8 – Common Features of Insurance Policies

**1 – Insurable Interest**

**Objective**: Given a case, evaluate one or more entities’ insurable interest

When determining whether a loss is covered under a property insurance policy, a professional must determine whether the insured, who is claiming a financial loss, has an insurable interest in the property that was damaged or destroyed. The analysis must determine two things: Whether the claimant is insured under the policy and if so, whether the insured has an insurable interest in the property.

An insured under a property policy must have an insurable interest in property that is damaged or destroyed in order to have a legitimate claim. Several legal bases can be established for an insurable interest. In some situations, multiple parties can have an insurable interest in the same property. Example; spouses who have tenancy in the same property both have an insurable interest in it. An examination of when and why insurable interest is required, along with the descriptions of the legal bases for insurable interest and the multiple parties that can have an insurable interest, will help insurance and risk management professionals determine whether the insurable interest requirement has been met when an insured submits a property claim.

**When and Why Insurable Interest is Required**

Insurable interest is an interest in the subject of an insurance policy that is not unduly remote and that would cause the interested party to suffer financial loss if an insured event occurred.

An insurable interest arises as the result of a relationship with a person or a right with respect to property. Whether an insurable interest exists depends on the relationship between the claiming party and the property, person or event that is subject of the insurance policy. To make a claim under a property insurance policy, the claimant must stand to suffer a financial loss if the insured property is damaged or destroyed.

The requirement for an insurable interest is a matter of law and exists even in the absence of policy provisions specifically addressing insurable interest. However, policies often include provisions that limit insureds’ right of recovery to no more than their interest in the covered property at the time of the loss.

The requirement for insurable interest is different in property-casualty insurance than in life insurance. In life insurance, the beneficiary must have an insurable interest in the life of the insured when the policy is purchased, but not necessarily at the time of the insured’s death. For example, Mary is the beneficiary on her husband’s life insurance policy. If the couple divorces, Mary may no longer have an insurable interest in her ex-husband’s life, but she would not be prevented from collecting under the policy in the event of his death.

In contract, insurable interest in property-casualty insurance must be present at the time of the loss. Example, if Jacob sold his home but did not cancel his homeowners policy, he could not present a valid claim under that policy if the property were subsequently damaged because he would no longer have an insurable interest in the home.

Insurance policies have an insurable interest requirement for these three reasons:

* It supports the principle of indemnity
* It prevents the use of insurance as a wagering mechanism
* It reduces the moral hazard incentive that insurance may create for the insured

Insurable interest supports the principle of indemnity by ensuring that only those parties who suffer financial loss are indemnified, and then only to the extent of their loss. Requiring an insurable interest prevents individuals or organizations from wagering (gambling) by insuring an event from which they would not suffer a loss and then profiting when that event occurs. In addition, because the insurable interest requirement limits insureds’ ability to profit from insurance, the incentive to cause losses intentionally (moral hazard) s reduced.

**Legal Bases for insurable Interest**

**Ownership Interest in Property**

**Ownership of property creates an insurable interest in that property, and ownership rights are legally protected**. Property owners have a legal right to sell, give away, and use their property. The extent of legal ownership determines the extent of insurable interest in the property.

*Although the term “property” is commonly used to refer to tangible objects such as buildings and their contents, is also includes intangible items, such as copyrights, patents, trademarks, intellectual property, and stock certificates*. Ownership rights to both tangible and intangible property have economic value and are guaranteed and protected by law.

**Contractual Obligations**

Insurable interest can arise out of some contractual obligations. Generally, contractual rights and related insurable interest fall into two major categories.

* **Contractual rights regarding people** – A contract may give one party the right to bring a claim against a second party without entitling the first party to any specific property that belongs to the second party. Example, if you do not pay your credit card debt, the credit card company can bring a claim against the outstanding balance on the credit card. However, the credit card company does not have any right to repossess any of the property as payment for the debt. The credit card company is an unsecured creditor. **Unsecured creditors do not have an insurable interest in debtor’s property.**
* **Contractual rights regarding property** – **Some contracts allow one party to bring a claim against specific property held by a second party.** Example, If I obtain a mortgage loan in order to buy a house, the **mortgage holder** can repossess the house if I fail to make the mortgage payments. This type of contract typically creates **an insurable interest in the secured property equal to the debt’s remaining balance**.

**Exposure to Legal Liability**

Sometimes one party can have legal responsibility for property owned by others. Having this type of legal responsibility creates an insurable interest in that property because the responsible party can suffer a financial loss if the owner’s property is damaged.

* A hotelier has an insurable interest in guest’s property
* A tenant has an insurable interest in the portion of the premises the tenant occupies
* A contractor typically has an insurable interest in a building under construction

In these cases, the responsible party has an insurable interest based on potential legal liability for damage to the owner’s property. The extent of that insurable interest is the property’s full value, including the owner’s use value.

**Factual Expectancy**

A majority of states have accepted factual expectancy as a valid basis for an insurable interest. Factual expectancy is a situation in which a party experiences an economic advantage if an insured event does not occur, or, conversely, economic harm if the event does occur.

*In these states, a party does not have to establish a specific property right, contractual right, or potential legal liability to prove insurable interest.* The party need only demonstrate potential financial harm resulting from the event to be insured. The focus is on the insured’s financial position rather than on a legal interest. For example; Tina’s finance gives her a diamond ring that he had stolen from a relative. When Tina’s apartment was burglarized, the ring is one of the items taken. During the investigation, the origin of the ring is discovered. Because a person cannot legally own property that rightfully belongs to another, Tina was never the legal owner of the ring. Nonetheless, courts would probably find that she would be entitled to recover the ring under her tenant’s policy based on her factual expectancy of loss.

**Representation of Another Party**

Insurable interest can be based on one party’s acting as a representative of another party. In this case, the representative can obtain insurance on property for the benefit of the property’s owner.

