



Property Insurance Terms and Conditions in Hard and Soft Markets: Coinsurance, Blanket Insurance, and Policy Forms

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Introduction

The period of the 1990s is considered a soft market for property and casualty insurance. Similarly, the period of the late 1970s and early 1980s is likewise so regarded. Both soft markets have been succeeded by very hard markets. A classroom guest from the surplus line market employed the list in Table 1 to differentiate hard and soft market conditions, and it is convenient to employ it here.¹

Table 1

Features of a Soft Market	Features of a Hard Market
Lower prices	No more room to cut
Market share goals	Underwriting pain
Cash flow underwriting	Reinsurance problems
Good investment returns	Investment returns not so good
Excess capital	Disciplined underwriting
Under-reserving	Need to strengthen reserves
Surplus lines flat	Surplus lines grow
Soft terms and conditions	Hard terms and conditions

The focus of this article is the last item on the list—terms and conditions. Soft terms and conditions are “unusually favorable to insureds.”

There have been two major hard property insurance markets in the last 25 years. The soft market of 1988–2000 followed the hard-market crunch of the mid-1980s, although it was punctuated by temporary hard-market shocks from Hurricanes Hugo and Andrew, and the Northridge earthquake. The very hard market of 2002 to 2003 has moderated at this time but current conditions are not as soft as the 1990s. This in part is because of the storms of 2005. The last six years provide an ideal prism to study property insurance terms and conditions ranging from very soft to hard to moderate markets. This article will describe how terms and conditions vary with market cycles. The methodology is informal and partly anecdotal. The writer as part of his professional responsibilities regularly interfaces with brokers and underwriters in the Chicago insurance marketplace, and much of what is reported below is based on such conversations. Naturally it is also based on regular reading of *Business Insurance* and other publications. In addition, the writer reviewed vintage insurance textbooks. It is the writer’s view that vintage terms and

Abstract

This article draws upon the writer’s professional experience with industry participants and his experience in litigation of insurance disputes. It focuses upon changes in property insurance terms and conditions as market conditions change from hard to soft, and back again. It explains the rationale for the sound underwriting principles (notably insurance to value and blanket coverage) exemplified in vintage insurance textbooks and how the application of these principles changes during market cycles.

conditions, such as he learned as a young professor, are exemplified in hard market terms and conditions. Generally in soft markets, many of these terms and conditions give way. Three specific areas are emphasized: insurance to value, blanket insurance, and propriety insurer forms.

The following description of market conditions was published in *Business Insurance* in 1985:

More Restrictive Insurance Policies. Again, in recent years, insurance companies readily agreed to broaden coverages and policy conditions. They removed exclusions and/or restrictions. They agreed to conditions that enhanced the policies for the insured, often at no additional cost. However, the tide is rapidly changing. Underwriters are now reviewing any special provisions or changes in policy conditions with the utmost care. Many are simply refusing to accept any modifications of standard forms.

Five years earlier the same publication reported, during the depths of the soft market, comments by the risk manager at General Motors boasting at the RIMS Conference about his company's property program that covered "virtually all risks, automatic unlimited locations, and blanket limits."

Coinsurance and Insurance to Value

Insurance to value is very important to sound property insurance underwriting. Anyone who has taught property insurance or studied for the CPCU knows how much emphasis is placed on the topic. Rate equity (fairness between insureds) is one reason that the insurance industry is concerned about insurance to value. Coinsurance policy provisions seek to make insureds share losses with the insurer when the insured is underinsured at the time of the loss. What is meant by "underinsured" is defined as some specified percentage times the actual cash value (or replacement cost if that optional coverage is selected or "gross earnings" in business income) of the insured property at the time of the loss. When the amount of insurance is less than the calculated amount, the insured becomes a coinsurer of his or her own loss to the extent of the underinsurance.²

Many insureds are willing to underinsure in order to enjoy lower insurance premiums. Their willingness is in part explained by the common knowledge that most property losses are partial due to fire protection. Consequently the insured might think: "Why insure against a total loss when the fire department is bound to get here quickly?" There are at least two problems that arise: rate equity and adverse selection. Those who underinsure are subsidized by those who insure to value when they receive full indemnity for partial losses. Most losses are partial, thus the underinsurer can expect his or her loss to fall within the limit. A rate structure that makes no allowance for insurance to value allows underinsurers to pay lower rates than they should.

