29(1): 25-54, 2006, Kluwer Law International, at p.12. The considerations that follows are based on the aforementioned article.

<sup>169</sup> *Ibid.*

<sup>170</sup> See, *inter alia*, Joined Cases C-159/91 and 160/91, *Poucet and Pistre* [1993] ECR I-637. Case C-205/03, *Federacion National de Empresas de Instrumentacion Cientifica Medica Tecnica y Dental (FENIN) v. Commission of the European Communities* [2006] ECR I-6295; Case T-289/03, *British United Provident Association Ltd (BUPA) and Others v. Commission* [2008] ECR II-81.

<sup>171</sup> See R. Van den Bergh and M. Faure, “Compulsory Insurance of Loss to Property caused by Natural Disasters: Competition or Solidarity?” *World Competition* 29(1): 25-54, 2006, Kluwer Law International, at p.18.

<sup>172</sup> *Ibid.*

<sup>173</sup> *Ibid.*

From that perspective, the possibility for insurers belonging to the pool to provide a diversification of policy conditions and insurance premiums appears to be crucial, and the only way possible to avoid the censure of the EU competition rules.

Damaged church-steeple taken down for safety after February 2011 earthquake at Christchurch, New Zealand



# Case study 3: New Zealand

New Zealand is a seismic zone and there has long been a scheme in place to deal with large loss events. This chapter sets out by describing that scheme. In September 2010 and February 2011, homeowners in Canterbury were affected by the two largest earthquakes the region had ever suffered. Many properties were damaged in both and particular issues arose when homeowners had not had the chance to repair their properties before the second earthquake.

## Background

The origins of the earthquake insurance scheme can be traced back to the War Damage (WD) Act 1941. It is worth noting that the statute was modelled on an act of an equivalent title introduced into the law of England and Wales in the same year.<sup>174</sup> The British Act established a WD Commission which administered compulsory insurance for buildings financed by a surcharge on income tax. Revenue collected was placed in the WD Fund and used to replace or repair any property that was damaged by enemy action, predominantly due to bombing. New Zealand decided to adopt a similar solution in view of the threat posed by the Japanese air force. Because of a different tax regime, the basis of the levy charged by the New Zealand WD Commission was the value of the property as stated in the fire insurance policy. Accordingly, while the British scheme was compulsory, the New Zealand mechanism operated mandatorily only where the proprietor insured his property against fire. It followed that, unlike the British programme, which covered the entirety of the assessed property, the arrangement devised in New Zealand extended exclusively to buildings; land and other realty having been excluded.

Since the enactment of the WD Act 1941, the project was oriented toward providing general disaster coverage.<sup>175</sup> “It was decided [...] that any surplus in the fund should be set aside to meet any disaster that might arise, such as an earthquake”.<sup>176</sup> The possibility of refunding the excess to the insured was dismissed.<sup>177</sup> The WD Commission had been established before Japan entered the Second World War on 7 December 1941. The threat of damage caused by bombarding was thus neither existent nor imminent. Bearing that in mind, it is probable that the provision of insurance against earthquake damage was to be the ultimate purpose of the legislation. With the war coming to an end, it became apparent that the fund would never have to be used for the intended purpose. A proposed revision of the WD Act 1941 was designed to widen the scope of the statute so as to include earthquake damage.<sup>178</sup>

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<sup>174</sup> Part I of the British War Damage Act 1941 dealt with compensation in respect of damage to land and other immovable property as a result of enemy action. It did not, though, impose any insurance arrangement. Part II established two insurance schemes in relation to damage to goods. There was a compulsory insurance scheme with regard to some business goods and a voluntary one addressing personal chattels and business goods not elsewhere included.

<sup>175</sup> Parr A, “Earthquake Insurance and Earthquake Reconstruction: The New Zealand Case”.

<sup>176</sup> Walter Nash, House of Representatives’ Debates, 7 October 1941.

<sup>177</sup> David Wilson, Leader of Council, Legislative Council Debates, 9 October 1941.

<sup>178</sup> It is thought that the 1942 Wairarapa earthquakes, which affected heavily Masterton, a town located in close proximity to Wellington, played a vital role in inducing the desire to create a scheme of governmental insurance against the risk of earthquake damage. Experience of the 1931 Napier earthquake showed the need for such a scheme to be in place. For the history of earthquakes in New Zealand, see <<http://www.teara.govt.nz/en/historic-earthquakes>>.

Consequently, the Earthquake and War Damage (EQWD) Act 1944 was enacted. It repealed the former statute together with the accompanying amendment.<sup>179</sup> It further established the EQWD Commission, chaired by the Minister of Finance, responsible for administering the EQWD Fund.<sup>180</sup> Revenue generated under the WD Act 1941 was incorporated into the fund and applied in the same way, though levy rate was reduced by 80%.<sup>181</sup>

Subsequently, section 4 of the Finance Act (No 2) 1948 broadened the coverage offered by the EQWD Act 1944 to include flood and storm damage “of abnormal and unforeseen nature and of extraordinary and widespread effect”. One-tenth of the premium levy from the EQWD Fund was diverted into a newly established Disaster Fund. Thereafter, coverage was extended to include landslip, volcanic eruption and hydrothermal activity. Tsunami and fire damage was also covered if occasioned by any disaster mentioned above.<sup>182</sup> Crucial revision of the scheme took place in 1993 when the presently operating regime was introduced.

## The current regime

Both the Earthquake Commission (EQC) Act 1993 and the accompanying Earthquake Commission (EQC) Regulations 1993,<sup>183</sup> as subsequently amended,<sup>184</sup> constitute the current regime of compulsory insurance against natural disasters in New Zealand. It does not impose upon the assured and the EQC a contractual relationship. Therefore, any liability of the EQC does not arise under a contract of insurance.<sup>185</sup> Moreover, the EQC is not a member of the voluntary Insurance and Savings Ombudsman which provides a platform for resolving any dispute between a consumer and an insurer.<sup>186</sup> Conditions of the insurance provided by the EQC can be found in Schedule 3 to the EQC Act 1993.<sup>187</sup>

### Part 1 of the EQC Act 1993

Part 1 of the EQC Act 1993 had established the EQC which replaced the EQWD Commission, previously responsible for administering the scheme of insurance under the EQWD Act 1944.<sup>188</sup> It is a

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<sup>179</sup> See section 27(1) of the EQWD Act 1944.

<sup>180</sup> See sections 2(1) and 4(2)(a) of the EQWD Act 1944.

<sup>181</sup> See sections 11(1) and 14 of the EQWD Act 1944.

<sup>182</sup> For a detailed discussion of the coverage extensions made to the EWDA 1944, see O’Riordan T. “The New Zealand Earthquake and War Damage Commission – a Study of a National Natural Hazard Insurance Scheme”, Natural Hazard Research Working Paper No 20, 1971, available at <<http://www.colorado.edu/hazards/publications/wp/wp20.pdf>> (accessed on 12 March 2013).

<sup>183</sup> Such regulations are made from time to time by issuance of an Order in Council by the Governor-General for a purpose specified under section 36 of the EQC Act 1993.

<sup>184</sup> See the EQC Amendment Regulations 2010 and the EQC Amendment Regulations 2011.

<sup>185</sup> See *Earthquake Commission v Disputes Tribunal* (1996) 10 PRNZ 317, where the insured was denied *locus standi* in the Disputes Tribunal because their claim did not arise in contract and was thus outside of the tribunal’s jurisdiction. See also *Coughlan v Earthquake Commission* [2007] NZHC 178, where it was held that the EQC is not covered by the Insurance Law Reform Act 1977 and therefore not barred from imposing a time limit upon a claim under the EQC Act 1993. The EQC Act 1993 itself nevertheless contains numerous references to a contract of insurance in relation to the arrangement therein established.

<sup>186</sup> See <<http://www.iombudsman.org.nz/participants>> (accessed on 13 March 2013). Following the second Christchurch earthquake on 22 February 2011, ISO set up a dedicated telephone service for people affected by the disaster. Currently, there is a special section on ISO’s website devoted to the Canterbury Earthquakes, which provides valuable insurance information, including case studies, for both consumers and businesses affected by the disaster.

<sup>187</sup> See section 27 of the EQC Act 1993.

<sup>188</sup> See section 4 of the EQC Act 1993.

Crown entity,<sup>189</sup> governed by a Board,<sup>190</sup> albeit subject to ministerial discretion enshrined specifically in section 12 of the act.<sup>191</sup> EQC is independent of the insurance market and any other commercial enterprise. The EQC is in charge of administering insurance against natural disaster damage, collecting premiums payable for that insurance, administering the fund and obtaining reinsurance in respect of whole or part of the insurance provided under the EQC Act 1993.<sup>192</sup>

Part 1 of the EQC Act 1993 had also instituted the Natural Disaster (ND) Fund which replaced the EQWD Fund, existing under the former legislation pursuant to section 10 of the EQWD Act 1944.<sup>193</sup> Administration of the fund is governed by section 14 (money payable into the fund) and section 15 (money payable out of the fund). Any deficiency in the ND Fund is to be remedied by the Minister of Finance providing the EQC with such sum out of public money as may be necessary for discharging EQC's liability. Hence, the scheme of insurance is backed by a Crown Guarantee.<sup>194</sup> Interestingly, the EQC is under an obligation to pay to the Crown each year a fee in respect of the standing guarantee. Such a fee is determined periodically by the Minister of Finance.<sup>195</sup>

## Part 2 of the EQC Act 1993

Part 2 of the EQC Act 1993 is the basis of the current insurance scheme. Every person who enters into a contract of fire insurance with a private insurance company in respect of a residential building is 'deemed' to have insured that building against natural disaster damage for the replacement value<sup>196</sup> to the amount specified under the Act, not greater than NZD100,000 per dwelling.<sup>197</sup> Natural disaster is taken to mean an earthquake, natural landslip, volcanic eruption, hydrothermal activity, tsunami or natural disaster fire.<sup>198</sup> Damage is to be construed as meaning any physical loss occurring as the direct result of either a natural disaster or measures taken under proper authority to mitigate the consequences of any natural disaster.<sup>199</sup> Remarkably, 'physical loss or damage' is defined as including any physical loss or damage to the property that is imminent as the direct result of a natural disaster

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<sup>189</sup> See section 4A of the EQC Act 1993.

<sup>190</sup> See section 4B of the EQC Act 1993.

<sup>191</sup> Section 12 of the EQC Act 1993 was subject to a review by Parliament which resulted in the passing of the EQC Amendment Act 1998. See, in particular, Hansard, Earthquake Commission Amendment Bill: Second Reading, Parliamentary Debates, Thursday, October 23, 1997. Subsequently, section 12 was further amended by section 200 of the Crown Entities Act 2004.

<sup>192</sup> See section 5 of the EQC Act 1993. Other functions of the EQC include facilitating research and education about matters related to natural disaster damage, methods of reducing or preventing such damage, and the insurance provided under the act, as well as such other responsibilities as may be conferred on it by any legislation or the relevant minister.

