COMMERCIAL FIRE UNDERWRITING

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d in the United States of America

These latter factors should be based on the rates before the coinsurance credit.

There are underwriting factors which should be considered in connection with a coinsurance clause, however. The most important is the matter of compliance with the agreed percentage. If the amount of insurance carried is less than the amount required (which is the agreed percentage of the value of the property at the time of the loss), every loss is reduced by the amount of the deficiency.

Good underwriting practice requires that consideration be given to a possible deficiency both at inception and during the life of the policy. Underwriters should know enough about the values of the property to determine if the agreed amount of insurance is being carried. Furthermore, they should take into account any proposed increases in valuation of which they are aware.

If a deficiency is apparent, this should not be ignored. It is true that the insurance company is protected by the penalty provision of the coinsurance clause. However, it is a poor practice to depend upon a clause which is understood by few policyholders. Public relations demand that all of us attempt to point out obvious areas of potential conflict before the conflict arises. In this case, the underwriter should secure from the producer all of the information about the situation.

Sometimes an apparent deficiency is not a problem. Perhaps, the valuation is less than was represented to the underwriter or the valuation will be reduced before the inception of the policy. Also, there are cases where policyholders deliberately underinsure with a coinsurance clause, considering their share of the loss in the same light as a deductible. This latter practice is acceptable provided the policyholders are aware of what they are doing and what the implications are (such as the fact that the dollar uninsured loss will increase as the size of the loss increases).

The rate credit given for a coinsurance clause is often so great that it is foolish not to use it. In fact, the specific rates in most states are now published with an 80 percent coinsurance clause included.

The percentage may be increased, and the reduction in the rate is generally 5 percent for a 90 percent clause and 10 percent for a 100 percent clause. A lower percentage may also be used, or the coinsurance clause removed entirely, for an additional charge, which may vary by territory.

There is another situation where the underwriter should be cautious if a coinsurance clause is used. This is the case of fluctuating values. If the values of stocks of merchandise fluctuates widely, there will be periods where the insurance is inadequate, ordinarily a poor situation. Even worse from an underwriting standpoint are the periods when the insurance is excessive because this raises the moral problem created by overinsurance. It is ordinarily prudent underwriting to recommend that no coinsurance clause be used or that a reporting form policy be written in such cases.

One further problem: it is possible that the coinsurance clause credit will reduce the rate and premium to such a point that some of the factors described in this chapter under the heading of "Low Rates" will apply. Not that the rate adequacy is a problem and coinsurance does not affect that. But the premium can be depressed to such a point that there simply is not enough money collected to cover expenses and to pay for the small loss which is always a possibility. The coinsurance clause credit may reduce the rate so far that acceptability and specific reinsurance are threatened.

Insurance to Value

The ratio of the amount of the insurance to the value of the property is important to a commercial fire underwriter. This is usually referred to as "insurance to value."

Basic fire insurance rates, with no coinsurance clause, are computed at about 50 percent anticipated insurance to value. Since it is advantageous to the insurance company to secure a high insurance to value, this percentage should be a minimum which is accepted by an underwriter.

Next, the ratio must be determined. This is usually handled in round figures. For example, a value of $102,000 and insurance of $50,000 is considered as 50 percent for practical purposes of underwriting. Note that this is just a guide; a claims adjuster faced with a loss involving a coinsurance clause would be much more exact.

Underinsurance. An applicant who will not insure at least 50 percent to value is trying to play the averages against the insurance company. Most of the losses will be small, and thus will be covered in full. The chances of a large loss are slight. This applicant is gambling that there will not be a large loss.

The underwriter, on the other hand, will not be getting sufficient premium to cover the losses. Remember, that all small losses will be paid in full and policy limits will be paid on a large loss.

Many underwriters refuse to write a policy which is definitely insured for less than 50 percent to value.

Overinsurance. The situation is entirely different if an applicant appears to want more insurance that the property is worth. This would be considered as being over 100 percent insurance to value.

Naturally, the first step is to be sure that there are not unknown factors which increase the value of the property. Very often cases which appear to be overinsured are found on investigation to be of superior quality or to result from error in estimating the size of the building.

