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## THE INSURANCE NEWSLETTER

Summer 2006

### Keeping Up-to-date on the Market

Well, here it is. MarketScout's barometer for March (latest figures) shows an overall drop of property/casualty (P.C.) rates countrywide of 6% from March 2005.

Let's break that down a bit. Worker's Comp is down 7%, but variation by state is affected by different state laws. Most liability lines are off 8% on average with big accounts—over \$1 million in premiums—off 9% on average and the rest averaging 7%.

Property insurance for commercial accounts are up 2% on average, but that's skewed by very large increases—some up to 40%—along southern shores. We might note that March 2005 showed a sharp decline of 13% from March 2004, property lines being the softest line pre-Katrina.

Final 2005 numbers for the P.C. industry are interesting. While 2004 showed the first underwriting gain in 26 years—a measly \$6 billion—2005 showed an underwriting loss of \$4 billion. The swing of only \$10 billion in the face of an increase of \$30 billion in catastrophe losses is notable.

Significantly, the industry had an investment gain of \$59 billion v. \$49 billion in 2004. This is the driver that pulled up the policy holders surplus (PHS) to \$427 billion.

What this means is that the insurers are competing for premiums to invest. What with 10-year treasuries yielding over 5% and money market investments throwing off more than 4 1/2%, insurers are doing what they've traditionally done; get the money to invest even if they lose on underwriting.

If past history since WWII is a clue, by 2007 they'll have their belly full of underwriting losses and they'll start tightening. Our guess is that 2008 will see the return of a hard market.

### Need for Regulation of the Insurance Business

You may know that the states—not the feds—regulate the insurance business. There are influential bodies clamoring for federal regulation. And there are those who would like to afford individual insurance companies the option of choosing federal or state regulation for themselves. What a mess that would be!

Arguing pro and con on the above situation can—and does—take up volumes. No need to get into that in this letter, other than to say that no system can be perfect.

Unsophisticated buyers of insurance may think that the sole purpose of regulation is to keep rates as low as possible. That's a bit too simplistic. One function, of course, is to protect the public from fraudulent

practices. Every state insurance department has a complaint bureau.

The insurance buying public needs protection. In this vein, the most important regulatory function is to see to it that the providers—the insurance companies—remain solvent.

This is crucial. An insurance policy is a promise to pay to those harmed by accident—or any type of insured damage. Such payment may take years after the insured pays its premium as a consideration of future compensation for its loss.

We can see that the public may be somewhat inconvenienced if the local supermarket, for instance, goes out of business. True for any of hundreds of types of non-financial institutions. But aside from the inconvenience, there's no real financial damage to the customers.

Not so with insurance policyholders. If your insurer—or the insurer of the car that seriously injures you in an accident—goes bust, you can be ruined financially. So, regulation of insurers to maintain their solvency is Numero Uno in serving the public. And that includes seeing that rates charged the public are adequate as well as not excessive and non-discriminatory. Amen!

### Lesson From Katrina

We've noted this before, but it bears repetition. In fact, it first came

to light in a big way after Hurricane Andrew in 1992.

After a disaster, particularly one that involves a large area, inevitably there is a shortage of both materials and labor. Result? Repair jobs cost more than anticipated—a lot more.

If the damage is far from a total loss to a given property, that falls on the insurance company—for the time being. They'll make up for it in the next round of rate increases.

However, a far more serious threat exists when the loss to a building is total or near total. If the replacement value in normal times was, say, \$500,000 and you insured it for \$500,000, after an area-wide catastrophe the replacement cost jumped to \$700,000, where does that leave you? (The 40% increase shown here is just for illustrative purposes. In a real situation, the amount could be more or less, but 40% is a reasonable ball-park figure).

All this is on top of the persistent rise in construction costs. As a building owner, you'll have to deal with both the steady increase in costs and the possible disaster driven sharp spike.

### **A Vital Factor**

Another thing that Katrina did: it made all of us more aware of the need for catastrophe planning. We've mentioned the need for advance planning many times. Who is responsible for what, what arrangements for leased equipment, what gets communicated to the rank and file, etc., etc. Let's make sure that we don't respond with the unprepared delays ala FEMA.

Another thing we've mentioned before—and must repeat for emphasis—is that almost all losses of any consequence bring uninsurable collateral losses. This is a good reason for having one person responsible for all safety matters, as noted in the last issue, and a safety manage-

ment team to work with the safety manager.

