COMMERCIAL UNDERINSURANCE: THE MAJOR LOSS IS MERCILESS

Underinsurance is a simple concept – but with a sting in the tail that could cripple an organisation. It means the policyholder has inadequate insurance coverage that may cause serious financial losses where the amount claimed exceeds the maximum that can be settled by the insurance policy. Underinsurance can manifest itself in your standard premises, equipment, plant or stock damage covers and it can also compromise a specialist business interruption policy.

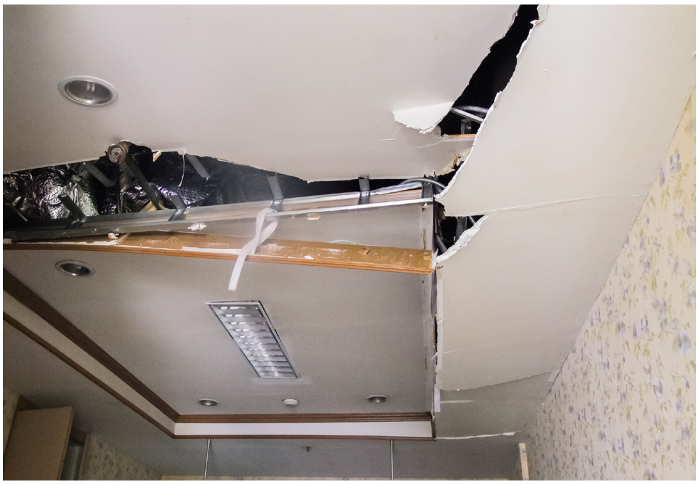
Yet despite clear risks, underinsurance remains a problem in the UK. Available figures paint a compelling picture…

- Research by The Building Cost Information Service demonstrates that UK commercial property underinsurance rates could be as high as 80% and that the sums insured regularly appear to trail valuations by 20%. [1]
- Similarly, research by the Chartered Institute of Loss Adjusters (CILA) found that business interruption policies – the key ones that get a business back on its feet after a major incident and claim – were underinsured by an average of 50%. [2]

Why should this be so? It's a combination of factors…

- A prevailing attitude amongst customers that as long as a cover is in place that ticks the compliance box then everything will be well. After all, it's only the few that suffer a heavy loss and so what are the chances?
- This is understandable: take smaller businesses under perpetual time and resource pressures. How disruptive is a top-to-bottom audit going to be and importantly, by how much will its results increase the annual premiums? However this is a false economy.
- An insurance industry that has been historically poor at helping customers relate the potential impact of underinsurance to the long-term survivability of their business in the event of a major claim.

In this bulletin, we provide you with the trips, traps and advice to indentify underinsurance in your organisation – and then how to minimise it.



Underinsurance: your property damage and business interruption covers

This is the simplest manifestation and relates to the inaccurate insured value of items like your premises and other infrastructure. It's usually caused by out-of-date, estimated or incorrect valuations – and can also be caused by insufficient limits in the policy. Here's a worked example.

- A commercial property has a rebuild value of £2 million but is insured for only £1.8 million: the underinsurance gap is 10%.
- Assume the costs for storm or fire damage come to £240,000, the insurer will then likely reduce that claim by 10% gap - paying out only £216,000 and leaving a shortfall of £24,000 for which the policyholder is now liable.
- The proportionality remedy under the Insurance Act means some insurers may only charge any additional premium due had the original sum insured been correct. But remember, that is only certain insurers and not the whole industry.
- However with a deliberate or reckless case of underinsurance, an insurer may allege a failure by the policyholder to observe the new duty of fair presentation. They could then refuse to pay the claim in its entirety.

[1] Insurance Times / 25 February 2015 / The Knowledge – Expert View / Underinsurance is a business problem / by Adrian McGuire (Zurich)
[2] Insurance Age / 07 September 2016 / NIG adds online calculator to help brokers tackle underinsurance / by Emmanuel Kenning

Buildings and premises: if your insurance valuations do not keep pace with change or are poorly configured you could still feel the financial pinch on your bottom line with just a relatively small loss. It's also a common mistake to insure for just the market value when the sum insured should be the rebuild cost.

