EARTHQUAKE...ARE YOU READY TO RUMBLE?

If you have not been paying attention recently, you may have not noticed, but lately, California has been rumbling.

Last year, Napa experienced a moderate earthquake (6.0 on Richter Scale 8/24/2014) that produced $1.0 billion in insured losses and, in recent weeks, both Los Angeles and San Francisco have felt minor tremors.

Seismologists in California used to say the San Francisco Bay Area should expect the “BIG” one in the next 30 years. Now they say it could be on the earlier side of those 30 years. See this article from the San Jose Mercury News (3/11/2015): Big Bay Area quake: 72 percent chance in next 30 years, scientists say [San Jose Mercury News]

Back in 2012, we were analyzing “black swan” events for a client on the heels of the 2011 Japan Earthquake/Tsunami/Nuclear Reactor (a Property “trifecta”). One obvious scenario was a similar event in South California, which we pitched as far-fetched – until this article appeared in the Los Angeles Times (4/20/2015). Earthquake fault heightens California tsunami threat, experts say.

Do you know what else is located in this area? An obsolete nuclear power facility that should have been taken off line years ago! (The San Onofre nuclear power plant has been shut down since January 2012 due to a leak of radioactive steam (New York Times – June 7, 2013).
CRITICAL EQ ZONES

The most recognized zones in the U.S. are California, Pacific Northwest and the New Madrid. California is subdivided into zones A-H with A (San Francisco) and B (Los Angeles) being the more critical due to seismic activity and concentration of population.

The New Madrid zone runs through the middle of the U.S. and, although it does not see as much seismic activity as California, it is a serious earthquake exposure. The fact that construction codes in the Midwest are more lax, the damage will likely be severe if this zone has a high intensity earthquake.
ARE YOU PREPARED IF THE HYPE BECOMES REALITY AND HITS HOME?

How can you prepare for any of these scenarios coming to life? Some of the following are obvious, but the 1994 Northridge Earthquake was a long time ago and complacency can set in. To stay proactive, we suggest:

**Review your Property insurance policy**
- How’s earthquake defined? Is it “earthquake” or “earth movement”?
- Do you know what limit will apply to earthquake or earthquake in such high hazard zones as California?
- How does your earthquake deductible read?
- If you have a percentage deductible, have you done everything you can to minimize the punitive effects of this deductible (e.g., **per unit wording**, cap or maximum)?
- If you have Contingent Business Interruption exposure, do you know how the percentage deductible will be applied? (Reference WAR policy later in this bulletin under “The Percentage Earthquake Deductible – In Some Cases Insurers Have Gone Too Far!” for help with this issue).
- Some policies exclude Contingent Business Interruption (CBI) if it is caused by earthquake in high hazard zones. For example, here is the exclusion that FM Global uses in their CBI section:
  - *This policy does not insure loss resulting from earth movement as respects a direct or indirect customer, supplier, contract manufacturer or contract service provider located in California, in the Commonwealth of Puerto Rico, in Hawaii, in Nevada, in the New Madrid Seismic Zone, in the Pacific Northwest Seismic Zone, or in the high hazard zones for earth movement.*
- Some policies exclude Service Interruption caused by earthquake in high hazard areas like California. Does your policy? Again, for example, look at FM Global’s exclusion under Service Interruption:
  - The following additional exclusions apply:
    - *This Policy excludes loss or damage directly or indirectly caused by or resulting from the following regardless of any other cause or event, whether or not insured under this Policy, contributing concurrently or in any other sequence to the loss:*
    - a) Earth movement for property located in Alaska, in California, in the Commonwealth of Puerto Rico, in Hawaii, in Nevada, in the New Madrid Seismic Zone, in the Pacific Northwest Seismic Zone, or in the high hazard zones for earth movement.
- Some policies exclude coverage for Miscellaneous Unnamed Locations (MUL) or Automatic Acquisition if caused by earthquake in high hazard zones.
- Some insurers have a long list of areas they consider high hazard earthquake zones (e.g., California, New Madrid, Pacific Northwest in North America; the list can be exhaustive if on a global policy with areas including Japan, Mexico, Chile, New Zealand, etc.)

The important message here: **There are no shortcuts. Read your policy.** The policy may appear to provide coverage in one area but then it takes away coverage in another area. Also remember, **NO TWO POLICIES ARE ALIKE.** They may appear that way on the surface, but it is the subtleties that can come back to bite you.

**Have you modeled your exposure?**
We all know that CAT models are not infallible and have proven inaccurate in the past, but it is a place to start to analyze the exposure. Insurers usually concentrate on the 250-year return period (some use the 500-year return period) when they judge how much capacity to put up on a given risk.
Once you have established the top 10 locations that drive the model results, you can drill down on these locations with full site earthquake surveys to fully understand and dissect your exposure.

For this particular account, the top three locations account for 43% of the average annual loss (underwriters use AAL to determine price for capacity); a deep dive into these locations might suffice.

