

Underinsurance and Non-insurance in the small business sector

Peter Jones
Manager, Commercial Property
Insurance, SUNCORP

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Introduction

Underinsurance and non-insurance both represent a major problem in the insurance market.

Underinsurance is defined as a situation where the existing insurance coverage is inadequate. Non-insurance is defined as a situation where the client is not covered for a significant risk.

The decision making process for insurance purchases made by Small and Medium Enterprises (SMEs) are driven by a number of possible factors including

- Safety, security, protection
- Peace of mind
- Risk reduction
- Financial security and certainty
- Requirements by financial backers
- Protection of their employees from injury or being sued

So why is underinsurance and non-insurance such an issue?

This paper will briefly outline the current situation with regard to the extent of under and non-insurance and provide insight into the contributing factors and possible solutions.

1. Current Situation

Research survey data and information clearly illustrate the significant magnitude of under and non-insurance which continues to exist.

Data highlights

There is a wealth of survey work and data mainly provided by the Insurance Council, on the magnitude of the problem.

Some headline numbers include:-

- 1.3 million SMEs in Australia (ABS, 2004)
- 85% operate from home (ABS, 2004)
- 93% of clients surveyed thought they were insured for the right amount or over-insured (ICA Survey 2001)
- 67% of clients surveyed believed their knowledge of insurance options and coverage was good or very good (ICA, 2001)
- 18% of have some form of inadequate cover. (Powling, 2001)
- 1 in 6 SMEs are not insured (ICA, 2002)
- 70% of business fail after a major loss (Major fire, storm, flood) (ICA, 2002)
- 42% have no Business Interruption cover (ICA, 2001)
- 79% of SMEs have heard of business interruption insurance yet only 35% have it (Cameron, 2006)

- 72% of SMEs have heard of machinery breakdown insurance yet only 21% have it (Cameron, 2006)
- 98% of SMEs have heard of income protection insurance yet only 44% have it (Cameron, 2006)
- 25% of NSW households have no building or contents insurances – 27.5% of buildings and 45% of contents for households are underinsured by at least 10% of true replacement value (ICA, 2007)
- 83% of Sums Insured are under the correct replacement value as determined by CGU valuation assessments (CGU at the Steadfast Conference, 2007)
- 60% of Australian families with dependent children do not have enough life insurance to look after their families for more than one year if they died (Dowling, 2005)

2. Key Factors in Underinsurance and Non-insurance

Reasons for underinsurance and non-insurance according to the ICA Survey 2001 were:

- Insurance policy not understood
- Un-affordability
- Lack of information
- Purchasing insurance based on price
- The cost of obtaining a formal valuation
- The need to improve marketing of insurance product to SMEs

The impact for the insurance industry resulting from underinsurance and non-insurance is:

- Adverse selection
- Moral hazard
- Lack of accurate/valid information

These issues create asymmetric information which insurers rely on to make pricing decisions – usually the wrong ones. This can ultimately lead to market failure.

Underinsurance and non-insurance are two of the insurance industry's major issues where all three of the abovementioned problems come into play.

Depending on the deliberateness or otherwise of underinsurance / non-insurance, the client is adversely selecting or creating a moral hazard. At best, they are not providing sufficient and accurate information upon which to assess the risk. Whilst it is possible to model into pricing an estimate of the degree of underinsurance in a property portfolio, I would expect as an industry we do not allow enough for this.

Implications

The potential consequences of under and non-insurance are quite significant which adversely impact a broad number of stakeholders including:

- **Individual business** – significant loss and potential failure of business due to financial loss and/or business interruption

- **Insurance industry** – lower sums insured place pressure on insurer to cover risk exposure of a smaller portfolio and impacts on premiums to those who choose to insure correctly. If profitability declines due to diminishing number of customers it may result in that insurer withdrawing from that insurance class, potentially putting pressure on market premiums due to less competition.
- **Government** – lower tax and duty collections from insurance premiums
- **Economy** – reduced economic flow-on effects of insurance as well economic impact from major event losses