* **Agents** – an agent may insure a property in the agent’s name for the principal’s benefit. Although the insurance proceeds are ultimately payable to the principal, the agent has an insurable interest.
* **Trustees** – a trustee may insure property in the trustee’s name for the trust’s benefit. The trustee has an insurable interest but must give the insurance proceeds to the trust.
* **Bailees –** a bailee may insure property in the bailee’s name for the bailor’s benefit. The bailee has an insurable interest, but if the bailor’s property becomes damaged or destroyed, the bailee pays any insurance proceeds to the bailor.

**In these situations, the party obtaining the insurance is not required to have an independent insurable interest in the property. The party derives it interest from its relationship with the party it represents**.

**Multiple Parties with Insurable Interests**

Under some circumstances, more than one party has an insurable interest in the same property, and, as a result, the sum of all insurable interests exceeds the property’s value. Example; a property owner and the lender holding a mortgage on the property both have an insurable interest in that property. The mortgage holder’s interest is the amount of the unpaid loan, and the owner’s interest is the property’s full value. Combined, the amount of these two interests could greatly exceed the property’s value.

When more than one person owns the same property, the nature of the ownership affects the extent of each party’s insurable interest. Property may be jointly owned according to these interests:

**Joint Tenancy (Joint tenants each with ownership not married)**

In joint tenancy, each owner, referred to as a “tenant”, owns the entire property and has a right of survivorship. **This is an automatic right on one tenant to the share of the other tenant when that other tenant dies.** Examples, if Manuel and Gerard are joint tenants of a restaurant building, each owns the entire building. If Manuel died, Gerard would automatically become the sole owner of the building and vice versa.

Because any one joint tenant could become the property’s sole owner, each tenant has an insurable inters in the property’s full value. If the restaurant was insured for its full value of $1M, Manuel and Gerard would each have a $1M interest. The combined interest would be $2M. Nonetheless, if the restaurant was destroyed by fire, the insurance policy would pay no more than the property’s value, subject to the $1M policy limit. That payment would probably be paid to the first named insured in the declarations.

**Tenancy by the Entirety (spouses)**

Tenancy by entirety is a joint tenancy between a husband and wife. **As with a joint tenancy, if spouses jointly own a property, each of them owns the entire property. If one of them dies, the other becomes the sole owner**; consequently, each spouse has an insurable interest equal to the full value of the property. As a result, the combined interest of both spouses would be twice the property value. However, as with a joint tenancy, in the event of a loss, an insurance policy would pay no more than the property’s value.

**Tenancy in Common (concurrent ownership building)**

Tenancy in common is a concurrent ownership of property, in equal or unequal shares, by two or more owners. Unlike joint tenants or tenants in the entirety, **tenants in common do not have survivorship rights. Example, Andy, Carl, and Rene are tenants in common of a factory, each holding one-third interest. If Andy dies, Carl and Rene would still each own only one-third of the factory. Andy’s third would pass to his heirs**.

With tenants in common, each party’s insurable interest is limited to that owner’s share of the property. The combined interests are equal to the property value. Any insurance payouts would probably be made to the first named insured, who would then be responsible or distributing the appropriate share of the money to the other tenants in common.

**Tenancy in Partnership**

**Tenancy in partnership is a concurrent ownership by a partnership and its individual partners of personal property used by the partnership. This type of tenancy is similar to a joint tenancy in that the partnerships and al partners have rights of survivorship**. Therefore, with a tenancy in partnership, both the partnership entity and the individual partners have an insurable interest in property used by the partnership.

Depending on the size of the partnership, the combined interests could be many times the actual property value because each partner, and the partnership, would have an insurable interest worth the entire insurable amount. If a loss occurred, the claim settlement would be paid to the first named insured, which could be the partnership entity or one of the partners.

**2 – Insurance to Value**

**Objective**: Explain why insurance to value is important to property insurers, how insurers encourage insurance to value, and what insureds can do to address the problems associated with maintaining insurance to value.

An important goal of insurers selling property insurance is to motivate each insured to buy a limit of insurance that approximates the full value of the covered property, commonly called “insurance to value”.

**Insurance to value is beneficial for both the insurer and the insured. Insurers benefit from insurance to value because it ensures that premiums are adequate to cover potential losses and it simplifies underwriting**. The insured benefits because sufficient funds are available in the event of a loss. Insurers use a variety of policy provisions to encourage insureds to purchase adequate limits of insurance. Although maintaining insurance to value can be challenging, various measures are available to assist insureds and insurance professionals with maintaining insurance to value.

**Why insurers Seek Insurance to Value**

Insurers seek to achieve insurance to value in the property insurance policies they write. The need for insurance to value can be understood by first examining loss frequency (number of losses that occur within a specified time period) and loss severity (the amount of loss, typically measured in dollars, for a loss that has occurred).

**During the risk management process, loss exposures are assessed to determine potential loss frequency and loss severity. For property loss exposures, the severity loss distribution is often skewed. That is, most of the losses that occur to property, especially real property, are small losses, with a total loss being a rare occurrence**. The point can be illustrated through a hypothetical severity distribution of a house valued at $150,000. The probability distribution table shows that if a loss occurs, 90% of the time, that loss is less than $5,000 (because the cumulative probability is 90%). Because the cumulative probability of a loss less than $25,000 is 98.5%, then only 1.5% of the time is the loss greater than $25,000. The maximum possible loss for the property is $150,000, which would occur only if the property were totally destroyed.

Using a very simplified method, the insurer could calculate the insurance rate and premium to insure the property by combining the severity distribution shown in the probability distribution table with a frequency distribution.

**The importance to the insurer of insurance to value can be illustrated by showing how the lack of insurance to value affects premium adequacy**. Example; suppose that the insurer provides a property insurance policy with a policy limit of $150,00 and that the premium is based on an insurance rate per $100 of coverage. Dividing $150,000 by $100 yields 1,500 units of coverage that the insurer is providing.

