

# A guide to underinsurance

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# Introduction

Insurance is an essential personal and business component, transferring risk and providing much-needed financial security.

However, for insurance to fulfil its objectives, the cover policyholders purchase needs to accurately reflect their personal and business requirements. Insuring assets for incorrect values, or setting cover limits too low, is likely to result in underinsurance.

Underinsurance can lead to policies not operating as intended, delivering less indemnity than needed following a loss, and jeopardising a policyholder's ability to recover.

One particular cause of underinsurance is inflation, which as seen in 2022 can have huge impacts. Inflation in the supply chain (the process of materials getting from source to consumer) can cause a ripple effect on prices, causing costs to rise, which in turn causes more inflation and increased prices. For example if the cost of materials increases to a construction company or to a retailer, they will in turn raise the prices they charge the end customer. Other supply chain issues, such as the lack of raw building materials and shortage of available labour, can also cause prices to rise as demand overwhelms supply. Both organisations and individuals are feeling the effects of these increasing costs at a time of economic hardship.

This guide looks at underinsurance from both an individual and organisational perspective, what causes it, what we're seeing in the market at the moment, and the impact it can have across the UK.



# 40%

The Chartered Institute of  
Loss Adjusters estimates  
underinsurance to be present  
on over 40% of claims.

*“Underinsurance has always been an issue in property insurance, despite the critical importance of setting values correctly. In the current economic environment of high inflation and supply chain disruption however the prevalence and scale of underinsurance has the potential to become exacerbated further. It is as a consequence even more important than usual to review values at this time to ensure that cover is adequate.”*

**Colin Prince, Underwriting Manager, UK Property**





# What is underinsurance?

Underinsurance occurs when cover is set too low to adequately meet a policyholder's needs. Underinsurance is a perennial problem in property insurance and it may become a major issue at the worst possible time, when policyholders suffer a loss. Being underinsured can lead to facing a substantial shortfall in a claim and with the policyholder needing to fund the shortfall themselves - something made even worse by the current cost of living crisis.

Losses are stressful enough for policyholders without them having to deal with this, which is why it's crucial that we work together to focus on sums insured and index linking in the periods between valuations, to ensure our policyholders are properly protected and we can fund all elements of a loss. The discovery of underinsurance can have a widespread impact following a loss, affecting other areas of cover, including those where underinsurance is not even present.

It is therefore important for organisations to consider the interconnectivity between different types of cover, ensuring every aspect of their insurance programme adequately reflects their needs.

*"Policyholders ensuring that coverage and sums insured are appropriately set will assist us in delivering the best outcomes for our policyholders who are unfortunate enough to suffer losses."*

**Colin Prince, Underwriting Manager, UK Property**

## What is meant by 'average'?

In situations where a policyholder is underinsured, the average is taken to make sure they won't receive a full payout when only a percentage of the premium that should be paid has been paid.

This means insurers reduce the amount paid out by the same proportion as the policyholder is underinsured.

For example:

A policyholder's house costs £500,000 but is only insured to the value of £250,000 (50%). If a full rebuild is required, the policyholder will only receive £250,000.

If a partial rebuild is required to the amount of £250,000, they will receive 50% (£125,000) because of the average clause.

*Note: Average sits outside the Insurance Act and our opt out does not cover this.*

# Sums insured: what to take into account

Setting the correct sum insured is one of the most important considerations when insuring property. Sums insured determine the amount policyholders receive in the event of a claim, and also form the basis of the premium calculation. When setting the stock sum insured, the figure should represent the maximum value at any one time. To do this, policyholders will need to consider a number of factors, which will be different for each individual case.

When taking out household contents policies, the contents includes everything that would be taken in a house move, such as furniture, TVs, and crockery, as well as items of clothing, sporting equipment and phones, laptops, cameras and anything similar to that.