3. Behavioural Factors

Client behaviour when purchasing less than full insurance can be classified as:

- **Myopia/invulnerability** – “it can’t/won’t happen to me” – this in the face of sound risk management principles to assess likely frequency AND severity and risk of ruin. Suncorp’s claims frequency for Fire and perils coverage is 4% for all claims (for claims over \$100,000 <0.1%), so SMEs are correct in assessing a low frequency, however the downside in many cases when an event does occur, can be catastrophic to the SME.
- **Inertia** – “not a priority”. Owners and managers of SMEs are consumed with the day to day running of the business, and too time poor to either assess risk, seek information or complete an insurance transaction.
- **Procrastination** – “I’ll get on to it when I’ve got the time” – not just a problem for SMEs
- **Apathy** – “she’ll be right mate”
- Perceived **affordability** – decisions made on price without full consideration of the cover provided
- **Past experience** - poor service experiences with insurance companies affect perceptions and judgment in making insurance purchasing decisions
- **Optimistic risk estimation** – It is not uncommon for individuals to underestimate their downside risk, and overestimate upside risk – resulting in an inaccurate assessment of risk exposure
- **Charitable expectations** - Use perceived safety nets e.g. the government or family benefactor assistance in the event of a catastrophe create perverse incentives to under or not insure
- **Value perception** - taxes and levies attaching to insurance packages distort the decision to purchase insurance – for some buyers the insurance premium plus taxes and levies does not represent good value
- **Ignorance or ill informed** - poor knowledge of risk exposures or insurance products to transfer or share risk
- **Rational Choice** – it should not be overlooked that a customer may rationally choose to under or not insure as an informed rational choice, accepting risk exposure

These behaviours are supported by various research surveys.

SMEs are prepared to tolerate a degree of uncertainty or vulnerability as they consider insurance premiums expensive and are loathe to spend more on insurance (Powling, 2001).

According to an ICA survey in 2001, SMEs spend less than 1% of total expenses on insurance (excluding workers compensation) with the average spend being \$2,130 (as at January 2002).

SMEs, in an attempt to contain costs, resist suggestions that their insurance is inadequate and brokers claim that if they attempt to arrange a more appropriate level of cover, the business is lost to competitors who quote minimal covers. (ICA 2002).

Business Interruption as a basic concept is simple but arranging cover appropriate to the exposure can be a complex undertaking for larger SMEs. This complexity leads to inadequacies in the policy responding to claims. These problem areas are only revealed when a claim arises (MSM Loss Management)

4. A Holistic View - it's not just general insurance!

It is prudent that proprietors of SMEs should also consider life, trauma and income protection.

In any one year in Australia there are, average 50,000 heart attacks, 74,000 angiograms and 50,000 strokes. 1 in 3 Australians will be diagnosed with cancer in their lifetime. The risk of illness with a long recovery time is not insignificant and some form of personal insurance protection is critical (Dowling, 2005).

Again, behaviours such as apathy, procrastination and a SME principal's sense of invulnerability come into play.

Further to this, The Australian (Bourlioufas, 2006) states that according to a 2006 CommInsure survey, five out of six Australians are not adequately protecting their income in case of illness or injury. We are far more likely to insure our house than our income that pays for the house.

Underinsurance and non-insurance issues should be considered in a holistic sense combining personal insurances such as home and motor, commercial insurance for the business and life/income protection insurance.

Perceived affordability and value for money considerations plus the behavioural elements discussed earlier, all play a part in the customer's decision making.

This is not a clear right or wrong decision, given the circumstances, e.g. the business affected by a major loss or the proprietor becomes seriously ill, and then in hindsight their buying decision of insurance will be seen as delivering the business into a better or worse situation

5. Additional Complications

Major loss inflation - following major events such as Cyclone Larry and the Canberra bushfires, there is an element of post loss inflation (escalation of expected claims cost) due to demand pressures arising from significant re-building work with a limited supply of builders and materials which increases "normal" re-building costs.

In Canberra, the increase in re-building was estimated at 35% and best estimates from Larry are similar.