The purpose of the safety/disaster management team is to develop and carry out a disaster plan and strategies for mitigating losses. In connection with uninsurable collateral loss as a result of a sizeable loss is the very real possibility of going out of business due to lack of preparedness to deal with a catastrophe. A "survival plan" has to get the attention of your top management.

P.S. If you need help in setting up a safety/disaster management team, give us a buzz.

### **New Policies for our Complicated Business Structure**

If you've ever been involved on either side of a merger or acquisition (M&A) you know the vital importance of the seller's representations and warranties (R&W) about the condition of the business. The seller is obliged to indemnify the buyer to extent that the R&W are not accurate and complete.

It's easy to see how deals can hit a snag when everything is not smooth in this area. Buyers back off if they smell something not entirely to their satisfaction. To the rescue: R&W insurance to pick up the seller's indemnity agreement and smooth the way for the deal to proceed. With it, the seller might negotiate a lower price and eliminate the need for a post-closing escrow account.

If you're a potential buyer, insist that the seller provide R&W insurance. If you're a seller, look into it with your attorney.

### **Errors & Omissions (E&O)**

Everybody reading this knows that doctors and other professional healthcare providers carry mal-

practice insurance. And presumably many of you know that other professions, e.g., lawyers, accountants, architects, engineers, also carry insurance of a similar nature, called Errors & Omissions insurance, or E&O for short. Included in the E&O class are Directors & Officers liability (D&O) and Employment Practices Liability insurance (EPLI).

But that's not the whole of it. Technology is obviously a relatively new area for E&O, but it's a very wide area with nonstandardized policies to meet the needs of various professional services in this field. These services may deal with such aspects of e-commerce as security breaches, Internet use, denial of service, loss of use, unauthorized access, theft of proprietary information, identity theft, etc., etc. Did we overlook many more?

Besides technology, other new customized forms of E&O may be applied to a variety of situations. Just as an example, suppose a real estate agent is charged with discrimination in a fair-housing complaint or doesn't disclose the existence of pollution on properties.

We mention these as just examples to indicate the broad reach of E&O exposures for which an insurance solution may be available. And in all such cases, please note that even if one is not liable, the legal costs of some of these charges can be enormous. The last we heard is that lawyers do not work for the minimum \$5.15 per hour.

Question: Do you or your company do any work that, if done improperly or alleged to have done improperly, expose you or your company to possible legal liability? If so, call us ASAP.

### **Global Exposures**

While the corner mom'n'pop deli may not have any global exposures, many modest-sized businesses of al-

most all kinds are apt to. It may be so much as having a plant overseas, but it's more like using an overseas contractor. And much more likely to have executives or salespeople to travel overseas to make contacts, solidify deals, etc.

The overseas exposures could be extensive and create substantial exposures to property damage and liability. When foreigners are injured by the activities of Americans they know to bring action in American courts where judgments are so much more generous than the courts elsewhere in the world. Commercial General liability (CGL) policies written here provide coverage that stop at our borders, with very minor exceptions. Coverage for business activities elsewhere need appropriate policies. Ditto for various forms of compensation or others abroad, whether permanently located or just traveling.

Besides all that, there are various services that may be required in the event of accidents or illness befalling employees while abroad. A few major insurers with a global reach would have access to English speaking doctors and other health providers. Knowledge of local customs and access to local lawyers may also be provided. Cost of repatriation in the event of a serious illness or accident could be expensive.

Not to be overlooked is a very ugly situation. Every year about 1,000 or so business people are kidnapped while traveling abroad. Naturally, some countries are a lot more dangerous than others, particularly in today's tense atmosphere. These are apt to be high net-worth people working for deep-pocket corporations.

But getting back to more mundane situations, financial loss can occur in many situations beyond the reach of local insurance. Here are a few examples:

—Loss of passports and becoming temporarily stranded.

—Being victimized by theft or assault.

—Accidental damage to hotel rooms or other property

—Injury to self or others or to property by driving rental cars.

—Falling ill—or even die—while working outside of U.S.

All the above are in addition to political risk as described—very briefly—in the next article.

## **Political Risk**

This is a continuation of the foregoing article, and as such the first item to mention is Foreign Credit insurance. Like its domestic counterpart, it pays you when your foreign customer goes broke and can't pay what they owe you. The only difference from domestic credit insurance is usually a 15% participation of each loss.

