

Point 8 of the AGENDA

'Advantages and Disadvantages of All
Risks-Policies from the Engineering
Insurer's Point of view'

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Advantages and Disadvantages of All Risks-Policies from the Engineering Insurer's Point of view

0. Preliminary Remark

In widely diverse groups, there have recently been many discussions on the subject "advantages and disadvantages of All Risks Policies in property insurance". All discussions have in common that they provide more or less detailed information about this multifaceted topic, but they have not led to the formation of a secured and objectifiable opinion up to now.

Therefore, please do not expect completely new statements or perspectives. Anyway, the wide discussion indicates that market trends require serious treatment of the subject.

The following aims at a factual, clear and precise presentation - drawing on previously published literature on this topic - points to the advantages and disadvantages, and presents the author's own evaluation which takes into account international experience.

The decision which way will be most successful regarding blanket property insurance covers must be made by each insurer in view of largely liberalized and deregulated insurance markets. Forecasts as to how the markets will actually develop are therefore speculative and are not contained herein.

1. Introduction

Mankind's existence and especially activities are always linked to perils. Perils threaten the active person as well as others, directly or indirectly involved persons or things. The more people are active, the more interrelated their relationships, tools and machines become; the denser the network of enterprises becomes even at the international level, the more diverse, frequent and important become the resulting risks and perils for persons, things and interests. Consequently, one loses trade of the existing perils.

Thus, for fear of the menace represented by manifold risks, the totality of all existing perils was paid due regard as early as 1350 with the establishment of the "marine insurance" as the first - and only - all risks insurance.

No reasonable businessman - and especially no insurance technician - voluntarily exposes himself to unforeseeable financial risks. Consequently, the insurance concepts developed out of the cover for individual significant risks, e.g. fire insurance: Think of the early fire letters, the guilds and the governing legal regulations. The beginning of the technical progress led to the insurance against further risks, such as the liability - think of the British boiler inspectors - or the material damage caused by explosion.

This process naturally led to totally different developments in each country and market, and different insurance branches appeared. If one wanted to be insured against all - or at least very many - risks, he had to compile a package (or have a package compiled) consisting of different branches, which created the risk of cover gaps or the disadvantage of overlapping coverage. Sought was a form of cover that would eliminate the possibility of such gaps and overlaps.

Fire insurers took up this idea and they extended their catalogue of risks and perils in the sense of today's "extended coverage (ec) and named perils".

Further progress was made by moving away from the traditional insurance principle of risk specialty and toward the universality of perils in the "all risks" product. An insurance is desired that covers any impairment of property disregarding the cause of the impairment that is, the universality of the risks and property to the extent there are not expressly excluded from coverage.

The development of such all risks concepts began in the USA in the 1950s, in a virtually linear fashion from simple fire insurance to the addition of named perils (ec) to multiple line insurance.

3 factors have decisively spurred the evolution of the All Risks Policy:

1. Due to the traditional separation of fire and marine branches on the one hand and the casualty insurance on the other hand, it was impossible e.g. for a fire insurer to cover the risks of burglary and glass breakage.
2. Constantly favorable claims development called for lower premiums. In order to maintain these, insurers chose to extend the scope of cover in the all risks direction.
3. As a pleasant side effect, it was expected that the policy terms and conditions would be simplified, and as a result, coverage litigation would decrease.

However, this expected effect has never occurred; on the contrary, the number of lawsuits increased due to increasing ambiguity.

Meanwhile, All Risks Covers have also gained more or less significant entry into different European markets. Interpretable findings

about the respective experiences, however, have not yet been submitted up to now.

After this introduction considering the development of All Risks Cover, please allow me to detail the advantages and disadvantages of this form of coverage.

2. Advantages of All Risks Covers

The following arguments correspond to insurers' interests in extending the scope of cover in the All Risks direction:

- The wish to maintain the premium level in spite of a favorable claims development; of course, brokers have the same interest in order to secure their commissions;
- the desire to simplify the terms and conditions in a mutually acceptable manner;
- as a result thereof, the expected decrease in coverage litigation;
- cost benefits due to the simplification of administrative matters;
- a stronger tie of the insured to the insurer by offering comprehensive umbrella protection;
- advantages with regard to a market share increase as well as the suppression of competition by offering new products, and as a result thereof, increasing premium volumes and market shares;
- for the engineering branches, the consequence would also be a increased market penetration;
- overcapacities in the reinsurance market have a favorable effect on All Risks Covers;
- the presently existing vehement pressure to streamline fire insurance creates movement in the direction previously out-

lined. Expected is equalization by extending the risks and branches;

- minimizing the anti-selection, i.e. collecting flood premiums from mountain inhabitant as compensation for coastal risks and collecting avalanche premiums from a coastal inhabitant as compensation for the mountain inhabitants' risk.