<sup>193</sup> See section 13 of the EQC Act 1993.

<sup>194</sup> Following the second Christchurch Earthquake on 22 February 2011, S&P initially did not alter the EQC's AAA rating precisely due to the availability of the security provided by the Crown pursuant to section 16 of the EQC Act 1993. See T Hunter, "Earthquake Commission retains rating", Business Day, 25 February 2011, available at <<http://www.stuff.co.nz/business/industries/4703609/Earthquake-Commission-retains-rating>> (accessed 26 June 2013). However, the EQC's rating was subsequently downgraded from AAA to AA+ as a necessary reaction to the New Zealand's credit rating cut from AA+ to AA. See NBR staff, "Local government downgrades follow S&P's sovereign rating cut", The National Business Review, 30 September 2011, available at <<http://www.nbr.co.nz/article/local-government-downgrades-follow-sps-new-zealand-sovereign-rating-cut-ne-101772>> (accessed 26 June 2013).

<sup>195</sup> See section 17 of the EQC Act 1993. Currently, the fee is set at NZD 10 million.

<sup>196</sup> For the definition of "replacement value", see section 2(1) of the EQC Act 1993.

<sup>197</sup> See section 18 of the EQC Act 1993. For the definition of a dwelling, see section 2(1) of the EQC Act 1993.

<sup>198</sup> See section 2(1) of the EQC Act 1993.

<sup>199</sup> See section 2(1) of the EQC Act 1993. For a legal analysis of the meaning of "damage" within the EQC Act 1993, see Duncan Webb, partner at Lane Neave Lawyers, "Red Zone Advice" for Lianne Dalziel MP for Christchurch East, 17 April 2012, available at <[http://img.scoop.co.nz/media/pdfs/1204/Lane\\_Neave\\_Legal\\_Opinion.pdf](http://img.scoop.co.nz/media/pdfs/1204/Lane_Neave_Legal_Opinion.pdf)> (accessed on 13 March 2013).

which has occurred.<sup>200</sup> Premium for the cover is currently set at \$0.15 for every \$100 of the relevant amount.<sup>201</sup> An excess of \$200 per dwelling or 1% of the amount payable under the Act, whichever is greater, is to be borne by the assured for all damage occurring within any one 48 hour period in case of a natural disaster other than natural disaster fire.<sup>202</sup>

Where a residential building is held covered under the Act, residential land on which that building is located is also deemed insured against natural disaster damage<sup>203</sup> at no additional premium.<sup>204</sup> An excess of \$500 per dwelling in the residential building which is situated on the land or 10% of the amount payable under the Act, whichever is greater, to the maximum amount of \$5,000 is to be borne by the assured for all damage occurring within a period of 48 consecutive hours.<sup>205</sup>

In addition, every person who enters into a contract of fire insurance with a private insurance company in relation to any personal property is deemed to have insured that property against natural disaster damage to the amount stipulated for under the Act, not greater than \$20,000.<sup>206</sup> Premium for the cover is the same as in the case of residential building insurance.<sup>207</sup> Nonetheless, the rate of excess is flat, currently set at \$200.<sup>208</sup> Therefore, if no fire insurance policy is in place, the scheme established by the EQC Act 1993 will not operate to insure the property concerned unless the EQC is willing to provide such cover upon an application made by a person with an insurable interest in that property.<sup>209</sup>

Pursuant to section 21(1) of the EQC Act 1993, property not insured by the EQC Act 1993 is listed in Schedule 2.<sup>210</sup> The EQC might also decline a claim made under the legislation if the property concerned was not constructed in accordance with standards considered appropriate at the time of erection.<sup>211</sup> It would, however, be necessary for the EQC to prove a causal link between the non-compliance with an established practice and the damage occasioned by the natural disaster in question.<sup>212</sup> Similarly, should the certificate of title for the land comprising the property contain an

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<sup>200</sup>See section 2(1) of the EQC Act 1993.

<sup>201</sup> See Regulation 3(1)(a) of the EC Regulations 1993. Prior to 1 December 2011 the premium for insurance of residential building or personal property stood at \$0.05 per \$100 of insured sum under the act – see Regulation 4(1) of the EQC Amendment Regulations 2011. See also *Regulatory Impact Statement. Increase to the EQC's Levy*, The Treasury, 5 October 2011, available at <<http://www.treasury.govt.nz/publications/informationreleases/ris/pdfs/ris-tsy-eqcl-oct11.pdf>> (accessed 26 June 2013).

<sup>202</sup> See section 1(a) of Schedule 3 to the EQC Act 1993 and Regulation 4(1)(a) of the EQC Regulations 1993. In case of natural disaster fire the period is extended to seven consecutive days – see section 1(b) of Schedule 3 to the EQC Act 1993.

<sup>203</sup> See section 19 of the EQC Act 1993. Insured value of the residential land is to be determined by application of the formula prescribed for under that provision. For the definition of “residential land”, see section 2(1) of the EQC Act 1993. For a broad construction of the definition of “residential land”, see *Earthquake Commission v Winch* [2008] NZHC 1721, where it was held that the right of way access over a neighbour’s property was a part of the land. See also *Auckland City Council v Man’O War Station Ltd* [1996] 3 NZLR 460, where it was held that an easement comes within the definition of “land”.

<sup>204</sup> See Regulation 3(3) of the EQC Regulations 1993.

<sup>205</sup> See section 1(a) of Schedule 3 to the EQC Act 1993 and Regulation 4(1)(b) of the EQC Regulations 1993. Again, in case of natural disaster fire the period is equal to seven consecutive days – see section 1(b) of Schedule 3 to the EQC Act 1993.

<sup>206</sup> See section 20 of the EQC Act 1993. For the definition of “personal property”, see section 2(1) of the EQC Act 1993.

<sup>207</sup> See Regulation 3(1) of the EQC Regulations 1993.

<sup>208</sup> See Regulation 4(1)(c) of the EQC Regulations 1993.

<sup>209</sup> See section 22 of the EQC Act 1993.

<sup>210</sup> Notably, intangible property, motor vehicles, tennis courts, paving and valuables are excluded from the cover.

<sup>211</sup> See section 3(c) of Schedule 3 to the EQC Act 1993.

<sup>212</sup> ibid.

entry indicating that the estate is likely to be subject to a specified natural hazard,<sup>213</sup> the EQC will be in the position to refuse the claim submitted under the Act.<sup>214</sup>

Where a property is also insured against natural disaster damage with a private insurance company, such insurance is to be treated as the primary layer cover unless the policy provides otherwise.<sup>215</sup> It is standard practice to stipulate for the EQC cover to operate as the first layer.<sup>216</sup>

Premium for a cover provided by the Act is to be collected by the company supplying the fire insurance policy to the insured.<sup>217</sup> Subsequently, it is to be transferred to the EQC within two months after the end of the month in which it was collected.<sup>218</sup>

On the occurrence of any natural disaster damage, an insured is required to give notice thereof to the EQC, either in writing or orally, within 30 days.<sup>219</sup> Equally, the assured is obliged to deliver to the EQC as soon as practicable a claim in writing containing a realistic account of the damage sustained by the property insured<sup>220</sup> as well as particulars of all other policies covering that property.<sup>221</sup> Nevertheless, if natural disaster damage is not immediately apparent, or the insured is unable by absence, incapacity or other disability to give notice to the EQC within the required time, the time for giving notice will be extended for up to three months, provided the EQC is not prejudiced by the lapse of time.<sup>222</sup>

### **Part 3 of the EQC Act 1993**

Part 3 of the EQC Act 1993 contains miscellaneous provisions which are technical in nature and thus not essential to the operation of the scheme as such. Notably, it addresses the issue of obtaining any information that may be reasonably necessary by the EQC for the purpose of the act, including entry on the land and inspecting the property concerned.

### **Part 4 of the EQC Act 1993**

Enactment of Part 4 of the EQC Act 1993 constituted a major departure from the previous regime of natural disaster insurance governed by the EQWD Act 1944. In accordance with section 41(7) of the Act, the EQC shall not accept any application for insurance of non-residential property. Hence, commercial property is excluded from the ambit of the EQC Act 1993.<sup>223</sup> David Middleton, former General Manager of the EQC of New Zealand, commented:

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<sup>213</sup> See section 36(2) of the Building Act 1991 and section 74 of the Building Act 2004.

<sup>214</sup> See section 3(d) of Schedule 3 to the EQC Act 1993.

<sup>215</sup> See section 30(2) of the EQC Act 1993.

<sup>216</sup> See *Tower Insurance Ltd v Earthquake Commission* [2011] NZHC 943, [4].

<sup>217</sup> See section 23(1) of the EQC Act 1993.

<sup>218</sup> See section 24(1) of the EQC Act 1993.

<sup>219</sup> See section 7(1)(a) of Schedule 3 to the EQC Act 1993.

<sup>220</sup> See section 7(1)(b)(i) of Schedule 3 to the EQC Act 1993.

<sup>221</sup> See section 7(1)(b)(ii) of Schedule 3 to the EQC Act 1993.

<sup>222</sup> See section 7(2) of Schedule 3 to the EQC Act 1993. See also *Coughlan v Earthquake Commission* [2007] NZAR 532.

<sup>223</sup> Section 41 of the EQC Act 1993 provided for a transitional period for insurance of non-residential property – see sections 41(1) – 41(4). Nonetheless, provision of such insurance ceased after 31 December 1995.

“Continuation of [commercial property insurance] would have necessitated a far more complex form of cover and increased EQC’s liabilities to unmanageable levels. It appears that the insurance industry is needed here in all its choice and variety; commercial property owners can make their own risk management choices, including alternatives like facility duplication and avoidance of risk-prone areas”.<sup>224</sup>

## Aggregation

As mentioned above, the EQC Act 1993 provides that if any person enters into a contract of fire insurance in respect of a residential property in New Zealand, such property is deemed to be insured under the Act for its replacement value up to the amount arrived at by multiplying the number of dwellings in the building by NZD100,000.<sup>225</sup>

Any damage exceeding this amount is covered by private insurers acting as excess insurers.

Following the September 2010 and February 2011 earthquakes, the issue which arose in *Tower Insurance Ltd v Earthquake Commission*<sup>226</sup> was how the Earthquake Commission cover responded to homeowners who made more than one claim for natural disaster damage suffered in more than one earthquake, where such damage exceeded in the aggregate the limit of liability provided under the Act for a residential building.

Thus, where there is more than one event causing natural disaster damage to the same property, and the EQC has not made any payment at the time of the subsequent event, what will the EQC’s liability be for the second event? Will the two earthquakes be regarded as a single event or as two consecutive events? If the first option is true, the limit of NZD100,000 applies only once, and in the second event, it applies twice so that the insured can recover twice from EQC before the excess insurance responds. It is not merely a question of one or two occurrences, but the argument can be expanded to whether the limit applies to all and any damage arising during the currency of the policy, and whether the EQC’s payment for the first loss reinstates the cover and the limit of NZD100,000. In the case of the 2010 and 2011 earthquakes, the EQC accepted that there were two separate events, given that they affected different faults at different depths.<sup>227</sup> There were nearly six months in between the earthquakes and the latter was unlikely to be considered as an aftershock of the first one, in the sense that they did not operate as a series of earthquakes.

