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ADJUSTING TODAY®

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EDITOR'S NOTE

As disasters and their ramifications have dominated property insurance headlines in recent years, a less-publicized development has been the gradual implementation of the "margin clause" on commercial property insurance policies.

Essentially, the margin clause nullifies the benefits of purchasing blanket coverage written on an agreed amount basis. Many have seen it as a move by insurers to reduce or restrict coverage—and do so quietly.

In this issue of Adjusting Today, *insurance expert Donald Malecki examines how margin clauses work, how they can work against the policyholder, and how and why today's business manager and insurance broker must be on the alert for the growing use of this provision.*

—Sheila E. Salvatore, Editor

Margin Clauses Making Agreed Value Options Extinct!

By Donald S. Malecki, CPCU

The first sign that the tide was turning in the popularity of commercial property insurance written on a blanket, agreed amount basis, came in the late '90s when some property policies—primarily for municipalities and other governmental agencies—were made subject to a "margin clause."

Put simply, *the margin clause dilutes the advantage of the agreed value option.* Consequently, the maximum an insured will receive in a loss situation, given sufficient blanket limits, is likely to be more than the amount declared on the statement of values for that location, but less than the amount needed to replace the property.

Review of the Mechanics

Understanding the full implications of the margin clause requires a broad-brush review of blanket and agreed amount coverage. Briefly, blanket coverage can be written in three ways: (1) vertically, (2) horizontally, or (3) as a combination of the two.

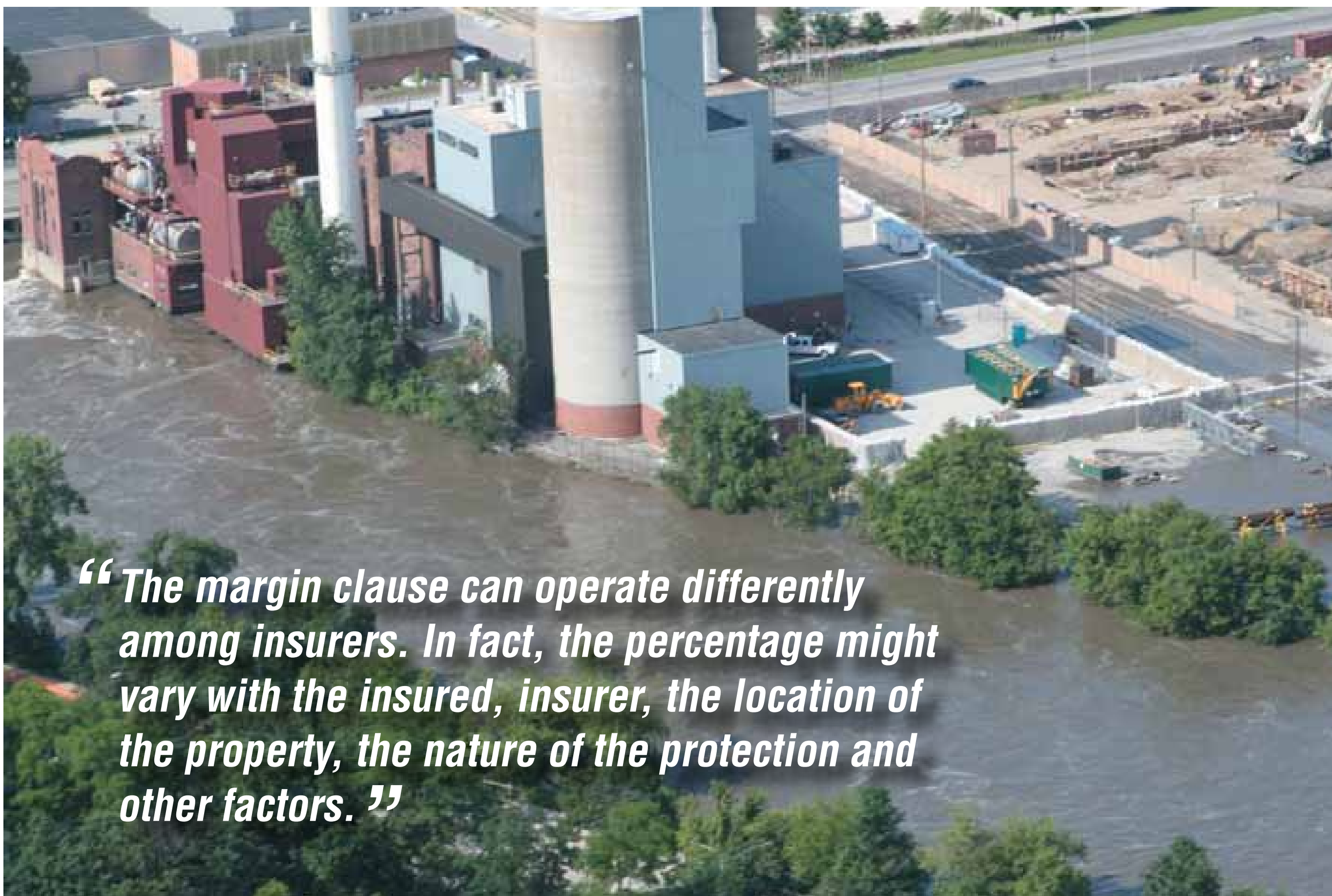
When insurance is written vertically, coverage applies to two or more items of property, such as a building and business personal property, in one building or structure; or in a single "fire division," meaning a building or a section of a building cut off by other buildings or sections by adequate clear space or a fire wall.

