

INSIGHT 07

DEDUCTIBLE VS EXCESS: A Comparative Guide Across Specialty Insurance Coverages

July 2025





Deductible

The portion of a covered loss that the Insured is responsible for paying before the Insurer starts to pay. The deductible is subtracted from the loss amount, and the Insurer pays the remainder, up to the limit of liability.

Example: If a property insurance policy has a USD1,000 deductible and a limit of liability of USD10,000, and the Insured sustains a loss of USD11,000:

- The Insured pays the first USD1,000 (the deductible).
- The Insurer pays USD9,000 (the maximum limit of liability minus the deductible).
- The remaining USD 1,000 is not covered by insurance because it exceeds the maximum limit of liability. The Insured must therefore pay the remaining amount.

Excess

The amount the Insured must pay towards a covered loss before the Insurer's liability is triggered. Unlike a deductible, the full limit of liability applies in addition to the excess, meaning coverage begins above the excess threshold. The excess may be in the form of a self-insured amount or an underlying insurance policy amount (sometimes referred to as the excess point or attachment point).

Example: If a property insurance policy has a USD1,000 excess and a limit of liability of USD10,000, and the Insured sustains a loss of USD11,000:

- The Insured pays the first USD1,000 (the excess when a self-insured amount applies).
- The Insurer pays USD10,000 (the full limit of liability).
- The total loss of USD11,000 is covered through risk sharing between the Insured and Insurer, as the Insurer's limit applies on top of the excess.

THE BACKGROUND

In the Specialty Insurance Market, deductibles and excesses are fundamental risk sharing mechanisms. They are used for several important reasons, including:

Reducing the number of small or attritional claims –

Insureds retain a portion of the risk, which prevents the Insurer from processing minor claims that may cost more to administer and adjust than to settle. Deductibles and excesses encourage Insureds to handle minor losses themselves;

Managing claims frequency – Helping Insurers control the number of claims, especially in high frequency, low severity circumstances;

Controlling premium costs – Policies with higher deductibles or excesses often come with lower premiums. By shifting more of the exposure to the Insured, this reduces the Insurer's exposure, allowing for more affordable coverage in some circumstances;

Moral hazard minimisation – The presence of a deductible or excess can help to discourage negligent or reckless behaviour by making the Insured responsible for the first part of any loss. This helps encourage better risk management and better maintenance of the property and operations of the Insured.

Though the terms '*deductible*' and '*excess*' are sometimes used interchangeably, the terms can have significantly different meanings depending on the policy wording context and jurisdiction. Both serve to ensure that Insureds retain a portion of the risk, promoting diligent behaviour, minimising administrative costs for Insurers and controlling premium spend.

For Insureds, understanding how deductibles and excesses function across various types of insurance, such as property insurance, business interruption insurance, and third-party liability insurance is essential to choosing the right coverage and managing financial exposures.



PROPERTY INSURANCE

In property insurance, deductibles and excesses typically apply on an 'any one occurrence' basis, although there are instances where the deductible or excess may be subject to an aggregate amount. A monetary amount will typically apply and the application of such deductible or excess encourages the Insured to maintain and protect their physical assets in order to prevent the occurrence of minor damages, which may fall within the amount retained by the Insured.

While a monetary deductible or excess is common practice, there may be instances where a percentage deductible or excess applies as an alternative. For example, in respect of natural perils such as an earthquake or named windstorm, there are instances where physical loss or physical damage that is caused by or arises out of such peril is subject to a deductible or excess that is calculated as a percentage of the insured value or the covered loss amount (e.g., 2% of the insured property value).

As outlined in the definitions, the application of a deductible or excess can have a significant impact on the amount recoverable from Insurers. In the Specialty Insurance Market, the excess may be represented as an amount that is retained by the Insured on their balance sheet, or it may represent the amount by which there is underlying insurance that has been procured by the Insured in a layered property insurance programme.

BUSINESS INTERRUPTION INSURANCE

In business interruption insurance, the deductible or excess is often expressed in the form of a waiting period or time excess. This represents the minimum amount of time that must pass before the business interruption indemnity commences. The waiting period is typically measured in hours or days and serves a similar function as the deductible or excess applied to property insurance policies, by filtering out minor interruptions or interferences. During the waiting period, the Insured is responsible for the lost income as a result of the interruption or interference during the period of indemnity / recovery period / reinstatement period (as applicable). Some business interruption policies apply a monetary deductible or excess, or a combination of both time-based and monetary deductibles or excesses, with the terms and conditions specifying that either the greater or lesser of the two will apply, depending on the policy wording language. Alternatively, some business interruption policies apply an Average Daily Value (ADV) waiting period which is a type of time-based deductible or excess that is expressed in monetary terms rather than a fixed duration. Instead of a traditional waiting period measured in hours or days, the deductible or excess is calculated by determining the business's average daily revenue or gross profit or other financial metric, typically based on financial performance over the previous 12 months. The policy then applies a deductible or excess equal to the ADV multiplied by a specified number of days. For example, if a business has an annual gross profit of USD3,650,000, its ADV would be USD10,000. If the policy includes

a 3 day ADV waiting period, the applicable deductible or excess would be USD30,000.

