

Underinsurance Factsheet

Over the years there have been numerous surveys to gauge the level of underinsurance in the UK. The figures may vary (45% to 80%), but it is clear underinsurance is a major problem in the UK and the degree of underinsurance is also frequently significant. This research usually concentrates on buildings, but is also often a problem with contents or business interruption and because of the 'Average' condition can cause serious financial consequences in the event of a claim.

What is Average?

Average is a clause applied to most business policies and means that if you do not insure for the full value you will bear a pro rata share of the loss that you suffer. The formula works as follows;

$$\frac{\text{Policy Sum Insured}}{\text{Correct Sum Insured}} \times \text{Claim} = \text{Payment}$$

So, if a building insured for £500,000 should have been insured for £625,000, the effect of 20% underinsurance on a £250,000 claim will see the insurer paying only £200,000 leaving a shortfall of £50,000.

Why may I be underinsured?

Usually it is not deliberate, but the cost of replacement is simply underestimated. There are a range of reasons and the most common are as follows:

1. **Understand your basis of settlement** – the majority of policies are on a reinstatement basis which is akin to 'new for old'. Do not assess sums insured on a second hand value unless 'indemnity' settlement has been agreed with insurers.
2. **Building sums insured should reflect rebuilding cost not market value** – this is a common mistake and whilst it can lead to an over valuation, with older properties is frequently insufficient.
3. **Check your Schedule correctly** – A Day One inflation provision applies to many policies, but you only get the benefit if the inflation actually occurs. It is reliant on the sum insured being adequate at the start of the period of insurance and you should review the sum insured in brackets, not the unbracketed figure that includes the inflation provision.
4. **Conservation areas and older or listed buildings** - do not just assess the cost of replacement with modern materials, partial damage to an older building may involve using original materials, especially for listed buildings.
5. **Include everything** – for buildings that means, internal features, foundations, boundary walls, outbuildings and car parks. For contents, it means from the largest pieces of machinery to the smallest items in the cupboards.
6. **And also include enough for the 'extras'** – these will include;
 - a. Consultancy fees such as Architects, Structural Engineers and Surveyors
 - b. Debris removal costs
 - c. The cost of complying with up to date building regulations and legislation such as the Disability Discrimination Act

These can represent significant costs and your sum insured needs to be sufficient to include them.

7. **VAT** – generally VAT registered companies do not need to include VAT in the sum insured, however, rules can be complicated and specialist advice is recommended.
8. **Exchange rate fluctuations** – these can be a significant factor, particularly when sourcing replacement machinery.
9. **Stock** – the sum insured is generally assessed on cost price to you, although finished goods can be insured at invoice price if pre sold. Remember to include raw materials, work in progress and even



waste materials if they have value to you. Insure for the maximum value at risk taking seasonal fluctuations into account. Some policies will automatically include seasonal increases and can be amended if they do not tie in with your busier periods. Special arrangements can be made if you have significant fluctuations in value during the year.

How do I avoid underinsurance?

A Professional Valuation is the safest way and some insurers will waive average if a professional valuation has been undertaken. Some may also assist with the cost of the valuation (ask your usual Nsure contact for details). If your property has been surveyed for marketing or finance purposes in recent years, check the report as it should include an assessment of the rebuilding cost.

Review your sums insured regularly, at least annually to reflect alterations, improvements or replacements that have occurred and the factors mentioned above. Do not just rely on index linking that applies to some policies.

It is not just buildings and contents that need to be fully insured, you should regularly review all your insurances to ensure that the cover and limits provide the protection you require.

Insurance Act 2015 Update (as at June 2016)

The Insurance Act comes into force on 12th August 2016 and will almost certainly influence the position on underinsurance. A policyholder's obligations of good faith and ensuring the accuracy of information will remain in force, but the Act redefines the policyholder's duty of disclosure and will require a 'fair presentation of risk'. This will include the requirement to give a fair presentation of the values at risk, i.e. not to be underinsured.

In the run up to the Act coming into force, some insurers are offering 'average free' policies, particularly for smaller business. However, whilst a claim may not be reduced in line with the average condition shown above, insurers will have rights of redress available to them under the new Act if there has not been a fair presentation of risk from the policyholder, including if the sums insured are understated.

At this stage, it is too early to know how this will actually affect cases of underinsurance and it may take a few legal challenges for exact certainty to emerge. In the meantime, it is far better to avoid being underinsured rather than take a chance.

We hope that you have found this factsheet of use and for further information please speak to your usual contact at Nsure.

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