Once an inventory of items has been produced, the replacement value of each individual piece needs to be calculated i.e. how much would it cost to replace every single item today? this replacement cost is the sum insured policyholders will need. It's important to remember that most insurance policies will have a single item limit that may be lower than any one item in the home, so speaking to an insurer before completing the inventory is recommended. Some items, such as pieces of art or jewellery may need professional valuations, especially those that have been handed down through generations.

A buildings sum insured is not the market value, but the amount it would cost to reinstate the building following a total loss (e.g. if it was destroyed by fire). It is important that, in addition to materials and labour, the reinstatement value includes costs such as demolition, site clearance, planning and professional fees.

Most insurance policies only cover the cost price of stock, excluding any anticipated profits. Therefore, where the business can reclaim Value Added Tax (VAT) this should always be excluded. It is therefore important to determine the maximum value of stock at all the different stages of a business's operation, from raw materials to work in progress, and from finished goods to waste materials.

# What is underinsurance?

## Business Interruption - maximum indemnity period

An increase in costs, such as alternative accommodation after a loss, and other inflationary costs mean that reinstatement is taking longer than before. Policyholders should be regularly reviewing the adequacy of their indemnity period. Below is a table which shows an example of a recovery period in the context of a maximum indemnity period.

Maximum Indemnity Period	Issues experienced during recovery	Period until full recovery	Claims settlement by insurer	Financial shortfall for policyholder
12 months	+9 months	21 months	Cease at 12 months	Does not recover
Chosen by policyholder as maximum possible time to fully recover. Set as maximum indemnity period on policy	Planning issues and winning back lost custom significantly lengthen anticipated recovery time.	Actual time taken for business to reinstate damaged property and return to its former profitability.	Business interruption claims payments cease after 12 months, before the business has fully recovered.	Unable to counteract reductions in revenue and the increased costs needed to successfully recover.

## The knock-on effect: turning building underinsurance into business interruption underinsurance

The knock-on effect of a major loss, such as a fire, can take months or years to recover from and in some cases may never be recovered from. Take a look below at an example of how building underinsurance can turn into something much more severe quickly.

1	2	3	4	5	6
After a major fire, a building is found to be significantly underinsured.	Reinstatement is postponed until the policyholder can source the funds need to complete repairs.	This, in turn, delays the business' recovery, taking significantly longer to return to pre-loss levels.	Under the business interruption policy, both the sum insured and maximum indemnity period would have been adequate.	However, delays resulting from the building's underinsurance mean the maximum indemnity period expires before the organisation is able to fully recover.	Building underinsurance has effectively led to business interruption insurance.

### Case Study: 50% underinsured

A building at a football club was 50% underinsured, which the insured accepted was the case. Average was applied and the claim proceeded with a reduction in consequence. The insured accepted a cash settlement as a contribution to the reconstruction of a new facility.

The underinsurance came as a result of the insured not appreciating the rise in building costs, something that was only enhanced by the presence of asbestos within the property. This highlights the need for understanding the costs associated with reconstructing the building to a basic modern standard, as well as regular valuations of the property to ensure compliance with potential clauses in policy wording.

# Impact of Climate Change

With the UK government announcing a number of changes to building regulations with a view to reducing CO2 emissions in construction and delivering net zero by 2050, there will be an associated rise in costs to go with it.

## According to the Building Cost Information Service:

- Materials prices are expected to rise by 15% over the next 5 years, with the main risk to material prices being the disruption of global supply chains and oil price rises.
- Labour costs are set to rise by 6.3% in the coming year, driven principally by labour shortages and the cost-of-living crisis. In comparison, national wages rose between 2 and 2.5% in the same period.
- The General Building Cost Index is expected to rise by 17% over the next 5 years.
- New construction production is forecast to rise by 15% by 2026 when compared with 2021.



These increases in prices, wages and production will continue to evolve and in doing so will increase the number of properties that are underinsured.

Not only will climate change impact new construction projects, but it will also have a significant impact on the retrofitting of houses and buildings – something that will need to be done across the board to improve energy efficiency and replace fossil fuels with renewable energy.

