

'MIND THE GAP'- TIPS TO HELP AVOID UNDERINSURANCE

With inflation reported to be increasing faster than at any time for the past 40 years, there is a heightened risk that insureds will find themselves underinsured. Prices are rising so fast that insurance cover that may have been adequate a few months ago may now be insufficient. Against this backdrop, it is perhaps not surprising that we are currently seeing a significant increase in the number of notifications from the membership involving issues of underinsurance.

By their very nature, such issues are often not evident until an insured makes a claim. However, BIBA has recently estimated that 40-45% of claims are affected by underinsurance. Given those numbers, it is essential that intermediaries are alive to this issue and the steps they can take to help avoid a problem.

WHAT IS UNDERINSURANCE?

Underinsurance arises when a contract of insurance provides an insufficient amount of cover to put an insured back into the position it would have been in, had the insured event not occurred.

If, during the consideration of a claim, an insurer or adjuster considers that the sum insured is insufficient, an average clause in the policy may be applied. This involves the insurer reducing proportionately the amount to be paid, in order to reflect the adequacy of the sum insured.

A simple example of this would be where the agreed sum insured for a property is £80,000, which is the amount set out in the expiring year policy. However, due to property price inflation, the true value of the property at the time of loss is £100,000. The claim is for £20,000 of property damage, and an excess of £2,500 applies.

An insurer applying average may proceed as follows –

- Insured value / true value = 80%
- 80% of claim = £16,000
- Application of excess reduces the claim payment to £13,500
- Underinsurance is £4,000.

Alternatively, if the policy does not entitle the insurer to apply average, the insurer may simply pay an amount up to the sum insured, leaving the insured with a shortfall. The best outcome will be that the insurer agrees to pay the claim in full but charges an additional premium, in order to reflect the amount of premium that would have been charged had adequate levels of insurance been purchased.

An insured who discovers during the claims process that the policy does not provide sufficient cover to meet the losses it has suffered, may well look to hold the intermediary responsible for the “gap” between insured and uninsured losses. Such a gap could be considerable.

WHY DOES UNDERINSURANCE OCCUR?

Underinsurance can sometimes be deliberate. This usually occurs as a result of an insured purposely under-declaring the value of the asset or potential liability to be insured, or intentionally understating the amount of cover that is required. This is likely to be done in an attempt to reduce the amount of premium payable. The current economic climate clearly increases the risk of insureds adopting this approach when renewing their cover. In such circumstances, the broker's file should make it clear that the client understands the level of underinsurance, and the potential consequence of that underinsurance in the event of a claim.

It is also essential that accurate values are disclosed to underwriters, and the broker can demonstrate that the insured's disclosure obligations have been discharged. This avoids a risk of insurers subsequently seeking to avoid the policy or decline claims in their entirety, on the grounds of deliberate or reckless misrepresentation.

It is arguably more common for underinsurance to be inadvertent. This usually occurs as a result of incorrectly calculating the value of the asset or potential liability to be insured, or the amount of cover that is required. Alternatively, valuations which were initially accurate may not have been regularly reviewed and updated. Accurate valuations of assets and potential liabilities are not straightforward, particularly when high rates of inflation (as are being experienced currently across the world) mean that the costs of repairing or replacing assets after a loss, or defending liability claims, can be much higher than estimated when the policy inception.

HOW CAN BROKERS HELP CLIENTS TO AVOID UNDERINSURANCE?

It is important to note that brokers are not professional valuers. It is good practice to make it clear in Terms of Business Agreements that the broker's responsibility will not extend to giving valuation advice and that clients should seek advice from a professional valuer, where necessary.

However, brokers can help clients to correctly calculate the amount of cover that they need by:

- Explaining what each sum insured and/or limit of liability in the policy reflects;
- Ensuring that sums insured and/or limits of liability are thoroughly reviewed at renewals;
- Advising the client to consider the extent to which the value of each asset to be insured may increase (or decrease) over the duration of the policy. This is particularly important during periods of high inflation, as are being experienced now, or where the insured makes improvements to the asset (such as property);
- Querying any significant changes (particularly reductions) in sums insured and/or limits of liability;
- Explaining how indemnity periods for business interruption losses operate (i.e. usually on a 24 month minimum basis), and how the definition of "Gross Profit" differs from accountancy definitions and how it can differ between different BI policy wordings;
- Explaining the difference between property losses payable on an "indemnity basis", "agreed value basis", and "reinstatement basis";

- Advising the client, where appropriate, to consider a “day one” policy with a suitable uplift, and/or an index-linked valuation and discuss with the client the most appropriate index to be used for the insured’s business;
- Explaining that the costs of rebuilding a property, or replacing stock as new, may outweigh the relevant “market value”; and
- Advising the client to consider the anticipated frequency and severity of liability claims that may be made against it, together with any contractual liabilities it may have assumed.

As always, any advice or explanations given to clients (whether verbally or in writing) should be fully documented on the broker’s file. Keeping a complete record of all advice given will be essential should a professional indemnity issue arise at a later date.

Griffin is happy to provide further assistance to any Member on the issue of underinsurance, where required.

This bulletin is for general information purposes only and does not provide a comprehensive or complete statement of the law relating to the issues discussed nor does it constitute legal advice. In addition, by its nature, this bulletin may be superseded by subsequent regulatory or legal developments. Professional advice should be sought where appropriate in relation to any particular circumstances.

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© Tindall Riley & Co Limited

Managers: Griffin Managers
Regis House
45 King William Street
London EC4R 9AN
Telephone 020 7407 3588
Email griffin@tindallriley.com
www.griffin-insurance.co.uk