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THE INSURANCE NEWSLETTER

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Understanding Coinsurance

Most folks who buy insurance have heard the term "coinsurance", but few understand it. Part of the reason is that the word is used in both property insurance and in health insurance, but it means different things in each.

If you have 80% coinsurance on a claim from a health insurance policy it's pretty straightforward....the insurance company pays 80% of the claim, you pay 20%. However, if you file a claim against a property insurance policy with an 80% coinsurance clause you'll get paid 100 cents on the dollar up to the policy limit, as long as you carry limits sufficient to satisfy the coinsurance clause.

Here's the background. Property insurance companies learned long ago that absent any other factors property insurance buyers as a rule would almost always tend to underinsure their properties, to carry an amount of insurance that would be less than the full value of the property insured. This stems from the common sense view that most property losses are partial losses; total losses are rare, and property insurance buyers know that. That's particularly true on blanket policies covering many different structures. Why pay a premium for full limits you're never likely to use?

This, however, is a problem for the insurance industry. Underwriters need an actuarially sound and consistent basis to measure exposure, track losses and determine rates. For property insurance in particular they need a common exposure basis; if one policyholder insures to 50% of value, another to 30%, another to 80% and so forth, there is no common basis. There is no way an underwriter can mash all those polices together to develop an actuarially sound and credible insurance rate.

Insurance companies solve this problem in property insurance by building in a clause that effectively forces policyholders to insure to a common base. This is the coinsurance clause, and it's primary purpose is to enforce a consistent standard for actuarial and rating purposes.

An 80% coinsurance clause in a standard property policy simply means that the policyholder must carry an amount of insurance equal to 80% of the insurable value of the insured property. Other options are allowed; policyholders can also elect to insure to 90% or 100% of value, but insuring to less than 80% is not allowed. If the amount of insurance meets this test, any claim is paid in full up to policy limits. Carry less than the required amount and you'll suffer a coinsurance penalty on any claim you might file. Your claim won't be paid in full, your payment will be reduced in the same proportion as the shortfall in the required amount of insurance.

A coinsurance clause can be a problem for the policyholder, because the proper amount of required insurance is calculated at the time of loss, not when the policy is purchased. Buildings might be renovated, upgraded, added to. Building contents values may routinely fluctuate, often substantially; for a simple example of this just imagine a retail store that increases inventory before the holiday shopping season and then sees inventory shrink dramatically after the holidays. Under these very common conditions an insured that made a good faith effort to carry the proper amount of insurance when he bought the policy could nevertheless be shorted on a claim settlement.

Insurers overcame this by offering several options to deal with potential coinsurance problems. The most common is called an agreed value clause. With this, the

underwriter can look at the amount of insurance requested and agree (hence the name, "agreed value clause") at policy inception that it satisfies the coinsurance requirement. Should a loss occur, the adjuster proceeds directly to claim settlement with no need to calculate any possible coinsurance penalties.

The agreed value clause is an excellent way to eliminate any concern about possible coinsurance penalties. Most often the policy holder will be required to furnish a signed statement of the values insured to the underwriter. The underwriter will rely on this to provide the agreed value clause. Some care must be taken with this to be sure it is reasonably accurate and correct. If the statement of values contains material errors, unintentional or otherwise, the claim adjuster could still come back at the time of loss and allege material misrepresentation on the part of the policyholder. Insurance companies take a very dim view of this; it's not something you want to deal with when you are trying to get a claim paid.

In summary, here are the steps anyone buying property insurance needs to follow to avoid problems at claim time:

1. Determine what basis of valuation you want to insure to. Replacement cost means current replacement cost, new property for old. Actual Cash Value (ACV) means replacement cost less physical depreciation. (Note this is not an accounting value, which is historical cost, depreciated.)
2. Based on the basis of valuation selected, determine the full value of the property to be insured.
3. Select a limit of insurance equal to 80%, 90%, or 100% of the full value.
4. If available or offered by your insurance company (some don't or won't), have an agreed value clause added to your policy.

Note that this is a simplified description. More needs to be done for a more complex property risk, one involving fluctuating values, multiple structures or locations, etc. We'll be happy to work with you to get those properly covered.

Key Person Disability Insurance

We spend a lot of time discussing the proper way to insure your property and equipment (see preceding article). This is important, of course, because your buildings, furnishings, machinery and equipment are essential resources for the conduct of most businesses or enterprises.

But what about another important resource, your human resources? Most organizations have certain key people who are essential to the success operation of the enterprise. These folks might be valuable because of their experience, contacts, expertise, innovation or knowledge. They might have important client relationships, hold and control the company's major accounts, have other key business contacts or possess essential information that is imperative to the profitable functioning of the business. Losing these key people, permanently or even temporarily, could be incredibly detrimental to an organization, and could have financial consequences equally as severe as the loss of a key machine or warehouse, and perhaps even more so.

