UNDERSTANDING CATASTROPHIC EVENT PROPERTY DEDUCTIBLES

A catastrophic event property deductible ("CAT deductible") differs from a traditional property insurance deductible. CAT deductibles are a significantly higher out-of-pocket expense to the policyholder and apply to specific perils (e.g. named storm, hurricane, flood and earthquake) rather than to all perils. The appearance of CAT deductibles emerged as a way for insurers to offer property insurance in high catastrophic risk areas while keeping the coverage affordable, although policyholders will likely disagree on this point.

FORMAT OF CAT DEDUCTIBLES

The format of a CAT Deductible will be as creative as the underwriters, agents, brokers and policyholders negotiating it. The three most popular forms of CAT deductibles are a high fixed dollar amount deductible, a deductible expressed in terms of National Flood Insurance Program ("NFIP") limits, and a percentage deductible.

FIXED DOLLAR AMOUNT DEDUCTIBLES

A CAT deductible may be expressed in terms of a large fixed dollar amount. The fixed dollar amount will apply to certain property, per location or, more commonly, per occurrence.deductible.

NFIP LIMITS AS A DEDUCTIBLE

A flood deductible may be expressed in terms of NFIP limits. For example:

- *"equal to the maximum NFIP limits **available** per building and its contents whether purchased or not."* OR
- *"equal to the amount **recovered** under an NFIP policy."*

The meaning of these provisions is not the same, and the potential impact to a policyholder is significant. Courts have wrestled with how to interpret this wording. The NFIP has different programs and maximum limits available. Consider the financial impact of a **maximum available limit** deductible of $500,000 per building and $500,000 for its contents or $1,000,000 per building/contents. Often, there is a time element deductible in addition to this substantial deductible (e.g. $100,000) because the NFIP does not insure time element.

To the extent possible, the harshness of this deductible approach should be tempered with a deductible application road map that includes, but is not limited to, the following elements:

- The policyholder has the right, but not the duty, to insure property with the NFIP.
- Loss that is not recovered under the NFIP policy should be insured in the flood coverage on the property policy (unless otherwise excluded) because the NFIP is very limited as to the property insured and how it is insured (e.g. actual cash value basis).
- Permission to have NFIP as underlying insurance to reduce or eliminate the property policy flood deductible.
- If the flood deductible wording reflects the "amount **recovered** under the NFIP" instead of the "amount **available** under the NFIP," then further boundaries should be set when the amount recovered is more than or less than the flood deductible. Additionally, this determination should be made on an occurrence basis and not "per building" basis, as NFIP is written.

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PERCENTAGE DEDUCTIBLE

One of the most common CAT deductible expressions is as a percentage. Percentage deductibles were originally applied in high hazard earthquake zones. Hurricane percentage deductibles in coastal areas started to become popular in the 1990s after Hurricane Hugo (1989) and Hurricane Andrew (1992). This deductible strategy applies to risk profiles susceptible to named storms (such as hurricanes, typhoons, tropical storms and cyclones), earthquakes, floods and sometimes even traditional wind/hail events.

PERCENTAGE CAT DEDUCTIBLE CRITERIA

This approach applies a percentage to the value of the property and business income & extra expense ("BI/EE"). However, the other criteria will set one insurer's application of a percent deductible apart from another insurer's application. Additional criteria may include, but not be limited to:

1. The property and BI/EE values that are used to calculate the deductible
2. Valuation date of the property when the deductible is calculated
3. Geographic area
4. Timing of the event

PROPERTY VALUES

The property values that are used to calculate the percentage-based deductible can vary. For example, is the deductible calculated utilizing:

- Property and BI/EE values of just property for which a claim is made?
- The entire location's property and BI/EE values even if a claim is not made for some of the property or BI/EE?
- The "per unit" value of damaged property (often defined as an individual building or structure, personal property of said building, inventory, business interruption values, property in a yard)?
- All property and BI/EE **at risk** regardless of whether the property is damaged or a claim is made? OR
- The entire statement of values regardless of where the property is located or if a claim is made?

Clearly, the calculation result will be significantly different depending on the methodology used by the insurer.

VALUATION DATE OF PROPERTY VALUES

The valuation date of the property also comes into play. In some cases, the difference between the valuation periods in the deductible calculation may not be significant. However, as the economy improves and property and BI/EE values increase, the importance of this distinction becomes clear.

- Are the property values as of the **date of loss** used in the calculation?
- Conversely, are the property values reflected on the statement of values on file with the insurer at **inception of the policy** used in the calculation?

GEOGRAPHIC AREA

The geographic region in which the property is located must also be considered. Flood and earthquake geographic qualifiers are expressed in terms of "zones," while hurricane and named storm are expressed in terms of "wind tiers."

The coastal areas along the Gulf Coast and Atlantic Ocean, often called Tier 1, will have a higher percentage deductible (e.g. 5%) than areas lying 150 miles or more inland, which are referred to as Tier 2 or Tier 3 areas (e.g. 1-3%). Geographic areas may be defined as an entire state (e.g. Florida) or by counties and are placed in these various hazard tiers for purposes of applying deductibles and limits of insurance.