Aggregation is an extremely important issue for all insurers, not just the EQC – floods like earthquakes may take place in quick succession; they may also be compounded over the course of a rainy summer as the ground becomes saturated. In such cases, do insurers respond once or twice for damage caused? If there is a cap in the policy, does this cap apply to each individual flood event (however a ‘flood event’ may be defined) or is it a total cap applicable to all floods occurring during the policy year? As floods can be expected to become an increasingly frequent occurrence, insurers

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<sup>224</sup> David Middleton, “The Role of the New Zealand Earthquake Commission” (2001) 16(2) Australian Journal of Emergency Management 57, 60.

<sup>225</sup> Per s 18(1)(c).

<sup>226</sup> *Tower Insurance Ltd v Earthquake Commission* [2011] NZHC 943

<sup>227</sup> Bugra, Aysegul, *Aggregation Clauses and New Zealand Law*, 2013, accessible at <<http://www.ila.com.au/docs/default-source/speaker-papers/insurance-gangnam-style---aysegul-bugra---aggregation-clauses-paper.pdf?sfvrsn=4>> (accessed on 24 June 2013).

become correspondingly less inclined to provide unlimited insurance and will be inclined to define events as a single event, perhaps by means of a very long ‘hours clause’. There is a fair amount of case law deciding whether the losses arising from events taking place in close proximity in time are the result of one event or successive events.<sup>228</sup>

## Reinsurance

The EQC has a comprehensive catastrophe reinsurance programme in place in the form of an excess of loss policy.<sup>229</sup> It is understood that under the current arrangement reinsurance coverage of \$3.25 billion is subject to a \$1.75 billion deductible.<sup>230</sup> Prior to the Christchurch earthquake of 4 September 2010, the EQC was only liable for the first \$1.5 billion of claims, with reinsurance covering the liability between \$1.5 billion and \$4 billion.<sup>231</sup> Reinsurance cover is operative for each “loss occurrence” – a term of aggregation defined as meaning all individual losses arising out of and directly occasioned by one ‘catastrophe’. ‘Catastrophe’ is defined to include any earthquake occurring within 720 consecutive hours (30 days) and a 250-kilometre radius of the original earthquake. Under these arrangements, each Christchurch earthquake constituted a separate and distinct loss occurrence.

While these reinsurance arrangements define a claim by the Commission against its reinsurers arising from any one event, they have no bearing on the claims of individual claimants seeking to recover from the EQC or from their excess insurers, because the reinsurance arrangements are freestanding contracts not subject to the EQC Act 1993.

The EQC incurred a cost of \$40 million for reinsurance in 2010. That figure doubled in 2011 and subsequently increased to \$130 million in 2012. It is estimated that the reinsurance premium will soar to \$160 million in 2013.<sup>232</sup> Additionally, the strategy of using a three-year reinsurance contract, which helped in minimising premium variation year to year, was replaced by a volatile mechanism of agreeing a one-year deal each time.<sup>233</sup>

## Comments

New Zealand provides a model where a government-supported entity supplies direct insurance deeming earthquakes included as an additional risk covered on top of a common risk, fire. The

<sup>228</sup> A “four unities” test was proposed in UK by Michael Kerr QC in Dawson’s Field Arbitration in 1972 to determine whether losses arose from one event or separate events. The test was thereafter recognised by Rix J in *Kuwait Airways Corporation v Kuwait Insurance SAK* [1996] 1 Lloyd’s Rep 664. The factors in determining unity of losses were time, locality, causation and intentions of the human agents. This test had been applied in many judgments later on, the most recent being *AIOI Nissay Dowa Insurance Company Limited v Heraldglen Limited and Advent Capital (No 3) Ltd* [2013] EWHC 154 which involved aggregation issues in a reinsurance contract in respect of whether two hijackings were separate events.

<sup>229</sup> For a thorough analysis of the excess of loss arrangement adopted by the EQC, see Robert Merkin, “The Christchurch Earthquakes. Insurance and Reinsurance Issues”, Canterbury Law Review, forthcoming.

<sup>230</sup> See <<http://www.stuff.co.nz/business/industries/7962539/EQC-reinsurance-cover-gets-a-boost>> (accessed on 4 April 2013).

<sup>231</sup> See *Tower Insurance Ltd v Earthquake Commission* [2011] NZHC 943, [48]. See also EQC, “EQC pay-outs now total over \$500m”, media release, 23 December 2010, available at <<http://www.eqc.govt.nz/news/eqc-pay-outs>> (accessed on 4 April 2013).

<sup>232</sup> See Alan Wood, “Reinsurance fee rises ‘likely past peak’, stuff.co.nz, 14 February 2013, available at <<http://www.stuff.co.nz/the-press/business/8300703/Reinsurance-fee-rises-likely-past-peak>> (accessed on 4 April 2013).

<sup>233</sup> See EQC, “Managing the Natural Disaster Fund”, media release, 26 October 2012, available at <<http://www.eqc.govt.nz/about-eqc/our-role/ndf>> (accessed on 4 April 2013).

relation created has been characterised non-contractual, although it is not dissimilar from an insurance policy. There is very little scope for a private, efficient market to develop alongside such an arrangement but the reinsurance of the fund is achieved on a commercial, market basis.

The creation of the New Zealand EQC Act 1993 was influenced by the British war insurance legislation. Following the North Sea Flood, the UK government rejected a proposal to adopt a solution based upon the WD Act 1941 with respect to flood insurance on the ground that it would impinge upon the realm of private insurance.<sup>234</sup> It must, however, be recognised that the private flood insurance market was in infancy at that time.<sup>235</sup> It would have been unfair to declare the insurance industry ill-equipped to deal with the issue before it had the opportunity to develop a proper response to the problem. It could nevertheless be argued that the WD Act 1941 and the subsequent discussion about adopting similar legislation in the context of flood risk serve to evidence the familiarity of the UK legal system with the concept of compulsory insurance.

Similarly, the establishment of Pool Reinsurance Company Limited (Pool Re) is evidence of the UK legal environment being acquainted with the idea of a pooling arrangement. The Pool Re scheme was set up by the UK government in cooperation with the private market so that the insurance industry might continue to cover losses resulting from damage caused by acts of terrorism to commercial property. On request by a policyholder, an insurer participating in the Pool Re scheme will quote a premium for the inclusion of terrorism cover. If accepted, it will then become part of their commercial property (or other relevant) policy. Alternatively, the insurer may simply include terrorism cover within the standard policy without the need for separate consideration by the insured.<sup>236</sup> Flood Re, the model proposed by the ABI for flood insurance in the UK, is said to have been inspired by the Pool Re scheme.

Following the unprecedented attack on the World Trade Centre in New York City on 11 September 2001, Pool Re was amended as the size and the expected frequency of terrorist activity changed. Establishment of a working group under the Department of Treasury furthered the revision of the scheme. PoolRe moved from the per head of cover, per insured basis to a treaty basis. It was agreed that the model would operate a per event retention, combined with an annual aggregate limit for each insurer, based on the overall terrorism market share of each insurer. Competition was introduced into the terrorism market by allowing insurers to set the premium for the underlying policy according to standard commercial practice.

Interestingly, Pool Re is backed by the UK government. Should the loss suffered as a result of a terrorist act be so large as to exhaust the fund, the UK government will step in to ensure the solvency of the fund. Such a payment will be in the form of a loan which Pool Re would have to repay from its future income. As in the case of the New Zealand EQC, in order to enjoy the benefit of the government backing, the pool must pay an annual premium to the government. It is submitted that nothing in principle prevents this type of mechanism from functioning in the context of a flood insurance pool.

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<sup>234</sup> See HC Deb 23 November 1954, vol 533, cols 1030-1031.

<sup>235</sup> See above.

<sup>236</sup> For detailed information regarding the operation of the scheme, see <<https://www.poolre.co.uk/>> (accessed 26 June 2013).

# Case study 4: Iceland

## The structure and set-up of the fund

Iceland is an example of a country with a similar model for catastrophe insurance to that adopted in New Zealand. Unlike the cover provided by the NZ Earthquake Commission, the Icelandic compulsory catastrophe policy does provide for insurance against the risk of flood.

Compulsory catastrophe insurance is provided by Iceland Catastrophe Insurance (ICI),<sup>237</sup> a State-owned corporation established under the Iceland Catastrophe Insurance Act 1975. Five people sit on the corporation's Board of Directors: three are elected by the Althing (Icelandic national parliament), one is nominated, in practice, by the insurance industry (theoretically, only those insurance companies responsible for collecting premiums can participate in the nomination process), and one is selected by the Minister of Business Affairs to act in the capacity of chairman.<sup>238</sup> Each member of the board is appointed for a term of four years.<sup>239</sup> Should Iceland decide to join the European Union,<sup>240</sup> ICI will be listed under Article 8 of Directive 2009/138/EC<sup>241</sup> (Solvency II), alongside *inter alia* the Consorcio de Compensación de Seguros<sup>242</sup> as an institution exempted from the application of the instrument.<sup>243</sup>

Every person who enters into a contract of insurance covering fire risk (e.g. an all risks policy) with a private insurance company in respect of a household is also deemed to have insured that building with ICI against natural disaster damage.<sup>244</sup> Such a building will be insured up to the amount determined for the purpose of valuation under the fire policy as assessed by the State Land Registry.<sup>245</sup> Since it is a legal requirement for each property owner to have a valid fire policy in place, the rate of penetration of the compulsory catastrophe insurance stands at 100%.

Natural disaster damage means direct damage caused by volcanic eruption, earthquake, landslide, avalanche, and/or flood.<sup>246</sup> Consequential or indirect damage is thus excluded from the ambit of the policy issued by ICI. Importantly, 'flood' is defined as meaning

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<sup>237</sup> "ICI" is a term of convenience. "Viðlagatrygging Íslands" is the actual name of the national entity responsible for provision of natural catastrophe insurance.

<sup>238</sup> See Article 2 of the Icelandic Catastrophe Insurance Act (ICIA) 1992 (No 55/1992).

<sup>239</sup> *ibid.*

<sup>240</sup> It is understood that Iceland's newly elected government suspended the negotiation on the accession to the EU amid referendum on joining the community. See <<http://www.bbc.co.uk/news/world-europe-22624110>> (accessed 2 June 2013).

<sup>241</sup> See Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance.

<sup>242</sup> Consorcio de Compensación de Seguros is a Spanish Insurance Compensation Consortium subordinated to the Ministry of Economy and Competitiveness through the Directorate General of Insurance and Pension Funds. It is, however, subject to private legal regulation, including the Law of Ordination and Supervision of Private Insurance and the Insurance Contract Law.

