Inflation effects for property and business interruption policies

The surge in inflation is impacting asset and business interruption values across all industries. In light of this, businesses should to review their insured values and their policy wordings to confirm that their insurance programmes are still adequate.

There have been significant rises in the cost of reinstating property. In the UK, inflation is expected to reach 10% in the fourth quarter of 2022[1] and the cost of integral building materials has been increasing at a much higher rate (see Figure 1).[2]

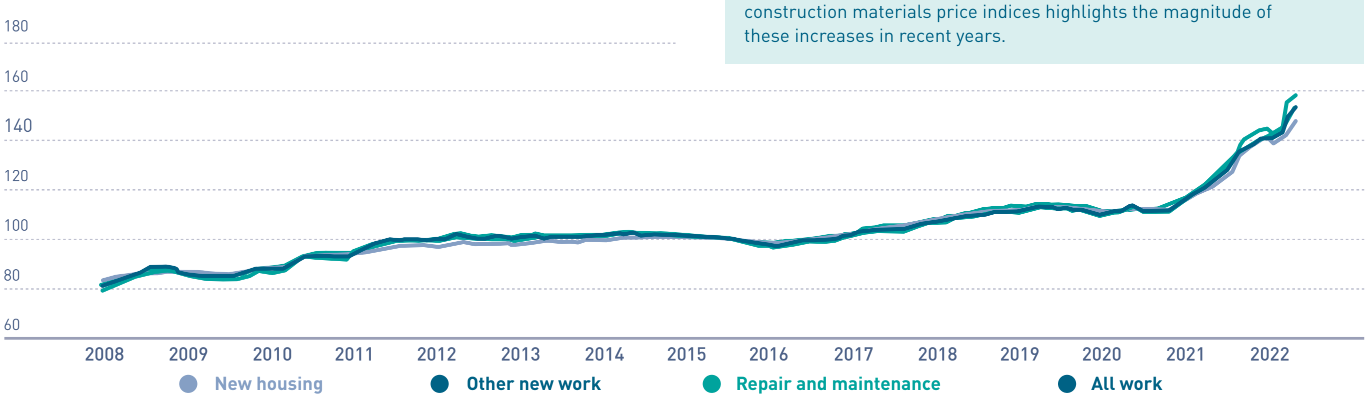
Added to this, the cost of labour and logistical services is also fast increasing with 70% of construction firms and 72% of transportation and distribution firms expecting to raise their prices over the coming three months.[3]

In this environment, it is more important than ever to be mindful of the risks of underinsurance.

Underinsurance may impede business recovery by capping claims payments below the actual value of lost assets.

01 | Construction material price indices, UK
Index – 2015 = 100

Businesses rebuilding or reparing property following a loss have experienced rapidly increasing costs of construction. The UK construction materials price indices highlights the magnitude of these increases in recent years.



Source: *Monthly statistics of building materials components, table 1.*

1| *Bank of England Monetary Policy Summary, May 2022*
2| ONS, Monthly Statistics of Building Materials and Components, May 2022 *(22-cs6 - Construction Building Materials - Commentary May 2022.pdf)*
3| *British Chambers of Commerce, April 2022*

Risk of underinsurance

Underinsurance occurs when the declared values of assets (like property, building, and contents) and exposures fall below actual values. It has consequences for policy loss limits, applications of underinsurance restrictions, and adequacy of business interruption coverage.

Policy loss limits

If the value of insured assets increases but the relevant loss limits are not appropriately increased, then in the case of significant underinsurance and a total loss, a business may not have full indemnity if the eventual loss exceeds the policy loss limit.

Property — application of average or underinsurance clauses

In the event of underinsurance, the insurer may proportionately reduce the amount that they are obliged to pay based on the difference between the insured value and the actual value of the lost asset.

Most insurer wordings include at least one average provision. These clauses allow insurers to proportionally reduce a claim.

Explanation of common average provisions and their implications

"Day one" — the policyholder declares values on a reinstatement basis on the first day of the policy period, but the insurer pays the cost of repair or reconstruction at the time of the loss. The accuracy of the values is assessed retrospectively in order to determine whether the value declared by the insured was accurate at the start of the period of insurance.

If the values declared on the first day of the policy period are found to be inadequate, then the insurer can proportionately reduce the claims payment.

Example "Day one" average calculation

$$\frac{\text{Declared value at inception}}{\text{Cost of reinstatement at inception}} \times \text{Loss}$$

Example of the application of average on Day one basis of claims settlement

"Standard reinstatement" — the policyholder declares values on a reinstatement basis, but the average condition only applies if the declared values are less than 85% of the reinstatement value. The sum insured needs to be able to address the full policy period, plus the probable rebuilding time thereafter. This could mean projecting an amount that will be adequate for several years ahead.

Example standard reinstatement 85% average calculation

If sum insured is at least 85% of the rebuild value at time of reinstatement = no average applies. If sum insured is less than 85% of the rebuild value at time of reinstatement:

$$\frac{\text{Sum insured}}{\text{Rebuild value at time of reinstatement}} \text{ x Loss}$$

Business interruption — adequacy of indemnity period

Most UK business interruption wordings have a maximum duration which insurers will pay business interruption losses following an insured event. These are usually set at 12, 18, 24, 30, or 36 months.

Delays resulting from damaged property not being reinstated before the expiry of the business interruption indemnity period may lead to uninsured extra costs and loss of revenue or profit.

The indemnity period may run out before supplies can be obtained and rebuilding can commence. Added to this, many businesses have had supressed trading over the pandemic, and are now returning to normal levels of activity while needing to increase their own prices to contend with payroll inflation.

This volatility can result in a significant shortfall in the amount a business would have expected to receive in the event of a claim.

Given global labour and supplies shortages, delays in shipments, and the potential for protracted construction projects, the length of business interruption indemnity periods should be reviewed and, if necessary, extended.

Business interruption — declaration-linked

Many UK business interruption policies include a declaration-linked mechanism that allows for 33.33% growth in the estimated gross profit over the indemnity period. This provides some protection against inflation; however, this may be inadequate for rapidly growing and rapidly changing businesses.

Next steps

Inflation is not unprecedented, and there are coverage strategies that can protect businesses through this period of volatility.

Businesses should review limits in their property and business interruption programmes to cater for higher insurance values, adjust indemnity periods to enable time to recover more fully, and tailor inflation-related clauses.

The implications of inflation vary by industry, geography, and even by unique business. Businesses and their brokers must work closely to pursue suitably broad coverage.

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