The government have set a target to reduce greenhouse gas emissions from public buildings by 75% in 15 years, however they estimate that this will have a total cost in excess of £25bn. Whilst the government will cover those costs over a number of years, there will need to be a similar overhaul for privately owned properties such as flats and houses, with which the cost will fall at the feet of the owner.

In additional research, it was estimated the cost of decarbonising residential properties will top £250bn, with the [majority of the 28.5m homes and 1.9m offices in the UK being heated by gas](#) boilers which will need to be replaced.

# £250 billion

The estimated cost of decarbonising residential properties across the UK.

# Tips for Property

Most organisations and individuals will hold some form of property insurance. For some, this will cover their buildings and everything in them, while others may just insure basic items or stock.

Whatever property an organisation chooses to cover, the following guidance will help to avoid underinsurance and ensure policies deliver the level of protection required.

## 1. Understand the condition of average

Property insurance policy wordings typically include a 'condition of average' clause. When underinsurance is present, this condition enables claims settlements to still be made under the policy, albeit reduced in proportion to the level of underinsurance.

For example, if a policyholder mis-states their total contents value by 50%, and therefore only pays 50% of the premium that should have been due, they can only expect to receive 50% of a contents claim's total value.

It is therefore important to carefully assess and declare accurate property values in order to receive full claims settlements.

### Application of the condition of average

Declared value	Actual value	Underinsurance	Claim value	Claim settlement
£500,000	£1 million	50%	£200,000	£100,000

## 2. Approach valuations from the correct starting point

Items such as buildings, contents and stock all come under the banner of 'property'. However, different types of property are insured in different ways.

It is important to check the basis of cover for each item before declaring its sum insured, and to understand how policyholders should approach each particular valuation. Failing to do so may provide a very different figure than is being requested, and can easily result in underinsurance.

Basis of cover	Settlement basis	Common items
Reinstatement	Cost of replacement with a new item that is similar but not better than the item lost/damaged.	Buildings, contents, plant & machinery
Indemnity	Cost to put policyholders back in the same position immediately before the loss, taking into account factors that impact value, such as condition and use.	Stock, certain contents, such as clothing, plant & machinery
Agreed value	A set value agreed between policyholder and insurer at inception of the policy.	Art, jewellery, rare or specialised items

## 3. Returning to a former position

Property insurance aims to put policyholders back in the same position they were in immediately before a loss. While slight nuances exist depending on the basis of cover, this remains the central principle.

When approaching valuations, it is important to consider how this happens in practice following a loss, factoring in all associated costs to the sums insured. For example, if there is a need to replace an office computer system, it is not just the cost of purchasing new equipment. Additional expenses may include IT consultancy fees, freight and installation.

It is important to avoid simply using balance sheet values or historical purchase prices to inform sums insured, as these are often significantly different to an item's actual value for insurance purposes.

## 4. Buildings – it's not just the building itself

A 'building' applies not just to a main structure, but also includes features such as foundations, boundary walls, drains, landscaping, car parks and outbuildings. Not including such features is a frequent driver of underinsurance. Precisely what is included will be defined in the policy wording.

Misapplying VAT is another common problem. Some aspects of a building's reinstatement might attract VAT while others might not, and the position can vary depending on each organisation's tax arrangements.

A qualified surveyor will be able to identify what needs to be included in a valuation and help policyholders arrive at a representative reinstatement value. This is vital as an incorrect decision to exclude VAT (20%) could add additional pressure to the adequacy of the value insured.

## 5. Buildings – don't use market value

A building's market value is irrelevant for insurance purposes.

Buildings sums insured need to reflect the full cost of reinstating a building following a total loss. In addition to materials and labour, this includes all associated costs such as demolition, debris removal, planning and professional fees.

