Risk Bytes
Understanding the application of average

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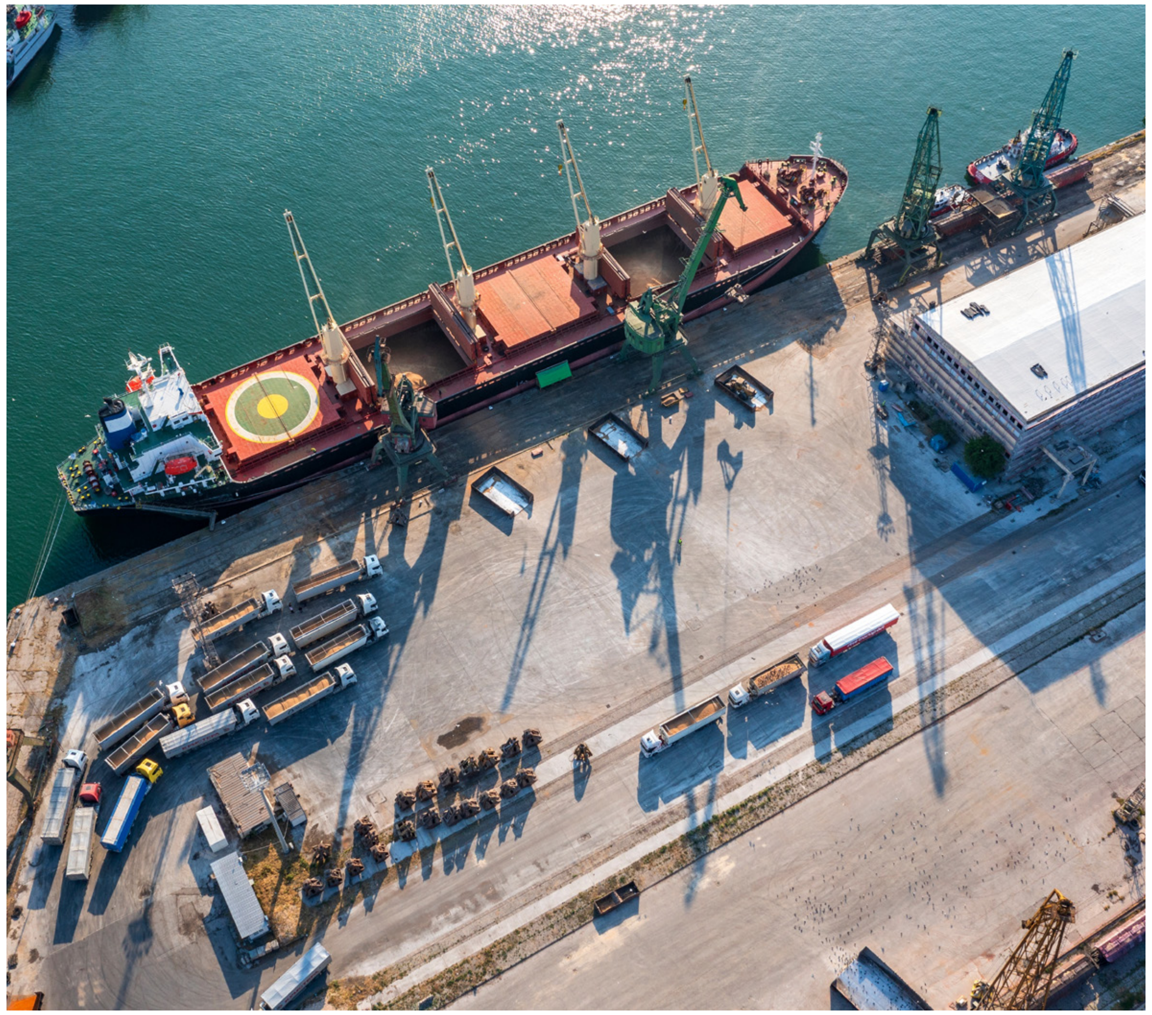
Introduction

This Risk Byte provides an introduction to the "average" clause in insurance policies for property and equipment, and why it is essential you have the right level of cover in place to avoid this clause being applied.

Key issues:

- Be clear and accurate in declaring the value of your insured property and equipment
- Ensure you understand how the average clause operates
- Keep declarations updated so as not to be underinsured
- Continually consider the impact of inflation on the value of your assets

This Risk Byte has been prepared focused on an English law perspective. You are encouraged to seek local legal guidance in case of queries in other jurisdictions.



