i-notes
Newsletter from India's Leading Insurance Broking House
July 06

Summary

India Insure
The risk managers

Message from the Editor

Dear Readers,

Yet another year has flown by and yet another birthday has been celebrated by Team India Insure. We turned 7 on June 9, 2006. 7 years is perhaps too short to gloat over compared to the decades and centuries that some corporate giants have been around for. But for Team India Insure – the 100-strong team of fire-brand 'entrepreneurs' – turning 7 means a lot. The team (both present and past) has braved the uncertainties of giving birth to a new industry and selling a new concept. We have earned the confidence of 200+ corporate customers across 9 cities. We have grown from being a Direct broker to a Composite Broker.

Thank you, India Inc., for giving us a reason to celebrate!

Going forward, the challenge will be to consistently delight our customers, attract and retain the best talent and sustain this growth. We will, of course, put our best foot forward – and we hope to continue to enjoy your support and blessings.

Over the past few years of running a broking operation, we have observed that there is one question for which all our clients – across manufacturing, IT and service industries – have sought answers from us. The question of "what value to fix as Sum Insured" for their assets. A tricky issue – which unless handled carefully – can bring us all to substantial grief. In this issue of ***i-notes***, we attempt to throw light on this very delicate but critical issue facing the insurance user. We trust you find it useful.

V Ramakrishna
Editor – ***i-notes*** & Managing Director, India Insure

How to be Adequately Insured in a Fire Policy

INTRODUCTION

Insurance has been gaining importance - thanks to the liberalization of the market since the year 2000. With several private insurers and a whole new breed of insurance intermediaries, the senior Finance and HR officials have been kept busy with the entire industry chasing them for the renewal of their insurance policies. Policies are being renewed very promptly ensuring that there has been no break in insurance. However, events like the recent spate of floods or an unforeseen accident in the plant has left a whole lot of CEOs shocked at the time of claim settlement, despite being insured.

The general myth is that if you suffer a loss while having an insurance policy, you will **always** be "put back into the same state as you were in prior to the loss" (read: *compensated fully*). Unfortunately, this can happen **only** if the value proposed for insurance is adequate enough to put you back in the same state. Insuring for a lesser value, known as under-insurance, will leave you bearing the uninsured percentage of loss.

THE DEMON OF UNDER-INSURANCE

Companies which have been regularly insuring their assets, paying their premiums promptly every year even with a zero-claim history, are justifiably disappointed and confused when their occasional claim is only partially settled. Quite naturally, they feel they have been short-changed somewhere. It would help for them to understand the concept of under-insurance, which is a very common factor for claims not getting paid in their entirety.

At every renewal, the insured is routinely asked for fully updated asset details along with estimated replacement / re-instatement values. The general practice so far has been to effect renewal based on the expiring policy with a few minor changes like enhancing the sum insured by a marginal percentage as advised by the insurer or the intermediary.

With insurance still seen by most users as an unavoidable 'expense' rather than a 'risk mitigation' tool, their prime concern is to scout for the lowest possible price. The insurer (or the intermediary), eager to impress and retain the client in the face of cut-throat competition, is compelled to "sing along". All goes absolutely well – till the day the insured is hit by a claim. The policy is then viewed under a magnifying glass. A surveyor is deputed by the insurer to carry out a loss assessment. After a detailed study, the surveyor arrives at the current market / replacement value of the asset. This is co-related to the "Sum Insured (SI)" declared by the insured – and if the said SI is lower than the replacement value arrived at earlier, the insured is slapped with the average (under-insurance) clause.

Soon the blame game starts. A lot of jargon - underinsurance, reinstatement, market value etc – is hurled at the client from all sides. But finally who is the end loser? Unfortunately, only the Customer.

Example:

A Company insures its buildings for Rs 6 crores on a reinstatement basis. They file a partial-loss claim for Rs 1.20 crores for Flood damage. The surveyor assesses the partial loss at Rs 1.20 crores, but declares that the sum insured, as per re-instatement value, should have been Rs 10 crores (the total rebuilding cost) and not Rs 6 crores.

The claim would be settled for Rs. 72 lakhs as follows:
(6 cr / 10 cr) 1.20 cr = Rs. 72 lakhs*

Hence the Insured receives only Rs. 72 lakhs against his claim of Rs. 1.20 crores and is self-insured for the balance Rs. 48 lakhs.

