IMIA 6 - 53 (96) E

NEW DEVELOPMENTS IN ADVANCE LOSS OF PROFITS

(ALoP)

By
D. Göbel and R.Glückler

Executive Summary:

The paper shortly analyses reinsurers' ALoP portfolio for the period 1980-1995. It informs about trends and specific insurance requests encountered. Special coverages and extensions of cover in respect of Insured Parties (e.g. BOT consortia), Insured Property/Sites and Insured Risks are being discussed. Furthermore reference is made to insurance of selected cost items and to the procedure of loss adjustment.

This year's presentation by the reinsurers concerns ALoP, which might be considered amazing. For the reappearance of ALoP at IMIA conferences resembles the reoccurrence of natural disasters: the intervals between them are getting shorter and shorter.

To wit: 11 years elapsed between the first emergence of this topic in 1982 in Montreux and the observations presented in 1993 in Madrid. Now the interval is down to a mere three years.

In the established - not to say "conventional" - engineering classes of insurance, it could be said that "three years are like a single day," to slightly alter and hyperbolize the biblical phrase. At our newest engineering daughter, however, - you know the way it is with a growing daughter - three years can represent a significant step in her development.

Be that as it may, we found at least a couple of remarkable recent developments that are worth reporting and discussing. Some of these developments arose out of the actual or assumed needs of insureds or their partners, for example banks; others were the product of reflection and experience among insurers and reinsurers.