What is the average clause?

Insurance policies covering property and handling equipment typically contain an average clause (sometimes referred to as an incorrect declaration penalty). The purpose is to protect the insurer in the event the insured suffers a loss against an asset that has been declared to the insurer to be less valuable than it really is, in other words underinsured. Values will generally be assessed under an average clause at the time of loss

Why is it important to be insured for the correct value?

If your property or equipment is underinsured, the average clause means you will recover proportionally less in the event of a claim. It is therefore vital to declare the correct value to the insurer at the start of the policy period – and to keep this value up to date.

Particularly during times of higher inflation, if the loss occurs towards the end of a policy year, there is a greater likelihood of an average clause being triggered.

Benefits:

- ✓ Avoids your insurer triggering the average clause
- ✓ Means your assets are fully protected
- ✓ Ensures you get full repair costs for damaged assets
- ✓ Covers you for replacing assets that are a total loss
- ✓ Minimises the risk to your business

Insured value

In the transport sector, property and carrying and handling equipment are generally insured on the basis of an "insured value". It is most important you define and declare this correctly before cover starts and, where applicable, on an ongoing basis.

The insurer should state on the policy documents a value for each item of insured equipment or property together with the basis of the valuation, using one of the following.

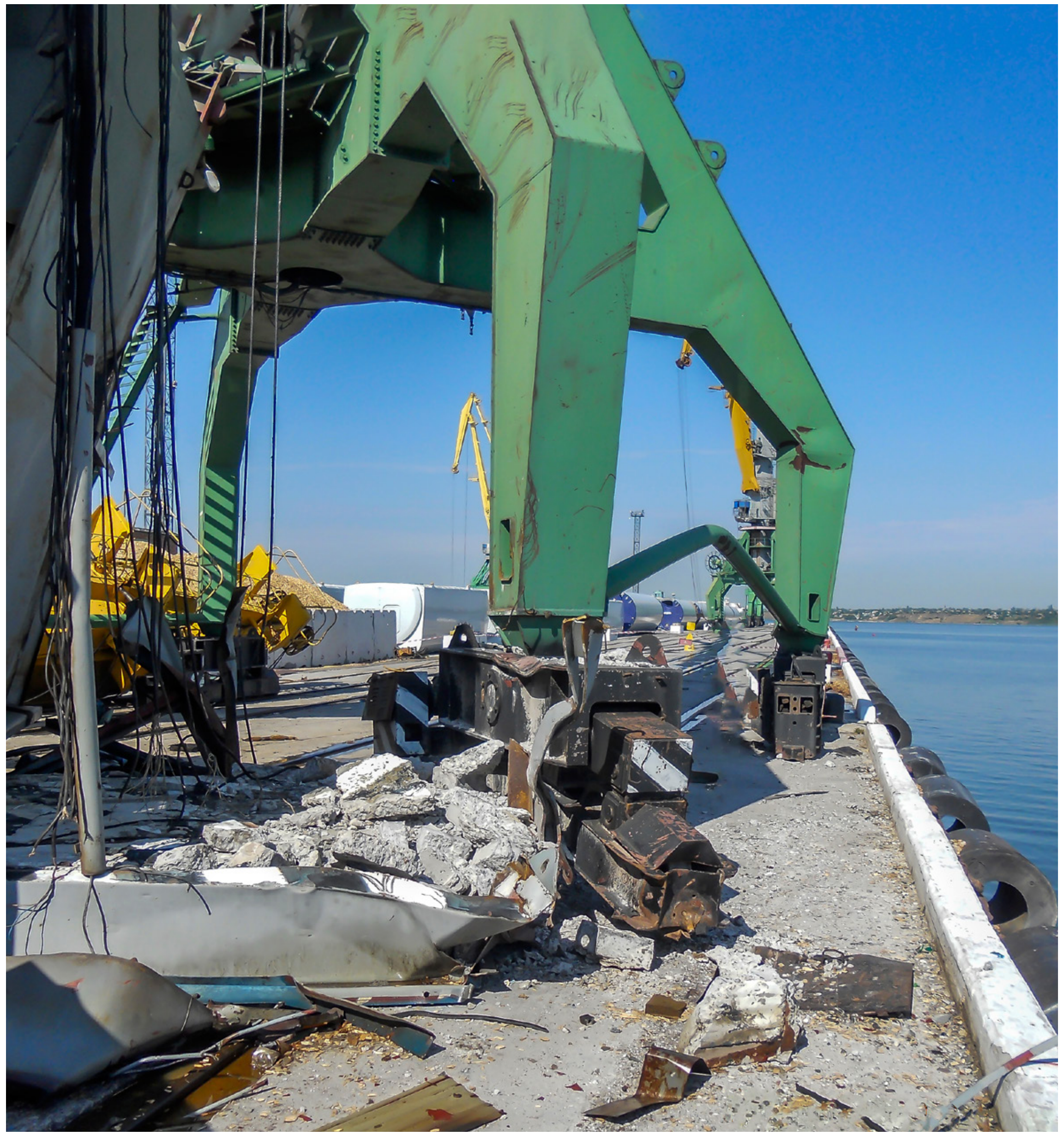
- **Depreciated value**
  This is appropriate for some types of assets. The value of equipment is calculated by you based on its age, percentage depreciation per year and the replacement value.
- **Market value**
  The value on the open market as declared by you, at the time and place the loss occurs.
- **New replacement value**
  The current new selling price of the asset plus finance, management and administration costs. This reflects the cost of replacement so will be higher than the market value.
- **Repair (or reinstatement) value**
  The total cost, including for example, debris removal or rebuilding.
- **Indemnity value**
  This is the cost of replacing older items with an item of the nearest, but no worse, type, age and condition. This will always be capped at the insured value as defined above.

