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## THE INSURANCE NEWSLETTER

Fall 2007

### Market Update

The insurance underwriting market, as a whole, is still soft — quite a bit. So what else is new? Some observers have likened it to a bubble, of which there have been several recent examples; stock market in 2000 (and maybe also 2007?), housing market in 2006, and the old familiar ones going back centuries.

It may or not be a bubble at this point, but several words of caution are in order. Right now, the property /casualty (P.C.) industry is in good financial health. Its history has been that of continuous moderate losses in underwriting, but consistent investment gains producing a fairly regular return on equity of about 9% — quite a bit less than that of the companies in the S&P 500.

But lately the return has been higher, due in part to the absence of catastrophes since the body blows of 2005, leaving 2006 with an underwriting profit for the first time since 1978! And, of course, help from the financial markets, which can be unpredictable, (What if China stops buying U.S. Treasuries due to the falling dollar? All hell could break loose).

So here's a note of caution for buyers of insurance. Be wary of any insurers that might be cutting its rates below that of the

market as a whole. They're not underwriting. They're looking to grab premiums to invest. The history of soft markets have shown that these "premium grabbers" often didn't survive when their investments turn sour. Of course, an insurance policy in a failed insurer is not something any policyholder would cherish (Understatement of the year).

### An Interesting Survey

The National Association of Insurance Commissioners — the regulators of the business — commissioned International Communications Research to conduct a survey of 1,000 adults, 673 of whom identified themselves as heads of households that carried Homeowners policies. The survey was conducted May 17-21.

The results showed the following percentages of those surveyed believed the following loss situations are covered by their homeowners policies but in fact are not covered.

- 33% damage from a flood
- 35% earthquake damages
- 68% vehicles stolen from or damaged on their property
- 51% damage from a break in the main water line outside their houses
- 34% mold damage

- 31% damage from termites or other infestation

They didn't give the numbers, but noted that many people didn't understand the difference between actual cash value (ACV) coverage and replacement cost (R.C.) coverage. And most people think they're covered for jewelry, antique and stamp and coin collections, whereas there's only limited covered for such valuables and others.

We suspect that most of our clients would have fared better than the results shown in the survey — at least we hope so. How did you do?

### Common Errors Among Our Clients

We got a call recently from one of our good clients. (All our clients are good clients). The conversation went something like this.

"I have \$560,000 on my Homeowners policy. Knock it down to \$500,000. With this lousy real estate market I probably couldn't sell it for more than 500."

He confused sale price with cost of construction. The latter determines the amount of insurance needed. Sale price includes the value of the land, which involves how the market evaluates such intangibles as schools,

shopping, commuting, cost of mortgage money, etc.

Cost of construction is determined by cost of labor and cost of materials to comply with the applicable building code. Whether we're referring to houses or commercial or industrial buildings the principle is the same.

One thing should not be overlooked: what improvements have been made since the cost of building it was incurred or last evaluated. Another bathroom? An elevator installed? And what improvements were added to the building code?

The amount of insurance purchased should take these into consideration, along with such items as debris removal, pollution repair, etc.

A pretty fair unscientific guess might be to increase the actual cost of construction today by, say, 15%, in the absence of any direct knowledge of the cost of "collateral" damage applicable to a given piece of property. Ignore the market price.

And this brings us to the next article.

### **What is Transurance?**

Never heard of it? Neither did most insurance people, because it's still in its infancy, and currently available only to some large buyers employing risk managers. However, we're informing you about it because it makes eminently good sense. If it proves successful it may well take its place as a regularly sought out coverage by businesses of a more modest nature.

Here's how it works. We've often noted that with every loss of almost any kind there's an unknown amount of uninsurable "collateral damage". Come to think of it, there is one form of transurance in use for the past

40 or so years, although not by the name of transurance. It's an optional endorsement to a Business Interruption (B.I.I.) policy known as "Extended Period of Indemnity", commonly referred to as the "lag" endorsement.

Here's how it works. You buy a B.I.I. Policy for, say \$300,000, figuring that a very bad loss will cause you to shut down for six months, with loss of earnings plus continuing expenses totaling \$50,000 a month for six months.