The policy wording language needs to be carefully considered to ensure that the application of the waiting period is expressly clear. There are instances where the waiting period may operate as a deductible, and conversely there are instances where the waiting period may operate as an excess.

In a Gross Profits (UK Form) policy wording that imposes an indemnity period time limitation, there may be the following definition applied when the waiting period operates as a deductible, whereby the waiting period is essentially being deducted from the indemnity period, thus reducing the number of recoverable days or months of coverage. The following definition from LMA5329, Business Interruption Extension – Insurable Gross Profit (Additions Basis – Net Profit plus Insured Fixed Costs – Full Value) is one such example of the waiting period applied on a deductible basis. In this example the indemnity period definition stipulates that it begins with the occurrence of the Damage, with the waiting period also commencing at such point:

Indemnity Period

The period during which the results of The Business are affected in consequence of the Damage, beginning with the occurrence of the Damage and not exceeding the "Maximum Indemnity Period" stated in the Risk Details to this Contract.

There are however variations to the foregoing language, and there are instances where the waiting period operates on an excess basis, whereby the indemnity period applies in excess of the waiting period and will commence upon the termination of the waiting period. Here is one such example of policy wording language where this approach has been adopted:

Indemnity Period

The period during which the results of The Business are affected in consequence of the Damage, beginning with the expiration of the Waiting Period and not exceeding the "Maximum Indemnity Period" stated in the Risk Details to this Contract.

Whilst no indemnity is typically afforded during the waiting period, consideration should be given to coverage for Increased Cost of Working (ICOW) and Extra Expenses (EE), which depending upon the specific policy wording language, may include an exception to the general rule of not providing cover during the waiting period where it can be demonstrated that the expenses incurred directly reduce the overall business interruption loss amount and are deemed to be economical.

The presence of a waiting period within a business interruption policy wording can sometimes be confused with qualifying periods, and careful consideration should be given to the policy wording language in this respect. A qualifying period may apply in respect of business interruption extensions such as prevention of access, denial of access or service interruption coverage, and typically stipulates a number of hours or days of interruption or interference must pass before coverage is triggered. The interplay between a waiting period and the service interruption period should be carefully considered. In some instances, coverage is afforded once the qualifying period is satisfied, however, there are instances where the waiting period applies along with the qualifying period i.e., following satisfaction of the qualifying period, the waiting period then commences.



THIRD PARTY LIABILITY INSURANCE

In third party liability insurance, deductibles and excesses form an important role in the structure of coverage procured by the Insured. For Insureds with complex operations, a suite of third party liability coverages may be arranged, with an umbrella liability policy also procured, responding in excess of underlying insurances that are scheduled. In such a scenario, the London Specialty Insurance Market commonly utilises umbrella liability forms such as the Joint Liability Committee forms, whereby the Limits of Liability respond in excess of scheduled underlying insurances or a self insured retention, whichever is the greater. The below provision can be found in the JL2022-016 (2022 Umbrella Policy):

2. LIMITS OF LIABILITY

Underwriters shall only indemnify the “Insured”, and any “Additional Insured” as far as applicable, for “Ultimate Net Loss” in excess of:

(a) the Underlying Insurance(s) set out in Item 2 of the Declarations, or,

(b) the Self Insured Retention set out in Item 3 of the Declarations,

whichever is the greater and then only up to the amount stated in Item 4(a) of the Declarations in respect of any one “Occurrence”.

Much like property insurance and business interruption insurance, there are also instances where a deductible may apply to third party liability insurance policies, whereby an amount will be subtracted from the overall indemnifiable claim amount.

CONCLUSION

Understanding the distinction between deductibles and excesses is crucial for Insureds navigating the complexities of specialty insurance coverage. While both mechanisms serve the purpose of promoting risk sharing, reducing minor claims, and managing insurance costs, their application and impact differ significantly across lines of business. In property insurance, the choice between a deductible or excess can influence the Insured's balance sheet exposure and recovery potential, particularly in layered or high-value programmes. For business interruption insurance, nuances in policy wording language, particularly around waiting periods, qualifying periods, and average daily value amounts can materially affect the timing and amount of coverage available, especially when losses span across fluctuating operational periods. In third party liability insurance, the interplay between scheduled underlying policies, self-insured retentions, and excess layers shapes the overall structure of liability protection, particularly for complex risks. Insureds, Insurers and Insurance Brokers must remain observant to the distinctions and implications of these terms, ensuring that coverage structures are appropriately aligned with the financial and operational realities of the Insured's business.



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