SHORTFALLS OF GROSS SALES RATING

The topic I will be discussing today is the impact that gross sales rating has had upon marine underwriters. The soft market conditions that have been in effect for the past 10 years is a cyclical occurrence that is the result of an over capacity in the marine insurance market. The result of the over capacity in the marketplace is much like a buyers market in the housing/real estate market. Underwriters are chasing premium to make budget goals and due to numerous markets looking at the same risk the temptation to offer a deal seems to be what underwriters are willing to do to land a piece of new business. I will admit that the majority of the policies in force are now written on a sales rated basis, principally due to the long duration of the soft market, however the underlying concept of the marine open cargo policy needs to be kept in mind:

The policy of marine insurance is a policy intended to make whole the Assured in the event of a recoverable loss occurring and acting as a financial safeguard against a marine loss from having a ruinous impact on an Assured’s operation and also gives banker’s and other loan facilities the comfort that their interests are being safeguarded as much as is reasonable.

However the advent of sales rating policies has obscured the understanding of ‘equitable’ and has caused confusion in numerous ways and I will try to elaborate some of the problems that have developed as respect to:

EXPOSURE
VALUATION
DEDUCTIBLE & WAIVER OF CO-INSURANCE
OTHER CLAUSES IN THE OPEN POLICY
RECOVERY ASPECTS

The principal of creating a premium for a known exposure is a sound principal, however, the only real paralleling of an exposure to gross sales exists at the time the account is written. Without continuous updates and amendments that each endorsement to the policy could have as respect to exposures, the underwriter is left at an agreed premium charge that may be dramatically altered by changing exposures during the term of the policy. The invention of ‘sales’ rating has caused a barrier to form between the Assured’s transit exposures and the underwriter with regard to understanding all of the ongoing exposures involved in an importing or exporting operation that the ‘sales’ fail to address:

EXPOSURE

• Wearing apparel accounts can have the fabric shipped from mills overseas directly to the processor in a developing country where the goods are to be sewn together, which may be in the area of 25% of the annual sales. The goods being shipped on a cross voyage from the overseas mill to the processor in Central America, Caribbean or some other developing country is a significant exposure and as stated could be about 25% of
the ‘sales’ values. Once the goods are completed and shipped back to the United States the sales price value could be exposed for the marine voyage. If the underwriter has only been furnished with an annual sales figure they may not understand that the correct exposure, due to the first leg having been a cross voyage and not directly related to the ‘sales’ values.

- On wearing apparel accounts the shipments to a country and the completed products from that same country can be further influenced by the recent trend for textile manufacturers to ship to processors pre-cut pieces of fabric. This exposure adds an additional leg to the transit exposure; meaning that the fabric is sent to the Assured in the US and cut with the aid of computer guided machines and then sent to the processing location for final assembly. The reason for the recent change in the fabric being cut before it is shipped is two fold:

  First, the use of computer guided cutters allow for the maximum utilization of the fabric being sewn and reduces the non-useable fabric to a minimum.

  Secondly, the processors are normally independent operations for hire and some individuals in the garment trade have felt that cutting operations being done in the processing country were not making the best use of the fabric and that the overage was being consumed and used by the processor.

- The processing of wearing apparel in a foreign country is a common exposure for a marine underwriter and underwriters may know how to develop the missing information that is obscured by having only a sales figure presented, where the processing coverage is being requested. One must keep in mind that the exposure could range from FOB the vessel in the Far East directly to the US or could involve high valued raw materials being shipped to Eastern Europe and transit from there to the US. On a sales rated account the underwriter may never know what exposure exists unless they are inquisitive and require a detailed understanding of what exposures exist.

- A more convoluted situation exists on drug and chemical exposures that are presented on a gross sales basis. There are exposures that move numerous times during different procedures and none of the transits involved except the last leg of the journey are indicative of the ‘sales values’. There have been accounts submitted that have had raw material obtained and blended in Sweden then shipped to a plant in Germany for sophisticated processing and then finally shipped to Italy for packaging and then shipped to the US. Needless to say the ‘sales’ figure was not indicative of the exposure to the underwriter.

- Drug and chemical companies have patents and continual product development because once a product has been in the market place and established its share of the end users the ability to continue to produce an adequate profit are harder and harder to obtain. These market conditions create the need to have expenses as low as possible so there is a strong desire to have labor performed where it is least expensive. However,
the machinery to do the processes may not exist locally, so the companies ship the machines to the developing country so that the cost of labor will be as inexpensive as possible, but the underwriter with the sales rated policy will unwittingly entertain the machinery shipment with no premium; due to the machine not being intended to be sold. When the machine is past its useful life the underwriter can again have the privilege of insuring the machinery again for no premium, but at least it is hoped this time that the underwriter is responsible for only Named Perils.

- Another example of when ‘sales’ are not indicative of the exposure is when there are inter-company shipments. This causes a real under estimation of the exposures due to the fact that none of the values shipped may result in ‘sales’ upon which the account has been evaluated. An example would be where an account has multiple product lines and that in order to benefit from cross selling or expense savings a single plant or company may perform operations to a multitude of goods that are then shipped back to the initial company and the sent out to final destination. The underwriter would not be able to discern from the sales figure if such an exposure existed. The traditional reporting policy informs underwriters of where goods are once shipped. Large accounts, where the Assured lacked their own overseas operations, had shipments made and shipped close to their final destination and after the overseas transit was completed the coverage ceased as the goods were moved into inventory. The reduction of expense dollars have eliminated this aspect to a great degree and high inventories have been reduced to ‘lean mean machines’ which with the advent of ‘just in time’ shipping have created a scenario where the merchandise is shipped as efficiently as possible and the final sale may occur after two or three transits have occurred on every ‘sales’ dollar. Multinational companies are now eliminating the redundant processing of goods and shipping from single sources as a way to reduce expenses. While this may appear to increase shipping costs, the advent of the Ocean Shipping Reform Act has given large shippers the ability to negotiate shipping rates and terms that would offer savings to the larger shipper.

