

Winter 2007

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Viewpoint

Equipment Breakdown Coverage in Homeowners

AAIS and HSB team up to develop new endorsements



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Articles in *Viewpoint* provide general discussion about topics in property/casualty insurance and AAIS products and services.

The content of the articles is not intended to provide definitive information regarding use of AAIS products and services, and in no way alters, supplants, or supersedes what is written in AAIS policy forms, manuals, bulletins, or other forms of information provided as part of our advisory services. Nor does the content of *Viewpoint* articles indicate any official AAIS position on insurance or other issues, unless specifically noted.

From the editor

Your products make your company what it is.

That may seem like an odd thing to say, because insurers customarily “outsource” their product development while maintaining other functions internally. Indeed, AAIS exists to serve its members as their product development resource.

In light of that, however, it’s important to remember that the policies you sell embody the promises you make and the risks you assume. They are, in short, what make you an insurer.

For years, there have been industry meetings devoted to automation, marketing, underwriting, claims, and other functions, but few--if any--devoted to exploring product-related issues of strategic importance.

The newly repositioned AAIS Main Event fills that gap.

This meeting, scheduled for April 22-24, 2007, in Charleston, S.C., is an updated version of the former AAIS annual conference. Its business program will address topics at a level targeted toward CEOs and heads of operational units.

You won’t want to miss this unique opportunity to learn how emerging exposures, political shifts, and other factors are changing what is covered or not under property/casualty policies.

And you won’t want to miss the unique opportunities The Main Event will offer you to share ideas concerning the course of product development with your industry peers and AAIS staff.

For information, go to page 10. I look forward to seeing you in Charleston.

Joseph S. Harrington, CPCU



Equipment Breakdown Coverage in Homeowners Insurance

AAIS and HSB team up to develop new endorsements

In our automated age, it was only a matter of time before equipment breakdown coverage was introduced in homeowners insurance.

This and other publications have documented the growth and transformation of equipment breakdown (EB) insurance, which covers losses to equipment caused by “accidents” within them, losses that are typically excluded from coverage under standard property forms.

Twenty-five years ago “boiler and machinery” coverage, as the line is sometimes called, was largely confined to industrial risks that had unique exposures for motorized equipment or steam boilers.

Since then, equipment breakdown insurance has expanded in scope as it has come to be applied to the networks of electronic equipment upon which almost all commercial operations depend.

As a reflection of this trend, AAIS has been adding equipment breakdown coverage parts to its programs over the past 10 years.

The endorsements have been developed in conjunction with The Hartford Steam Boiler Inspection & Insurance Company (HSB), a leading writer of equipment breakdown coverage, but the endorsements can be used with any equipment breakdown reinsurer.

The process started in 1997 with the introduction of equipment breakdown coverage parts in the AAIS Commercial Output Program. In subsequent years, counterparts were developed for use with other AAIS commercial lines programs.

In 2004, AAIS introduced equipment breakdown coverage in its Farmowners, Farm Properties, and Agricultural Output programs.

Now, in the latest expansion of the application of equipment breakdown, AAIS will initiate a nationwide filing in 2007 of two equipment breakdown options under its Homeowners Program.

Timing

Both insurers and homeowners have compelling reasons to be interested in this emerging new coverage, according to Michael Fusselbaugh, HSB’s senior vice president for strategic business development.

“Companies and agents are looking for ways to add value and offer choices to their clients,” he says.

To that end, HSB is marketing homeowners equipment breakdown coverage to primary carriers as “a new and unique

coverage that makes your homeowners policy distinct in a market of look-alike products.”

Equipment breakdown losses are explicitly excluded under standard homeowners policies, leaving insureds--especially those with “high-end” homes--with a potentially substantial gap in coverage.

“Newer, large homes have more infrastructure equipment than in the past,” Fusselbaugh says. “Some require multiple heating or air conditioning units.

“Many are being constructed with more built-in equipment like stoves in center islands, wall-mounted ovens, security systems, and communications systems.

“In some regions, permanent electricity generators are becoming more common.”

Automated homes

There’s much more to come in home automation. Experts say that our homes won’t simply have equipment in them, but they will be working systems in and of themselves.

Microsoft Corporation has created a model home that tells you how to cook a meal or manage a wash load, thanks to built-in scanners that read codes on groceries, clothes, and other items. The house literally talks to you, telling you when you’re missing an ingredient or that you’ve mixed whites and colors.

“Newer, large homes have more infrastructure equipment than in the past. “

— Michael Fusselbaugh, senior vice president for strategic business development, The Hartford Steam Boiler Inspection & Insurance Company

The model home is no futuristic fantasy for the rich and famous, but a “vision of what the average person’s home might be like in five to 10 years,” reads a report on Microsoft’s corporate website.

“Wired Home,” a special publication of *Wired* magazine, estimated that more than half of all houses built in 2006--“not just the upscale ones”--had “structured wiring” installed for facilitating home automation.

That automation will be tapped for more vital purposes than laundry and recipes.

“In the event of a fire,” the publication states, “the house could sound an alarm, call the fire department, turn off the HVAC to stop smoke from spreading, broadcast evacuation instructions, and even flash the lights to guide the fire department.”

Market

Sensing current demand and future growth, at least four primary companies have announced that they are now making equipment breakdown coverage available in their homeowners programs: AIG’s Private Client Group; American National Property & Casualty, Springfield, Mo.; Grange Insurance, Columbus, Ohio; and Mutual Assurance Society of Virginia, Richmond.

HSB expects at least 20 more companies to introduce the coverage in 2007, and HSB is not alone among equipment breakdown insurers in offering the coverage.

Mutual Boiler Re, Malvern, Pa., also provides the coverage through reinsurance relationships with primary homeowners carriers. The Mutual Boiler Re website emphasizes that, for homeowners, the coverage is a cost-effective alternative to product and home warranty plans, which are limited in the protection they provide.

Product warranties and service contracts typically cover only one piece of equipment for defects in its design or assembly, and most of the former do not cover break-



downs arising from human error in the installation, operation, or maintenance of equipment.

Virtually no product warranties or service contracts provide coverage for loss of use of a home in the event an equipment failure makes it uninhabitable.

In short, homeowners commonly find themselves completely unprotected from loss from failures of key household equipment.

