Loss Prevention Standards – Asset Classes

Underinsurance

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Underinsurance can result in policy cover being inadequate at the time of a loss, and potentially leading to reduced claims payments.

This Loss Prevention Standard provides guidance to help reduce the risks of underinsurance and the associated financial impacts.

AVIVA

Underinsurance

Introduction

Underinsurance occurs when the sums insured under an insurance policy in respect of property and business interruption covers are less than the accurate values at the time of a loss. If a loss occurs, the claims payment can be reduced proportionately, which can have significant financial consequences to a business that may already be dealing with a range of challenges after the loss event.

Many businesses and organisations are potentially exposed to the risks of underinsurance. Aviva estimate 35% of small to medium enterprise (SME) customers who insure their buildings are underinsured, and according to a YouGov survey undertaken by Aviva only 39% of UK businesses reviewed their business insurance covers within a 12-month period. A further 10% of SMEs stating they wouldn't survive if they had to pay more than £10,000 towards a claim.

Note: Data taken from Aviva Underinsurance Guide 2022

Causes of Underinsurance

Underinsurance can occur in a number of ways, including but not limited to:

New Assets

Extending existing buildings, or acquiring new premises or plant increases the values of assets, however the sums insured may not be increased accordingly.

Valuations

Sums insureds in respect of buildings and equipment are often based on professional valuations. These need to be regularly reviewed to assess the impacts of inflation; material costs and labour cost fluctuations and availability, particularly in areas where major projects or infrastructure changes may be consuming available labour or impact transport routes. Other factors such as walling, landscaped grounds, car parks etc., should be included.

Inflation

Periods of rising inflation can quickly result in sums insureds becoming inadequate, and the annual review of values insured undertaken by many businesses may no longer be sufficient.

VAT

Businesses that are not VAT registered, may be unaware that some policies exclude VAT in claims payments.

Supplier Costs

Manufacturing costs can increase when raw materials, labour or energy costs increase. These costs may not always be promptly reflected in stock sums insured.

Seasonal Fluctuations

Some businesses increase the value of stock prior to peak trading periods such as Christmas or Summer, or a new product launch. These fluctuations may not be sufficiently accommodated under some insurance policies.

Business Interruption

An underestimated assessment of how promptly a business could be expected to recover following a loss event often accounts for inadequate indemnity periods and/or coverages being selected in business interruption policies.

Unforeseen delays in reinstating buildings and equipment can also often result in the policy indemnity period being exhausted prior to full recovery from the loss event.

Note: Not having an appropriate understanding of a business model and any contracts in place, may result in incorrect or insufficient BI coverages being purchased e.g. Committed Costs. Please see Aviva's full range of Loss Prevention Standards related to Business Interruption.

Consequences of Underinsurance

The effects of underinsurance can include:

- Delays in reinstating or repairing damage.
- Cashflow issues as companies have to find, or reallocate funding, to contribute to reinstatement costs.
- Production impacts as resource and funding is allocated away from other business lines or activities.
- Supply chain issues as suppliers prioritise the needs of other customers.
- Reputational damage including to Environmental, Social and Governance (ESG) targets and aspirations.
- Profit and income can be affected by protracted downtime, which can also impact share price.
- Loss of key employees, potentially to competitors.
- Impact on future insurance policies.

Case Study

A property in the course of refurbishment was lost to fire, assumed to be as a result of earlier hot work repairs. The policy sum insured, when compared to valuation undertaken following the loss, suggested underinsurance of around 65%. Whilst the claim provided up to the declared sum insured, this was not the true cost of reinstatement.

How is Underinsurance Calculated

Most property and business policies are subject to a policy condition known as the **Average Clause**. This essentially states the insurer will pay claims in proportion to the amount of any underinsurance. For example, a property damage claim for a building lost to fire and insured for only 50% of its true reinstatement cost, would be limited to 50% of the loss amount, regardless of the size of that loss. Some Insurers modify this clause so that average only applies if the sum insured falls below a certain percentage, for example 75%. This is known as a **Special Condition of Average**.

Avoiding Underinsurance

General

- Responsibility for setting, reviewing, and signing off sums insured within insurance policies rests with the business or organisation.
- This process should be formalised, and responsibilities agreed within the organisation.
- Insurers and Brokers can often assist by providing guidance and data on market conditions and may have arrangements with specialist providers.
  - ✓ Aviva provide access to a range of Specialist Partners who undertaken reinstatement cost assessments and valuations at discounted fees for Aviva customers.
  - ✓ The Aviva Business Interruption Calculator can assist with calculating the correct sums insured under business interruption policies.

Buildings and Machinery/Contents

The sum insured should generally represent the reinstatement cost of the buildings, machinery, and contents as new. Some policies may instead provide for an 'indemnity basis of cover' or reinstatement value less a reduction for wear and tear, typically when the assets are aged and/or in poor or worsening condition.

