Lesson 1 Fundamentals of Commercial Property Insurance – Introduction

What are the fundamental concepts of commercial property insurance?

- To understand what is insured, we must look at the types of business property which are exposed to loss. Not all of the properties will be handled by commercial property insurance. Some require other types of coverage products. Some are simply not the subject of insurance, such as land.

- To understand who is insured, we must look at both who is insured under the policy, and also look at those parties who have an insurable interest in the property.

- To understand how a loss will be paid, we must understand the methods used to value the property. We must also understand the concept of coinsurance.

Learning Objectives

After completing this lesson you will be able to:

- Identify the types of commercial property exposed to loss.
- List parties that could have an insurable interest in property.
- Define actual cash value (ACV), replacement cost, and functional replacement value.
- Explain the coinsurance formula and given appropriate information, determine an adequate policy limit and explain how to apply the coinsurance formula after a loss occurs.
- Identify the difference between specific, schedule, and blanket insurance.
- List ways to provide coverage for fluctuating business personal property values.
- Calculate amounts payable under the Value Reporting Form penalty provisions.

Forms used in Lesson 1:
Peak Season Limit of Insurance (CP12 30)
Value Reporting (CP13 10)
Lesson 1 Topic A Commercial Property Exposed to Loss

Learning Objective: Identify the types of commercial property exposed.

1. Real Property

Real property is comprised of buildings, structures and fixtures that are tangible. Real property can be seen.

- **Land** is real property, but it is generally not the subject of insurance.
- **Buildings** are real property. They have walls and a roof. You can probably envision many types of buildings, ranging from a small one-story vet clinic to a skyscraper.
- **Structures.** A structure is any construction, including buildings. However, examples of structures that are not buildings include a 3-sided lumber yard storage shed or a gazebo. Another example can be seen in the picture at right. A stadium is an example of a structure.
- **Outdoor Fixtures.** These are man-made objects, other than buildings or structures, which are attached to land in some manner.

2. Insured’s Personal Property

The insured's personal property is also known as Business Personal Property. The Commercial Property Coverage Forms define what is covered as business personal property. In general, this includes all of the equipment, supplies and material used to operate the insured's business. Office equipment is an example of Business Personal Property.

3. Personal Property of Others

Personal property of others is property that is in the care, custody, or control of the insured. Many businesses have property of others on their premises. When this exposure is incidental, we use commercial property forms. A computer repair shop is a business that has the personal property of others in its care.

If the exposure were extensive, such as would be the case in an appliance repair shop, we use commercial inland marine coverage forms.

A computer repair shop is an example of a business that has personal property of others in its care.
Lesson 1 Topic B Insurable Interest

Learning Objective: List parties that could have an insurable interest in property.

Parties with an insurable interest have a financial stake or equity in a property. In the instance of commercial property, these parties would be:

Owner

Business owners stand to lose their investment in their building and equipment as well as their source of income.

Mortgage or Lien Holder

The mortgage or lien holder has an insurable interest when there is an unpaid balance on the property loan.

Lessees or Tenants

When tenants sign leases, they are granted the right to occupy the designated premises for a stipulated period of time. This right-to-use creates an insurable interest for the tenant.

Signers of Contractual Agreements

Certain contracts, such as those you might sign when leasing phone systems, copy machines or even entire buildings, may require the lessee to provide direct damage insurance on the leased property. This contractual arrangement creates an insurable interest.
Lesson 1 Topic C Types of Loss

Direct

Insureds sustain direct losses when there is concrete, visible damage to the insured’s property. This also includes theft of business personal property.

Indirect

A loss of income resulting from a direct loss to property is an indirect loss. For example, Joe’s Dry Cleaners operates in Omaha, Nebraska. A tornado destroys the business (a direct loss). Now Joe is out of business and loses income (indirect loss) until he can rebuild or move his business to another location.

Direct losses are visible and tangible.
Lesson 1 Topic D - Valuation of Commercial Property

How commercial property is valued is very important, particularly at the time of a loss. Several valuation options apply to commercial property policies. The four types we will cover in this course are listed below.

