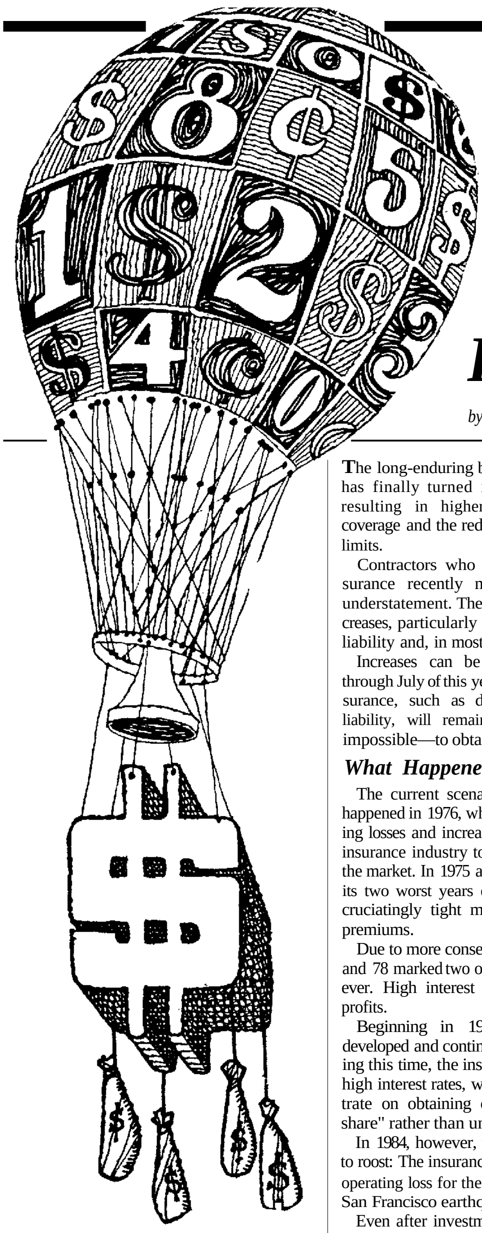

# The Insurance Crunch

## *Paying More and Getting Less*

*by William S. McIntyre*

The long-enduring buyer's insurance market has finally turned into a "seller's market," resulting in higher premiums, restricted coverage and the reduced availability of high limits.

Contractors who have renewed their insurance recently might consider this an understatement. They faced shocking rate increases, particularly in the area of "umbrella" liability and, in most cases, general liability.

Increases can be expected on renewals through July of this year. And some types of insurance, such as design-build professional liability, will remain very difficult—if not impossible—to obtain.

### *What Happened?*

The current scenario is a replay of what happened in 1976, when falling premiums, rising losses and increasing inflation caused the insurance industry to sharply withdraw from the market. In 1975 and 76, the industry faced its two worst years ever, resulting in an excruciatingly tight market and skyrocketing premiums.

Due to more conservative underwriting, '77 and 78 marked two of the industry's *best* years ever. High interest rates also helped boost profits.

Beginning in 1979, a buyer's market developed and continued until mid-1984. During this time, the insurance industry enjoyed high interest rates, which caused it to concentrate on obtaining cash flow and "market share" rather than underwriting profits.

In 1984, however, the chickens came home to roost: The insurance industry suffered a net operating loss for the first time since the 1906 San Francisco earthquake.

Even after investment income, the net loss was $3.8 billion, while net written premiums were $122 billion. This compared to a net profit of $8.5 billion in 1978 based on just $79 billion in premiums.

As losses began to mount in '84, insurance-company managers decided to take drastic steps. As a result, prices began to increase during the last half of '84 and gathered momentum in 1985.

Many insurers who had reduced rates in an attempt to increase their share of the market, or simply to meet their competition, abandoned that strategy and began to re-underwrite all their business accounts. Rates were substantially increased on many of their good accounts, and marginal ones were cancelled or not renewed.

Behind the scenes, the reinsurance market also experienced dismal operating results. Reinsurance is a process where primary insurance companies lay off part of the risks they insure. When the reinsurance market becomes more conservative and restrictive, coverages such as umbrellas, builders' risk and professional liability are substantially affected.