The insurer, charging a premium of $948 for a policy with a limit of $150,000 (the value of the property), is using an insurance rate of approximately $.063 per unit of coverage ($948 / 1,500 = $0.63). Further, **suppose that the insured evaluated the severity distribution and chose to retain the 1.5 % probability that losses would be above $25,000 by buying a policy with a limit of only $25,000**

**The insurer would lose money on the $25,000 limit policy (250 units of coverage) if it charged the same rate (0.63 per unit of coverage) as for the policy with the $150,000 limit**; this would result in a premium of only $158 (250 units x $0.63 = $158), and the lower premium would not be sufficient to cover the expected losses under the policy.

In the severity distribution that the insurer faces stops at $25,000 the expected value of that distribution is now $2,250. With the same frequency distribution as used previously, the expected loss is now $450 [0.8 x $0) = (0.2 x $2,250) = $450], and assuming the same expense loading, the premium would be $750 [$450 / (1 – 0.4) = $750]. For a policy limit of $25,000, the insurer is offering 250 units of coverage with a rate of $3.00 per unit of coverage. This is substantially higher than the $0.63 per unit rate that was calculated when the property insurance limit was equal to the property’s total value.

The insurer is then faced with a decision to either charge a higher safe rate for property insurance when the policy limit is less than the property’s value or require insureds to choose policy limits that are close to the full value of the property. Insurers generally prefer the second choice, referred to as insurance to value.

**Insuring to value is typically beneficial for both the insurer and the insured. The insurer benefits in two ways. First the premium is adequate to cover potential losses. Second it simplifies the underwriting process by reducing the need to determine exact values during underwriting**. The determination of underinsurance (not insuring to value) is made at the time of loss; therefore, the underwriter does not need to determine whether the property is being underinsured.

The insured benefits from insurance to value because sufficient funds are available in the event of a total loss, and the uncertainty associated with large retained loses is reduced.

Insurance to Value Liability Policies – Determining the maximum possible loss for most liability los exposures is impossible because the severity of such exposures, in theory, is limitless. That is, the law generally does not limit the dollar amount of damages that a court can award to an injured party as damages payable by the responsible party. Therefore, insurers do not see insurance to value for liability policies.

However, liability insurers use insurance rates that are adequate for whatever “layer” of coverage they are insuring. For example, the rate charged for the primary liability policy (which covers the highest frequency of covered claims) is normally higher than the rate charged for an excess liability policy covering claims that exceed the primary policy’s limit of insurance.

Although insurance to value does not apply to liability policies, it is still important for insureds to estimate the potential severity of their liability loss exposures and buy appropriate limits of liability insurance to cover these exposures.

**How Insurers Encourage Insurance to Value**

As an incentive for insuring to value, many policies include insurance-to-value provisions that reduce the amount payable for both partial and total losses if the insured has not purchased adequate limits of coverage. These provisions, which include coinsurance clauses and similar provisions, serve dual purpose: rewarding those who have insured to value and penalizing those who have not.

**Many commercial property insurance policies contain coinsurance clause, which make the insured responsible for retaining part of any loss if the property is underinsured below some specified percentage of the property’s insurable value**. The most common coinsurance percentages for buildings and business personal property are 80,90, and 100%. The insurable value is the actual cash value (ACV), the replacement cost value, or whatever other valuation basis applies, according to the policy’s valuation clause.

The coinsurance formula explains how the amount payable is determined, if the coinsurance requirement has not been met, and can be express in this manner:

Amount Payable = limit of Insurance (at time of loss X Coinsurance % X total amount of covered loss

Value of covered property

Insurance students often remember the formula as **“did over should times loss”**

**Amount payable = Did / Should X Loss**

Did = The amount of insurance carried (policy limit)

Should = the minimum amount that should have been carried to meet the coinsurance requirement

For example, a business owns a building with a replacement cost value of $10M. It insures the building for $9M with a property policy providing replacement cost coverage subject to 100% coinsurance clause. If a covered peril causes $5M of damage the insured will not receive the full $5M from its insurer, because the building is underinsured. 9M / 10M X $5M = $4.5M

*Business income and extra expense policies also commonly include coinsurance requirements, but the requirements are based on projected net income and operating expenses for the one-year policy period rather than on property values.* The coinsurance percentages available for business income and extra expense insurance are 50, 60, 70, 80, 90, 100, and 125%, reflecting the fact that some business may be able to resume operations in 6 months or less(about 50% coinsurance), while others may require a year or more to resume operations (roughly corresponding to 100-125% coinsurance).

*Insurance to value provisions in homeowner’s (HO) and businessowners (BOP) policies also encourage insureds to purchase adequate limits, but they do so in a different way than the commercial property coinsurance provision does*. With HO and BOP insurance to value provision, the amount payable by the insurer will never be less than the ACV of the damaged property, subject to policy limits. *With coinsurance, the amount payable (depending on the degree of underinsurance) can be less than the property’s ACV.* Under the HO and BOP insurance to value provisions. The amount payable will be one of these amounts:

* The replacement cost value of the property – effectively, a reward for those insured to at least 80% of the replacement cost value of the property
* The actual cash value of the property – effectively, a penalty for those not insured to at least 80% of the replacement cost value of the property
* An amount between the replacement cost value and the ACV of the property, determined by the same “did over should times loss” formula used in the coinsurance penalty, with which the loss amount is on a replacement cost basis.

**Addressing Insurance-to-Value problems**

Maintaining insurance to value avoids coinsurance penalties and other insurance to value provisions penalties that might reduce the amount payable in the event of a loss. Underinsurance penalties are not a concern for insureds who maintain insurance limits that meet or exceed coinsurance requirements or the insurance to value requirement. However, **maintaining such limits is difficult, for at least these reasons:**

* **The amount of insurance necessary to meet coinsurance requirements is based on the insureds property’s value at the time of the loss, but the policy limit is selected when the policy is purchased**
* **When selecting insurance limits, an insurance buyer typically estimates property values based on an informed guess**
* **The insurable value at the time of the loss often cannot be precisely measured until the property is actually rebuilt or replaced**
* **Values change over time**

Insurance professionals can help property insurance buyers minimize problems associated with valuation by recommending that they take these steps:

* Hire a qualified appraiser to establish the property’s current replacement cost value and set policy limits accordingly. The property owner should adjust the appraisal using indexes and/or a record of additions and deletions each year and should reappraise the property every few years.
* Review and revise policy limits periodically to ensure that they are adequate to cover potential losses
* Consider appropriate coverage options – for example, agreed value optional coverage, inflation guard protection, and peak season endorsement

**3 – Property Valuation Methods**

**Objective**: Explain how property is valued under each of the following valuation methods in property insurance policies: Actual Cash Value; Replacement Cost; Agreed Value; Functional Valuation

When covered property is lost or damaged, the amount payable under a property insurance policy depends on the property’s value. Every property policy states how the insurer and the insured determine that value. The policy valuation method is contained in the valuation provision.