Coverage

For AAIS Homeowners affiliates, that could change under two equipment breakdown endorsements AAIS is filing.

The language of the endorsements will be familiar to any P/C professional with a basic knowledge of equipment breakdown coverage.

The two endorsements extend coverage under the policy to losses resulting from “accidents” that result in damage to “covered equipment.” That term is explicitly defined to mean property insured under Coverage A - Residence or Coverage B - Related Private Structures that generates, transmits, or utilizes energy, or that operates under vacuum or pressure under normal use.

Covered types of losses include:

- Sudden and accidental mechanical or electrical breakdown; and
- The sudden and accidental tearing apart, cracking, burning, or bulging of a steam or hot water heating system or air conditioning system.

Both endorsements state that the coverage provided under them does not apply to electronic entertainment or computer equipment, kitchen or laundry appliances, and other specified property.



“This coverage is another tool AAIS is making available to our affiliates to help them have a competitive edge in their markets.”

— Susan Luecke, AAIS assistant vice president, personal lines

What sets the endorsements apart is that one of them extends coverage to kitchen

and laundry appliances that are permanently installed in the structure of the insured residence.

Three coverages

Three types of coverage are provided under the AAIS Homeowners equipment breakdown coverage extensions.

Coverage for direct physical damage to covered property is provided up to a built-in limit of \$50,000 under each endorsement; the insurer can specify a higher limit on a schedule that appears on the endorsement.

In addition, each endorsement extends Coverage D - Additional Living Costs and Loss of Rent, to losses caused by equipment breakdown. This coverage is subject to a built-in limit of \$200 per day, up to \$1,000 per accident, unless higher limits are shown on the schedule.

Finally, the endorsements extend the Homeowners coverage for Refrigerated Property (perishable food, medicine, etc.) to such property that spoils because of a breakdown of equipment. This coverage is provided up to a built-in limit of \$500 per accident; again, a higher limit can be identified in the schedule, but the refrigerated property coverage does not increase the overall equipment breakdown limit.

For physical damage and loss of use, the equipment breakdown endorsements include deductibles that are built-in at the level of the policy loss deductible for fire loss, with the option to create a different deductible, higher or lower than the fire loss deductible.

Competitive edge

“This coverage is another tool AAIS is making available to our affiliates to help them have a competitive edge in their markets,” says Susan Luecke, AAIS assistant vice president

for personal lines and principal developer of the AAIS Homeowners Program.

Luecke notes that there is already coverage in standard homeowners forms for certain types of losses arising from breakdowns of equipment.

For example, if a furnace overheated and caused a fire, there would be coverage for building and personal property damaged by the fire and smoke, even without the equipment breakdown endorsements.

Similarly, if a hot water heater suddenly burst and spilled water, there would typically be coverage for the water-damaged property under forms with broad or open perils coverage.

What the equipment breakdown endorsements add is coverage for the loss to the actual equipment that suffers an accident, whether or not there is damage to other property.

In this respect, homeowners equipment breakdown coverage creates an interplay between product warranties for the covered equipment and the equipment breakdown coverage.

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Warranties

“The question of warranties always comes up in discussions,” says Fusselbaugh at HSB.

He cites two reasons why EB coverage in a homeowners policy might be more attractive and beneficial to homeowners than the typical product or “whole home” warranty.

- The terms and conditions of warranties vary greatly, making it complicated to settle losses. In comparison, homeowners equipment breakdown coverage can simplify the adjustment of both equipment and standard property losses.
- The aggregate cost of warranties will, in most cases, exceed the cost of equipment breakdown coverage.

“As coverage extensions, we anticipate that these equipment breakdown enhancements will command only a small fraction of the overall homeowners account price,” says Fusselbaugh. “For most homes the cost will be less than 5% of the current homeowners package.”

HSB is counting on the relatively low cost of equipment breakdown coverage to help avoid adverse selection.

When asked why someone would not wait until equipment has aged before buying the coverage, Fusselbaugh replied, “With a marginal extra cost, we should get greater participation, and that should help reduce the possibility of adverse selection.”

Interplay

Warranties aren’t going away, however, because equipment breakdown coverage will not, in any event, cover a system’s failure to operate as intended.

As it is, AAIS is rewriting the “other insurance” provisions in its homeowners base forms to address situations presented by the interplay of product warranties and insurance, with or without equipment breakdown coverage.

In one provision, wording is added to state that coverage does not apply to loss, cost, or expense that is also covered by any warranty, plan, or agreement that provides for the repair or replacement of property.

Another provision adds that “this homeowners insurance is excess over any amount payable by such warranty, plan, or agreement.”

Provisions such as these, as well as the equipment breakdown deductible, are designed to prevent equipment breakdown coverage from transforming homeowners policies into home maintenance contracts.

“The equipment breakdown deductible selected by the insured removes many of the small, maintenance losses,” Fusselbaugh says. “Warranty reimbursements may then cover much of what would be under the policy deductible.”

Relationship

At this point, AAIS is filing only the endorsements and corresponding rules for homeowners equipment breakdown coverage. Even when they take effect, primary insurers will be dependent on their equipment breakdown reinsurers for rating information and underwriting expertise, says Luecke.

Their success in selling equipment breakdown coverage profitably will depend on the quality of their relationship with their reinsurer, she says.

For example, the equipment breakdown coverage endorsements include standard exclusions for “wear and tear,” and reasonable people can disagree about what constitutes “wear and tear.”

Industrial insureds that have long been purchasers of equipment breakdown coverage are accustomed to the idea that there will be disputes over the allocation of claims among insureds, property carriers, and equipment breakdown reinsurers.

It’s an entirely different matter when the coverage is introduced into personal lines, where there is an assumption that the policyholder is not a sophisticated insurance buyer.

The primary carrier would bear the burden of either:

- Telling an insured that coverage he or she bought for a specific purpose could not be granted because of circumstances surrounding a loss; or
- Paying the loss and hoping the equipment breakdown reinsurer would cover it.

Either way, “the insured sees one face,” says Fusselbaugh, and that face needs to reflect a strong underlying relationship. ■



Cow Power

Farms seeking to insure growing number of electricity-generating manure digesters

The humble “cow pie,” and its porcine equivalent, are getting more respect these days.