Similar geographic classifications apply to earthquake and flood. Property in high hazard earthquake zones like Alaska, Hawaii, California, New Madrid and the Pacific Northwest will require a higher percentage deductible than property located in other areas of the United States. The deductible percentage for property located in high hazard flood zones, such as A or V, will be higher than for property located in a region of the country which rarely floods.

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TIMING

The timing of loss, damage or destruction may affect the application of a CAT deductible. A CAT deductible may include the following timing conditions:

1. **Hour Event Occurs.** The CAT deductible may apply if there is loss, damage or destruction occurring within 24 hours **before** the storm is named by an appropriate weather service. The CAT deductible may also apply if the loss, damage or destruction occurs within 72 hours **after** a named storm is downgraded.

2. **Overlap of Policy Terms.** A catastrophic event may occur at the end of the policy period and overlap with a new policy period. An insurer may include a specific provision as to how their policy applies should this situation happen. Unfortunately, some of these provisions may be punitive to a policyholder.

3. **Definition of Occurrence.** A standard definition of occurrence is "*Any one loss, disaster, casualty or series of losses, disasters or casualties arising out of one event.*" Occurrence may be further defined to include an hour period of the occurrence. For example, a period of 72 hours for named storm and flood or 96 hours for earthquake. In this situation, all loss, damage and destruction from the designated peril that occurs during this hour period will be considered one occurrence for purposes of applying limits and deductibles.

Is an hour period good or bad? It depends. What if the named storm hovers over a geographic area for five days? The risk profiles of policyholders are not the same and the "good or bad" analysis should be performed on a case-by-case basis.

HURRICANE OR NAMED STORM – DOES IT MATTER?

The policy will define whether an event is considered a **hurricane** or named storm. A hurricane CAT deductible will apply when the loss, damage or destruction of property is caused by a hurricane and not some other weather-event category. NOAA has stated: "When a storm's maximum sustained winds reach 74 mph, it is called a hurricane." A named storm includes a hurricane and other named storms, such as tropical depressions and typhoons.

Unfortunately, it can be difficult to determine if the storm is a hurricane or some other storm category when loss, damage or destruction occurs. This can create challenges and frustration during the claim adjustment process. When a hurricane becomes a lower category storm, the insurance and government regulators may guide insurers as to what deductible will apply. For example, Hurricane Sandy was a hurricane as the storm traveled up the Atlantic coast. However, the storm was downgraded to a tropical storm before making landfall. While some insurers applied their **hurricane** CAT deductible to this lower category storm, the Governors of New York, New Jersey and Connecticut disagreed.

To avoid this situation, many insurers prefer to use a named storm CAT deductible instead of a hurricane CAT deductible. The application of a named storm definition requires the CAT deductible to apply on a broader scale than just a hurricane.

CAUTION: OTHER WIND/HAIL DEDUCTIBLES

Some insurers require a CAT deductible approach for other wind/hail storms, as well. This is a deviation from traditional industry practice. Other types of storm events occur throughout the country. While the risk profile of an insured is always a factor in determining what the deductible structure will be, it is important for policyholders to understand whether their insurer requires a CAT deductible approach to common storms.

AGGREGATE DEDUCTIBLES

When a policyholder has high property deductibles, some insurers will negotiate an aggregate and trailing or maintenance deductible. The aggregate deductible will place a cap on the amount a policyholder will pay in high deductibles during a policy year. Once the aggregate deductible cap is reached, the deductible going forward during that policy year for future loss events is a significantly lower amount (e.g. $25,000). The application of an aggregate deductible with a trailing or maintenance deductible will differ between insurers and isn't offered by all insurers.

STACKING DEDUCTIBLES

Ideally, deductibles should not stack in a policy. However, sometimes this cannot be avoided. Policyholders should understand how their policy will respond when more than one deductible may be applied after a loss event. This is particularly important when a policy has one or more CAT deductibles because of the substantial cost-shifting to the policyholder.

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For example, during a named storm, a policyholder may incur loss from wind, flood and even other perils, like looting, fire or explosion. There is much litigation concerning how two or more deductibles apply to an event. Deductible provisions apply in conjunction with all policy provisions and are not stand-alone provisions.

ALL OTHER PERILS DEDUCTIBLE WHEN THERE IS NO PROPERTY DAMAGE

Catastrophic events do not always result in loss to property or BI/EE values reflected on a Statement of Values. Sometimes, the loss to a policyholder will only affect sub-limits on the policy (e.g. debris removal of landscaping). Deductible wording may allow insurers to apply the CAT deductible to this kind of loss. If possible, the deductible wording should be amended so the smaller "all other perils" deductible applies in this situation. However, this is not a common approach and isn't available in many situations.

REGULATION

State laws and insurance regulations are designed to protect consumers. Insurers must follow state laws and regulations when the insurer binds property coverage in a state. Failure to follow state laws and regulations may result in deductible provisions being found null and void.

While there are exceptions or carve-outs in laws and regulations for non-admitted insurers (excess & surplus lines), it cannot and should not be assumed that non-admitted insurers have no obligations to consumers. To make this assumption would be an error.

CONCLUSION

CAT deductibles place a substantial cost-shifting burden on policyholders. Policy wording is crucial to determine the potential financial impact of high deductibles. It should not be assumed that all parties involved will interpret wording the same way.