Terms and Conditions in a Harder Property Insurance Market: Coinsurance, Blanket Insurance and More

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Purpose and Importance of Research

I began this paper when I was asked by the Chicago Chapter of the CPCU to give a luncheon seminar (January 2003) on what was going on the rather hectic property markets of the post 9/11 environment. I relied on an underwriting manager of a major primary insurer to prime me with information. Since that time, I have talked with more people, consulted a number of text books, and reviewed *Business Insurance* of the mid-1980's period. Upon reflection, I wonder if I could have given nearly the same talk in 1986.

The period of the 1990's is regarded as a soft market for property and casualty insurance. Similarly, the period of the late 1970's and early 1980's is likewise regarded. Both soft markets have been succeeded by a very hard market. Identifying the characteristics of these market conditions might include:

Features of a soft market	**Features of a hard market**
Prices are lower	no more room to cut
Market share	u/w pain
Cash flow underwriting	reinsurance problems
Good investment returns	not so good
Excess capital	disciplined u/w
Under-reserving	strengthen reserves
Surplus lines flat	surplus lines grow
Soft terms and conditions	hard terms and conditions

The focus of this paper is the last item on the list, terms and conditions. By soft terms and conditions I mean "unusually favorable to insureds".

Hard markets are rare, 2 in 20 years (with exception of "blip" in the early 1990's for Hugo, Andrew and Northridge). This paper identifies specifics as to how terms and conditions had become soft; further the paper identifies changes in terms and conditions in the post 9/11 harder market environment. The methodology employed is interview of brokers and underwriters in the Chicago insurance market place, and much of what is reported below is based on such conversations and thus anecdotal. In addition I have examined (and quoted) property and liability textbooks that help to articulate the rationale for terms and conditions. Finally I have reviewed selected insurance contracts, both Insurance Services Office (ISO) and proprietary forms. The following description of market conditions was published in *Business Insurance* in 1985*:*

More Restrictive Insurance Policies. Again, in recent years, insurance companies readily agreed to broaden coverages and policy conditions. They removed exclusions and/or restrictions. They agreed to conditions that enhanced the policies for the insured, often at no additional cost.

However, the tide is rapidly changing. Underwriters are now reviewing any special provisions or changes in policy conditions with the utmost care. Many are simply refusing to accept any modifications of standard forms.

The same publication reported five years earlier, April 14, 1980, in the depths of the soft market, the risk manager at General Motors boasting at the RIMS Conference about his company property program that covered "virtually all risks, automatic unlimited locations and blanket limits". A few months later, June 16, 1980, *Business Insurance* featured an article extolling the virtues of agreed value endorsements in place of coinsurance. The foregoing provide an *a priori* rationale for the hypothesis of this article.

I. Coinsurance and Insurance to Value

Insurance to value is supposed to be a very important principle of property insurance. Anyone who has taught property insurance or studied for the CPCU knows how much emphasis is placed on the topic. Rate equity (fairness between insureds) is one reason that the insurance industry uses coinsurance. Coinsurance policy provisions seek to make insureds share certain losses with the insurer when the insured is underinsured at the time of the loss. What is meant by "underinsured" is defined as some specified percentage (often 80%) times the actual cash value (or replacement cost if optional coverage selected) of the insured property at the time of the loss. When the amount of insurance is less than the calculated amount, the insured becomes a coinsurer of his/her own loss to the extent of the underinsurance. For example, if the ACV at the time of the loss is $1,000,000, the coinsurance percentage of 80%, and the amount of insurance is $600,000, when there is an $80,000 partial loss, the insured will recover only $60,000, less the deductible, as follows: ($600,000/(.80*$1,000,000) times the loss of $80,000 equals $60,000).

Many insureds will underinsure in order to enjoy lower insurance premiums. The proclivity to underinsure is founded upon the common knowledge that most property losses are partial due to fire protection. Consequently the insured might think: "Why insure against a total loss when the fire department is bound to get here quickly." There are at least two problems that arise: rate equity and adverse selection. Those who underinsure are subsidized by those who insure to value as is shown in the simplified rating example provided in Table One on next page.