While the value of manure for fertilizer has been known since time immemorial, animal waste from both cattle and hogs is now being tapped as a source of electrical power for the farms where it is produced and for regional electrical grids.

A small but growing number of farms--perhaps 100 to date nationwide--have installed anaerobic manure digesters that separate and capture methane gas that is naturally produced by animal waste and burn it to generate electricity.

Manure digesters are being hailed as an economically effective and environmentally friendly response to several contemporary problems: dependence on foreign oil, strained power grids, greenhouse gas emissions, and offensive odors from livestock operations.

That's why federal agencies are collaborating with state agricultural departments on an “AgSTAR” program to promote the use of anaerobic digesters through technical assistance and financial incentives.

Growth

“The number of anaerobic digesters used on livestock farms has increased over the past 5-6 years as U.S. Dept. of Agriculture grants to assist in their construction have become available, and the technology has improved,” says Bill Johnson, agricultural compliance manager for Alliant Energy, Madison, Wis., a utility serving areas of Illinois, Iowa, Minnesota, and Wisconsin.

In Wisconsin, there are currently 11 digesters in use, each of which generates 600-700 megawatts of electricity, enough to supply about 500 homes, according to David Jenkins, manager of the Wisconsin Electric Cooperative Association (WECA), also based in Madison.

“They are being used more now than in the past because of a Wisconsin law that requires utilities to use 10% renewable energy by 2015,” says Jenkins. He adds that 22 other states have similar laws, with varying percentage requirements.

“Utilities tend to like manure digesters because they are base load power sources that operate 24/7,” he says. In contrast, “solar and wind sources are intermittent.”

According to the U.S. Environmental Protection Agency (EPA), anaerobic digesters are responsible for reducing U.S. agricultural emissions of methane, a greenhouse gas, by 124,000 metric tons of carbon equivalent each year.

The EPA also reports that digesters generate 30 gigawatts (GW) of electricity annually, an amount roughly equivalent to that generated in a day by a major metropolitan utility company.

Revenue

Most manure digesters work by having animal waste flushed into an enclosed pool, where it is heated to separate the methane, which is captured and piped away or burned onsite to drive electrical generators. (The methane is often also burned to heat the manure and create more methane, thus establishing a self-sustaining cycle after the initial warming.)

“Revenue from the generation of electricity is not a significant source of income for farms,” says Johnson of Alliant Energy, “but the sale of electricity allows a farm’s manure management system to become a source of revenue rather than a cost center.”



“The sale of electricity allows a farm’s manure management system to become a source of revenue rather than a cost center.”

— Bill Johnson, agricultural compliance manager, Alliant Energy

“A manure digester can repay its costs in about six years and contribute savings in the form of free electric power and heat on the farm,” says Jenkins at WECA. However, he adds, “only larger farms seem to be able to support a digester, as no one has yet figured out a way that farms with fewer than 500 cows can use them efficiently.”

Digesters produce other byproducts that contribute to farm income, however.

For example, the solid material left behind after the methane has been separated out can be used sold as fertilizer and/or bedding for animals.

Both of those byproducts may be of higher quality than their counterparts which have not gone through the digester process, says James Bessler, AAIS’s manager of farm and agricultural programs.

According to Bessler, “recovered digested solids are generally free of pathogens, as those pathogens are killed by the digestion process.”

Similarly, he says, the process kills undigested seeds that might pass through an animal, thus reducing the possibility that weeds will germinate in manure and thus reducing the amount of herbicide that needs to be applied to fields.

Exposures

Even for farm insurers accustomed to underwriting unique combinations of personal, commercial, and farm exposures, manure digesters pose new challenges.

“Insurance companies are increasingly faced with questions on how to handle exposures generated from these systems,” says Eric Hubicki, assistant vice president for agriculture in the Chicago office of Munich Reinsurance America.

“Generally,” Hubicki says, “a well-designed and managed digester will have few safety concerns.

“However, the biogas can pose health risks for workers and be explosive in confined spaces. Electrical equipment and

connections in biogas exposed areas requires special adaptations to avoid spark ignition.”

“If the methane is piped to a tank for storage, the operation is essentially a flammable gas compressor station like that found in the natural gas industry,” says Michael Fusselbaugh, senior vice president for business development at The Hartford Steam Boiler Inspection & Insurance Company (HSB), Hartford, Conn.

“For underwriting purposes, this operation should be treated similarly to that of a hazardous petrochemical manufacturing plant,” Fusselbaugh adds.

Hubicki and Fusselbaugh are not alone in citing the risk of combustion posed by digesters, but others say that risk is less than it is for other types of energy producers, because the methane is kept at low pressure.

“Digesters have safety devices that guard against excessive pressure,” says David Ritzinger, senior engineering exposure



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analyst for Mutual Boiler Re, Malvern, PA.

“The first of these are flares, which will ignite to burn excess methane if the pressure exceeds a certain limit,” he says. “If the flares fail, a device similar to a boiler safety valve will open to release the gas into the atmosphere.”

Income

Manure digesters also have a substantial equipment breakdown exposure for units that can cost up to \$1.5 million to install.

“Loss of the engine generator set is the largest equipment hazard exposure associated with this system,” says Ritzinger at Mutual Boiler Re. “It is possible that a chemical reaction can cause the process to produce sulfuric acid [which] can lead to corrosion of engine components.

“Significant corrosion of components such as the engine crankshaft can lead to catastrophic failure of the engine.”

“Severe and rapid corrosion and deterioration is common in

almost all equipment in a raw methane operation,” says Fusselbaugh at HSB. “Equipment that is not professionally designed, manufactured, installed, and maintained could have a high failure rate.”

As costly as digesters can be, perhaps the most daunting exposure for farm insurers, because it is an unfamiliar one, is the business income exposure for power generation.

“A loss exposure could arise if the farmer fails to live up to the terms of his purchase power agreement with the utility,” says Jenkins at WECA. “Farmers should be careful to get good legal advice before and while entering into such agreements.”

“We recommend [that] insurance carriers review the contract [or] agreement between electric company and the farmer,” says Hubicki at Munich Re America. “One item to look for includes making sure interruptions of electrical current from either side can be handled smoothly and safely by the farmer’s systems.

