British Insurance Brokers' Association

How to avoid under-insurance

A BIBA guide for small and medium-sized businesses

BIBA

Top tips

- Use professional valuation services to help you decide on your sums insured – useful information can be provided by your broker or insurer, or via http://abi.bcis.co.uk or www.rics.org/bcis. Regular valuations will help ensure the sums insured are correctly assessed.
- Getting the numbers right when you buy your insurance policy will help avoid any inadequate sums insured becoming even less suitable year-on-year.
- Sums insured for buildings should be based on the cost of rebuilding not the market value – particular features of your premises might affect the cost of reconstruction.
- For business interruption consider buying declaration-linked insurance because it provides an uplift of 33%, providing that the sum insured and period of indemnity are both correct initially and declarations are made when requested by insurers.
- When looking at business interruption insurance remember that accountancy and insurance policy definitions of annual gross profit are different. Make sure your assessment of gross profit matches the one in your policy.
- When thinking about an indemnity period for business interruption covers, remember that 24 months is likely to be the minimum period needed for a business to fully recover its trading level and to rebuild its customer base.
- Checking documentation is always a good idea; many insurers will make every effort to draw your attention to the important conditions of your policy but it is always important to check to make sure there are no errors.
- Disaster recovery or business continuity plans may help you recover after a loss.
- If you buy a simple online package policy check that the liability limits of indemnity, business interruption indemnity periods and other standard policy limits are sufficient.
- Liability policies are complex. Make sure that you have considered the risk of claims against you and check whether you have taken on any liabilities under your terms of business contracts.
- New risks sometimes emerge. Consider how the risks to your business change, including areas such as cyber risk or data protection.
- The costs of claims preparation, such as the costs of instructing an expert or an accountant to help with the claim are not usually included in your insurance cover and may be costly; discuss with your broker whether you need to buy additional insurance to cover this.

Insurance is a key purchase for businesses and you assume it will protect you when you need it for example if there is:

- loss or damage to your property; or
- injury to your employees; or
- injury to someone else or damage to their property caused by you or your business.

Suitable insurance forms a vital part of business continuity planning - but how can you be sure that you are buying the right *amount* of cover? Finding at the time of a claim, that the policy you bought is not enough can have devastating consequences and under-insurance, as it is called, can be a significant issue.

Why getting the right level of insurance cover is critical to your business

Insurance companies base their premiums on, among other things, the value of the risk they are insuring which is usually based on the information a policyholder provides. If, at the time of a claim, this amount is found to be lower than the assessed value at the time of the loss then the insurers (who will not have been paid enough premium) may seek a proportionate remedy to put them in the position they should have been in when accepting the risk. This might result in more premium being charged or different policy terms applied or a reduction in the claim payment (which in some policies is called a condition of average).

Under-insurance can arise as a result of a failure:

- to correctly assess the amount of insurance cover you need;
- to understand *how to arrive* at a suitable sum insured or liability limit of indemnity;
- to understand what a sum insured or limit of indemnity represents;
- to select an *appropriate indemnity* period for business interruption cover;
- to take account of the fact that *accountancy definitions of gross profit are different to insurance definitions* when arranging business interruption cover;
- to obtain up to date *valuations*;
- to keep sums insured *under review* from year-to -year; and
- to recognise that policy standard limits are not always enough.

Where to get help

Insurance brokers want to make sure that you buy the right insurance for your business and are able to provide advice on how to assess sums insured and can help you to buy insurance cover that meets your needs. They will help you to understand the basis of your insurances and how sums insured can be calculated to ensure you are properly covered if you have a partial or a total loss.

Obligations

Under the Insurance Act 2015 businesses have certain obligations when applying for their insurance. The requirements of the Act are designed to help you get fairer treatment from your insurer in the event of a claim. However, they also require you to be strictly honest about the nature of your risk. Your insurance broker can explain your obligations regarding what you must tell insurers as well as the consequences of failing to disclose material information in what the Act calls a ‘Fair Presentation’. Remember though, that even though your broker can help you work through your insurance needs, you have all the information about your business which will need to be shared with your insurer.

Calculating sums insured – buildings and other property

In general the purpose of your insurance is to put you back to the same financial position after a claim as you were just before it happened; you should not be able to profit from an insurance claim.

The way the policy is set up will affect how to calculate a suitable sum insured.

Policies set up on an indemnity basis – claims settlement will take into account the value resulting from the age and condition of the property at the time of the loss or damage so putting you into the same position as immediately before the loss.

Policies set up on a reinstatement basis – claims settlement that will provide a replacement for property that is ‘similar but not better than’ sometimes called new for old.

Policies set up on an agreed value basis – claims settlement is based on a value agreed at the inception of the policy, for example, for specialised or rare property.

