Property Insurance Resolutions for 2010

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"The road to hell is paved with good intentions."

-Attributed to Samuel Johnson, John Ray and Saint Bernard of Clairvaux

"The devil is in the details"

-German Proverb

"A good decision is based on knowledge and not on numbers".

-Plato

$25,000.
$100,000.
10% of the policy limit.

What do these numerical expressions have in common? Maybe nothing. Maybe everything. It will depend if one is a unit of exposure and the other a coverage limit. A $25,000 limit for a $100,000 exposure may be problematic at time of loss. The devil is in ***not*** knowing the details. Coverage needs to mirror exposure whenever possible. All property risk management details must be understood prior to policy inception: peril, exposure to loss, values exposed and minimum coverage limit. Numbers used in any insurance policy to express a coverage limit, including sublimit, must be analyzed to ensure adequate coverage at time of loss. Pre-printed sublimits in a property insurance policy, even when expressed by the insurer as a "coverage extension", may not be enough limit at time of loss. The most expensive insurance policy in any market cycle is the one that does not provide coverage as needed. An insufficiently insured transit loss may be as devastating financially to an organization as a building fire.

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It is the start of another calendar year and for many risk management professionals will mark the inception of a new insurance policy year. Those that sell property insurance will strive to shave more dollars off their client's annual insurance cost and call their process a renewal strategy. Risk managers will request a lower price from their service providers to demonstrate value within their organizations and consider the cost reduction to be a renewal strategy. While we all need to implement and maintain cost *effective* property insurance the "effective" aspect must be viewed in terms of all aspects of coverage: terms, limits, sublimits and deductibles-not just rate per $100 of total insured value and resulting premium. An inexpensive property insurance policy that does not cover claims as thought or bought prior to loss becomes is a very expensive insurance policy when its cost is viewed in terms of total cost of risk and need to unexpectedly tap capital of the organization. We must remember that cost of risk includes uninsured loss whether subject to deductible, exclusion, inadequate limit or improperly placed coverage.

There is more to property insurance than simply the major categories of building, contents and business interruption. What about all the various sublimits and nuances within the grants of coverage? A 2010 New Year's resolution for risk management professionals is to make time to understand what makes up the complete property insurance policy whether ISO or one insurer's independent filing. The sum of all property loss exposures must be understood in order to create a sound property insurance policy that is *loss* effective as well as *cost* effective.

Many of the problems uncovered during an insurance policy review are not from complex issues but simply from the risk management professional from not spending enough time to understand

and arrange the basics of coverage. This article can be used as a form of checklist when thinking in terms of basics when considering exposure, coverage and post issuance policy review. As checklist this article is not to be considered comprehensive; it is to provoke thoughts and discussion between risk management professional whether risk manager, broker or agent.

<u>Named Insured</u>
It is essential that any individual and/or entity with an insurable interest in real or personal property be identified as named insured. An omnibus clause may be appropriate to automatically insure the interests of any subsidiary entity of a named insured. Pay particular attention to wording used to be sure all entities are within the “omnibus”. A common problem is an entity that is owned by same individuals as other entities but it is not a subsidiary of any other entity and therefore may fall outside the omnibus clause. These entities will need to be specifically identified as a named insured.

<u>Mortgages and loss payees</u>
Check to see if any mortgagees and/or loss payees changed during the year or if changes are planned in 2010. Proper identification of these interests will reduce the potential for forceplaced insurance by mortgagee or loss payee and an unnecessary insurance expense for the insured organization.

<u>Perils insured</u>
It is relatively easy to consider property damage and business interruption perils when we think in terms of accident, acts of god and natural disaster. Our society continues to become more complex from “man-made” perils of local/state/federal statues, politics, economics and technology. “Man-made” perils can have serious financial impact on an organization and thus must be considered to ensure proper risk management practices are implemented and property insurance arranged as deemed appropriate. The following are illustrations of some man-made perils are:

- Terrorism: It has been more than eight years since the foreign terrorist acts of September 11, 2001. The fifteenth anniversary of the Oklahoma City domestic terrorism bombing will be observed in a few months. Local and worldwide politics and economic issues may create a new wave of terrorism in the US.

- Computer virus, e-data destruction, e-data extortion and e-commerce denial of service: Electronic technology is the backbone of all most any organization today. Lack of technology backbone can be disastrous for an organization depending on the depth and extent of the event.