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Risk Meter, a service of CDS Business Mapping, Boston, Mass.

Responses by Jamie Munson,
director of consulting services

AAISdirect:

A portal created by partnerships

AAISdirect started out as an online library of AAIS forms, manuals, and bulletins, and it continues to serve that function.

Users now have a newly designed home page with search capabilities across all documents, lines, and states, plus improved paging and results displays, and new feedback forms for contacting AAIS.

“AAIS is committed to making AAISdirect an indispensable resource of AAIS materials plus complementary services for evaluating and pricing risks.”

— Paul Baiocchi, president, AAIS

More importantly, AAISdirect users now have direct access to data sets of rating information in Microsoft Excel or XML format they can import into company systems without the time, cost, and errors associated with manual input.

The biggest enhancements to AAISdirect, however, have been the addition of complementary risk information services provided by third party vendors.

“AAIS is committed to making AAISdirect an indispensable resource of AAIS materials plus complementary services for evaluating and pricing risks,” says Paul Baiocchi, president of AAIS.

Today, every AAIS affiliate that uses AAISdirect, regardless of their line(s) of affiliation, has access to the “Risk Meter” risk mapping service.

What are the biggest challenges today in risk mapping in personal lines, and how is Risk Meter addressing them?

Maintaining underwriting discipline is the biggest challenge.

2006 was an extremely profitable year for many carriers, but with this success, downward pricing pressure is inevitable. It’s easy to talk about underwriting discipline and enforcing rules, but until you give the end user a suite of tools that truly makes the job easier, rules will not be enforced.

Information is what drives decisions, and information comes at a cost. In the past, the resources devoted to gathering underwriting information involved a great deal of manpower, which is extremely expensive, laborious and riddled with inaccuracies. Risk mapping brings crucial data to the desktop in “real time” with a high level of accuracy at a fraction of the cost.

For example, it should be pretty easy to determine a rating territory, right? But, I would guess that most companies have an error rate in excess of 10%. This can have a huge impact on premium--positive and negative--and create a lot of compliance headaches with state insurance departments



... What about commercial lines ... ?

Volume is typically lower and premiums much larger in commercial lines. Therefore, any investment in gathering information is money very well spent. It is stunning how little this information costs in comparison to even a small claim.

For example, suppose that a structure is not in a flood zone, but is a couple of hundred feet away from one. Suppose also that the structure is elevated one foot above the base flood elevation. If a flood goes three feet above its normal height, a carrier could be facing hundreds of thousands in a single claim.

... and farm lines?

We are beginning to see increased awareness of risk mapping for farms. With the tools available today, carriers can get a bird’s eye view of property and its outbuildings, fields, crops, and more.

Risk mapping allows a carrier to segment business in a way that was not possible before. This allows for better pricing and [determining] how perils may affect a given area. There are now tools available to locate farms and other rural property by range, section, and township.

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e2Value, Inc., Stamford, Conn. provider of property valuation services

Responses by Todd Rissel,
chairman and CEO

What are the biggest challenges today in residential property valuation, and how is e2Value addressing them?

Keeping up with market changes is the greatest challenge for most valuation providers.

The housing market used to be a fairly stable market that had a few downturns as tax laws changed and interest rates adjusted. Over the past 20 years, however, market forces have changed how housing is perceived as an investment:

- The Federal Reserve stabilized inflation.
- A greater portion of the public started participating in the stock market.
- There was a dramatic rise in the stock market in the 1990s, followed by a dramatic crash in the early 2000s. At the same time, more commodities traded are affected by world prices and speculation.
- The investing public looked for safer markets, and real estate seemed like a stable market, based on historical results.
- “Baby Boomers” have more cash to spend than previous generations and had a desire to have more than one home.

With the demographic changes, real estate became more like a stock market and had more dramatic swings up and down—as investors learned in the 1990s and through the early 2000s.

Dramatic changes in housing prices are more likely today than in the past.

Also, in the past, the cost of building materials were driven primarily by local conditions, but now people realize that what happens in China matters in their neighborhood. It is truly a world economy and we compete for materials we used to have a lock on.

In the past, data providers focused on the price of a brick or drywall or lumber. Today, the dynamics of world markets matter much more in property valuation. At e2Value, we focus on markets, demographics, population trends, immigration, the age of the population, and more, in addition to the cost of materials and labor.

It is easy to determine the price of a brick. It is not as easy to determine how market conditions will impact the building the brick will be used in, or the composition of the workforce making, delivering and installing the brick.

. . . What about commercial and farm property valuation?

There is no way to separate the commercial, farm and residential building markets from local or worldwide influences. The housing market and its appetite

Risk Meter, a service of CDS Business Mapping, Boston, Mass., provides online access to more than 30 categories of geographic information related to hazards at a location. The information provided specifies a location’s distance from coastlines, fault lines, and flood zones, as well as its exposure to hail, tornadoes, wildfires, crime, and other hazards.

Of particular importance to companies that use AAIS programs is Risk Meter’s information on the distance from an insured location to the nearest fire station. That distance is a determining factor in the application of AAIS’s simplified fire protection definitions (“protected,” “partially protected,” and “unprotected”). Having the distance available automatically through Risk Meter saves time and improves accuracy.

In addition, insurers that use *AAISdirect* for specified lines of insurance have access to online property valuation applications developed by e2Value, Inc., Stamford, Conn., a leading developer of online valuation applications.

AAIS Homeowners, Mobile-Homeowners, and Dwelling Properties affiliates can have access through *AAISdirect* to e2Value’s “Residential” online property valuation service, which provides systematic valuation procedures for a wide range of residential property, including high value homes, modular and kit homes, condos and co-ops, alterations and additions, and more.

Since November 2005, AAIS Farmowners and Farm Properties affiliates have had access to e2Value’s “Farm & Ranch Estimator” application, one of the first programs to implement automated valuation for farm property.

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The AAIS MAIN EVENT



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The program will address emerging exposures and other topics at a level targeted toward CEOs and heads of operational units.

Keynote speaker: Tommy G. Thompson

former Cabinet Secretary
and Governor of Wisconsin

Few people in public office have earned the widespread recognition for effectiveness and integrity that **Tommy G. Thompson** has earned for his service as Secretary of the U.S. Dept. of Health and Human Services from 2001-05, and as Governor of Wisconsin from 1987-2001.