<sup>243</sup> See Third Meeting of the Accession Conference with Iceland at Deputy Level, Brussels, 24 October 2012, Press 444 (No 15371/12), available at <[http://www.consilium.europa.eu/uedocs/cms\\_data/docs/pressdata/EN/genaff/133154.pdf](http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/EN/genaff/133154.pdf)> (accessed 2 June 2013).

<sup>244</sup> See Article 5 of the ICIA 1992. Analysis of the regime applicable to insurance of commercial property and infrastructure is beyond the scope of this report. Similarly, every contract of fire insurance with in relation to contents does attract the ICI coverage against disaster damage. See Article 5 of the ICIA 1992.

<sup>245</sup> See Article 9(1) of the ICIA 1992.

<sup>246</sup> See Article 4 of the ICIA 1992.

“a flood which occurs when rivers or creeks abruptly overflow their banks or when waves from seas or lakes run ashore causing damage or destruction of the property insured. An annual or regular flooding from a river, creek, sea or lake is not to be construed as a flood [for the purpose of the ICI policy]. The same applies to usual melt-water or flood caused partly or wholly by man, e.g. when water tanks, dams or other structures break due to conditions other than natural disasters”.<sup>247</sup>

The premium for the cover provided by ICI is currently set at 0.025% of the sum insured.<sup>248</sup> It is to be collected by the private insurance company that supplied the underlying fire policy to the insured. The insurance company is entitled to an agreed rate of commission in exchange for collection of the relevant premium on behalf of ICI.<sup>249</sup> A deductible of 5%, yet not less than ISK 85,000 (GBP 453.05) in relation to residential property<sup>250</sup> and ISK 20,000 (GBP 106.60) with respect to contents insurance<sup>251</sup> for each individual loss is to be borne by the assured.<sup>252</sup>

Liability for compensation with respect to each event is limited to 1% of the total insured capital at the time of the occurrence of the natural disaster.<sup>253</sup> Should the total amount payable in satisfaction of the claims submitted exceed that amount, the monetary value of each claim will be reduced proportionately.<sup>254</sup>

The ICI scheme is backed by a comprehensive reinsurance programme, involving twenty foreign reinsurance entities, in the form of an excess of loss policy. There is no express legal obligation placed upon ICI to obtain reinsurance coverage.<sup>255</sup> It is, however, a sensible business practice to seek such additional protection, especially keeping in mind the enormous economic loss that might be caused by a natural disaster. In 2012, the reinsurance contract worth ISK 30 billion (GBP 160.5 million) was subject to a ISK 10 billion (GBP 53.5 million) deductible. Nevertheless, the reinsurance coverage together with the excess applicable increases annually, reflecting the extent of damage caused by intensified natural hazard.

In the event the fund, including the reinsurance arrangement, is exhausted, ICI may request a loan from the Treasury.<sup>256</sup> However, the grant of such a loan will be subject to an overriding discretion of the relevant Minister.<sup>257</sup>

If a building has been constructed against the law or contrary to established practice, compensation payable by ICI for damage to that property may be denied or reduced in so far as the structure of the building contributed to the damage or destruction occasioned by the natural disaster in question.<sup>258</sup>

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<sup>247</sup> See Article 1(5) of the Regulation on the Iceland Catastrophe Insurance (RICI) 1993 (No 93/1993).

<sup>248</sup> See Article 11(1) of the ICIA 1992.

<sup>249</sup> See Article 11 of the ICIA 1992.

<sup>250</sup> See Article 10(2) of the ICIA 1992.

<sup>251</sup> See Article 10(1) of the ICIA 1992.

<sup>252</sup> See Article 10 of the ICIA 1992.

<sup>253</sup> See Article 18 of the ICIA 1992.

<sup>254</sup> ibid.

<sup>255</sup> See Article 20 of the ICIA 1992.

<sup>256</sup> ibid.

<sup>257</sup> ibid.

<sup>258</sup> See Article 16(2) of the ICIA 1992.

Furthermore, should a building be built in an area known to be susceptible to natural disasters, ICI may also deny or reduce the compensation otherwise accrued under the compulsory catastrophe insurance policy.<sup>259</sup> A previous history of a building sustaining damage as a result of a natural catastrophe will be treated as indicative of the disaster-prone location of the structure.<sup>260</sup>

## Comments

The Icelandic scheme exhibits many features of a prudently constructed system. The relationship between the fund and the State is carefully regulated. Catastrophe insurance is compulsory and is based on 100 per cent insurance penetration, spreading the duty to contribute to the fund as widely as possible. There is careful definition of the risks insured against. Reinsurance is permissible but not mandatory, allowing the managers of the fund to assess what is the best business option.

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<sup>259</sup> See Article 16(1) of the ICIA 1992.

<sup>260</sup> ibid.

# Case study 5: Turkey

## Background

Turkey is located in one of the most active earthquake regions in the world. It is estimated that 92% of the total surface area and 95% of the total population are situated in zones of varying degrees of seismic risk.<sup>261</sup>

Pursuant to Disaster Law No 7296, the Ministry of Public Works and Settlement was required to finance reconstruction of any property damaged in the course of or destroyed by a disaster. Therefore, the government repeatedly assumed the role of the ‘benevolent father’ supporting those who suffered as a result of a natural catastrophe.<sup>262</sup> Significant reliance was placed upon the World Bank’s Emergency Recovery Loan and other emergency funding.<sup>263</sup> Consequently, consumer lacked an incentive to buy insurance and rely on governmental aid instead in the event of damage to or loss of property.<sup>264</sup> It was a classic manifestation of the “Samaritan’s Dilemma”, whereby the provision of support reduced the capacity of the recipient to become more self-reliant.<sup>265</sup>

For instance, following the Erzincan earthquake on 13 March 1992, the World Bank provided the Turkish government with the Erzincan Earthquake Rehabilitation and Reconstruction Loan (EERRL) in the amount of USD 240 million. In response to the devastating flood on 21 May 1998, estimated to have been anywhere between a one in 200 to a one in 1000 year occurrence (depending on location), the World Bank initiated the Turkey Emergency Flood and Earthquake Recovery Project (TEFER) worth USD 369 million. Posterior to the Izmit Earthquake, which occurred on 17 August 1999, the Marmara Earthquake Reconstruction Project (MEER) was originated by the World Bank in the amount of USD 505 million.<sup>266</sup>

## The Turkish solution: structure

In view of the Izmit Earthquake, the Turkish government supported a feasibility study on disaster insurance, which subsequently led to the creation of the Turkish Catastrophe Insurance Pool. Both the enormous loss of life and the severe impact upon the economy caused by the event triggered a long-awaited change. Sadly, the earthquake resulted in over 18,000 casualties, 50,000 injured and approximately 51,000 collapsed or heavily damaged buildings (another 110,000 buildings were

<sup>261</sup> See Baris ME, “Effectiveness of Turkish Disaster Management System and Recommendations” (2009) 23 Biotechnol. & Biotechnol. Eq. 1391, 1391.

<sup>262</sup> See Gurenko E, Lester R, Mahul O, Oguz Gonulal S, *Earthquake Insurance in Turkey. History of the Turkish Catastrophe Insurance Pool* (The World Bank 2006), 8 and 71-72.

<sup>263</sup> ibid., 8.

<sup>264</sup> ibid.

<sup>265</sup> See Buchanan JM, “The Samaritan’s Dilemma” in Phelps ES (ed.), *Altruism, Morality and Economic Theory* (Russell Sage Foundation, New York 1975) pp. 71-85. See also Coate S, “Altruism, the Samaritan’s Dilemma, and Government Transfer Policy” (1995) 85(1) A.E.R. 46 and Ghosh S, Karaivanov A, “Altruism in the Principal-Agent Model: The Samaritan’s Dilemma Revisited”, research paper, available at <<http://home.fau.edu/sghosh/web/images/samsdilemmamar24.pdf>> (accessed on 1 May 2013).

<sup>266</sup> For detailed information regarding the EERRL, the TEFER and the MEER, see “Project Performance Assessment Report”, World Bank, Report No 32676-TR, available at <[http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2005/07/15/000160016\\_20050715144818/Rendered/PDF/326760TR.pdf](http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2005/07/15/000160016_20050715144818/Rendered/PDF/326760TR.pdf)> (accessed on 5 May 2013).

moderately or lightly damaged) displacing more than 600,000 people. It was not unrealistic to estimate the total economic loss caused by the catastrophe at approximately USD 20 billion (roughly 9.5% of GDP in 2000).<sup>267</sup> Consequently, the need to deal with the previously underestimated problem through adoption of an ex-ante risk management policy became apparent, as opposed to the reactive approach including heavy reliance on *ex-post* funding taken thus far.

It was also the inability of the insurance industry to increase catastrophe insurance penetration that convinced the government of the necessity to devise an alternative solution for the management of the risk. Prior to the Izmit Earthquake, the Turkish insurance industry was ill-equipped for underwriting earthquake insurance due to limited capital and insufficient risk management expertise.<sup>268</sup> It was believed that insurers would be either unwilling or unable to meet claims arising out of a large disaster. Before the establishment of the TCIP, Turkey's total accumulated industry earthquake reserves were approximately USD 30 million. By contrast, the annual fire and engineering premium income, a substantial part of which was earthquake related, was USD 140 million.<sup>269</sup>

Leaving catastrophe insurance solely to the private market would result in a business practice involving selective coverage offering. Each owner of a property located in a high-risk area would be exposed to the possibility of being unable to obtain an insurance policy either due to unwillingness to insure on behalf of the insurance company concerned or an exorbitant rate of premium requested in exchange. Bearing in mind the relatively low level of average household income in disaster-prone areas, such an outcome was highly undesirable.

From the very beginning, the Turkish government was of the opinion that leaving catastrophe insurance coverage to consumer choice was simply not a viable solution in a country with extremely low insurance penetration level. Immediately prior to the introduction of the Governmental Decree Law No 587, the earthquake insurance penetration stood at 4.6%, primarily due to catastrophe insurance coverage being offered as an optional endorsement to a fire policy, thus increasing substantially the combined premium rate.<sup>270</sup> In the context of general non-life insurance, even in 2003, four years after the TCIP was established, Turkey had the lowest rate of insurance penetration compared to peer countries in terms of GDP per capita – approximately 1.35% of GDP and USD 47.7 per capita.<sup>271</sup>

Having carried out a consultation with various stakeholders, the Turkish government decided that the TCIP should a) be compulsory for all registered urban dwellings; b) offer basic coverage affordable for most Turkish homeowners; c) be a true risk transfer program; d) have sufficient claims-paying capacity to materially limit the government's fiscal exposure to catastrophe risk; e) be able to build a national catastrophe fund over time capable of paying all but the most catastrophic insured losses; f) encourage mitigation through risk-based premium rates; and g) rely on the

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<sup>267</sup> See OECD, "Large-Scale Disasters. Lessons Learned" (OECD, Paris 2004), 78, available at <<http://www.oecd.org/futures/globalprospects/40867519.pdf>> (accessed on 5 May 2013).

<sup>268</sup> See Gurenko E, Lester R, Mahul O, Oguz Gonul S, *Earthquake Insurance in Turkey. History of the Turkish Catastrophe Insurance Pool* (The World Bank 2006), 12-13.