Effects of inflation

You should pay particular attention to current levels of inflation when calculating declared values, particularly for property. In recent years, raw material and labour costs have risen significantly. These factors should be built in to any valuation to ensure your declared values are as accurate as reasonably practicable.

Remember, the values are assessed at the time of loss. In the current economic climate, simply using historically declared values risks the average clause being applied in the event of a claim.

TT Club's standard property and handling equipment cover does not apply the average clause unless the under-insurance value is more than 20%.



How the average clause works in practice

In the event of a claim, your insurer will usually appoint an independent surveyor. Part of the surveyor's task will be to assess the value of your asset at the time of the accident and to compare this with the value you provided in declarations.

If you did not declare an accurate value of the property when the cover started, your insurer will in most cases apply the average clause. In other words, you will be considered your own insurer for the difference between the value declared to the insurer and the real value of the property, and you will bear a pro-rata proportion of the loss accordingly.

Example:

- Value you declared to your insurers: US$600,000
- Independently assessed actual value of your property: US$900,000

Your declared value represents two thirds (66.67%) of the independently assessed actual value and as a result the average clause will apply. Any recovery under the insurance policy will be calculated by applying 66.67% to the declared value.

In the event of a total loss, the maximum amount you can recover would be US$400,000, less the policy deductable. To replace the item at its current value, you would need to find at least another US$500,000.

It should be stressed that this is a simplistic overview of what can be a very complicated area of cover. For example, the average clause does not generally apply to labour costs in the case of handling equipment. Also, for property other than handling equipment, the average clause is typically only applied if the declared value is less than 80% of the actual value.

Case Study 1

A transport operator insured its forklift truck for US$10,000. The insured value of the item is based on market value, as specified in the insured's policy. However, due to inflation, its value had actually increased to US$20,000. The asset was therefore underinsured by US$10,000 or 50%.

The operator made a claim for US$5,000 worth of accident damage to the forklift truck.

However, under the average clause, the insurer only agreed to pay out 50% of the claim, namely US$2,500, less the policy deductible, because the asset was only insured for half of its insured value, which was agreed to be the market value at the time of the loss.

The insurer was receiving only 50% of the premium it ought to have been to provide full cover for the forklift truck. Consequently, the operator only received 50% of the amount of its claim.

Insured value	$10,000
Actual value	$20,000
Insurance shortfall	$10,000 (50%)

Accident damage claim	$5,000
Insurer claims payment	$2,500 (50%)
Repair shortfall	$2,500

Case Study 2

A port insured an extensive array of assets, including warehouses, other buildings and harbour infrastructure. Many of the assets were damaged during a severe storm, with some being repairable while others were a total loss.

During an investigation of the port's claim for damage, it became clear that the insured values – for which the declaration had not materially changed for two years – were below the true values.

Consulting engineers provided a value range for each item, some of which differed from the declared value by more than 30%.

The average clause was applied and a settlement was negotiated with the port. The port recovered significantly less than the value of its claim.

Summary

It is your responsibility to provide accurate information on the insured value of your insured property and equipment.

In particular, if stated in the assets schedule that a piece of equipment is insured at "new replacement value", this is the value declared to the insurer by you and is not binding on the insurer.