The risk is real. Industry statistics show that an individual faces a sizeable risk for at lease some period of disability during their working career. The greatest number of disability cases involve people in the 30-49 age bracket, with the average age for disability being 41. With modern medical procedures 67% of people who suffer heart attacks, the number one killer in America, survive, while cancer survival has reached a level of 56%. Good news, but both usually involve periods of disability and absence from work. The Federal Home Loan Banks have reported that their own data shows the major cause of mortgage loan foreclosures is disablement of the mortgagee, 48%, against only a 3% foreclosure rate due to untimely death.

And the disability of a key employee creates a hazard for businesses, too. This is especially true in organizations with relatively thin top management staffs where a small handful of key people make the whole operation run. Key Person disability insurance can provide crucial benefits to such an organization to protect it financially in the event that a key employee can't pull his weight due to a disability. For short-term disabilities benefits could be used to hire temporary help to pick up slack or fill in for other employees who must cover for the disabled employee. For permanent disability, benefits could

be used to help defray the costs of hiring and getting a replacement up to speed, make up for any loss in revenue and cover unfunded salary continuation costs. In this situation, high limit disability insurance can be invaluable to an organization by providing cash flow to help companies move forward and maintain profitability in the event of key employee disability.

If any of this describes you, let's talk about how we can help you cover this potentially serious exposure.

Workers Compensation and Aging Workers

The National Council on Compensation Insurance (NCCI) is a national ratemaking and statistical organization. Three dozen states subscribe to NCCI, but much of the information they publish is applicable even in those that don't.

NCCI recently published their findings from a study on workers compensation and aging workers. The results are interesting for any employer.

- In looking at WC claim costs per worker, differences were still found in claim costs by age (with older workers costing more), but the data indicated that "older" starts at age 35, with all groups of workers aged 35 to 64 having similar costs per worker. Workers in the 20 to 24 age group have markedly lower severities and claim costs and workers age 25 to 34 fall in the middle.
- The long-standing assumption that younger workers have much higher injury rates is no longer true. Differences in injury frequency by age have virtually disappeared.
- Differences in leading types of injuries are a major factor in differences in severity by age. Older workers tend to have more rotator cuff and knee injuries while younger workers have more back and ankle sprains.
- On the indemnity side, higher wages are a key factor leading to higher indemnity costs for older workers.
- With medical costs, older workers were found to receive more treatments per claim.

In their conclusion, NCCI notes that differences in injury frequency by age group, which were pronounced as recently as fifteen years ago, have largely disappeared. Frequency rates respond to safety management, so it's reasonable to infer that better attention to safety management by employers has had an impact here.

Injury severity and claim costs for older workers is roughly 50% higher than for younger workers. These higher loss costs for older workers are driven by three identifiable factors. Variation in the mix of types of injuries accounts for approximately half the difference in loss costs. For the rest, the key factor for differences in indemnity severity was higher wages generally paid to older, more senior workers leading to higher benefits being paid. On the medical cost side, the key factor driving higher costs for older workers was simply more treatments per claim.

From an insurance cost perspective there is a partial offset to the higher costs of claims older workers generate. This is because they generate higher premiums than younger workers, due to the higher wages older workers generally earn. Other sources have also reported on the higher productivity generally found in an older workforce. Add it up and the higher loss costs from older workers are substantially mitigated when offset against the higher premiums they generate and by their increased productivity.

These findings can be viewed as reassuring, in that an aging workforce has a less negative impact on loss costs than might have been originally thought.

WC: List the States

Speaking of workers compensation, here's a common and often misunderstood problem with workers compensation policies we occasionally see.

If you look at the first page of the Declarations in a standard workers compensation insurance policy, you'll see Item Three - Coverage right in the middle of the page. Item 3.A. is Workers Compensation Insurance: it says "Part One of the policy applies to the Workers Compensation Law of the states listed here:". The states in which you have employees should all be listed here.

Workers Compensation laws are state specific, and all different. Unlike most all other policies, a workers compensation policy does not define coverage; it just says, in effect, that whatever the law says workers compensation is in a particular state, that's what the policy covers. For that reason every workers compensation policy will list at least one state in Item 3.A.

There is also Item 3.C., Other States Insurance. This will usually name "all states", except four named monopolistic states where workers compensation can only be purchased though state programs, and also excepting states specifically named in Item 3.A.

Why is all this important? If you get into the policy itself, it states it will provide coverage according to the workers compensation laws of the states listed in Item 3.A. Under the Other States section, it says it will also provide coverage for "Other States" if you begin work there after the policy is effective. Good news; you have automatic coverage if you hire employees in other states.

But...this same section also says "If you have work on the effective date of this policy in any state not listed in Item 3.A. ....coverage will not be afforded for that state unless we are notified within thirty days." (Italics added.)

What's it mean? If you add employees in other states during the policy, they are automatically covered (except four monopolistic states). But... if you have employees in other states at policy inception, and you fail to list those states on the policy, you are out of luck... no insurance.

Solution? Quite simple. With every renewal make sure you list at policy inception all states where you have employees, even if only temporary. This is a small but important detail to pay attention to.

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