Each building will have features that can significantly alter a reinstatement cost, such as difficult site access, period features or specialist construction techniques. A qualified surveyor will have the expertise to identify and quantify these factors, and one should always be engaged when establishing sums insured for insurance purposes.

# Tips for Property

## 6. Contents

Contents insurance protects policyholders if any items within homes or buildings are lost or damaged. Accordingly, every item within the property must be accounted for in a valuation, from the largest piece of production machinery all the way down to stationery.

While smaller items may seem insignificant on their own, cumulatively they can make an enormous difference to an overall contents sum insured.

Keeping an up-to-date property inventory for insurance purposes will assist in this task. However, remember to approach valuations from the correct perspective (see tips 2 & 3 above), which will differ from inventories used for balance sheet purposes.

## 7. Plant and machinery

Plant and machinery is commonly insured on either a reinstatement or indemnity basis. These items can be particularly susceptible to depreciation, so it is particularly important to approach valuations from the correct basis (see tip 2 above).

Where the items are still readily available, determining values should be relatively simple. However, for older or difficult-to-source items, policyholders may need to base valuations on alternatives of a similar type, capacity and utility.

If dealing with large, specialist or bespoke pieces, there are likely to be a variety of additional considerations, such as costs for design, manufacture, installation and commissioning. Speak with potential suppliers to understand the current cost of meeting any needs.

## 8. Stock isn't static

Many businesses hold higher levels of stock during busier times of the year. To avoid underinsurance, sums

insured should always be set at the maximum potential value that could be held at any one time.

Different businesses also use stock in different ways, increasing or decreasing its value over time. A furniture maker, for example, will purchase raw materials and increase their value as they move through the production process. A corner shop, however, will simply sell finished goods that have a reasonably static wholesale cost.

Therefore, to calculate an accurate stock sum insured, the maximum potential values at different stages of an operation will first need be considered.

## 9. There is no substitute for professional help

Due to the wide range of factors that can influence property valuations, it is always recommended to seek professional advice to help establish accurate sums insured.

These professionals' fees are minimal when compared with the potential financial shortfalls that underinsurance can cause following a loss. Many insurers and brokers can also help policyholders access reduced rates via preferential supplier arrangements.

Some of today's policy wordings will remove the condition of average altogether when sums insured have been verified via professional valuations, therefore eliminating the risk of underinsurance and enhancing the value of such services.

## 10. Conduct regular reviews

Property values do not remain static, and sums insured need to stay under continual review to remain accurate over time. A thorough review of all sums insured should therefore be conducted at least annually, typically at renewal.

However, this does not necessarily mean paying for full professional

## Stock at different stages

- **Raw materials** - market cost of materials including freight, unloading, storage and irrecoverable taxes and duties
- **Work in progress** - raw materials plus manufacturing costs directly incurred, including direct factory overheads
- **Finished goods** - net manufacturing cost of finished goods. Or, for many businesses, the wholesale purchase cost, including associated expenses such as freight, unloading, storage and irrecoverable taxes
- **Waste materials** - certain waste materials will have a commercial value and a market rate.

surveys each year. Most surveyors will recommend conducting a full valuation at least every three years, with annual desktop appraisals in between. These desktop appraisals allow surveyors to apply their knowledge and expertise to an organisation's unique circumstances, and update valuations accordingly.

Remember, values can go up or down. Regular reviews will also help avoid paying for cover that is above and beyond any need.

## 11. Act on changes to risk

A property will typically undergo some changes during the policy period. For example, a new piece of machinery might be purchased, new technological equipment or general items purchased for decoration.

In addition to thorough reviews at renewal, it is essential to update sums insured when any changes occur. If in doubt, policyholders should discuss the changes with their insurer to establish whether a policy requires adjustment.



# Tips for Business Interruption

Business interruption (BI) insurance provides a lifeline following a loss, supporting organisations financially until they make a full recovery.

However, inaccurate sums insured and inadequate indemnity periods are a major source of underinsurance, jeopardising the chances of recovery for many businesses.

