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Lease Insurance:
A Solution to an Escalating Problem

In today's hardening insurance market, leasing companies have a real opportunity to provide a value-added service to their small business customers through a lessor-provided lease insurance program. In general, such a program, when well-designed and properly managed, has several significant competitive advantages over the customary BOP alternative offered to lessees through their own agents.

By Steve Dinkelaker

The cost of commercial property and casualty insurance in all business sectors has soared spectacularly during the past year. Soaring premiums represent not so much fallout from last year's September 11 attacks as an industry-wide effort to recover from more than a decade of under-pricing in the insurance markets.[1] Competitive forces that had long pressured insurers to slash prices and broaden coverage became intolerable when the bull stock market ended in 2000. No longer able to offset underwriting losses with strong investment income returns, property and casualty insurers are taking bold measures to tighten underwriting standards and raise premiums to restore their financial stability.

Small business lessees have been particularly hard-hit by these insurance developments. The escalating cost of premiums — typically rising 50% to 100% or more per year, with similar price hikes likely to continue over the next few years — has been an unwelcome blow to small businesses in a slow economy. The insurance industry's efforts to restore financial stability have made it especially hard for many small businesses to source affordable comprehensive insurance coverage on their leased equipment.

"Going Bare"

In response to spiraling insurance costs, a significant number of small businesses have decided to eliminate some or all of their property and casualty insurance coverage — in insurance parlance, to "go bare." One recent insurance-industry study estimated that 31% of all U.S. businesses with under 20 employees were "going bare."[2] This trend continues to accelerate as financially strapped business owners struggle to survive by cutting back on rising premium expenses. Ominously, such widespread insurance cancellations and non-renewals indirectly affect the value of small-ticket[3] leased equipment portfolios, most often without the knowledge of the leasing company that owns them.

Ironically, the same small business lessees who are cutting insurance protections are those that may need it most. The standard lease agreement insurance clause[4] is intended to protect both the lessor and the lessee against loss or damage to leased equipment assets. Such protection is especially important to small-ticket lessees, whose leased equipment often plays critical roles in the business and who typically lack the financial resources to recover from major catastrophic losses by fire, hurricane, flood, or theft. Without sufficient insurance, a catastrophic loss can put a small business lessee out of business and force the lessor to write off the lease.

Importance of Monitoring Lease Insurance

In today's insurance environment, disappearing insurance coverage poses a largely unappreciated risk to small-ticket equipment lessors. Before funding small-ticket leases, most lessors do ask for, and receive, evidence of sufficient insurance from such lessees — at least above a certain dollar threshold (for example, above $25,000 or $50,000 in original equipment cost). Such evidence may come in the form of a "binder," which provides for only 30 days of coverage, or a "certificate," which typically provides for one year of coverage. Both are normally processed as endorsements to a lessee's pre-existing Business Owner's Policy ("BOP policy"), which is the predominant form of commercial property and casualty insurance available to today's small business lessee.

Even when lessees effect insurance coverage through their own agents and insurers, the insurance certification process itself may lull an otherwise savvy lessor into believing it has adequate insurance protection. A lessee's insurer is not required to provide an "additional insured" leasing company with a renewal certificate after the original binder or certificate expires. Nor is an insurer obliged to give the leasing company notice when a lessee's BOP policy later expires without renewal. The only required notice an insurer must provide to an "additional insured" lessor is when the underlying BOP policy is cancelled during its term, usually for non-payment of insurance premiums.[5] While a typical small-ticket lease may last for three or five years, a standard BOP policy normally covers only one year at a time. Such disconnected lease and insurance coverage terms provide repeated opportunities for a lessee's insurance coverage to lapse without the lessor's knowledge.

