

MORE INSURANCE EXPERTISE  
IN MORE PLACES

# FOCUS ON UNDERINSURANCE AND ADEQUATE BUSINESS INTERRUPTION INSURANCE

YOUR GUIDE TO MINDING THE GAPS





Valuation experts Barrett Corp & Harrington say "On average 77% of the properties they survey are underinsured by 45%"

\* Sources: <http://www.bch.uk.com>

# COPING WITH A SEISMIC SHIFT

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The Insurance Act 2015 represents a seismic shift in insurance law since 1906 and came into force on 12 August 2016. The requirements of the Act are exacting and have been created to help you get fairer treatment from your insurer in the event of a loss or claim. However, the Act also stipulates that you have a ‘duty of fair presentation’ of your risk. This means that you must disclose every material circumstance you know, or ought to know and must provide sufficient information to allow a prudent insurer to make further enquiries. You are also required to present your risk in a manner which is reasonably clear and accessible and ensure that every material representation is substantively correct and made in good faith.

It’s this shortfall between policy cover and reality that has led to problems in the past.

Indeed, The Financial Conduct Authority (FCA) recently released a thematic review of commercial claims\* which revealed what they termed ‘an alarming degree of Underinsurance’. It’s a state of affairs that can have disastrous consequences for the insured. The FCA also found that nearly 25% of the Business Interruption claims that were examined involved the loss exceeding the indemnity period set at 12 months.

With these findings, and the onerous obligations that characterise the new Insurance Act – checking that you have appropriate levels of cover in place to protect your business and your livelihood needs to be a key concern.

This guide has been designed to highlight the main issues relating to Underinsurance for you and should serve as a timely reminder to see what condition your business is in.

\*Source: BIBA, Professional Indemnity Volume 6: Managing Under-Insurance – A guide to prevention. 5th May 16.

**In their recent thematic review into the handling of SME claims, the FCA discovered that “12 out of the 20 case studies there were issues relating to sums insured. In 8 cases the material damage sums insured for buildings, trade contents and/or stock were inadequate. In 4 cases the loss exceeded the 12 month maximum indemnity period.”**

# WHAT IF THE WORST WAS TO HAPPEN?

For the purposes of running through an example, let's imagine that you are a responsible business owner working in the retail sector. A business owner who takes the matter of protecting their business very seriously. You have cover for physical damage that also incorporates business interruption cover so, not only are your assets protected, but also loss of revenue in the event of an incident.

However, when the time comes to make a claim you discover all is not right. The true rebuilding cost of your shop is found to be £3million, with an estimated timescale, including site clearance and planning, of two years. Yet you have only insured the shop for the market value of £1.5million, which, after any excess, is the maximum sum that your insurer will pay out.

To make matters worse, you have also grossly underestimated the annual turnover of your business, which you have indicated to your insurers is £100,000 but in reality is closer to £500,000. The business interruption component of your cover is also limited to £100,000.

## So where did it all go wrong?

In short, the above example highlights the problem of Underinsurance. Quite simply, if you are underinsured for either your physical assets or for the impact of business interruption, your insurers will reduce your claim settlement.

Of course, different policies apply different means of settling claims in such an event, but it's likely that insurers will apply what is known as a 'condition of average'.

For example, if the rebuilding cost of your property is determined to be £200,000 and you have only insured for £100,000 – only 50% of any claim would be paid before the deduction of any excess. This could mean that, in the event of a serious incident, your business is exposed to a large financial loss.

In addition to this, under the proportionate remedies within the Insurance Act 2015, the claim could also be reduced proportionately if an additional premium would have been charged at inception or terms can be applied retrospectively, if these would have been applied at inception.

Alternatively, your insurer's policy may state that, in such an event, the claim will not be settled on a 'new for old' basis, but will instead make a deduction for wear and tear. Again, this will have severe financial implications for your business.

## How bad could it get?

The worst-case scenario under the remedies within the Insurance Act 2015 may be that your insurers consider that the declared rebuilding sum insured represented a deliberate or reckless breach and would be within their rights to avoid the policy altogether, with no return of premium. In other words, you would have no insurance and no ability to make a claim with no refund. For more information please speak to your usual contact or refer to our guide on the Insurance Act.





