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World-wide Exposure: The Top areas of Underinsurance

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Introduction

We have been hearing about significant underinsurance in the marketplace for quite some time now. In 2005 the Australian Securities and Investments Commission (ASIC) found that one in 6 SME's had not insured their properties and even those that were, insured significantly under replacement value. While the information that underinsurance has reached critical levels is known, the main reasons for underinsurance are still to be resolved.

The Problem of Underinsurance

Many small businesses lack an understanding of the consequences for their business in the event of a major interruption to trading such as a fire, flooding or systems failure. A review of assessment work, worldwide reveals some common threads in relation to underinsurance and why there is a strong presence of underinsurance amongst Small to Medium Enterprises (SME's).

The 2001 and 2004 ABS Small Business Survey estimated just under 200,000 uninsured small businesses were operating in Australia. The one in six figure does not account for businesses that were under-insured or not appropriately insured.

Cameron Research 2006 stated that of these businesses:

- 13% did not have fire insurance
- 65% did not have businesses interruption insurance, and
- 18% did not have burglary insurance.

Approximately 70% of small businesses affected by major loss do not recover.

With a combination of planning, professional support and adequate BI insurance cover, businesses could be well prepared to deal with unforeseen circumstances and the resulting consequences on business continuity.

Over the past few years, industry bodies such as the ICA and ASIC have tried to educate SMEs on being properly insured. However, the campaigns have had little impact on SME business insurance levels across Australia.

Causes of Underinsurance

The most common driver to underinsurance is the perceived high cost of premiums. But the myth surrounding the high cost of premiums for appropriate insurance cover is quashed when small business spending on insurance represents less than 1% of their total expenses (source ABS stats - cited in ICA report 2002).

The decision can be influenced by an inability on the part of the insured to fully understand the policy document or the possible individual product knowledge failure of lending authorities preventing full advice to clients on appropriate insurance.

A national survey of 1200 consumers found that 87% believed it was the policyholder's responsibility to decide on their level of insurance, 7% nominated the insurer and 5% a professional Valuer.

While the majority of policyholders believe it is their responsibility, most are unaware of their insurance needs.

Top Areas of Underinsurance

Building

Recent examples from over 2000 small business assessments found 82% being underinsured on building. We find such underinsurance is not unique to Australia but is a significant issue for small business globally. The current economic climate has also meant sharp

increases in the rate of non-insurance or lack of sum Insured maintenance.

While Australia has bucked the global trends in terms of the downturn here building materials and labour costs have continued to rise. SME's are not keeping abreast of the sharp cost escalation and it is for this reason there has been a significant increase in average deficiency within the level by which they are underinsured, rising from 39-56%.

Building assessments based on the rebuilding costs, show Insured's are forgetting to allow additional inflationary costs such as shipping as a result of increased fuel costs and professional fees such as engineer's costs. In addition there can be hefty removal of debris costs. While most have made an allowance for some removal of debris, the amount required is often underestimated.

Significantly, some costs are often forgotten altogether such as removal of asbestos, potentially faulty wiring and local government / rebuilding zoning which are subject to new regulation, all of which can affect a property's rebuilding cost. Our research has shown that these areas are rarely thought of by a property owner until after the time of a disaster where a number of new requirements surface and costs quickly escalate.

Business Interruption

The ABS and ICA estimate that 67% of small businesses have no BI insurance or are under-insured.

World-wide adjusting experience supports these figures and where Business Interruption was covered, we found 95% were deficient in at least one aspect of Business Interruption cover.

Underestimation of Gross Profit was still considerably high with an average of 60% underinsured on the Gross Profit Sum Insured. It appears there is still a lack of understanding of the product, which is of concern considering it could be the

difference between staying in business and losing everything.

While some SME's had a handle on Gross Profit from their statements, they rarely consider what would happen if they did not get up and running during a 12 month period. There are many cases where businesses have not been able to re-establish, for example, due to the owners of the property redeveloping the site for up to three years. Businesses within shopping centres are a good example of such considerations.

In addition to the indemnity period the trend at which a business is travelling must also be considered. Profits from statements each year do not consider the future trend of the business during the indemnity period. In addition the trend may be increasing further than accounted for if the incident occurs just before policy renewal. We found of those assessed over 70% had no cover for claim preparation / accountancy costs. Of those who had cover, they were on average 100% underinsured in this area.

Increase in complicated or lengthy claims and with accountancy costs also on the rise, Insured's were far short of Insuring for the costs involved. We have found that while property owners may have Loss of Rent they rarely keep cover in step with rental increases and often omit that there may still be high accountant's fees in the event of a major loss.

Liability

Many businesses fail to realise the potential for exposure in the area of liability. We found 30% of owners did not have some cover at all let alone the correct level of cover.

Many property owners were unaware of the potential for injuries which can occur as a result of the condition of their premises and can often rely on the tenant having their own liability cover. Their tenant may run activities which may involve heavy public (customer) traffic and areas which may potentially cause accidents such as uneven surfaces, steps or multiple levels, access to common areas, lighting, poorly designed steps, steps into or steps down into shops, all which could cause an incident and result in an action against the building owner.

45% of those SME's who have Insured were on average underinsured by 100% on both Public and Products Liability. The extent of potential litigations and inflationary factors and current business climate has meant that the potential damages has escalated and need to be reflected in the Sums Insured.

Plant Machinery and Contents

Up-to-date records of Assets which included Plant, Machinery and contents continued to be an issue for SME's. Equipment, while vital to the business, is often found to have become discontinued and obsolete and has not been considered by the Small Business owner, as to how the equipment may be replaced in the event of an incident.

Plant and equipment value is commonly only thought about in relation to tax purposes and often left to accountancy considerations. Depreciated values can often get translated into Sums Insured for assets when in the event of an incident new replacements are required. 50% of businesses having their contents Sum Insured reviewed were underinsured by an average of 50%. In addition to the inflationary and new cost considerations, delivery and setup were still being forgotten.

Solutions

Small to Medium Business is becoming more and more aware of the issues around underinsurance which have become increasingly highlighted by significant and catastrophic events in the media. However conscious vigilance, from the industry and in particular the Insurer and broker, is required to promote the areas and services which tackle underinsurance for their SME clients in order to halt this worrying trend.

Summary

This white paper has discussed the top areas of underinsurance facing the SME world-wide. For more information on solutions to address the underinsurance issue for your clients, Cerno can provide professional assistance to support your efforts.

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