Extra Cost of Reinstatement - In addition to post loss inflation, the re-building following damage can trigger a requirement to comply with current building codes e.g. after Cyclone Larry, there was a requirement to comply with 1980 Cyclone Buildings Standards. This is referred to in commercial insurance packages as Extra Cost of Reinstatement, and can add up to \$25,000 in additional costs which may not have been included in Sum Insured calculations.

Climate change – in response to climate change, governments (State and Local) have been quick to move on regulating water and energy saving devices (water tanks and solar power) for domestic dwellings. For commercial, the requirement will be for water storage tanks as a minimum.

SMEs and their advisors should be alert to current re-building requirement changes and ensure the sum insured reflect this additional exposure.

Climate scientists have predicted a future of increasingly severe weather events. This will result in increased damage to SME property.

There has never been a better time to have the right insurance.

6. Overseas experience – is Australia unique?

According to Broking Matters in May 2006, *“National Audit Office statistics reveal there are 3.8m SMEs in the UK. AXA says there are five areas of business risk; operational, strategic, financial, compliance and environmental...It is basic risk management knowledge that may SMEs lack and the implications on underinsured SMEs are massive...AXA found that 56% of the (UK) brokers they interviewed feel that SMEs are underinsured with many more unwilling to take advice or prepare for the worst case scenario. The research also revealed that the majority of brokers (in the UK) believed that SMEs lack understanding about the real cost of their assets and their insurance products generally.”* (Broker Matters, May 2006)

7. Possible Solutions

The issue of under and non-insurance needs to be addressed on a number of fronts

- **Business/Risk Management plan** - all SMEs should have a business (risk management) plan incorporating a contingency plan for major events that could affect the business. (ICA 2001)

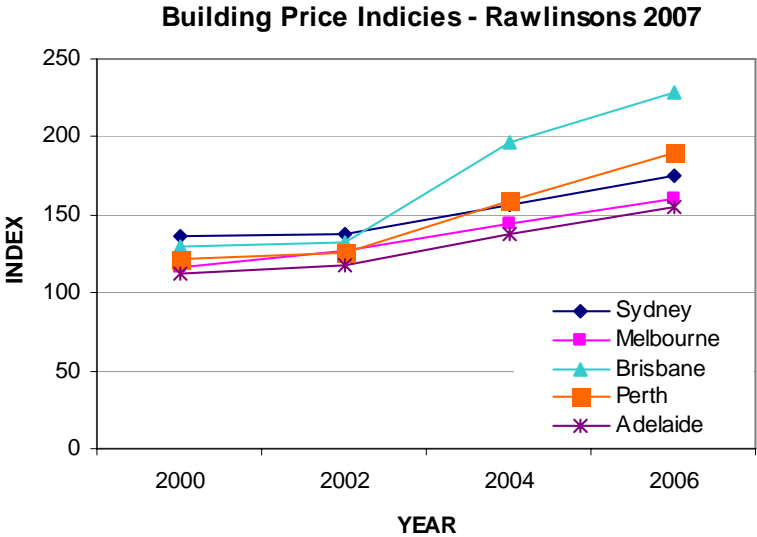
In asking the question, “what would you do in the event of a major loss affecting the business?”, considerations include availability of stock, raw materials, alternative premises, risk of loss of customers, covering commitments for salaries and wages, continuing cost of servicing loans – all excellent entrees into a discussion on Business Interruption insurance.

- **Annual health check** - insurance sales staff present an annual insurance program to all SMEs reviewing Building and Contents/Stock sums insured, updating Business interruption vales, detailing business trends and changes to the business – a full health check. My own experience indicates for many smaller SMEs, insurers and brokers alike have difficulty justifying the cost of such a service to all customers

as a percentage of premium received (average premium \$2130 generates say \$400 commission does not stack up well against say a 2 hour annual review commitment) – perhaps the internet linked via front end systems could provide valuable information for a self directed annual review, at the right price. More than 62% of SMEs have access to internet (according to ABS June 2004) and this proportion is growing making internet solutions increasingly viable.