The following tips will enable you to select the correct level of BI protection, and help assure future resilience to loss events.

## 1. Have a plan

Planning how to respond to potentially harmful events is vital for any business, and an essential first step in choosing the correct BI cover.

Business continuity planning is a valuable exercise that helps increase an organisation's resilience through anticipating potential losses and planning how best to respond.

It is advisable to record key findings in a formal business continuity plan (BCP), which should remain under regular review and testing, and serve as a core risk management tool. For example, should a key supplier suffer a major loss, a good BCP might detail arrangements with alternative suppliers that could quickly meet urgent customer orders.

In addition to boosting resilience, considering potential loss scenarios is the best way of identifying much of the information needed to set suitable BI cover levels.

For example, without fully understanding how an organisation's variable costs will change following a loss, it will not be possible to set an accurate gross profit sum insured (see tips 3 & 4 below). Equally, without contemplating potential worst-case scenarios, it will not be possible to choose a suitable maximum indemnity period (see tip 5 below).

## 2. Choose the cover that's right for you

There are three main types of BI cover:

- Loss of gross profit
- Loss of gross revenue
- Increased cost of working

Loss of gross profit is the most common form of BI cover, but does feature certain complexities that commonly lead to underinsurance if approached incorrectly. It is therefore important to fully understand how each type of cover operates and carefully assess which is best suited to an organisation's particular needs.

For example, loss of gross profit is specifically designed for manufacturing-type risks and recognises that a downturn in production will actually lead to some cost savings as well.

These savings are known as 'uninsured working expenses', and form an important part of the gross profit sum insured calculation (see tip 4 below). For organisations with few, or no, uninsured working expenses, a gross revenue basis is likely to be the more suitable basis of cover.

Business continuity planning will enable you to understand how resilient an organisation's operations are, and the likely impacts following a loss.

	Cover	Best suited to	Complexity of setting the sum insured
Loss of gross profit	Loss of profit + increased cost of working.	Businesses with directly variable costs.	Extra care needed to avoid underinsurance.
Loss of gross revenue	Loss of revenue + increased cost of working.	Businesses with few or no directly variable costs.	Simply requires insured's turnover.
Increased cost of working	Increased cost of working only.	Resilient businesses, which will continue to earn revenue whether their premises are damaged or not.	No calculation required. Limit select by insured.



# Tips for Business Interruption

## 3. Approach calculations correctly

BI claims are settled by reference to specific formulas listed in the policy wording. As with all sums insured, it is essential to approach BI calculations correctly in order to avoid underinsurance.

Calculating loss of gross profit sums insured is where many experience difficulties, and where underinsurance frequently originates. A leading reason is that an accountant's definition of 'gross profit' differs considerably from the figure required for insurance purposes.

The former deducts all production costs, whereas the latter recognises that some costs will continue following a loss and therefore need to remain in the sum insured.

Not recognising this important distinction frequently leads to figures being provided that do not follow the calculation stipulated in policy wordings, resulting in significant levels of underinsurance.

### Common pitfall - 'Gross Profit' definition

Accountancy	Insurance
Sales	(Turnover + Closing Stock + Work in Progress)
-	-
Cost of Production	(Uninsured Working Expenses + Opening Stock + Work in Progress)
=	=
Gross Profit	Insurance Gross Profit

## 4. Take care with 'uninsured working expenses'

Uninsured working expenses (UWEs) form a vital part of the insurable gross profit calculation. If insuring on a loss of gross profit basis, it is important to fully understand the meaning of UWEs and only specify costs that truly fit.

UWEs are costs that vary in direct proportion to a reduction in turnover (i.e. if turnover reduces by 30% then that cost will also reduce by 30%).

UWEs can often include items such as raw materials, production wages and freight. However, it should never be assumed that these costs are always UWEs. This is something that can vary between organisations,

and needs to be identified via business continuity planning. Routinely subtracting certain items during the gross profit calculation is a common source of underinsurance.