Rebuilding cost

It is important to remember that the sum insured for buildings needs to represent the reinstatement or rebuild cost, not the market value of your premises, including any driveways, garages and outbuildings etc. The sum will need to include costs for:

- materials;
- labour;
- architects;
- surveyors and other legal fees;
- the cost of demolition and debris removal;
- VAT (as necessary); and
- any public authority or planning costs and inflation or other increasing costs that happen during the policy period as well as any rebuilding period.

The rebuild cost may be higher if you have a specialised property, such as a listed building, or other special features that may be more difficult, more costly, or take longer to rebuild or repair a standard property.

Rebuilding cost vs market value

Costs and value can be very different. A building worth £1m on the property market because of the land it stands on but might cost only £500,000 to rebuild.

Another premises in a different location might be worth only £200,000 on the market but because of particular special features might cost £350,000 or more to rebuild.

Market value should not be used as a sum insured.

Your broker or insurance provider can help you find a professional valuation service if you need more help with this. Online calculators can be useful to give an estimate of the rebuild cost - http://abi.bcis.co.uk or www.rics.org/bcis Regular valuations will help ensure the sums insured are correctly assessed.

Contents

Business insurance policies typically cover contents, machinery, plant and equipment at the premises and sometimes elsewhere. The replacement as new value of these items is the amount that should be insured, not the value stated on your balance sheet.

Your stock sum insured needs to represent the cost of raw materials, work in progress plus finished goods.

An up-to-date inventory or all of your contents, machinery, plant etc, is useful when considering how much cover you need. If you have customer goods on site, the value of these should be included too. Smaller items can add up to a significant sum, often these items are not included on an inventory or fixed asset schedule.

If you have items of specialised or complex machinery or equipment it may be useful to talk to people who supplied them about the cost and availability of suitable similar replacements or repairs as these could take some time to replace. If you have equipment that is no longer manufactured you might need to insure for the value of a new equivalent machine.

It is worth remembering that the effect of the planned EU exit might have an impact on the cost and the delivery time for replacement machinery, plant or other contents if your supplier is based in the EU.

Assessing your business interruption insurance needs

Business interruption (BI) insurance is dependent upon your property insurance and can help with your business continuity planning. The cover provides financial support to help your trade continue during the period where you might be suffering from a reduced or lost turnover as a result of a claim due to damage at your property, affecting your ability to produce your goods or services.

When considering your BI insurance the sum insured needs to represent your expected gross profit or gross revenue over a set period of time that you expect it would take to get your business back to its pre-claim trading level (the indemnity period). It is important to correctly assess both the sums insured and the indemnity period. **Be careful to check indemnity periods offered by 'standard policies' or online quotes as these might be insufficient.**

Two years is likely to be the minimum period needed for a business to fully recover its trading level. It is wise not to be over optimistic about your business recovery time and take into account how much control you will have in any rebuild operation – you may be dependent on landlords to manage any repairs which might delay matters.

40% of businesses do not have enough business interruption cover to get them back on their feet

Building Cost Information Service 2012

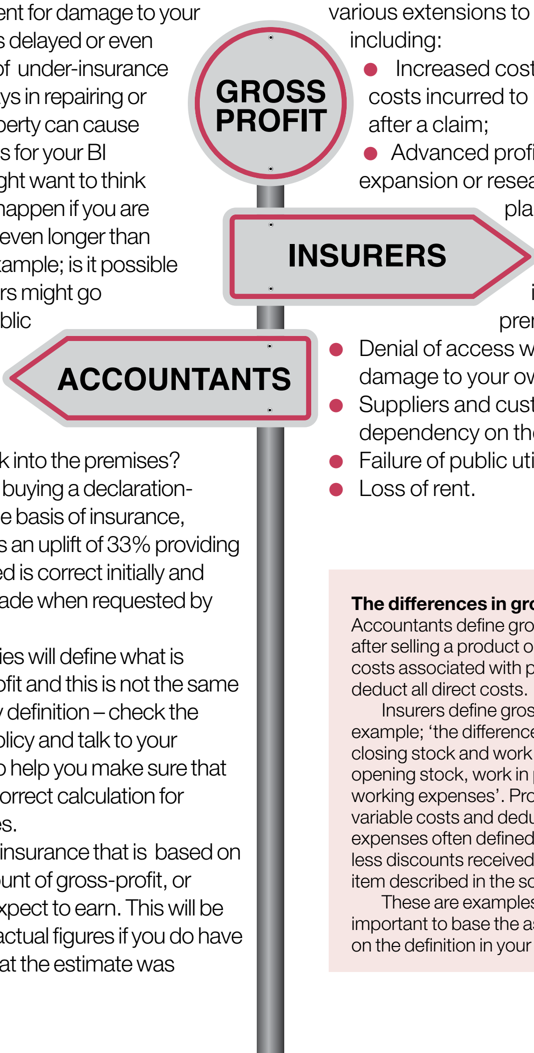
In 25% of SME claims reviewed by the FCA, the indemnity period expired before they returned to a normal trading position

FCA thematic review of SME claims TR15/6 2015

Think about what might happen if you are unable to trade for even longer than planned for

It is worth considering other aspects such as whether you will need to apply for planning permission for any rebuilding, or whether stock is seasonal, whether there may be damage to suppliers or customer's premises as well.