However, you also figure that after repairs and restocking are completed in six months, customers will take time in getting back to do business with you. Smart thinking! So you buy four months of "lag" insurance for, say, \$100,000, figuring that you'll still have a partial loss for those four months.

Essentially, this is a form of transurance. Looking at it from a modern point of view, you recognize that a loss of, say, \$1million to a building would also generate, say \$150,000 in uninsurable collateral losses that you can't pinpoint in advance. But they'll be there. So you buy transurance of \$150,000 — or 15% of your building insurance and pay 15% more premium. And when you have a loss of, say, \$100,000, you'll collect \$115,000. Not yet. You can't buy it yet. But it will be here.

In fact, there are forms of it that have been around a long time. Your local building code may have been upgraded since your building was built requiring more expensive materials and certain extra features. You can today increase your coverage to meet the requirements of the new code and increased cost of construction. That's quite similar to "transurance."

While we're at it, the code

may require you to knock down the undamaged portion of a building more than, say, 50% destroyed by fire or other peril. Fire insurance will pay only for the portion destroyed by fire. There is no coverage for the part you knock down with the wrecking ball unless you buy the appropriate extra coverage — also similar in effect to "transurance". Its official name is "Ordinance or Law" coverage.

Be the first kid on your block to know about transurance.

### **Deductions and Retentions**

For years we've been preaching the need to improve your loss ratios with your insurers as a means of keeping your premiums down. And one point we kept harping on was to take deductibles and retentions as high as you can feel comfortable with. But we were in no position to tell you what amounts you can feel comfortable with. Perhaps your CPA can.

Meanwhile we've come across a guide from an independent source to give some rules of thumb. You may want to consider any of the following that make sense to you. And perhaps discuss them with your financial advisor. .

- 1% of revenues from operations; or
- 10% of pretax earnings; or
- 2-5 % of working capital; or
- 1-5% of current assets; or
- 1-8% of operating income; or
- 2-5 % of operating cash flow

All the above refer to annual retentions, not to individual policy deductions. We did not invent these benchmarks; we're just passing along the info we received.

## Importance of Disaster Planning

If there is one word to consider, it's PREPARATION. The disaster maybe man-made or made by Mother Nature. If preparations are not made, it could put you out of business. Whether you operate a business as a tenant or own your own building or own a building with multiple tenants.

Here's a "for instance". A wide area power failure destroys all your computing data and you did not prepare daily backup off-site storage. With adequate preparation, the worst that would happen would be having to manually duplicated that day's data. A bit of a mess, to be sure, but the rest would be saved. If not — well, you complete the sentence.

Like a good boy scout, be prepared. Everyone has his or her assignment. Leases of temporary premises, machinery, computers, phone equipment, etc. are arranged on a "what if" basis. Monitoring of all safety items, such as sprinklers, alarm systems, security personnel is a must. The list is endless.

The point is that NOW is the time to have a meeting of a designated crisis management team to design all the details. Then print it up and distribute it to all employees and designated outside agencies, e.g., police and fire departments. Depending on the makeup of your employees, you might have some copies done in Spanish or whatever language may be necessary.

Of course, all this preparation is necessary to keep the viability of your business entity, regardless of all the insurance you carry. The collateral damage and expenses may or may not be covered in part or in whole, but the lack of preparedness may cause

the permanent loss of business.

P.S. The meeting of the crisis management team called at midnight after the disaster, to meet in the home of the CEO, may just be a bit too late to be effective!

## A P.S. to an Article in the Last Issue

Remember the article on Product Recall insurance? No matter what paper you read, you surely read the item about Mattel recalling 19 million toys made in China. Then there was the New Jersey importer ordered to recall 255,000 radial tires for pick-up trucks, SUVs and vans after the company disclosed that its Chinese manufacturer had stopped including a safety feature that prevented the tires from separating.

Tread separation is the same defect that led to the recall of millions of Firestone tires in the year 2000. So it's not just "made in China" that we have to worry about.

## A New Angle on Health Insurance

Most everybody is aware of major medical insurance, often referred to as "catastrophe" insurance. But like many very inclusive forms of insurance the public is not aware of its limitations. (As another example, please refer to second article).

Call it "Critical Care" or "Critical Illness", this largely unknown policy can fill the financial gap where Major Medical policies leave off.