The issue of coinsurance and of equity between insureds is not new. In 1911, Solomon Huebner, a leading name in insurance education, in his book *Property Insurance* wrote:

The above illustrations demonstrate that a disregard of the coinsurance principle results in a grave injustice to those who do not desire to run the risk of taking partial insurance, and who, in consequence, pay premiums out of all proportion to the benefits received. The coinsurance clause, however, remedies this injustice . . . Justice demands that [the insured] should receive in the proportion that he was willing to pay premiums. . . .³

Another vintage text by Mowbray and Blanchard reports that coinsurance was a topic of discussion at the Merritt Committee Hearings⁴ in New York in 1910. The Committee concerned itself with fire insurance rates and rating practices. In the excerpt below, Mowbray and Blanchard comment and provide a table from the Merritt Committee including actual New York loss data.

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Author's note: This article was inspired by the writer's presentation before the CPCU Society's Chicago Chapter.

Why should one who has insurance in the amount of \$5,000 on property worth \$10,000 not be indemnified for any loss to a maximum of \$5,000? A popular answer to this question, which is not without validity, is provided by a second question, which might be asked by the insurer: Suppose that a loss of \$5,000 or less occurs; to which half of the value does it apply, the insured's or the insurer's?

Figures on the distribution of fire loss given in the report of the Merritt Committee are quite as cogent for purposes of illustration as when they first appeared. On a certain class of building the average experience per 100 fires and per \$100 of value was approximately as follows:

Loss	No. of Fires	Average Loss	Total
\$10 or less	82	\$2	\$164
\$10.01-\$20	6	14	84
20.01-30	3	25	75
30.01-40	2	35	70
40.01-50	1	45	45
50.01-60	1	55	55
60.01-70	1	65	65
70.01-80	1	75	75
80.01-90	1	85	85
90.01-100	2	99	198
Total			\$916

Mowbray and Blanchard concluded, on the basis of the above table of losses, that the net fire rate would be: (1) \$.09 per \$100 if all insured to value; (2) \$.34 per \$100 if all insure to only 10 percent; and \$.17 if all insure to 80 percent. They go on to opine that a "graded rate system" such as is in use today would be impractical although superior.⁵

The issue of rate equity and fairness aside, a system that does not enforce insurance to value invites adverse selection and moral hazard. If underinsurance is rampant, then the population of those insuring to full value will include those most likely to have total losses, i.e., those selecting against the company. Then there is the obvious reason that the insurance company does not want to put itself in a position where most total losses are only partly indemnified and the obvious public policy implications of such a situation.

Soft and Hard Market Conditions

When market conditions soften, brokers and agents often succeed in negotiating away coinsurance, especially for large-market risks. Aside from the old reliable "insureds hate coinsurance and don't understand it," the argument for waiving coinsurance generally becomes "there are other ways to enforce insurance to value." For example, one might use the Statement of Values (CP 16 15 07 88) where the values of each property are scheduled. A careful underwriter might take steps to verify that each amount is correct and up to date, but in a softer market where an underwriter might strive to maximize written premium or preserve or increase market share, less care may be taken. Or, perhaps an underwriter justifies underinsurance by writing an insurance amount equal to the possible maximum loss (PML) rationalizing that the client may resist buying more insurance than he or she thinks could possibly be needed. The fallacy of this argument is regularly demonstrated by experience, never so vividly as the experience of the World Trade Center, which was obviously grossly underinsured (or else why debate one occurrence or two).

The weakness of the "no coinsurance" rationale is that hypothetical values presented *a priori* are never tested in the reality of the marketplace.⁶ The strength of

the coinsurance framework is the value in the denominator of the coinsurance fraction that is established at the time of the loss. Clearly what happens in soft markets is that buyers with bargaining power, generally the larger risks, are able to overcome the sound underwriting logic of coinsurance. This very fact was presaged by Huebner in 1911:

But coinsurance serves another very useful purpose in protecting property owners against the efforts of great industrial and mercantile corporations to shirk the payment of their just share of premiums.