Table I – Coinsurance and Equity

Historical actuarial data indicates:
All houses are worth $10,000 for a total loss.
Following loss frequencies and severities apply per 1000 houses: Unit of insurance equals $1,000 of insurance

SIZE OF LOSS	#	DOLLARS
10,000 (Total loss)	1	10,000
5,000	1	5,000
4,000	1	4,000
3,000	2	6,000
2,000	3	6,000
1,000	4	4,000
500	10	5,000
Total Expected Losses		40,000

Case 1
If everyone insures to value: 10,000 units insurance
Units of Insurance (1,000 houses*$10,000 value/$1,000 units of insurance) $4
Rate per $1,000 ($40,000 expected losses/10,000 units of insurance)

Case 2
If everyone insures to half value:

Units of insurance (1,000*$5,000/$1,000)	5,000 units of insurance
Expected losses half value insurance	35,000
Rate per $1,000 ($35,000/5,000)	$7

Case 3
Merge the groups without any coinsurance provisions:

Units of insurance (10,000+5,000)	15,000 units of insurance
Expected losses (40,000+35,000)	75,000
Rate per $1,000	$5

Table One shows that when insureds that underinsure and insureds that insure to value are pooled together (case 3), the rate per $1,000 is $5. Pooled separately those who underinsure should pay $7 (case 2) and those who insure to value should pay $4 (case 1). Thus the coinsurance "penalty" is necessitated to prevent the subsidy.

The issue coinsurance and of equity between insureds is not new. In 1911 Solomon Huebner, a great name in insurance education, in his book *Property Insurance* wrote:

The above illustrations demonstrate that a disregard of the coinsurance principle results in a grave injustice to those who do not desire to run the risk of taking partial insurance, and who, in consequence, pay premiums out of all proportion to the benefits received. The coinsurance clause, however, remedies this injustice…. Justice demands that [the insured] should receive in the proportion that he was willing to pay premiums….[1]

Another old text by Mowbray and Blanchard reports that coinsurance was a topic of discussion at the Merritt Committee Hearings[2] in New York in 1910. The Committee concerned itself with fire insurance rates and rating practices. To make the point made in Table One, the Merritt Committee included an actual loss table based on New York experience which is included in the quotation below:

Why should one who has insurance in the amount of $5,000 on property worth $10,000 *not be indemnified for any loss to a maximum of $5,000? A popular answer to this question, which is not without validity, is provided by a second question, which might be asked by the insurer: Suppose that a loss of $5,000 or less occurs; to which half of the value does it apply, the insured's or the insurer's?*

Figures on the distribution of fire loss given in the report of the Merritt Committee are quite as cogent for purposes of illustration as when they first appeared. On a certain class of building the average experience per 100 fires and per $100 of value was approximately as follows:

Loss	*No. of fires*	*Average loss*	*Total*
$10 or less	*82*	*$2*	*$164*
$10.01-$20	*6*	*14*	*84*
20.01-30	*3*	*25*	*75*
30.01-40	*2*	*35*	*70*
40.01-50	*1*	*45*	*45*
50.01-60	*1*	*55*	*55*
60.01-70	*1*	*65*	*65*
70.01-80	*1*	*75*	*75*
80.01-90	*1*	*85*	*85*
90.01-100	*2*	*99*	*198*
Total			*$916*

Mowbray concludes, on the basis of the above table of losses, that the net fire rate or pure premium would be: (1) $.09 per $100 if all insured to value; (2) $.34 per $100 if all insure to only 10%; and $.17 if all insure to 80%. Mowbray goes on to opine that a "graded rate system" such as is in use today would be impractical although superior

The issue of rate equity and fairness aside, a system that does not enforce insurance to value invites adverse selection and moral hazard. If underinsurance is rampant, then the population of those insuring to full value will include those most likely to have total losses.

Soft and Hard Market Conditions. In the large company market[3], coinsurance disappeared very much as presaged by Huebner in 1911:

But coinsurance serves another very useful purpose in protecting property owners against the efforts of great industrial and mercantile corporations to shirk the payment of their just share of premiums.