**Transfer the Risk?**

The market is soft currently and if you were unpleasantly surprised with earthquake premiums in the past, you may have the opposite experience now. Capacity is abundant and the DIC market is very competitive. It is a great time to test the waters.
THE PERCENTAGE EARTHQUAKE DEDUCTIBLE – IN SOME CASES, INSURERS HAVE GONE TOO FAR!

Flash back to 1985. A hard insurance market caused by the Casualty insurance side, with the challenges of pollution, asbestos – and insurers were under-reserved to epic proportions never before experienced, affecting every line of insurance.

This was the advent of the percentage earthquake deductible. Insurers had to minimize any area which could break the bank or drain their surplus. The days of $25,000, $100,000 or even $250,000 flat California earthquake deductibles were over. Hello to the 5% of total insurable values deductible!

Insureds and brokers got it. They didn’t like it, but they understood the industry was in crisis, and ridiculously small deductibles did not make sense for major catastrophes such as earthquake in California.

But wait…just as small deductibles do not make sense, 5% of an insured’s exposure in a heavily concentrated area (or at a multi-billion dollar location) was NEVER the intent of the industry.

Example:
In 1985, one of our clients had a $3.4 billion location in Southern California on the San Andreas Fault and had a $100,000 deductible: 5% = $170,000,000! Insurers agreed to a $5 million cap or maximum because uncapped was too punitive for this client.

The message here is: Analyze your exposure and if you have a concentration of values that makes the percentage deductible excessively punitive, pursue a cap.

Example of Capped (Maximum) Percentage Deductible wording (as exists in Willis All Risk a/k/a WAR 2015 edition)

<table>
<thead>
<tr>
<th>With respect to any “Earthquake” at “locations” in “High Hazard Earthquake Zones,” applied separately at each “location” for which a claim is made, the Deductible shall be:</th>
<th>Separately: X percent of the value of the “unit of insurance” for which the Insured is making a claim against this policy, subject to a minimum of $XXX,000 per occurrence combined all coverages and a maximum of $XXX,000 per occurrence combined all coverages. The deductible shall apply separately to each “unit of insurance.” Contingent Time Element losses shall be subject to the minimum deductible only.</th>
</tr>
</thead>
</table>

Note the language WAR has for CBI … how will CBI be treated in your policy?
PER UNIT WORDING – MINIMIZE YOUR LOSS

To minimize the effects of the percentage deductible, cap the percentage and employ “per unit” wording. If the values can be specifically reported in this manner, then only the units that sustain loss or damage are triggered to be included in the calculation of the deductible.

Below is the “per unit” wording included in the 2015 edition of WAR:

The following shall be considered a separate “unit of insurance”:

(a) the reported value on file with the Insurer of each separate building or structure
(b) the reported value on file with the Insurer of all personal property at each separate building or structure
(c) the reported value on file with the Insurer of all inventory at each separate building or structure
(d) the reported value on file with the Insurer in each yard at each separate building or structure
(e) the actual value of BUSINESS INTERRUPTION GROSS EARNINGS and BUSINESS INTERRUPTION LOSS OF PROFITS for the twelve (12) months immediately following the date of the direct physical loss, damage or destruction.

As respects any other “Time Element” loss, no deductible shall apply except as outlined in (a), (b), (c), (d) and (e) above.

If a “unit of insurance” has not been reported then the value for deductible purposes will be calculated at the time of loss.

All as per the valuation clause of the policy.

SUMMARY

Serious earthquakes may not have occurred in your area, but do not let that make you complacent, especially if you have exposure in a high hazard zone. Read your policy now. Model your exposure and obtain quotes for higher limits if necessary.

CONTACTS

If you have questions, don’t hesitate to contact your Willis Client Advocate® or your National Property Practice contact included on this page.

David Finnis  
National Property Practice Leader  
david.finnis@willis.com  
404 302 3848

Senior Resource  
Steve Quinterno  
steve.quinterno@willis.com  
212 915 7959

Senior Resource  
Kevin Geraghty  
kevin.geraghty@willis.com  
415 291 1541

South Regional Manager  
Atlanta, GA  
Nancy Woode  
nancy.woode@willis.com  
404 302 3852
Midwest Regional Manager
Chicago, IL
Dick Forand
dick.forand@willis.com
312 288 7343

West Regional Manager
Denver, CO
David Hartline
david.hartline@willis.com
303 996 6723

California Regional Manager
Los Angeles, CA
Frank Beuthin
frank.beuthin@willis.com
213 607 6341

Northeast Regional Manager
New York, NY
Paul Richardson
paul.richardson@willis.com
212 915 7939

Atlantic Regional Manager
Radnor, PA
Sue Winterode
susan.winterode@willis.com
610 254 5697

Willis North America Inc.

Brookfield Place
200 Liberty Street, 7th Floor
New York, New York 10281-1003
United States
Tel: +1 212 915 8888

www.willis.com

The observations, comments and suggestions we have made in this publication are advisory and are not intended nor should they be taken as legal advice. Please contact your own legal adviser for an analysis of your specific facts and circumstances.

14160/05/15