top of main document

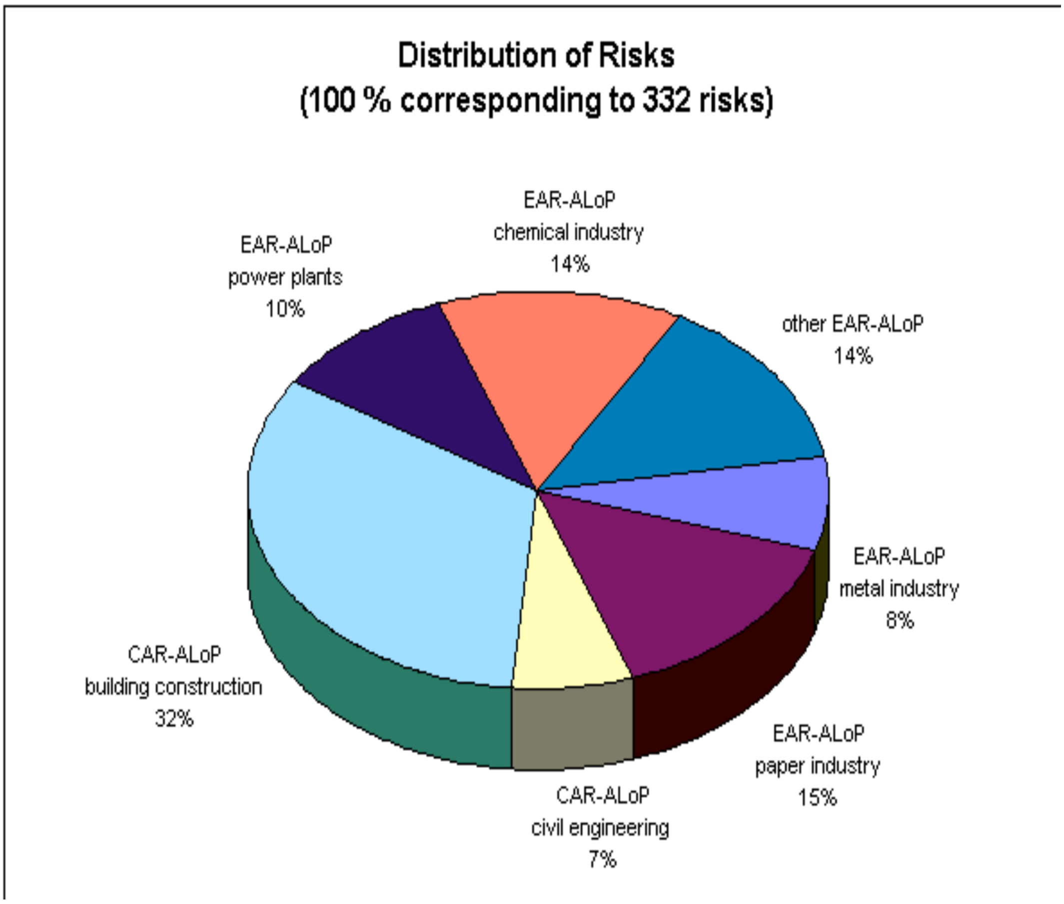
Analysis of Covered Risks

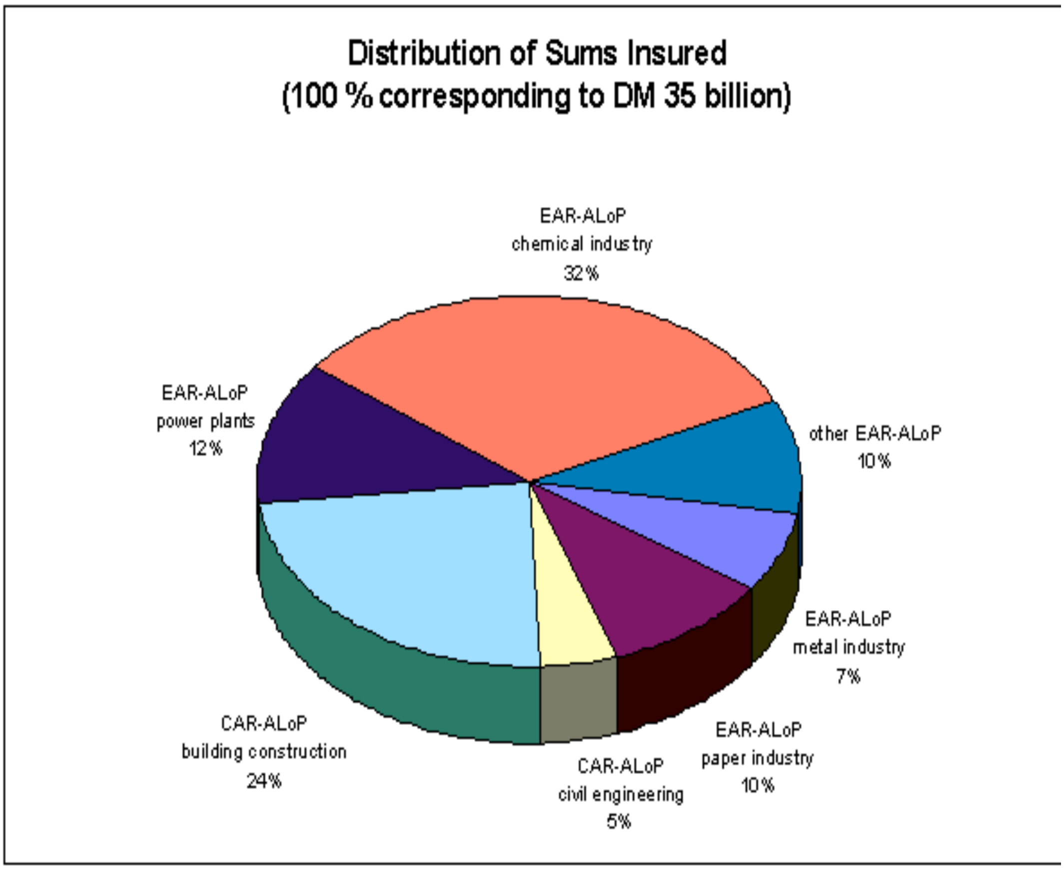
As indicated in the 1993 IMIA presentation on advance loss of profits, comprehensive statistics are not yet available on this class of insurance, since in many cases the figures are not recorded separately. To make the first step towards greater transparency, in Figures 1 to 3 we present a breakdown of a reinsurance portfolio of

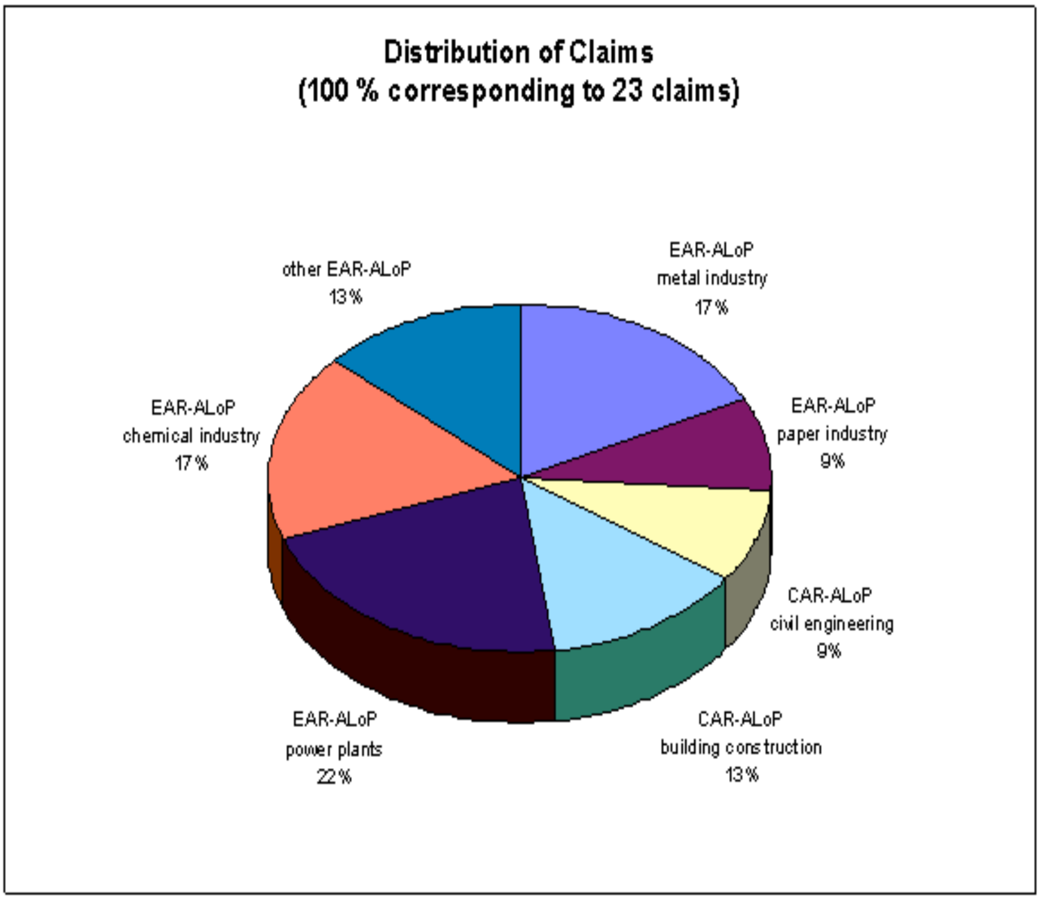
332 risks which were covered and expired between 1980 and 1995 and on which complete data were gathered. All the figures have been extrapolated to 100 %. Although this portfolio cannot claim to be universally valid, it does give some telling information about the insured projects and the claims record.