In his keynote address to the Main Event, Thompson will address critical issues in public health and safety that affect the level of risk in the United States, and the loss exposures of insurers.



Tommy G. Thompson



Dr. Robert Blaunstein

Emerging Issues in P/C Insurance Nanotechnology: The coming transformation

No one is better prepared to address the growth of nanotechnology and its impact on insurers than **Dr. Robert Blaunstein**, manager of loss control under contract for American Safety Ins. Co., Santa Monica, Calif.

Foods and Beverages: Unrelenting scrutiny

When it comes to analyzing trends in food-related claims, **David Herman** stands at the forefront. As senior counsel and senior director of claims for the Foods Products Association, Herman manages the association's claims program and oversees all aspects of the group's participation in product liability lawsuits.



David Herman



Charles Kingdollar

Personal Injury and the Internet: The growing exposure

Charles Kingdollar, vice president in the emerging issues unit of Gen Re, has been monitoring trends in personal injury claims and jury awards, and what they may portend for carriers.

Politics & Products

Part I: Sam Miller, executive vice president, Florida Insurance Council

Rarely, if ever, have the provisions of property/casualty policies been subjected to as much public scrutiny as they are today. Whether it be in response to terrorism or flood losses, or the use of credit-based scoring and loss histories, policy provisions and underwriting are being debated by consumers and public officials as never before.



Sam Miller

Part II: CEO panel

Successful executives make it their business to understand what's happening in the public arena so they can anticipate and, where possible, shape events. Our exploration of the impact of politics on products will continue with a panel of CEOs who have demonstrated effective leadership for their organizations and the industry as a whole.

Moderator:

James Sullivan, president and CEO, Co-Operative Insurance Companies, Middlebury, Vt. and chairman of AAIS

Panelists:

- **Charles Chamness**, president, National Association of Mutual Insurance Companies
- **Judy Jackson**, president and CEO, NLC Insurance Companies, Norwich, Conn.
- **L. Gerald Roach**, president, Mutual Assurance Society of Virginia, Richmond
- **Richard Zick**, president and CEO, Utica First Ins. Co., Utica, N.Y.

AAIS Update

The Main Event has been redefined and repositioned to reflect AAIS's role as a strategic partner with its member companies, working with them to develop and implement products that achieve strategic objectives while meeting regulatory guidelines and market expectations.

As part of our program, AAIS staff will review recent market developments in product lines where AAIS is active, describe recent enhancements to AAIS products and services, and seek input on future initiatives.

Roundtable Discussions

Attendees at the AAIS Main Event will have opportunities to share ideas with other attendees in roundtable discussions scheduled for Tuesday, April 24th. Attendees can choose among three roundtable discussion groups:

- One on personal lines;
- Another on commercial lines; and
- A third focusing on executive concerns.

SOCIAL EVENTS



AAIS Golf Outing

Rivertowne Country Club, Mt. Pleasant, SC
www.rivertownecountryclub.com

This year's AAIS Golf Outing takes place at Charleston's first Arnold Palmer Signature Golf Course. Personally designed by the legend of the game, the 18-hole championship course includes 13 holes that wind along the Wando River and Horlbeck Creek. The 7,200-yard venue provides spectacular challenges meant to deliver a memorable golfing experience to every player.

Tour of Middleton Place

www.middletonplace.org



Our guest/spouse tour and lunch will take place at Middleton Place, an estate known for its history and beautifully landscaped gardens.

Participants will be able to visit the Middleton Place House, built in 1755, and the Plantation Stableyards. An authentic Low Country lunch will be provided.

Reception and Dinner

The Old Exchange & Provost Dungeon
www.oldexchange.com

Our closing reception and dinner will take place at The Old Exchange & Provost Dungeon, a beautifully restored 18th century structure that has served as custom house, pirate prison, and meeting hall.



Provost Dungeon



To register:

- ▶ For copies of the conference and hotel registration forms, go to www.AAISonline.com or call Joe Harrington at 800-564-2247



Tort reform

Will it be rolled back?

It has been more than 20 years since the hard market in commercial liability insurance that was dubbed the “Insurance Crisis” by consumer media and the general trade press.

The crisis brought the cause of tort reform to public consciousness and, ever since, the campaign to place limits on jury awards, non-economic damages, “venue shopping,” and

the use of certain legal doctrines has been a high priority for insurers and other industries.

“The basic assumption was that insurers would face less underwriting uncertainty in states that enacted reforms, which would translate into lower insurance premiums, higher profitability for insurers, and a greater willingness to underwrite risky lines of business,” reads a 2004 report entitled *The Effects of Tort Reform, Evidence from the States*, by the U.S. Congressional Budget Office (CBO).

“If liability reforms worked as intended, they would lead to reductions in both the magnitude and occurrence of damage awards and would have an immediate impact on insurance losses.”

The campaign achieved considerable success over the years, with numerous states limiting or eliminating the doctrine of joint and several liability, where a party with a small portion of the blame for an injury can end up paying for most of the loss—usually through liability insurance.

Other reforms enacted include:

- Limitations on punitive damages and non-economic awards, such as awards for “pain and suffering,” which could be assessed far in excess of actual monetary damages;
- Limitations on the interest rates that could be charged for prejudgment interest, the amount of interest that could be earned on a monetary award between the time of an injury and the handing down of a judgment;
- Increased recognition in trials of “collateral sources” of recovery for plaintiffs;
- Changes in product liability law to give manufacturers more ability to defend against claims when they are not culpable; and
- Reforms regarding appeal bonds and jury service designed to help defendants compete on a more level playing field than previously.

The cause of tort reform reached a significant milestone—some might say a high-water mark—with the enactment in 2005 of federal laws limiting the amount of non-economic damages in medical malpractice cases heard in federal courts, and imposing federal standards on class action suits.

Changes

Things changed in 2006.

With the election of a Democratic Congress, and increased numbers of Democrats in state legislatures, critics of tort reform feel emboldened to challenge its fairness and effectiveness, particularly as it comes to lowering insurance rates.



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For years, consumer advocates have argued that tort reform has had little, if any, impact on insurance rates for consumers.