If a claim payment for damage to your physical property is delayed or even rejected because of under-insurance – the resultant delays in repairing or replacing your property can cause knock-on problems for your BI insurance. You might want to think about what might happen if you are unable to trade for even longer than planned for. For example; is it possible that your customers might go elsewhere? Will public utilities to the premises be affected? Might there be additional costs to move back into the premises?



For BI consider buying a declaration-linked, non-average basis of insurance, because it provides an uplift of 33% providing that the sum insured is correct initially and declarations are made when requested by insurers.

Insurance policies will define what is meant by gross profit and this is not the same as an accountancy definition – check the definition in your policy and talk to your insurance broker to help you make sure that you are using the correct calculation for insurance purposes.

You can buy BI insurance that is based on the estimated amount of gross-profit, or revenue that you expect to earn. This will be assessed against actual figures if you do have a claim to check that the estimate was accurate – if it was less than the actual figure the claim might be reduced by the same proportion – check with your broker ways in which you can reduce the risk of this difference occurring.

Your broker will also be able to discuss the various extensions to BI cover that are available including:

- Increased cost of working for additional costs incurred to keep the business running after a claim;
- Advanced profits – where you have expansion or research and development plans which will generate profits in the future which might be affected by an insured loss at your premises;
- Denial of access where there is no material damage to your own premises;
- Suppliers and customers where there is a dependency on them;
- Failure of public utilities; and
- Loss of rent.

The differences in gross profit calculation

Accountants define gross profit as 'the residual profit after selling a product or service and deducting the costs associated with production and sale' – and deduct all direct costs.

Insurers define gross profit in the policy, for example; 'the difference between the sum of income, closing stock and work in progress and the sum of opening stock, work in progress and uninsured working expenses'. Property and BI adjusters deduct variable costs and deduct uninsured working expenses often defined in the policy as, 'purchases less discounts received, bad debts, rent and any other item described in the schedule'.

These are examples of gross profit definitions; it is important to base the assessment of the sum insured on the definition in your policy wording.

Few businesses can afford to defend a legal liability claim without sufficient insurance

What about under insurance of liability risks?
Liability policies are intended to pay the costs of defending an allegation of legal liability against your business together with any settlement or award of damages. They include employers' liability cover, public and products liability covers, as well as more specialised insurance such as directors' and officers' liability, cyber cover, environmental liability and professional indemnity insurance.

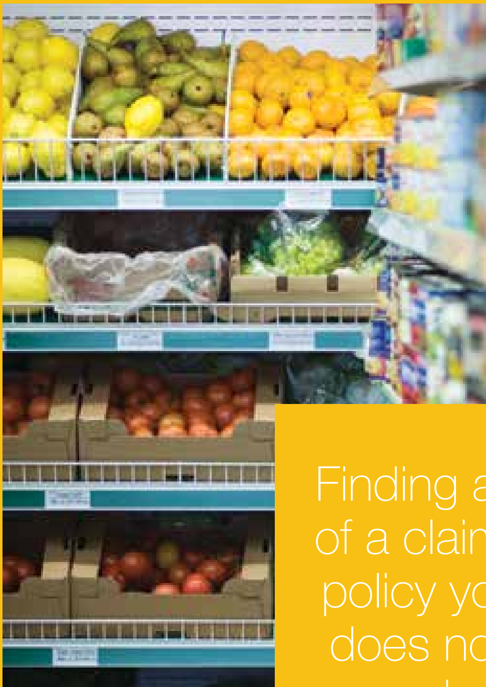
To work out the liability risk for your business you need to think about any potential claims that might be brought against you or your business because of something you have done. Making an estimate of the value of awards that might be made against you and their frequency will help you to request a suitable level of cover which in liability policies is referred to as a limit of indemnity. Often insurers may offer levels of £5million to £10million which can seem plentiful, however even these amounts may not be enough if there is a serious incident or substantial connected claims. If your insurance cover is not sufficient to meet a claim against you, your business assets might be at risk.

If you have employees there is a legal obligation to have at least £5million of employer's liability cover.