As the market hardened in 2001, many large risks still managed to avoid use of coinsurance. One broker told the writer that coinsurance might be proposed by an underwriter and negotiated around provided there is adequate insurance to value. Underwriters began insisting on appraisals, property schedules, and sub-limits. Another brokerage manager wrote to his colleagues:

In presenting to market, an electronic spreadsheet is necessary. More importantly property carriers are tired of the under reporting and sloppy reporting of values. If their capacity is set at \$25MM, they do not wish to pay losses up to \$50MM, and they want the proper premium for the risks they quote. Providing the market with the proper amount of engineering information is critical. International accounts will want a spreadsheet with COPE information. HPR markets will want 5 or 6 months' lead time to do the inspections or will require engineering reports and sprinkler diagrams on locations over \$50MM at the least.⁷

The foregoing applies to the large company market. In the 1990s, even in middle markets, coinsurance was sometimes absent because of the use of brokers' forms that had no coinsurance provision or by endorsements from generous underwriters.⁸ When the markets hardened, insureds who once might have had coinsurance waived by a friendly underwriter interested in expanding market share in a soft market receive instead coinsurance provisions or at least agreed amount endorsements backed up by current appraisals.

It is sometimes argued that coinsurance is unfair because it requires the insured to have enough insurance at the time of the loss when he or she buys the coverage before the loss. The situation can be especially problematic in coastal areas where storms cause rebuilding costs to spike leaving the insured underinsured and subject to coinsurance penalties. An excellent risk management solution is the agreed value optional coverage. It requires that the parties establish an agreed value to replace the ACV (or replacement cost) in the coinsurance calculation. The underwriting rules require the agreement be based on an appraisal and only be in effect one year whereupon a new appraisal is required (unless the friendly underwriter waives the appraisal). The underwriting rules also call for a 5 percent increase in the rate.

Blanket Insurance and Insurance to Value

There is no form or endorsement for blanket insurance.⁹ Generally, the word "blanket" on the declarations page indicates that coverage is on a blanket basis. What blanket means is that one amount of insurance is applied to more than one property in contrast with "specific" insurance where each item of insured property has a specific amount of coverage attached to it. The potential for underinsurance is clear and compelling. If the locations are sufficiently separated to avoid a multi-location catastrophic loss, the insured would like to insure the maximum possible loss instead of the total value.

Blanket insurance is not a new concept. A 1962 chapter by George V. Whitford of Reliance Insurance in the *Property and Liability Insurance Handbook*¹⁰ included:

Insurance can be made to extend over more than one unit or one type of property in one location. A single contract can cover: two or more types of property in one location, one

type of property in two or more locations, two or more types of property in two or more locations. Such insurance is referred to as blanket coverage. . . . Coverage of the contents of three warehouses with one amount of insurance embodies the blanket approach.

The rationale for blanket insurance was likewise stated in Huebner, Black, and Webb's 1994 edition of *Property and Liability Insurance*:¹¹

But with respect to machinery or stocks of goods, where values shift rapidly and greatly from one location to another but remain fairly constant as regards total value, the clause performs a distinct service. In such cases it is difficult, if not impossible, to carry adequate specific amounts of insurance on the several locations. Although it is comparatively easy to know the aggregate value, it is most difficult, and in many instances impracticable, to keep a record of the values at each separate location.

Similarly, Whitford wrote:

The advantages of blanket insurance may be quite apparent. Suppose that an insured operates several retail stores where the total value of stock stays almost constant but where frequent variations of stock among stores occur. With blanket insurance he need give concern only to making certain that the total insurance is adequate. Without such an arrangement, he would continuously have to adjust the amount of insurance upwards or downwards at each individual location.