As the market hardened in 2000 many large risks still managed to avoid use of coinsurance. One broker told the writer that coinsurance might be proposed by an underwriter and negotiated around provided there is adequate insurance to value. Underwriters began insisting on appraisals, property schedules, and sub-limits. Another brokerage manager wrote to his colleagues:

In presenting to market an electronic spreadsheet is necessary. More importantly Property carriers are tired of the under reporting and sloppy reporting of values. If their capacity is set at $25MM, they do not wish to pay losses up to $50MM and they want the proper premium for the risks they quote.

Providing the market with the proper amount of engineering information is critical. International accounts will want a spreadsheet with COPE information. HPR markets will want 5 or 6 months lead time to do the inspections or will require engineering reports and sprinkler diagrams on locations over $50MM at the least

The foregoing applies to the large company market. In the 1990's even in middle markets coinsurance was sometimes absent because of the use of broker's forms or by endorsement s from generous underwriters. In the middle markets the insured who 5 years ago might have had coinsurance waived by a friendly underwriter interested in expanding market share in a soft market will certainly find coinsurance provisions or agreed amount endorsements backed up by current appraisals. More on the middle markets later.

II. Blanket Insurance and Insurance to Value

In this discussion I use the term "blanket insurance" to mean the application of one amount of insurance to more than one property exposure units. The concept is not a new one. A chapter by George V. Whitford of Reliance Insurance in the *Property and Liability Insurance Handbook*[4] included:

Insurance can be made to extend over more than one unit or one type of property in one location. A single contract can cover: two or more types of property in one location, one type of property in two or more locations, two or more types of property in two or more *locations. Such insurance is referred to as blanket coverage and is in contrast to "specific"…. Coverage of the contents of three warehouses with one amount of insurance embodies the blanket approach.*

The rationale for blanket insurance is likewise stated by Huebner, Black, and Webb's 1994 edition of *Property and Liability Insurance*:[5]

But with respect to machinery or stocks of goods, where values shift rapidly and greatly from one location to another but remain fairly constant as regards total value, the clause performs a distinct service. In such cases it is difficult, if not impossible, to carry adequate specific amounts of insurance on the several locations. Although it is comparatively easy to know the aggregate value, it is most difficult, and in many instances impracticable, to keep a record of the values at each separate location.

Similarly the rationale for blanket insurance can be found earlier from Whitford:

The advantages of blanket insurance may be quite apparent. Suppose that an insured operates several retail stores where the total value of stock stays almost constant but where frequent variations of stock among stores occur. With blanket insurance he need give concern only to making certain that the total insurance is adequate. Without such an arrangement, he would continuously have to adjust the amount of insurance upwards or downwards at each individual location.

III. Abuse of Blanket Insurance and the Harder Market Solutions

There are two points to note about the passages by Huebner, Black, and Webb and Whitford: (1) both clearly **assume** insurance to value, and (2) both examples pertain to personal property (*machinery or stocks of goods, retail store inventories*) and not real property. As compelling as the argument for blanket insurance might be when there are relatively stable total personal property values shifting from one site to another, there is a total absence of corresponding logic for blanket coverage for real property (unless the exposure units are too numerous to identify). The INS 23 text, *Commercial Insurance,* by Flitner and Trupin[6] talks about the use of blanket insurance on real property and extols the advantages to insured. The argument is a simple one: if there is a blanket limit on real property and the coinsurance percentage is 90% as required in rule book, when there is a total loss the insured receives 100% as compared to 90% (assuming specific insurance similarly written at a 90% coinsurance rate). Huebner, Black and Webb earlier sound the same theme:

For example, imagine an insured who has three buildings in different locations valued at $100,000, $150,000, and $200,000 for a total value of $450,000. Each could be insured with a "specific" amount of insurance applicable exclusively to each building. Each amount would need to satisfy the indicated coinsurance percentage. Alternately, the insured might buy $405,000 on a blanket basis based on 90% coinsurance that is mandatory for blanket coverage..

To point out the advantages to the insured of blanket insurance on real property is not to justify it use. The question remains: why does the insurance industry write blanket limits on real property and not even charge an additional premium? The writer has been able to find no explanation. For example Huebner, Black, and Webb simply comment:

Blanket insurance is advantageous to insureds such as in the case above. Properly arranged, blanket need not cost any more per unit of insurance than specific insurance.