**Actual Cash Value (ACV):** A method of establishing the value of property wherein depreciation and obsolescence are deducted from the value of the property. Formula: replacement cost minus depreciation = actual cash value

**Replacement Cost:** Insurance issued in an amount to cover the property described for a limit which will be adequate to replace the structure at the cost of today’s labor and materials

**Functional Replacement Cost:** Provision which changes the policy valuation so as to provide for replacement with a different structure which performs the same service or function but which is less costly

**Selling Price Clause for Stock Sold, But Not Delivered:** A property insurance provision that changes the value on finished goods to that of their selling price rather than their actual cash value or replacement cost; therefore, profit is included in the insured amount.

Actual cash value is the cost to replace the premises or item at the time of the loss, minus depreciation. ACV is the traditional valuation method used in writing insurance policies.

The intent is to place the insured back into the exact situation that existed prior to the loss.

If you are writing an actual cash value insurance policy, you must carefully explain this concept to your clients since they will actually share in a loss (incur out-of-pocket expenses) when they totally rebuild, replace or restore the damaged property.

For example, the roof of a building may have a useful life of 20 years, depreciating at a rate of 5% per year.

If a covered loss occurs after 10 years, 50% of the roof’s replacement cost at the time of the loss is deducted in calculating the actual cash value.

In other words, the insurer will only pay for half of the amount it will take to replace the roof.

**With ACV Valuation, insureds share in the cost to replace or restore property, should a total loss occur.**
Learning Objective: Calculate Actual Cash Value and Replacement Cost Value.

Replacement Cost is another commonly used method of valuation.

This valuation method will cover the amount needed to replace a premises or item with like kind and quality in today's dollars.

Depreciation is not considered. Most insureds prefer this method of valuing property over ACV because they want their insurance company to cover the entire cost of replacing damaged or destroyed property.

Take a look at the table to see how these two valuation options work.

**Table 1.1: ACV and Replacement Cost Comparison**

<table>
<thead>
<tr>
<th>Actual Cash Value Insurance</th>
<th>Replacement Cost Coverage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Replacement Value: $100,000</td>
<td>Replacement Value: $100,000</td>
</tr>
<tr>
<td>Depreciation: - $20,000</td>
<td>Depreciation Not Considered</td>
</tr>
<tr>
<td>ACV Paid: $80,000</td>
<td>Replacement Cost Paid: $100,000</td>
</tr>
</tbody>
</table>

Note: Replacement Value is assessed at the time of loss.

**Knowledge Check**

*Complete the practice problem to make sure you understand these ACV and Replacement Cost.*

Your insured purchased an item when it was new for $2000. It has since depreciated in value by 10%. The replacement cost today would be $2300. What is the ACV for the fence?

A. 2000  
B. 2200  
C. 2070  
D. 2300

The answer is $2070.

Actual Cash Value is the Replacement Cost minus Depreciation. In this situation $2300 - $230 ($10% Depreciation) = $2070
Knowledge Check

**Complete the practice problem to make sure you understand these ACV and Replacement Cost.**

An item of property is damaged by a covered peril. For insurance purposes, the item is valued using actual cash value. It costs $2000 to replace it with like/kind materials at the time of the loss. The item was originally purchased for $1500. Depreciation is calculated at 10%. What amount will the insurance company pay to replace the item?

A. $2000  
B. $1300  
C. $2200  
D. $1800

The answer is: $1800. 
Actual Cash Value is the Replacement Cost minus Depreciation. In this situation $2000 - $200 ($10% Depreciation) = $1800

**Functional Replacement Cost**

Occasionally, insureds have a building that cannot, or has no need to be “put back” exactly the way it was. Sometimes structure replacement with like kind and quality materials is cost prohibitive or unnecessary. 
The insured’s concern in the case of a total loss would be to have a building that would provide a similar function. 
Reasons for electing this type of coverage include:

a. Actual replacement is not feasible or is not desired.  
b. Limit of insurance is based on the amount needed to buy property that will serve the same purpose as the original property.  
c. Functional replacement addresses the obsolescence problem of old, out-of-date properties.

