

Underinsurance: The Risk of Insuring Below the Actual Value



If Client A valued their house taking into account depreciation, in the event of a fire, how would the insurer calculate the quantity of the claim to be paid? If Client B owned a factory producing plastic containers valued at TZS 1 Billion but insured it for TZS 500 million, what proportion would the insurer pay if a loss of TZS 400 Million occurred due to an explosion caused by thieves? This article will explain the concept of underinsurance, the average clause, and provide examples in covers such as motor insurance and domestic package.



Underinsuring is like walking on a tightrope without support

Underinsurance occurs when a client insures for less than the true value. It can be due to any of the below factors:

- Cost
- Lack of awareness
- Gaps due to policy exclusions

It is therefore of critical importance that the client ensures that the sum insured values indicated in the policy are accurate and have been determined as scientifically as possible. We therefore recommend that professional surveyors, property assessors and specialist valuation experts assist the client in providing the correct sums insured. The expenses incurred in hiring professionals to value the insured property and subsequent increases in premiums may be considerable however in comparison the loss in terms of claims settlement due to

underinsurance can be even costlier.

Provide an accurate sum insured and avoid falling off the financial tightrope!



Property and Motor insurance policies are generally subject to the Average Clause

The average clause formula is below, with an explanation of each variable:

$$\text{Average} = \frac{\text{Sum Insured}}{\text{True Value}} * \text{Loss}$$

This example will demonstrate the risk of underinsurance with respect to motor insurance. Client A purchased a vehicle valued at \$50,000 during a Christmas sale. The purchased vehicle was on sale at 30% off. When purchasing comprehensive insurance for his vehicle, he declared the purchase price as the sum insured. The true value of the vehicle is actually USD 71,429. In the following week, he collided with another vehicle on

the road, which due to significant damage to the bumper and hood, cost USD 5,000 to repair. The insurer will pay just \$3,500 for the repair, which as per the formula is 70% of the value of the loss.

The sum insured is the value stated for the property in the domestic package policy document. For example, Client B insured the furniture in her apartment for \$20,000 even though the actual value was \$100,000. The \$20,000 would be the sum insured. The true value is \$100,000. Applying the formula, we would determine that 20% of the true value is insured. Therefore, if a fire occurred due to a gas leak in Client B's house, and the assessed loss of the furniture is \$50,000, the insurer will pay based on the assessment, only up to the sum insured of \$20,000. The client is his or her own insurer for the remaining proportion, which in this case would be \$30,000.

We therefore strongly advise all clients to ensure that the sums insured are accurate and to read the policy document thoroughly to avoid the possible significant damage caused by underinsurance. The client should also be careful not to over insure.

For any further assistance, please visit our office or give us a call.