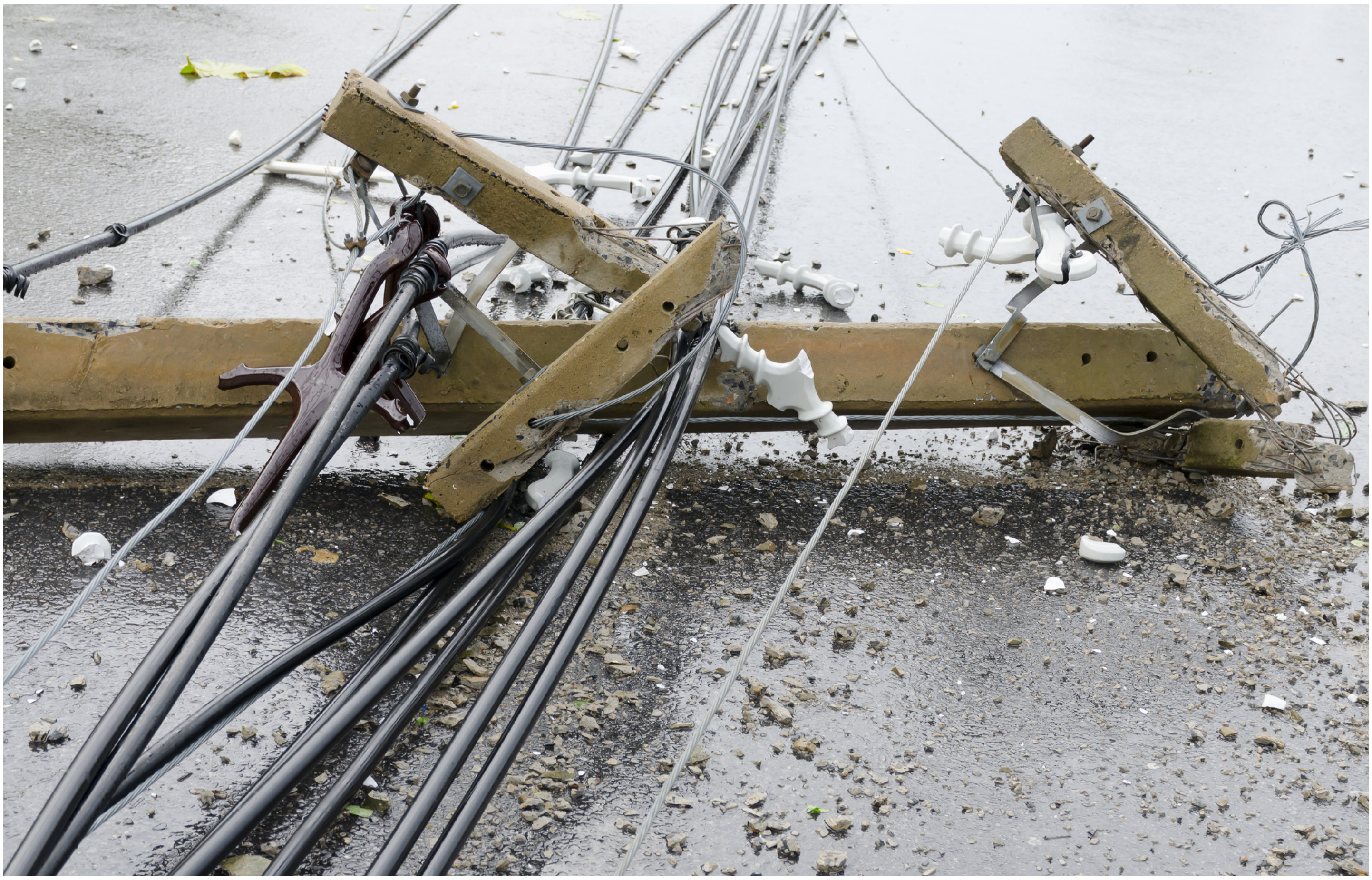
- Rebuild and major repair includes line items like all professional fees (architects', legal, planning), demolition or make-safe costs, labour and fit-out.
- Consider also the premises status. If they are listed, older or in a conservation area you may be compelled to use original or replica materials for restoration – which can add extra costs. There is also potential for rebuild planning permission to be refused – for instance where your site may now be deemed too close to a residential area built in the interim.