Improper use of blanket insurance is an invitation to underinsurance, and it is widely recognized to have been such in the soft market period of the 1990's. One underwriter reported to me the post 9/11 activity of going through the files and finding one after another outdated or incomplete statement of values. Regardless of whether there was one occurrence or two at the World Trade Center, the one thing that is plain is the exposure was underinsured. One broker commented to me when I asked why: "Because in a soft market underwriters do not care and insureds and their broker will take advantage". Probably the WTC was on a blanket real property program with no coinsurance backed up with a schedule of values and sub-limits that seriously understated values.[7] One theory I have heard is that in reporting values the interests included one building only; another I have heard is they insured what they viewed a maximum possible loss, six eight or ten floors. Irrespective the World Trade Center was obviously underinsured.

It is interesting that a tool like blanket insurance on contents can be misused and abused in such a way that the original intent is changed. Not long ago there were terms and conditions designed to prevent such abuse from happening. Gordis reports on the pro-rata distribution clause. This clause is no longer to be found in the ISO forms library. Gordis[8] wrote:

Fire insurance policies are sometimes written to cover blanket over two or more locations. A Pro Rata Distribution clause is a most always attached to such blanket policies. The clause operates to distribute the amount of the policy by providing that insurance attaches in each building or location in the proportion that the values at the location bear to those in all locations covered. The Pro Rata Distribution clause thus limits the Company's liability at each separate location, with only a specific proportion of the policy applying to each location.

EXAMPLE: Values at Location A - $5,000
Values at Location B - $10,000
Values at Location C - $15,000

A Blanket policy of $24,000 with a Pro Rata Distribution clause covers all three locations. The Pro Rata Distribution clause operates to distribute the insurance as follows:

Amount of Insurance Applicable to Location A

Values at Location A = $5,000, or 1/6 of $24,000 = $4,000.
Values at All Locations = $30,000

Amount of Insurance Applicable to Location B

Values at Location B = $10,000, or 1/3 of $24000 = $8,000.
Values at All Locations = $30,000

Amount of Insurance Applicable to Location C

Values at Location C =$15,000 or 1/2 of $24000 = $12000.
Values at All Locations =$30,000

Under the terms of the Pro Rata Distribution clause, if values fluctuate as between the different buildings, the insurance will automatically change. Thus, in the above example, if all the values were to shift to Building A, all insurance would automatically apply there. If insurance is carried to the full value of all the property, the loss payment will not be limited by the clause. Contrariwise, if property is underinsured, then under this clause, it is equally underinsured at every location. If the owner carries 50% insurance to value, he is 50 % underinsured at each location that the policy covers, regardless of how the total value is distributed among the different locations.

Blanket insurance on real property seems much more respectable in such a framework. Huebner, Black and Webb comment:

The purpose of this clause is to distribute the insurance automatically over the several items in proportion to their respective values, irrespective of the fluctuations that may occur from time to time in such values. In the case of buildings, since they are subject to little fluctuation, in value, there is little need for such a clause.

Again, note the underlying assumption of insurance to value. And it is that assumption that was violated in a widespread way in the soft market years.

In 1911 Soloman Huebner wrote of the importance of a "distribution clause":

Where property is thus distributed over several items and changes its location from time to time, the interests of both insured and insurer are protected by the use of the "distribution form" of the coinsurance clause.

<u>Conditions Today.</u> In today's market some of the discipline of a pro rata distribution clause has returned. It is common to find blanket insurance for both property and business income with current property schedules and location sub-limits (effectively blanket insurance in name only). A more generous provision is a "loss limit" where the largest possible potential loss location is set as the maximum for any location. Another approach is sub-limits with a margin or 5% or 10% at each location.

A soft market legacy problem is blanket contingent business income coverage. Flitner and Trupin in *Commercial Insurance* describe "business income from dependent properties" as follows:

In insured may be so dependent on a single supplier or single customer that damage to the operations of the supplier or customer may interrupt the insured's operations. For example, a manufacturer may use a raw material that is available from only one supplier. If the supplier's factory is destroyed, the manufacturer cannot continue to make its products. The unendorsed BIC does not cover this loss exposure because the loss of business income must result from direct damage to the insured's property.

