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Lease Insurance:
A Solution to an Escalating Problem—Part II

In the last issue of the Monitor, Steve Dinkelaker of American Lease Insurance discussed the benefits that lessor-sponsored lease insurance programs can bring to equipment leasing companies and their small business customers. In Part II, Steve offers an in-depth look at the emergence of professionally directed lease insurance programs to manage insurance risks in the small-ticket leasing segment.

By Steve Dinkelaker

In the last issue of the Monitor, I discussed the benefits that lessor-sponsored lease insurance programs can bring to equipment leasing companies and their small business customers. Essentially, lease insurance programs provide equipment lessors with a means of strengthening portfolio values through insurance clause enforcement while earning legitimate additional fee income from program administration. To small business lessees, lease insurance offers significantly better and cheaper coverage than is available through typical commercial insurance agents and carriers.

These benefits have taken on greater importance in the present insurance market, which has experienced sharp premium hikes, narrowing coverage, and declining numbers of small businesses able and willing to meet insurance obligations. To small business lessees stunned by dramatic increases in their business insurance costs, the hallmark features of a standard lease insurance program — full replacement cost coverage and fixed insurance charges (set at the same premium level for the entire term of the lease) — offer a strong incentive to them to purchase lessor-provided lease insurance on their leased equipment. Accordingly, professionally designed and managed lease insurance programs offer equipment lessors a significant value-added service that not only ensures lessee compliance with contractual insurance requirements, but also adds meaningful strength to lessor portfolio values.

In this article I will provide an in-depth look at the emergence of professionally directed lease insurance programs to manage insurance risks in the small-ticket leasing segment. I will also evaluate several lease insurance program variants that have developed in the last decade, as well as certain substitute forms of lease insurance, which I believe may pose unnecessary marketing, underwriting, legal, or regulatory risks.

The Development of Outsourced Lease Insurance Programs

Historically, the first lease insurance policy was developed in the 1980's in response to a market need for specialized small-ticket equipment coverage. Until that time, few small-ticket leasing companies had bothered to enforce the insurance clause requirements in the standard lease agreement, due to the widespread unavailability of lease insurance coverage tailored to the needs of the small-ticket market.

Because leasing companies lacked experience in designing or administering insurance programs, the first lease insurance program model was developed by insurance professionals. Still prevalent in the leasing industry, this model involves the lessor's delegation of its insurance monitoring function to an outside professional lease insurance program manager. This manager[1] must first source an appropriate lease insurance policy — a process that requires negotiating customized policy terms with an appropriate insurance provider, which then files the resulting policy with appropriate state regulatory authority. The manager then communicates with lessees on the lessor's behalf by mail, assesses lessees' insurance clause compliance (or lack thereof), processes coverage under the lessor's policy, provides customer service to lessees and their insurance agents, handles claims under the lessor's policy, and monitors lessee-provided alternate insurance for expiration or cancellation during the lease term. The billing and collection of insurance charges from those lessees who use lessor-provided coverage — which an outside insurance manager cannot perform as efficiently or effectively — are retained by the leasing company, which thereby earns additional fee income.

Lease insurance programs succeeded because their advantages were obvious: outsourced handling of burdensome insurance monitoring, resulting in strengthened portfolio values coupled with a legitimate opportunity to earn additional fee income by providing value-added billing and collection services.

Recent Improvements in Outsourced Lease Insurance Programs

Enhanced Coverage. Initially, lease insurance was limited to property insurance coverage primarily on office equipment, which typically comprised copiers, telephones, computers, and other similar equipment — those classes of equipment least likely to develop third party liability insurance claims. With the latest lease insurance policies, property insurance has been augmented with coverage for lessor liability. This enhanced coverage extends lease insurance programs to classes of equipment posing concerns to lessors, as owners of the equipment, about the potential for liability. Medical, construction, restaurant, garage, and other equipment that have potential to cause property damage or bodily injury to third parties can now be covered by lease insurance. This enhancement effectively extends lease insurance program applicability to virtually all equipment types (exclusive of rolling stock).