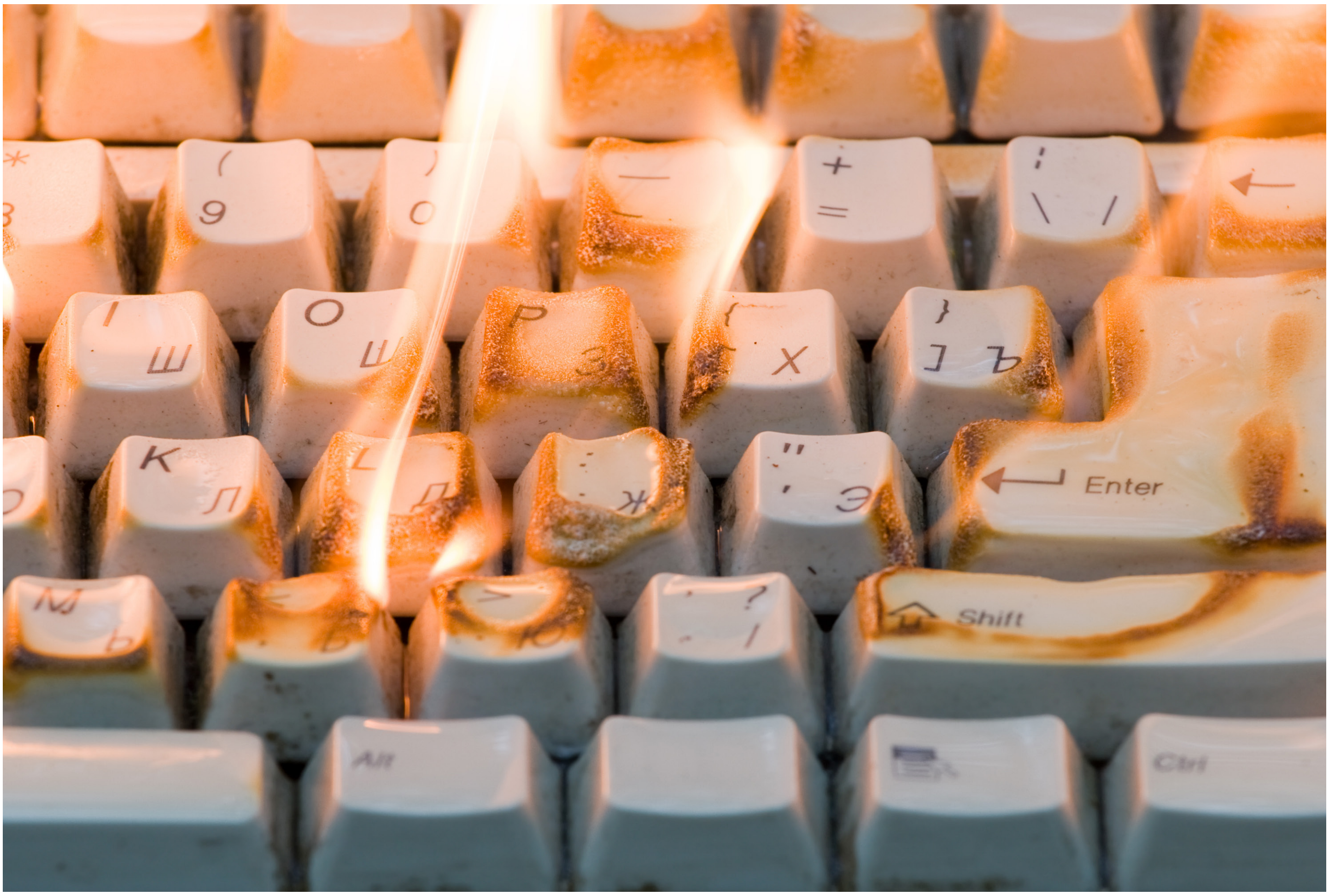
Machinery and plant: keep a full and regularly updated list of all plant, machinery and office technology. Know the up-to-date pricing too: if you need to replace kit not manufactured in the UK – say the fork lift trucks are imported from Germany – you'll need to allow for currency fluctuations.

