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THE INSURANCE NEWSLETTER

Fall 2005

Reading the Underwriting Market Conditions

In June 2003, Property/Casualty (P.C.) insurance rates for commercial lines averaged 18% higher than in June 2002 — a very hard market indeed. In June 2004, rates increased by an average of 7% from those of June 2003. Still a very hard market.

However, in June 2005 — the latest month for which we have the MarketScout figures — these same averages showed a decrease of 3% from June 2004, but still 22.5% higher than 2002, according to our calculator. (Just multiply 1.18X1.07X.97).

The 3% drop is a welcome turnaround for insurance buyers, and the trend is continuing. Note that these are all averages and do not necessarily apply to individual situations. For example, very large accounts with premiums running at least in the high six-figure range and up, are showing rate decreases greater than the average. The larger the account the greater the decrease, other things being equal. Eliminate them and the averages for June are probably more like 1% or 2% lower than last year. Nevertheless the trend is welcome.

A possible fly in the ointment. Before Congress took its August recess, there were noises from the Administration and some members of Congress about not renewing TRIA — The Terrorism Risk Insur-

ance Act — which expires at the end of 2005. Insurance companies, banks, construction companies and other business interests immediately set off alarm bells. The administration backed off a bit and indicated a willingness to permit a two-year renewal on terms that would substantially reduce the participation of the federal government.

At this time, the situation has not been resolved. Dropping TRIA altogether may well reverse the downward course of property and workers' comp insurance rates, and cause a severe restriction of underwriting capacity. Even a sharp curtailment of the government's participation may do likewise, but not having a precedent to go by, that would be hard to predict.

Stay tuned.

P.S. Late news flash! July figures just came out: Down 5%. Draw your own conclusions for the future.

Disaster Planning and Preparedness

We hate to even mention terrorism, but events over the past few years makes us recognize it as a possible disaster that has to be prepared for. But the list of possible disasters is pretty extensive.

— Earthquakes are ubiquitous, with damages over an extensive period of time recorded in 49 of our 50 states — all but Florida. Note

that the strongest quakes recorded centered not in California or Alaska but in New Madrid (pronounced MAY-drid), MO., earlier in the 19th century, but earthquakes can occur at any time. Damage was recorded as far away as Indiana and Louisiana, and in seven more states in between.

— Tornadoes are not confined to Kansas and Oklahoma, although they are most subject. Even New England has felt the sting of tornadoes.

— Hurricanes. They seem to be getting worse, with scientific evidence pointing to global warming as a contributing factor. In addition to the entire Gulf Coast, the entire Atlantic coast is subject. The hurricane of September 1938 killed over 1,000 people in little Rhode Island alone.

— Mudslides, avalanches, forest fires and other nature-made disastrous, with floods being about the most disastrous.

— A huge disaster can come from various aspects of a computer crashing and destroying stored data, whether by human intervention or by natural disasters, without proper backup at another location.

— And, of course, man-made events, such as fires, explosions, airplane crashes, riots — you name it.

Any of the above are threats to property owners and businesses wherever they may be. Despite

having adequate insurance, a real catastrophe can destroy a business without an advance plan to cope with it and mitigate the damage.

Preparedness does not mean a hastily called meeting at midnight at the house of the company president. It means having a written plan, stating plainly who does what and where, what provision is made for replacement of damaged equipment, what property and equipment can be leased at a moments notice, etc., etc..

The written disaster plan, put together as a team project, has to be printed, with copies in the possession of all supervisory personnel and possibly in the hands of all employees of a small firm. Annual review should be made to see if anything should be modified or added to.

Hopefully, it will never be needed. But pay attention to good old Ben Franklin — “An ounce of prevention is worth a pound of cure.” Thanks, Ben.

A Sleeper in Time Element Insurance

Time Element insurance is a catchall phrase referring to damage to property, wherein the loss is determined by the time it takes — or should take — to restore the property. Thus a small damage that might be repaired in a month will determine the loss of business and continuing expenses to a policyholder of Business Interruption insurance of, say, \$50,000. If a more extensive fire should occur, causing a business interruption of, say, six months, the loss might be \$300,000. This, of course, is an over-simplification, but you get the idea.