- Ensure the buildings reinstatement values are subject to a formal review process. This should be undertaken at least annually, with formal valuations undertaken at least every three years, however these frequencies should be reviewed during periods of rising inflation.
- The costs of debris removal and professional fees are often underestimated during sums insured reviews and should be fully considered.
- Use experts to assist with calculating sums insured if these skills are not available within the organisation.
  - ✓ For simple and lower value buildings, desktop valuation schemes are available which use a range of online tools and publicly available material to provide a suggested reinstatement sum insured.
  - ✓ Formal valuations, undertaken by a qualified Surveyor are normally recommended for larger; unusual; highly specified and/or listed properties where online assessments wouldn't be appropriate, due to the bespoke nature of the properties.
    - ▪ Consideration should be given to any materials within existing structures that may require specialist handling in the event of a loss, such as asbestos. Such issues can cause delays to rebuilding works and additional cost.
- Machinery suppliers can assist with assessing the reinstatement cost of bespoke or specialised equipment. Installation and commissioning costs should be included if such work is undertaken by third party companies.
- Specialist valuers can assist with calculating the sums insured in respect of long established, unusual and/or legacy equipment.
- Ensure consideration is given to adverse or unusual economic conditions that might impact costs from overseas suppliers, such as regular or ongoing currency fluctuations.
- Check property policies to ensure sums insured are index-linked.

Stock

The stock sum insured includes finished stock, deadstock, raw materials, work in progress and should reflect the maximum replacement cost of such goods, factoring in any increased stock holding around peak trading periods.

- Stock inventories can assist with establishing maximum stock levels and values across trading periods.
  - ✓ Consider any seasonal peaks or stock piling.
- Suppliers of core or key goods should also be asked to provide an overview of current and projected pricing expectations.
- Customers goods, where stored at the premises, should also be included.

Business Interruption

The business interruption sum insured is invariably based on gross profit or income, with deductions made for uninsured costs and variable expenses such as power, fuel, raw materials, transportation, some elements of payroll etc. The policy cover is usually limited to an indemnity period, such as 12, 24 or 36 months following the loss, and policies typically feature extensions of cover for trading losses attributed to damage at the premises of a key customer or supplier.

- The policy sum insured should be routinely reviewed, and where necessary verified by competent persons within Finance Departments, Company Accountants etc.
- The appropriate indemnity period should be selected.
  - ✓ Insufficient indemnity periods are often selected, resulting in financial challenges whilst recovery is in hand. Business interruption policy cover typically applies until the business or organisation has fully recovered to profitability, not just until the business resumes trading.

- ✓ Repairs to damaged premises may be delayed due to planning issues, difficulties sourcing materials and labour, in some cases criminal investigations. This can have a knock-on effect to resumption of trading recovery.
- ✓ Replacement machinery delays should be anticipated, particularly equipment that is bespoke, sourced from overseas manufacturers, or where the original equipment manufacturer is no longer in business and alternative repairers/manufacturers have to be sourced.
- ✓ Underinsurance issues in respect of buildings and/or machinery can delay reinstatement of key facilities, particularly if any shortfall has to be found during an already challenging period.
- ✓ Key supplier agreements can be impacted as a result of the down time and may take longer than expected to re-establish or source new suppliers.
- ✓ The time taken to reinstate data is often underestimated and should be adequately considered.

- Standard policy limits for losses attributed to suppliers or customers may not be sufficient. Ensure any significant contracts with suppliers/customers are adequately covered.
- Rental income from tenants should be included in the policy sum insured. This revenue may cease in the event of the premises being uninhabitable.

Key Action Steps

- Ensure formal procedures for the review of policy sums insured are in place, with verification by competent persons or companies as necessary, e.g. Chartered Surveyors, Chartered Accountants etc.
- ***Annual reviews of sums insured*** are typically sufficient, should no major changes or acquisitions have taken place, however fast changing workplaces, acquisitions, or period of rising inflation may result in more regular reviews being necessary.
- ***Formal building valuations*** should be undertaken ***at least every three years.***
- Business interruption policy covers should be routinely reviewed to ensure appropriate indemnity periods and policy extensions, including those relation to customers and suppliers, are in place.
- Discuss specific exposures or concerns with your Broker and Insurers and, check what expert services or preferred provider arrangements are available.

Specialist Partner Solutions

Aviva Risk Management Solutions can offer access to a wide range of risk management products and services at preferential rates via our network of Specialist Partners, including:

- Building Reinstatement Cost Assessments: BCH.
- Building Reinstatement Cost Assessments: Cardinus.
- Building Reinstatement Cost Assessments: Sedgwick.
- Plant, Machinery and Contents Assessments: Charterfields.

For more information please visit: Aviva Risk Management Solutions – Specialist Partners

Sources and Useful Links

- Aviva Underinsurance Guide.
- Aviva Business Interruption Calculator

Note: Whilst UK standards and legislation are referenced in this document, other international standards and legislation should be referenced where applicable.

Additional Information

- **Business Impact Analysis**
- **Business Interruption – Indemnity Period and Maximum Indemnity Period**
- **Business Interruption - Calculating a Specified Suppliers Extension Limit**
- **Business Interruption – Committed Costs**
- **Business Interruption - Rebuilding Period and Rebuilding Valuation**
- **Supply Chain Risk Management**

To find out more, please visit Aviva Risk Management Solutions **or speak to one of our advisors.**

Email us at riskadvice@aviva.com or call 0345 366 6666. *

*The cost of calls to 03 prefixed numbers are charged at national call rates (charges may vary dependent on your network provider) and are usually included in inclusive minute plans from landlines and mobiles. For our joint protection telephone calls may be recorded and/or monitored.

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