You must ensure you understand the nature of the cover being placed with the insurer and supply the correct insured values to provide adequate cover.

All property required to be covered must be declared to the insurer. This includes any new property acquired during a policy year. **If it is not declared, it will not be covered.**

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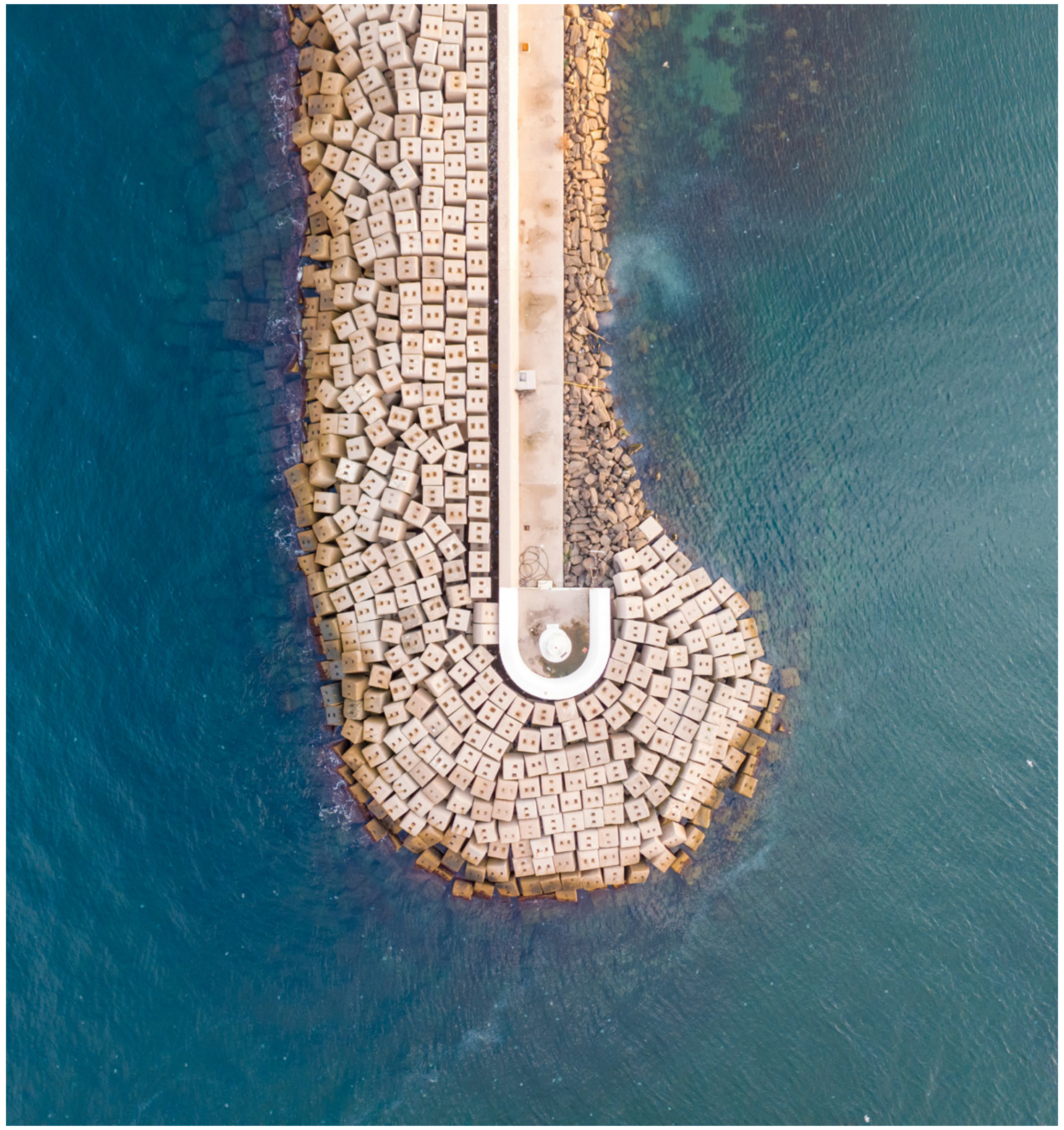

Checklist

- [x] Have you provided an accurate current value of your insured equipment and property to your insurer?
- [ ] Have you told your insurer about any new equipment or property you have acquired since you took out the insurance?
- [ ] Have you considered the recent effects of inflation on the correct values of your insured assets?
- [ ] Have you considered the risk to your business of being underinsured?

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For more information

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