

Underinsurance

Introduction

Underinsurance is a frequently used term in insurance and often associated with 'Average' although the two should not be confused. The potential impact of underinsurance in the event of a claim should not be underestimated.

The following statistics published by Barrett Corp Harrington for 2007/11 indicate the extent of the problem:

- 85% of cases reviewed contained an element of underinsurance
- The average increase was in excess of 60%

What is underinsurance?

Underinsurance is the failure of the insured to set adequate sums insured or fully cover their potential losses. Examples include:

- Setting the Material Damage sum insured (Buildings, Contents, Machinery/Plant etc.) below the full cost of replacement
- Selecting a Business Interruption Indemnity Period that is too short for the time required for a business to fully recover

Under our insurance policies we will never pay more than the Sum Insured or Limit of Indemnity. If you insure your office contents for £25,000 and they are all damaged and they cost £50,000 to replace, an insurer will never pay more than the £25,000 sum insured.

It will therefore be appreciated that if we were dealing with a £50m building instead, the consequences of underinsurance would be catastrophic.

Average – What is it and why do Insurers apply it?

Insurers need to ensure they collect sufficient premium for each class of insurance to meet claims responsibilities. To achieve this fairly, each insured needs to contribute their respective share based on their full reinstatement value.

Average is applied in the event of underinsurance at the time of a loss. This is the principle that insurers will proportionately reduce their settlement by the level of underinsurance. Thus, taking our example above, if £10,000 of contents were damaged in a partial loss, the claim would be settled at £5,000 as only 50% of the replacement value was declared.



Isn't this unfair?

Large losses are less frequent than smaller ones so the majority of each insured's premiums contribute to the first portion of the risk.

If this is a little hard to understand ask yourself what discount you would expect from your premium if you self insured the first 50% of the risk. You would expect more than a 50% discount.

What causes underinsurance?

There are a number of documented common causes which are mentioned below.

Inflation

One of the most difficult aspects to predict is the effect of inflation.

It should be remembered a loss could happen on the final day of your insurance period and reinstatement may not be completed until several years thereafter. Predicting the inflation over such an extended period can be very difficult.

Under a normal basis of settlement the insured would need to build in a buffer for the effects of this inflation.

Under the **Day One Basis** of cover the insured is only required to assess the correct value as at the beginning of the period insurance. They can select a suitable inflation provision and the insurer will pay up to that amount.

It should be noted that the premium is based on the Day One Declared Value and only nominal charges are applied for higher inflation provisions. You should still review the declared value each year as inflation will most likely occur between periods of insurance.

Inadvertent Omission of Items

The most common mistake when considering the total rebuild of a property is to exclude some of the most crucial aspects of reinstatement. These include:

- Professional Fees
- Debris Removal
- Foundations
- Public Authority Requirements
- Green Upgrades
- Value Added Tax

Cost of Reinstatement

When assessing the cost of reinstatement some special factors need to be taken into account. These include:

- Applying the rebuild cost not the market value
- Historic buildings or Listed Features

Professional Valuations

Given the level of assets that are normally at risk we would highly recommend commissioning professional valuations such as from a suitably experienced RICS (Royal Institution of Chartered Surveyors) qualified surveyor for buildings. Best practice would be to carry these out annually but certainly at intervals of no more than three years with an annual reassessment to allow the surveyor to take account of issues affecting rebuild costs including inflation, legislation changes, alterations to the building and its site which would not be captured by simple indexation.

Obsolete Buildings

In some circumstances, following severe damage an insured may prefer a completely different type of building to the existing one. This could be due to a lack of demand for the use of the building or the type of construction and materials used. Planning and consents do have to be taken into account but a special 'obsolete buildings' basis of cover may be appropriate.

This requires the full reinstatement value to be declared and a loss limit is often selected to reflect that damage may be so significant that the most economic solution would be to clear the building and replace it with a modern one at a reduced cost. This will also cater for partial damage where repair may be required.

As this is a specialist cover, please talk to your insurance advisor about this.

Special consideration

The following type of property requires special consideration.

- Stock
- Machinery and Plant
- Computers
- Fine Art

You should discuss these with your insurance advisor.

Business Interruption

This cover will indemnify the insured against downturn in their financial earnings caused by insured physical damage. It is often overlooked that this is not just the reinstatement period but the time for the business to recover fully to the position prior to the incident.

Many of the factors that can cause delays are linked into those mentioned above. These include:

- Obtaining planning consents
- Availability of materials
- The resilience of the Business Continuity Plan
- Availability of alternative premises whilst unable to operate fully at the damaged premises
- Investigation delays (e.g. if damage involves fatalities)
- Time to recover original customer base

The insurance market has devised forms of cover to help protect the insured from the potential effects of underinsurance; the most common being Declaration Linking. Here insurers provide an uplift of up to 33% on the declared revenue or profit.

Chartis' position

We are committed to treating our customer's fairly and would like to emphasise that at Chartis, we do not want any of our clients to be in any way underinsured. Even if we are unable to accommodate the whole risk we would much prefer to explore alternative options that would not put our insured in a position where their ability to continue trading is in any way compromised.

Conclusion

We would encourage you to seek professional advice when dealing with insurance reinstatement cost valuations particularly with high value or unusual construction.

However the most important message of all is to remember that your premium is just a small proportion of the value at risk and for a few extra pounds you can buy peace of mind.

Solution Supplier

An example of a suitably experienced RICS registered firm for building insurance valuations in the UK is Barrett Corp & Harrington Ltd who specialise in reinstatement cost assessments for insurance purposes contact details : 0844 412 4495 www.bch.uk.com

Note that it is not a requirement that you use this particular supplier. Care should however be taken to ensure that the supplier chosen is well experienced and insured to undertake reinstatement cost assessments.

Royal Institution of Chartered Surveyors – contact details: www.rics.org/findasurveyor

For more information, ask your Chartis Risk Engineer

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