

TOPIC 1: COMMERCIAL PROPERTY COVERAGES---Four Classroom Hours

Obj 1-1. A **LOSS EXPOSURE** is a situation that presents the possibility of loss, *even if* the exposure is not identified *and* the loss never occurs.

The three elements of a loss exposure:

1. **The item subject to loss**--what can be lost.
2. **The peril or cause of loss**--how the subject can be lost.
Perils cause losses.
Hazards increase loss frequency and/or severity.
3. **The financial impact of loss**--how much value can be lost, can be measured in absolute dollars, percentage of assets, or effect on price per share of common stock.

A **PROPERTY LOSS EXPOSURE** is a chance an entity will suffer a financial loss due to damage, destruction, taking, or loss of use of property in which it has a financial interest.

Example: The chance of earthquake damage to a building in California.

COMMERCIAL PROPERTY LOSS EXPOSURES:

1. **Real property**--is land and its attached structures (what you'd leave if you moved).
Examples: buildings, storage sheds, broadcast towers, bridges, etc.
2. **Personal property**--is all other property (what you'd take if you moved) including
 - a. **owned personal property**--furniture, inventory, and other contents;
 - b. **personal property of others**--non-owned property in the insured's care, custody, and/or control; *and*
 - c. **property off-premises.**

THE TWO TYPES OF RISK:

1. **Pure risk**--is the risk of accidental loss.
Pure risk presents the chance of loss or no loss--the chance of financial loss *without* the chance of financial gain.
Examples: fire, death, and tornado.
2. **Speculative risk**--is the risk inherent in an organization's operations.
Speculative risk involves loss, no loss, *or gain*--the chance of financial loss *with* the chance of financial gain. Speculative risk is usually created intentionally.
Examples: stock market investing, starting a business, and gambling.

Insurance is designed to address pure risk, but *not* speculative risk.

CONSEQUENCES OF LOSS--the potential financial effects of a loss. **Financial effects:**

1. **Direct loss**--results from physical damage to, destruction of, or loss of physical control over property. **Direct loss includes**
 - a. reduction in property value *and*
 - b. increased repair or replacement cost.
2. **Indirect loss**--results from direct loss and often causes
 - a. **loss of revenue**--lost income.
A **business interruption or business income loss** is loss of revenue from damage to owned property.
A **dependent property business interruption loss** is loss of revenue caused by damage to another's property (a supplier or customer).
 - b. **extra expense**--extraordinary expenses incurred to continue operations after a loss.
3. **Consequential loss**--is *not* just another term for indirect loss.
Consequential loss is loss by spoilage of perishable items *or* loss of value of undamaged property caused by damage to other property (loss of one earring).

Obj 1-2. An **INSURABLE INTEREST** exists in property *if* the person would suffer a financial loss *if* the property were damaged or destroyed.

Insurance policies pay no more than the insured's insurable interest.

If an insured could collect more than his insurable interest, it would increase moral and morale hazards.

Moral hazard--is a condition that increases the likelihood of intentional loss.

Moral hazard arises from active inducement of loss and/or the temptation to exaggerate loss.

Morale hazard, aka attitudinal hazard--is a subjective applicant characteristic that indicates possible passive indifference to loss, such as repeated failure to lock or remove keys from a car and failure to take obvious steps to prevent or reduce loss.

Property is **INSURED TO VALUE** when the amount of coverage equals the insured's insurable interest in the property's insurable value.

Some policies have coinsurance clauses, which require insureds to buy coverage at least equal to the stipulated percentage of the property's insurable value.

INSURANCE-TO-VALUE PROVISIONS require the insured to carry at least as much property insurance as the maximum possible loss or a stated percentage of the maximum possible loss.

Insurance-to-value is important in property insurance because only 2% of real property losses are total losses.

When insureds do *not* buy insurance for the full value of the insured property, they still have most of their losses paid in full anyway (because 98% of real property losses are partial losses) for very low premiums.

