

Class 4 Outline
Business Finance 749
Spring Quarter, 2007

I. Review of Riot and Civil Commotion Peril – Broad Form

- A. See p. 134 of Policy Handbook

II. Blanket Insurance

- A. Basic method of insuring buildings and personal property is to schedule a specific amount of insurance in the declarations for each building and a specific amount of business personal property for each location.

- B. Specific insurance example

- \$1,000,000 on the building at 123 Main Street, Des Moines, IA
- \$800,000 on the business personal property at 123 Main Street, Des Moines, IA

- C. Alternative is blanket insurance. Blanket insurance covers either of the following with one limit of insurance.

1. Two or more types of property
2. One or more types of property at more than one location

- D. No special endorsement is required to effect blanket insurance. The word “blanket” is simply added to the statement of coverage in the declarations.

Might reads as follows

- \$1,800,000 blanket on the building and your business personal property at 123 Main Street, Des Moines, IA

- E. Property at different locations can also be covered on a blanket basis. In that case, coverage can apply to one or more types of property at more than one location:

- \$5,000,000 blanket on the building and your business personal property at
 - 760 Walnut Street, Cincinnati, OH
 - 987 Third Street, Cincinnati, OH
 - 12 Elm Street, Ft. Thomas, KY
- \$7,500,000 blanket on the buildings at
 - 76 Broadway, Malvern, PA
 - 971 Tenth Street, Philadelphia, PA
 - 88 Highland Road, Pottstown, PA

- F. Coinsurance Requirement

1. Blanket insurance may require additional cost
2. Minimum coinsurance clause is 90%.
3. At 90%, the insured does not receive the 5% discount that applies to specific insurance
4. To meet coinsurance requirements, the insured with coinsurance must buy more insurance than otherwise would be required.

Class 4 Outline
Business Finance 749
Spring Quarter, 2007

G. Advantages of Blanket Insurance

1. Example – Furniture Store company
 - a. Two locations
 - b. \$1,000,000 business personal property at each location
 - c. 80% coinsurance requirement
 - d. Might purchase specific insurance of \$800,000 at each location.
 - e. What if the loss is \$1,000,000?
 - f. If a blanket policy were purchased with a limit of \$1,800,000 (90% of \$2,000,000)
 - g. Loss would be fully paid as long as total amount of insurance satisfied the coinsurance clause

2. Debris Removal

III. Causes-of-Loss-Special Form

- A. This form insures against “risks of direct physical loss.” This means that all direct physical damage losses are covered unless specifically excluded.

- B. Burden of proof falls on the insurer to show that a loss is not covered because of an exclusion or limitation.

- C. Exclusions and Limitations
 - a. Contains most of the exclusions of the basic and broad forms

 - b. Exclusions Unique to the Special Form
 - Wear and tear
 - Rust, corrosion, fungus, decay or deterioration
 - Smog
 - Settling, crackling, shrinking or expansion
 - Infestations and waste products of insects, birds, rodents or other animals
 - Damage to property by dampness or dryness of atmosphere, changes or extremes in temperature, or marring or scratching
 - Weather conditions that contribute to other excluded causes of loss. For example, covered property is damaged by flood waters that were driven in part by high winds. The flood damage will not be covered even though windstorm is not otherwise excluded.
 - Acts or decisions, including the failure to act of any person, organization or governmental body.
 - For example, if flooding occurs because municipal authorities fail to take proper flood control measures, the damage from flood will not be covered.

- D. Theft-related exclusions
 - a. Dishonest acts of the insured or of partners, members, officers, managers, directors of the insured.
 - b. Losses resulting from employee dishonest acts can be covered under a separate crime form.
 - c. Voluntary surrendering of possession of property as a result of fraudulent scheme, trickery, or unauthorized instructions.