# TAKE POSITIVE STEPS NOW TO AVOID THE WORST-CASE SCENARIO LATER

## Valuations for Insurance Purposes Service

The assessment or valuation of buildings and other business assets such as stock, plant and machinery for insurance purposes, not to mention the potential business disruption losses suffered as a consequential loss is a skill. To be able to deal with the subject competently a valuation surveyor needs to have a good knowledge of the asset to be valued and the basis upon which an insurance policy will compensate an insured party if the asset is damaged or destroyed.

The most problematic valuations for insurance tend to be those where the subject matter is in the commercial or industrial sector. True long term business interruption can be very difficult to predict due to the number of factors involved and the valuation of commercial and industrial buildings can be complex due to the large sums involved, potential VAT implications and/or the new Community Infrastructure Levy. If a mistake is made it could be costly if you have to make a claim. Talk to Towergate about getting professional valuations and business interruption cover reviews of your business assets.

# THE SCALE OF THE PROBLEM

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According to recent research by the Building Cost Information Service, part of the Royal Institution of Chartered Surveyors, 80% of commercial properties in England and Wales are actually underinsured.

The widespread nature of the problem in recent years has seen the British Insurance Brokers' Association (BIBA) publish specific advice for businesses in an attempt to counter the problem.

BIBA believes the heart of the problem is that too many businesses focus on the price of their policies, yet this can often be a false economy. A significant number of businesses simply fail to ensure their property is insured for the right sum. Yes, competitive premiums and value for money are very important, but ensuring you have appropriate cover in place is paramount.

## **Not forgetting... business interruption**

Having the right level of business interruption cover is also incredibly important but, unfortunately, this is also a major issue for UK businesses. Aviva's recent SME Pulse research found that around two thirds (62%) of UK SMEs either don't have business interruption insurance or are unsure about whether it's included in their current business insurance policy.

Despite this, one in five SMEs surveyed (21%) said they had experienced disruption to their business – it took up to three months for a quarter of them to get back to normal business trading and, for the remainder, it took up to two years or more.

### **You could be underinsured when:**

1. You haven't factored in costs for gates, fences or car parking areas in your calculations
2. Your property is a listed building – the time and cost of repairs/rebuilds are likely to be far greater than for an unlisted building, impacting your business interruption cover
3. You haven't factored in costs such as site clearance or access – particularly where your business might need, for example, a crane or heavy plant to help with remedial work as a result of a claim. This could also add time that needs to be taken into account for your business interruption cover

# CONCERNED THAT YOUR BUSINESS COULD BE UNDERINSURED?

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To help you, we've put together a checklist of the top eight instances when Underinsurance occurs and includes scenarios relating to both property insurance and business interruption insurance.

## **Your cover is based on the market value of the building, but it should be based on the rebuild cost**

For buildings, this means the full cost of rebuilding your property including any outbuildings, plus any extra charges that could be involved in rebuilding.

What we're talking about here is the 'sum insured'. When you buy a property you will have a valuation. However, unless you have a reinstatement cost valuation conducted for your insurance, this figure could soon become out of date.

## **You haven't had your property professionally valued for insurance purposes**

When you purchased your property you would have needed a valuation by a suitably qualified professional such as a surveyor. This gives the market value of the property and also a reinstatement cost for insurance purposes.

Subsequently, the building's sum insured in your schedule should have been adjusted monthly and updated each year at renewal.

## **You have altered or extended the property**

You need to inform your insurer if you have altered or extended the property connected with your business, especially if the change increases the sum insured.

## **You haven't factored in the costs of professional fees such as an architect or surveyor**

The sum insured value will also need to include the cost of demolishing the entire structure, including removing the floor slab and foundations, as well as all professional fees associated with rebuilding such as architects, surveyors, planning experts and so on. It's important not to underestimate professional fees as these can add up to 15% to the cost of the rebuild.

## **You are carrying more stock now than when you took out your insurance policy**

As your business grows, it is more than likely that your stock levels will increase accordingly. It is fundamental that your insurer is updated with the changed stock levels. Moreover, it is also important to inform your insurer of stock that fluctuates substantially in different seasons. Examples of this is increased stock surrounding Christmas.

