UNDERINSURANCE: IS IT REALLY A BIG DEAL?

The requirement to stipulate an accurate value of the risk you want to insure, and the consequences for not doing so, have been the subject of legal argument and are likely to be further tested in the courts following the Insurance Act 2015 (The Act) that came into force in 2016. The Act applies to all insurance policies and midterm adjustments made on or after 12 August 2016.

The duty imposed on the non-consumer Insured is to make a "***fair presentation of the risk***" to the insurer.

We are now seeing Insurers argue cases whereby they dont believe that a fair presentation of the risk has been achieved.

"The financial liability of the risk you wish to insure is, arguably, a material fact which will influence the Insurers decision on whether to insure, on what terms and for what premium."

It stands to reason therefore, that undervaluing could be considered an 'unfair presentation' of that risk, which goes to the core of insurance.

So, what happens if you get it wrong?

Failure to do this, if reckless or negligent, can have serious consequences and could result in the insurer avoiding the policy altogether. However, The Act provides several proportionate remedies available to insurers in circumstances where a fair presentation of the risk has not been made, but the breach was neither negligent or reckless.

It is for the Insurer to demonstrate:

- whether it would have entered the contract;
- on what terms; and
- for what premium

had a fair representation of the risk been made.

What does this mean in practice?

It certainly raises an interesting question, particularly if the policy contains an average clause.

The condition of 'average', as it applies to underinsurance, is not well known and even less well understood, but the consequences can be very real if they are applied to you.

The principle, in a nutshell, is that insurer liability will be reduced proportionally by the amount you have underinsured by.

For example, in a claim where the sum insured is £70,000 and at the time of a total loss the real insurance value is £100,000, you have only insured 70% of the risk and paid a premium relevent to that sum. The condition of average would mean that any loss is proportionally reduced to 70% of the value of the loss.

This mechanism encourages the insured to make correct and accurate statements of value before concluding the policy.

The Insured is considered to be their own insurer for the amount they have chosen (accidentally or otherwise) not to insure.

In these circumstances the likely outcome will be driven by commercial sense on the basis of what was intended at the outset of the contract. The average clause is likely to apply in circumstances where the breach is not considered reckless or negligent. In extreme circumstances or where the breach is reckless or negligent, policy avoidance could be implemented as a result.

The application of the average clause could be devastating for SMEs or individuals, particularly in the event of a total loss.

Delving into the inner principles of insurance, this is to ensure everyone who pays an insurance premium, pays a proportionate premium to the risk they are bringing to the 'insurance pool'. Paying a premium for a lower sum insured than is accurate, but holding the insurer fully liable for a partial loss, would not be fair to the rest of the premium payers in that 'pool'.

Fair Presentation and the Average Condition: What can you do?

As an individual or commercial entity, take the time to accurately assess your risk, bring in experts where required. The fundamental premise behind insurance is to reduce exposure to risks that you would be unable to withstand; therefore it stands to reason that an accurate assessment of the financial value of that risk should be of paramount importance.

An ideal way to resolve the issue is for all to be in a postion whereby the relevent underwriter feels informed and comfortable enough to be able to agree to remove the average clause.

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