Avoiding underinsurance

A guide for businesses and their insurance partners

Contents

3 Introduction

4 What is underinsurance?

6 Top tips – Property

10 Top tips – Business interruption

Introduction

Insurance is an essential business component, transferring risk and providing much-needed financial security.

However, for insurance to fulfil its objectives, the cover you purchase needs to accurately reflect your business requirements. Insuring assets for incorrect values, or setting cover limits too low, is likely to result in underinsurance.

Underinsurance can lead to policies not operating as intended, delivering less indemnity than needed following a loss, and jeopardising an organisation's ability to recover.

Despite its serious consequences, underinsurance remains common, with some claims professionals reporting that up to 89% of their customers are underinsured.

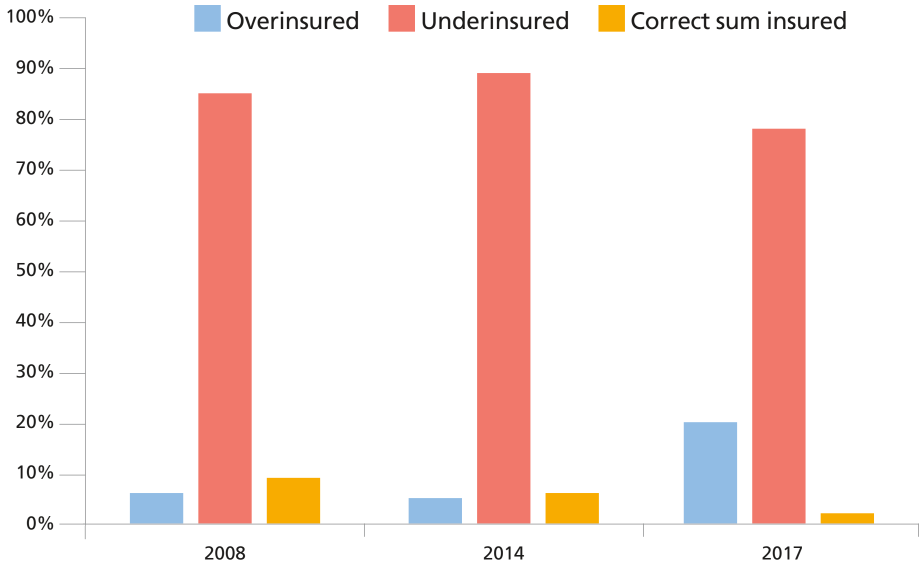
This guide looks at how we can work together to eliminate underinsurance, by explaining its impact, identifying frequent causes, and offering practical tips for those areas most commonly affected.

> "Underinsurance is a perennial problem. It is difficult to understand why the issue seems to have such a low profile at executive board level when it poses such a threat to business survival and on-going success."

