

Welcome to the latest edition of our client newsletter from the Allied Insurance Group. We are a co-operative of 25 independently owned insurance brokers operating throughout New Zealand. Because of our combined strength we are able to secure for our clients competitive terms and conditions.

Allied recently held our third annual conference, attended by 37 delegates from our 25 Brokerages. The conference went for one and a half days and it provided an opportunity for the Insurance Companies to update us on how they see our market developing in the short term and what initiatives and developments they have in progress. The remainder of the time was spent in open forum where the Brokers discussed a number of topics concerning our industry and a sharing of knowledge on business practices.

There is an interesting article on the insurance of income derived from rental properties in this issue. In these tough economic times some Clients may look to reduce or cancel this type of cover, but the consequences could be disastrous if you suffer a loss. Full insurance is critical to a business as any sort of loss not fully insured can leave you very exposed financially.

We trust you will find this newsletter interesting and if you have any comments your Broker would be pleased to hear these from you.

## INSIDE ARTICLES

### LIGHTING THE WAY

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### ASSET INSURANCE

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### HUMOUR

## INSURANCE OF RENTAL INCOME

If you receive rental income, or even sub-let part of the premises you rent, and you do not have Loss of Rent cover – **contact your insurance broker!**

Rental income (also referred to as Rents Receivable, Gross Rental or Loss of Rent) is normally insured under a business interruption policy, generally requiring its own item of cover.

We discuss:

- Who should have insurance for rental income?
- How it works
- What to insure
- An example
- Some traps/issues

### Who should have insurance for rental income?

The answer is – any entity that earns rental income.

This can include:

- Any entity (e.g. company, family trust) whose sole activity is to own one or more rental properties.
- A business whose core activity is, for example, manufacturing or retailing, but also earns rental income from properties it owns.
- A business that sub-lets a portion of the premises its leases.



## How it works

The most common example is where the premises are damaged, and rent abates. The landlord can claim the loss of rental income and any extra costs incurred (subject to normal policy requirements).

By insuring its rental income, landlords will protect their income stream whilst the premises are repaired and rental income resumes.

This works in the same way as business interruption insurance for gross profit cover for a trading business, or gross fees for a professional firm.

This is subject to a maximum claim period, called the indemnity period.

## What to insure

If you are familiar with business interruption insurance, it is common to insure gross profit, additional increase in cost of working and claim preparation costs.

A similar approach is taken for property owners earning rental income.

Property owners need to consider insuring:

- Rental income (including on-charged costs such as rates)
- Additional increase in cost of working
- Claim preparation costs

Just as with business interruption, an Indemnity Period also needs to be selected. This is the maximum period of claim, during which loss of rental income can be claimed.

## An example

The value of rental income insurance is best illustrated with an example.

A business owns retail premises with one tenancy. During 2009 a fire occurred. The tenant vacated, and due to the extent of damage cancelled the lease. It permanently relocated to alternative premises.

The tenant ceased paying rent from the date of the fire. It took 4 months to complete repairs, and a new tenant was found. This tenant negotiated a 3 month rent holiday. Therefore the landlord did not receive 7 months of rental income, totaling \$35,000. Actual turnover for 2009 was \$25,000 instead of \$60,000. In addition it was unable to on-

charge all outgoings. An extra \$5,000 of costs was incurred in advertising/ letting/legal fees, so overall instead of the landlord earning net profit of \$5,000 in 2009, it resulted in a net loss of \$38,000 – a shortfall of \$43,000.

The loss of rents insurance paid the full shortfall of \$43,000, made up of loss of rental income & outgoings of \$38,000 and extra costs of \$5,000.

**Table 1** is a summary of the trading accounts for the property company for 2008, its projection for 2009, and actual results for 2009 which were affected by the fire. The projected rental income of \$60,000 for 2009 was based on full occupancy.