## **Capital additions**

'Capital additions' clause is included in most policies which will allow the sum insured to be increased to take account of property alterations and equipment that may have been acquired since the previous policy renewal. Usually, there is an upper limit on such capital additions. It is essential that you let us know of any major pieces of equipment, or new depots or locations that are taken on or acquired after the date of renewal, so that they can be added to the policy.

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## Property Damage

Periods of higher inflation, noting that Buildings reinstatement values selected at each renewal need to anticipate future cost levels sometimes years later, because a loss might occur towards the end of an annual policy term, with subsequent start delays in rebuild caused by planning and tendering processes, and construction phases themselves can be lengthy.

Additional costs, need to take into account not just professional fees and debris removal, but also public authority requirements and latest building regulations, all of which collectively can easily generate an extra 20% on top of the pure reconstruction cost.

## Business Interruption

Incorrect selection of Gross Profit (or Insured Profit) values for manufacturers, wholesalers, or retailers of tangible goods, as no care has been taken to calculate them to match the policy definitions e.g. salaries and wage roll, or other inappropriate deductions have been made from turnover.

Selection of the wrong cover type, from under-estimation of likely disruption or over-optimism over the business's resilience to loss events e.g. Increased Cost of Working/ Extra Expenses coverage might be selected, instead of "full profits" coverage provided by Income, Revenue or Gross Profit coverages.

**"Looking at a sample of 383 clients where Underinsurance was a problem in 2014, a survey team referred 206 commercial property clients for professional valuations. In the remaining 177 cases, in-house risk management surveyors found that each client had effectively underinsured their business by, on average, £486,000"**

Source – Aviva



# SO WHAT'S THE SOLUTION?

For starters, it's vital that you don't just focus on finding the cheapest priced policy for your property and/or business interruption insurance.

It is critical that you receive good advice, and a good broker will discuss with you that your sums insured are adequate and that the policy provides good quality cover and, crucially won't leave you underinsured in the event of a claim

## Business interruption cover, in brief

Business interruption insurance should be added to the overall business insurance policy, providing cover for loss of income and helping the business to recover in the event of an incident. Business interruption insurance details vary from insurer to insurer, but all are based on an accurate assessment of the amount of time it would take for your business to recover from an event that impacts your normal operations – in technical language the 'indemnity period'. Calculating this period accurately is critical.

Most policies will cover business interruption as a result of:

- Damage caused to your own premises or equipment caused by fire, storm, flood or a range of other accidental insured events
- Damage caused by similar events to third party property in the vicinity of your premises, preventing access
- Damage caused by similar events to premises or infrastructure of your public utility providers

Some policies can also be extended additionally to cover:

- Damage caused to the premises of your suppliers or clients or contract sites
- Mechanical or electrical breakdown of your essential plant items

Remember that the recovery process can take longer than you anticipated, so even small business can take longer than 12 months to get back on their feet – and regain vital lost custom.

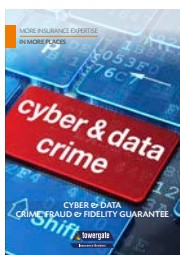
## Some cases in point

1. A hairdresser was carrying more stock than they had told their insurer they had. The figure they had provided was used to calculate the insurance cover. So when the business suffered a theft of more than £1,900 worth of stock, the owner found that the claim was covered but was based on an 'average clause' – i.e., it was paid based on the percentage of cover that was taken out rather than what the cover should have been. This left the owner underinsured by £900 and needing to find that money elsewhere.
2. A manufacturer had a fire at their premises and lost everything. When they took out their insurance they had decided that they could recover from any major event within 12 months and, therefore, had only taken out business interruption insurance to cover them for loss of income for that period. Unfortunately, although the repairs themselves were covered by property insurance, the extent of the damage and the specialist nature of their business meant that planning permission, repairs, the build time for machinery and time to regain lost custom would take three to four years. This was obviously significantly longer than they had first thought when calculating how long they would need business interruption insurance for and, consequently, they were seriously underinsured.