Horizontal coverage signifies that a single kind of property, such as buildings, is being covered in two or more fire divisions at one or more locations. A combination of the two, which is quite common, would require coverage encompassing two or more buildings or structures and their business personal property.

One of the prerequisites of blanket insurance is the statement of values. This lists the type of property to be covered, i.e., buildings, business personal property or personal property of others; the location of such property and its replacement value.

The statement of values needs to be completed and filed with the insurer annually so that the underwriter can promulgate the blanket rate, which is determined by taking the average of those declared property values.

At the time insurance on commercial property is purchased, the insured must select an amount that will meet the applicable coinsurance percentage, ranging from 80 to 100 percent. However, when the insurance is to be written on a blanket basis, 90 percent coinsurance is the required minimum.



"The margin clause can operate differently among insurers. In fact, the percentage might vary with the insured, insurer, the location of the property, the nature of the protection and other factors."

Unless the insured maintains insurance coverage with a limit of at least 90 percent on the covered property—at the time of loss—both the insured and insurer must pay a portion of the loss. In other words, the insured will be penalized and required to share the payment of loss with the insurer.

"This means that the margin clause will now likely be issued by most insurers whenever blanket property insurance is desired."

Capping Payments with the Margin Clause

It has been a long time developing, but purchasers of commercial property insurance have come to learn how to avoid the application of coinsurance and to maximize the benefit of this insurance with some cost savings. This is done by purchasing blanket property insurance with an agreed value provision.

When the agreed value provision or option applies, it, in essence, suspends the application of the coinsurance clause. This means that an insured can escape having to assume a penalty if the insurance limit on the covered property that sustains physical loss or damage is less than the required coinsurance percentage.

An example might be helpful here. Assume that a business owner maintains a blanket policy with an agreed value provision for its business personal property located in four different rented buildings. The value of this business personal property at each of the four locations as reflected in the statement of values is $250,000. The applicable blanket limit is $1 million, even though the required minimum coinsurance amount is $900,000.

After a destructive fire, it is determined that the amount of insurance that should have been written for that location is $500,000. Even though the amount of insurance is 50 percent less than required, the business should still be paid in full because the owner maintained a blanket limit of $1 million.

Following the disastrous hurricane losses of recent years, insurers have discovered that many of the businesses purchasing commercial property insurance on a blanket, agreed value basis were drastically underinsured. Yet, by avoiding the application of coinsurance through

the use of the agreed value option, insurance purchasers have been able to capitalize on their losses without having to spend more on insurance than otherwise might have been necessary.

To combat the advantages of blanket, agreed amount coverage, some insurers—undoubtedly through the insistence of reinsurance companies—began to issue blanket, agreed amount policies, subject to margin clauses.

The margin clause can operate differently among insurers. In fact, the percentage might vary with the insured, insurer, the location of the property, the nature of the protection and other factors. Referring to the earlier illustration, if a margin clause of 110 percent were to be applicable, the most the insured would net would not be $500,000, but instead, $275,000 ($250,000 x 110 percent).

The New "Optional" Margin Clause

One of the commercial property policy changes implemented by the Insurance Services Office in August 2008 in most jurisdictions was an optional margin clause. This means that the margin clause will now likely be issued by most insurers whenever blanket property insurance is desired.

Under ISO's approach, an endorsement entitled "Limitation On Loss Settlement—Blanket Insurance Margin Clause" (12 32 06 07) will be available in relation to the Building and Personal Property Coverage Form, Condominium Association Coverage Form, Condominium Commercial Unit-Owner's Coverage Form and Standard Property Policy.

The margin clause amount can range from 110 to 150 percent. (Over the past couple of years, the margin clause amount in policies subject to it has commonly been 120 percent.) Whatever the case may be, this endorsement explains how the amount of insurance payable will be calculated: the maximum loss payable will be determined by applying the applicable margin clause percentage to the value of the property as declared in the latest statement of values.