Adrian McGuire, Head of Technical Property Underwriting at Zurich

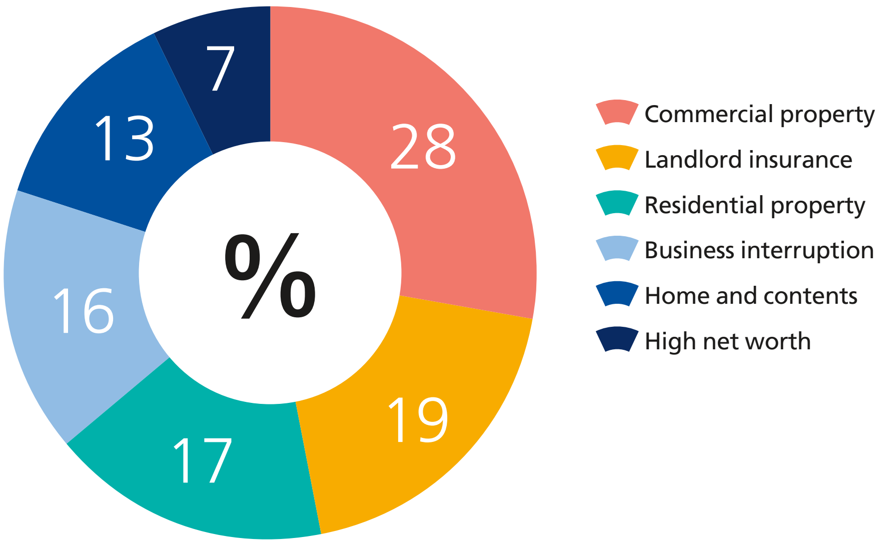
Rates of underinsurance

Source: QuestGates annual survey of valuations



Lines of business most likely to suffer

Source: Insurance Times broker survey 2015

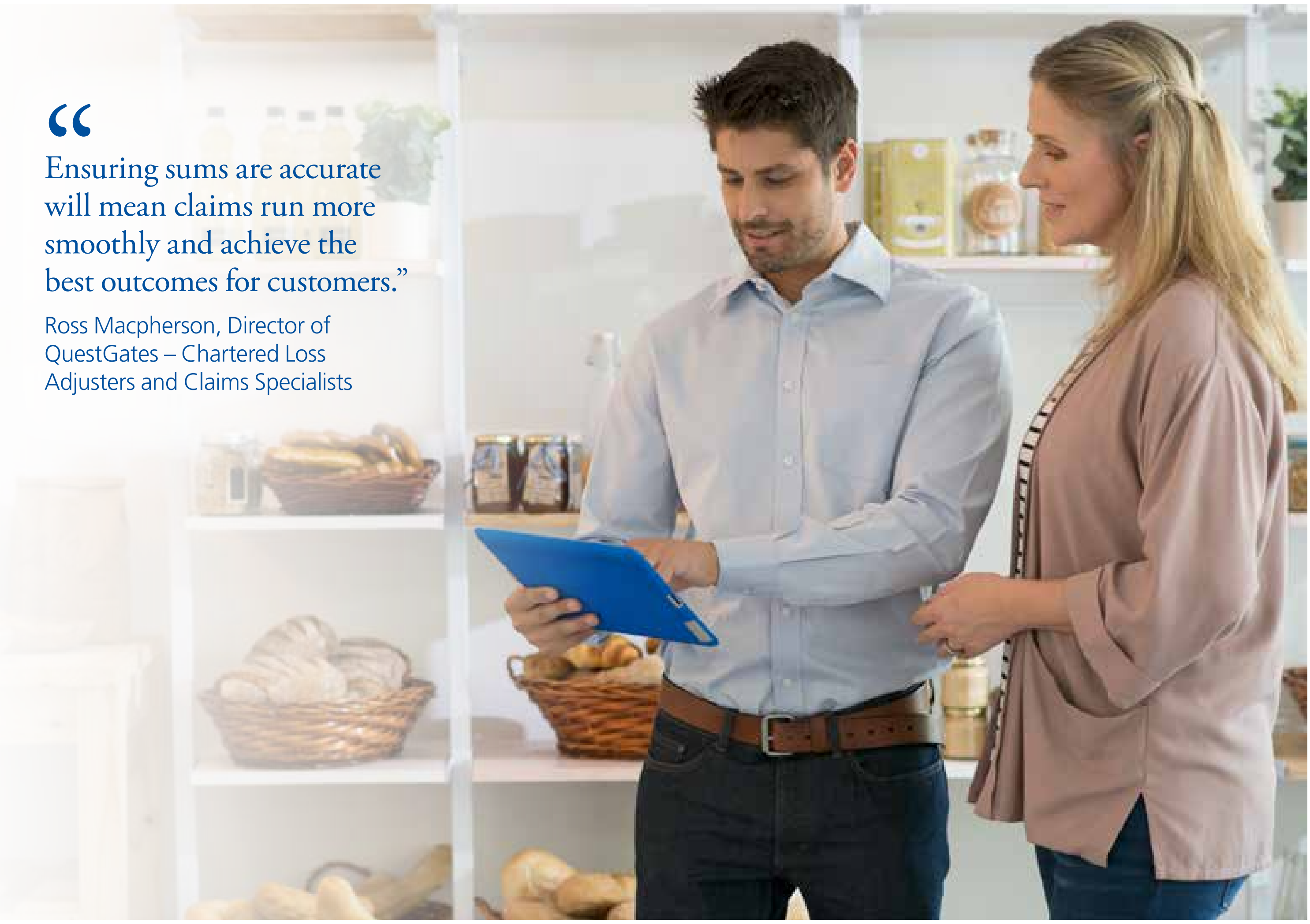


What is underinsurance?