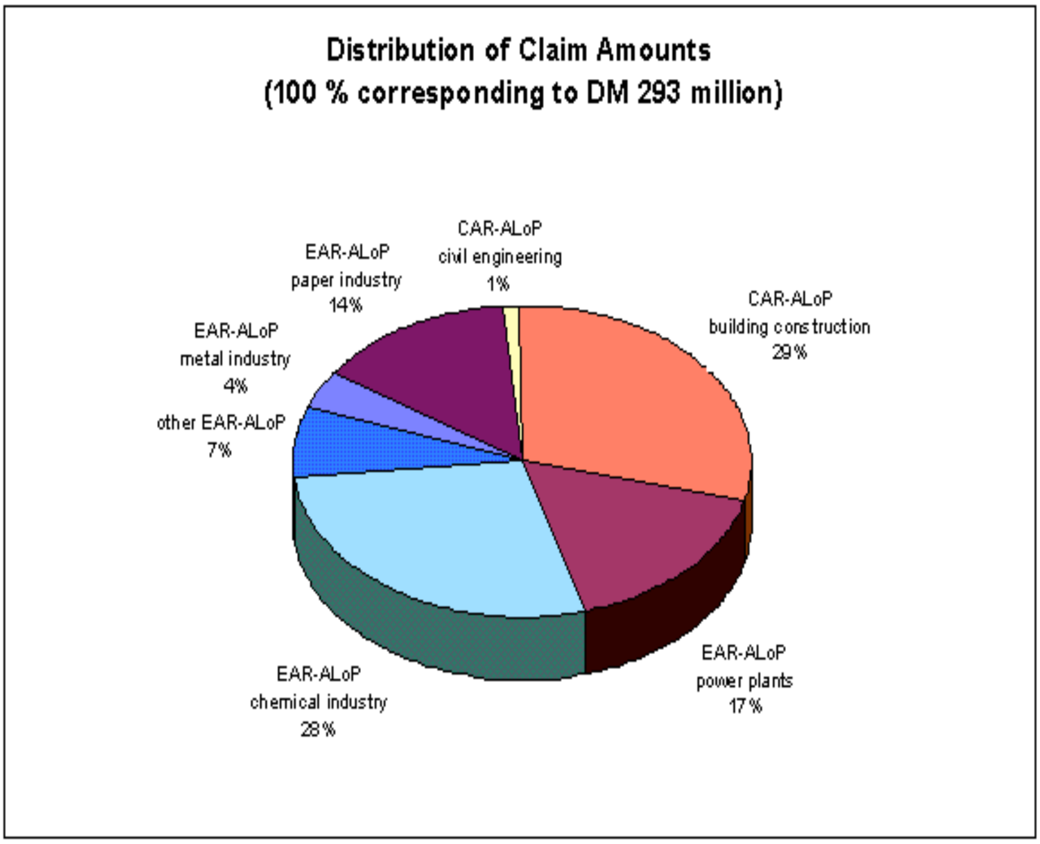
1. Risk-Specific Aspects

In terms of the total sum insured of the ALoP policies in force, which came to DM 35 billion, CAR-ALoP and EAR-ALoP accounted for about 30 % and 70 %, respectively. As much as 30 % of the total sum insured was for EAR-ALoP risks in the chemical industry, 12 % for power plants and 10 % for the paper industry. With an average sum insured of DM 105 million per risk for the portfolio as a whole, the averages ranged from DM 76 million for building projects and DM 250 million for chemical plants. The claims data that could be gathered was on amounts exceeding DM 100,000. But given the size of the claims arising in ALoP, this should not detract substantially from the significance of the figures. The 332 risks that were analyzed gave rise to 23 claims with a total of DM 293 million or on average DM 12.7 million per claim. The largest average claim was for chemical plants: DM 20 million. That is not surprising, considering the large ALoP sums insured for these risks. The high loss ratio in the paper industry's EAR-ALoP and in CAR-ALoP resulted from a major loss in each of these areas, which underscores the vulnerability of ALoP.




Distribution of Sums Insured
(100 % corresponding to DM 35 billion)
EAR-ALoP
chemical industry
32%
other EAR-ALoP
10%
EAR-ALoP
metal industry
7%
EAR-ALoP
paper industry
10%
CAR-ALoP
civil engineering
5%
CAR-ALoP
building construction
24%
EAR-ALoP
power plants
12%


Distribution of Claims
(100 % corresponding to 23 claims)
EAR-ALoP
metal industry
17%
EAR-ALoP
paper industry
9%
CAR-ALoP
civil engineering
9%
CAR-ALoP
building construction
13%
EAR-ALoP
power plants
22%
EAR-ALoP
chemical industry
17%
other EAR-ALoP
13%