**Actual Cash Value**

Actual cash value if one of the most prevalent methods used with property insurance policy to determine the amount payable for a property loss because it supports the principle of indemnity by restoring the insured to its pre-loss condition. ACV is typically calculated as the property’s replacement cost at the time of loss minus depreciation.

**The following are three common methods of determining ACV for property:**

* **Replacement cost minus depreciation**
* **Market Value – many courts have ruled that ACV means market value, the price at which a particular piece of property could be sold on the open market by an unrelated buyer and seller**
* **The broad evidence rule – Actual cash value determined based on court decisions that require all relevant factors to be considered**.

The term “actual cash value” is rarely defined in insurance policies, and the definition adopted by courts often varies by jurisdiction and type of property insured. Although the traditional definition of ACV has been limited to replacement cost minus depreciation, other methods of determining ACV have evolved, including the use of market value and the broad evidence rule.

When a property insurance policy specifies that property will be valued on an ACV basis, the insured must choose a policy limit to fully insure the property on that basis. The following is the actual cash value policy provision from ISO Building and Personal Property (BPP) coverage form (subscriptions b.-3. Change the valuation methods for special items such as glass, outdoor equipment, and tenant’s improvements and betterments):

Valuation: We will determine the value of Covered Property in the event of loss or damage as follows: a. At actual cash value as of the time of loss or damage, except as provided in b., c., d., and e., below.

**Replacement Cost Minus Depreciation**

**Most property has its highest value when new and depreciates at fairly steady rate as a result of age and use. Depreciation reflects the value of the use that the insured has already received from the property**. Although depreciation can be based on physical wear and tear, which usually increases with age, it can be based on age alone. It can also be based on obsolescence caused by fashion, technological changes, or other factors that occur rapidly and suddenly. Disagreement regularly develop about how to determine the appropriate amount of depreciation to deduct.

The important distinction about depreciation in calculating ACV is that the ACV calculation is base done economic depreciation, not accounting depreciation;

In account, if property is expected to have a useful life greater than one year, organizations can depreciate the property over its useful life rather than expensing it in the year of the purchase. This accounting depreciation expense is the allocation of the property’s value, as reflecting in an organization’s accounting and tax records, over the property’s useful life (usually a schedule set by tax codes).

Accounting depreciation is distinct from the economic depreciation of property. Economic depreciation is the difference between the replacement cost of the property and its current market value. Economic depreciation is typically the result of physical or functional depreciation. Physical depreciation is the wear and tear on the property and is usually reflected in a reduction in the property’s ability to perform its intended function, regardless of use.

Functional depreciation is usually the result of technological advances because the function performed by the capital expenditure is no longer needed or can be performed better by other methods. For example; personal computers purchased 3 years ago would have greatly reduced value even if they were never removed from their cartons.

**Market Value**

**Many courts have ruled that ACV means market value (also referred to as fair market value)**. Market value is easily established for autos, personal computers, and other property that has many buyers and sellers for which information is available about recent sales. However, it can be difficult to establish market value if there have been few recent transactions involving comparable property.

**Market valuation is also useful when property of like kind and quality is unavailable for purchase, such as with antiques, works of art, and other collectibles. These types of property may be irreplaceable, making replacement cost calculations impossible. Market valuation can also be the most accurate way to determine the value of some older or historic buildings built with obsolete construction methods and materials.**

**The market value of real property reflects the value of the land and its locations, as well as the value of any buildings or structures on the land. Because most insurance policies cover buildings and structures but not land, the land’s value must be eliminated in establishing insurable values.**

**Broad Evidence Rule**

The broad evidence rule arose when courts stipulated that insurers had to consider more than just depreciation or market value when determining ACV. The exhibit contains **a sample of some of the elements that various courts have used in applying the broad evidence rule to determine a building’s ACV:**

* **Obsolescence**
* **Building’s present sue and profitability**
* **Alternate building uses**
* **Present neighborhood characteristics**
* **Long-term community plans for the area where the building is located, including urban renewal prospects and new roadway plans**
* **Inflationary or deflationary trends**
* Any other relevant factors

**Replacement Cost**

The second valuation method in property insurance policies is replacement cost. Replacement cost is commonly used n insurance policies covering buildings and in many policies, covering personal property.

According to the terms set out in the exhibit, *if property covered on a replacement cost basis is damaged or destroyed, the insured is entitled to the current cost of repairing damaged property or of buying or building new property of like kind and quality, even if the destroyed property is several years old, and even if its replacement cost exceeds the original purchase price*. If the cost of new property has decreased, as often happens with computers or other electronic equipment, replacement cost coverage pays the current lower cost.

Often, a particular model or style of electronic equipment is not longer made. Although the equipment is technically irreplaceable, the replacement cost for property of comparable material and quality can still be determined. Example: discontinued TV, a comparable TV can be purchased form the same mfg.

Even when the replacement cost method of valuation is specified by the property insurance policy, certain types of property are not valued using that method. Examples; Antiques or Artwork. These types of property are typically valued at their ACV as determined by market value.

**Technically, replacement cost coverage violates the principle of indemnity. As insured who sustains a loss to old, used property and receives insurance payment for new property has profited from the loss. To reduce the moral hazard, most replacement cost policies pay out only after the insured has actually replaced the damaged or destroyed property, or in some cases, only if the loss is a relatively low value**.