Another common error is to only think in terms of total losses, whereas the majority of losses are likely to be partial.

For example, consider a factory that sends shipments via weekly containers. In the event of a total loss, where production stops completely, this cost should cease, as there are no products to ship. However, following a partial loss, it is likely that this cost will actually remain the same, as weekly shipments will still need to be made. Freight is therefore not a UWE for this organisation, as the cost will not vary in direct proportion to any reduction in turnover.

## 5. Maximum indemnity periods - be conservative

A maximum indemnity period (MIP) is the time following a loss during which BI claims can be made. If the MIP expires then claim payments will cease, even if the sum insured has not yet been exhausted. Setting an adequate MIP is therefore just as important as calculating an accurate sum insured.

BI insurance is designed to support policyholders until they recover to the position they were in prior to a loss – i.e. return to their former profitability. A common source of underinsurance is to think that this is simply the time taken to reinstate damaged property. However, once an organisation's property is reinstated, an equal or greater amount of time is often needed for activities such as recruiting staff, commissioning equipment and, vitally, winning back lost business.

Additionally, there is a vast range of circumstances that can delay an organisation's recovery. Not contemplating worst-case scenarios, either by not using proper business continuity planning or being too optimistic about recovery times, is a frequent source of underinsurance.

MIPs should reflect the maximum time it could take a business to return to its former level of profitability based on worst-case scenarios.

# Tips for Business Interruption

## 6. Adjust sums insured in line with MIPs

A simple, yet common mistake, is to not alter sums insured in line with any changes to the MIP. For example, if changing from a 12- to a 24-month MIP, then the underlying sum insured may need to at least double, as it is now applied to double the length of time.

However, this is only a basic calculation, with further consideration needed to ensure sums insured remain adequate for the full length of the MIP (see tip 7).

## 7. Account for future trends

While cover may be adequate at inception, organisations do not remain static, with revenue and profitability changing over time. BI insurance is designed to put the policyholder back in the position they would have been had they not suffered a loss, and sums insured need to take account of future business trends in order to avoid underinsurance.

With the impact of inflation and supply chain issues we speak of in this document, we would strongly recommend any risk with a 12 or 24 month indemnity period reassess whether this is giving adequate protection in these inflationary times. For example, should an organisation suffer a loss towards the end of a 24-month policy period, and it then takes 12 months before they fully recover, that is 36 months after which the BI cover levels were initially set. If that business was growing at a constant rate of 20% per year, then it would have grown significantly by the end of those 36 months had it not suffered the loss.

To ensure cover is adequate for the duration of the MIP, the sum insured needs to reflect both current and future circumstances, accounting for any anticipated business trends.

### Recovery time - extra considerations

- Thinking and decision time
- Planning enquiries, applications, additional requirements and delays
- Environmental or neighbour issues
- Demolition and debris removal
- Long lead times for replacing plant and machinery
- Installation and commissioning of new equipment
- Discovery of hazardous materials, such as asbestos
- Potential Health and Safety Executive inquiries or proceedings
- Recruiting and retraining staff
- Seasonality – may miss important trading periods
- Difficulty in winning back lost customers and opportunities

## How Zurich Resilience Solutions can help

Zurich Resilience Solutions (ZRS) offers a suite of risk management services including building reinstatement cost assessments. In addition to in house expertise, ZRS offer access to specialist organisations who are able to assist in providing a range of assessment approaches tailored to your needs, ranging from desk top reviews, through to detailed on-site assessments. These include:

- Cardinus: <https://www.rushton.co.uk/insurance-valuations/>
- Rushton International: <https://www.cardinus.com/building-insurance-valuation/>
- Bailey Partnership: <https://www.baileypartnership.co.uk/services/>

For more information, those in the public sector should get in touch with their local Zurich contact, whilst personal lines and commercial policyholders should contact their brokers.





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