- Building laws, demolition and increased costs of construction: Enforcement of municipal building codes or state or federal statutes may create significant financial loss to the organization then that considered strictly for “‘natural peril”.

- Vacancy/unoccupancy: Another year of economic uncertainty may lead to closings of offices, warehouses, manufacturing and other types of locations. It is better to deal with vacancy/unoccupancy issues as soon as possible and not wait for possible uninsured loss.

<u>Loss valuation</u>
While it is generally understood agreed that replacement cost valuation (new for old) is preferred over actual cash value (replacement cost less physical depreciation) one has to be sure that the property subject to loss will be replaced if destroyed. A schedule of insured locations that consists of real and personal property can include both replacement cost and actual cash value depending on the status of the asset. If a particular building is considered obsolete and will not be replaced then actual cash value may be the proper way to insure. Debris removal is often a percentage of the building limit and included within the building coverage limit. Any change to actual cash value should be done after review and understanding of potential impact on debris removal coverage.

Insurance to Value

Property insurers want to know that the coverage limit for real and personal property equates to the properties expected replacement cost or actual cash value. A co-insurance requirement is usually found in any property insurance policy as a means to penalize an insured that under reports the value of the asset-whether it is building or contents. Contents may be difficult to estimate a value when subject to manufacturing or assembly process and move from raw material to finished goods. The loss settlement clause in the policy should be used as a checklist to ensure that the contents are properly valued at each stage of production or assembly.

Co-insurance requirements may range, depending on insurer, from 80% to 100%. Rate credits increase as the co-insurance requirement increases. Thus the rate per $100 of reported value for 100% co-insurance should be less than that of an 80% co-insurance value. The relationship between reported value and rate credit is not linear; the rate credit to go from 80% to 100% may be 10% while the values to report has increased 25%. The decision on what values to report cannot be made simply on net rate impact on premium (rate/$100 value multiplied times value to report = annual premium). The insured has to consider the need for full coverage limit using 100% values in view of possible total loss and inadequate limit if lesser amount is used such as 80%.

Once the values have been decided by insured and co-insurance percentage established it is possible the insurer upon request will suspend the co-insurance clause for the policy coverage period by agreed amount or similar endorsement. A co-insurance waiver should be requested whenever possible to limit the possibility of co-insurance penalty at time of loss.

Business interruption

An interruption in an organization's revenue and/or increased operating expense from insured peril can pose an exposure greater than the direct damage loss itself. It is critical that the risk management professional understand the short and long term effects that damage to buildings and/or contents can have on organization's ability to continue sales, maintain pre-loss operating expenses and profit margin. Accurate completion of a business interruption worksheet is necessary for at least five main reasons.

- First, to satisfy the insurer's need to understand the insured's pre-loss operations in order to underwrite the exposure and set rate and premium.
- Second, a means for the insured to itemize those expenses that may not continue during period of interruption thus confirming "no exposure" and allowing a coverage limit (and premium) commensurate with expected exposure.
- Third, a way for the insured to consider alternate means of operations (use of alternate premises, purchase finished product from others, etc.) during the period of interruption.
- Four, a means for the insured to consider a coverage limit at less than the indicated exposure which is equal to or greater than the minimum co-insurance clause required by the insurer.
- Five, a tool the insurer can use when asked by insured to waive co-insurance requirements of the business income coverage endorsement.

When considering the business interruption exposure the risk management professional must consider whether, and to what extent, the organization needs to continue "ordinary" payroll. In a tight labor market it may be decided that such payroll is critical and to continue to pay these employees so the organization does not risk losing its skilled workforce to other employers during the term of the interruption.

Business interruption coverage ends when the damaged property is repaired or replaced. It is possible that the organization may still suffer a decrease in sales and lower profitability even when it is once again to function at 100%. There may be a lag in time that business resumes at a level equal to that which existed pre-loss event. Thus an extended period of indemnity endorsement may be needed to continue business interruption coverage past time of repair or replacement to a stated date in the future.

Business interruption exposure identification is not complete if the risk management professional considers only the locations and operations of the insured organization. Consideration must be given to an interruption at supplier locations which may limit or even eliminate incoming raw materials to the insured organization as well as an interruption experienced by a key customer thus limiting the sale of finished goods by the insured organization. These contingent exposures are insurable and will require specific underwriting information before coverage can be quoted or bound by the organization's insurer.