**In many policies with replacement cost provisions, the insured has the option of settling the claim based on AVC and then has 180 days to refile the claim on the replacement cost basis. This gives the insured the opportunity to obtain funds from the insurer at the time of loss, use those funds to help pay for the rebuilding, and then collect the full replacement cost value on the completion**.

If the policy specifies that property is covered on a replacement cost basis, the insured must select a policy limit to fully insure the replacement cost property value. For buildings, the replacement cost value is usually higher than the property’s depreciated ACV. Property insurance rates per $100 of insurance are usually the same whether the property is insured for replacement cost or ACV. However, replacement cost insurance is more costly because higher limits are required to insure to value.

**Other Valuation Methods**

Although insurers usually settle losses by paying the replacement cost or ACV of lost or damaged property, many other valuation provisions are used for special classes of property, sometimes within policies that value most property on a replacement cost or ACV basis. The two more common other valuation methods are Agreed Value Method and Functional Valuation Method

**Agreed Value Method**

*Some property insurance policies are valued policies, not contracts of indemnity. These policies typically cover commercial watercraft, antiques, paintings, and other objects whose value can be difficult to determine. The valuation provision in such policies uses the agreed value method. If a total loss occurs, the insurer will pay the agreed value specified in the policy*. Partial losses are paid on actual cash value, repair cost, replacement cost, or whatever other valuation method the policy specifies. Although agreed value is not a specific formula as are some of the other valuation methods, it is nonetheless useful when it would otherwise be difficult to calculate a precise value. The agreed value method does not stipulate what the agreed value has to be relative to the true value of the property. The only stipulation is that both parties have to agree to the value in the policy.

The agree value method should not be confused with the agreed value optional coverage, which is an arrangement for suspending the coinsurance clause in a commercial property insurance coverages such as the Building and Personal Property Coverage Form or the Business Income Coverage Form.

**Functional Valuation Method**

**The functional valuation method is sometimes used when replacing buildings or personal property with property of like kind and quality is not practical and when the ACV method does not match insurance needs**.

For example; suppose an organization that has been using a former school house as an office suffered a loss that destroyed the building. The functional valuation method would value the building at the cost to rebuild an office, not a schoolhouse*. In the functional valuation method, the insurer is required to pay no more than the cost to repair or replace the damaged or destroyed property with its functional equivalent*. This method is available by an endorsement to commercial property policy. It is also used for residential buildings used by the ISO homeowners modified coverage form, HO-8.

**When applied to personal property, the functional valuation method requires the insurer to pay no more than the cost to replace with equivalent but less expensive property. This method is commonly used with electronics and computers, because new computers may be more functional but less expensive than the models that have to be replaced.** The insurer might also pay the actual repair cost or the applicable policy limit, if either is less than the cost of functionally equivalent property.

When applied to real property, the functional valuation method permits the insurer to use common construction methods and materials. Three-coal plaster wall might be replaced with wallboard, restoring its function but not using the same material.

**4 – Valuation of Liability Claims**

**Objective**: Explain how the amount payable for a claim covered under a liability insurance policy is determined

The crucially important issue in post-loss analysis of liability insurance policies is the valuation of covered claims.

Unlike property insurance policies, liability insurance policies (or the liability coverage provisions within a multiline policy) usually do not specify ow the amount of a covered claim is determined. Under most circumstances, the maximum amount the insurer pays is the less of two amounts:

* The compensable amount of the claim
* The applicable policy limit(s)

**Compensable Amount of the Claim**

**The compensable amount of the claim depends mainly on the variables involved in how the claim is settled and the extent of damages ultimately awarded to the claimant**.

**Settlement of the Claim**

**Most liability claims do not go to a formal trial, and the compensable amount of the claim is determined by negotiations between the liability insurer (or its attorney) and the claimant (or the claimant’s attorney).** During these negotiations, the parties try to anticipate what a court or jury would do if presented with the same facts. **Both parties have an incentive to reach an out-of-court settlement because of the uncertainty, time, and expense involved in a formal trial**.

Most liability insurance policies give the insured/defendant no right to prohibit the insurer and the claimant from reaching a settlement within the policy limits. Often, an insured wants to mount a vigorous defense and vindicate the insured. However, the insurer’s goal is to minimize its total cost for defense or damages. Sometimes the insurer pays a claim that might successfully have been defended because defending the claim would cost more than paying the damages. In other cases, the insurer does not want to risk losing a lawsuit that would set a dangerous precedent for other, similar claims.

**If settlement cannot be reached by the parties involved, the liability claim will go to trail, and the extent of the insured’s liability to the claimant is then based on legal principles**. The compensable amount of the claim is the amount the jurors decide to award the plaintiff as damages. Subject to policy conditions and limits, the insurer pays that amount on the insured’s behalf. In some situations, the judge exercises the power to reduce or set aside an award or reduce or overturn an award on appeal. This may be done if the judge believes the jury award was excessive or not based on legal principles. Although policy limits restrict the insurer’s liability, neither the jury nor the judge is bound to confine an award to the policy limits. If the court awards a judgement that exceeds policy limits, the insured/defendant is responsible for paying the excess award.

For claims exceeding policy limits, the insured has a right to legal counsel, usually at the insured’s expense, to protect the insured’s interests. Otherwise, the liability insurer usually has control over defense costs and the amount it wants to offer as settlement.

**Extent of Damages**

When the insured is liable for damages, the key issue affecting the valuation of a liability claim is the amount of monetary compensation that will reasonably indemnify the party who incurred the loss. Although a judge or jury may ultimately determine this amount, the insurer, the insured, and the claimant try to estimate this amount during any settlement negotiations.

The US common law system requires the amount of damages awarded to compensate the claimant for loss incurred as of the trial date. This presents a problem if not all damage has been repaired by trial date or settlement date. In some cases, such as those involving permanent disability, damages must be partly based on estimate of future expenses,

The claimant usually has the burden of proof regarding bodily injury and property damage. The claimant must establish what losses were proximately caused by the insured. However, even though the insured caused the loss, the claimant has a duty to mitigate loss. Consequently, the claimant may not recover for damages that result from the claimant’s lack of care after the accident.