Industry	Sum insured (culmulative) million DM	Premium (culmulative) million DM	Gross rate* million DM	Claims (culmulative)	Actual rate	Loss ratio	Number of risks	Number of claims
Building construction	8,350	24.2	84.0	16.8	2.9	347	109	3
Civil engineering	1,630	70.0	3.1	3.2	43.0	4	22	2
CAR-ALop	***9,980***	***94.2***	***87.1***	***14.5***	***9.4***	***93***	***131***	***5***
Paper industry	3,450	12.3	40.0	19.3	3.6	325	49	2
Power plants	4,340	58.5	48.7	18.7	13.5	83	34	5
Chemical industry	11,240	81.4	83.6	12.4	7.2	103	45	4
Metal industry	2,460	17.2	12.3	8.3	7.0	72	26	4
Other EAR-ALop	3,540	17.0	21.4	10.1	4.8	126	47	3
EAR-ALop	***25,030***	***186.4***	***206.0***	***13.7***	***7.4***	***111***	***201***	***18***
Total ALop	***35,010***	***280.6***	***293.1***	***14.0***	***8.0***	***104***	***332***	***23***

top of Analysis of Covered Risks

top of main document

2. Insurance-Specific Aspects

The performance of ALoP is naturally still far less balanced than that of other classes with relatively low premium income. This is due to the extremely high level of exposure. Whereas material damage covers show percentagewise relatively low PMLs, the PML in ALoP frequently comes up to nearly 100 % of the annual sum insured. Such conditions arise when, say, a key machine suffers a total loss during the testing stage and has to be rebuilt, reassembled and retested. Where maximum indemnity periods exceed one year, the customary calculation based on the annual sum insured may even exceed 100 %. Thus, a maximum indemnity period of two years can entail a PML of 200 %, less the monetary equivalent of the time excess. For these reasons, higher loadings for major losses and fluctuations have to be reckoned into the premium calculations for ALoP than for other classes. At a loss ratio of 104 % for the portfolio, the insurers are still far from achieving this goal. Considering that correct risk assessment, necessary standards of inspections and adequate claims handling are far more time- and cost-intensive than in material damage insurance over the past 15 years, there was a premium shortfall of more than 40 %, as against the premium calculated on basis of the "gross rate" shown in figure 3. It should be added, however, that the reinsurers reporting here turned in positive results for their share of the portfolio. The reasons are their relatively small share of the risks which went very poorly, thanks to their good selection, and certainly a little luck, too. But this favorable experience is no guarantee for the future. A single major ALoP loss can turn the previous trend around completely.

top of Analysis of Covered Risks

top of main document

3. Trend

The trend of recent years shows that the unsatisfactory level of rates definitely does not have to be accepted as irreversible and "market-induced." Our past experience shows that, increasingly, it is possible to put across fair premium rates to insureds. The sooner principals come to realize their exposure, in other words the threat posed to their economic position if the commencement of their business is delayed, the sooner they see that the size of the ALoP premium asked is justified. A single week's delay in production is equivalent to as much as 19.23 ‰ of annual output. Depending on the normal hours worked, a premium based on 1 ‰ of the annual sum insured would be just enough to compensate the financial loss caused by any of the following delays:

- 8.8 hours at 365 days worked per year and 24 hours worked per day
- 6.2 hours at 260 days worked per year (5-day week) and 24 hours worked per day
- 2.1 hours at 260 days worked per year and 8 hours worked per day

In absolute figures, the potential ALoP loss sustained by a large paper mill, for example, is about DM 30,000 per hour, DM 22 million per month or DM 260 million per year. The volume of premiums and the number of risks have risen in recent years, chiefly owing to the influence of banks, which provide large shares of the finance for such investments. Another trend is the call for ALoP to be extended into a kind of "allround coverage," in other words to include everything you can hardly get, if at all, in other lines of insurance.

top of Analysis of Covered Risks

top of main document

New Developments

Insured Parties

The purpose of ALoP coverage is to protect the principal or operator of insured projects against financial loss due to delayed completion as a result of indemnifiable material damage. This makes sense, for the principal or operator suffers a financial loss comprised of unrecovered standing charges and lost operating profit. That is why the principal or operator is the only party insured in ALoP. This fact is pointed out in the very name of some policies that are called "Principal's Advance Loss of Profit."

The following are cases that diverge from this system.

top of New Developments

top of main document

1.1 Inclusion of Contractors

Contractors may incur additional costs resulting from delayed completion of a project caused by indemnifiable material damage, such as:
- interest on the guarantee retention for the interval between the scheduled and actual commissioning of the facility
- additional costs incurred by the contractor, for example costs of maintenance and upkeep of undamaged objects during the delay.

These extra costs definitely represent an interest that is worth insuring. But they ought to be covered separately. Their inclusion in ALoP coverage is not possible because they do not affect the principal's interests.

top of New Developments

top of main document

1.2 Insurance of Operating Consortia (BOTs, Build-Operate-Transfers)

Increasingly, large-scale projects are needed to improve public infrastructures, such as
- Power plants
- Transportation systems
- Airports
- Roads, bridges, tunnels
- Water supply systems

And increasingly, the public sector is unable to meet the large financial requirements involved. Private-sector models are often a solution. Consortia do the planning, financing, building and operating of a project on their own responsibility. An agreement is made with the customer, for example a state-owned or municipal enterprise, to take over the services or goods to be produced by the facility at a fixed price that allows it to be run profitably. After a period of usually 10 to 30 years, the facility is transferred to the customer at an agreed residual value or at the current market value. The build-operate-own (BOO) model is a variant in which there is no subsequent transfer to the principal. These privately financed projects require a high degree of security. That is why ALoP coverage is often taken out - under added pressure from the banks involved. In BOT and BOO projects, the principals and contractors are one and the same. Consequently, the consortium, which is the contractor and principal figures as the insured of both the material damage and the ALoP coverage. It is hard to tell what impact that has on the moral hazard. In theory, it should improve, since the consortium has got to be interested in putting the facility into operation on time - not just on account of the deductible - and it has more control over the accomplishment of this objective than in "ordinary" projects. The risks in ALoP are exacerbated by provisions obligating the consortium to buy a certain fixed quantity of raw materials and/or operating materials as of the scheduled date of business commencement.