<u>Policy limits and sublimits</u>
Risk management professionals spend considerable time (or should as discussed above) to determine appropriate coverage limits for buildings and contents. A limit can be equal to the reported value of a particular building or location of contents. In lieu of a specific limit by location for building or contents one can seek a limit that is equal to the sum of all building values combined, a separate limit equal to the sum of all content values or even a limit that is equal to the combined sum of all building and contents values. The blanket approach to coverage limit may reduce the possibility of inadequate limit at any one location. An insurer that is satisfied with the report of values used and the underwriting profile of each location may grant some form of blanket coverage. This is a coverage enhancement that typically does not increase cost to the insured.

<u>Sublimits</u>
A sublimit is simply a coverage limit that is less than other policy limits of coverage. A policy sublimit is usually found in property insurance policies as a limit for specific exposure such earth movement, valuable papers or unscheduled location coverage. The limits may not have any relation to actual exposure except by coincidence. Since the limits are provided by boiler plate policy wording it is possible the limit may not actual exposure of a specific insured and thus be inadequate at time of loss. The risk management professional needs to review each sublimit during the renewal process and again mid-policy term whenever the organization undergoes significant change such as acquisitions, new construction or change in operations. Typical coverages subject to sublimit are shown below. This list is for illustration only and may include additional items depending on insurer and whether policy form is based on ISO or is independently filed.

- Equipment breakdown ("boiler & machinery")-direct damage and business interruption
- Flood-direct damage and business interruption
- Earth movement-direct damage and business interruption
- Service interruption-direct damage and business interruption
- Transit-per conveyance/per occurrence
- Unscheduled locations including exhibitions-buildings and contents
- Newly acquired property-buildings and contents
- Accounts receivable
- Valuable papers
- Computer virus/Electronic vandalism
- Expediting expenses
- Pollution clean-up

The risk management professional whether broker, agent or risk manager should review each sublimit based on exposure and accept the limits as provided or request an increase (or decrease) as deemed appropriate for the insured's exposure.

<u>Loss retention</u>
Deductibles apply to direct damage losses and waiting periods are typically used for business interruption coverages whether business income or extra expense. Take time to relate the waiting period to a dollar amount to determine if the amount is within the risk bearing capability of the insured organization or if it can be increased for cost effective premium savings. This type of cost/benefit analysis needs to be done for equipment breakdown coverages (B&M) at same time of review of general property exposures.

Multiple property policies

Different situations and exposures may require more than one property insurance policy. Not all property insurers will include equipment breakdown coverage in their policy thus requiring the exposure to be insured by separate policy. Not all property damage losses are easily categorized as being strictly in the property policy or in the equipment breakdown policy. While the insurers try to determine what each is liable for to their insured, the organization faces a delay in loss settlement. A joint loss agreement on the property policy and equipment breakdown policy can alleviate some of the time delay in loss settlement. There is no cost to use of the endorsement and is usually available by request to property and equipment breakdown insurer.

Layered property

A primary policy is written with additional coverage and limits by excess policies-may be one or more. Consistent coverage terms by layer (policy) are needed to ensure a loss paid by the primary insurer will extend into subsequent excess policies to the extent coverage is provided. Not all excess policies by design will be as broad as the coverage terms of the underlying policy(ies). There are three main coverage issues in an external layered program.

- Follow form: Excess policies need to follow the terms and conditions of the primary and underlying policies in order to provide seamless coverage. An endorsement that states “follow form” will reduce the potential of a coverage gap.
- Drop down: Excess layers throughout the program must not only follow form but provide drop downs when excess coverage follows underlying coverage that is subject to policy aggregates such as flood and earth movement.
- Priority of payment: Excess policies need to recognize underlying loss as satisfying an attachment point even if the excess layer is less broad than underlying due to sublimit or specific coverage or peril exclusion.

Conclusion

Year 2010 will likely prove to be as challenging as prior years for risk management professionals. Risk management professionals whether risk manager, broker or agent can demonstrate great value by taking the time to understand the organization’s exposure, need for property insurance and a timely plan to implement cost effective coverage on the 2010 policy effective date.

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