# GAPS IN INSURANCE

Whilst reviewing these aspects of your insurance cover, now may be the time to look at other potential gaps in your business's insurance; for example;

## Cyber attacks continue to escalate ...but are you really covered?



According to the latest research, cyber crime is on the rise, with the sums involved now potentially very painful. The average cost of a cyber attack to large business in the UK now stands at some £36,500, with

the most severe attacks costing millions, as revealed by the government's Cyber Security Breaches Survey 2016.

## Brexit should prompt Intellectual Property protection review

The consequences of the 23 June 2016 UK Referendum result to leave the European Union will take years to unravel, with potentially profound economic and political change, but already specialists in the field of intellectual property are urging businesses to review their protection arrangements.

According to Richard Kaiser, a partner at law firm Michael, Best & Friedrich, it is unclear how these rights will be affected once the UK ceases to be a member of the EU.



## Are UK companies sitting on an environmental time bomb?

The Environmental Liability Directive (ELD) became law in the UK on 1st March 2009.

Would businesses cope if they suddenly had to respond to claims that their company's activities, or even just its premises and land under its control, had somehow caused pollution or environmental damage.

Particularly as the directive is comprised of two new liability criteria, not usually covered in the UK by a standard liability insurance policy. Namely strict liability for specified environmentally hazardous activities and fault-based liability for all other business activities.

The business interruption and cost implications almost don't bear thinking about. So the chances of a company's existing insurance policies protecting them against a pollution or environmental incident are low.



## Terrorism – a major threat to businesses

The UK Government advises that the threat level from terrorism in mainland Britain for the UK is currently 'Severe'. 'Severe' is the next level up from

'Moderate' and means that a terrorist attack is thought to be highly likely, according to the Joint Terrorism Analysis Centre, (JTAC) – an authority, comprised of representatives from 16 Government departments and agencies.

Previously, the risk of a terror attack is thought to have primarily been an issue for major cities. However, there is now every possibility that the risk has increased and become more geographically spread. Despite the recent devastation caused by groups or individuals, many companies still remain exposed to major crisis and disruption to their business resulting from an act of terrorism.

Given the nature of this particular risk exposure, insurance against acts of terrorism should be included in a company's insurance review process. Alternatively, please speak to the service team at Towergate to discuss your options.



## Management scrutiny highlights the need for Management Liability cover

Securities class actions have long been associated with the US, where the strong plaintiff bar and potential for massive payouts in certain federal jurisdictions has positively encouraged a swathe of legal action against a range of business owners, both large and small.

The new collective action regime introduced by the Consumer Rights Act of 2015 came into effect on 1 October 2015. In brief, the Act's provisions facilitate collective proceedings for competition law breaches before the Competition Appeal Tribunal (CAT), by granting the CAT the power to grant collective proceedings orders and to grant collective settlement orders.

The introduction of the Consumer Rights Act has led to speculation in many legal quarters that there could well be a surge in US-style class actions in the UK meaning Management Liability

Insurance could be a gap in insurance cover for many UK businesses.

## Group Personal Accident and Travel

The key asset of any business is its employees. Although when it comes to considering insurance protection, other insurances often take priority and protection for employees can be overlooked. With Group Personal Accident cover, a business can minimise any interruption caused by a fatal accident or short and long-term employee absence.

Group Personal Accident benefits are paid to the business for the benefit of the business or its employees.

Some of your staff may be on the road or travel overseas a lot. Group Travel insurance covers lost business expenses, including cover following death, injury, illness or loss whilst travelling, and emergency medical expenses and repatriation, not to mention the cancellation cover if a trip is cancelled due to an insured peril. Though not covered by Group Personal Accident, it can be 'bundled together' to offer a more comprehensive set of employee covers, cost efficiently.

# THE NEXT STEP IS OVER TO YOU

## For 'More insurance expertise in more places' talk to the team at Towergate

As one of the largest corporate and SME insurance brokers in the UK we understand the business you're in. Through our trusted local teams and our network of experts, we give you substantial access to an extensive range of tailor-made, trade-specific insurance and risk management programmes.

We hope you have found this guide to Underinsurance and how best to avoid it useful.

Please get in touch if we can be of any further assistance to your business.

Simply talk to your usual contact or email [enquiries@towergate.co.uk](mailto:enquiries@towergate.co.uk) or visit [www.towergate.co.uk](http://www.towergate.co.uk)

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