Class 4 Outline
Business Finance 749
Spring Quarter, 2007

- d. Loss by theft of construction materials not attached as part of the building, unless the materials are held for sale by the named insured.
 - e. Loss that is missing without explanation and is evidenced only by inventory shortage.
- E. Additional Coverage – Collapse
- a. Essentially the same as the additional coverage for collapse under the broad form
- F. Additional Coverage Extensions
- a. Property in transit
 - Provides up to \$5,000 of protection for loss to the insured's property in transit
 - The property must be in or on a motor vehicle owned, leased or operated by an insured.
 - It cannot be in the care, custody and control of the insured's sales personnel.
 - Does not provide special-form coverage
 - Perils insured against are fire, lightning, explosion, windstorm, hail, riot, civil commotion, vandalism, upset or overturn of the conveying vehicle with another vehicle or an object other than the roadbed, and theft.
 - Theft is limited to theft of an entire bale, case or package by forced entry into a securely locked body or compartment of the vehicle, evidenced by marks of forced entry
- G. Water Damage, Other Liquids, Powder or Molten Material Damage
- a. Extends coverage to pay for the cost of tearing and replacing any part of a building necessary to repair an appliance or system from which water or another liquid – or even powder fire-extinguishing agents or molten materials escaped.
 - b. Does not pay for the repair of any defect that resulted in the leakage.

IV. Assessing Net Income Exposures

- A. In assessing the business income exposure, net income is the valued thing. Net income losses can be caused by either:
- 1. Unexpected drops in revenues
 - 2. Unexpected increases in expenses or
 - 3. Combination of both.
- B. Both business risk and hazard risk can result in net income losses. Thus, identifying business risk and hazard risk exposures is the first step in identifying net income exposures.

V. Business Risk Net Income Exposures

- A. The main business risks are price risk and production risk.
- 1. Price risk is unanticipated variability in the cost of the product's input or in a product's output price.
 - 2. Production risk is unanticipated variability in a product's production level.

Class 4 Outline
Business Finance 749
Spring Quarter, 2007

- B. Business risks can be either general or organization-specific.
 - 1. In traditional risk management field, the terminology systematic and non-systematic risk is employed.
 - 2. Another set of terms used is to distinguish between fundamental risk and particular risk.

- C. The degree of exposure to general business risk differs by organization.
 - 1. Service organizations tend to be susceptible to business cycles
 - 2. Utility organizations tend to be less susceptible to business cycles.

- D. The impact of some general business cycle risk may be permanent and irreversible.
 - 1. An entire product line or service may fall out of favor with customers.
 - 2. Price risk may drive expenses up that cannot be passed on to the end consumer.

- E. Organization-specific risk may be caused by price or production risk.
 - 1. The impact of organization-specific risk can be net income losses by reason of:
 - i. Reductions in revenue
 - ii. Increases in expenses
 - iii. Combination of both

 - 2. Organization-specific risk can be caused by actions of:
 - iv. Competitors
 - v. Regulators
 - vi. Governmental Organizations

 - 3. An organization's own decisions or activities are also a major source of organization-specific business risk. Two examples of organization-specific risk which result in a reduction of revenue are:
 - i. Poor product planning.
 - ii. Credit risk

 - 4. An organization's net income can also drop because of increased expenses. Unexpected expense increases for input or production functions that cannot be passed on to customers represent a net income loss.

VI. Hazard Risk Net Income Exposure

- A. Hazard risks are risks that can result in losses but not gains. In traditional risk management terminology, these are known as pure risks. These are risks that are accidental from the insured's point of view.

- B. Three types of hazard risk exposures that can cause net income losses are:
 - 1. Property loss exposures
 - 2. Liability loss exposures
 - 3. Personnel loss exposures.

Class 4 Outline
Business Finance 749
Spring Quarter, 2007

VII. Property Net Income Exposures

C. Property loss exposures related to net income losses can be divided into two categories:

1. Damage to the organization's property
2. Damage to property of others

D. Damage to the organization's property

1. Most net income losses arise as a result of physical damage to property at the organization's own premises.
2. Thus, property damage exposures should also be looked at through the lens of potential net income loss exposures.
 - a. It is also important to identify any exposures that involve potential damage to the organization's property while off premise, such as might occur
 - i. When the property is in transit
 - ii. When the property is being stored or worked on at the premises of a bailee.
 - b. In addition, damage can occur to both tangible and intangible property.