Underinsurance occurs when cover is set too low to adequately meet a policyholder's needs. Below are some examples that demonstrate how underinsurance can affect different types of insurance cover.

Property – buildings sum insured

Declared reinstatement value	Actual reinstatement value	Cost of repairs following a loss	Claim settlement by insurer	Financial shortfall for policyholder
£750,000	**£1,000,000**	**£500,000**	**£375,000**	**£125,000**
Estimated by policyholder using an online valuation calculator. Declared as buildings sum insured on policy.	True reinstatement value based upon professional valuation. Building only insured for ¾ of its true value.	Policyholder suffers a major fire resulting in a partial loss. Will cost £0.5m to reinstate the building.	Condition of average applies. Final settlement proportionally reduced to ¾ of claim value.	Additional funds need to be sourced in order to complete repairs to the building.



> "Ensuring sums are accurate will mean claims run more smoothly and achieve the best outcomes for customers."
>
> Ross Macpherson, Director of QuestGates – Chartered Loss Adjusters and Claims Specialists

Business interruption – maximum indemnity period

Maximum indemnity period	Issues experienced during recovery	Period until full recovery	Claim settlement by insurer	Financial shortfall for policyholder
12 months	**+9 months**	**21 months**	**Cease at 12 months**	**Does not recover**
Chosen by customer as maximum possible time to fully recover. Set as maximum indemnity period on policy.	Planning issues and winning back lost custom significantly lengthen anticipated recovery time.	Actual time taken for business to reinstate damaged property and return to its former profitability.	Business interruption claims payments cease after 12 months, before the business has fully recovered.	Unable to counteract reductions in revenue and the increased costs needed to successfully recover.

Widespread impact

The discovery of underinsurance can have a widespread impact following a loss, affecting other areas of cover, including those where underinsurance is not even present.

It is therefore important for organisations to consider the interconnectivity between different types of cover, ensuring every aspect of their insurance programme adequately reflects their needs.

Knock-on effect

- After a major fire, a building is found to be significantly underinsured
- Reinstatement is postponed until the policyholder can source the funds needed to complete repairs
- This, in turn, delays the business's recovery, taking significantly longer to return to pre-loss levels
- Under the business interruption policy, both the sum insured and maximum indemnity period would have been adequate
- However, delays resulting from the building's underinsurance mean the maximum indemnity period expires before the organisation is able to fully recover
- Building underinsurance has effectively led to business interruption underinsurance

Top tips – Property

Most organisations will hold some form of property insurance. For some, this will cover their buildings and everything in them, while others may just insure basic office equipment or stock.

Whatever property an organisation chooses to cover, the following guidance will help to avoid underinsurance and ensure policies deliver the level of protection required.

1 Understand the condition of average

Property insurance policy wordings typically include a 'condition of average' clause. When underinsurance is present, this condition enables claims settlements to still be made under the policy, albeit reduced in proportion to the level of underinsurance.

For example, if a policyholder mis-states their total contents value by 50%, and therefore only pays 50% of the premium that should have been due, they can only expect to receive 50% of a contents claim's total value.

It is therefore important to carefully assess and declare accurate property values in order to receive full claims settlements.

Application of the condition of average

Declared value	Actual value	Underinsurance	Claim value	Claim settlement
£500,000	£1,000,000	50%	£200,000	£100,000

2 Approach valuations from the correct starting point

Items such as buildings, contents and stock all come under the banner of 'property'. However, different types of property are insured in different ways.

