SMEs: Overbalancing and underinsured

The impact of underinsurance can be crippling for any business that suffers a loss, but it often hits small and medium enterprises (SMEs) particularly hard.

There are many myths and misconceptions that exist around the issue, and these need to be demystified in order to help SMEs bridge the knowledge gap and avoid the danger.

A thematic review by the Financial Conduct Authority (FCA) in 2015 revealed that many SMEs have a ‘sums insured’ value that, when it comes to making a claim, can leave them with a significant financial shortfall1.

In response to the review’s findings, Allianz Insurance plc (Allianz) removed the ‘average’ clause from its core range of policies designed for SMEs and unveiled a new quotation process. This includes the use of modelling data to help brokers fulfil their responsibility to create a ‘fair presentation of risk’2.

The data used by brokers and Allianz during the quotation process is used to identify where a customer profile is at odds with the usual trend for the trade and area. As an aside, this data supports the FCA’s finding that around 40% of SMEs (with some variation across different areas and sectors) could be underinsured.

Using this data and removing the ‘average’ clause significantly alleviates the problem of underinsurance, securing confidence at the point of purchase and not just at the point of claim.

This is a complex issue and a combination of education and innovative product design will continue to improve the situation.

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1 ‘TR15/6: Handling of insurance claims for Small and Medium-sized Enterprises (SMEs)’ (22/05/2015) – Financial Conduct Authority
2 ‘Average’ is never good enough but a ‘fair presentation’ is! (25/01/2016) – Allianz Insurance plc, MyNewsDesk
The impact of ‘average’

A few policyholders or brokers may undervalue a business intentionally to reduce the cost of insurance, but it is apparent, in the majority of cases, that it is innocent misrepresentation, done unwittingly.

Those that do undervalue their business in a calculated way to reduce their premium might be surprised at how little they ‘save’ and, if a costly major loss claim comes about, they’d see the saving promptly wiped out. They’d also perhaps experience significant financial difficulties in the aftermath – especially if the average clause is applied.

Yes, it’s true that major loss incidents are rare, but protecting your business in the event of loss is vital.

Most small businesses have to take risks to survive, but taking a chance on insurance cover is too high a price to pay. The price increase of a policy is likely to be far outweighed by the peace of mind it affords when correct and more realistic valuations are provided.

When something is underinsured, the policyholder will only get up to the full ‘sums insured’ value following a loss, leaving them in the red. If an average clause is on the policy, then they might not even get that – and they’ll be even more out of pocket.

As I put it in September 2016, “It’s no good insuring a business for £500,000, when it’s really worth £1m.” The money saved on a reduced premium will never match up to the consequences of an average clause being applied after a major loss, while the reassurance gained from properly researched valuations and a slight increase in premium can be priceless.

A business has insured its premises for £800,000 (material damage only).

A fire rips through the insured premises and during the claims process it’s worked out that the total material loss adds up to £950,000, but also that the total rebuilding cost of the property on the premises is actually near to £1.2m.

This means that the property was underinsured. If an average clause is on the policy, then this formula will be used to calculate the payout:

\[
\text{Claim} \times \frac{\text{Sum insured}}{\text{Rebuilding cost}}
\]

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£950,000 \times \frac{£800,000}{£1,200,000} = £633,333
\]

The result of this equation would be £633,327, and that would be the total payout the policyholder would get; leaving them with a shortfall of £316,673.

3 ‘SME underinsurance: Protecting customer outcomes’ (27/09/2016) – Post Online
What’s it worth?

Here are some tips:

**Ignore the ‘market value’ of a building**

Base insurance cover on how much it would cost to rebuild the property and re-purchase stock and equipment. Don’t forget that a listed building will probably be more costly and time-consuming to repair/rebuild than others and, in many cases, delays can be driven by obtaining appropriate planning consents. Remember to consider the cost of property kept outside the main structure(s), including vehicles, items in external storage and gates and fences and other security installations (eg cameras).

**Keep the value of property and possessions front of mind constantly**

When new equipment is purchased, even if it’s replacing older models that are being removed, it’s important the relevant insurance policy is revisited to check that the cover is still appropriate for the increased value of contents. Don’t forget that the value of some items, like precious metals and stones, might actually increase after purchase.

If an SME puts off the task of valuation, it might not be until an unfortunate situation happens where a claim needs to be made that the truth comes out that the property is underinsured and the payout won’t match up to what they need.

**Adding 2 and 2, but getting 3?**

If you’re not sure about re-building costs or the value of contents, then use a professional service approved by the insurer to get better estimates.

Cunningham Lindsey provides valuation services to Allianz Commercial policyholders with a 10% discount. Find out more at www.riskdirector.co.uk

**Monitor stock fluctuations**

For many businesses, the amount or type of stock on-site might be dramatically different at certain times of the year, such as Christmas (more food, alcohol and giftware) and Bonfire Night (fireworks, sparklers, etc). This could cause an upward spike in the required ‘sums insured’ and/or introduce hazards that might not be covered by the policy.

The insurance broker should always be notified during the quotation process if this might be a possibility, as well as when it does actually happen (especially if it’s unexpected or the stock is particularly hazardous, like fireworks).

**Check policy exclusions, definitions and limitations**

Some scenarios resulting in material losses may unsuspectingly be left completely uninsured because of clauses or specific exclusions within an insurance policy. For example, there might be confusion about who is responsible for, and whose policy applies, when hired or contractor’s equipment is on the premises. Instead of waiting for the need to claim to arise, think about it during the quotation process and always discuss it and make necessary arrangements with the contractor or hire company.

**Make sure you haven’t missed anything**

Certain items can slip through the net when calculating sums insured. Have you thought about the flooring? What about the cost of bathrooms and white goods in kitchen areas? Is there property currently being held elsewhere that might return to the premises during the policy term?