A common example of the need for functional replacement cost is when solid brick construction is replaced by modern, less expensive materials.

**Selling Price Clause for stock sold, but not delivered**

This clause states that once stock (merchandise) is sold, the value of that stock will be its selling price. Profits gained from the sale are included in the coverage.

For example, a retail furniture store buys a sofa wholesale for $500. It retails for $900. The sofa is sold, but not yet delivered, when a fire destroys the store. The policy will pay $900 because the Selling Price Clause allows the insured to recoup its profits from the sale of the sofa, in this case the additional $400.
Lesson 1: Topic E Valued Policy Laws

In a number of states in the country, there is special legislation governing valuation of certain property in the event of a total loss. If the insured's property is totally destroyed by a peril specified in the state law, the amount stated in the Declaration Page is considered to be the value of the property at the time of loss and is payable in full.

A valued policy law would apply to a certain type of property and a specific peril. Not every state has passed a valued policy law.

Please refer to the end of Lesson 1 Topics E to complete Self Quiz A-E
Lesson 1: Topic F Coinsurance

Learning Objective: Explain the coinsurance formula and given appropriate information, determine an adequate policy limit and explain how to apply the coinsurance formula after a loss occurs.

What is Coinsurance?

Coinsurance is an insurance-to-value requirement wherein the insurer stipulates that the insured must carry an amount of insurance equal to a specified percentage of the value of the property.

These specified percentages may be 80%, 90% or 100%, and either Actual Cash Value or Replacement Cost may be used in valuation of the property. As long as the insured carries the required amount of insurance, there is no penalty. If the insured carries less than the required amount of insurance, a penalty applies. This means that the insured will not collect the full amount of the loss.

Why Is It Necessary?

Writing policies for limits of insurance that match the exposures at risk is important for both insurance companies and insureds. The company collects an appropriate premium for the exposure, and the insured is more likely to carry enough insurance to pay for losses.

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<table>
<thead>
<tr>
<th>For The Insured</th>
<th>For The Insurer</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Adequate protection in the event of a loss</td>
<td>• Better premium level risk insured</td>
</tr>
<tr>
<td>• Lower rate per $100 of insurance, making it more economical to buy the higher amount required</td>
<td>• Prevents the purchase of insurance for the payment of small maintenance losses</td>
</tr>
<tr>
<td></td>
<td>• Insures rate adequacy over time</td>
</tr>
</tbody>
</table>
Insurance Carried/Insurance Required X Loss = Loss Payment

<table>
<thead>
<tr>
<th>Coinsurance Formula</th>
</tr>
</thead>
<tbody>
<tr>
<td>Insurance Carried *</td>
</tr>
<tr>
<td>____________________</td>
</tr>
<tr>
<td>Insurance Required** x Loss = Loss Payment</td>
</tr>
</tbody>
</table>

The formula is designed to reduce the loss payment by a coinsurance penalty if the insured does not carry adequate limits of insurance to handle the loss.

If the insured carries enough insurance, no penalty will be applied to the loss.

When you examine this formula, you can see that there are three calculations that you must understand.

We’ll learn how to use the formula by pretending that we have a $50,000 covered building loss.

Use the following facts:

- The policy requires that the insured carry limits sufficient to cover 80% of the building loss.
- The replacement cost of the building is $250,000.
- The insured’s policy shows a building limit of $180,000
- The amount of the loss is $50,000

**Calculation 1 - How much insurance SHOULD HAVE been carried?**
Multiply the coinsurance percentage by the building at the time of the loss. You can do this by selecting the appropriate numbers from the drop down menus in the fields.

80% x 250000 = $200,000

We’ve discovered that the insured SHOULD HAVE carried at least $200,000 (80% of $250,000).

How does that compare to what he DID carry?

**Calculation 2: Calculate the ratio that will be applied to the loss.**
$180,000 (Insurance Carried) DID HAVE
$200,000 (Insurance Required) SHOULD HAVE

Insurance Carried (Did Have)/Insurance Required (Should Have) = %
180,000/200,000 = 90%
Calculation 3: Return to the coinsurance formula to determine how much the insurance company will pay.