<sup>269</sup> See Gurenko E et al, 13.

<sup>270</sup> ibid, 31.

<sup>271</sup> ibid, 13.

distribution and claims settlement capabilities of the Turkish private insurance market.<sup>272</sup>

On 27 December 1999, Governmental Decree Law No 587 made earthquake insurance compulsory as of 27 September 2000.<sup>273</sup> The Turkish Catastrophe Insurance Pool was thereby created. In order to reduce adverse selection against the pool (a business practice known as “cherry-picking”), it made the TCIP the sole-source provider of coverage up to an initial limit of \$25,000. Some claim that a distinct disadvantage of the insurance scheme was that it had been established by a mere decree rather than a fully-fledged statute enacted by the Parliament.<sup>274</sup> Nonetheless, on 17 August 2012, Catastrophe Insurance Law No 6305 superseded the Governmental Decree Law No 587.<sup>275</sup>

The TCIP was thus made the sole provider of Compulsory Earthquake Insurance.<sup>276</sup> Since the inception of the scheme, the maximum insurable amount per dwelling has more than tripled. Currently, it stands at TRY 150,000 (GBP 53,537.70),<sup>277</sup> which is almost the same as that specified under New Zealand’s Earthquake Commission Act 1993. The sum insured is calculated by multiplying the square metre of the dwelling by the square-metre value indicated in the Tariff and Instruction of Compulsory Earthquake Insurance published annually by the Undersecretariat of the Treasury.<sup>278</sup>

Instead of a flat rate of premium for the cover provided, the TCIP has adopted a differential risk-based pricing. Currently, the premium payable for the Compulsory Earthquake Insurance varies from 0.44% to 5.50%, depending on the type of construction of the building concerned<sup>279</sup> and the earthquake zone in which it is located.<sup>280</sup> Nonetheless, the minimum amount of the premium payable is set at TRY 25 (GBP 8.99),<sup>281</sup> while the maximum premium payable (in case of a dwelling other than a masonry building, or a building with steel or concrete load bearing framework, located in earthquake zone 1) cannot be more than TRY 8,250 (GBP 2,938.76). Undoubtedly, a distinct advantage of such an approach to establishing the relevant premium is that consumers in all seismic zones are encouraged to purchase the cover supplied by the TCIP. At the same time, the rate of premium in the high-risk zone is kept at an affordable level due to a degree of cross-subsidisation. This is extremely important in a country where the vast majority of urban properties at risk belong

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<sup>272</sup> ibid, 21.

<sup>273</sup> See Article 9 of the Governmental Decree Law No 587. On 27 March 2001, the government’s obligation to finance post-disaster reconstruction of dwellings covered by the decree law ceased.

<sup>274</sup> See Gurenko E, Lester R, Mahul O, Oguz Gonulal S, *Earthquake Insurance in Turkey. History of the Turkish Catastrophe Insurance Pool* (The World Bank 2006), 24.

<sup>275</sup> For the English text of the legislation, see TCIP’s website, available at <<http://www.tcip.gov.tr/mevzuat-587Sayili-kanun.html>> (accessed on 5 May 2013).

<sup>276</sup> See Article 7(1) of the Catastrophe Insurance Law No 6305. “Compulsory Earthquake Insurance” was defined as meaning compulsory insurance offering coverage for material damage to any building covered by the legislation caused directly by an earthquake as well as material damage due to fire, explosion, tsunami, and/or landslide caused by an earthquake – see Article 2(1)(g) of the Catastrophe Insurance Law No 6305. See also General Terms and Conditions, published on 13 May 2011 in the Official Gazette (Issue No 27933), available at <<http://www.tcip.gov.tr/mevzuat-genel-sartlar.html>> (accessed on 19 May 2013).

<sup>277</sup> See Article 3 of the Tariff and Instruction of Compulsory Earthquake Insurance, published on 29 December 2012 in the Official Gazette (Issue No 28512), available at <<http://www.tcip.gov.tr/mevzuat-tarife.html>> (accessed on 18 May 2013).

<sup>278</sup> See Article 4(1) of the Tariff and Instruction of Compulsory Earthquake Insurance.

<sup>279</sup> For the definition of each building style, see Article 2(7) of the Tariff and Instruction of Compulsory Earthquake Insurance.

<sup>280</sup> See Article 2(1) of the Tariff and Instruction of Compulsory Earthquake Insurance.

<sup>281</sup> ibid.

to homeowners with low household income.<sup>282</sup> Consequently, the TCIP is based on a notion of solidarity between residents of low risk seismic zones and those in high risk seismic zones whereby cover is compulsory for everyone and premiums can be kept affordable.

Every dwelling built in or after 2007 is eligible for a 10% discount over the tariff price quoted for the Compulsory Earthquake Insurance.<sup>283</sup> Prior to 28 February 2014, an additional 20% reduction in premium payable can be obtained if the TCIP policy is renewed within 30 days from the expiry date.<sup>284</sup> Thereafter, a 10% discount will apply on the first renewal made within such a time frame, with each subsequent commencement attracting a 20% reduction in the tariff price due.<sup>285</sup>

In order to avoid “penny claims” a 2% deductible to the sum insured is applicable on each loss occurrence. Earthquakes occurring within 72 consecutive hours are treated as a single loss occurrence for that purpose.<sup>286</sup> It is not altogether clear whether an aftershock is an earthquake within the meaning of the TCIP policy.<sup>287</sup>

Earthquake insurance offered by the TCIP is sold as a stand-alone product. Interestingly, the idea of combining natural catastrophe cover with a fire insurance policy, adopted notably in New Zealand, was rejected by the Turkish government. It was thought that selling them as a package would make catastrophe coverage subject to considerably higher affordability constraints. By offering the former separately from comprehensive household insurance, the growth of catastrophe insurance coverage in Turkey is not limited by the general growth of property insurance penetration.

Only urban dwellings registered in the land registry subject to private ownership are covered by the legislation. Consequently, buildings belonging to public establishments and households located within village settlements are excluded from the ambit of the Catastrophe Insurance Law No 6305.<sup>288</sup> It was thought that it would be unreasonable to extend the scope of coverage to rural areas, as the average household income was extremely low there. In addition, inspections on buildings located outside towns are rare.

## Enforcement

Notwithstanding the fact that earthquake insurance issued under the decree was made compulsory for every owner of property covered by the legislation, the lack of any meaningful statutory enforcement mechanism constituted a major obstacle to the uniform implementation of the scheme. Even though those who did not hold a valid Compulsory Earthquake Insurance were not entitled to claim compensation from the State under any disaster legislation,<sup>289</sup> nothing in the decree

<sup>282</sup> In 2012, Turkey’s GDP per capita (purchasing power parity) was estimated to be USD 15,000. By contrast, at the same time, the UK’s GDP per capita (PPP) was roughly USD 36,700. See <<https://www.cia.gov/>> (accessed on 20 May 2013).

<sup>283</sup> See Article 2(2) of the Tariff and Instruction of Compulsory Earthquake Insurance.

<sup>284</sup> See Article 2(3) of the Tariff and Instruction of Compulsory Earthquake Insurance.

<sup>285</sup> See Article 2(4) of the Tariff and Instruction of Compulsory Earthquake Insurance.

<sup>286</sup> See Article 5(1) of the Tariff and Instruction of Compulsory Earthquake Insurance.

<sup>287</sup> Whether an aftershock can be treated as part of the same event as the primary earthquake is a different matter. For a discussion concerning multiple events, see R Merkin, “The Christchurch Earthquakes. Insurance and Reinsurance Issues” (forthcoming).

<sup>288</sup> See Article 10(1) and Article 10(2) of the Catastrophe Insurance Law No 6305. Similar exclusion was contained in Article 2 of the Governmental Decree Law No 587.

<sup>289</sup> See Article 11 of the Governmental Decree Law No 587.

law precluded such people from obtaining insurance coverage against natural disaster damage with a private insurance company.<sup>290</sup>

Theoretically, each local authority was obligated not to carry any procedure related to a building subject to the Compulsory Earthquake Insurance unless it was thoroughly documented that such a cover had been taken out by the consumer and the related premium had duly been paid.<sup>291</sup> Therefore, homeowners were required to present a valid Compulsory Earthquake Insurance policy if they wished to register their property or complete any real estate transaction. Such a requirement was retained in the Catastrophe Insurance Law No 6305.<sup>292</sup>

Additionally, each company providing water and electricity is now obligated to check that there is a Compulsory Earthquake Insurance policy before opening an account for the supply of services to a customer (commencing the performance of a connection contract) and prior to effecting a subscriber change transaction (concluding a retail sale contract).<sup>293</sup> Moreover, a bank is under an obligation to procure a Compulsory Earthquake Insurance on behalf of the consumer concerned if such is not in place at the time of concluding a mortgage agreement for the property in question.<sup>294</sup> Similarly, should the housing credit be still operative at the expiry date of the TCIP policy under consideration, the bank is bound to renew the insurance arrangement for the benefit of the customer.<sup>295</sup>

Despite the existence of the enforcement mechanisms described above, there is still no legal penalty or fine imposed upon the consumer in case of a failure to obtain a Compulsory Earthquake Insurance. It is thus believed that the effect of introducing sophisticated statutory implementation measures will be limited.

## Nature of the TCIP

Although throughout the legislation the TCIP is referred to as a public legal entity associated with the Treasury, it has been clear from the inception of the scheme that it is *de facto* a PPP (public-private partnership).<sup>296</sup> Although the government is represented on the Board of Directors of the TCIP,<sup>297</sup> it does not formally own the pool. Each of the following institutions should nominate a representative, at the Assistant General Manager level or higher, of suitable

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<sup>290</sup> Currently, in order to obtain a voluntary insurance cover against earthquake damage one must procure the Compulsory Earthquake Insurance in the first place. See below.

<sup>291</sup> See Article 12 of the Governmental Decree Law No 587.

<sup>292</sup> See Article 11(2) of the Catastrophe Insurance Law No 6305.

<sup>293</sup> See Article 11(3) of the Catastrophe Insurance Law No 6305. See also the Code of Practice Relating to Requiring Compulsory Earthquake Insurance in Electricity and Water Subscription (Connection Contract) and Subscriber Change (Retail Sales Contract) Transactions, available at <<http://www.tcip.gov.tr/zorunlu-deprem-sigortasi-elektrik.html>> (accessed on 14 May 2013).

<sup>294</sup> See Article 7(2) of the Tariff and Instruction of Compulsory Earthquake Insurance.

<sup>295</sup> ibid.

<sup>296</sup> See Article 3 of the Catastrophe Insurance Law No 6305. See also Article 4 of the Governmental Decree Law No 587.