**When property is damaged, the owner may recover the reasonable cost to repair it the property or replace it if it cannot economically be repaired. When property must be replaced, the owner is entitled to its reasonable market value before damage or destruction. Generally, the owner may also recover damages to compensate for the loss of use of the property for a reasonable period**.

Under certain circumstances, a claimant may also recover for profits lost from the inability to use the damaged or destroyed property. A few jurisdictions also permit third-party damages for the reduction in value of property that has been damaged and repaired.

**Unlike Property Damage claims, evaluation of bodily injury claims considers much broader range of damage elements for the claimant, such as:**

* **Reasonable and necessary medical expenses incurred and those expected to be incurred in the future**
* **Type of bodily injury**
* **Wage loss or loss of earning capacity because of the bodily injury**
* **Other out-of-pocket expenses, such as household assistance**
* **Current and future pain and suffering resulting from the bodily injury**
* **Extent and permanency of disability and impairment**
* **Disfigurement resulting from the bodily injury**
* **Preexisting conditions that could have contributed to the bodily injury**

When bodily injury results in a claimant’s death, the claim is generally categorized as either a survival action (how much would have been recovered if the claimant had lived) or a wrongful death action (monetary loss to the survivors). The category into which the claim falls affects its valuation.

**Policy Limits**

The insurer’s payment of the claimant’s compensable damages for which the insured is liable is capped by the policy’s applicable limit(s).

A liability policy (or liability provisions within a multiline policy) ay be subject to only one policy limit or to several. Example; the only limit applicable to liability coverage in a commercial auto policy is the dollar limit, such as $1M, which is the most the insurer will pay for all damages because of bodily injury or property damage in any one accident. In contrast, commercial general liability (CGL) policies typically contain multiple policy limits.

**When a liability policy contains multiple limits, the maximum amount payable for a covered claim depends on a complete analysis of the interactions among the various limits.** For **example, a covered CGL claim for $600,000 in damages may be within the $1M each occurrence limit, but if prior claims paid during the same policy period have reduced the applicable aggregate limit (the most the insurer will pay during the policy period) to $200,000 the insurers payment will not exceed $200,000**. If the same claim is subject to the policy’s $100,000 Damage to Premises Rented to You Limit, then the insurer’s payment will not exceed $100,000.

In addition to covering the claimant’s damages, insurers also agree to pay defense costs and various supplementary payments, such as the cost of surety bonds required in connection with claims, court cost taxed against the insured, and interest payments on judgements. In many common policies, (such as homeowners policies, personal and commercial auto policies, businessowners policies, and CGL policies), defense costs and supplementary payments typically do not reduce the policy limits. However, once the insurer has paid out the applicable limit(s) for a claim, the insurer’s duty to defend and pay supplementary payments ends.

**In other policies (such as directors and officers liability policies, pollution liability policies, and other specialty liability policies), the insurer’s payments for defense costs an supplementary payments are typically applied to reduce the policy limits. In such policies, defense costs can consume a significant part of the applicable limit(s). For example; if an insured with a $1M policy limit were held liable for $950,000 judgement and defense costs were $100,000, the insurer would pay only $900,00 of the judgement after having paid the defense costs. If instead the insured had a liability policy that covered defense costs in addition to the limit, the insurer would pay both the $100,000 in defense costs and the $950,000 judgement in full.**

**5 – Reasons for Property Insurance Deductible**

**Objective**: Explain how deductibles in property insurance benefit the insured

Deductibles are a risk financing technique that requires the insured to retain a portion of the loss that is being transferred to an insurer. Knowing how deductibles in property insurance can benefit insureds assists insurance risk management professionals in selecting or recommending deductibles.

By requiring the insured to retain some part of each loss covered by property insurance, deductibles reduce the premium cost to the insured through these effects:

* Encourage risk control by the insured
* Eliminate the need for the insurer to process small losses, thereby reducing the insurer’s loss costs and loss adjustment expenses

**Encourage Risk control**

Having some of the insured’s own funds at stake theoretically gives the insured the risk control incentive to reduce losses. **A deductible serves this purpose most effectively when it is large enough to have a noticeable financial effect on the insured. Deductibles that are too small do not offer enough financial incentive, and deductibles that are too large defeat the purpose of transferring the loss exposure to the insurer**.

Deductibles are not particularly effective when used with large property exposures, especially those that are not likely to incur a partial loss. Example; Consider the costs involved in launching a satellite. With hundreds of millions of dollars at stake, even a $100,000 deductible on satellite launch insurance would neither encourage additional risk control nor substantially reduce the insurer’s costs.

**Reduce Insurer’s Costs**

A typical property deductible eliminates the insurer’s involvement in low-value losses. It is not cost-efficient for an insurer to deal with low-value losses because the insurer’s loss adjustment expenses often exceed the amount of indemnity payable to the insured.

The expensive and inefficient process of insuring small claims is sometimes called dollar trading (or trading dollars). An insurance premium and loss exchange in which the insured pays the insurer premiums for low value losses, and the insurer pays the same dollars back to the insured, after subtracting expenses.

Risk transfer mechanisms in general – and insurance in particular – are not designed to cope with these types of low-severity losses. Sizable property insurance deductibles help eliminate dollar trading. The insured retains small losses as normal, out-of-pocket expenses and uses insurance to protect against major, unpredictable losses. Deductibles are most effective in reducing insurer’s expenses for coverages such as auto collision, in which small, partial losses are common.

**Deductibles reduce the premiums insurers must charge and ultimately benefit the insured because they:**

* **Reduce insurer’s overall loss costs and loss adjustment expenses**
* **Provide insureds with risk control incentives**
* **Reduce the morale and moral hazards incentives**

For most property insurance policies, insureds can choose from a variety of deductible levels. In making this choice the insured must balance the benefits of the premium reduction with the need for insurance protection for large losses.