Two points to note about these quoted passages: (1) Both Whitford and HBW **assume** insurance to value; and (2) both examples pertain to personal property (*machinery or stocks of goods, retail store inventories*) and **not** real property. As compelling as the argument for blanket insurance might be when there are relatively stable total personal property values shifting from one site to another, there is a total absence of corresponding logic for blanket coverage for real property (except in the situation where the exposure units are too numerous to identify). The INS 23 text, *Commercial Insurance*, by Flitner and Trupin¹² talks about the use of blanket insurance on real property, and emphasizes the advantages to the insured. The argument is a simple one: if (a) there is a blanket limit on real property and (b) the coinsurance percentage is 90 percent as called for in the underwriting rules, when there is a total loss the insured receives 100 percent. This contrasts with the use of specific insurance and using the same 90 percent to determine amount of coverage, an insured with a total loss gets 90 percent. HBW earlier sound the same theme:

For example, imagine an insured who has three buildings in different locations valued at \$100,000, \$150,000, and \$200,000 for a total value of \$450,000. Each could be insured with a "specific" amount of insurance applicable exclusively to each building. Each amount would need to satisfy the indicated coinsurance percentage. Alternately, the insured might buy \$405,000 on a blanket basis based on 90 percent coinsurance that is mandatory for blanket coverage.

To point out the advantages to the insured of blanket insurance on real property is not to justify its careless use. The question remains: why does the insurance industry write blanket limits on real property at the modest price of 90 percent coinsurance priced at a 80 percent coinsurance rate (especially if coinsurance is waived)? The writer has been able to find no explanation except that the exposures are too numerous to enumerate. For example HBW comment:

Blanket insurance is advantageous to insureds such as in the case above. Properly arranged, blanket need not cost any more per unit of insurance than specific insurance.

Improper use of blanket insurance is an invitation to underinsurance, and it is widely recognized to have been such in the soft market period of the 1990s. One broker commented to me when I asked why this was allowed to happen: "Because in a soft market underwriters do not care and insureds and their brokers will take advantage."

In the not-too-distant past, there was an endorsement used to enforce insurance to value. Gordis (1976) discusses the pro-rata distribution clause.¹³ This clause is no longer to be found in the ISO forms library. Gordis writes:

Fire insurance policies are sometimes written to cover blanket over two or more locations. A Pro Rata Distribution clause is almost always attached to such blanket policies. The clause operates to distribute the amount of the policy by providing that insurance attaches in each building or location in the proportion that the values at the location bear to those in all locations covered. The Pro Rata Distribution clause thus limits the Company's liability at each separate location, with only a specific proportion of the policy applying to each location.

The writer remembers teaching the pro rata distribution clause to agents in the 1970s and 1980s. With the pro rata distribution clause, blanket insurance on real and personal property is much more respectable. HBW comment:

The purpose of this clause is to distribute the insurance automatically over the several items in proportion to their respective values, irrespective of the fluctuations that may occur from time to time in such values.

Again, note the underlying assumption of insurance to value. And it is that assumption that was violated in a widespread way in the soft market years. The requirement of 90 percent coinsurance for blanket is meaningless if appraisals are not up to date. There is no enforcement mechanism. The ISO Statement of Values (CP 16 15 07 88) is an underwriting and rating tool, and has no bearing in claims settlement.

In 1911, Soloman Huebner wrote of the importance of a "distribution clause":

Where property is thus distributed over several items and changes its location from time to time, the interests of both insured and insurer are protected by the use of the "distribution form" of the coinsurance clause.

Harder Market Conditions

In the recent harder market, some of the discipline of a pro rata distribution clause returned. It became common to find blanket insurance for both property and business income with current property schedules and location sub-limits (effectively pro rata distribution) perhaps with a margin of 5 percent or 10 percent. A more favorable (for the insured) provision is a "loss limit" where the largest potential loss location is set as the maximum for any location. The writer has specifically heard of Katrina claims presenting a problem for an insured subject to a loss limit. The loss limit was set based on the largest location in a larger city, but the extraordinary building costs and lengthy business interruption led to losses exceeding the loss limit.

Another soft market legacy problem is blanket contingent business income coverage. Flitner and Trupin in *Commercial Insurance* describe "business income from dependent properties" as follows:

An insured may be so dependent on a single supplier or single customer that damage to the operations of the supplier or customer may interrupt the insured's operations. For example, a manufacturer may use a raw material that is available from only one supplier. If the supplier's factory is destroyed, the manufacturer cannot continue to make its products. The unendorsed BIC does not cover this loss exposure because the loss of business income must result from direct damage to the insured's property.