E. Damage to the property of others

1. These exposures are sometimes called contingent net income loss exposures.
2. A contingent net income loss exposure is an exposure for which the interruption of the organization's operations is conditional on another organization's ability to fulfill its duties.
3. Organizations tend to depend on the following kind of organizations:
 - a. Key suppliers
 - b. Key buyers
 - c. Leader properties
4. Net income losses can also result from the acts of civil authorities.
 - a. Damage to nearby property may create such a hazardous loss exposure to the wider area that the police or fire departments prohibit access to the area.
 - b. This action may prevent an organization from occupying and using its property, even though the property of the organization itself sustained no damage.

F. Liability Loss Exposures

1. Liability loss exposures can create both direct and indirect costs.
2. A major indirect cost associated with liability is loss of reputation
3. Loss of reputation could result in:
 - a. Loss of customers and market share
 - b. Inability to attract qualified people
 - c. Unwillingness of suppliers to do business with the organization

Class 4 Outline
Business Finance 749
Spring Quarter, 2007

- d. More difficult credit terms
- e. Higher capital costs

VIII. Business Income Insurance

- A. Covers the reduction in an organization's income when operations are interrupted by damage to property by a covered peril.
- B. Severity of a business income loss is directly related to the length of time required to restore the property.
- C. Because of this, business income coverage is called "time element" coverage.
- D. Business income coverage is also referred to as "business interruption" coverage, because the loss results from the interruption of the insured's business.

IX. Business Income Losses

- A. In general terms, the business income loss can be calculated by subtracting the amount of net income actually earned during the period of interruption from the amount of net income that the firm could have reasonably expected to earn during the period of interruption
- B. More specifically, the business income loss consists of:
 - ✓ Lost income for the period of interruption
 - ✓ Plus continuing expenses for that period
 - ✓ Plus any extra expenses
- C. Simplified Example: Sam's Hardware Store
 - a. Partial fire loss
 - b. 3-month interruption for building to be repaired
 - c. Revenue: reduced to \$0
 - d. Some expenses reduced or eliminated: payroll, electricity, etc.
 - e. Some additional expenses to reopen store a.s.a.p., overtime labor, express shipping costs on merchandise

	Expected	Actual	Business Income Loss
Revenue	\$300,000	\$-0-	
Continuing Expenses	\$240,000	\$60,000	
Extra Expenses	\$-0-	\$60,000	
Net profit (or loss)	\$60,000	(\$120,000)	\$180,000

- D. Impact of Continuing Expenses
 - 1. Any reduction in continuing expenses during business interruption lessens the business income loss.
 - 2. However, continuing expenses generally cannot be eliminated entirely during the period of business interruption.
 - 3. In many cases, a company's continuing expenses are greater than the profit the company would have earned

Class 4 Outline
Business Finance 749
Spring Quarter, 2007

- Many expenses are fixed, that is, they do not “vary” with revenue volume.
- High fixed costs can create higher risk

E. Extra Expenses

1. Extra expenses are expenses that an organization would not have incurred if the business interruption had not occurred.
2. Examples:
 - Labor overtime costs and overnight shipment costs incurred to install repair parts to an assembly line shut down by an explosion.
 - Cost to rent a substitute warehouse after the warehouse owned by a wholesale distributor is severely damaged by a fire.
 - Rent of mobile classrooms by a college to continue classes following a hurricane.
3. There are two types of extra expenses:
 - i. Expenses incurred to reduce the business income loss
 - ii. Expenses incurred to maintain service to customers, even though the expenses will actually increase the net income loss.

F. Coverage Trigger for Business Income Losses

In order for business income insurance to apply, the following must occur:

- ✓ An interruption from operations
- ✓ Caused by property damage from a covered peril
- ✓ To property at locations or situations described in the policy
- ✓ Resulting in a loss of business income and/or extra expense.

G. Business Income Coverage Forms

1. Business Income (and Extra Expense)
 - Covers both business income loss and extra expenses losses
2. Business Income (Without Extra Expense)
 - Covers business income loss but only covers extra expenses to the extent that they reduce the business income loss.
3. Key points:
 - Either business income coverage form (BIC) can be included in a commercial property form such as the BPP.
 - The causes of losses covered for business income can be either:
 - i. The same causes of losses designated for other coverage forms (such as the BPP) or,
 - ii. Causes of losses that apply to business income coverage only
 - The two versions of the BIC are similar in all respects except extra expense coverage