A lessor defeats the prime purpose of requiring insurance protection from its lessees at funding when it neglects to monitor insurance status throughout the lease term — neglect that may significantly reduce the real value of its portfolio, especially that part consisting of small-ticket leases. The current insurance crisis compels leasing companies to take lessee insurance obligations more seriously as they look for ways to maintain the value of their small-ticket leased assets. And with increased reliance on banks for funding and capital, equipment lessors are under growing pressure to adopt the monitoring practices prevalent with comparable assets in the banking industry. There, the lender routinely and thoroughly audits all mortgage and vehicle loan assets (regardless of size) for valid and sufficient insurance.[6]

Advantages to Lessees of Lessor-Provided Lease Insurance

In today's hardening insurance market, leasing companies have a real opportunity to provide a value-added service to their small business customers through a lessor-provided lease insurance program. In general, such a lease insurance program, when well-designed and properly managed, has several significant competitive advantages over the customary BOP alternative offered to lessees through their own agents.

One prominent defect in BOP coverage is that it provides the lessee only with reimbursement for "Actual Cash Value" ("ACV") for an equipment loss. ACV is defined as "Replacement Cost" less depreciation. Today, such "Replacement Cost" coverage, although a basic requirement of the insurance clause in the standard lease agreement, is not available from insurers as a BOP endorsement, even for an extra premium. In contrast, a customized lease insurance policy — like ones I have written specifically for the small-ticket equipment leasing industry — will provide for the actual replacement of lost equipment with new equipment under the same lease when there is a total loss. For the lessee, equipment replacement takes considerably less time than processing a BOP policy's ACV reimbursement, enabling the lessee to continue operations virtually uninterrupted. Actual replacement also includes the cost of arranging, delivering, and installing the new replacement leased equipment, no matter when the loss occurs during the term of the lease. Significantly, a lessee covered by such enhanced replacement coverage does not suffer any shortfall in amounts due to the lessor from a loss. This, too, contrasts favorably with a BOP policy's ACV reimbursement, where only the depreciated replacement value is paid for lost equipment and the lessee must make up the deficiency between actual replacement cost and the ACV reimbursement.[7]

In addition to equipment replacement, lease insurance policies generally provide better coverage to small business lessees than are available under their BOP policies, even though lessees are not 'insureds' under these policies. Although the lessor, and its 'assignors' and 'assignees,' are the only insureds under a lease insurance policy, lessees benefit from better coverage when they use lease insurance. Lease insurance coverage is better for lessees (and lessors, too) because it is broader coverage. For example, BOP coverage for 'theft' typically excludes coverage for such losses when there are no visible signs of illegal entry or exit, as in cases where employees or contractors with access to the lessee's premises have stolen leased equipment. In contrast, any illegal taking of leased equipment is covered for losses under lessor-provided lease insurance policies. Besides broader theft coverage, these policies also provide other coverage enhancements for flood losses (available by endorsement to a BOP, for an extra premium) and power surge (not available with a BOP, even with extra premium). I know of no coverage available under a BOP policy that is not provided for under a lease insurance policy.

In the present insurance climate, however, perhaps the most important advantage of a lessor-provided lease insurance program for small business lessees is the competitive insurance charges associated with such coverage. The underlying insurance premiums for lease insurance coverage are stable and should continue that way indefinitely, despite the turmoil in the general commercial insurance market. Because lease insurance effectively combines risks in equipment classes (e.g. computers, machine tools, or construction equipment) across the entire country, an individual lessee's location or individual loss experience is not counted negatively in determining future premiums or the continued availability of coverage. Moreover, a key feature of lease insurance premiums is that they are fixed for the term of the lease for any single lease and cannot be increased. This means that small business lessees using coverage under a participating lessor's program will avoid the sharp increases in the price of coverage now common in the general market.