It is important to check the basis of cover for each item before declaring its sum insured, and to understand how you should approach each particular valuation. Failing to do so may provide a very different figure than is being requested, and can easily result in underinsurance.

Basis of cover	Settlement basis	Common items
Reinstatement	Cost of replacement with a new item that is similar but not better than.	• Buildings • Contents, plant and machinery
Indemnity	Cost to put you back in the same position immediately before the loss, taking into account factors that affect value, such as condition and use.	• Stock • Certain types of contents, such as clothing, plant and machinery
Agreed value	A set value agreed between policyholder and insurer at inception of the policy, often taken from an expert valuation.	• Art • Jewellery • Rare or specialised items

3 Returning to your former position

Property insurance aims to put you back in the same position you were in immediately before a loss. While slight nuances exist depending on the basis of cover, this remains the central principle.

When approaching valuations, it is important to consider how this happens in practice following a loss, factoring in all associated costs to your sums insured. For example, if you need to replace an office computer system, it is not just the cost of purchasing new equipment. Additional expenses may include IT consultancy fees, freight and installation.

It is important to avoid simply using balance sheet values or historical purchase prices to inform sums insured, as these are often significantly different to an item's actual value for insurance purposes.

4 Buildings – it's not just the building itself

A 'building' applies not just to a main structure, but also includes features such as foundations, boundary walls, drains, landscaping, car parks and outbuildings. Not including such features is a frequent source of underinsurance. Precisely what is included will be defined in your policy wording.

Misapplying VAT is another common problem. Some aspects of a building's reinstatement might attract VAT while others might not, and the position can vary depending on each organisation's tax arrangements.

A qualified surveyor will be able to identify what needs to be included in your valuation and help you arrive at an adequate sum insured.

5 Buildings – don't use market value

A building's market value is irrelevant for insurance purposes, and its use for building sums insured is a frequent source of underinsurance.

Buildings sums insured need to reflect the full cost of reinstating a building following a total loss. In addition to materials and labour, this includes all associated costs such as demolition, debris removal, planning and professional fees.

Each building will have features that can significantly alter a reinstatement cost, such as difficult site access, period features or specialist construction techniques. A qualified surveyor will have the expertise to identify and quantify these factors, and one should always be engaged when establishing sums insured for insurance purposes.

Have you accounted for?

- External items – driveways, boundary walls, gardens, car parks, drains
- Demolition, debris removal, protection of surrounding sites or party walls
- Changing regulations – rebuilds may now need to factor in features such as disabled access, reduced environmental impact or improved fire protection
- Site geography – access difficulties, protecting surrounding buildings, proximity to watercourses, state of underlying land
- Professional and administration fees, such as architects, lawyers, surveyors and planning applications
- Listed or period features – may require specialist trades and materials
- VAT – advice should be taken as to whether or not you need to include VAT in your sums insured

> "In certain areas of the country, and with certain types of property, you will find that the market value is actually only a very small fraction of a building's rebuild cost."
>
> Colin Prince, Property Lines Underwriting Manager at Zurich

6 Contents – don't forget the small things

Contents insurance protects you if any items within your buildings are lost or damaged. Accordingly, you must account for every item in your valuation, from the largest piece of production machinery, down to the stationery in your desks.

While smaller items may seem insignificant on their own, cumulatively they can make an enormous difference to an overall contents sum insured.

Keeping an up-to-date property inventory for insurance purposes will assist in this task. However, remember to approach valuations from the correct perspective (see tips 2 & 3 above), which will differ from inventories used for balance sheet purposes.

7 Plant and machinery – availability, logistics and exchange rates

Plant and machinery is commonly insured on either a reinstatement or indemnity basis. These items can be particularly susceptible to depreciation, so it is particularly important to approach valuations from the correct basis (see tip 2 above).

Where the items are still readily available, determining values should be relatively simple. However, for older or difficult-to-source items, you may need to base valuations on alternatives of a similar type, capacity and utility.