Perusal of the two ISO forms (CP 15 09 10 00 and CP 15 08 10 00) both include a schedule where contributing, manufacturing, recipient, or leader locations can be listed and an amount of insurance indicted applicable to each. Brokers and underwriters reported that in the 1990s, a major account might have contingent BI on a blanket basis. The losses cascaded in the wake of 9/11 when insureds from across the country

were collecting contingent business income written on a blanket basis. In the harder market, one finds substantially reduced limits and underwriters ask questions like: “Why do you need it?” “What exposures do you have?” and ultimately “Suppose we schedule those exposures with sub-limits.” Another harder market variation found (where blanket contingent BI is written) is the introduction of the distinction between primary and secondary exposures. For example, suppose an Illinois insured has a business income loss because there is a fire in a plant in North Dakota and that plant is a supplier to the Illinois company’s supplier in Nevada. The North Dakota plant is a secondary location, and possibly not covered in programs written in harder markets. In soft markets, coverage is likely afforded the loss from the secondary location.

Terms and Conditions in Policy Forms

Brokers’ Forms

One of the serious problems of the soft market was the extensive use of brokers’ forms for writing coverage. The brokerage houses developed these forms for binding coverage. Instead of including specific terms and conditions, these forms have blanks to be filled in by the binding broker. An example of the calamitous consequences for insurers that can ensue is illustrated in an actual situation with which the writer is familiar. The ISO property form limits coverage on newly acquired real property to \$250,000 for 90 days. A major insurer wrote a \$50 million check for a “newly acquired property” that the underwriters did not even know they had insured. There was no \$250,000 limit in the brokers’ form, and the blanket limit was adequate for the loss. In harder markets, one finds drastically diminished use of brokers’ forms. In harder markets, coverage is bound on the primary lead underwriter’s form. The next underwriter might or might not accept that paper depending on whether he or she had had time to study the lead form. If not, the second underwriter might use his or her own form, and so on for a third or fourth company. Thus, on information, there were major non-concurrency problems during the height of the hard market. Fortunately, over time this problem has diminished as carriers have grown accustomed to other insurer’s forms and have become more willing to follow. Brokers’ forms have not returned but may be on the way as markets soften.

Return to ISO Forms in the Middle Market

Business Insurance reported on April 28, 1986: “Hard Market Wiping Out Manuscript Forms.” A broker on a RIMS Conference panel commented, “Today we don’t start with a blank piece of paper. Instead we are relying on existing forms and changing them as needed.” This has happened in the last five years just as it did then. A related development in the middle markets is the declining use of proprietary middle-market coverage forms and the coverage expansions that become embedded in those forms. One of the giant primary insurers (not identified here) withdrew from use its proprietary forms and returned to ISO forms. Examination line by line reveals some of the differences. (See Table 2.)

Table 2

Proprietary Form	ISO Form
Personal property within 1,000 feet covered	Only 100 feet
Leased personal property covered	Only if contractual obligation to insure
Property in transit: \$5000	No coverage
Outdoor property covered	Limited \$1,000 of coverage
Boats up to 21 feet are covered	Rowboats and canoes only
Brands and labels coverage built in	By endorsement for additional premium
Civil authority cover: 4 weeks	Only 2 weeks
Debris removal: 50% of direct physical loss	25% of direct physical loss
Removal: 180 days	30 days only
Coverage extensions apply automatically	Apply only if 80% or higher coinsurance
Newly Acquired Property <ul style="list-style-type: none"> • Real: no limit, 180 days • Personal: no limit, 180 days 	\$250,000, 30 days \$100,000, 30 days
Personal effects of others are covered	Only for \$2,500

Conclusion and Implications

Indications today (late 2006) are that markets continue to soften except in coastal areas. The latter might change with there being no important storms in 2006. Soft markets tend to last longer than hard markets and tend to continue to soften. Absent a major unexpected underwriting catastrophe, the trend will probably continue.

The heart of the issue for the insurance industry is its inability to maintain sensible pricing. If one reads the news in 1985 and 1986, one will find industry leaders calling for “pricing for profit.” By 1987, the market was going soft all over again. Nearly the same thing was being said in 2001 and 2002. Generous terms and conditions go along with generous pricing, and with time, both lead to underwriting losses and ultimately another hard market.