For lessees with no existing BOP policy under which they can add coverage for new leased equipment (i.e., those who are 'bare'), well over half of these lessees will opt to use lessor-provided lease insurance. A well-designed lease insurance policy — one that fully protects the equipment against loss and the insured lessor against liability claims resulting from the equipment use — allows lessees to secure such coverage at much less expense than they would generally pay through their own agents to satisfy lease requirements. Lessor-provided lease insurance coverage is an effective, economical, and convenient alternative to arranging for a new BOP policy, with monthly insurance charges billed by the lessor on the lessee's regular monthly lease invoices. Even among lessees with an existing BOP policy, more than one third choose to use coverage under the insured lessor's policy, after comparing the comprehensive aspects of such coverage and its associated charges with the more limited BOP coverage and its associated premium costs.

Benefits to Lessors with Lease Insurance Programs

Lease insurance programs were first invented in the mid-1980s for use with small-ticket lessors of copiers, telecommunications, and other office equipment, during the last hard insurance market.[8] Lease insurance program applications today have expanded and evolved to serve the needs of small-ticket lessors of almost all types of leased equipment (with lease insurance coverage on rolling stock still an excluded exception).

In the next issue of the Monitor (on the theme of "Risk Management"), I will provide an in depth look at the varieties of lease insurance programs present today in the small-ticket leasing segment that are used to manage this increasing business risk to equipment lessors. I will also discuss the recent challenges and marketing opportunities facing the increased use of lease insurance by a concentrated group of healthy, surviving, small-ticket lessors, with recommendations for maximizing the value of such programs to all participants. *m*

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NOTES:

1 Wall Street Journal, April 11, 2002.

2 National Underwriter, March 29, 2001. For employers with 20 to 49 employees, 19% were estimated as "going bare."

3 Following the leasing industry standard definition, small-ticket leases are those of less than $250,000 in original equipment cost.

4 This clause requires a lessee, as a condition of the lease, to provide proof of 1) 'all-risks' (now called 'special form') property coverage on the leased equipment for its 'replacement cost,' naming the leasing company as a "loss payee" in the event of loss, and 2) liability insurance for the lessor covering third-party claims for bodily injury or property damage arising out of the use of the equipment, naming the leasing company as an "additional insured." Absent such evidence of sufficient insurance, the clause gives the lessor the right, but not the obligation, to purchase such insurance to protect the equipment and the lessor.

5 Often these obligatory insurer cancellation notices are numerous if a lessee is slow paying in regard to their monthly insurance premiums, and are followed by insurer notices of reinstatement of coverage a few weeks later when the lessee finally makes the delinquent premium payment — falsely suggesting that these cancellation notices comprise notices for all lapses in lessee coverage. Such cancellation notices cover only a small percentage of lapsed coverage incidents, which normally derive from non-renewal of coverage at expiration — and these more numerous incidents do not produce a written notice from the insurer.

6 In the absence of other valid mortgage or vehicle insurance coverage, banks routinely effect "force-placed" insurance that — due to the very high premiums for this coverage — results in covering only a small percentage (typically less than 2% on mortgages and 4% on vehicles) of those borrowers who are unable or unwilling to provide other valid and sufficient insurance.

7 Where equipment is not replaced under the lease after a loss, resulting in the pay off of the remaining lease payment obligations, BOP coverage always pays less than the lessee needs to satisfy this financial obligation while a custom lease insurance policy would always pay off the lessor's stipulated loss value, including the lessor's net investment in the lease and its residual value (leaving the lessee with no further financial obligation). BOPs also always have deductibles of $500 or more, while lease insurance policies usually have no deductible, regardless of whether or not the equipment is replaced — BOP deductibles further increase the lessee's shortfall payment due to the lessor when there is a loss.

8 Who remembers the Time magazine cover story in 1986 entitled, "Sorry, America, but your {liability} insurance has been cancelled!!?" Day Care centers, municipal governments, doctors with malpractice exposures, and numerous other entities were threatening to (or did briefly) shut down due to the lack of affordable liability coverage. Today's hard insurance market is due primarily to the skyrocketing cost of property insurance coverage, and has not reached (nor may it ever reach) such a dramatic state as the prior hard market. Stay tuned, though, as this hard market is far from completing its cycle.