If, for some reason, the property values are not itemized on the statement of values, this endorsement directs that the insurer will determine the appropriate values prior to the margin clause's application. *This is fair warning that insureds should not give insurers the opportunity to do this!*

What the actual loss payment may be will hinge on such things as the amount of loss or damage, limit of insurance, coinsurance, deductibles and the provision dealing with valuation. In essence, for any payment to apply, there first has to be direct physical loss or damage to covered property from a covered cause. What's more, the margin clause percentage does not increase the blanket limit of insurance.

All of this means that when a margin clause is applicable, it will be applied separately to each building, to contents contained in each building or to the contents of each premises. After it is determined how much is payable—through the application of the margin clause—the amount might be reduced by any applicable deductible.

In light of the application of the margin clause, the agreed value provision, for all intents and purposes, will become extinct. This means that unless the insurance is written without a coinsurance clause, the insured may also have to cope with a coinsurance penalty!

An Illustration

Assume the following set of facts: A property policy is purchased covering three buildings written on a blanket basis for $6 million. A statement of values is completed showing that each of the three buildings is covered for $2 million at replacement cost. The policy is subject to a 90 percent coinsurance clause, a $10,000 per-occurrence deductible and a margin clause of 120 percent.

One of the buildings is completely destroyed by fire and is determined to have a replacement value, at the time of loss, of $3 million. At the time of loss it also is determined that the three buildings had a combined value of $9 million.

By applying the margin clause, the maximum available to pay the insured is $2.4 million. This is determined by using the statement of values reported amount of $2 million for the destroyed building and multiplying it by the margin percentage of 120.

With the amount of insurance purchased ($6 million) being less than required by the 90 percent coinsurance clause, the insured is subject to a coinsurance penalty of .2593 or $777,900. This is determined by multiplying $9 million (the combined value at the time of loss) by the 90 percent coinsurance amount. The result is $8.1

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million—the amount necessary to avoid the coinsurance penalty.

The next step is to divide the amount of insurance carried by the insured by the amount of insurance that *should* have been carried: $6 million divided by $8.1 million equals .7407, times the amount of loss ($3 million), equals $2,222,100—the amount payable prior to applying the $10,000 deductible. The net loss payable is then $2,212,100, which is less than the maximum coverage available under the margin clause ($2.4 million) and therefore the amount owed by the insurer. As a result, the insured is coinsured, subject to a penalty of $187,900.

On the other hand, had the insured reported $3 million for the building destroyed by fire and at least $8.1 million in insurance, there would not have been a coinsurance penalty. In that case, the maximum coverage provided, based on the 120 percent margin clause, would have been $3.6 million before the deductible.

Detecting the Clause

Why the margin clauses had their origin with municipalities is uncertain. It could be because they often have many locations that include older buildings and officials are concerned more about price than with the right amount of insurance. Of course, at the time of loss, insureds do not ask how much their insurance cost. They want to know when they will receive the loss payment check!

One of the most important points to remember about margin clauses is that it can be difficult to determine whether this provision even applies. It is sometimes couched within the policy provisions. The insured may not realize that such a clause exists until there is a close examination of the property policy.

The endorsement adopted by ISO certainly will alleviate having to hunt carefully for a margin clause, since that endorsement should serve as a red flag. A concern, though, is that not all insurers subscribe to ISO and some might have implemented the margin clause before or otherwise apart from the commencement of ISO's endorsement. Whether

those insurers will use a similar endorsement or simply insert a statement as to the margin clause percentage is open to question.

Here to Stay

Chances are very good, however, that with the possible exception of highly protected risks (HPR), many insurers will be incorporating the margin clause into their commercial property policies. This means that the agreed value provision is likely to go the way of carbon typing paper and telephone pay booths.

It took a long time for insurance buyers to learn how to capitalize on their insurance coverage through the use of the blanket, agreed amount approach, even though it has been more expensive to purchase than scheduled insurance on a specific value basis. It is probably safe to say that it will also take time for them to undo what they have learned.

Time, however, appears to be of the essence, since insurers are not wasting it in applying this policy feature.

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Donald S. Malecki, CPCU

Mr. Malecki is a principal of Malecki Deimling Nielander & Associates, LLC, an insurance and risk management firm. He began his career over 50 years ago and has held the titles of insurance underwriter, broker, insurance company claims consultant, archivist, historian and teacher.

ADJUSTERS INTERNATIONAL

CORPORATE OFFICE
126 Business Park Drive
Utica, New York 13502
1.800.382.2468
Outside U.S. (315) 797.3035
FAX: (315) 272.2054

editor@adjustingtoday.com

PUBLISHER
Ronald A. Cuccaro, SPPA

EDITOR
Sheila E. Salvatore

WEB ADDRESSES
www.adjustersinternational.com
www.adjustingtoday.com

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