Two endorsements are available to provide coverage. They are the Business Income Form Dependent Properties-Broad Form and the Business Income From Dependent Properties-Limited Form. These endorsements cover the insured's loss of income resulting from physical damage to property at other locations. The broad form endorsement extends the BIC to include loss from damage to property at other locations, subject to the BIC's regular limit of insurance. The limited form is used to provide different limits for dependent property exposures.

Dependent property exposures usually result when the insured has a business relationship with one of the following:

- *A contributing location, which furnishes materials or services to the insured*
- *A recipient location, which purchases materials or services from the insured*
- *A manufacturing location, which manufactures products for delivery to the insured's customers,*
- *A leader location, which attracts customers to the insured's location (a major department store at a shopping center, for example)*

Perusal of the two ISO forms (CP 15 09 10 00 and CP 15 08 10 00) both include a schedule where contributing, manufacturing, recipient, or leader locations can be list and an amount of insurance noted.

Soft and Hard Market Conditions. Brokers and underwriters have told me that in the 1990’s a major account might have contingent BI on a blanket limit. The losses cascaded in the wake of the WTC when insureds from across the country were collecting contingent business income because 9/11. In the harder market one finds substantially reduced limits and underwriters asking questions like: “Why do you need it?”; “What exposures do you have?”; and ultimately “Suppose we schedule those exposures with sub-limits”. An interesting variation found where blanket contingent BI is written is the introduction of the distinction between primary and secondary exposures. For example, suppose an Illinois insured has a business income loss because there is a fire in a plant in North Dakota that is a supplier to the Illinois company's supplier in Nevada. This is a secondary location and probably no longer covered. In the 1990's such a loss would probably be covered.

IV. Other Observations on Harder Market Terms and Conditions

Brokers Forms. One of the serious problems of the soft market was the extensive use of brokers forms for writing coverage. The brokerage houses developed these forms for binding coverage. Instead of including specific terms and conditions, these forms had blanks to be filled in by the binding broker. An example of the calamitous consequences for insurers that can ensue is illustrated in the actual case that follows. The ISO property form limits coverage on newly acquired real property to $250,000 for 90 days. I have personal knowledge that one major insurer wrote a $50 million check for a 9/11 loss of "newly acquired property" that the underwriters did not even know they had insured. Today one finds drastically diminishing use of "brokers forms". Indeed one broker I spoke with remarked that he had actually seen one recently, but, he commented, it was on an international exposure. The pattern today is that coverage is bound on the primary lead underwriter's form. The next underwriter might or might not accept that paper depending on whether he/she had had time to study the lead form. If not, the second underwriter might use his/her own form and so on for a third or fourth company. Thus, I am informed, there were major non-concurrency problems created the market in the period immediately after 9/11.

Fortunately, with time this problem has diminished as carriers have grown accustomed to other insurers forms.

Cost of Reinsurance. Before 9/11 insurers would provide blanket limits to suit the needs of the insured. In the harder market, that is not so. Companies today are disinclined to write all of a $500 million risk. One large company market broker told me that the old pattern was for the primary, unwilling to write the whole risk, to arrange facultative reinsurance. But reinsurance markets are limited in their capacity as well. Today the more common pattern is for the broker to arrange layers by offering the risk to four or five carriers, and then possibly seeking reinsurance. This opens the door to the non-concurrency problem. Another interesting development is passing on the facultative reinsurance cost directly on to the insured rather than embedding the cost in the preimary premium.

Deductibles and Limits. Combined deductible have been replaced by split deductibles meaning that one deductible for the property program has been replaced by separate deductible for business income and direct property loss. The same applies to combined single limits. Naturally deductibles are higher. The commom big company market business income deductible is 10 days instead of the standard ISO 3 days. Insureds that used to have a $10,000 deductible now have a $100,000 and the company with a $100,000 now has a $500,000 or $1,000,000 deductible. Sub-limits are appearing for CAT exposures such as California earthquake, flood, and New Madrid earthquake. A common sub-limit is 2% of insurable value.