The following arguments particularly correspond to the interests of the insured:

- Clear and comprehensible formulation of the policy terms and conditions and, consequently, a transparent situation and short claims-adjustment period;
- price advantages through avoiding overlapping cover between different insurance branches;
- avoiding cover gaps, i.e. the complete insurance cover is offered to the insured as a so-called "Sleep-easy-package".

So, there are a number of arguments from the insurer's point of view as well which favor All Risks Cover. We now come to the arguments against All Risks Cover.

3. Disadvantages of All Risks Covers

- An important counterargument consists in the lack of a statistical basis necessary for a secured rating. At least for a transitory period, a reliable basis for estimating claims volume is lacking. But even on the assumption that All Risks terms and conditions had been existing for some time and corresponding experiences and analyses had been presented, it would still be very doubtful whether the submitted data could be interpreted and utilized under uniform points of view. It is for each insurer to decide individually how to define the risks he covers. Thus, there are considerable doubts whether

precisely in the process of transition to a unified European market, characterized by freedom of contract and deregulation, it will be possible to derive useful statistical indications from the different covers presented by the diverse offerers, which are necessary to adequately calculate the premium requirements resulting from the new type of cover.

A further difficulty for the assumption of risk results from the fact that under this type of cover, sudden perils can actuarially affect property in a hitherto unknown way (e.g. a balcony is overstrained after x years and breaks off). An endless number of further examples come to mind where one cannot know or estimate the frequency or volume of those claims. Questions which should well influence premium calculation.

- In light of negative experiences especially in the USA, one cannot exclude the possibility that the market or at least important sectors thereof, will decide against the All Risks Policy. Thus, the particular implementation risks are the following:
 - * development of demand
 - * premium development in proportion to the scope of cover
 - * reaction of the courts to the new scope of cover, and terms and conditions.

- A considerable disadvantage for the insurer which cannot be overlooked is the shifting of the burden of proof in case of loss or damage. In case of "named perils", the insured has the burden of proving that the damage was caused by one of the insured perils. In case of a cover under the principle of universality, the insured must only prove the occurrence of the damage. The burden of proof that the cause of the damage is excluded from coverage rests with the insurer, and is often very difficult.

- With a corresponding number of exclusions, the expression "All Risks" can easily be interpreted as "false labelling". In case of doubt, a court will decide in favor of the insured. In the USA, where all risks property insurance models have already been offered for 40 years, the corresponding policies are not offered under the "all risks" designation. First of all, the name "comprehensive form" was chosen; this designation which can also be interpreted as a very extensive cover has since been replaced by the insignificant expression "special form". In the long run, an insurer will never profit from creating in the insured a false sense of security, so the "label" is of utmost importance.

- The insurer is in the quandary
 - * on the one hand, in desiring a scope of cover that is unambiguous and therefore predictable;
 - * on the other hand, to be able to offer extensive cover which addresses the client's needs.

The solution of this quandary cannot be an all risks cover without exclusions, because this would truly be unpredictable for the insurer or uninteresting for the insured due to excessive premium requirements.

With regard to the truthfulness of the label, the French expression "tous risques sauf" would correspond most to the facts, however the "sauf" shows the problem: an exhaustive list of exclusions is unrealistic, unmarketable and certainly neglects the customer's needs.

This shows another aggravating disadvantage of an All-Risks-cover, which is considered favorable to the customer's interest.

- General cover against natural perils such as landslide, falling rock, avalanches, rising waters, inundation, earthquake etc. is often problematic, especially in respect of anti-

selection and clash risks.

The well-established insurers simply declare these perils uninsurable. On the other hand, the industrial insured attaches great importance to cover for precisely these unforeseeable perils.

The controversy in respect of the inclusion or exclusion of different natural perils has actually nothing to do with the principle of universality: As fire insurers now include the tempest perils in the scope of cover, they could as well include further natural perils. Conversely, in an all risks cover, individual or all natural perils can either be totally excluded or registered and rated independently.

The ABAG's extensive cover of natural perils authorized by the Federal Insurance Commission (BAV) is remarkable, in that none of the above mentioned perils are excluded. It remains to be seen how ABAG users will face the wellknown problems and whether the negative experiences in the USA will be repeated.