The three main types of Time Element policies are Business Interruption, Extra Expense and Rent (or Rental Value). Most of our clients do carry one of the above, depending on their need. But many firms also

require an offshoot of the above. See if the offshoot — known as Contingent (B.I. Or E.E. as the case may be) — applies to you.

Say, for example, that your operation consists of assembling various parts from different outside sources not owned by you. You rely heavily on one such source — or several — to supply an important part that is in your assembling process. That outside source suffers a disastrous fire — or other insurable disaster — and must temporarily stop shipping to you. Your operation grinds to a halt, as you can't get those parts, or you have to incur heavy extra expenses to get them from another source. You have suffered a Contingent loss.

Other examples abound, such as:

— You rely on a source of raw materials far a manufacturing process;

— Your largest customer is shut down due to a fire — or other disaster — and says “Don't ship anymore until I rebuild”;

— Your retail store suffers a loss of business because a fire destroys the supermarket in your shopping center;

— Your restaurant, bar, etc., suffers loss of business because of fire, etc. to a nearby attraction such as a stadium, theater, etc.;

— Your municipality suffers a tax loss due to destruction of one of the largest tax-paying enterprises in town.

Get the picture? All these suffer a loss of income of one sort or another because a dependent facility had to shut down — permanently or temporarily — even though your property was not damaged by the fire, etc.

Dozens or hundreds of businesses in the vicinity of the WTC suffered Contingent Business Interruption or Contingent Extra Expense or Contingent Rent loss after 9/11.

Do you have a contingent exposure we should know about? Let's talk. Give us a buzz.

P.S. If a dependent source is in a foreign country, contingent coverage could usually be arranged. (If it's in Iraq, fuggedaboutit).

Court Decisions Alert the Public

The publicly owned companies have been well aware of the need for D&O — Directors and Officers Liability insurance — for some 30 to 40 years. Today, virtually every such company provides D&O to protect their directors and officers, or they wouldn't find qualified people to fill those positions. One could say that the D&O market is quite saturated with insurance for these entities.

As we noted in the last issue, D&O for privately owned companies is quite necessary, and more and more family-owned companies are beginning to realize the need for it. The market for this is far from saturated, but it is getting there.

Perhaps non-profits are well ahead of privately owned corporations. None of you reading this would — or should — serve on the boards of your local hospital, church, condo or whatever unless you were assured that it carries D&O to protect you.

So far, we haven't mentioned one area of D&O that is developing a strong push. As we noted in the very first paragraph of our Spring 2005 issue, courts held individual directors of World Com and Enron personally liable for more than \$1 million each, and the courts stipulated that they may not be reimbursed by the corporations nor covered by insurance by the corporations. Alarm bells are ringing!

So, the answer is: A rush to get IDL, a new acronym for Individual Directors' Liability, a form that has

been around for some time, but for which demand has been spotty. But now, with legislative orders for corporations to have more independent directors, and with courts changing the roles of such independents from rubber stamps of the CEOs who appointed them to truly independent thinkers, the demand for IDLs is growing. And more insurers are showing an interest in writing them.

If any of the above situations — non-profits, privately held corporations or independent directorship — apply to you, please give us a call.

Some Things to Look for on Experience Rated Policies

You should know that the loss experience used for experience rated policies, such as Workers' Comp, is not confined to the losses actually paid during the rating period. If that were the case, a new or fast growing venture with a premium of, say, \$50,000, may have had only \$5,000 or less in paid losses during the year. That sounds as if the loss ratio is so low that you should get a terrific experience credit. "If it sounds too good to be true, it probably is."

The fact is that all but the smallest claims are paid out over a period of time, sometimes stretching out over a number of years. The big factor in determining losses is the reserve insurers set up for future payment.

The formula for losses incurred during the policy period is "Losses (and loss adjustment expense) paid, plus loss reserves on the last day of the policy period, minus loss reserves on the last day of the prior policy period."