If dealing with large, specialist or bespoke pieces, there are likely to be a variety of additional considerations, such as costs for design, manufacture, installation and commissioning. Speak with potential suppliers to understand the current cost of meeting your needs.

If sourcing items from overseas, some contingency should be included for potential currency fluctuations, as even small fluctuations can have a large overall impact on high-value items.

As with buildings, valuing plant and machinery accurately requires specialist knowledge and experience. For organisations with a lot of equipment, or for those that heavily rely on such items for their day-to-day operations, it is especially important to conduct regular professional valuations.

8 Stock isn't static

Many businesses hold higher levels of stock during busier times of the year. To avoid underinsurance, sums insured should always be set at the maximum potential value that could be held at any one time.

Different businesses also use stock in different ways, increasing or decreasing its value over time. A furniture maker, for example, will purchase raw materials and increase their value as they move through the production process. A corner shop, however, will simply sell finished goods that have a reasonably static wholesale cost.

Therefore, to calculate an accurate stock sum insured, the maximum potential values at different stages of an operation will first need be considered.

Stock at different stages

- **Raw materials** – market cost of materials including freight, unloading, storage and irrecoverable taxes and duties
- **Work in progress** – raw materials plus manufacturing costs directly incurred, including direct factory overheads
- **Finished goods** – net manufacturing cost of finished goods. Or, for many businesses, the wholesale purchase cost, including associated expenses such as freight, unloading, storage and irrecoverable taxes
- **Waste materials** – certain waste materials will have a commercial value and a market rate

9 There is no substitute for professional help

Due to the wide range of factors that can influence property valuations, it is always recommended to seek professional advice to help establish accurate sums insured.

These professionals' fees are minimal when compared with the potential financial shortfalls that underinsurance can cause following a loss. Many insurers and brokers can also help customers access reduced rates via preferential supplier arrangements.

Some of today's policy wordings will remove the condition of average altogether when sums insured have been verified via professional valuations, therefore eliminating the risk of underinsurance and enhancing the value of such services.

10 Conduct regular reviews

Property values do not remain static, and sums insured need to stay under continual review to remain accurate over time. A thorough review of all sums insured should therefore be conducted at least annually, typically at renewal.

However, this does not necessarily mean paying for full professional surveys each year. Most surveyors will recommend conducting a full valuation at least every three years, with annual desktop appraisals in between. These desktop appraisals allow surveyors to apply their knowledge and expertise to an organisation's unique circumstances, and update valuations accordingly.

Remember, values can go up or down. Regular reviews will also help you avoid paying for cover that is above and beyond your organisation's needs.

> "It is a myth that customers will have to pay for a full valuation every time. Most of the legwork is done in the first visit. After this point, it is usually a case of building on good practice and bringing the valuations up to date."
>
> Mike Green, Underwriting Manager at Zurich

11 Index-linking is not a failsafe

Many insurers seek to minimise their customers' risk of underinsurance by 'index-linking' buildings sums insured at renewal, using relevant price indexes to estimate average cost increases.

However, index-linking is only a countrywide average, applies solely to buildings, and cannot account for the wide range of factors particular to each property. Index-linking should therefore not be used as a substitute for thorough annual reviews and regular professional valuations.

12 Act on changes to your risk

An organisation will typically undergo some changes during the policy period. For example, a new piece of machinery might be purchased, or an area of a building renovated.

In addition to thorough reviews at renewal, it is essential to update sums insured when any changes occur. If in doubt, discuss the changes with your insurer to establish whether a policy requires adjustment.

Top tips – Business interruption

Business interruption (BI) insurance provides a lifeline following a loss, supporting organisations financially until they make a full recovery.

However, inaccurate sums insured and inadequate indemnity periods are a major source of underinsurance, jeopardising the chances of recovery for many businesses.

The following tips will enable you to select the correct level of BI protection, and help assure future resilience to loss events.

1 Have a plan

Planning how to respond to potentially harmful events is vital for any business, and an essential first step in choosing the correct BI cover.