A 1999 report from the Center for Justice & Democracy (CJ&D) entitled "Premium Deceit" claimed that "trends in rates/loss costs do not support the hypothesis that 'tort reform' has succeeded in holding down insurance costs or rates."

"The basic assumption was that insurers would face less underwriting uncertainty in states that enacted reforms."

— *The Effects of Tort Reform: Evidence from the States*, by the U.S. Congressional Budget Office (CBO), 2004

The report was authored by J. Robert Hunter, director of insurance for the Consumer Federation of America, and Joanne Doroshov, executive director of the CJ&D. Hunter and Doroshov analyzed adjustments in liability rates and loss costs from 1985 through 1998 by the Insurance Services Office, Jersey City, N.J.

They concluded, among other things, that "states with little or no tort law restrictions have experienced the same level of

insurance rates as those states that enacted severe restrictions."

In a 2002 rebuttal of "Premium Deceit," the American Insurance Association (AIA) stated that, "The insurance industry never promised that tort reform would achieve specific premium savings, but rather focused consistently on the benefits of fairness and predictability."

In a changed political environment, supporters of tort reform may be challenged to demonstrate the benefits of tort reform, and to whom those benefits accrue.

The prospect of a legislative roll-back of tort reform seems remote, because tort reform advocates have been largely successful in convincing the public that the civil justice system is abused to enrich plaintiffs and attorneys.

(Tort reform critics argue that this mindset was created by sensationalizing individual lawsuits or judgments that appeared to be outrageous, without providing the full context of a complaint or fully explaining the final disposition.)

There is a much greater possibility, however, that tort reform measures may be struck down by courts and not reinstated.

Before insurers jump to the defense of tort reform, they may want to know: Has tort reform worked, and has it served the industry's interest?

Costs

In its “2006 Update on U.S. Tort Costs,” Tillinghast, the actuarial consulting arm of the reinsurance firm Towers Perrin, reported that the rate of tort costs growth in 2005 was 0.5%, one of the lowest ever recorded. This comes after 20 years during which the tort costs as a percentage of gross domestic product had essentially leveled off, after nearly doubling as a percentage of GDP from 1960 to 1985.

In a 2005 report on “Recent Legislative and Judicial Trends Affecting the U.S. Casualty Industry,” the international brokerage firm Guy Carpenter stated that: “Overall, we would suggest that the U.S. tort system is less hostile and is providing a more level playing field for corporate defendants and their insurers . . . Recent developments on the federal and state levels may have positive effects for U.S. corporations and their insurers.”

In its 2006 update to the report, Guy Carpenter added that “reforms achieved over the years appear to have had a restraining impact on the growth rate of tort costs.

“With continued progress expected at the federal and state levels, it is not too unrealistic to expect that soon we may experience an overall decline in tort costs.”

If tort costs are indeed stabilizing, however, Tillinghast is not so sure that tort reforms deserve the credit.

“It’s difficult to say whether tort reform measures have impacted this slowdown in tort costs,” says Russ Sutter, a principal in Tillinghast’s St. Louis office, and one of the principal authors of the tort costs study, in a company statement.

According to Sutter, the principal cause of the overall decline in tort costs has been the decline in frequency of auto accidents, which constitute the largest component of U.S. tort costs.

Insurers contacted for this article said that tort reforms contributed to making a market attractive for writing liability insurance, but most thought that other factors—such as rate levels, terms and conditions, and interest rates—were more important factors.

“Tort reforms over the years appear to be having an incremental impact on insurance claims,” says Andrew Marcell, managing director of Guy Carpenter’s casualty and professional liability specialty practice.

Studies

“Inflation-adjusted growth in paid claims is less than 1% per annum,” Marcell adds. “General liability has become a more attractive line.”

There are studies claiming to demonstrate that tort reform has contributed to reduced claim cost and volatility in general liability insurance.

According to the CBO report, a 1993 study demonstrated that modification of joint and several liability, caps on punitive and non-economic damages, and other reforms enacted in 1986 reduced losses by 10.1% and premium levels by 9.1%. Reforms enacted the following year were found to produce reductions of 4.6% and 4.3%, respectively.

Similarly, a 1998 study “found that damage caps and other reforms reduced insurance companies’ costs and the premium they charged, which at the same time increased profitability.”

Kip Viscusi, professor of law, economics, and management at the Vanderbilt University Law School, was one of those authors, and he tells *Viewpoint* that tort reform has undeniably improved market conditions for general liability insurers.

“Tort reforms, such as limits on non-economic damages and caps on punitive damages, have reduced losses in general liability insurance,” he says.

“To the extent that these caps and limits affect very large awards and the most volatile components of awards, they also make loss levels more predictable,” he continues. “From my vantage point, the primary goal of tort reform should be to enhance the predictability of losses rather than simply lower loss levels.”

The importance of predictability in losses is supported by statements from Scott Harrington, a professor of insurance and risk management at The Wharton School at the University of Pennsylvania.

In a 2004 paper, Harrington wrote that, “A number of studies [has] stressed that increased uncertainty associated with tort rules and jury awards [in the mid-1980s] increased the amount of capital needed to back coverage and, therefore, the cost of capital.”

The paper adds that, “an expanding tort liability system that entails substantial uncertainty about the cost of future claims will inevitably lead to increasingly expensive coverage.”

General liability insurers who are not sure of the benefits of tort reform for their operations may want to find out fast, lest they find out the hard way as reforms are scaled back. ■



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- 1996 Worked in conjunction with the Florida Office of Insurance Regulation to develop evaluation procedures for the assignment of FSRs to newly formed P&C companies.
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>> AAIS NEWS

AAIS speakers to address NAMIC seminars

Two AAIS vice presidents have been selected to lead sessions at underwriting seminars sponsored by the National Association of Mutual Insurance Companies (NAMIC).

Robert Guevara, AAIS vice president of inland marine, will address two breakout sessions at the NAMIC Commercial Lines Underwriting Seminar, Feb. 28 to March 2 in Chicago. On Thursday, March 1, Guevara will speak on "Demystifying Commercial Output Coverage." The following morning, March 2, he will lead a presentation entitled "Understanding Current Inland Marine Coverage Issues for Construction Risks."