- **Indexation** - SMEs should insist upon some level of indexation to be applied to their annual renewal to ensure coverage keeps pace with increases in building costs. Indexing generally occurs in home insurance policies, however it is not well practiced in the commercial insurance world most likely due to the complexity in commercial valuation, or there is some reluctance from market participants to increase pricing via an automatic sum insured process.
- **Information updates** - Provide information to customers on the cost of building increases over a period of time, to assist in making an informed decision about risk management and the insurance purchase. See below table

Increase in building cost from 2000-2006	
Sydney	29%
Melbourne	38%
Brisbane	75%
Perth	56%
Adelaide	38%



These indices apply to buildings more than \$500,000 and should be taken as an approximate guide. A full valuation should be arranged to determine the correct Sums Insured.

- **Regular Maintenance** - repair and maintain property as in all likelihood as an SME customer in the insurance industry, you are probably underinsured, so take all steps possible to reduce your risk of loss

8. The Suncorp Approach – A Case Study

Suncorp sought to determine a baseline on the prevailing level of underinsurance and non-insurance in the SME Property Portfolio.

The initial work was completed by arranging a dataset of all clients in all channels, the criteria being

1. no change in Sum Insured for Building/Contents/Stock (outside some minor indexation provided for some channels) in the last 3 years
2. fire policies in place for a business customer with no Business Interruption

The results were consistent with the ICA Survey 2001, particularly Business Interruption as the non purchase equated to 42% of eligible policies.

After consultation with our sales teams, our initial response was to:

- Provide the sales teams with access to building cost reference guides
- Deliver training programs on Business Interruption
- Deliver training on explaining the operation of the policy Underinsurance condition i.e. for losses more than 5% of the total declared value, the insurer will liable to pay no more than the proportion of the loss that the declared value bears to 80% of the cost of reinstatement at the time the policy was entered into. In effect the client becomes their own insurer.
- Develop value propositions for our customers on the benefit of addressing underinsurance and non-insurance.
- Use the dataset to identify customers who had not changed sums insured or had no Business Interruption, and start there.

The results were not what we expected and “up sells” were patchy at best – so back to the drawing board.

We identified some deficiencies with the initial response

- Sales teams were not comfortable in using the building cost reference material and this material did not include contents or machinery
- SMEs generally understood the issues, but wanted independent advice on valuations, at no cost to them
- More training work was required on understanding the Business Interruption policy
- Sales teams were not confident in a discussion which ultimately lead to the customer paying more for their insurance program

We are running a pilot program with the following features:

- Use of consulting services to provide full building, contents and machinery and business interruption valuations –

Whilst the cost of these services as a percentage of the property premium is not insignificant; the purpose of the pilot is:

- to measure the costs vs. “up sells” achieved
- to take a longer term view as early indications are the service has been well received by customers

- predicted to increase loyalty and the duration of the insurer relationship;
There is also benefit to the sales team's training in terms of learning the best approach to engage with customers on business interruption and valuation issues.
- sales teams to accompany the consultant on client visits to better understand the method of calculating business interruption sums insured and coverage requirements
- more intensive sales training on selling the customer "the right cover"
- sharing the "good news stories" where clients are happy with the service provided and we are now receiving "the right price"
- develop incentive campaigns for the sales to compete on results on successful "up sells"
- developing budgets on the expected "up sells"

Recent results have been encouraging. The battle continues with our sales teams in becoming more confident with the approach (success breeds success) and I am sure version four will have further refinement.

Conclusion

The current state of play is well researched and documented. I have offered my views on the behaviours which lead to underinsurance and non-insurance and to provide insights into possible solutions.

This is not an easy problem to address and multiple approaches with good execution are required.

As an industry, the challenge is to encourage changes in SME behaviour to achieve:

- Matching customer risk management expectations with the insurance package they purchase
- Desirable customer claims outcomes
- More reliable information upon which to develop valid pricing models. It is anticipated this will provide SMEs with optimally priced and affordable products matched to the risk exposure

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