In effect, they cheat the insurer and their fellow insureds.

THE BENEFITS OF INSURANCE-TO-VALUE:

1. **To the insurer--**
 - a. The premium is enough to cover potential losses.
 - b. Underwriting is simplified because instead of determining exact values during underwriting, the determination of underinsurance is made at the time of loss
2. **To the insured--**
 - a. The insured knows that there will be enough funds to pay a total loss.
 - b. The insured reduces the uncertainty associated with large retained losses.

Obj 1-3. **COINSURANCE PROVISIONS** require the insured to bear a fixed proportion of any loss (ie, **to coinsure**) if he does *not* carry *at least* as much insurance as is required by the coinsurance provision. **That minimum amount of insurance required to avoid coinsuring equals** the coinsurance percentage *times* the property's insurable value (as determined by the method of loss valuation).
Coinsurance acts as a penalty imposed by the insurer for the insured's failure to buy enough insurance.

FOUR REASONS WHY 80% COINSURANCE IS THE MOST COMMON APPROACH:

1. **Tradition**--Historically, 80% coinsurance was the standard approach.
2. **Practicality**--Very few losses are total losses. Insurance to 80% of value covers *most* claims.
3. **Margin of error**--Coinsurance at 80% provides some margin for error in predicting the full value of property.
4. **Cost**--The total premium for insurance at 80% of value with an 80% coinsurance clause is less than the total premium for insurance at 100% of value with a 100% coinsurance clause [*by 10%*].

THE COINSURANCE FORMULA follows: (Know this cold!)

Maximum amount payable = [(insurance carried / insurance required) X loss], *then* minus the deductible.

The **maximum amount payable** is only *one* maximum (along with the policy limit and the insured's insurable interest).

Insurance required = value of insured property X the coinsurance %.

The amount of insurance required equals the insurable value (ACV if ACV coverage, RC if RC coverage) times the coinsurance percentage (often 80%).

The amount of loss equals the ACV or RC of the loss.

Teachers suggest students remember the formula as '**Did over should times loss minus deductible.**' as in 'The amount the insured did carry, divided by the amount the insured should have carried to comply with the coinsurance requirement times the amount of loss minus the deductible'.

Do *not* confuse '**coinsurance**' as used in property insurance (to encourage insurance-to value) with '**coinsurance**' as used in health insurance (to encourage the insured to control the loss amount by making him pay a fixed proportion of all loss, now often capped at \$1,000 to \$10,000).

Notes:

1. If the insurance carried (**set at time of policy inception**) equals or exceeds the insurance required (**set at time of loss**), the coinsurance clause has *no* effect and losses are paid in full up to the policy limit.
2. **The formula yields a maximum amount payable in excess of the policy limit when** the amount of insurance exceeds the insurance required, in which case the policy limit is the effective maximum.
3. The insurer *never* pays more than the amount of loss.
4. **If the insurance required exceeds the insurance carried**, the coinsurance clause imposes a penalty and *no* loss will be paid in full.
5. **The coinsurance percentage clause chosen depends on** the property, the perils, and the premiums.

Like it or not, insurance buyers face loss exposures which they must finance. Deductibles, coinsurance, choice of perils, underinsurance, and settlement bases (ACV or RC) allow insureds to draw the line between retention and insurance almost anywhere they want.

Obj 1-4. **APPROACHES USED IN PROPERTY INSURANCE TO VALUE PROPERTY:**

1. **Actual cash value**--means replacement cost, new, at current prices *minus* allowance(s) for **depreciation**, which usually reflects three factors:
 - 1) **physical wear and tear** (usually determined based on **straight line depreciation**--constant, fixed depreciation throughout the item's normal expected useful life),
 - 2) **obsolescence** (due to fashion and/or technological change), *and/or*
 - 3) **age** (as distinct from physical wear and tear and obsolescence).
2. **Replacement cost**--Replacement cost coverage replaces used property with new property of like kind and quality.