Variable costs that are not normally insured in ALoP, since they are not incurred in the event of delay, become "fixed costs" as a result. That may be oil or gas for power plants and refineries, ore for metal production or wood for paper mills. Per unit of time, approximately the same quantities of these products are required. It is relatively easy to insure them in ALoP if these cost elements are added to the annual sum insured. The insurability of seasonal products (sugar cane, sugar beets, fruit), most of which are perishables, depends by and large on the timetable, in other words the available "time buffer." Special attention should also be paid to ways of minimizing losses by selling to third parties. Of late, some contracts between principals and consortia provide for a kind of "constructive total loss," especially for power plants. If on account of an indemnifiable material damage the performances rendered fall short of those promised by a stipulated percentage, the entire performance is regarded as not having been rendered and is not paid by the customer. So one has to bear in mind when assessing risks and calculating premiums that compensation is almost always paid in full, even in cases of only "partial shortfall."

top of New Developments

top of main document

1.3 Inclusion of Banks

Not only in BOT/BOO projects is the bulk of capital expenditure financed by banks. The proportion of outside capital is frequently over 65 %. That lenders seek to keep their risk down to the bare minimum is understandable. Financial institutions often demand that they be included in ALoP policies as additional insureds. They would also like to have direct recourse to insurers and reinsurers through coverage extensions such as cut-through clauses. Non-invalidation or non-vitiation agreements are supposed to reverse the forfeiture of benefits due to the non-observance of obligations. A critical analysis should be conducted to determine whether it is justified, as more and more banks have been demanding of late, to turn ALoP insurers into guarantors of the loans extended.

We feel that financial institutions should not be insured parties in ALoP. Under their loan agreements with principals, their interests are provided for irrespective of the conditions of insurance. The use - or better non-use - of non-invalidation clauses will be discussed a little later.

top of New Developments

top of main document

Insured Risks

Due to their all-risks nature, even the standard versions of the material damage insurances EAR and CAR (or Contract Works Insurance) on which ALoP coverage is based provide a very broad scope of cover. The "designers" of ALoP tried to retain as far as possible in the standard policies the catalogue of insured perils that trigger financial losses. In the wording of most ALoP policies, the main deviations from the scope of cover under material damage insurance are the exclusion of ALoP claims after earthquake, volcanic eruption and tsunami and the exclusion of surrounding property. Their inclusion, hence complete congruence of EAR, CAR and the respective ALoP covers, is being requested more and more often. There are also calls for the following extensions:

top of Insured Risks

top of main document

1. Natural Hazards

The exclusion of the natural hazards of earthquake, volcanic eruption and tsunami should not be considered irreversible. In the first place, it serves as a "barrier" against unwitting exposure that may exceed underwriting capacity. The accumulation of material damage and ALoP cover is such that one single risk can suffice to put many an insurer right up against its capacity limits. The situation becomes significantly more dangerous when several covered risks are located in one loss accumulation zone for natural hazards. An exact PML assessment and accumulation control becomes a must. In some cases, risks in certain areas can only be accepted with a reduced limit for natural hazards or without cover for natural hazards altogether. It is particularly crucial here, of course, to carry out careful inspections to make sure the appropriate standards of planning and execution are being observed so as to minimize exposure to natural hazards not only before acceptance, but also while the policy is running. Reinsurers, in particular, can provide extensive service here with their international network of offices.

top of Insured Risks

top of main document

2. Marine Risks

As in EAR and CAR, ALoP coverage does not attach until the insured items are unloaded at the construction or erection site. Thus, off-site transportation of any kind is excluded from EAR, CAR and ALoP. The exclusion should apply without exception to all transportation, whether on inland waterways, by sea or air. That does not render the insured uncovered, for recently marine insurers have been offering adequate solutions by way of marine consequential loss insurance with suitable professional service in risk assessment, loss minimization and claims adjustment. Generally speaking, the exclusion applies to inland marine as well. However, some exceptions are made here in respect of short-range transportation of locally manufactured items along clearly defined routes. This sometimes can be included for a risk-commensurate premium. To avoid in case of losses any difficulties in demarcation from marine insurance, the 50:50 clause should be dispensed with. An exact examination by experts right after the goods are unloaded has turned out to be a better solution to the problem of demarcating marine and marine consequential loss insurance, on the one hand, from EAR, CAR and ALoP, on the other.

top of Insured Risks

top of main document

3. Denial of Access

Access to insured construction sites can be impeded by various off-site contingencies usually involving damage to roads, bridges, tunnels or canals, if any of those are the only means of approach. The repairs, which can take a long time, may delay the progress of the works at an undamaged construction or erection site by an equally long period of time. It is hard to assess these risks; that is why they can only be covered in exceptional cases, possibly subject to limits. Orders by public authorities are another possible impediment to access. An undamaged approach bridge could be closed for extended investigations, for instance, because a bridge of similar design has collapsed. This coverage must remain entirely excluded.

top of Insured Risks

top of main document

Insured Property/Site

1. Prototypes

In the case of objects of which there is insufficient operating experience, the testing and commissioning risks are incalculable even if manufacturer's risk is excluded. That is why the cover of prototypes in the test and commissioning stages is limited to external damage.

top of Insured Property/Site

top of main document

2. Used Machinery/Plants

Various degrees of difficulty are involved in ALoP insurance of used machinery and plants.