	<b>Actual 2008</b>	<b>Projected 2009</b>	<b>Actual 2009</b>
Rental income	35,000	60,000	25,000
Outgoings on-charged	3,000	5,000	2,000
Sub-total	<u>38,000</u>	<u>65,000</u>	<u>27,000</u>
All expenses	60,000	60,000	65,000
Net Profit	<u>(22,000)</u>	<u>5,000</u>	<u>(38,000)</u>

### Notes

1. Rental income is \$5,000 per month
2. Outgoings on-charged are rates & insurance
3. 2008 Rental income was low because a previous tenant left and the new tenant received a "rent holiday"



## Summary

In this example, if an Indemnity Period of 12 months was insured, the insurance should be for Rental income & outgoings of \$65,000. In addition we would recommend cover for Additional Increase in Cost of Working and Claim Preparation Costs, in the region of \$15,000 and \$5,000 respectively.

In this example the damage was not significant, and in our experience timeframes to repair/rebuild, and then find a replacement tenant can easily be understated.

We would recommend that an even longer Indemnity Period, of 18 or 24 months, be considered. Serious damage, including structural issues, satisfying council issues, rebuilding and getting a new tenant can take considerable time.

## Some traps/issues

Some common errors we have seen that can lead to under-insurance, or worse still no insurance include:

- Landlords cancelling rental income insurance during periods when the premises are vacant.
- Failure to have an adequate indemnity period.
- Businesses that have business interruption insurance, and sub-let surplus space to a third party, receive rental income, but overlook to insure this income stream.
- Failure to insure for Additional Increase in Cost of Working.
- Failure to insure the rental income. E.g. where a business that owned its premises (and therefore paid no rent) transfers the property and mortgage into a family trust and now pays an arms length rent.
- Failure to insure the outgoings that are on-charged to tenants.
- Failure to recognize that the insurance is not for last years rental income, but for future income. In the example, Table 1 has actual rent/outgoings projected for 2009 of \$65,000, which is based on a full year's occupancy. If cover had been based on the previous year (where there had been a period of vacancy) of \$38,000, there would have been shortfall, because actual losses were \$43,000.

## Conclusion

In our experience insurance of rental income throws up more than its share of problem claims.

There is insufficient space in this article to cover this topic in depth and provide greater explanation to the above traps/issues. If you have any concerns about your own insurance requirements contact your Allied Insurance Group broker.

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## Lighting the Way

In these uncertain economic times, it is important that New Zealanders continue to value their insurance cover and don't sacrifice the security that a good risk management program brings to their lives and business. Cutting back on insurance cover to help handle money matters may ease cash flow in the short term but can backfire in the long term, leaving you seriously out of pocket.

As always, the relationship between you and your broker is fundamental to ensuring that your insurance is in order. A consultation with your broker may be necessary to make them aware of any issues you may be facing as a result of the current recession. Now, more than ever, it is important at renewal time that you discuss with your insurance broker your insurance program and hear their value proposition and advice.

There are many horror stories regarding under-insurance, where sums insured or indemnity periods are insufficient to cover the damage or loss. It is important that you are aware of what may result from allowing insurance cover to be sacrificed and that you understand the wider implications of leaving yourself unprotected.

There are some options for you if you are looking to cut costs because of reduced or deferred income:

- An increased voluntary excess is one way to save on premium, while still maintaining an adequate level of cover. If you increase the claim amount you pay before the insurance policy kicks in, you pay a lower premium. You can then plan for your premium payment as well as your excess, rather than risking unknown costs at the other end if you reduce sums insured.
- Instead of paying your insurance premium in a one-off payment, monthly payment options spread your premium payments over a 12 month period and give you more flexibility with cash flow.

In this current economic environment, nobody can afford to be in a position where they cannot reinstate due to inadequate sums insured or indemnity periods. Rather than reducing insurance cover, it is more important that any unforeseen losses are fully insured due to reduced capital being available.

Speak to your insurance broker today to find out about the best options for your insurance cover.