INDEMNITY AND SUM INSURED

Indemnity is one of the basic principles of insurance. The idea of insurance is that the insured should be "put back to the same state he was in prior to the occurrence of loss provided he was adequately insured" - the bottom line being that he should not stand to gain by the occurrence of the event.

The value that has been proposed by the customer for the insurance to be taken is termed as the Sum Insured.

HOW DO YOU PROTECT YOURSELF ADEQUATELY IN A FIRE POLICY?

Having discussed the disastrous consequences of under-insurance, let us present some tips on how to avoid under-insurance and be adequately covered under a Fire Policy.

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Building

Points to remember while insuring a Building:

- Insurance to be preferably taken on "Re-instatement Value" basis
- Land value to be excluded
- Sum Insured to include the present day cost of construction of a building of a similar kind at the same location, including the cost of all items like Pipes and electric/ telephone cables
- In case of increase in price foreseen during the policy period, to opt for escalation at a suitable percentage.

Plant and machinery

The fire insurance on these assets is on the same basis as applicable to buildings i.e. on "Reinstatement Value Basis" or Market Value Basis.

Points to be remembered to have complete insurance in case of Plant and Machinery

- In case the assets are to be covered after the commissioning in case of long drawn out projects, the escalation percentage to be looked into and insurance not to be taken on the invoice cost.
- Material received at premises, yet to be capitalized to be declared under a separate head. This would apply to P&M as well as contents.

The above considerations apply to only new industrial units. If the factory is old, say 20 years, the original capitalised costs are no basis at all for insurance purposes. In the intervening period of 20 years, not only prices would have gone up substantially, but the following changes would also haven taken place:

- The manufacturer would have substantially changed the features of the machine with a number of technological improvements.
- The manufacturer could have stopped producing the same type of machine altogether.
- The manufacturer could have gone out of existence.
- What was imported 20 years ago, may now be manufactured indigenously, in technical collaboration with the foreign manufacturer or otherwise. Due to this, substantial difference in prices would have resulted, particularly because of absence of import duty on indigenous machinery.
- The import of a particular machine may be prohibited because of development of indigenous capacity.
- The old machine may have become obsolete because of complete change in technology.

In such circumstances, the best method for ascertaining the current replacement value of a machine would be to find out from the suppliers the current price of a similar machine, and make suitable adjustments from the price quoted, towards technological advancements. Cost of fabrication of identical machinery at current day component and labour cost is also a method of determining the price cost of the original machine on current day replacement basis.

Computers & other sophisticated electronic items

The valuation of these items is very difficult. A Computer bought 5 years ago for say Rs.1 lakh may cost only Rs.50000/- today and that too for an improved model. As technological advancements are rapid in this field, the Insured should ascertain directly from the manufacturer the current price of a comparable system, at the time of every renewal of the Insurance Policy. This is one field in which prices are not really going up, but going down. While insuring Computers, the insured should also value the hardware, the software; the Computers related stationery and the Computer environment separately, and not club them together in one sum insured. This equally applies to various electronic items.

Stocks

Valuation of stocks for insurance purpose is comparatively simpler. In view of the principle of Indemnity implied in the contract of Fire Insurance, the stock should be valued after eliminating all anticipated profits at each stage. Therefore, while valuation of stock is done, the following points should be kept in mind: -

Points to remember while insuring Stocks:

Raw Material

- Net cost at which the material is available to the Insured on the date of and at the place of fire i.e. the exact market prices prevailing, less discounts, if any.
- The cost of Octroi, freight, taxes and levies, loading / unloading transit insurance etc., from the place of purchase upto the insured's premises would also form part of the cost of raw materials.

Finished goods

- Value for insurance purposes is represented by the net manufacturing cost including factory overheads. Normally excise duty is payable only when the finished goods leave the factory. Whilst the finished goods are still in the manufacturer's premises, it is better to insure them for their net manufacturing cost without excise duty.

Raw materials / finished goods in bonded warehouse

- As soon as the finished goods acquire bonded status the duty is deemed to have been earned by the Revenue authorities. Duty remission is permitted in case of loss or damage by Act of God or fire (not attributable to willful negligence of the insured or their employees). For goods in bonded status, sum insured should include excise duty as remission may not be available in case of loss.

Stock-in-process

- For fixing the Sum Insured for stocks in process, the maximum value represented in the cost of raw materials, other inputs and processing cost at any given time in the manufacturing area should be worked out and declared as a separate item. Since declaration policies are not permitted for stocks in process, it is essential to insure on the basis of maximum value likely to be present at any time during the period of insurance.