- The above mentioned advantage of increased market penetration through stronger client ties is of course associated with the risk of losing a business connection.
- Although the handling of an all risks cover is supposedly more simple, less expensive and more rapid, it runs the risk of activating "innocent capacity", that is naive and unconditional readiness to subscribe which is neither in the insurer's nor in the insured's interest.
- Long-term global consideration of a great number of specific risks also creates the risk of losing risk-specific know-how, which can only be acquired in detail and over a long period of time. In case of universal risk cover, this development contrasts with the insurer's as well as with the insured's needs

to minimize and so to control the total risk through expert and competent risks analyses in order to employ corresponding loss prevention measures; for the insurer, the total risk will therefore become predictable and insurable on a long-term basis.

4. Valuation and Summary

- As a result of concerns about existence, fortunes and success, people desire comprehensive security/insurance in the form of a "Sleep-Easy Insurance Package" against the perils that threaten them. In short, there is a demand for extended coverages.
- A truly comprehensive all-risks cover does not and cannot exist, because it would be neither predictable nor affordable and would, in the long run, lead to the retreat or the demise of the insurers. This cannot be in the interest of the insured. The marine insurance in the early Middle Ages has remained the only exception.
- An extension of the insurance cover results from the solicitation of customers, the fight for market shares and competitive advantages achieved by "innovative products", if the battle is not to be fought on the price front, which would only achieve short-term success.
- The experiences in the USA nourish the fear that also in other markets the change from the named perils to the so-called all risks covers will not bring the simplifications with regard to handling, terms and conditions, definitions and finally the legal interpretations expected by both the insurer and the insured, but rather the contrary.

The above-mentioned thesis is also supported by the following considerations:

Enterprises oriented toward growth and profit will require more risk management, or rather, safety management as competitive pressure continues to grow. In this respect, the well versed insurer can be a valuable partner to them due to his special knowhow acquired in different branches and disciplines which enables him to help build up and extend safety management.

The necessary knowhow - as the definition goes - can only be achieved and deepened by a division of labor in a clearly defined branch. This does not mean that comprehensive thinking and acting without separation of branches should not be supported. However, the global all risks cover harbours the danger that risks will only be considered generally, and that no detailed risk analysis with corresponding measures to minimize the risk will be effected. In other words: insurance, not security is offered.

And I am convinced that this is precisely the wrong way. Why ?

It is unforeseeable that the often complained pressure on premiums will cease. The market for property insurance in itself will continue to be interesting and therefore will remain. No easing on the price front is to be expected.

Facing deregulation efforts and competition in respect of the "wording" (extended coverages, decrease in the number of exclusions, wide definitions and so on), a solution to the problem over the terms and conditions is not to be expected.

What remains is the risk aspect: In my opinion, there is the only effective starting point. Due to their first-class technical knowhow, the renowned and solvent property insurers must succeed in convincing their clients as well as the potential insurance holders that a more or less anonymous insurance against their risks is not

the key to the future, but rather skilled cooperation, starting from the risk analysis over the transfer to risk precautions up to the insurance against the remaining risk. A "normal" customer relationship cannot be the objective any longer, but the development of a sort of "security partnership", which will certainly take some efforts. That sounds grandiloquent and idealistic: What has to be done ?

The insurer must extend his services (risk analysis, risk consulting) and thus revalue and consolidate his customer relationships. This makes high demands on the staff's qualification, and certainly represents a challenge to the brokers. However, it has to be made clear to the client that these services are of value to him and that it is therefore impossible to render them free of charge. Furthermore, it has to be explained to him that only "competent capacity" can minimize his entrepreneurial business risk in the long run, that "innocent capacity" might be obtained at a lower price, but that it is not worth its price, since competence, the intention to enter into a partnership in case of loss or damage and, as a result, a long-term reliable security for the risks of the enterprise are missing.

Back to the All-Risks conception:

The demand for complete insurance cover without gaps will continue to exist and will even increase.

Now, the insurers are required to face this demand with intelligence, creativeness and competence. To my mind, this cannot mean All-Risks cover with a great number of exclusions, but: establishing a system of insurance building blocks which must be built up in detail and with the technical competence resulting from the developed branches, and which must be well elaborated regarding the interfaces. This system will be compiled corresponding to the customers' individual needs, in a way according to the building-block principle.

Technical competence stands behind every building block and will be developed further. The art consists in offering the whole to the client in one hand as a functioning building, but controlling securly and competently, if required, each floor, each flat in its special distinction.

It is hard to imagine that "innocent capacity" can completely satisfy in the long run the customer's demand for security, considering the securing and insurance of technical risks which are to a high degree subject to rapid change and innovation. The market situation challenges the insurance industry to become active with creativeness, technical competence and an excellent marketing in favor of competence and against innocent capacity. Certainly, this is a long way, but in my opinion the only reasonable way, to long-term success.

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