It's a fact that cover reviews, sums insured, policy limits and estimates can be left untouched over time despite major changes like expanded premises, new equipment or a larger workforce. Your best defence is to consult an independent professional to audit all your assets and pressure-test their values and replacement costs annually and without fail. Reinstatement values for buildings, machinery and plant are usually new-for-old. Equipment costs – like building materials and labour rates – fluctuate, usually upwards with inflation. This means a detailed but obsolete valuation schedule, perhaps only by 12 months, could still leave you short in the event of a claim.

Underinsurance in business interruption policies

- This is the specialist policy that supports your organisation following a major event – for instance catastrophic flood or fire – and covers the financial assistance you may need, including, for example, the cost of renting temporary premises. To work properly, it requires a thorough and up-to-date assessment of the interruption exposure part of which should be a business continuity plan that represents a true picture of the time and resources you need to achieve pre-loss turnover levels. The indemnity period should be long enough to cover the time it takes to get back to pre-loss turnover and recover market share: that timescale is commonly underestimated. The result is that your cover could expire before you are back to pre-loss levels.
- A good rule of thumb is the bigger the business, the longer it takes so examine the timeframes carefully and set them accordingly. Do not forget to add in some slack to cover unexpected delays.
- Examine all policy limits and check they match the needs of your organisation as identified in your exposure assessment – insufficient limits on the amount the policy pays out are another common underinsurance failure.
- Establishing the most accurate and detailed business interruption values possible will mean you avoid the impact of potentially large uninsured losses that then have to be written off.





Understanding how profitability relates to business interruption cover

Gross profit is sales minus the costs of production but the insurance definition is different to that of standard accounting. The BI policy usually defines gross profit as turnover less the cost of raw materials and other expenses directly variable with turnover. The confusion is the accidental cause of much underinsurance with business interruption policies.

- Turnover, work in progress and stock are easily defined by accounting methods. You can also specify 'uninsured working expenses' (aka 'specified working expenses') because insurance defines these as varying in direct proportion to turnover. If turnover drops by 20%, insurance expects costs will also drop by 20%.
- However there may be costs that don't fall in proportion, for example, if you suffer a major incident and you forward-buy materials under contract at a fixed price over time, those costs won't change proportionately despite the drop in turnover you might experience.
- It's therefore very important for insurance purposes to make sure that semi or non-variable costs are not deducted from your gross profit figure and make sure the policy wording recognises this. Otherwise you may find yourself without cover for those contracted commitments.
- Where an organisation is not making significant purchases the sum insured for insurance purposes is best measured using a gross revenue model.

Our general tips for preventing underinsurance

While the risk underinsurance poses can be hidden, the hygiene factors for identifying and removing it come down to embedded process, habit and repetition. Any audits or valuations made should be carried out by an independent professional.

Rebuild: your overall sum insured is the most you would need to rebuild and replace from absolute scratch.

Limits: are the policy limits insufficient? Check them against the needs of your organisation.

Values: update the new-for-old replacement of plant, assets and premises for your organisation annually.

Recovery: set a realistic indemnity period within business interruption insurance that gives your organisation enough time to recover. Remember that many business interruption policies are written on a non-average basis and that makes the accuracy of the sum insured even more important. Your sum insured should reflect the anticipated business growth and not just past performance.

Review: an annual review of all relevant policies with your broker, based on your changing valuations, will ensure you have the strongest and most effective cover available. Do not forget areas like employers' liability, public liability and professional indemnity: as your circumstances evolve, so do your patterns of risk.

Inflation: always check your insured sums have automatically been index-linked to inflation. Your liabilities at 2016 rates will differ from those in 2017.

Arthur J. Gallagher: our conclusions…

Underinsurance is much like leaving a property exposed to wear and tear without repair: sooner or later you may find yourself with a much larger bill than you expected. Designing underinsurance out of the equation is all down to solid, repeated assessment processes that reflect the performance of your organisation, the costs of physical repair and the professional and public liabilities it faces – all of which change over time.

Avoid false economies, however tempting they are. Do the detail work with your broker to make sure you have a clear, in-depth picture of cost, value and liability that is current, accurate and therefore able to support effective, properly-funded insurance.

About Arthur J. Gallagher

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