No Lessor Premium Advances. When lease insurance programs first started, lessors were required to advance full-term premium on behalf of covered leases. Lessors recovered their advances by including principal and interest in the lessees' fixed monthly insurance charges. Prompted by concerns over the possible application of state premium financing statutes to some lessees,[2] one large lessor employed a third-party financing entity to advance premiums on its behalf — a practice that has now been extended to almost all lease insurance programs. At present, the typical lease insurance program does not require the lessor to advance any premiums, thus relieving the lessor of what can otherwise constitute a significant financial outlay.[3]

Systems Integration. Until recently, most lease insurance programs required participating lessors to make substantial modifications to their lease accounting software in order to accept billing data for the remaining terms of covered leases. (Alternatively, the lessor would have to manually re-key all its billing data). Newer programs provide for fully integrated export and import of both billing and collection data between the insurance manager and lessor. This eliminates the burdensome task of reconciling amounts collected in the lessor's systems with the amounts billed in the manager's systems. Complex systems integration that once took months to complete can now be accomplished in weeks.

Reinsurance Participation. Initially, lease insurance policies were sourced from major insurance carriers that took all the underwriting risks and profits generated by the policy. After gaining policy experience, large lessors with high volumes of earned premium began to establish their own reinsurance vehicles in order to share in any underwriting profits on their lease insurance portfolios. Because of regulatory hurdles and the expense of setting up reinsurance entities, lessor participation in underwriting risks and profits has traditionally been limited to lessors with high volumes of earned premium. Recent program innovations, however, have made experience-rated risk and profit sharing available to qualified lessors with more moderate levels of earned premiums.

In-house Lease Insurance Program Alternatives

During the last decade, the fee income opportunities offered by standard lease insurance programs spurred some equipment lessors to develop alternate models to increase their fee income — usually at the expense of one or more standard program benefits. In general, these program variants involved one or more of the following variants: 1) eliminating professional lease insurance program management; 2) eliminating monitoring of lessee-provided insurance, and its associated costs, and 3) eliminating or reducing insurance benefits, especially the "replacement cost" coverage so valuable to small businesses in the event of loss.

In-sourced programs. Lessor efforts at income maximization began with the decision to in-source the lease insurance program and incorporate all stages of program management into leasing company operations. Used by some high volume small-ticket lessors, this step eliminated the involvement of the outside lease insurance manager, leaving equipment lessors to craft new programs for greater income advantage without the guidance of a knowledgeable lease insurance professional.[4] Such lessors generally use their regular insurance broker to act as the insurer's agent in purchasing a lease insurance policy, despite the broker's lack of expertise in lease insurance. Without knowledge of, or involvement with, the administrative details of the lessor's lease insurance program, such brokers are often not qualified to offer meaningful advice on program improvements, policy language, or emerging areas of liability.[5]

Non-monitoring programs. One standard lease insurance program feature to be eliminated in the soft insurance market (prevalent until last year) was the commitment to monitor lessee-arranged insurance coverage. Some large lessors with in-house programs developed a model in which lease insurance charges were imposed automatically, without prior notification. In this model, small-ticket lessees are billed for lease insurance charges on the first computer-generated lease invoice following lease inception, without being given time to provide evidence of alternate insurance coverage. Lessees who protest against automatic-coverage charges are typically excused from insurance requirements after the charges are removed from the bill, even though they have provided no proof of alternate coverage. While this program model retains the insurance coverage feature of standard lease insurance, by excusing non-compliance it leaves a gap in portfolio coverage that reduces the underlying security and value of leased assets.

Non-insurance programs. Another important program feature to be sacrificed to lessor income-maximization goals was the provision of full insurance benefits to small business customers in exchange for insurance-like charges. Some leasing companies developed in-house program models that retained the monitoring and billing functions of the standard lease insurance program, but eliminated or reduced the underlying insurance coverage. Such programs require lessees who do not maintain alternate insurance coverage to pay the lessor a monthly "risk fee"[6] or "property damage surcharge"[7] to compensate the lessor for its risk of damage or loss to leased equipment. Unlike insurance, these programs provide no value or reduced value to the lessee in the event of loss.

Insurance-waiver programs. Another non-insurance program that emerged in the 1990's was the "waiver of insurance" model, essentially a copy of the damage-waiver programs used in the car rental industry. Under this model, the leasing company agrees to waive its insurance requirement in exchange for a "loss damage waiver charge" paid by the lessee. The charge (equal to a lease insurance charge) covers the lessor's cost of replacing destroyed or stolen property, but is not backed by insurance. In the car rental industry, such programs have been prohibited by law in many economically significant states (including New York and New Jersey).