**Don’t shy away from asking for help**

As well as the insurer’s preferred supplier for valuation services, consider consulting a surveyor approved by the Royal Institute of Chartered Surveyors, and take advantage of their Building Cost Information Service.
Don’t be so material

Besides the immediate costs of repurchasing or repairing property following material damage, there will be additional expenses associated with rebuilding and reinstalling property and actions taken to limit how much the event interrupts the business.

For instance, the policyholder might need to rent and move into temporary premises and hire equipment so they can fulfil customers’ orders while work is being done.

Many business owners underestimate how long it takes to return to ‘business as usual’, and so this becomes another instance where they might fall into the ‘underinsurance trap’.

Additionally, it’s often forgotten that the original source of interruption might not be of a material nature. Supply chain and public transport infrastructure disruption are issues that we’ve been aware of for decades, but now there are new and emerging risks to think about. Here are a few of the emerging risks:

**IT and connectivity failure** – The majority of businesses are now dependent on internet connectivity and IT equipment for the day-to-day running of business. So if that connectivity is lost, or equipment becomes damaged or corrupted, there could be a ripple effect across operations that could put a dent in the business’s reputation and finances.

**Currency fluctuations** – At the start of 2016, the exchange rate of GBP to Euro was a healthy 1.26 to 1.36. At close of business on 23 June 2016, it was 1.31. A day later, it sunk to 1.23, and by 6 July 2017 it was down to 1.16.

Since the Brexit vote, the British pound has continued to struggle, to the point where the rate has got as low as 1.07, and no higher than 1.21.6

A struggling currency can hit businesses hard, with imports getting pricier and exports losing value, and the cost of recovering from a disruptive incident possibly becoming more expensive.

**Information security threats** – In June 2017, a variant of the malware known as ‘Petya’ infected computers across Europe, causing a ‘ransom note’ to appear on victims’ screens and blocking access to the computer’s files and programs. Just a month before, a similar attack, nicknamed ‘WannaCry’, crippled the UK’s NHS.

The frequency and range of cyber-attacks is on the rise and many have the potential to leave a figurative disaster zone in their wake as it can mean lost business, a damaged reputation and a costly recovery process.

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4  ‘BA IT systems failure: Uninterruptible Power Supply was interrupted’ (02/06/2017) – The Register
5  ‘BA faces £80m cost for IT failure that stranded 75,000 passengers’ (15/07/2017) – FT.com
6  XE Currency Charts – XE.com

At 09:30 (BST) on Saturday, 27 May 2017, British Airways’ Boadicea House (BoHo) data centre at Heathrow Airport suffered an IT failure lasting 15 minutes. It caused a ripple effect (more like a tsunami) which resulted in tens of thousands of passengers worldwide being unable to travel and left stranded, often also having no idea where their luggage was.4 This incident is expected to cost the business £80m5.

While not insignificant, £80m is a manageable sum for the likes of British Airways and their reputation doesn’t seem to have taken too much of a hit (despite the fun the media had pointing out that an ‘Uninterruptible Power Supply’ was interrupted). If something similar were to happen to an SME that doesn’t have so much cash in reserve or the elite PR team and brand strength then it could be the end for that business.
Interrupting the interruption

One of the key areas of underinsurance that removing an average clause or better valuations can’t solve is the lack of appreciation for what it takes to return to ‘business as usual’ after a major loss.

If a policyholder thinks it’ll take 12 months to rebuild and that’s what they were quoted for in their insurance cover, and it actually ends up taking 3 years, they’re going to be in trouble.

**Where are they going wrong?**

Earlier in this article, it was touched upon that the cost of work to rebuild or repair structures or equipment can be more than expected, but so can the length of time it takes to complete the work.

Before work starts, the site probably needs to be cleared and prepared and this might require the use of cranes and other big plant and equipment which would need to be hired in.

All the while, inspections need to be carried out as the site evolves to ensure it’s safe and being completed to the right standards.

Now the rebuilding can start. But the contractor might not be with you right away – they have other clients. Materials and equipment need to be sourced. And you need an architect to create the plans for the project.

Okay, now you can get going, but when they were installing something they noticed there were issues that hadn’t been detectable before, so things need to be paused while that’s resolved.

See how things can drag on?

Finally, everything’s rebuilt, reinstalled and restocked, but where are the customers?

While your business recovers, even the most loyal customers might stray.

Of course, the business can move into temporary premises during the works, but it’s unlikely that there wasn’t an impact on the service provided immediately after the incident, and that your business continued exactly like it did before.

Those with an online business might be thinking this sort of sequence of events isn’t applicable to them, but it can happen to some extent in the virtual world too.

The web hosting firm, 123-Reg, accidentally deleted some of their customers’ websites and made their email accounts inaccessible. A lot of these customers were small businesses who lost a key, if not their primary, touchpoint with their own customers.

Some of 123-Reg’s customers had backed up their website to their own drives so were able to restore it. Others, however, faced either starting from scratch, which would take time and, if they didn’t personally have the know-how, money, or waiting for the restoration process to be completed and hoping for the best.⁷

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⁷ ‘123-reg deletes sites in massive clean-up script blunder, customers let rip’ (18/04/2017) – ARS Technica UK
Education, valuation and restoration

Brokers and business owners are responsible for preventing and limiting cases of underinsurance and many insurers offer support. At Allianz, we do this by flagging concerns to a broker when their customer’s information differs from our expectations, formed by data sets for organisations with similar traits.

It starts with understanding the issues surrounding the matter and then tackling them, but it doesn’t stop there. The types and amount of issues, and the factors surrounding them are constantly evolving, so we all need to stay alert to what might next lure us into the underinsurance trap.