Inflation implications for property and business interruption policies

June 2022

Businesses worldwide are experiencing the effects of the highest inflation rate in a generation.

The surge in inflation is impacting our clients' asset and business interruption values across all industries. In light of this, businesses need 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]

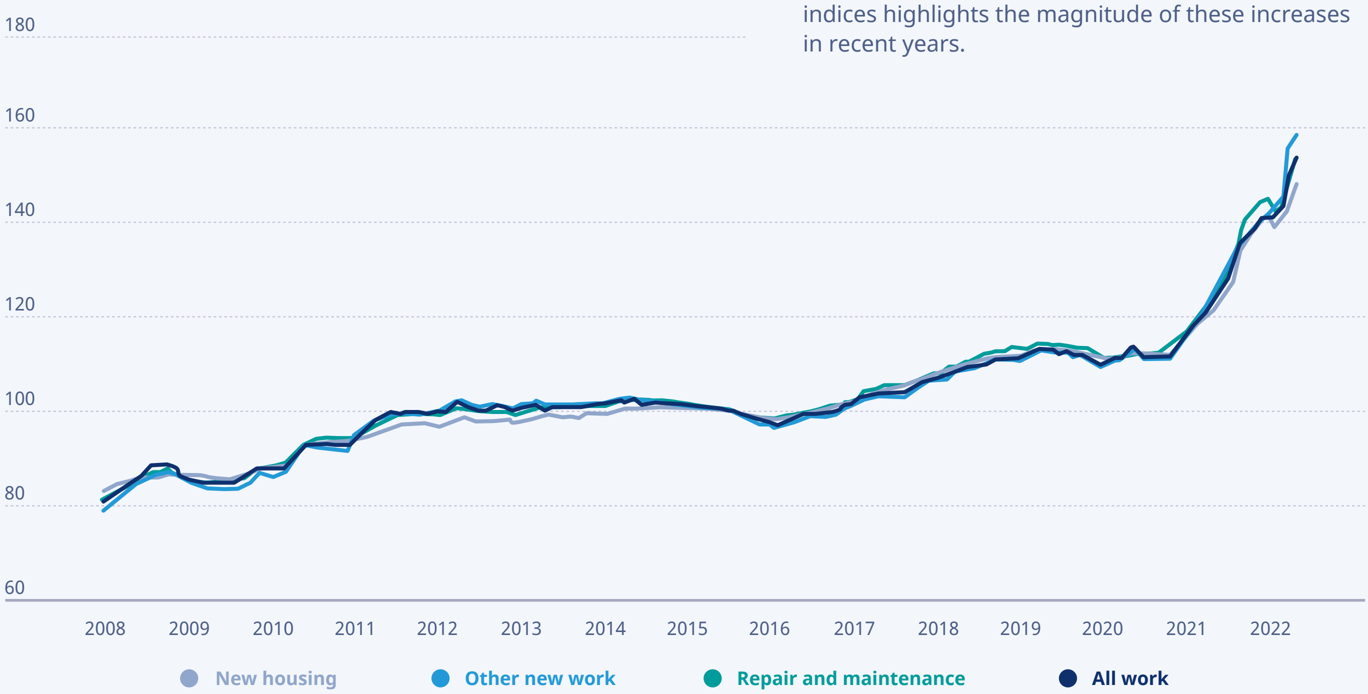
In this environment, it is more important than ever to be mindful of the risks of underinsurance.

Underinsurance may impede business recovery by capping claims payments below the actual value of lost assets. Furthermore, stipulations in policy terms could mean additional implications if underinsurance occurs.

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 a 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 will 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 will 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

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

A Day One uplift can be included in a policy to protect against inflation. Many default to 15% or more, but Marsh's Placement Plus policy and some bespoke wordings have 25% or more. This means the declared values are increased or "uplifted" by 15% to 25%. However, in a high inflation environment with lengthy rebuild periods (more than 12 months) even 25% may not be sufficient. The Day One values provided to the insurer must always be accurate, if a deduction for underinsurance is to be avoided.

Average: Day one 15% uplift worked example

	1 January 2022 Renewal date	15 December 2022 Loss occurs	30 December 2022
Declared value	**£10 million**	**Partial loss: £5 million**	
True reinstatement cost	**£12 million**	*Insurer suspects underinsurance, obtains retrospective valuation of property as at the inception of the period of insurance*	
Actual cost to repair			£5,400,000 (£5 million + 8% annual inflation)
Average applied		Sum insured: Cost to rebuild at day one:	£10,000,000 £12,000,000 x £5,400,000 = £4,500,000 (£900,000 shortfall)

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:

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

Insurer remedies for underinsurance in the Insurance Act 2015

In some bespoke policies, there is neither an average provision nor a specific revaluation condition. However, this does not mean that underinsurance will have no consequences. For policies governed by the Insurance Act 2015, insurers are provided with proportionate remedies for a breach of the duty of fair presentation.

An under declaration, even innocently made, could constitute a breach of the duty of fair presentation under the Insurance Act 2015 allowing the insurer to proportionately reduce a claims payment if they would have charged a higher premium.

An under declaration deliberately or recklessly made may allow insurers to seek to avoid the insurance cover and refuse to pay any claims.

Business interruption — adequacy of indemnity period

Most UK business interruption wordings have a maximum indemnity period. This is the 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.

A 12-month indemnity period may not be adequate in this environment. 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.

MARKET STRATEGIES CASE STUDY

A large hospitality firm included additional information in their insurance presentation to address their valuation methodology in addition to regular risk engineering updates. The presentation included details of third-party valuation experts and the approach for trending of values. This gave insurers greater comfort and allowed the Marsh team to negotiate to maintain existing policy language and avoid a more onerous average clause.

HOW YOU CAN RESPOND

We strongly recommend that you update the declared values of your assets and exposures where needed to account for increases caused by inflation or to capture other changes to your insurance values since you last reported them.

This may mean modifying your declared values in the interim before your next renewal as valuation projects often require a significant lead time.

Insurers are increasingly querying the accuracy of reported values. Clients who cannot convince insurers that their reported values are accurate or demonstrative of a robust approach to valuing their assets, may encounter coverage restrictions at renewal.

NEXT STEPS

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

Businesses should increase 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 while mitigating against premium increases in these turbulent times.

Contact

For further information, please contact:

Ben Margetson
Technical Director, UK Corporate

ben.margetson@marsh.com

Felix Ukaegbu
Coverage Leader, Placement, Risk Management

felix.ukaegbu@marsh.com

David Mitchell
Risk Management Placement

david.c.mitchell@marsh.com

Clarissa Franks
Placement Leader, Risk Management, Corporate and Commercial

clarissa.franks@marsh.com

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