



Keith Till  
National Broker Manager

# Australian small business: under-covered and under-insured

While one in six small businesses have no insurance,<sup>1</sup> many more don't have all the appropriate covers and/or adequate sums insured to survive a significant event. Which begs the question, how do your clients measure up?

**A** small business' chances of survival following a major loss event are sobering at the best of times, let alone when they don't have adequate insurance cover or, worse still, no insurance.

According to the Insurance Council of Australia, 70% of businesses in the latter situation are destined to fail in the wake of a serious blow, which could include anything from a legal claim against the company to an earthquake, fire, storm or other peril.<sup>2</sup> And while there are no surprises there for brokers, scratch below the surface a little around the issue of small to medium enterprises (SMEs) and their insurance cover and you're probably in for a bit of a rude shock.

## Coverage issues

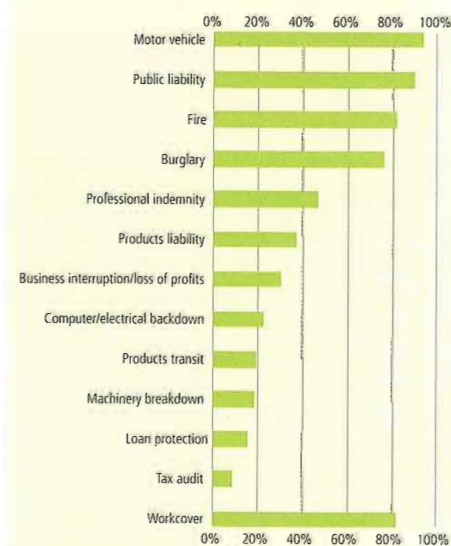
According to a recent Cameron Research survey, 84% of small business owners believe they are adequately insured, despite the fact that only 31% of SMEs have business interruption (BI) insurance (and 23% have never even heard of it). Meanwhile, one in six small business owners who consider themselves to be adequately insured have no burglary insurance, one in eight no fire insurance, and one in 20 no public liability insurance.<sup>3</sup>

In the broader small business community, the percentage of SMEs that haven't got these essential covers is even higher (see Table 1). But what's probably of greater concern is that around seven in 10 businesses don't have any BI cover. Given that 70% of SMEs use the services of professional brokers it appears we need to put more focus on the importance of this cover.<sup>3</sup>

## BI – who needs it?

In the wake of Hurricane Katrina a couple of years ago, the US Small Business Administration (SBA) approved more than US\$369 million in business disaster loans in the Mississippi. The economic injury loans, which the SBA made available to

Chart 1: Proportion of small businesses with different types of insurance



Source: Insurance and the Small Business Market, Cameron Research Group, June 2006



“Businesses without BI cover have less than a one in 10 chance of survival following a major loss!” – Allan Manning

small businesses that had experienced declines in revenue following the catastrophe, were designed to help them meet their ongoing operating expenses, such as rent and payroll. “A lot of small businesses didn't have business interruption insurance, and their sales dropped significantly,” says SBA spokesperson John Martin. “But they still have to meet expenses.”<sup>4</sup>

Closer to home, more than 1000 businesses applied for government assistance in the wake of Cyclone Larry – the only lifeline stopping many of them from going to the wall.<sup>5</sup>

As these recent events reinforce, most SMEs need BI as, contrary to a widespread misconception, it doesn't just insure a business' net profits. It also covers the owner's ongoing overheads that they continue to incur after a major loss.

## BI made easy

Loss assessor and educator Allan Manning says calculating the BI sum insured for the average small business isn't as difficult as some may think. “The problem with BI is that it involves numbers, which is a real turn-off for most time-poor small business owners,” says Manning, whose website [www.bicalculator.com](http://www.bicalculator.com) provides a wealth of information about BI including a handy online sum insured calculator. “To complicate things, the insurance definition of gross profit isn't the same as the accountancy term. Insurable gross profit is the sum of the net profit and all ongoing expenses of a business. When determining what is going to be

ongoing, both a partial loss and a total loss must be considered.

“For the average small business, you'll arrive at an adequate sum insured for BI by taking sales and simply subtracting the cost of purchases to achieve those sales. Then make an allowance for growth – both during the period of insurance and the indemnity period.”