## ASSET INSURANCE

Based on recent published New Zealand statistical data the cost of Plant, Machinery and Equipment rose 6% in the year to December 2008. Anyone reviewing their annual insurance requirements for such assets for 2009-2010 could be forgiven for taking this data and applying it "en masse" to their assets and thinking all was well.

Whilst for many asset types this level of increase may be correct, many of New Zealand's major manufacturing and process industries import high cost/value machinery from overseas suppliers. In the event of a loss it is therefore safe to accept that replacing such assets would follow the original purchase path.

The currency exchange rates fluctuation we have endured for the past twelve months has meant that purchasing overseas supplied machinery is now significantly more expensive than it was this time last year.

The table to the right clearly shows the decline in the New Zealand dollar's purchasing power against the currencies mostly quoted to our businesses when purchasing assets overseas.

Whilst the decline in dollar value against our major trading partners may be welcome news for exporters, for importers and businesses seeking realistic asset insurance levels it has exacerbated the impact of the problems with the global economy.

A major CB Richard Ellis client recently sought our advice on the machinery insurance levels needed for the 2009-2010 period. Many of the assets owned by this client are overseas sourced and our detailed

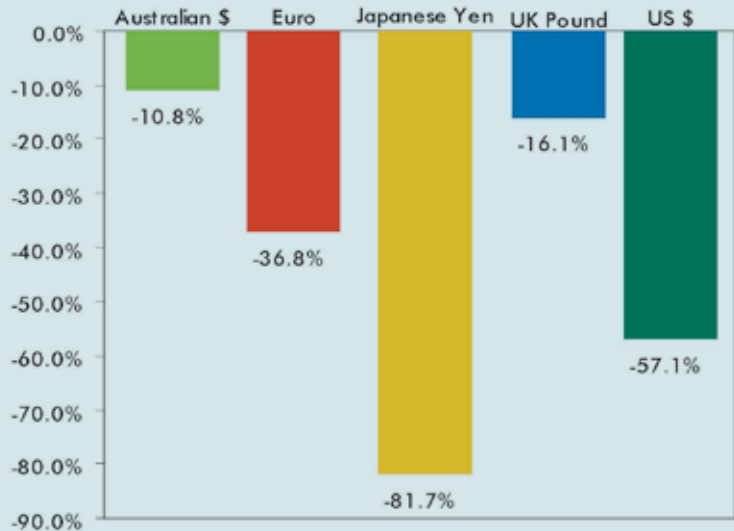
investigations resulted in an 11% increase in replacement costs for the overall asset package during the period February 2008 to February 2009.

So our message is clear, make sure your valuers not only assess the correct overall insurable value of your assets but also know which equipment would need to be replaced with overseas sourced machines following a loss.

*Don't run the risk of under insurance!!!*

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**Decrease in Purchasing Power  
NZ Dollar February 2008 -2009**



## Humour

A lawyer purchased a box of very rare and expensive cigars, then insured them against, among other things, fire. Within a month, having smoked his entire stockpile of these great cigars and without yet having made even his first premium payment on the policy the lawyer filed a claim against the insurance company...

Delivering the ruling, the judge agreed with the insurance company that the claim was frivolous. The judge stated nevertheless that the lawyer held a policy from the company, which it had warranted that the cigars were insurable and also guaranteed that it would insure them against fire, without defining what is considered to be unacceptable 'fire' and was obligated to pay the claim. Rather than endure lengthy and a costly appeal process, the insurance company accepted the ruling and paid \$15,000 to the lawyer for his loss of the cigars lost in the 'fires'.

## Now for the Best Part

After the lawyer cashed the cheque, the insurance company had him arrested on 24 counts of ARSON!!

With his own insurance claim and testimony from the previous case being used against him, the lawyer was convicted of intentionally burning his insured property and was sentenced to 24 months in jail and a \$24,000 fine.

*Disclaimer: The articles featured in this newsletter are not necessarily the opinions of Allied Insurance Group or the Member Brokers and they do not accept responsibility for the contents of the articles. No part of this newsletter may be reproduced without the written permission of the editor.*

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