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Intelligence MEMOS

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From: Thorsten Koeppl
To: Natural Disaster Watchers
Re: How Canada Can Prepare Before Disaster Strikes

Canada's natural disasters are becoming both more frequent and more expensive. Last summer it was widespread wildfires; this spring, it is extensive Prairie flooding. And looming in the background are major earthquake risks in two heavily populated areas: British Columbia's Cascadia fault line and Quebec's Charlevoix region.

Climate catastrophes on this scale could overwhelm the capital and reserves of Canada's property and casualty insurance sector – forcing government intervention and leaving taxpayers exposed. Recognizing this risk, the Department of Finance recently began consulting about setting up a backstop to cover these extreme losses.

Without question, this is a sensible and critical step that would bring Canada into line with many of its peer countries. But the debate shouldn't be about whether Canada needs a catastrophe backstop. The country already has one. It's implicit and taxpayer-financed in the form of provincial and federal disaster relief, reconstruction efforts and possible assistance for the insurance sector after a major disaster hits. The question is how Canada can best deal with national disasters before they strike rather than leaving taxpayers to pay for them afterwards.

Markets for insuring against tail risk – events that occur infrequently, but with severe losses that are highly concentrated for specific regions – do not work well. To cover these risks, insurers are required to put up a large amount of costly capital, making comprehensive disaster coverage expensive for consumers. Insurance prices also tend to spike after large disasters as reserves fall, making insurance even less affordable for all consumers. Insurance against natural disasters then often comes with high deductibles and exclusion clauses that limit their value.

Households may also underestimate the likelihood of a severe natural disaster affecting them directly. Others may count on governments stepping in with financial assistance after a catastrophe. Faced with higher premiums, many Canadians reduce their coverage or choose not to insure against such events at all.

The federal government can alleviate these market failures by explicitly assuming the tail risk associated with natural disasters. But such a backstop needs to be well-designed. The government should only take on the tail risk with the private market still covering the normal risk. And the transfer of risk should be structured as a fully priced, federal reinsurance scheme with the costs passed on to the insurance customers that generate the risk.

Such a reinsurance scheme has several advantages.

First, unlike private insurers, the government can smooth risk by building up reserves over time and borrowing if necessary to cover payouts. This is a much cheaper solution than relying on private capital to backstop catastrophic risks upfront. While consumers would still pay for insurance, they would likely face more affordable premiums with taxpayers being compensated for taking on tail risk.

Second, the reinsurance scheme needs to have large uptake. One way to ensure this is to make disaster insurance the default option in insurance contracts, potentially with an opt-out clause at the expense of forgoing federal disaster relief. The scheme should also not only cover earthquakes, but all natural disasters above a certain size which allows the reinsurance pool to cover all regions in Canada.

Third, consumers still need to have incentives to reduce their exposure to disaster risk. Those incentives are strongest when they face premiums that reflect the true cost of insurance. This means risk-based pricing where people in high-risk areas will pay more than those in low-risk areas, but still at an overall lower cost due to the public reinsurance scheme.

This is not merely a theoretical argument. My recent **C.D. Howe Institute report** demonstrates through simulations how such a scheme would work for Canada. Properly priced federal reinsurance can protect taxpayers, ensure that the private insurance market still functions, and lead to a better, more comprehensive insurance product at a much lower cost than through private insurers alone.

Canada can either price catastrophe risk now or continue dumping it onto taxpayers after a catastrophe. The question is no longer whether the government is involved in managing catastrophic risk. It already is. The real challenge is whether Canada will use this moment to build a better solution in the form of a well-designed federal reinsurance scheme before the next disaster strikes.

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