For most property insurance policies, the premium reduction is not directly proportional to the size of the deductible. Because small losses are more frequent than large losses, the premium reduction is on a sliding scale – that is, the premium credit increases much more slowly than the size of the deductible.

In the exhibit, shifting from a $500 deductible to a $2,500 deductible reduces the policy premium by $400 while increasing the retained loss exposures by $2,000. The premium reduction for shifting from a $50 000 deductible to a $75,000 deductible is only $300, and retained losses increased by $25,000.

Given these figures, shifting from a $500 deductible to a $2,500 deductible would be attractive in many cases. However, shifting from a $50,000 deductible to a $75,000 deductible is not as attractive. Even if the pricing is actuarially sound the organization could absorb the extra $25,000 losses, few organizations would choose to retain an extra $25,000 in property losses to save $300 in premium unless other factors were involved, such as the insurer offering much broader coverage when the high deductible applies.

**When premium costs are considered, premium credits tend to encourage the use of medium-sized deductible that eliminate the dollar trading for small losses but that provide a reliable source of recovery for large losses**. What constitutes “medium-sized” varies substantially among both families and organizations that purchase property insurance.

**6 – Liability Deductibles and Self-Insured Retentions**

**Objective:** Explain why deductibles are not commonly used in some liability policies but are commonly used in other liability policies, and how a self-insured retention differs from a deductible

Knowing when and why a deductible or a self-insured retention (SIR) is appropriate for a particular liability policy helps insurance and risk management professionals to arrange coverage competently.

Although deductibles are commonly used with most types of property insurance policies, deductibles are seldom used for some types of liability insurance but are commonly used for other types. In some cases, a self-insured retention (SIR) is used instead of a deductible. SIR is a dollar amount specified in an insurance policy that the insured must pay before the insurer will make any payment for a claim.

**Reasons for Limited Use**

Insurers have multiple reasons for restricting the use of deductible in liability policies.

**Deductibles in liability policies are not as effective as they are in property insurance policies. If a liability policy has a deductible, the insured may not report seemingly minor incidents until the situation is escalated. However, because insurers want to control liability claims from the outset, they want to be involved in even small liability claims.** Liability claim investigation involves determining not only the nature and extent of damages, but also who is legally responsible for paying those damages.

**In addition, for most liability insurance policies, deductibles would not noticeably reduce premiums. One reason for this is that relatively few liability claims involve small amounts.** Although most property losses are small enough for the insurer to avoid them by using a moderate deductible, liability losses tend to be larger. More important, as mentioned, the liability insurer wants to be involved in all claims including small ones. Even with a deductible, the liability insurer usually pays all costs without contribution from the insured, for investigation and defense coverage, just as it does for policies without deductibles. Usually the deductible applies only to the damages paid to the claimant, not to defense costs.

With property insurance, the insurer simply subtracts the deductible from the covered amount to determine the amount payable to the insured. However, in liability insurance, the insurer must recover the deductible from the insured. **The insurer usually must pay the third-party claimant the agreed-upon settlement in full, without reduction for any deductible. The insurer then has the right to recover the amount of the deductible from the insured. Sometimes, the insured may be financially unable or unwilling to pay the deductible**. So, the insurer may ultimately have to bear the deductible cost.

Consequently, insurers are selective in choosing the insured for which they will consider a liability deductible because the deductible, while providing a premium discount to the insured, can present problems for the insurer.

Deductibles are not usually included in Commercial General Liability, personal liability, or auto liability policies. However, significant deductibles are common with some specialty liability policies, such as those covering professional liability or directors and officers liability. By involving the insured in each loss, these deductibles are used primarily to encourage risk control. Deductibles are also common in bailee legal liability coverages, such as those for warehouses and auto service businesses. These coverages protect the insured against loss to a specified category of property, and the deductible function similarly to those used with property insurance.

**Self-Insured Retentions**

Some liability insurance policies include an SIR. The differences between a deductible and a SIR are these:

* With a liability insurance deductible, the insurer defends on a first-dollar basis, pays all covered losses, and then bills the insured for the amount of losses up to the deductible.
* With a SIR, the insurer pays only losses that exceed the SIR amount. The insurer does not defend claims below the SIR amount. Consequently, the organization is responsible for adjusting and paying its own losses up to the SIR amount.
* With an SIR, the full policy limit is payable on top of the SIR, while a liability policy deductible may reduce the policy limit. (individual policies can vary on this point of comparison)

To compensate for the insurer’s lack of control over self-insured claims, a policy with a SIR usually requires strict reporting to the insurer of any claims that have the potential of exceeding the SIR amount.

SIR’s are common in professional liability insurance policies and some other specialty policies. SIRS are commonly found in the “drop-down” coverage of umbrella policies. The drop-down coverage of an umbrella policy provides primary coverage, subject to the SIR, on claims that are not covered by an underlying primary insurance policy.

**7 – Other Sources of Recovery**

**Objective:** Describe the multiple sources of recovery that may be available to an insurance policyholder for a covered loss

In many cases, an insured will have one or more other sources of recovery for a loss covered by the insured’s policy. In post-loss coverage analysis, insurance and risk management professionals seek to ascertain all other sources of recovery so that the appropriate policy provisions can be applied.