Bundled maintenance programs. A final version of the non-insurance program is one in which a lessor (typically a captive lessor) incorporates an aspect of lease insurance into its extended warranty and maintenance program. Under this model, the equipment replacement feature of lease insurance is added to the parent's maintenance contract, treating the two as a single bundled product. In the event of fire, thpeft, or other covered loss or damage to leased equipment, the "replacement" feature operates as it does in a lease insurance policy. No insurance policy is issued, and payments to the lessor are typically not backed by reserves to pay out projected losses. Whether such a "quasi-insurance" program can pass muster in the highly regulated insurance field without paying appropriate premium taxes to state regulatory authorities remains an open question.

Conclusion

Lease insurance programs generally enable leasing companies to earn extra fee income by providing valuable insurance services to their small business customers. Processing fees for billing and collecting are a standard income-producing feature of both outsourced and in-sourced lease insurance programs. While a leasing company may look to a lease insurance program (or quasi-insurance program) for ever-increasing amounts of fee income, in today's climate it may do so at some peril. In the long run, it appears that fee income programs will succeed in the leasing industry, as they do elsewhere in the financial services sector, by offering legitimate customer value and by meeting applicable professional standards and regulatory requirements. ***m***

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Dinkelaker is credited with the "invention" of lease insurance, having founded and directed Lease Insurance Agency Services Corporation (LIAS) of Bellevue, Washington, the first agency to offer lease insurance programs to equipment lessors in the early 1980s.

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American Lease Insurance (ALI) provides a customized, comprehensive lease insurance program of property and liability insurance coverage and insurance tracking to equipment lessors and lease servicers.

ENDNOTES:

1 The manager must be licensed as either a property and casualty insurance agent or broker, or both, in the state in which the lessor is located.

2 In many jurisdictions, premium financing statutes govern the financing of insurance premiums for consumers. Sole proprietors and other small businesses may be construed in some jurisdictions to fall under statutory protection. A lessor that finances lease insurance premiums on behalf of such lessees may be covered by such statutes. By contrast, a third-party financing agent that advances lease insurance premiums on behalf of the lessor (not an individual lessee) is not subject to premium financing laws.

3 I know of one insurance carrier today that permits lessors to pay premiums on a monthly basis for covered leases. This monthly premium option, however, has an unwelcome side-effect of destabilizing lease insurance coverage. When premiums are advanced on a monthly basis, the insurance carrier typically retains the right to cancel coverage or increase premiums during the lease term due to poor loss experience — an option that can eliminate coverage or raise lessee insurance charges during the lease term. A carrier that forfeits its cancellation and re-rating options when accepting monthly premiums for term coverage engages in unsound underwriting. By using lease insurance with full-term premium advances, coverage terms are fixed and the insurance provider has no right to cancel coverage or increase premiums on covered equipment throughout the lease term.

4 A lessor operating an in-house lease insurance program may obtain an insurance agent's license, but is generally prohibited by state "controlled business" statutes from writing insurance on more than a certain small percent of transactions in which it has a financial interest. This, in effect, makes it impossible for a leasing company to act as its own insurance agent on its lease insurance program.

5 For example, one major lessor with an in-sourced lease insurance program recently settled a class action suit regarding its administrative 'fees' for in excess of $6.5 million.

6 In the "risk fee" model, a fixed monthly fee, calculated on a percentage of the original equipment cost, is charged for each month in which a lessee fails to provide evidence of insurance coverage, ostensibly to compensate the lessor for its increased credit risk in leasing uninsured equipment. Typically, such "risk fees" are a penalty and provide no insurance coverage or benefit to the lessee.

7 In the "property damage surcharge" model, a monthly surcharge (calculated on a percentage of the original equipment cost), is imposed on an uninsured lessee and applied against the balance of lease payments in the event of total loss. The property damage surcharge is actually a form of credit insurance that pays off the balance owing to the lessor at the time of the loss. As such, it provides no replacement equipment to the lessee and does not accord the lessee any accrued equity for lease payments made to the date of loss.