One of the interesting consequences of the cycle changes is the impact on agent errors and omissions. When underwriters adopt hard market terms and conditions, the producers must recognize the significance of the changes and make sure the client is aware of the significance. When coverage is no longer written on a blanket basis (see endnote 8) the ill-informed and underinsured policyholder can have large uninsured losses and might well blame the agent.

Endnotes

1. At the Katie School, a wide range of industry guests lecture to our students. In this particular instance the guest spoke in my Property Insurance class about the surplus lines insurance markets and its (increasing) role in harder markets.
2. For example, if the ACV at the time of the loss is \$1,000,000, the coinsurance percentage of 80 percent, and the amount of insurance is \$600,000, when there is an \$80,000 partial loss, the insured will recover only \$60,000, less the deductible, as follows: $(\$600,000 / (.80 * \$1,000,000))$ times the loss of \$80,000 equals \$60,000).
3. Soloman S. Huebner, *Property Insurance*, D. Appleton and Company, 1911, p. 167.
4. Mowbray, Albert H. and Ralph H. Blanchard, *Insurance: Its Theory and Practice in the United States*, 4th Edition, McGraw-Hill, 1955, pp. 80 and 81. The authors quote the Merritt Report: *Report of the Joint Committee of the Senate and Assembly of the State of New York Appointed to Investigate Corrupt Practices in Connection with Legislation and Affairs of Insurance Companies, Other than Those Doing Life Insurance Business*, pp. 82ff. For years, insurance textbooks have made reference to the Merritt Committee because of its impact on the fire insurance business (as well as the Armstrong Committee for its impact of life insurance).
5. A graded rate system allows the insured to select the coinsurance percentage that will apply. The lower the coinsurance percentage, the higher the rate the insured must pay. The framework is standard in the ISO Commercial Property Program.
6. Consider the Statement of Values. It suggests that a new statement be filed each year for blanket rates to continue to apply, and has a space where the insurer can require an officer of the policyholder to verify values and sign. However it also says "optional with company." The writer recalls talking with a reinsurance underwriter shortly after 9/11 who told of his experience of going through file by file and finding outdated statements of value, clearly a legacy of the soft market.
7. This is a quote from an actual document generated by one of the large brokerage houses early in 2002. It was made available to the writer provided that the source remained unnamed.
8. During extreme soft-market conditions such as the late 1990s, concessions granted by underwriters to larger risks are extended to not very large risks. The writer, in his role as a consultant and expert witness in litigation, recalls one situation where an indoor recreational facility valued at less than \$5 million, was written with no coinsurance on a blanket basis and not enough coverage when a winter storm struck. The hard market ensued and at renewal the blanket was removed and the policyholder became grossly uninsured. Shortly thereafter a large loss ensued. It is the responsibility of the policyholder to understand terms and conditions of coverage purchased, but often cases like this come back and bite the broker in the form of E&O claims. Obviously, this is a "war story," and the identities and details remain confidential.
9. The Statement of Values (CP 16 15 07 88) is used when the agent or broker requests a blanket average rate from the ISO but includes no contractual language applicable to claims handling.
10. Long, John D. and Davis W. Gregg, editors, *Property and Liability Insurance Handbook*, Richard D. Irwin, 1965. Whitford's chapter is 4.
11. Huebner, S.S., Kenneth Black, and Bernard Webb, *Property and Liability Insurance*, Prentice Hall, 1996, p. 156. Although the cited date is 1994, this is indeed a vintage text. The Huebner book cited in endnote 3 became Huebner and Black and then Huebner, Black, and Cline before Bernie Webb was assigned the most recent revision.
12. Flitner, Arthur L. and Jerome Trupin, *Commercial Insurance*, American Institute of CPCU/IIA, Chapter 2, p. 31.
13. Philip Gordis, *Property and Casualty Insurance*, 23rd Edition, Rough Notes, 1976, p. 52. Back in the day before there were CPCU textbooks, Long and Gregg, Huebner, Black, Cline, and Gordis were all used in the CPCU curriculum.