<table>
<thead>
<tr>
<th>Coinsurance Formula</th>
</tr>
</thead>
<tbody>
<tr>
<td>Insurance Carried *</td>
</tr>
<tr>
<td>____________________</td>
</tr>
<tr>
<td>Insurance Required** x Loss = Loss Payment</td>
</tr>
</tbody>
</table>

Insurance carried/ Insurance required = .90
Actual loss = $50,000
.90 x $50,000 = $45,000

Remember, if the insured carries sufficient limits, the coinsurance formula is not applied. Let’s review the formula from another angle. We will look at a situation in which the insured is adequately covered.

Building Value (at time of loss) $100,000
Coinsurance Clause 80% of Building Value (at time of loss)
Insurance Carried $85,000
Amount of Loss $10,000

How do you determine the amount of insurance required?
   a. Multiply 80% time the building value at the time of the loss
   b. Use the 100% of the building value at the time of the loss

The answer is a.
Coinsurance Formula

\[
\frac{\text{Insurance Carried}^*}{\text{Insurance Required}^{**}} \times \text{Loss} = \text{Loss Payment}
\]

TIP:
National Alliance classroom instructors have a great tip for remembering the coinsurance formula for determining how much the insurance company will pay:

"Did have" divided by "Should have" multiplied by the loss amount

When working coinsurance problems, don’t just use the replacement cost of the building for “Insurance Required”. Make sure you’ve considered the ratio of insurance to value required by the insurance company.

Agreed Value

Some insureds will balk at coinsurance. An alternative to the coinsurance clause is through an arrangement called Agreed Value.

Agreed Value is an up front agreement wherein both the insured and the insurer agree to a fixed value of the property to be insured. A Statement of Values must be prepared and signed by the insured and submitted to the insurance company for approval and agreement. The agreement is effective for one year, and must be renewed.

The features of Agreed Value include:

- The insurer does not apply the coinsurance clause as long as the insured carries an amount of insurance equal to (or greater than) the agreed upon value.
- This coverage remains in effect for one year only, and must be renewed each year. A new statement of values must be filed with the insurance company each year.
- The insured pays a higher rate per $100.

Please refer to the end of Lesson 1 Topics F to complete Self Quiz F
Lesson 1 Topic G - Writing Commercial Property Coverage

Learning Objective: Identify the difference between specific, schedule, and blanket insurance.

In this topic, we discuss the three main ways you can write commercial insurance policies. These three ways are by using:
• Specific Insurance
• Schedule Insurance
• Blanket Insurance

Specific Insurance

Under this method, a fixed amount of insurance applies separately to each item insured. Click on the thumbnail below to see how Specific Insurance works.
Schedule Insurance

You may sometimes hear the phrase Schedule Insurance. This is a list of specifically insured items at two or more locations. Click the thumbnail below for more details on Schedule Insurance.
Blanket Insurance

Blanket insurance is one limit of insurance applying to two or more insured items. When a policy is written on a blanket basis, **the total blanket limit is available to pay losses** regardless of what type of property is involved or what location is involved. You can see how this is advantageous to insureds.

Insurance companies can write blanket insurance one of two ways:

2. **One type of property in more than one separately rated building.** (Click on the thumbnail to view an animated presentation on this form of Blanket Insurance.)
2. Two or more types of property in one or more separately rated buildings. (Click on the thumbnail to view an animated presentation on this form of Blanket Insurance.)

**Blanket Insurance Requirements**

When writing blanket insurance, certain requirements must be met:

- A minimum coinsurance of 90% generally is required.
- A Statement of Values listing each location and all items to be covered must be signed.
- Same Causes of Loss must apply to all property.