Susan Luecke, assistant vice president for personal lines, will lead two sessions on homeowners insurance issues at the NAMIC Personal Lines Marketing & Underwriting Seminar, April 18-20 in Savannah, Ga. On Thursday morning, April 19, Luecke will discuss property coverage issues and the AAIS response to them in the 2007 revision of the AAIS Homeowners forms. A companion program on liability issues and the AAIS response will follow later in the morning.

For information on the conferences, and to register, go to www.namic.org.

AAIS files loss costs for terrorism coverage in Commercial Properties

AAIS is introducing loss costs for pricing terrorism coverage in its Commercial Properties Program.

A countrywide manual supplement filing, now underway, will substitute the new loss costs, based on modeled data, for rating factors currently filed for use in pricing "certified" terrorism losses that are reinsured under the federal government's Terrorism Risk Insurance Program (TRIP).

At the same time, loss costs are also being introduced for "non-certified" terrorism losses (those that are not reinsured under the federal program), and for terrorism losses that may occur after TRIP terminates but before the end of a policy period. Rating procedures are provided for both physical damage and business income coverage.

With this filing, AAIS also introduces terrorism rating zones in some states. Where applicable, the zones are defined on the basis of ZIP Code.

For information on affiliating with AAIS for use of its Commercial Properties Program, contact Rick Maka, director of marketing, at rickm@AAISonline.com or by calling 800-564-AAIS.

Personal and Farm Inland Marine programs available separately

AAIS has divided its Personal Inland Marine (PIM) Program for filed classes into two separate, updated programs.

In addition to revised PIM forms and rating information, a new Farm Inland

INDUSTRY NEWS

STAFF UPDATES

TECHNOLOGY

MEMBER COMPANIES

INDUSTRY MEETINGS

Marine (FIM) Program is being introduced for use with AAIS

or independent insurance programs for farm and agricultural accounts.



The new farm program includes updated farm machinery and livestock forms and rating information previously provided under the personal program, but also introduces forms and rating information for a newly developed farm irrigation equipment class.

While the language in the FIM forms address both family farms and commercial farming ventures, the farm program's policy terms and conditions are patterned primarily after those used in commercial lines.

Along with the new farm program, a revised Personal Inland Marine Program has been filed with updated forms, new optional endorsements, and revised schedules. The revised PIM forms include built-in optional coverages previously available as separate endorsements.

Each program provides a revised countrywide manual, and both are being filed with a proposed effective date in most states of June 1, 2007. Also, companies currently using the AAIS Personal Inland Marine Program can continue using the updated PIM and new FIM for the cost of one affiliation.

This latest enhancement to AAIS's inland marine offerings completes the process of updating all AAIS inland

marine programs, filed and nonfiled, to utilize common policy structures and provisions that meet the latest regulatory requirements and market expectations.

For information on affiliating with AAIS for use of its inland marine programs, contact Rick Maka, director of marketing, at rickm@AAISonline.com, or by calling 800-564-AAIS.

Treatment of terrorism modified under Farm Umbrella Program

AAIS has withdrawn several terrorism endorsements and notices, and modified two others, under its Farm Umbrella Program.

The decision to do so came after analysis of the U.S. Treasury's final rule regarding extension and modification of the federal Terrorism Risk Insurance Program (TRIP).



Farm multi-peril coverage was originally covered under the federal terrorism reinsurance program when it was created in 2002, but removed from TRIP under an extension enacted in 2005. The application of umbrella policies to underlying exposures was clarified by the final rule issued in late August 2006.

In light of federal action, AAIS has determined that the program's "make available" requirement no longer applies to farm umbrella policies. Hence, several endorsements and notices related to the program will be withdrawn over coming weeks.

Also, two endorsements are being revised to state explicitly that federal terrorism reinsurance does not apply to commercial auto or farm multi-peril losses, two types of losses covered under the original TRIP but subsequently removed from the program.

Affiliates will be informed by bulletin of action taken in individual states.

Revised manuals being filed under Homeowners Program

AAIS has begun a countrywide filing of a revised Homeowners Program manual developed to support revised forms and endorsements due to take effect in a number of states around the middle of this year.

Among other things, the revised Homeowners manual provides rating factors for optional coverages in its countrywide section, with state exceptions to the factors provided in separate state manual pages. Those state pages also provide exceptions to rules, additional rules, territorial definitions, and loss cost rating information specific to each state.

In other important enhancements, the revised Homeowners manual will display rating information for optional liability coverages in factor rating formats, and will provide rules and rating information for new optional coverages for association deductibles, residents of assisted living facilities, and students living away from described premises.

>> AAIS NEWS

Loss estimate supplements issued for Commercial Liability

AAIS has issued a new Loss Estimate Supplement for the AAIS Commercial Liability manual.

Previously referred to as the “Guide (a)” manual, the supplement includes estimated loss information and corresponding rules for risk classifications that are included in the countrywide Commercial Liability manual but not in the state rating pages.

Certain classifications may not have standard rating information if the risks within the class display a large variance in their characteristics or their probability of loss. Also, there may not be rating information for classifications that are so hazardous that no loss cost could be developed, or those for which credible statistics are not available due to a low number of risks.



A number of states permit AAIS to distribute the Loss Estimates

Supplement without taking filing action. In those states, however, companies must be prepared to document how a premium was developed and make the documentation available to state insurance departments upon request. AAIS bulletins provide detailed information regarding company action associated with the Loss Estimates Supplement.



AAIS preparing filings to address Florida windstorm mitigation requirements

AAIS is preparing filings in Florida to comply with a regulation that mandates premium discounts for implementation of specific windstorm mitigation factors.

Under the revised regulation, rate filings submitted on or after Jan. 1, 2007 for programs that provide residential property coverage must include revised windstorm mitigation factors. All insurers must submit filings by March 1, 2007.

AAIS is preparing filings under its Businessowners and Commercial Properties programs, both of which can be used to provide coverage for condominium and other residential buildings, as well as its Homeowners and Dwelling Properties programs. Affiliates will be informed by bulletin as the filings are approved.

The AAIS Mobile-Homeowners Program is not affected by the regulation, as it has separate loss mitigation discounts for manufactured housing.