There is a unique problem involved in overinsurance in some states. These are "stated value" states, where the laws provided that in case of a total loss the policy limit must be paid. This means that the insurance company cannot apply depreciation or obsolescence to reduce the value below the amount of insurance carried. The theory behind this practice is that the insurance company should know the value of the property it insures–having accepted premium for a high value, it cannot try to settle the claim for less after a loss. This type of law, which differs in detail among the states, is found

in only a few states. Where it is found, of course, a stated value law requires the underwriter to be very cautious about the possibility of overinsurance.

Overinsurance should always call for an investigation of the moral hazard. In a stated value state, the policyholder could recover more than the loss, thus making a profit out of a fire. In other states, payment will not exceed the value of the property damaged but this fact should not be accepted as an excuse for overinsurance. In the first place, this condition makes the job of the claims adjusters much more difficult. In the second place, the policyholders might not know that recovery would be less than the amount of the policy in case of a total loss, and believing that a profit can be made from the fire, they may encourage it. The result in the latter instance could be a very sizeable loss, even if less than the policy limits.

Every case of known overinsurance should be analyzed carefully. This is a dangerous condition and is seldom tolerated by an experienced underwriter.

Determination of Values. It is essential that underwriters be able to determine the values of properties to be insured, at least as an approximation. They cannot watch for underinsurance or overinsurance if they do not know the values.

A starting point is the cost to construct a similar building or to secure the personal property. Appraisals may be necessary, but average costs per square foot may be adequate for some buildings.

Depreciation should be applied unless the insurance is written on a replacement cost basis. Underwriters need to know how actual cash value is computed in the states where insurance is written.

When reviewing policies which have been on the books for some time, underwriters must determine if property values have been adjusted to remain in line with current costs. A reputable building cost index may be helpful in this calculation.

Blanket insurance, rather than specific coverage, may be used to avoid coinsurance penalties, but requires a careful determination of values. An agreed amount clause may be used to avoid underinsurance problems. In all such cases, underwriters must understand the provisions of the forms, and must be comfortable with the values and amounts of coverage.

Beating the Averages

The primary task of underwriters, as was explained earlier in this chapter, is to try to write insurance on properties which are average or better. Or, at least, they should write no more than their share of the properties which are worse than average. The references are to "average" in exposure to loss in relation to rate.

Rate is a measure of exposure to loss but only in an average way. While rate can be used in underwriting, it has its limitations. Unless obvious problems of low rate or high rate are present, the rate is not much of a guide to a commercial fire underwriter.

How, then, does the underwriter select? Given two properties with rates which are approximately equal, how is the primary job of selection performed?

The answer lies in the total of all of the factors which have been discussed in this book. In fact, true underwriting takes each of these into consideration.

For example, consider a large restaurant. A specific rate has been published for it and perhaps an occupancy credit or debit has been applied. Does this mean that this particular restaurant will be profitable at that rate?

Here are just simple illustrations of the factors which might be taken into account. All of them have been mentioned in previous chapters of this book.

1. *Construction.* Remodeling, new roof, and other construction changes can be made after the rate is published. Consideration must be given to such changes which are not reflected in the rate and to the overall susceptibility of the construction features. A particular problem in restaurants is frequent renovation where inflammable decorations or seat covers may be used and where paint and plastic hazards may be introduced.

2. *Occupancy.* The rate for this restaurant under consideration will reflect the type of occupancy. However, this factor cannot be completely ignored. For one thing, the type of restaurant may have changed and perhaps more deep grease frying is used or perhaps open flame candles have been added recently to give a different atmosphere. Another possible problem is the type of adjacent occupancies–perhaps the exposure was taken into account in the rate but considerable damage to a restaurant could take place from smoke which enters from a fire in an adjacent occupancy.

3. *Fire Protection.* The type and condition of fire extinguishers can be of great importance in a restaurant. This factor, alone, could conceivably change a particular restaurant from a profitable fire prospect to an unprofitable one and yet the rate might not reflect the situation.

4. *Exposures.* The rate is intended to take into account the adjacent locations which expose the property. But these other occupancies can change or the chance of a fire in them can be increased because of financial difficulties or fashion changes. Each exposing occupancy must be analyzed completely.

5. *Location.* Neighborhood conditions can change after a rate is promulgated and subtle changes can occur which may not affect the rate. Perhaps street traffic and parking have become so heavy that firefighting equipment would have