Case study
Five years ago, a small business that constructs advertising signs was advised by their broker to increase their level of public liability cover from £1million to £5million at the renewal of their insurance policy. The company agreed following insistence from the broker. Six days later, an unusually high wind blew one of their signs off a single story building. The sign travelled along a high street and struck a pedestrian causing a severe disability. The business was found liable because the board had not been secured correctly and the claim was settled at £4.7million, with the insurance policy covering the payment.

Calculating the right amount of liability cover is not a completely straightforward activity and is an area where an insurance broker can provide advice and help you with a liability risk assessment. There are a number of factors that can help you be comfortable with the limit of indemnity you arrive at including the following points.

- The number and value of claims previously made against you - or against similar businesses.
- The risk of an incident where your property causes loss or damage to a third party – such as spreading fire.
- The known sources and triggers for claims against you.
- The likelihood of significant number of employees being affected by the same event.
- The costs of defending an allegation of legal liability, irrespective of the outcome and whether these costs are included in the limit of indemnity or in addition to it.
- Whether your trading contracts impose any additional liabilities (known as liability assumed under contract) which are not normally covered by a standard insurance policy.
- Additional factors such as economic loss; legal defence costs, cyber liabilities and liability
- The chances of being hacked or suffering another type of cyber-attack.
- Whether there are likely to be multiple claims from multiple claimants.
- The effect of future inflation on claims made years after the policy has expired as well as increasing court awards.
- The risk of claims coming from overseas, where personal injury awards can be much higher than in the UK.



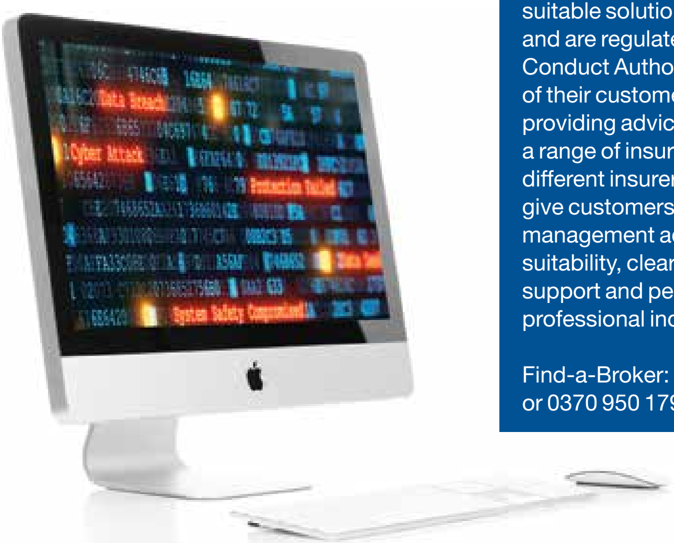
Finding at the time of a claim, that the policy you bought does not provide enough cover can have devastating consequences

Cyber insurance is a vital consideration. The HM Government 2015 Information Security Breaches Survey stated 69% of large organisations and 38% of small businesses were attacked by an unauthorised outsider in the last year

Cyber

Cyber threats are a growing and rapidly changing threat to UK businesses of all types and sizes. Although hacks and data breaches of major companies sometimes make the headlines, in reality smaller companies are just as likely to be impacted by a cyber attack that might access confidential data steal funds or affect programming of essential equipment.

The Federation of Small Businesses (FSB) said that 66% of SMEs do not consider their business to be vulnerable to cyber threats, but the latest data shows that 74% of SMEs reported they had suffered an information security breach in the past year with costs reaching £310,800. These figures suggest that many SMEs could be under-estimating their need for cyber cover.



The Association of British Insurers' guide for SMEs: 'Making sense of cyber insurance', available from www.abi.org.uk, provides an introduction to the protection offered by cyber insurance. It covers six key areas to look out for in cyber insurance policies including cyber interruption loss, privacy breach costs, cyber extortion, 'hacker damage', media liability and cyber forensic support. As with any insurance policy it is vital to understand what you are covered for and to find a policy that best meets your needs. Talking to a broker might help you find suitable insurance.

Further help and advice

General insurance brokers and intermediaries can help businesses find suitable solutions to manage their risks and are regulated by the Financial Conduct Authority. Brokers are the agent of their customer working in their interests providing advice, guidance and choice on a range of insurance products from different insurers. Insurance brokers can give customers choice of products, risk management advice, advice on policy suitability, clear information, claims support and peace of mind via their professional indemnity insurance.

Find-a-Broker: www.biba.org.uk
or 0370 950 1790

To ensure that you have the right level of insurance, contact a BIBA broker – 0370 950 1790 or www.biba.org.uk

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