Gas stations are an example of commercial property that cannot be blanketed.
Advantages and Disadvantages of Blanket Insurance

<table>
<thead>
<tr>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>• The total amount is available to pay for a loss at any one location. The insured can apply insurance where needed.</td>
<td>• An annual signed Statement of Values is required.</td>
</tr>
<tr>
<td>• Coinsurance applies to the total blanket limit rather than to each separate item.</td>
<td>• Possible underwriting restrictions.</td>
</tr>
<tr>
<td>• Insured has up to 100% insurance at each location, but only has to carry 90% insurance to value.</td>
<td>• Can cost more (5% surcharge in rate for some Causes of Loss)</td>
</tr>
<tr>
<td>• Takes care of contents' values that could fluctuate from location to location.</td>
<td>• Some properties cannot be blanketed.</td>
</tr>
<tr>
<td></td>
<td>• Limitation on Loss Settlement - Blanket Insurance (Margin Clause) Endorsement (CP 12 32)</td>
</tr>
</tbody>
</table>

Please refer to the end of Lesson 1 Topics G to complete Self Quiz G
Lesson 1: Topic H - Handling Value Fluctuations

Learning Objective: List ways to provide coverage for fluctuating business personal property values.

Many companies have varying levels of inventory. For example, a children's toy store may start stockpiling inventory for the Christmas season beginning in August. The store's inventory continues to increase as the holiday shopping season nears. By January, inventory may drop suddenly as the shopping season ends.

Insurers have three ways to handle what the industry calls fluctuation in values:

Peak Season Endorsement (CP 12 30)

Value Reporting Form (CP 13 10)

Blanket Insurance

Carrying blanket insurance is one way to handle changing values. With blanket insurance, one limit applies to property at multiple locations. There is no need to inform the insurance company when inventories move from one location to another.

However, there are other ways to handle changing values for insureds whose stock or inventory increases and decreases many times throughout the year. You could endorse the policy every time a change occurs, but this is not very convenient or efficient.

Peak Season Limit of Insurance CP 12 30

The Peak Season Endorsement Form automatically increases the insured's business personal property limit for specified periods to take care of seasonal increases in values.

On the form, the insured lists the location, the type of property covered, the additional limit of insurance and the specific time period covered. You can list as many peak seasons as needed. This endorsement is good for those types of business that have the same levels of fluctuation at the same time year after year. There are some drawbacks to using this form.

Limitations

1. The beginning and ending dates of the increased limits are very specific.
2. The insured's business personal property exposure may not exactly match the endorsement.

Note: To learn more about Peak Season Limit of Insurance, read over Form CP 12 30.
Value Reporting Form CP 13 10

Learning Objective: Calculate amounts payable under the Value Reporting Form penalty provisions

The Value Reporting Form is intended for insureds whose personal property values fluctuate unpredictably in time and amount. (Click on the thumbnail graphic.)

The Value Reporting Form is best used for businesses that carry varying amounts of inventory over time.

Property eligible for coverage under Value Reporting Form includes:

• The insured's merchandise and stock
• The insured's business personal property
• The property of others in the insured's care

Please see the animated presentation on Value Reporting in Lesson 1 Topic H p5.

Here's how it works.

The Policy Limit

The insured sets the policy limit to reflect the year's highest projected values. This is the limit that should be shown on the policy declaration page. Note: As long as the insured makes timely and accurate reports, this limit is available to pay losses throughout the term of the policy.
The Provisional Premium

At the start of the policy year, the insured pays an advance premium based on 75% of the policy limit (the year's highest projected values). This "deposit" is called the provisional premium. The insured then submits periodic reports describing the amount of values at hand.

The table below describes the five types of periodic reports.

<table>
<thead>
<tr>
<th>Code</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>DR</td>
<td>Daily; values computed daily but reported to insurer monthly</td>
</tr>
<tr>
<td>WR</td>
<td>Weekly; values computed weekly but reported to insurer monthly</td>
</tr>
<tr>
<td>MR</td>
<td>Monthly; most common report</td>
</tr>
<tr>
<td>QR</td>
<td>Quarterly</td>
</tr>
<tr>
<td>PR</td>
<td>Policy year. Note: Many companies will not offer this option.</td>
</tr>
</tbody>
</table>

Table 1.4: Types of Periodic Reports

At the end of the policy year, the insurer averages out the reports and charges a final premium based on the average amount at risk. This final premium is compared to the provisional premium. Depending on the result, the insured is then reimbursed some of the premium or is billed to pay additional premium. The insured pays only for what was at risk, and the insurer receives a premium that matches the insured's exposure.