Sometimes only individual machines at a plant are dismantled and then re-erected in a different department. Such activities are already covered by most MLoP policies and do not require any additional ALoP insurance. The opposite to that is the transfer of complete dismantled plants from industrialized to developing countries. For example, facilities that are no longer running economically in high-wage countries and may have already been more or less "mothballed" for a number of years are sold cheap. After their dismantling, shipment and erection in low-wage countries, they can go on serving their purpose for some time to come. These facilities may be in any of a wide range of industries, from small printing presses to steelworks. For insurers - if this stage is to be covered as well - the dismantling entails additional risks. Materials may break, for example, due to added strain in efforts to separate tightly fit machine parts and/or due to material fatigue. It is hard to tell in advance how long large-scale dismantling is going to take. It is often not clear until the work is in progress whether worn parts have to be replaced by new ones (that must be made to order). Particularly in the case of "rotating" machines such as motors, turbines, pumps and compressors, they often have to be taken apart before one can tell whether it is necessary to make major repairs or even replace components on account of corrosion etc. The firms doing the work hardly give any guarantees on such overhauls; what is more, distinguishing between indemnifiable and non-indemnifiable damage is problematical. It becomes particularly complicated if the manufacturer of the facilities is no longer in business.So if dismantling is to be included in the ALoP insurance of used plants, it is advisable to limit the cover to fire, lightning, explosion, impact of flying devices (FLEXA) and natural hazards with the reservations already mentioned. In re-erection, full scope of cover is frequently provided in ALoP for the erection stage proper. During the testing and commissioning stage, however, only external damage is usually covered. But depending on the quality of the facility, the ALoP insurance can range from total exclusion to full coverage of machines that are completely overhauled and revamped by the manufacturer. This, too, requires risk management in the form of expert inspections.

top of Insured Property/Site

top of main document

3. Surrounding Property

There seems to be a trend among principals to seek loss of profits for their own existing plants or buildings caused by damage to property under ALoP insurance. For example, during the installation of a new paper machine, an existing line may be destroyed by the spread of a fire. The resultant additional consequential loss due to the fire may approximate the ALoP sum insured. This risk is absolutely worth insuring. But it should be insured by extending the scope of existing operational covers in material damage and LoP or, if that is not possible, in a separate, adequately rated supplementary cover.

top of Insured Property/Site

top of main document

4. Off-Site Locations

Large-scale "infrastructural measures" are necessary for some projects. For example, mains may have to be laid for the supply of power, gas, oil or water or, in the case of power plants, for the distribution of electricity. For the most part, these activities take place away from the site of the insured project, but are occasionally included in the cover. Recently, acts of sabotage have been carried out on insufficiently protected premises where, for example, the landowners felt they had not received adequate compensation; in some cases, this even delayed the construction work. Consequently, it may be advisable to exclude off-site property or insist on stipulations requiring better protection.

top of Insured Property/Site

top of main document

5. Suppliers' Premises

More and more requests for ALoP require inclusion of delays due to damage to equipment to be erected that occurs during its production on suppliers' premises. In extreme cases, there are requests for unspecified worldwide coverage of all the suppliers involved in a project.

Extensions of this kind can hardly be insured because insurers have at best limited means of assessing and influencing the risks involved because of their sheer complexity. To assess the risks, one would have to investigate each and every supplier's factory and the possible ways of minimizing losses, for example by buying comparable products. That is why suppliers' extension should only be insured on a case-by-case basis for specific suppliers with coverage confined to non-cumulative risks (fire and explosion), possibly imposing a limit.

top of Insured Property/Site

top of main document

Indemnity

Ordinarily, ALoP indemnifies the actual loss of gross profit sustained, in other words a company's standing charges and the unearned operating profit. Gross profit is calculated by deducting variable costs, which do not need to be insured, from turnover. In ALoP the sum insured is inevitably based on assumptions about the future trend of business. Whether these projections are realistic is not evident until after the business commences, in the first income statement. Changes in the economy, for instance, can occur while the facility is being built or erected (markups of raw materials, markdowns of products, changes in market potential due to unforeseen competition etc.) which could not be predicted when the project was being planned and financed. The time between project planning and business commencement is less than two years only in exceptional cases, and, where construction takes several years, it is prolonged accordingly. For a realistic assessment from the insurers' point of view, the agreed maximum indemnity period must be allowed for too, which underscores the need to forecast often anticipated turnover and gross profit for a period of three years or more (anticipated gross profit). Thus, especially in ALoP, there can be no diverging from the principle of indemnifying only the actual loss sustained. An insurer who abandons this principle would be enriching the principal or assuming his entrepreneurial risk.

Some deviations from the standard mode of indemnity are outlined in the following:

1. Selected Fixed Costs (mostly interest)

Increasingly, we receive ALoP proposals in which only selected components of gross profits are supposed to be covered, such as fixed costs or interest payable to banks. The idea is usually to safeguard the interests of banks by means of ALoP insurance. Such selected coverage is sometimes comparable to agreed-value compensation. Compensation on an agreed-value basis is no longer based on the gross profit of a company and may end up enriching the insured in case of loss. This could happen in the event of full compensation of interest, for example, if the insured company is operating at a loss and consequently would not have earned the interest in full anyway even had it not been for the delay. The logical conclusion is that even sectoral coverage needs to be tied to the criteria of a reduction in turnover and take an operating loss into account. That is why we consider it worthwhile to express the selected costs (such as interest payments) as a percentage of anticipated annual gross profit. To keep the insured on the safe side, the percentage of gross profit should be high enough to create a realistic safety margin so as to avoid underinsurance.

top of Indemnity

top of main document

2. Fixed Daily Indemnities

One argument often adduced for fixed daily indemnities is how simple it is then to adjust the loss. However, this approach would derogate from the fundamental principle of LoP insurance, namely to compensate the actual loss sustained, and it would not rule out the possibility of unduly enriching the insured.