Additional sources of recovery may violate the principle of indemnity because the insured could be indemnified more than once for the amount of loss. Various insurance policy provisions, such as other-insurance provisions and subrogation provisions, have been developed to manage situations in which multiple recoveries may be possible. Before applying these policy provisions, one must identify the **other sources of recovery, which can include:**

* **Noninsurance agreements**
* **Negligent third parties**
* **Other insurance in the same policy**
* **Other insurance in a similar policy**
* **Other insurance in dissimilar policies**

**Noninsurance Agreements**

Individuals and organizations often have contractually enforceable source of recovery that does not involve insurance. Examples of noninsurance agreements that may overlap with insurance coverage of the loss include:

* A lease agreement might make a tenant responsible for damage to leased property that is also covered by insurance
* A credit card protection plan might protect the card holder against claims for damage to a rented car, partially duplicating auto physical damage coverage in the renter’s auto policy
* A credit car protection plan might protect property purchased with the card against theft or accidental damage. The same property could be covered under a homeowner’s policy
* An extended auto warranty, home warranty, appliance service agreement, or other plan can provide a contractually enforceable source of recovery that may overlap with an auto or homeowner’s policy, depending on the cause of loss

Although credit card benefits are often underwritten by an insurer, the benefit itself is provided through a contract between the credit card company and the cardholder. The cardholder is contractually entitled to the benefits promised by the credit card company, which often duplicate insurance benefits. Even if the property is also insured, a cardholder might find it desirable to claim benefits from the credit card company. Unlike property insured, the credit card benefit generally is on a first dollar basis with no deductible.

To respond to the overlap in coverage provided by noninsurance agreements, many homeowner’s policies include a provision addressing noninsurance (service) agreements. This provision indicates that the coverage provided by the homeowner’s policy is excess over any recovery that the insured may be able to get from a service agreement.

**Negligent Third Parties**

As a matter of law, a party who is injured or whose property is damaged by a negligent third party generally has a right to recover damages from the third party – regardless of whether the third party has liability insurance. **The recovery from a third party (or the third party’s liability insurance) could overlap with any first-party property insurance coverage (the insured’s own property insurance policy). Most first-party insurance policies have policy provisions that address these situations. Although the two types of policies might be involved (the third party’s liability insurer and the insured’s property insurer0, the relevant policy language is captioned “subrogation” rather than “other insurance**.

Regardless of whether a careless driver has liability insurance, his legal obligation to pay damages does not affect the contractual obligations of the insurer providing first party coverage – unless the insurance contract specifies otherwise. The carless driver is obligated, and the first-party carrier is contractually obligated to pay for the damage to the car. However, that does not mean you will recover twice the amount of loss incurred. According to the subrogation provision in the personal auto policy, if you recover from your own insurer, that insurer can attempt to recover from the careless driver or his insurer. If that insurer pays you, you will have to reimburse your insurer.

**Other Insurance in the Same Policy**

**Property and/or liability policies may provide two or more coverages under the same policy. When these package policies are used, a given loss may be covered by more than one of the coverages offered.** Therefore, an insurance professional needs to analyze the policy to determine whether it contains a policy provision that limits the number of coverages that apply.

These are examples of loss for which insurance is provided by more than one coverage.

* A scheduled personal property endorsement attached to a homeowner policy provides coverage for scheduled (specifically listed) items, many of which are also covered under the unscheduled personal property of the homeowners policy
* Personal property used to maintain or service a building – such as fire extinguishing equipment, outdoor furniture, or refrigerators – is specifically covered under the building coverage of many commercial property insurance forms. The same items may also qualify for coverage as personal property under another insuring agreement of the same form.
* A passenger injured while firing in a car may have medical payments coverage for medical expenses regardless of who was at fault. The passenger may also bring bodily injury liability claims against the driver of the car (if the driver was partly as fault for the accident) and may have a right of action against other drivers involved. Coverage might apply under the liability medical payments, and uninsured motorists coverages f the car owner’s personal auto policy, depending on the facts of the case.

Because the insured’s loss is covered it might not seem important to know which coverage applies. However, although each of these examples may appear to involve a distinction that does not have a material effect on the claim, the distinction may be material to the amount payable. Consequently, it is important to be aware of the applicability of more than one coverage in a given situation.

If the multiple coverages involved have different valuation provisions or deductibles, the insured may be able to recover more by filing under on coverage instead of another. The second example shows that under certain commercial insurance policies, personal property used to maintain the building may also be considered part of the building as well as personal property. If the insured suffers a fire that destroys the storage shed and the landscaping equipment was stored in it, the insured may claim the equipment as personal property loss or a building loss. If the building is insured on a replacement cost basis and personal property is insurance an ACV, the insured may be better claiming the loss as a building loss.

Alternatively, the insured may have the option of combining (stacking) the limits of coverages of all the coverages that apply. That is, the insured can combine the various limits to cover losses that are larger than only one individual limit. Example; suppose you have 2 cars insured under a personal auto policy, each vehicle has $50K in uninsured motorist coverage. Your husband suffers a $75K loss resulting from bodily injury cause by an auto accident with an uninsured motorist. Based on the statutory regulations, you and your husband have a total of $100K in uninsured motorist coverage that will pay for the entire $75K in bodily injury losses.

**Other Insurance in a Similar Policy**

In some cases, coverage overlaps because the same party is protected by two or more policies usually issued by different insurers.

Example, Fred moves to a new home and buys a homeowners policy to cover it, but does not cancel the homeowners policy on his old home, which is still for sale. Both parties simultaneously cover some of Fred’s loss exposures, such as personal property at other locations. Other insurance situations like this usually involve more than one insurer as well as more than one policy. The question is therefore not simply which coverage apples to the loss, but which insurer will pay and how much. These situations are often resolved with each insurer sharing some portion of the loss, in accordance with the policies other-insurance provision.

**Other Insurance in Dissimilar Policies**

A loss is sometimes covered by more than one type of insurance, often from two or more insurers.

* Bills owns a utility trailer. Under some circumstances, liability claims involving the trailer might be covered by both Bills homeowners policy and his personal auto policy.
* A restaurant offers valet parking on its premises. The valet parking activity might be covered under the restaurant’s commercial general liability policy and its commercial auto policy
* Janice is injured in an auto accident while performing work-related activities. Janice may be able to recover under her personal auto insurance, her individual or group medical expense or disability insurance, or her employer’s workers comp insurance

Dissimilar insurance policies do not necessarily include provisions that clearly coordinate coverage with other types of policies. Because of the typical lack of provisions governing coordination of coverage for dissimilar policies, these type of overlaps in coverage are often the most difficult to resolve. In some cases, the relationship between policies when more than one policy is in place is governed by the policies’ other-insurance provisions.