The insured is responsible for:

- Submitting timely periodic reports to the insurer.
- Providing the insurer with honest and accurate reports.
- Submitting reports within 30 days of the end of each reporting period.
  EXCEPTION: The insured has 60 days to submit the first report of a new policy.

Penalties

What happens when the insured neglects to make timely and/or accurate reports? We discuss the penalties here.

Note: For a description of the penalties, look at page 2 of the Value Reporting Form CP 13 10.
A. Full Reporting

First, note that the Coinsurance condition is replaced. The Value Reporting Form states that an insured must make accurate reports. If he or she does not, the loss payment is reduced. The policy will pay a percentage based on what the insured reported.

Here is an example. Joe’s CD Land incurs a $10,000 loss. Joe reported $80,000 when, in fact, the business had $100,000 on hand on the date of the Value Reporting Form. The policy says to:

1. Divide the amount reported by the actual amount on hand (or what Joe should have reported), then;
2. Multiply the loss by the percentage derived in Step 1.

To calculate the loss payment for Joe’s CD Land:

**Step 1:** $80,000/$100,000 = 80%

**Step 2:** 80% x $10,000 = $8,000 will be paid.

B. Reports in Excess of Limit of Insurance

The most the policy will pay is the amount stated on the Declaration page, even if the insured accurately reports a higher amount. Even though the insured will not collect more than the policy limit, the total amount reported will be included in the final premium calculation.

Tip
If an insured does report an amount higher than the limit, endorse the policy immediately to reflect the higher amount of coverage.

C. Failure to Submit Reports

The penalties for late reports are handled in two ways:

1. If the insured never makes a report (or if the first report is delinquent)
   The policy will pay 75% of the amount that otherwise would have been paid.

2. If the insured stops making reports
   If the insured makes the first report and then at some point in the policy year stops making reports, the policy will pay no more than the amount reported on the insured’s last report.
Let's take Joe's CD Land again. Joe makes accurate and timely reports for six months at which time he stops. The last value reported was $60,000. If Joe's CD Land then suffers a loss, the most the policy will pay is $60,000, even if the loss exceeds that amount. The table below reviews these four situations that could arise and the consequences to the insured should a loss occur. Please note that the limit of insurance in this example is $100,000 and anything paid to the insured is calculated at the time of loss.

<table>
<thead>
<tr>
<th>Full Reporting Provision</th>
<th>Reports in excess of the limit</th>
<th>Failure to Submit First Report</th>
<th>Failure to Submit Subsequent Reports</th>
</tr>
</thead>
<tbody>
<tr>
<td>Insurer pays the percentage reported</td>
<td>Insurer pays the policy limit</td>
<td>Insurer pays 75% of amount that otherwise would have been paid</td>
<td>Insurer pays the last reported value</td>
</tr>
<tr>
<td>Example</td>
<td>Example</td>
<td>Example</td>
<td>Example</td>
</tr>
<tr>
<td>Reported: $40,000</td>
<td>Reported: $125,000</td>
<td>No Report</td>
<td>Last reported value: $82,000</td>
</tr>
<tr>
<td>Actual Values at the time of report: $80,000</td>
<td>Loss: $60,000</td>
<td>Loss $80,000</td>
<td>Loss $100,000</td>
</tr>
<tr>
<td>Policy pays: $40,000 + $80,000 x $60,000 = $30,000</td>
<td>Policy pays: $100,000</td>
<td>Policy pays: $60,000</td>
<td>Policy pays: $82,000</td>
</tr>
</tbody>
</table>

Table 1.5
Advantages and Disadvantages of Value Reporting Form

<table>
<thead>
<tr>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Insured only pays for actual values at risk</td>
<td>Paperwork-intensive</td>
</tr>
<tr>
<td>Company receives premium for actual value</td>
<td>Insured pays penalties if reports are late or are inaccurate</td>
</tr>
</tbody>
</table>

Note To learn more about Value Reporting, read over Form CP 13 10.

Please refer to the end of Lesson 1 Topics H to complete Self Quiz H