top of Insured Property/Site

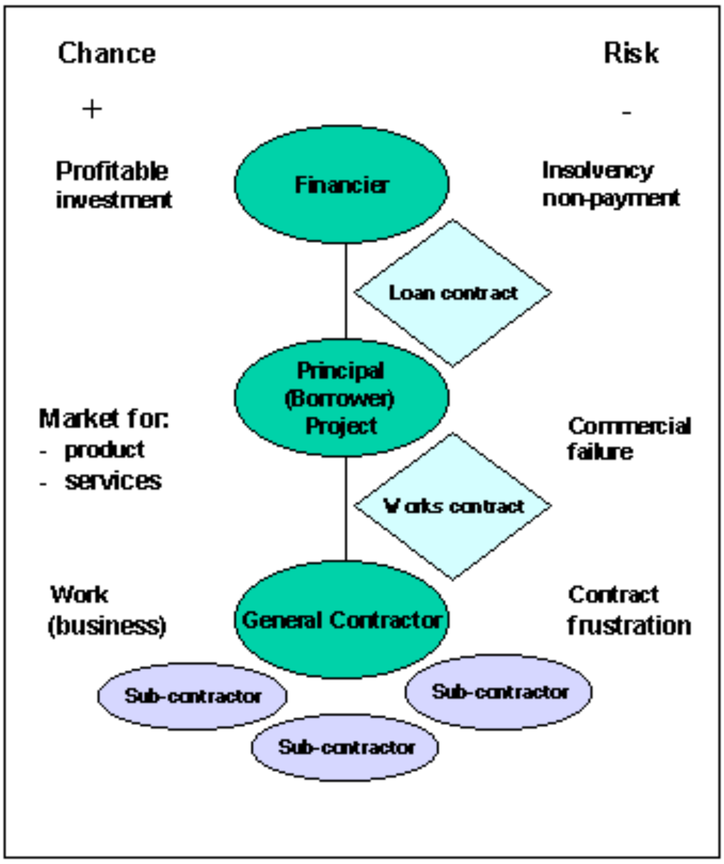
top of main document

Conditions

Some of the key developments in ALoP conditions were generated by discussions about existing wordings, demands of banks and insight based on the insurers' practical experience.

1. Time Excess

In the IMIA publication on ALoP as early as 1982, there is a discussion of the question whether to use time excess in the form of a single deductible per project ("in the aggregate") or in the form of deductible for each physical loss. A deductible per event was recommended at the time. But with the exception of the U.S. market, the time excess in the aggregate has prevailed. A compromise that is sometimes made is to adhere to a single time excess per project but not to make any allowance in the indemnification for minor delays of up to two weeks, for instance. The discussion of this topic was resumed about two years ago and so we would like to explain why we have opted for and recommend a single deductible. Under machinery loss of profits and fire business interruption insurance, the indemnity period and the agreed time excess immediately follow every single physical loss. Under ALoP, every case of physical loss does disrupt the construction or erection work, but the impact of the damage does not manifest itself until later, when it may delay the scheduled commencement of the insured business. Thus, the interruption triggers a single loss of profits with a single indemnity period. For systematic reasons, only one time excess is therefore applicable. This is shown in the attached chart. But above all, we recommend a single time excess in ALoP for the following practical reasons: A single case of physical loss can have widely varying effects on the scheduled business commencement. Delays in erection or construction at the outset of a project can usually be made good. If a damage does not hit the "critical path," that is to say does not affect the timing, it will have no impact whatsoever on the scheduled business commencement. That is what often makes it very difficult, at economically justifiable expense, to ascertain the effect of a single case of physical loss on the indemnity period. Moreover, the individual time excess per physical loss can result in unbalanced claims settlements. The time excess per claim must of necessity be shorter than a single deductible for the entire project. Thus, if only one major loss occurs during the insurance period, the insured's share of the loss will be relatively small. On the other hand, if there are several loss events, even if they do not affect the scheduled business commencement, the insured will automatically have a very large accumulated deductible to bear, assuming it is charged the full deductible per claim regardless of the actual allocable delay. The insured will argue that most of the delays have been made up for and should not be subject to any deductible since they did not affect the business commencement; instead, the delay should be ascribed to only one single event. In our opinion, the prerequisite for effective use of a time excess in the aggregate is the stipulation of a suitably long duration. It should not be less than four weeks per 12 months of construction or erection, while four weeks is sometimes considered the minimum even for projects that take less than 12 months. For a simpler and more pragmatic handling of claims, the "proportional" time excess should always be stated in the wording of ALoP policies, which is the product of the average per diem loss during the indemnity period and the number of days stipulated as the time excess.



top of Conditions

top of main document

2. Non-Invalidation, Non-Vitiation

The trend in construction and erection risks is towards greater or even complete outside financing. One positive side-effect for ALoP is that banks are among the best agents for insurers, since they often insist on ALoP coverage, at least for interest or redemption, in order to minimize their risk. The negative aspect of this trend is that the lenders expect absolute protection from insurance. A policy is invalidated or vitiated if the insured wilfully or by gross negligence fails to observe any of his obligations. Then the insurer pays no indemnification. This applies where false information is deliberately given about risks or losses, for instance, or where risk aggravations are not reported. Under non-invalidation or non-vitiation clauses, banks are entitled to compensation from the insurers even if there are any reasons for refusing indemnification for the actual insured because an obligation under the policy has not been observed. We feel these clauses are severely devaluating the insurance conditions and are unacceptable in engineering insurances, particularly in connection with ALoP. In the case of clients with an outstanding reputation, there may be ways of insuring the banks' interests separately in the London market under lenders non-vitiation insurance or lenders security insurance.