With replacement cost coverage, the insurer pays

 - a. the cost of buying new property at *current* prices *or*
 - b. the cost of repairing the property.

Replacement cost is based on the *current* replacement cost (as of the time of loss), *even if* the original purchase price was significantly lower or higher than the current cost.

To reduce the moral hazard, most policies pay only *after* the insured repairs or replaces the damaged or destroyed property.

Some building policies require the insured to rebuild with identical construction, in the same location, *and/or* for the same purpose.

Otherwise, the policy deducts for depreciation.

Many replacement cost provisions let the insured settle the claim based on ACV (to get funds for rebuilding) and then refile within 180 days to collect the replacement cost upon completion.

3. **Actual loss sustained**--Business income coverage, in effect, covers for ACV by insuring for "actual loss sustained" during shutdown.

Obj 1-5. A **PACKAGE POLICY** insures at least two coverage parts (property and general liability). A **monoline policy** insures only one type of coverage or one coverage part (property, inland marine, crime, boiler, general liability, auto, farm, workers' compensation, umbrella, or surety).

A COMMERCIAL PACKAGE POLICY (CPP) combines two or more monoline policies into one policy to provide (at least) property *and* liability coverage to commercial insureds.

A CPP includes three components:

1. **Common policy declarations**--information about the insurer, the insured, *and* the insurance.
2. **Common policy conditions**--apply to all coverage parts *unless* a coverage part states otherwise.
3. **At least two of these fourteen coverage parts**--commercial property, commercial general liability, commercial crime, equipment breakdown, commercial inland marine, commercial auto, farm, businessowners, capital assets, e-commerce, employment-related practices liability, financial institutions, management protection, *and* medical professional liability.

Each coverage part contains its own declarations page and coverage forms.

INFORMATION SHOWN IN THE COMMON POLICY DECLARATIONS: policy number; names of the insurer, producer, and named insureds; first named insured's address and business description; policy effective and expiration dates; the premium for each coverage part; the total premium; *and* **the 'in consideration' clause** (the insurer agrees to provide the described coverage in return for the premium).

SIX PROVISIONS OF THE COMMON POLICY CONDITIONS:

1. **The cancellation clause** lets the first named insured cancel at *any* time and lets the insurer cancel for nonpayment with 10 days' notice or for any *other* legal reason with 30 days' notice. The first named insured *must* be notified of cancellation.
2. **The changes condition** states that the written policy is the *entire* contract and may *only* be changed by written endorsement. *Only* the first named insured may request policy changes.
3. **The examination of books and records condition** allows the insurer to check the insured's books as they relate to the policy for up to *three* years after expiration, so the insurer may accurately determine premium when a variable premium base, such as payroll or sales, is used.
4. **The premiums clause** states that the first named insured must pay the premium and will receive any premium refund.
5. **The transfer of rights and duties under the policy clause** prohibits the insured from assigning its future policy rights without the insurer's permission *but* it automatically transfers those rights to his legal representatives *if* he dies.
6. **The inspections and surveys condition** allows, but does *not* require, the insurer to inspect the insured's premises and operations (to determine insurability and proper rating). The insurer *may* tell the insured the survey results, but is *not* obligated to make safety inspections.

A disclaimer clause states that the insurer does not

- a. claim to make safety inspections,
- b. guarantee conditions are safe, *or*
- c. guarantee the insured is complying with legal regulations.

The disclaimer protects the insurer against lawsuits by people who were allegedly injured by the insurer's failure to identify a hazardous condition *and* claims by the insured that the insurer failed to detect legal violations, with resulting fines.

A COVERAGE PART consists of

1. declarations specific to that part;
2. one or more coverage forms, containing insuring agreements, exclusions, and policy provisions;
3. any applicable endorsements; *and*
4. a conditions form that applies to the coverage part.