Sample transition rule supplement released for Commercial Liability

AAIS has released a revised sample transition rule and manual supplement under its Commercial Liability program. The rule is designed to help minimize the effect of rate level changes that may occur as affiliates convert from the traditional state-specific manuals to the newer countrywide manual that uses inflation-sensitive rating bases.

Among other things, the revised supplement clarifies that the transition rule is intended to cap premium charges at the policy level, and it explains the implications of the transition plan for policies subject to audit.

AAIS conferring with West Virginia over new regs for farm mutual insurers

AAIS is conferring with staff from the West Virginia Department of Insurance over the product implications of new regulations on farm mutual insurers. Under legislation enacted in 2006, West Virginia farm mutual insurers will now be required to renew their certificates of authority every year. In the process of doing so, they will have to report on the amount of business they write in “underserved areas.”

Among other things, the new law imposes restrictions on the types of liability coverage farm mutual companies can write, even with a liability extension to their certificate of authority. AAIS staff is seeking to clarify the nature and extent of those restrictions as they apply to watercraft and certain motorized vehicles, and will be advising affected affiliates by bulletin as questions are clarified.

AAISdirect offers audio commentary

AAIS now offers audio commentary to users of the *AAISdirect* Internet service with a weekly series of “podcasts.”

Initially, the podcasts will be posted on Fridays and briefly describe the bulletins issued by AAIS for the week. In 2-3 minutes, these commentaries will provide *AAISdirect* users with an



overview of product-related developments for the week, and indicate which bulletins need immediate attention.

The podcasts will be provided as mp3 files which can run on most computers with Internet access. To run them, users of *AAISdirect* can simply click on an icon on the *AAISdirect* home page.

AAISAlert seeks input on emerging exposures

AAIS invites property/casualty professionals to submit their observations and concerns regarding emerging exposures through our new *AAISAlert* web page.

The *AAISAlert* online submission form asks users to describe new exposures they are concerned about, indicate how they address the exposure or plan to address it, and how it is likely to affect AAIS programs. One need not be a member of AAIS to participate.

Ideas generated through *AAISAlert* may be incorporated into AAIS’s program revisions, and may also become topics for AAIS meetings.

For more information, contact Joseph Harrington, AAIS director of corporate communications, at joeh@AAISonline.com. ■



continued from page 9

“It is important to find out who would ultimately be responsible for any interruptions or surges, especially [since] power outages and/or surges caused by a farmer’s electric generating equipment could be dangerous to electric company line workers.”

“Digesters can reduce the pollution risk of a livestock enterprise [and] there is much less odor associated with the digester process.”

— James Bessler, AAIS manager of farm and agricultural programs

On your own

While manure digesters present farm insurers with several new property exposures, they appear to reduce general liability exposure, says Bessler at AAIS.

“Digesters can reduce the pollution risk of a livestock enterprise,” he says. “The waste is more contained than when it is stored in a pit or lagoon.

“With that,” Bessler adds, “there is much less odor associated with the digester process” and, thus, less of a chance that a farm will be the target of a nuisance suit by its neighbors.

While manure digesters have spread rapidly enough to catch the attention of farm insurers and reinsurers, Bessler says there haven’t been enough of them for a long enough time to develop loss costs and a specialized coverage form to address the risks they pose.

For the time being, at least, insurers are largely on their own to value and schedule the unique property and income exposures presented by the digesters they encounter, and to insure it as scheduled farm property or through a commercial property endorsement. ■

AAISdirect continued from page 11

In the latest enhancement to *AAISdirect*, companies affiliated with AAIS for its Agricultural Output, Businessowners, Commercial Output, and Commercial Properties programs can have access to e2Value's "Commercial" property valuation program.

Among other things, the Commercial valuation service provides data for all major construction specification items (HVAC; wall, roof finishes; plumbing and fire protection) plus the ability to value multiple structures, with photos, within one valuation.

These online services, provided without additional charge to *AAISdirect* users, allow carriers to identify hazards and estimate insured values quickly and systematically, helping them improve their insurance to value ratios and collect the appropriate premium for their exposures.

"It is clear to us that AAIS is highly focused on satisfying the needs of their affiliates and presenting them with cutting edge service and technology-based opportunities," says Todd Rissel, CEO of e2Value, Inc. "We're pleased to expand our relationship with AAIS for the benefit of the insurance industry."

"We are excited to be working with AAIS and its member companies," says James Munson, director of consulting services for CDS. "The value provided with this service will help companies maintain underwriting discipline without substantial changes to their own underwriting processes."

In the accompanying segments, Rissel and Munson respond to questions posed by *Viewpoint* regarding future developments related to their services. ■

e2Value continued from page 10

Finally, in all three areas--personal, commercial, and farm lines--users of risk mapping can earn a considerable return when it comes to negotiating for reinsurance. The more information you provide, the quicker it gets done and the better your rate.

How is the widespread use of risk mapping applications affecting insurance underwriting operations?

Risk mapping is improving both the efficiency and accuracy of underwriting operations.

Companies make great efforts to develop rules for pricing and underwriting. Once those rules are in place, they need access to timely, accurate information. Risk mapping is a natural fit. Once a location is identified, there are dozens of pieces of information that can be used to price the risk correctly, apply deductibles, bind the coverage, or deny the coverage.

Furthermore, as companies embrace real-time web-based services, benchmarks can be established, reviewed, and revised quickly as needs arise. Companies that do not embrace these technologies will fall further and further behind the competition.



What changes do you anticipate in the future regarding the capabilities and use of risk mapping applications?

- Improved accuracy. In the future, parcel level geocoding will be the norm. With higher resolution aerial imagery, you will literally be able to see each insured location clearly
- Integrated web services. More and more companies are realizing the value and ease of receiving information in near real time through server to server communication. This, again, leads to huge improvement in efficiency.
- Straight-through processing. You can have the greatest rules-based engine in the world, but without information to feed into it, the benefits will not be realized. The more business you can bind without a person touching it, the larger your gross and net premiums will be.
- More data. As more data is developed and introduced, insurers will be able to further segment business and classify risk with more objectivity. Remote sensing, real time weather feeds, and real time aggregation are possibilities for the future. ■

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For more information, contact Joseph Harrington, director of corporate communications at joeh@AAISonline.com or by calling 800-564-AAIS.

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