Political risk insurance as such covers such risks as war, expropriation, confiscation, inconvertibility of foreign currency, cancellation or suspension or restriction of export or import licenses. The usual arrangement involves a 5% participation by the insured

There's a subtle difference between a participation and deductible. A participation applies as a **percentage** of the loss. A deductible usually applies as a **dollar amount** to the loss, but in some special situations it applies as a **percentage of the policy amount**.

## **Some Things to Think About**

Here's one: "Insurance does not eliminate risk but provides some monetary compensation in the event a risk turns into a loss."

This is a doubled-barreled thought. For the first place it points up the need for risk management,

which is a broader concept than insurance. It points up the need to take steps to reduce risk, or to eliminate it if possible and practical.

If you dispose of your automobile you've eliminated a risk, but it may not be practical, despite the high cost of gasoline. If you take a course in defensive driving you've taken a step to reduce risk, but of course you still need insurance.

The other barrel is the word "some" in the quote above. Insurance provides some monetary compensation, but not all of it. We can call the uncompensated part of loss as uninsurable, or as collateral loss. You have a fire and it takes 6 months to rebuild, replace and restore. Your Business Interruption policy compensates for your financial loss during those 6 months, and for another few months if you broadened your policy with the Extended Period of Indemnity endorsement. But there's no way of compensating you for the permanent loss of customers who got in the habit of buying elsewhere during those 6 months. There are examples of uninsurable collateral loss in virtually every type of insurance situation, pointing up the need for risk management.

The above applies not only to business but to individuals in their personal lives. One example: try to stay healthy even if you have the best health insurance policy.

Another thing to think about is a saying we heard when we were just starting out in the business: "Insurance is not for stolen hubcaps." The meaning, of course, is that you don't buy insurance for trivial losses, even if they are of the frequent kind.

A good example—and there are many—would be a company that ships \$1million worth of small parcels by US Parcel Post, UPS or FedEx, with very few parcels exceeding \$100 in value. Does it pay to insure every shipment? Of course not. Whoever insures it will be sure

to load the cost of losses by 50% or so to arrive at its premium. Even insuring the very few parcels that run to say, \$1,000, may not make too much sense for a firm doing a million dollars in mail order sales. But at some point—say, a shipment worth \$10,000, insurance might be appropriate.

The essence of insurance is to insure the unexpected, not the expected. The expected loss is the high frequency loss for which you are guaranteeing a profit for the insurer who loads the expected loss for administration costs, taxes and profit.

The large high severity, low frequency risks are those that call for insurance. A prime example is the risk of loss by terrorism. Not a farm silo in the middle of No. Dakota, but

almost any commercial or industrial enterprise in any kind of built-up area. Rates are now very low, compared to what they were a few years ago, yet the spokesmen for Al Qaeda consistently warn us that they'll strike again. Hopefully, they won't, but no one can guarantee that.

To buy insurance or not to buy is very simple. Follow this formula.

- High severity, low frequency: Buy
- High frequency, low severity: Don't Buy
- Low frequency, low severity: Don't Buy
- High frequency, high severity: If you can't completely eliminate this risk, then buy insurance with as high a deductible as would eliminate most of the insurance claims.

## **One Last Thought**

If you're in business, obviously you have employees. You may also have contractors. Your relationship with contractors differs legally from your relationship with your employees. If you're confusing one with the other it can cause a very messy situation with regard to such things as Workers Comp, Employment Practices Liability (EPLI) and others, to say nothing of pensions, Social Security deductions, etc., etc.

While insurance may be affected, this is essentially a legal situation. It may be a good idea to periodically consult with counsel as to what your true relationship—employer or principal—may be with certain individuals.

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## **DO YOU WANT THE AREA'S BEST GROUP DENTAL PLAN?**

At **Forrest Sherer Insurance**, we are dedicated to researching the best benefits available for our employer groups and, when it comes to a GREAT DENTAL PLAN, we strongly recommend **Health Resources, Inc. (HRI)**.

### **Why Health Resources, Inc?**

With their dental plans, your employees will enjoy a dental benefit that features:

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- NO WAITING PERIODS
- NO CLAIM FORMS
- NO PRE-EXISTING CONDITIONS
- BEST OF ALL - NO BALANCE BILLINGS

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**To inquire about a HRI dental plan, please call one of our benefit specialists:**

**Leah Fouts**

**Jacque Pentell**

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