Workers' compensation and general liability are affected to a lesser extent, because major insurance carriers often assume as much as the first $1 million of risk.

What all this means is that during the next three years, contractors will be paying more money for less insurance.

### *Putting It into Perspective*

While the abrupt change in insurance pricing and availability can be very upsetting to contractors, it must be put into proper perspective.

For instance, a comparison of renewal rates per $100 of payroll or receipts to what was being paid in 78 and 79 reveals that insurance rates as a unit cost have not yet reached the levels that existed in those years. Looking at it this way, then, we could conclude that if rates were affordable then, they're affordable now.

The main problem with the precipitous rate increases is that many contractors will have to absorb the difference between what they included in their construction bids and what they will have to pay in premiums.

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The entire process underscores the fact that the insurance market is one of the last truly free markets in existence. Contractors are advised to take the long view of the entire process and plan ahead carefully.

### *Workers' Compensation*

Worker's compensation insurance continues to be the largest premium item for most contractors. In states where rates are negotiable or subject to scheduled credits and debits, rates are being increased or credits substantially reduced. In some cases, surcharges also are being applied.

Because of concerns over the continued solvency of insurers, state regulators are allowing substantial rate increases. For example, the Texas State Board of Insurance allowed an increase of approximately 25 percent on Aug. 1, 1985, and another of almost 40 percent on Oct. 1.

In addition, more conservative factors for rating experience will be approved, thereby causing higher experience-rating modifiers even if experience has not deteriorated.

Some contractors have purchased workers' compensation insurance from companies that pay dividends to policyholders. In some cases, these contractors will be disappointed to learn that their net costs will be higher because their insurers reduced or eliminated their dividends.

For the smaller contractor, workers' compensation is becoming unavailable in the standard market. As a result, many contractors are being insured in the various state-assigned "risk pools."

Underwriters also have become more conservative in regard to workers' compensation. Many are refusing to write contractors with substantial exposures to occupational diseases.

When the market tightens, alternatives to insurance—such as group programs and self insurance—become more attractive. Those associations that have developed sound pools, safety groups or similar programs will see a substantial increase in volume.

### *General Liability*

Average rate increases for general-liability insurance have been in the range of 40 to 75 percent. Coverages for damage to work—such as completed operations, pollution liability and professional services—are being reduced or eliminated.

One technique that may be helpful in controlling premium increases—particularly when there has been a high frequency of losses in the past—is to assume a high deductible.

Liability coverage was thrown into a total state of confusion as of Jan. 1, when two new standard policy forms were introduced.

The major change involves the introduction of a "claims made" policy, which is now in effect in six states—Vermont, California, Colorado, Idaho, Minnesota and Wyoming.

While the former policy used an "occurrence form" that provided coverage for bodily injury and property damage that *originated* during the policy period, the "claims made" version provides coverage only if the claim for damages is made *during* the policy period.

The "occurrence" form may remain available as an option; in fact, while the "claims made" form was approved in November for use in more than half the states, five states have banned it altogether. But most industry experts predict that in states that allow it, most insurance companies will either mandate the "claims made" form or drastically increase the cost of "occurrence" forms.

Since it presents the potential for major gaps in coverage, contractors are well advised to learn how the new "claims made" trigger operates—not to mention the ins and outs of its various features, including retroactive dates, extended reporting periods and special exclusion endorsements.

In addition, new aggregate limits will apply in comprehensive general-liability policies. For example, if a contractor buys a $500,000 policy, the new policies will pay only $500,000 during the year. The old comprehensive policy would have paid $500,000 for each and every occurrence during the year for many types of claims.

As a result, greater risk will be pushed to umbrella insurers, which are expected to take steps to lower their exposure or raise their prices.

On July 1, coverage may be further restricted by including legal-defense costs as part of this aggregate limit.

These new aggregate limits probably will cause greater problems in arranging coverage for large contractors than for small contractors.

### *Umbrella Policies*

In the last half of '84, 100 percent increases were common with umbrella policies—and the cost has continued to soar. Increases of 200 to 300 percent were typical from January to April of '85—and yet again in the last quarter of the year.