top of Conditions

top of main document

3. Inspections

Inspections of ALoP projects are an absolute must while a policy is in force. The timing and number of inspections depend on the severity of the risk and the experiences during the preceding stage of construction or erection. Of vital importance is the inspection of sensitive parts on arrival at the site, during preliminary storage if there is a high concentration of valuable supplies, during critical stages of construction or erection (for example when particularly heavy objects are lifted with special equipment) and right before testing begins. Inspections are "indirectly" made a condition of most ALoP policies by requiring progress reports. Depending on the risk involved, a period of three to six months is stipulated as the maximum interval between reports. Indeed, at large, highly exposed construction sites, such as Hong Kong airport, a commissioner of the insurers is present the whole time. The inspections should be conducted by experienced specialists from independent consulting firms or from direct insurers or reinsurers. The inspectors should be instructed to focus in particular on measures to reduce the risk of fire and on a critical investigation of the natural hazard risks.

To this end, insurers and reinsurers provide aids, such as a check-list "fire protection at construction sites". Seeing as time is literally money in ALoP, it is essential to subject the construction and erection plans to close scrutiny, identifying any deviation from the time schedule and analyzing the impact thereof on the target date. However, that is not all the inspector has to do. In this connection, he must also check whether any delays in the scheduled business commencement are caused by damage and whether there are any ways of minimizing the loss.

top of Conditions

top of main document

4. Loss Adjustment

Loss adjustment in ALoP also involves breaking new ground. If loss adjustment was a highly complicated matter in fire business interruption and MLoP, the subtleties in ALoP go even a few steps further. In operational covers, there is an existing accounting system which can be used in case of a loss. The cost structure at the time of the loss event is clearly documented, and it is fairly easy to follow the development up to the resumption of operations. In ALoP, at least for the construction of new plants or buildings, loss adjusters work only on the basis of anticipated costs until the first income statement becomes available after business commencement. As a result, the instalments stipulated in the special conditions of the policy, which are necessary for the principal's liquidity, are heavily influenced by assumptions. Hence, in addition to a technical expert to remedy the material damage, it is usually necessary to call in an accountant to assess the financial loss. Here we do not want to go into the frequently encountered agreements on claims assistance or claims control clauses, which are supposed to ensure close cooperation between direct insurers and reinsurers. What is extremely crucial is close collaboration between the insured, direct insurer and loss adjuster. In ALoP, unlike fire business interruption and MLoP, the financial loss never immediately follows the physical loss. It does not occur until the scheduled date of business commencement, and that may be many months after the occurrence of the physical loss. That is why for correct loss adjustment and efficient loss minimization it is absolutely essential that every event be reported that could lead to delays and could establish a claim under ALoP. 48 hours are usually

allowed for notification. Losses can be minimized in ALoP
- during the period between the occurrence of property damage and the scheduled date of business commencement, in other words during the originally planned construction or erection period;
- during the period of delay, in other words the indemnity period. It is therefore essential that loss minimization must begin prior to the date of the scheduled business commencement. In many cases, financial losses can be averted entirely by making up delays or rescheduling during the construction or erection stage. To this end, it is essential for the inspector or claims adjuster to have a good knowledge of the works progress schedules and the progress control. The steps to be taken to minimize the loss are comparable to those in fire and machinery LoP.

top of Conditions

top of main document

Conclusions for Insurers

Based on their evolution to date, the demand that undoubtedly exists, and the emergent trend, we draw the following conclusions about ALoP:

1. Separate Statistics and Evaluation of ALoP Risks

Many ALoP insurers and reinsurers, not excluding ourselves, sometimes experience a kind of "anxiety" about dealing with this class. This is not solely due to its being a highly exposed and relatively new business - what is new and exciting has a certain appeal, too. Not only does it demand efforts in development work, but it also affords opportunities of taking advantage of market niches and new potentialities. One of the biggest hindrances in ALoP thus far has been the low degree of statistical reliability and a resultant uncertainty about the rating level. "Underwriter's feeling" will always remain a necessary ingredient of rating, but there ought to be a way of verifying it. To date, ALoP premiums and claims have usually been recorded in the corresponding material damage lines. Separation is essential and ought to be administratively feasible, too. Given the present "size" of the business, it should also generally be possible to cede the risks on a facultative basis, for better statistical evaluation.

top of Conclusions for Insurers

top of main document

2. Professional Insurance of Justifiable Needs

Like any other product, ALoP has got to be, as far as possible, a perfect solution to the problems of our clientele, the principals. To confine ourselves to simple risks (such as the mounting of individual small machines) and reject highly exposed ones (such as new enterprises on greenfield sites) would certainly not be conducive to development. The criteria of acceptance should be technical insurability and a fair price with a reasonable time excess. Seeing as the perils insured in EAR and CAR and in ALoP are truly comprehensive, further coverage above and beyond that should not be afforded. Above all, insurers should not overstep the bounds to a point where they are assuming the entrepreneurial risk. The generally acceptable wordings of standard ALoP policies provide a solid foundation for appropriate cover. There is certainly no fail-safe recipe for proper risk assessment. Close scrutiny of construction and erection schedules, conditions of shortfall, reserve capacities and ways of minimizing losses requires expertise and considerable expense of time on the part of underwriters. "Risk management" in the form of inspections, monitoring works progress and checking projects for conformity with the applicable standards is a very expensive undertaking in every respect. The same goes for the complicated task of claims settlement, of course. So ALoP is going to remain a challenge for us all in the next few years, particularly if we aim not just to do business, but also to make a profit on it.

top of Conslusions for Insurers

top of main document

back to Paper Published