<u>Terrorism</u>. In the Chicago market, one broker reports a strong tendency to buy terrorism coverage based on location. It was widely reported some months ago hat less than 30% of insureds bought terrorism coverage at the time of the mandatory offer. My broker reports that since then surprising numbers of insureds are buying , especially if priced appropriately for the location exposure (which some insurers don't do). Two reasons for the acceleration in terror cover are lender concerns and board of director concerns. So more terrorism insurance is being sold

IV. Return to ISO Forms in the Middle Market

Business Insurance reported on April 28, 1986: "Hard Market Wiping Out Manuscript Forms". A broker on a RIMS Conference panel commented: "Today we don't start with a blank piece of paper. Instead we are relying on existing forms and changing them as needed". As comments early in this paper indicate, this is happening today. An interesting development in the middle markets is the declining use of proprietary middle market coverage forms and the coverage expansions that had become inherent in those forms. One of the giant primary insurers withdrew from use two of their proprietary forms and returned to ISO forms. I was allowed to examine the old forms and developed the list sampling some of the differences. Table Two reports some findings that illustrate the point.

Table Two

Comment [g1]: Dr. Flanigan, I can remove the boxes for this table if you do not want them to be in. -AJ

Propriety Form	ISO Form

Personal property within 1000 feet	100 feet
Leased Personal Property	Only if contractual obligation
Property in transit: $5000	none
Outdoor Property	Limited $1000
Boats up to 21 feet	Rowboats and canoes
Brands and labels built in	By endorsement
Civil Authority: 4 weeks	2 weeks
Debris removal: 50%	25%
Removal:180 days	30 days
Coverage extensions apply	Only if 80% coinsurance
Newly Acquired Real: no limit, 180 days Personal: no limit, 180 days	 $250,000, 30 days $100,000, 30 days
Personal effects of others	$2500

V. Conclusion and Implications

The heart of the issue for the insurance industry is its inability to maintain sensible pricing. Read the news in 1987 and 1988 and you will find industry leaders calling for “pricing for profit”. By 1989 the market was going soft all over again. Recently I spoke with an executive of a major reinsurance company. He told me that his company was going to continue to price for profit but he also shared with me that two of his major competitors were weakening in their resolve. He also told me that, unlike his company, the underwriters of his competitors still enjoy bonus systems that reward “how many premium dollars are brought in the door”.

Writing in December 2003, the general view is the property markets are leveling off. See the *National Underwriter* of November 10, 2003: “Rate Hike Levels to Ease But Markets Far From Soft”. According to *Best’s Aggregates and Averages*, the last time the industry earned an underwriting profit was 1978. The mediocre ROE of the industry is well documented. If the industry cannot control the urge to increase market share at the expense of pricing discipline, 1978 might be the very last time.

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[1] Soloman S. Huebner, *Property Insurance*, D. Appleton and Company, 1911, p. 167.

[2] Mowbray, Albert H and Ralph H. Blanchard, *Insurance: Its Theory and Practice in the United States,* 4th Edition, McGraw-Hill, 1955, pp. 80 and 81. The authors quote the Merritt Report: *Report of the Joint Committee of the Senate and Assembly of the State of New York Appointed to Investigate Corrupt Practices in Connection with Legislation and Affairs of Insurance Companies, Other than Those Doing Life Insurance Business,* pp. *82ff.*

[3] Insurers and brokers have their own terminology to refer to the big company market, for example, the “global national market”, the “corporate customer market”, the “enterprise market”, and more.

[4] Long, John D and Davis W. Gregg, editors, *Property and Liability Insurance Handbook,* Richard D. Irwin, 1965. Whitford’s chapter is Chapter 4.

[5] Huebner, S.S., Kenneth Black, and Bernard Webb, *Property and Liability Insurance,* Prentice Hall, 1996, p. 156.

[6] Flitner, Arthur L. and Jerome Trupin, *Commercial Insurance,* American Institute of CPCU/INA, chapter 2, p. 31.

[7] ISO form CP 16 15 07 88 Statement of Values is designed to list real property locations for purposes of premium calculation. It has no contractual bearing on loss settlement. What is needed is a separate endorsement that sets specific sub-limits per location.

[8] Philip Gordis, *Property and Casualty Insurance, 23rd Edition* ,Rough Notes, 1976, p. 52.