Goods in the hands of wholesalers & retailers

- To the wholesaler, the value of the goods is represented by the landed cost at which he receives his supplies from the manufacturer. To the retailer, it is the landed cost at which he receives his supplies from his wholesaler. In short, anticipated profits are not insurable.

Add-on Clauses & Valuation

The insured will be well-advised to take advantage of add-on clauses available under a Fire Policy, namely

- the Escalation Clause (which provides a facility for automatic periodical increases to Sum Insured),

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Machinery Loss of Profits Insurance

INTRODUCTION

Protecting a company's income flow has been a major cause of concern in the recent past and this has become constant source of worry for risk managers. While almost everyone is aware that insurance to a great extent helps putting back a company on its feet after the loss, it is the intangilble or the consequential loss which is difficult to perceive and in several cases forces the company to shut down without even making an attempt to recover. The lesser known insurance policies like the Fire Loss of Profits and Machinery Loss of Profits help overcome these losses to a great extent. History records the first ever MLOP policy being approved by the regulator in Germany.

WHAT DOES MLOP COVER?

While a normal fire or machinery insurance policy does help the company recover the material loss sustained, it does not protect them against all the losses incurred due to the fire or breakdown. The financial loss due to the loss of profits and the standing charges still being incurred after the loss with reduced or no income now being generated is what gets covered under the machinery loss of profits insurance.

Machinery loss of profit policy gives cover against consequential losses following loss or damage to the property insured under machinery breakdown and/or boiler and pressure plant insurance. This policy covers actual financial losses suffered by the insured due to business interruption arising from:

a) Reduction in turnover and

b) Increase in cost of working

Sum Insured

The Sum Insured is made up of the annual operating profit and the standing charges, ideally during the 12 months for which the policy has been taken.

Pricing

The rate primarily depends upon the nature of machinery, usage, contribution to the total turnover, existence of standby machinery, reserve capacity, indemnity period etc and is guided by the Tariff Advisory Committee.

Conditions for a claim to be tenable

For a claim to be tenable there must exist an admissible machinery claim, which even if falls within the excess would be considered sufficient for the LOP claim to be admitted subject to the other conditions being satisfied.

CLAIMS CASE STUDIES

Case 1:

The loss involved a combined cycle gas turbine power plant, having one 166 MW gas turbine and one 63 MV steam turbine, each with their own alternators and generator transformers.

After 26 months of commercial service, one of the transformers' phases suffered a short circuit in its low voltage windings, and the transformer tripped out of service. The damage to the windings due to overheating became evident on examination. It was decided to enhance the cooling system by doubling the capacity of the air fans and oil circulating pumps. A new transformer, up-rated to 220 MVA, was ordered accordingly with a scheduled delivery in eight months' time. Meanwhile emergency temporary repairs were carried out on the failed transformer as a matter of urgency, since the power station's entire generation was lost whilst the transformer was out of service. Six weeks later the transformer was returned to service at a reduced load pending the arrival of the new up-rated transformer.

After a further three months' service the transformer failed again, with extensive damage to all windings and ancillaries necessitating a complete rebuild. Following investigation, it was suspected that an internal contact had not been adequately secured during the temporary repair three months previously, leading to gradual overheating and eventual short circuit fault.

The transformer on order was urgently expedited and the delivery period was reduced from eight months to six months. Even so, the power station again lost all generation for a further two months.

Whilst the Rs. 4.50 crores physical damage loss was not remarkable for this size of transformer, the power station had lost all generation for an aggregate period of 3 1/2 months, with a partial loss of generation for 3 months. The Business Interruption loss amounted to Rs. 96 crores.

In the light of this experience, the power station now has two additional transformers on site as spares for the gas turbine and steam turbine generator transformers. It has also taken MLOP & FLOP cover.

Case 2:

An LOP claim under a Fire policy was declared inadmissible by the insurer as the loss of over 300 crores, though had occured out of inundation, the cause of inundation was breakdown of a welding joint in the pipeline which is not a cover under the fire risk and hence could not be admitted under the Fire LOP. Following this loss, the company has now taken an MLOP cover.

SOME FEATURES OF AN MLOP COVER

A machinery LOP policy can be purchased only in conjunction with a Machinery policy and cannot be taken as a stand alone policy. As is the provision under Machinery breakdown insurance, the MBD policy can be taken on a selective basis.

MLOP can also be covered under the Industrial All Risks policy as an option.