Business continuity planning is a valuable exercise that helps increase an organisation's resilience through anticipating potential losses and planning how best to respond.

It is advisable to record key findings in a formal business continuity plan (BCP), which should remain under regular review and testing, and serve as a core risk management tool. For example, should a key supplier suffer a major loss, a good BCP might detail arrangements with alternative suppliers that could quickly meet urgent customer orders.

In addition to boosting resilience, considering potential loss scenarios is the best way of identifying much of the information needed to set suitable BI cover levels.

For example, without fully understanding how an organisation's variable costs will change following a loss, it will not be possible to set an accurate gross profit sum insured (see tips 3 & 4 below). Equally, without contemplating potential worst-case scenarios, it will not be possible to choose a suitable maximum indemnity period (see tip 5 below).

2 Choose the cover that's right for you

There are three main types of BI cover:

- **Loss of gross profit**
- **Loss of gross revenue**
- **Increased cost of working**

Loss of gross profit is the most common form of BI cover, but does feature certain complexities that commonly lead to underinsurance if approached incorrectly. It is therefore important to fully understand how each type of cover operates and carefully assess which is best suited to an organisation's particular needs.

	Cover	Best suited to	Complexity of setting the sum insured
Loss of gross profit	Loss of profit + increased cost of working.	Businesses with directly variable costs.	Extra care needed to avoid underinsurance.
Loss of gross revenue	Loss of revenue + increased cost of working.	Businesses with few or no directly variable costs.	Simply requires insured's turnover.
Increased cost of working	Increased cost of working only.	Resilient businesses, which will continue to earn revenue whether their premises are damaged or not.	No calculation required. Limit select by insured.

For example, loss of gross profit is specifically designed for manufacturing-type risks and recognises that a downturn in production will actually lead to some cost savings as well. These savings are known as 'uninsured working expenses', and form an important part of the gross profit sum insured calculation (see tip 4 below). For organisations with few, or no, uninsured working expenses, a gross revenue basis is likely to be the more suitable basis of cover.

Business continuity planning will enable you to understand how resilient an organisation's operations are, and the likely impacts following a loss.

3 Approach calculations correctly

BI claims are settled by reference to specific formulas listed in the policy wording. As with all sums insured, it is essential to approach BI calculations correctly in order to avoid underinsurance.

Calculating loss of gross profit sums insured is where many experience difficulties, and where underinsurance frequently originates. A leading reason is that an accountant's definition of 'gross profit' differs considerably from the figure required for insurance purposes. The former deducts all production costs, whereas the latter recognises that some costs will continue following a loss and therefore need to remain in the sum insured.

Not recognising this important distinction frequently leads to figures being provided that do not follow the calculation stipulated in policy wordings, resulting in significant levels of underinsurance.

Common pitfall – 'Gross Profit' definition

Accountancy

$$\text{Gross Profit} = \text{Sales} - \text{Cost of Production}$$

Insurance

$$\text{Insurable Gross Profit} = \left(\begin{array}{c}\text{Turnover}\\ +\\ \text{Closing Stock}\\ +\\ \text{Work in Progress}\end{array}\right) - \left(\begin{array}{c}\text{Uninsured Working Expenses}\\ +\\ \text{Opening Stock}\\ +\\ \text{Work in Progress}\end{array}\right)$$

4 Take care with 'uninsured working expenses'

Uninsured working expenses (UWEs) form a vital part of the insurable gross profit calculation. If insuring on a loss of gross profit basis, it is important to fully understand the meaning of UWEs and only specify costs that truly fit.

UWEs are costs that vary in direct proportion to a reduction in turnover (i.e. if turnover reduces by 30% then that cost will also reduce by 30%).

UWEs can often include items such as raw materials, production wages and freight. However, it should never be assumed that these costs are always UWEs. This is something that can vary between organisations, and needs to be identified via business continuity planning. Routinely subtracting certain items during the gross profit calculation is a common source of underinsurance.

Another common error is to only think in terms of total losses, whereas the majority of losses are likely to be partial.