<sup>297</sup> For the legal framework concerning the operation of the Board of Directors, see generally the Regulation about the Operation Principles and Procedures for the Board of Directors of Turkish Catastrophe Insurance Pool, published 15 December 2012 in the Official Gazette (Issue No 28385), available at <<http://www.tcip.gov.tr/mevzuat-yonetmelik.html>> (accessed on 19 May 2013).

knowledge and experience,<sup>298</sup> to be appointed by the Treasury Minister to the Board of Directors: the Undersecretariat of Treasury,<sup>299</sup> the Ministry of Environment and Urbanisation, the Head Directorate of Disasters and Emergency Management, the Capital Market Board, the Association of the Insurance and Reinsurance Companies of Turkey, the Board of Supreme Education, and the Pool Manager.<sup>300</sup> Moreover, the TCIP is not subject to the legislation concerned with fiscal supervision of public economic enterprises.<sup>301</sup>

Furthermore, both the technical work and the operational management of the TCIP are contracted out by the Undersecretariat of Treasury to an insurance or reinsurance company. Such a company acts in the capacity of the Pool Manager during a term of maximum five years.<sup>302</sup> Initially, Milli Re, the biggest national reinsurance company and a subsidiary of the largest bank in Turkey (IS Bank), was selected for that purpose. Leaving selection of the Pool Manager to international competition was not a viable option, as the government preferred to have some control over the process. Milli Re had always had a government representative on board. According to the agreement concluded in 2005 and renewed in 2010, Eureko Sigorta A.Ş. was contracted to perform the role of Pool Management Company. This engagement of the private sector in the administration of the TCIP is designed to minimise the bureaucratic burdens involved in the scheme.

Insurance industry was entrusted with the task of writing the Compulsory Earthquake Insurance for and on account of the TCIP. Every private insurance company with a valid license is authorised to sell earthquake insurance on behalf of the TCIP,<sup>303</sup> provided that it obeys by strict branding rules established by the management of the pool when pursuing such activity. It is paid a commission of either 12.5% or 17.5% of the earthquake insurance premium, depending on whether the policy was sold in or outside the Istanbul Province<sup>304</sup> respectively.<sup>305</sup> It is worth noting that the rate of commission for a TCIP policy sold outside Istanbul was increased in order to encourage such insurance activity in other parts of the country. Some claim that the commission is often not enough to cover the fixed agency cost of issuing a single policy outside Istanbul.<sup>306</sup> It was also made mandatory for each insurance company concerned to notify the coverholder of the necessity to renew the policy one month prior to the expiry.<sup>307</sup> In order to encourage effective and efficient underwriting, an incentive commission can be paid or a success award might be given to a

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<sup>298</sup> See Article 4(2) of the Catastrophe Insurance Law No 6305.

<sup>299</sup> Ordinarily, the representative of the Undersecretariat of Treasury is the chair of the Board of Directors – see Article 4(3) of the Catastrophe Insurance Law No 6305.

<sup>300</sup> See Article 4(1) of the Catastrophe Insurance Law No 6305.

<sup>301</sup> See Article 3(3) of the Catastrophe Insurance Law No 6305.

<sup>302</sup> For the legal framework concerning the operation of the Pool Management Company, see, generally, the Regulation about the Operation Principles and Procedures for the Board of Directors of Turkish Catastrophe Insurance Pool, published 15 December 2012 in the Official Gazette (Issue No 28385), available at <<http://www.tcip.gov.tr/mevzuat-yonetmelik.html>> (accessed on 19 May 2013).

<sup>303</sup> See Article 7(1) of the Tariff and Instruction of Compulsory Earthquake Insurance.

<sup>304</sup> According to the Turkish Statistical Institute, the Istanbul Province has an area of 5,313 km<sup>2</sup> and a population of 13,854,740. See <<http://www.turkstat.gov.tr/>> (accessed on 20 May 2013).

<sup>305</sup> See Article 8(1) of the Tariff and Instruction of Compulsory Earthquake Insurance.

<sup>306</sup> See Gurenko E, Lester R, Mahul O, Oguz Gonulal S, *Earthquake Insurance in Turkey. History of the Turkish Catastrophe Insurance Pool* (The World Bank 2006), 78.

<sup>307</sup> See Article 9 of the Governmental Decree Law No 587.

prosperous insurance company and/or agency within the procedure established by the TCIP's Board of Directors.<sup>308</sup>

Even though the insurance industry does not assume any risk under the TCIP, it is at the heart of the success of the program. Selling the Compulsory Earthquake Insurance on behalf of the pool, it can directly influence the volume of the sale and the perception of the program in the eyes of the public.<sup>309</sup>

Should the value of the property concerned be higher than the maximum insurable amount under the Catastrophe Insurance Law No 6305, a voluntary insurance can be provided by a private insurance company on top of the cover furnished by the TCIP.<sup>310</sup> Therefore, the TCIP policy should be treated as the first layer of cover. It is the responsibility of the private insurance company to ensure that the Compulsory Earthquake Insurance has been effected.

Originally, an obligation was imposed upon the TCIP to ensure the solvency of the fund at a level sufficient in accordance with sound insurance business practice. Should, however, the fund be exhausted due to the insured loss exceeding the expected level, each claim was to be proportionately downscaled.<sup>311</sup>

## Operation of the scheme

Since it was set up, the TCIP has paid out approximately TRY 145 million (GBP 51,984,240) in satisfaction of claims submitted. Premium income from 2000 to 2012, inclusive, totalled around TRY 2.74 billion (GBP 980.5 million). In September 2012, the total sum insured by the TCIP equalled TRY 280.98 billion (GBP 100.41 billion).

Lack of awareness about the existence and working of the pool among the public proved to be the main obstacle to uniform implementation of the original legislation. Indeed, a significant segment of the population had no idea whatsoever of the availability of insurance. Lack of risk awareness was yet another problem. Although 96% of Turkey lies in an active earthquake zone, most people have never considered whether their houses would withstand an earthquake. As a result, while the danger and cost brought about by seismic activity finally received governmental recognition, potential damage remained greatly underestimated by the citizens. It must be emphasised at this point that making natural catastrophe insurance compulsory is not the most appropriate course of action where low demand for such cover is caused by lack of general information. If consumers do not purchase insurance because they lack awareness about the probability and magnitude of the risk, information remedies are the appropriate answer to cure these deficiencies.<sup>312</sup> Notwithstanding the endeavour to raise public awareness of the program and the risk associated with natural disasters, these two issues still constitute major impediments to a widespread success of the TCIP.

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<sup>308</sup> See Article 8(3) of the Tariff and Instruction of Compulsory Earthquake Insurance.

<sup>309</sup> See Gurenko E, Lester R, Mahul O, Oguz Gonulal S, *Earthquake Insurance in Turkey. History of the Turkish Catastrophe Insurance Pool* (The World Bank 2006), 54.

<sup>310</sup> See Article 9(1) of the Tariff and Instruction of Compulsory Earthquake Insurance.

<sup>311</sup> See Article 17 of the Governmental Decree Law No 587.

<sup>312</sup> See, in particular, A Schwartz and L Wilde, "Intervening in markets on the basis of imperfect information: a legal and economic analysis" (1979) 127 (3) University of Pennsylvania Law Review, 630–682.

Those who were aware of the program and the risk either thought that they could not trust it or were subject to a popular misconception about the ultimate cost and the potential benefit to be derived from the product offered by the TCIP. It was mainly viewed as a tax levied by the government to finance post-disaster reconstruction of urban dwellings. People lacked confidence in the project because they thought that the government could at any time draw on the funds collected by way of premiums. Moreover, a significant portion of the population did not understand the working of the TCIP and believed that it would be too difficult to file a claim and collect payment.<sup>313</sup> Unfortunately, the uncertainty among the public with regard to the nature and working of the TCIP has since remained high.

Furthermore, those who actually participated in the pool did not often appreciate the need to renew their TCIP policy on an annual basis. Regrettably, despite a considerable marketing effort, attracting public attention to the TCIP remains a major challenge for the government. Currently, approximately 70% of TCIP policyholders do not renew their covers upon expiry. Unsurprisingly, the government claims that this is the fault of the insurance companies concerned, for failing to dispatch renewal notices in time. On the other hand, the insurance industry blames the government for insufficient marketing of the program.

According to the official governmental data, in 2010 the TCIP covered 23% of properties countrywide. Shockingly, following the tragic Van earthquake on 23 October 2011, it was revealed that only 7% of households in that region<sup>314</sup> had a TCIP insurance policy in place.<sup>315</sup> Therefore, ensuring uniform implementation of the regime across Turkey is still a major challenge. There is, however, a sign of improvement with respect to the level of penetration achieved by the TCIP. By the end of 2012, the penetration rate stood at 24.8%. Currently, 32% of eligible properties are insured against earthquake damage with the TCIP.<sup>316</sup>

## Comments

The lack of penetration of insurance in the Turkish market is a key factor. The decision to create a single risk pool for earthquakes and to seek to develop that form of insurance was influenced by the low levels of penetration in the general home and property insurance markets. In the UK, such penetration is already good and can probably be further improved if so desired.

The Turkish pool is limited to a single risk, earthquakes, and cross-subsidises insurance for that risk between non-seismic and seismic zones. A scheme based on solidarity between zones at risk and zones not at risk has obvious weaknesses. For the scenario involving UK and floods, it is important to note that the cross-subsidy is likely to be a delicate matter. It may be argued that people have chosen to build and to buy houses on flood plains or in flood risk areas, and that the risk of their

<sup>313</sup> See Gurenko E, Lester R, Mahul O, Oguz Gonulal S, *Earthquake Insurance in Turkey. History of the Turkish Catastrophe Insurance Pool* (The World Bank 2006), 70.

<sup>314</sup> According to the Turkish Statistical Institute, the Van Province has an area of 19,069 km<sup>2</sup> and a population of 1,051,975. See <<http://www.turkstat.gov.tr/>> (accessed on 20 May 2013).

<sup>315</sup> See <<http://www.insuranceinsight.com/insurance-insight/news/2119760/turkish-catastrophe-insurance-pool-covers-homes-earthquake-zone>> (accessed on 17 May 2013).

<sup>316</sup> For statistical data regarding the TCIP policy, see <<http://www.dask.gov.tr/zorunlu-deprem-sigortasi-istatistikler.html>> (accessed on 16 May 2013).

homes becoming worthless should not be subsidised by prudent homeowners. There may be limited understanding of the risk of flash floods, which is not restricted to the immediate flood plains. Arguments that solidarity is a misplaced basis for insurance are likely to meet a more perceptive audience in times of economic hardship.

That said, the UK insurance market is a great deal more comprehensive and efficient than the Turkish market. That makes cross-subsidy a less important concern: the homeowner who is not living on a flood plain may on the other hand be living in a seismic zone or near facilities where a Buncefield Oil Depot event<sup>317</sup> is a potential risk. It ought to be possible to effectively bring across the idea that insurance is not limited to immediately foreseeable risks, but that effective insurance is precisely designed to deal also with the unfathomable and unforeseeable risks of a century event.

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<sup>317</sup> See <<http://www.hse.gov.uk/news/buncefield/community-impact.htm>>, accessed on 15 June 2013.