Time Excess: Generally losses due to an interruption lasting for a short period of time can be borne by the insured itself. Time excess is the minimum period of time declared at the time of taking the policy during which the claim will not be paid ie. Only a claim which falls beyond the excess period would be deemed payable under the MLOP policy. The standard practice is to have a time excess on 7 days.

Loss Minimization: Loss minimization measures taken by the insured plays a very vital role in the MLOP policy. These measures include the hiring of substitute machinery like motors, generators, transformers, boilers etc, hastening of repair works. While these expenses get added to the claim amount, they go a long way in the overall reduction in the quantum of claim.

CONCLUSION

While it is a suitable means of protecting oneself completely against relevant losses, care should be taken in ascertaining the sum insured. The criticality of each machinery in the way it contributes to the overall turnover needs to be studied carefully as also the period required to get back to normal work

Maintenance - A Strategic Management Tool

Source – Swiss Re

Until just a few years ago, providing care and maintenance for technical systems was seen as a necessary evil. Today, its potential for innovative opportunities to assure and even improve quality, competitiveness and productivity is widely accepted.

Maintenance is evolving from a primarily technical procedure into a strategic management process. While this development could lead to new business prospects, changing maintenance practices could also have an impact on technological risks in one way or another.

There are five basic categories of maintenance procedure

- *Run-to-failure or breakdown maintenance*
  The technical system is run without maintenance until malfunctions become apparent
- *Scheduled or time-based maintenance*
  Maintenance is performed on the system at regular Intervals. for example every four weeks or after a certain number of operating hours, regardless of its actual condition
- *Predictive or condition-based maintenance*
  This method depends on the actual condition of the technical system maintenance work is performed only when it is really necessary
- *Risk-based maintenance*
  A risk-based approach concentrates on those functions of a technical system whose unscheduled outage would result in particularly high costs or damage
- *Integrated maintenance*
  This form of maintenance takes Into account the fact that care and maintenance affect all aspects of a company and are themselves Influenced by all of these aspects The aim is thus to recognise the various interconnections between maintenance and - for example - customer satisfaction, product quality, the ability to deliver on schedule, manufacturing processes business location workforce skills, regulations and liability and to influence these correlations for the better.

The idea behind modern maintenance procedures is not limited to cutting costs. The real advantage is that they afford an opportunity to optimise the benefits of maintenance in relation to the cost either by reducing the maintenance effort required to achieve the same level of availability of the technical system and/or by enhancing the utility of the equipment.

But this does not mean that the aim should be to simply cut the cost of maintenance. As experience shows, such short term savings, on their own, often result in significant extra expense due to more frequent and longer break-downs.

A better understanding of maintenance processes is essential if attempts to optimise them are not to prove counterproductive. Depending on the technology involved, this may call for considerable investment for example in developing diagnostic techniques that permit maintenance to be precisely timed so as to interfere with ongoing operations as little as possible.

In short optimising maintenance does not mean simply reducing the cost of care, upkeep and repair It may also mean increasing overall expenditure In order to achieve greater reliability.

Maintenance cannot eliminate technical risks. At best systematic inspection, care and repair can help to reduce them; just like a healthy diet reduces the risk of falling ill but is no guarantee for perpetual good health.

Maintenance is thus an inherent element of technical risks. It is always involved to some extent even if its contribution to the overall risk can rarely be assessed accurately. It is neither possible to predict with any certainty how errors and omissions in inspection, upkeep and repair will affect a future loss event nor to positively trace back damage and in-direct consequences to specific deficits in maintenance.

How to be Adequately Insured in a Fire Policy ....contd. # 2

- Omission to Insure Additions clause (which covers assets which the insured may erect or acquire during the policy period)
- Removal of Debris clause (which covers the cost incurred by an insured in the removal of debris from the premises of the insured, dismantling, demolishing, etc. following an Insured Peril)

Insureds will also benefit from a periodical valuation of their assets by reputed valuers – which can become the basis for determining Sums Insured.

Conclusion

The assumption by the Customer today is that by opting for a "Reinstatement Value Clause" in the policy and seeing the clause figuring on the face of the policy, he is adequately covered. We have already seen that is not so! The only way to be adequately insured is by selecting the right Sum Insured and then opting for the Reinstatement Clause (with/ without escalation) where applicable. It is advisable to contact your insurer or intermediary for advice on this aspect at least 3 months prior to any major assets renewal.

Disclaimer

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