For example, consider a factory that sends shipments via weekly containers. In the event of a total loss, where production stops completely, this cost should cease, as there are no products to ship. However, following a partial loss, it is likely that this cost will actually remain the same, as weekly shipments will still need to be made. Freight is therefore not a UWE for this organisation, as the cost will not vary in direct proportion to any reduction in turnover.

5 Maximum indemnity periods – be conservative

A maximum indemnity period (MIP) is the time following a loss during which BI claims can be made. If the MIP expires then claim payments will cease, even if the sum insured has not yet been exhausted. Setting an adequate MIP is therefore just as important as calculating an accurate sum insured.

BI insurance is designed to support policyholders until they recover to the position they were in prior to a loss – i.e. return to their former profitability. A common source of underinsurance is to think that this is simply the time taken to reinstate damaged property. However, once an organisation's property is reinstated, an equal or greater amount of time is often needed for activities such as recruiting staff, commissioning equipment and, vitally, winning back lost business.

Recovery time – extra considerations

- Thinking and decision time
- Planning enquiries, applications, additional requirements and delays
- Environmental or neighbour issues
- Demolition and debris removal
- Long lead times for replacing plant and machinery
- Installation and commissioning of new equipment
- Discovery of hazardous materials, such as asbestos
- Potential Health and Safety Executive inquiries or proceedings
- Recruiting and retraining staff
- Seasonality – may miss important trading periods
- Difficulty in winning back lost customers and opportunities

Additionally, there is a vast range of circumstances that can delay an organisation's recovery. Not contemplating worst-case scenarios, either by not using proper business continuity planning or being too optimistic about recovery times, is a frequent source of underinsurance.

MIPs should reflect the maximum time it could take a business to return to its former level of profitability based on worst-case scenarios.

6 Adjust sums insured in line with MIPs

A simple, yet common mistake, is to not alter sums insured in line with any changes to the MIP. For example, if changing from a 12- to a 24-month MIP, then the underlying sum insured may need to at least double, as it is now applied to double the length of time.

However, this is only a basic calculation, with further consideration needed to ensure sums insured remain adequate for the full length of the MIP (see tip 7).

7 Account for future trends

While cover may be adequate at inception, organisations do not remain static, with revenue and profitability changing over time. BI insurance is designed to put the policyholder back in the position they would have been had they not suffered a loss, and sums insured need to take account of future business trends in order to avoid underinsurance.

For example, should an organisation suffer a loss towards the end of a 12-month policy period, and it then takes 24 months before they fully recover, that is 36 months after which the BI cover levels were initially set. If that business was growing at a constant rate of 20% per year, then it would have grown significantly by the end of those 36 months had it not suffered the loss.

To ensure cover is adequate for the duration of the MIP, the sum insured needs to reflect both current and future circumstances, accounting for any anticipated business trends.

8 Make use of our free BI Calculator

We are committed to helping our customers and brokers achieve the best outcomes and avoid underinsurance.

Business interruption is an area where underinsurance is commonly discovered, jeopardising organisations' chances of recovery should they suffer a loss. To help you navigate the task of setting accurate sums insured and maximum indemnity periods, we offer a free Business Interruption Calculator tool.

This innovative online tool provides detailed guidance through the steps needed to set accurate cover levels.

To access this free tool, or to find out more about how we can help you avoid underinsurance, please speak to your local Zurich contact.

How Zurich can help

Explore our interactive risk resource hubs for further tools and guidance on underinsurance and other key topics.

https://insider.zurich.co.uk/risk-resources/underinsurance-risk-resource/

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A public limited company incorporated in Ireland. Registration No. 13460.
Registered Office: Zurich House, Ballsbridge Park, Dublin 4, Ireland.
UK Branch registered in England and Wales Registration No. BR7985.
UK Branch Head Office: The Zurich Centre, 3000 Parkway, Whiteley, Fareham, Hampshire PO15 7JZ.
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Produced by Marketing Communications and Creative team UK 2017

MCOBZA01