At the same time, many restrictive clauses are being adopted, so you should review umbrella policies carefully. One approach might be to request from your agent a comparison between the renewal policy and the 1983 policy, with an outline of any differences in coverage.

While primary insurance companies want to reduce their exposure, umbrella companies are requesting higher underlying limits.

For instance, the primary insurance company may provide liability limits of only

$500,000, while the more competitive umbrella carriers will demand underlying limits of $1 million.

As a result, the intermediate limits of liability—i.e., $500,000 with an excess of $500,000—will be very expensive, as this will be viewed a "no man's land" by much of the insurance industry.

**_General contractors are experiencing a greater problem with uninsured subcontractors._**

Many contractors substantially increased their umbrella limits during the soft market due to extremely low prices. It was not unusual for each $1 million in coverage above $5 million to cost just $250. In some cases, the prices for these layers have increased by as much as 2,000 percent—prompting many contractors to reduce their limits.

A good rule of thumb for contractors to use in selecting limits is to purchase limits equal to their annual volume or, in some cases, an amount equal to their largest project. (Usually the larger project generate larger liability exposures and therefore require higher limits of coverage.)

Smaller contractors probably should consider $5 million in coverage as the absolute minimum in an umbrella policy.

### *Builder's Risk*

There has been less impact in the area of builder's risk and and installation floaters, but substantial rate increases have been instituted. Some policies have even been cancelled midstream, forcing contractors or owners to replace their coverage at substantially higher rates.

Design-build contractors are experiencing major problems in arranging professional liability coverage—and substantial premium increases when coverage is available.

At the same time, many primary insurance companies are now adding a professional-liability service exclusion to their general-liability and umbrella policies.

On the other hand, coverage for damage resulting from design errors or omissions continues to be available under builder's-risk policies.

### *Other Developments*

Due to rising insurance costs and the reduced availability of coverage, general contractors are experiencing a greater problem with uninsured subcontractors. This is particularly evident in areas that insurers perceive to be more hazardous, such as steel erection and roofing.

Over the next two years, some contractors are likely to go through the unhappy experience of having their insurance company become insolvent. In other words, the company will go bankrupt, and the contractor will be left holding the bag for unpaid bills.

Now more than ever, contractors should pay careful attention to the financial stability of their insurance carriers. Remember: *Insurance companies can go broke!*

Finally, during the buyer's market, many contractors negotiated various forms of cash-flow programs. These contractors can expect attempts to substantially reduce the cash-flow benefits previously made available.

If this happens to you, try to retain these benefits. If you fail, give serious consideration to self insurance, captive insurance companies or association plans.

### *Plan Ahead*

In the years ahead, contractors should approach their insurance coverages and costs in the same fashion they approach taxes—with an eye for cutting costs. Planning and positive action will be required to avoid excessive premium increases and undesirable reductions in coverage.

The importance of being represented by professional insurance people cannot be overemphasized. As one contractor put it, the contractor who waits until the last minute to negotiate insurance costs will be "nailed to the wall." Heed this warning and start early to negotiate the renewal of your insurance policies.

However, starting early in no way guarantees that you won't be hit with: renewal proposals at the very last minute.

Therefore, every effort should be made to negotiate an arrangement whereby the current insurance program can be extended for 60 to 90 days at some agreed premium so you can buy some time to review other approaches. If this option cannot be secured, insist on an early renewal proposal from your existing insurance carrier.

In times of soft insurance markets, it's natural for contractors to become somewhat lax in the areas of safety and risk management. In the current market, however, risk management cannot be delegated with a premium payment.

Instead, contractors will be held accountable for their management practices, and the better contractors will be rewarded for maintaining discipline in the areas of risk management and safety.

Avoid becoming too preoccupied with costs; coverage and services considerations are very important as well. Yes, insurance will continue to be a problem over the near term, but all problems also present opportunities. Profits can be increased through sound safety practices, effective risk management and reasonable self insurance.

As a positive note, consider this: The bad news may be that your insurance costs are going up, but the good news may be that your competitors' costs are increasing even more. •

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