

# Finding Hidden Assets — Is Your Equipment Breakdown Reinsurance Program Broken?

by Thomas N. Thompson, CPCU, ARe



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**R**emember the thrill of finding coins between the cushions of the couch when you were a child? Insurers may experience a similar, albeit tamer, response to finding claims that have slipped through the cracks of their reinsurance reporting processes. Where do they look for these missed recoveries? Equipment breakdown reinsurance is a good start for a variety of reasons. This complex and ever-evolving line of business is one of the most difficult forms of insurance to process from a reinsurance perspective. A review of the

historical equipment breakdown program may be just what is needed to uncover these hidden reinsurance assets.

Originally written in 1866 to cover boiler explosions, principally on steamboats, equipment breakdown insurance has expanded to cover loss resulting from the accidental breakdown of almost any type of equipment that operates under pressure or that controls, transmits or uses mechanical or electrical energy. Unfortunately, the expansion of the equipment covered has not come without added complexity. Today's equipment breakdown programs include numerous coverage nuances, exclusions and extensions that make them extremely challenging to administer.

Because of the unique characteristics associated with this line of business, most insurance companies cede 100 percent of their equipment breakdown insurance to reinsurers who specialize in this coverage. As a result, insurers are left with what would seem to be the relatively simple task of remitting premiums and reporting losses to its equipment breakdown reinsurance partners. While the payment of premium is typically straightforward, the cession of equipment breakdown loss is not.

For most insurers, the property claim adjusters are charged with identifying and reporting equipment breakdown claims to the reinsurer who then adjusts the claims on behalf of the insurer. Unfortunately, the recognition of equipment breakdown claims is not always easy, and there are many factors that complicate this task. Some are as follows:

- **Multiple perils involved in the same event** — assume a power surge short-circuits an electrical distribution panel which in turn starts a fire that destroys a building. In this type of scenario, the damage to the electrical panel from the surge may account for only a small portion of the overall cost of the claim. It is not uncommon for such a claim to be categorized or coded as a fire loss without any consideration given to ceding the electrical panel damage to the equipment breakdown reinsurer.
- **Overlapping coverage** — equipment breakdown coverage may duplicate the coverage being offered under other non-equipment breakdown lines. Damage caused by, or resulting from, water is just one example of overlapping coverage contained within, or between, forms. While each reinsurance arrangement differs from one company to the next, claims involving overlapping coverage are usually shared between the insurer and reinsurer on a joint-loss basis. However, too often insurers do not look to the equipment breakdown reinsurer for participation in the claim if its own coverage applies to the loss.
- **Power surges** — power surges stem from artificial and natural sources. Natural sources, such as lightning, are commonly retained by the insurer while surges produced from artificial sources, such as failure of a power supply, are the responsibility of the equipment breakdown reinsurer. Differentiating between the two types of surges is not always easy. This is especially true for lightning strikes that occur away from an insured's premises.

*Continued on page 2*

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Continued from page 1

The insurer and reinsurer should have a clear definition of what does and does not constitute damage from lightning as it relates to equipment. The absence of such an understanding may lead to more power surge claims being retained by the insurer.

- **Applying the cause of loss incorrectly** — equipment breakdown claims frequently require in-depth investigation in order to arrive at the correct cause of loss. Rushing to a conclusion regarding the cause of loss may limit an insurer's equipment breakdown recoveries. An example would be assuming the breakdown of a piece of equipment, say a pressure relief valve, was caused by wear and tear (not covered by equipment breakdown) when in fact, it was the result of faulty materials or workmanship (covered by equipment breakdown). If the reason why this relatively inexpensive valve failed is not correctly identified, it may lead to the unnecessary retention of thousands of dollars of water damage by the insurer.
- **Unique coverage extensions** — equipment breakdown insurance will often pay for business interruption or spoilage of perishable items caused by damage to equipment owned by a service provider, such as a utility or landlord. The insurer should be familiar with all the coverage extensions offered by the equipment breakdown reinsurer so that it may benefit from this additional coverage.
- **Numerous exclusions** — equipment breakdown insurance and reinsurance usually contain numerous exclusions relating to the type of equipment and causes of loss covered. These exclusions tend to frustrate and confuse claim adjusters attempting to apply the coverage. Over time, adjusters may develop the opinion the equipment breakdown coverage is rather narrow in scope, which in

turn may lead to fewer claims being reported to the reinsurer.

- **Lack of exposure to claims and in-depth training** — contributing to challenges faced by adjusters in identifying and reporting equipment breakdown claims is the fact that they do not handle them on a daily basis. The exposure to these types of claims is simply too infrequent to allow the adjuster to become proficient at handling the more complex coverage issues. While equipment breakdown reinsurers attempt to remedy this problem with training, this training is usually limited to the coverage basics and does not delve into the many coverage nuances associated with this line of business.
- **Claim size** — many equipment breakdown claims that are left unreported are relatively small from a reinsurance perspective, usually less than \$10,000. Smaller claims simply do not attract the same level of attention within an insurance company, and therefore are more susceptible to being overlooked. Surprisingly, smaller equipment breakdown claims are also sometimes intentionally retained by the adjusters because of the additional time and cost required to involve the reinsurer. When the business is ceded on a 100 percent first dollar quota-share basis, the retention of several smaller claims can add up to sizable missed recoveries.
- **Varying methods of attachment** — historically, equipment breakdown reinsurance was more commonly attached to a specific policy using an endorsement or separate coverage form. Over the past decade, equipment breakdown reinsurers have made a concerted effort to write this business on a portfolio-type basis by either embedding the coverage in the property form or endorsing the coverage on all commercial and

business property forms issued by the insurer. Writing the reinsurance on a portfolio basis simplifies the reporting process. However, the transition from a policy-specific to a portfolio basis, or not having all the property business include equipment breakdown insurance, will contribute to missed reinsurance recoveries.

There are many more reasons why claims are not always reported to reinsurers. The more common issues for equipment breakdown claims have been presented here. A formal claim review will help to identify these and other types of unreported claims as well as weaknesses in the adjusting process. When contemplating such a review, an insurer should require the following of the individual or vendor being considered for this project:

- (1) Extensive experience with equipment breakdown insurance and reinsurance claims.
- (2) A proven track record of identifying and collecting unapplied reinsurance.
- (3) No previous involvement in the program being reviewed. This is simply to avoid any potential conflicts of interest.

One final note: In general, equipment breakdown reinsurance was overpriced when it was being transitioned from a policy-specific to a portfolio basis around 2000 to 2005. Only in the last couple of years have insurers seen prices drop to more accurately reflect the exposures being ceded. A review of an insurer's historical equipment breakdown business will help to offset those excess premiums from earlier years while ensuring claims are not being left unreported in the future. ■