Flooding in Hasankeyf, Turkey

# Analysis: public intervention in the catastrophe insurance market

## The limits of insurance

There is only a market where there is an opportunity. For insurers to be able to viably offer insurance, there needs to be a chance that at least for some of the insured persons, the loss insured against does not take place at all during the insured period or that only a very small loss is incurred. Floods and other catastrophic events are characterised by widespread losses. As such widespread losses therefore become increasingly likely, for instance with changing weather patterns,<sup>318</sup> insurers must raise their premiums to cover the potential losses. There are a number of ways that insurers can manage such increasing risks.

First, insurers may change policy terms to accommodate the change in the risk. A large excess will absorb much of the catastrophe risk. In reinsurance, the use of ‘hours clauses’ is a common tool. An ‘hours clause’ provides essentially that the claims must have arisen within a brief period of time in order to count as arising from a single event.<sup>319</sup> If the losses are not from a single event but from separate events, they may individually add up to less than the excess so that there is no possibility to claim. The clauses can be used in direct insurance and are usually present in reinsurance policies.

Second, terms may exclude some forms of loss in the same way as nuclear risks are excluded by most policies. Floods may have different causes and an insurer may be willing to insure against some forms of flood but not others. Weather events can be defined for insurance purposes with quite a great amount of precision.

Third, insurers may seek to operate through brokers with local knowledge. Premiums can be imposed per postcode or can be refined so that the house at the top of the hill is offered insurance at a lower premium and the house near the river is offered insurance only at a higher premium.

Fourth and not least, insurers may seek to reinsurance their losses, passing on the losses to a reinsurer whose total risk is spread out across a greater base.

Each of these strategies to limit losses has consequences. An excess will reduce the burden of the insurance carried by the insurer, even in the case of widespread losses, but each individual insured will be ‘self-insured’<sup>320</sup> for possibly their entire loss and the insurance may lose its meaning. For the insured it does not matter if the water in the front room is rain water or comes from the river. The broker with local knowledge will be able to supply insurance at a fair price to the house on the hill, but will not touch the house near the river with a barge pole. The differentiation becomes more refined but the result of that is that some homes become uninsurable at a realistically affordable

<sup>318</sup> A good illustration is the example of a seismic zone, where the tectonic tension will increase over time and a new earthquake will become more and more likely for each earthquake-free year. Although the next earthquake cannot be exactly predicted, as time passes it will become increasingly likely to take place within the next year.

<sup>319</sup> Usually 72 hours but sometimes for a different length of time: see this earthquake endorsement, 168 hours: [http://pacificcoastes.com/assets/DICNA\\_Endorsement\\_200\\_Earthquake\\_Coverage\\_10\\_08.pdf](http://pacificcoastes.com/assets/DICNA_Endorsement_200_Earthquake_Coverage_10_08.pdf) (accessed on 24 June 2013).

<sup>320</sup> A euphemism for uninsured.

premium. Reinsurance is essentially a numbers game and almost any risk can be reinsured – but the terms and price of reinsurance and the possibility to claim are crucial: a reinsurance policy will closely define the excess and the number of events which directly influence the possibility for the direct insurer to claim.

## A unified definition of insurance

It has been discussed in this Report what would happen if the single definition approach were to be adopted in UK. We have assumed, perhaps wrongly but within the confines of this research project necessarily, that there is no appetite for a definition imposed by parliament, government or, say, the Financial Conduct Authority. However, unlike Australia, the UK is subject to EU rule-making and it is therefore critical to estimate what the outcome would be for a solution adopted unilaterally by the market itself, through a market association active in the UK. With the general free-market approach of the UK insurance industry, it is particularly interesting to see what the impact of EU rules on an industry-adopted solution might be.

We have concluded that such a solution would be adopted in the best interests of consumers, and that it is therefore not impermissible under EU rules, but that the industry would have to go through the process of obtaining an individual exception for such a standard definition.

## The moral hazard

There is a range of moral hazard implications arising in relation to flood insurance.

First, there are people who live in existing accommodation which is or has recently become at risk of flooding. The moral hazard implications here are that such insureds may neglect to take technical flood preventive measures such as installing flood doors or flood bricks, tiling the floors for ease of cleaning and generally keeping valuable goods on the top floor instead of the ground floor. This type of moral hazard can be countered by insurers by placing conditions on the insurance. The proposer can be asked to guarantee that a list of specific flood-related precautions will be taken.<sup>321</sup> The insured's moral hazard is mitigated by the fact that they will be inclined to protect the original value of the property: thus an uninsurable property is likely to become unmortgageable and by extension worthless.

A second type of moral hazard occurs in the case of new insurance risks. Construction on flood plains and construction that does not mitigate or perhaps even increases flood risk (eg by paving over absorbent ground and modifying the water table) is in principle just as profitable as construction on flood-safe ground. Insurability may in fact be the only difference between a new home at risk of flooding and one not at any such risk. Creating opportunities to insure where the market forces would not normally allow it will contribute to the saleability of properties constructed on flood plains and enhance the market forces providing the impetus for such construction. Counteracting the moral hazard in this regard thus has a snowballing effect on construction, mortgages and the housing market.

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<sup>321</sup> Following the entry into force of the Consumer Insurance (Disclosure and Representations) Act on 6 April, 2013, such guarantees cannot be made by way of basis clause in a proposal form but must be made individually or in the form of conditions precedent rather than (the more severe type of term) warranties.

## The public/private puzzle

There are a number of models for how to structure the public/private puzzle. Some countries have rejected the market approach entirely and have created catastrophe funds, based no doubt on the thinking that there is no market so efficient as to cover catastrophic risks of the ultimate magnitude. This is a tempting solution where insurance penetration is poor in any case and it is easy to consider it a better option to start afresh with an entirely public fund. Such a fund may be reinsured, as in New Zealand, or not, as is permissible in Iceland. Compulsory insurance and cross-subsidies are common features of such pools. They may cover a range of catastrophic risks as in Iceland or just one risk, as in New Zealand and Turkey.

A mixed market/public approach for direct insurance may be to provide for an excess or a cap, below and above which the private market may take over and provide insurance on commercial terms. In New Zealand, excess insurers may provide cover outside the scope of the cover provided by the catastrophe fund. In Turkey, the insurance market enters the fray in the form of brokers and claims managers, while the insurance is supplied by the catastrophe fund itself.

Some fundamental questions about the differences and relationship between the public and private sectors should be asked where the setting up of a fund is contemplated. This report deals with the legal and regulatory measures that may be employed to guarantee the availability of flood insurance, but it is appropriate also to discuss some of the tensions arising between public governance and private contractual relationships – indeed some of these questions should most certainly be asked in the process of creating the structure and set-up of a fund.

The complexity of funding of catastrophic risks with the involvement of government is enhanced by the fact that public financing and budgeting are governed by rules and good practice formulated by the IMF and the OECD and ultimately dictated by democracy, transparency and sustainability. One fundamental feature is that all income for a given budgetary year should be gathered in a single budget which should be decided by parliament.<sup>322</sup> An extra-budgetary fund for flood insurance would arguably violate this practice. However, there may be valid reasons for setting up a fund if there is a strong link between earmarked taxes and benefits.<sup>323</sup> In the year-end report, contingent liabilities related to flood insurance should be estimated and disclosed.<sup>324</sup>

Furthermore, an annual budgetary decision-making procedure is the antithesis of what is required in the catastrophic loss context, where the aim needs to be the collection and safe-keeping over time of funds to make up for events that rarely happen. Catastrophe relief funding by its nature needs to be collected over time, deposited responsibly and released efficiently upon the incidence of a rare and to a greater or lesser extent unpredictable event.

Not only are government budgetary procedures a poor fit for a catastrophe fund, but in addition, the extraordinary nature of the catastrophe fund means that a fund supported by government is subject

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<sup>322</sup> OECD Best Practices for Budget Transparency (2002), see <http://www.oecd.org/governance/budgeting/Best%20Practices%20Budget%20Transparency%20-%20complete%20with%20cover%20page.pdf> (accessed 24 June 2013).

<sup>323</sup> IMF, Manual on Fiscal Transparency (2007), page 62 para 148-149, especially FN 73, see <http://www.imf.org/external/np/pp/2007/eng/051507m.pdf> (accessed on 24 June 2013).

<sup>324</sup> IMF, Manual on Fiscal Transparency (2007), page 58 para 144; OECD Best Practices for Budget Transparency (2002) para 2.6.

to such forces as the temptation of government to divert the funds for the use for purposes other than disaster relief, which will appear to the uninformed eye to be ‘just sitting there’. It could for instance be difficult to argue against proposals to use idle funds for preventative measures. There is also the risk of a lack of confidence in citizens in the fund and its management. Not least there may be a lack of skill in the funds financial managers, who may deplete the value of the fund through sheer incompetence or lack of guidance on investment of the money. In order to avoid costly management and to reduce risks the fund might be restricted to invest its capital in government bonds and bills. The existence of a fund furthermore provides no guarantee whatsoever that the State will not have to step in in any case and cover some part of the catastrophe damage if it proves too large.

Where catastrophe insurance is compulsory, there is a case for arguing that it is in reality a tax and that as such, it ought to be included in the Treasury budget. The management of the national budget is, as already mentioned, subject to rules prescribed by good practice and ultimately by the needs of democracy. A State fund is subject to particular constraints or advantages that do not normally concern a commercial entity, including an insurer. Thus should the fund as a part of the State have the possibility to issue bills and bonds on its own to meet its duties to indemnify large losses? Should there be an explicit State guarantee for such borrowing? Or should the fund benefit from an unlimited and unconditional authority to draw whatever sums needed from the Treasury to cover such eventualities?

Possible means to avoid the problems associated with a State fund, to avoid potential government interference and to reinforce the faith of the public in the fund, include setting it up as a separate body and feeding it through a non-tax like collection, perhaps engineered by insurers rather than by the State as an additional tax on the insurance premium.<sup>325</sup>

There is also a question as to the ownership of the fund. It may be owned by the State, it may be set up to own itself as an independent body, or it may be owned in some form by the insurance industry. The question of ownership may or may not be related to the nature of the terms of insurance offered: who develops the terms of insurance to be offered by the fund? Whoever is responsible for determining the insurance terms will need clear guidance as to whether insurance is to be provided on purely commercial or contract terms, or if there is to be a social aspect to fees charged and claims management. In other words, does the fund provide social security or insurance in the commercial sense?

A further question, regardless of whether the fund is a part of the State or if it is a private entity, is whether the fund is to act only as a buffer (limited liability) so that the State needs to step in in any case once there is a very large loss event. A related question is as to the size of the fund: is it to be estimated in terms of per cent of the GDP, or is it a question of petty cash in national budgetary terms? Finally, a comparison should be made with measures to guarantee bank deposits (a maximum of €100,000) to the extent that the State acts as the guarantor of last resort for the failings of private industry. The failure of a bank is a distinct situation from the lack of affordable insurance, which is arguably a simple market failure, but the role of the State as guarantor is not dissimilar.