**VALUATION**

While values being reported for premium purposes does not indicate a loss settlement will be paid on the same basis, it is surprising how many accounts feel it is what they should be paid; regardless as to amount of work performed as of the date of loss. The justification for this concept is that in the past the values reported under a traditional reporting open policy and the amount recoverable in the event of a claim occurring were based on the same calculations. A problem can occur if the policy states that the goods and/or merchandise will be valued at sales price, because raw goods that have not been processed could still be construed to be entitled to a sales valuation in the event of a claim, should the underwriter fail to exclude ‘unincurred costs’.

The most equitable way to address the valuation of the goods at any one point in time is to have a valuation clause that will start at the sales price and then deduct all unincurred charges as of the time of loss in order to re-establish the principle of an equitable settlement. Losses which occur before the goods can be fully processed always cause a problem, but if the Assured can demonstrate that the goods have been sold or
made on consignment, which would result in a lost sale then the underwriter has to respond to the financial loss in excess of the physical loss. If in the event the goods are unsold the piece goods or merchandise could be valued at a standard invoice cost plus a percentage of advance.

It has become common on marine open policies covering wearing apparel accounts for the value of completed goods to be valued at sales price and thereby benefit Commercial Property underwriters by excluding the Business Interruption exposure on goods processed overseas. The competition in the marine market has extended to cover the increase in value, often accompanied with a reduction in premium.

Machinery exposures on an account where they were never contemplated when the account was written would be difficult to have the valuation reflect other than the Used Machinery Clause, which would be the cost of the part or parts lost as it relates to the value of the entire machine, but limited to the value of the entire machine. If the machinery being shipped is new then there would not be too much of a problem; except that the underwriter isn’t going to be any premium for the risk due to the goods not being intended for sale.

Drug and chemical accounts have valuation problems when written on a sales rated basis because there may be overseas locations that would consider the value of the goods at sales price, but the originator may want to have the damaged goods valued at replacement cost. These different points of view seem to be more prevalent as the inventories being maintained are as low as possible, which can cause the loss of a sale if in the event the goods do not arrive intact and without the ability to draw down from existing inventories.

DEDUCTIBLE & WAIVER OF CO-INS.

The application of the deductible on claims is the same on a sales rated account as a traditional reporting open policy, however, the waiver of co-insurance clause is eliminated on sales rated accounts and the application of co-insurance is an aspect that the underwriter must deal with because it would have an impact on the amount of the claim should the value of the shipment involved exceed the policy limit, due to the sales rating eliminating the ability for the underwriter to obtain premium on the values in excess of the policy limit.

OTHER CLAUSES IN THE OPEN POLICY

The dangers of an account are not recognizable when the only information available is the sales figures. Wearing apparel accounts are further enhanced as respect to their volatility when one adds the inclusion of consequential coverage when all the underwriter has as information submitted is the annual sales figure. Compound the exposure with a ‘control of damaged goods clause’ where the Assured is the ‘sole judge’ as to the determination as to the extent of loss and the smallest partial loss now has the potential for becoming a loss far in excess of the individual shipment value and undermining the intent of a fair and equitable settlement.

An example of typically offered clauses that could result in losses far in excess of what the underwriter was contending to bear would the inclusion of the following clauses:

- Debris Removal
• Extra Expense
• Consequential loss
• Control of Damaged Goods
• Expediting Expenses
• Warehouse Coverage

While each of these clauses can be underwritten and offered where the exposure is fully understood and continuously evaluated it is almost impossible with only gross sales being submitted to fully appreciate the exposures.

RECOVERY ASPECTS

In the event of a recoverable claim occurring, it must be remembered that in the event of a loss aboard a vessel the only amount the underwriter is able to use in subrogation proceedings is the invoice cost so any significant increase in the valuation will be uncollectable as respect to potential recovery proceedings. With sales price valuation there is typically a minimum of 50% of recoveries that are precluded before any recovery proceedings begin.

The underwriter should fully understand the ramifications of cross voyages and vessel carriers utilized, which may reduce the amount of recoveries by having a convention of liability other than the Carriage of Goods By Sea Act (COGSA).

Underwriters should also be aware of any carrier’s local laws or foreign arbitration clauses contained in the bill of lading that could have a damaging impact on the potential recoveries and the enhanced costs that will be required in order to effect recoveries.

Also carriers may have entered into contractual agreements with the shippers and eliminated or reduced the rights of subrogation in return for reduced freight rates under the Ocean Shipping Reform Act.

In the competitive market the profits being demanded cause every account to handle exposures in manner as cost efficient as possible. Once a market is saturated and the profit margin maximized, the accounts are forced to branch out to new exposures in order to out perform their rivals. The sales rated account quickly losess its relevance to exposure as the accounts evolve into exposures never know to the underwriter. The underwriter may never know about new products or trades if they have neglected to be proactive and to listen to Assured as to what changes have occurred from the initial understanding.

Without being proactive and understanding the exposures fully the only recourse the underwriter has in the event the account becomes unprofitable is to make broad sweeping changes that may be resisted because the Assured may feel they only have a problem with a specific exposure. But with the loss of the shipment and volume information the underwriter’s ability to analyze the account is one-dimensional and actions taken are typically implement ‘across the board’. Such actions are hard to understand on a class of business where every policy has the ability to be manuscripted.