Here's an example from real life. Mrs. S. had a triple bypass followed by a period of hospitalization. Her husband took unpaid family leave to be with her during her hospitalization.

They had loss of income for both Mr. & Mrs. S. to say nothing of the ongoing pile of bills. Extra charges for delayed payment of credit card bills and others of a similar nature. Major Med took care of the direct medical bills, subject to policy deductible, but not these other collateral costs, which could run into pretty high five figures in many cases.

Critical care policies can take care of tem. These policies are fairly well known in the UK, Canada, Australia and some other European countries. US insurers, producers, employers and consumers need education about it, hence this article.

## Computers are Great, But . . .

But their use carries substantial risks that are not insured or insurable under standard policies. We're not overly concerned with damage to hardware by the usual insurable perils, e.g., fire, explosion, theft, etc. But we are very much concerned with damages or loss to software, and especially the enormous potential of liability to others directly as a result of the use of computers. Here are just some of the risks faced by business users of computers.

- Loss of information. This involves the data of the user as well as its liability to others, e.g., customers, suppliers, etc. for the loss of their data due to malfunction, virus, hacking etc. of the primary user.
- Failure of technology. e.g., network security, involving corruption, disruption or theft of data by insiders or others. For business as a whole, there is more unauthorized use by insiders than by outsiders.

### Breach of privacy

• Misuse and/or theft of intellectual property. e.g., copyright or patent infringement, trade secrets. The latter is a big risk created by employees, especially ex-employees.

• Errors and Omissions. This is a broad scope including such features as programming, rendering (or failure to render) services, operation of websites, etc.

Traditional policies fall far short of covering these and other risks, e.g., cyber crime. The entire list of shortages is mind-numbing.

The underwriting facilities for writing e-commerce exposures are substantially greater than they were in, say, 2000, but it's still largely confined to the few dozen

largest companies backed up by world-wide reinsurers.

You may have a policy that needs updating or you may not have such a policy. In any event, it would be worthwhile for your IT manager, whatever his or her designation may be, to give us a buzz and mention his or her concerns and we'll get the appropriate application in the mail to get the ball rolling.

### **F.Y.I. — Top 10 Risks Facing Business**

The 2nd largest insurance broker in the world, Aon, surveyed 320 corporations, each doing in excess of \$1 billion in revenues, and com-

puted this list of the top 10.

1. Damage to reputation
2. Business interruption
3. Third party liability
4. Distribution or supply chain failure
5. Market environment
6. Regulatory / legislative changes
7. Failure to attract or retain staff
8. Technology failure
9. Failure of disaster recovery plans
10. Loss of data

So you don't do a billion a year. But take a good look at these, particularly the last three, noted elsewhere in the newsletter.

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## ***EMPLOYEE BENEFITS UPDATE***

As you are well aware, your group medical premiums have been increasing at an alarming rate. Each year you struggle to continue offering a group medical plan to your employees. To hold or reduce the cost, you switch carriers, raise the deductible, increase the out-of-pocket expenses to the employees, and even increase the employees' share of the premiums.

Raising the deductible and out-of-pocket expenses for the employees seems to have the most effect on holding or reducing the medical premiums. However, if your employees have regular monthly medical expenses for medications, blood work, doctor office visits or an expensive surgery, you realize they may have great difficulty actually paying the deductible and out-of-pocket expenses. It has been said that medical expenses are the number one reason for personal bankruptcy.

How can you help without a significant increase in your cost of doing business? There is a way! Call us today to explain the benefits of a **Flexible Spending Account**. For a small upfront investment and minimal monthly administration fee, you can help your employees meet those medical expenses. Let us give you the details and help you attract and retain good employees.

\* \* \* **ANNOUNCING JASON LESTER** \* \* \*

Jason Lester joined the Forrest Sherer Insurance team as an Employee Benefits Account Executive this year under the management of Leah Fouts. He is working with employer groups in Indiana and the contiguous states offering fresh perspectives to control medical costs. Prior to joining our team, Jason worked for a large, direct-writing insurance company gaining extensive experience in the employee benefits and property & casualty fields. Jason attended Indiana University and the Kelly School of Business and is excited to be back in Terre Haute.

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