Should flood insurance be made compulsory by proper legislation, a potential criticism would be

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<sup>325</sup> IMF Manual on Fiscal Transparency (2007), Coordination of budgetary and extra-budgetary activities, pages. 59, 61-64.

that it is a *de facto* tax levied by the government in order to finance post-disaster relief for those affected. Some would claim that the government might as a result be tempted to withdraw money from the fund administered by the pool for the purpose of financing part of the public budget deficit or to subsidise other government-supported programmes.<sup>326</sup> Indeed, it could be of particular concern during a slowdown in economic activity or recession, even more so if a natural catastrophe is long overdue. It is thus noteworthy that in 1990 the New Zealand government reallocated NZD 239 million from the EQWD Fund, as it then was, to other uses.<sup>327</sup>

Therefore, it ought to be ensured during the legislative stage that the fund is afforded sufficient protection against any such intervention. Accordingly, the Catastrophe Insurance Law No 6305 in Turkey rather preemptively provides for an exhaustive list of purposes for which the revenue of the TCIP may be used.<sup>328</sup> A similar arrangement can be found in the EQC Act 1993, though the list contained therein is not an exhaustive one.<sup>329</sup> In addition, nothing in principle would prevent the NZ Minister of Finance from exercising the power incorporated in section 17 of the EQC Act 1993 in a manner akin to an outright withdrawal of the money from the ND Fund.<sup>330</sup>

Article 3 of the ICIA 1992 in Iceland should be understood to impose an appropriate standard upon the management of the fund with regard to the transparency of the internal accounting. ICI must publish annually in the Official Gazette a report detailing its financial situation. It is submitted that if the safeguards described above are employed in relation to a scheme of compulsory flood insurance, the fear of government interference with the accumulated fund would be unjustified.

In gross terms, if the fund in reality supplies private insurance and the contractual arrangements and investment regulation are of an entirely private nature, it is a private body that should not be included in public accounts nor be considered a government agency. On the other hand if the fund will be supported by an earmarked tax; be entitled to unlimited support from the State; the investments of the fund are limited to government bonds; and perhaps has a purpose deemed to be in the nature of a social service, it is more akin to a government body and should be included in the national budgeting procedures.

## Policy terms

Finally, a few words should be said about the terms of the insurance policy. In New Zealand, the Court in the case *Earthquake Commission v Disputes Tribunal* (1996) 10 PRNZ 317, denied the insured *locus standi* in the Disputes Tribunal on the basis that the claim did not arise in contract and therefore was outside the tribunal's jurisdiction. It has also been held<sup>331</sup> that the EQC is not covered by the Insurance Law Reform Act 1977 and therefore not barred from imposing a time limit upon a claim under the EQC Act 1993.

<sup>326</sup> See Gurenko E, Lester R, Mahul O, Oguz Gonulal S, *Earthquake Insurance in Turkey. History of the Turkish Catastrophe Insurance Pool* (The World Bank 2006), 69.

<sup>327</sup> DM Jaffee and T Russell, *Catastrophe Insurance, Capital Markets and Uninsurable Risks*, The Wharton Financial Institutions Centre, Working Paper 96-12, available at <<http://fic.wharton.upenn.edu/fic/papers/96/9612.pdf>> (accessed 26 June 2013).

<sup>328</sup> See Article 9(3) of the Catastrophe Insurance Law No 6305.

<sup>329</sup> See section 15 of the EQC Act 1993.

<sup>330</sup> See above.

<sup>331</sup> In *Coughlan v Earthquake Commission* [2007] NZHC 178.

The EQC Act 1993 itself nevertheless contains numerous references to a contract of insurance in relation to the arrangement therein established. Section 30 refers to a contract made “otherwise than under this act”. The analysis for a directly made policy covering earthquakes only, which thus is not made “otherwise than under this act” under s 30 is not so straightforward. A very technical question arises as to the nature of the relationship established between the EQC and the insured when earthquakes are deemed included in the cover for fire policies: is the cover for earthquake damage an implied term in a contract (there is no doubt that the fire policy itself is an insurance contract), or is the earthquake risk bundled or tied in with the fire insurance? The former means that contractual interpretation and remedies apply to the earthquake insurance, and the latter may give rise to competition issues.

In relation to compulsory insurance, a technical contract law issue also arises. Flood insurance taken out by homeowners who do not run any risk whatsoever of flooding is arguably a contract where the insured receives no consideration in return for its premium. Doubts therefore arise in relation to how appropriate it is to compel people not living in areas subject to any flood risk at all to purchase mandatory flood insurance. The argument is moot for most insureds, given that as soon as there is any element of flood risk there can be no failure of consideration on the part of the insurer, even if the insurance is vastly overpriced in relation to the risk – that would simply be a bad bargain but not an invalid contract. However if insurance is made compulsory by law, and there is just one homeowner in the territory whose property is not subject to any form of flood risk whatsoever, there is a failure of consideration.

If the compulsory flood insurance is sold as a stand-alone product, as in the case of the TCIP, a technical contract law issue might arise under English law, should it be treated as a contract of insurance rather than a mere statutory arrangement. For a contract to be valid, it must be supported by consideration.<sup>332</sup> It can be “some right, interest, profit, or benefit accruing to the one party, or some forbearance, detriment, loss, or responsibility, given, suffered, or undertaken by the other”.<sup>333</sup> Although consideration need not be adequate, it must always be sufficient.<sup>334</sup> Arguably, a contract of flood insurance with respect to a property situated in an area not at all susceptible to flooding does not confer any benefit whatsoever upon the insured in return for the premium paid. One might thus sensibly question the enforceability of such an arrangement. It would be legally impossible to compel people not living in areas subject to any flood risk to purchase mandatory flood insurance unless such a contract was to be made expressly enforceable by a statute. Otherwise, failure of consideration would render the agreement void *ab initio*. Needless to say, a provision to that effect would constitute a direct impeachment of the underlying principle of English law, i.e. freedom of contract. Accordingly, in the opinion of the authors, a solution to the problem of availability of flood insurance in the form of a compulsory stand-alone flood product is best avoided.

On the other hand, if the obligatory flood insurance were to be effected as a part of the underlying fire insurance policy, whether implied into, bundled or tied in with it, the arrangement would not be void for want of consideration. This is so precisely because the element of risk related to flood

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<sup>332</sup> See *Currie v Misa* (1875) L.R. 10 Ex. 153.

<sup>333</sup> *ibid.*, 162 (Lush J.).

<sup>334</sup> See *Dunlop v Selfridge* [1915] A.C. 847.

would not constitute a separate contract of insurance. On the contrary, it would be a component of a valid contract under which consideration between the insured and the insurance company was exchanged. Some could still challenge the relationship between the assured and the body responsible for administering the compulsory flood insurance. Recently, a court of law in another common law jurisdiction confirmed such relationship to be merely of statutory character.<sup>335</sup> Consequently, the type of solution adopted in New Zealand and Iceland is to be preferred to that presented by the TCIP. Although such a model would impinge on *laissez-faire*<sup>336</sup> to the same extent as the ‘stand-alone product’ framework, it would not pose a parallel conceptual dilemma of infringing the doctrine of freedom of contract. Since no contract would be imposed upon the insured, he would not be subject to comply with an agreement entered into regardless of consent. Should the assured occupy a property not exposed to the risk of flooding at all, it could be argued that he would suffer from an additional burden placed upon him by the scheme under an existing contract of fire insurance. Still, such an auxiliary obligation might be convincingly justified on the ground of solidarity or social responsibility.

Each argument put forward above is based upon the assumption that there are properties which are genuinely not exposed to even the slightest risk of flooding. The validity of the discourse is also dependent upon the scope of the flood cover which would be provided under either type of the compulsory scheme.<sup>337</sup> If the mandatory scheme of flood insurance were restricted solely to properties located in areas which are susceptible to flooding, the issues outlined above would not be of any concern.<sup>338</sup>

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335 See *Coughlan v Earthquake Commission* [2007] NZHC 178.

336 For the concept of the doctrine, see JS Mill, *Principles of Political Economy* (Appleton and Company, New York 1885), available at <<http://www.gutenberg.org/files/30107/30107-pdf.pdf>> (accessed 26 June 2013). See also S Fine, *Laissez Faire and the General Welfare State a Study* (The University of Michigan Press, Ann Arbor 1956).

337 For instance, if the definition of ‘flood’ adopted under such a policy is limited to natural hazard only and does not encompass flooding due to escape of water accumulated on the roof following an ordinary rainfall or burst water pipe, it would be difficult, if not impossible, to ascertain the benefit conferred upon the insured. For the definition of ‘flood’ in the UK, see above.

338 It is understood that the operation of the model proposed by the ABI would be confined to areas at risk of flooding. It is, however, not altogether clear whether the government will endorse such a notion.

# Conclusions

There is a potential market failure in relation to flood insurance. It arises due to the fact that there is only a market where there is an opportunity. For insurers to be able to viably offer insurance, there needs to be a chance that at least for some of the insured persons, the loss insured against does not take place at all during the insured period or that only a very small loss is incurred. Floods and other catastrophic events are characterised by widespread losses. As such widespread losses therefore become increasingly likely, for instance as a result of changing weather patterns,<sup>339</sup> insurers must raise their premiums to cover the potential losses.

The invisible hand therefore has its limitations if the aim is to supply affordable insurance to all households. Socially, the aim of supplying affordable insurance is not only a possible but an essential aim, as a widespread absence of insurance will mean that a catastrophic event results directly in people becoming homeless, their homes becoming worthless and neighbourhoods becoming depopulated: besides the human misery, there may be significant further indirect impact on GDP in terms of the availability of labour and services in the immediate area and beyond. This is therefore most certainly a matter for government which may be considered an insurer of last resort, given that injured persons will need emergency and hospital care and possibly life-long care, and homeless persons will need alternative housing. One way or another, while there may not be an obvious legal duty on government to protect individual persons from flood risks, society needs to be prepared for foreseeable, catastrophic events.

There is a range of methods by which government may become involved in the provision of insurance. The basic market structure is direct insurance covered by reinsurance: the body public may become involved as the first insurer, it may cover the excess, it may provide an intermediate layer of insurance, or may be the ultimate reinsurer of the particular type of risk. The terms of private insurers will automatically be affected by and adapted to any action taken by government, and it is essential to contemplate and predict this effect in advance in order to preserve (or where applicable create) insofar as possible plausible market terms on which insurance may be provided and reinsurance sought.

A fund such as that now said to be contemplated for flood risks in England and Wales would, it appears, be the only catastrophe fund that only covers flood risks and not a range of all natural disasters. The proposed terms for government backing are at the time of writing unclear but it is not only the risk as proportion of GDP that should give the Treasury pause, but also considerations as to what exactly the relationship ought to be between the fund and the direct insureds, and the fund and the body public.

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<sup>339</sup> A good illustration is the example of a seismic zone, where the tectonic tension will increase over time and a new earthquake will become more and more likely for each earthquake-free year. Although the next earthquake cannot be exactly predicted, as time passes it will become increasingly likely to take place within the next year.

# List of correspondents

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