On a brand new policy, there is nothing to subtract. On an expanding exposure, the loss reserve will grow — other things being equal

— so the incurred loss would be greater than the paid loss.

Since the insurers set up reserves — an inexact science — and don't always know when a claim should be closed out, this is where you come in. You should review all open claims once a year well prior to the end of the experience modification period. A list of open claims is available from your carrier. When the list shows an open claim on "John Doe" who went back to work some time ago, that fact — and others like it — should be brought to your carrier's attention.

If a claim reserve shows up that looks grossly inflated in relation to the actual condition of the injured party, the insurer's assessment of the case may be correct — or it may be wrong. Eventually they come out in the wash, but why wait if facts indicate a possible error.

Another self-audit should be made on Worker's Comp, General Liability and, in some cases, on Auto Liability. This type of audit has to do with proper classification of exposure. Today, so many businesses change their operations so that some classifications of employees no longer exist. For example, if the manufacturing operation is being phased out and the service operation is growing, be sure that the audit on the policy reflects that.

Similarly, in rating Auto liability, changes in vehicle exposure should be accounted for. Trucks formerly classified as "Heavy" or "Long Distance Usage" may have been replaced by "Medium" or "Local Delivery". These are just examples.

The important thing is that it's your premium money, and someone within your organization has to be on top of these things.

A Source of Losses Overlooked

According to estimates in a 2004 report by the Association of Certified Fraud Examiners, the typical business organization loses about 6% of its annual revenue by fraud. Shocking, when you put numbers together; A smallish business doing \$5 million a year in sales would, on average, lose \$300,000 a year to fraud!

The survey also found that small businesses, i.e., those with fewer than 100 employees, suffered disproportionately large losses by theft by employees and were less likely to survive such losses.

The association noted several reasons for this; obviously not all necessarily apply to all small businesses, but noting a few may be helpful.

— The desire or need for small-business owners to be out practicing their trade rather than looking over the bookkeeper's shoulder;

— Small work environments tend to foster close relationships, leading owners to be more trusting of their employees;

— Small business owners often fail to seek prosecution of employees involved in crimes. The unprosecuted criminal then moves on to another job where he or she pulls the same tricks, emboldened by the feeling of immunity.

Many of these are not the typical "criminal types". Many are simply driven by a financial disaster — sudden gigantic medical bills, overwhelming credit card debt, a kid on drugs, an extra-marital involvement, etc., and the old "three B's: booze, babes and bookies". These things also happen to trusted long-time employees, including the unsuspected grandmotherly type.

The sharp increase in recent years is more due to the ease of theft by computer than due to any change in

human nature.

Of course, the primary answer is another of Ben Franklin's sayings: "Eternal Vigilance is the Price of Liberty." And a timely review of your dishonesty insurance for adequacy. Call us for the latter, and heed old Ben's advice, which can take the following procedures.

1. One person for receiving money and another person for recording deposits.
2. Check bank statements and credit card bills for any unusual looking entries.
3. Get background checks before hiring.
4. Be sure you have an outside auditor.

Another Look at Market Trends

Notice: the law of supply and demand has not been repealed.

The supply of underwriting capacity is the combined net worth of all the property/casualty (PC) companies, expressed as consolidated surplus, which was \$416.2 billion at 12/31/04. Net premiums written in 2004 were \$409 billion — a very comfortable ratio of writings to surplus, of just under 1:00 to 1:00. There's plenty of capacity to write a lot more. That could indicate more competition to write, with an expected softening of rates.

The other side of the coin is that in 2004 the return on net worth for the industry as a whole was 10.3%.

Not too bad, unless compared with 14.9% for the Fortune 500 companies for the period of 1971 to 2003.

Ergo, company managements are driven in two directions. One is to utilize their underwriting capacity by being more competitive. On the other hand, potential investors have to be satisfied that investing in Insurance Company A would be at least as rewarding as investing in Fortune 500 Company A.

There are other factors as well, but we don't want to bore you with technical details. Overall, industry consensus indicates a continuation of softening prices for at least another year, possibly bottoming out in 2007. But if TRIA dies, all bets are off; it won't be a soft landing.