Manning also recommends that brokers add an additional item of between \$25,000 and \$50,000 to the BI policy to cover the increased cost of working following a claim.

“The thing to remember is the level of cover must be reviewed every year,” he says. “If you fail to do that, you risk falling into the under-insurance trap should the business grow.”

Manning says that research he conducted as part of his doctorate on this subject revealed that businesses without BI cover have less than a one-in-10 chance of survival following a major loss.

“For what it is, BI is a relatively inexpensive form of insurance cover,” says Manning. “It's a profitable class for insurers, so there's a lot of competition in the marketplace. Whereas in 1970 BI was 120% of the fire rate, today it's around 65%.”

“The thing small businesses need to understand is that BI isn't a ‘nice-to-have’ insurance. Say your building burns down. Sure the fire insurance will pay for its reconstruction, but that could take years. How will you keep the business going in the meantime?”

“The BI insurance is like a personal accident

cover for the business. It meets all the ongoing expenses of the business and any additional expenses incurred to maintain turnover, plus it protects the business owner's net profit.

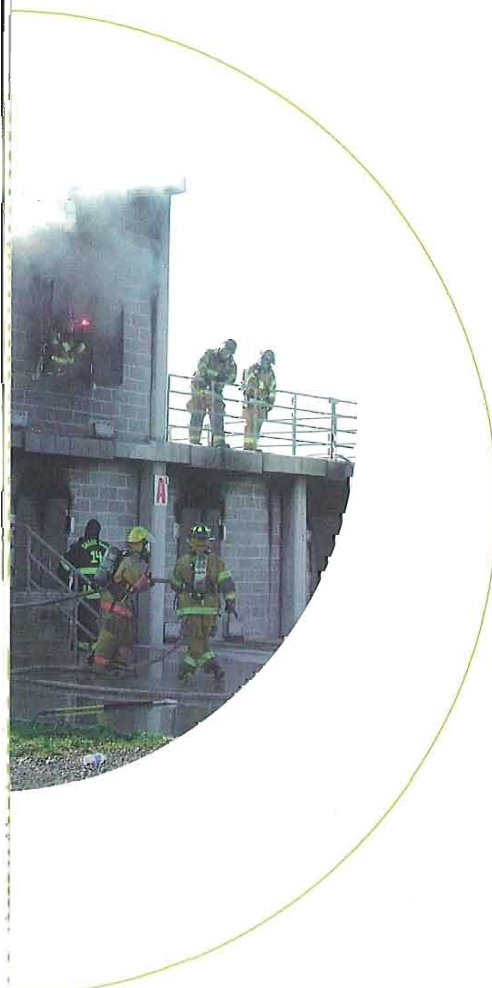
“This means everyone's salaries are paid, including the owners, until sales are back to normal, and any business loan repayments are met. Given many SME loans are secured against the owner's home, that's a great comfort.”

## The under-insurance monster

Even if your clients have all the appropriate risk covers in place for their business needs, can the same be said for their sums insured? As an exercise, we recently got our actuaries to look at the fire sums insured for Zurich Business Insurance clients. In 2006, 75% of renewed policies didn't increase their sums insured despite the fact the Consumer Price Index (CPI) went up by 3.6%.

Delving a little deeper, we discovered that nearly half the clients who'd been with Zurich for the previous three years hadn't increased their sums insured during this period. At the same time, CPI had gone up 8.6%, general building costs by 16.9% and commercial building costs by 20%.<sup>6</sup> Stainless steel costs had gone up by 50% in one year alone. And these were just routine price increases.

In the wake of a catastrophe, building costs can go through the roof, as our recent experience with Cyclone Larry has reinforced. Scarcity of materials,







shortage of qualified tradespeople and the affected area's remote geographical location pushed building prices in far North Queensland up by more than 100%. No doubt this helps explain reported under-insurance rates of 50% or more in the wake of the disaster and why brokers should always take into consideration worse case scenarios in their advice to clients.

### The Zurich insurance report

While many small business owners recognise the importance of having insurance per se, quite often they pay scant attention to their broker's advice to increase their sums insured or take out BI. And they often don't re-evaluate their insurance needs as the business grows, which can lead to an ever-worsening cycle of under-insurance.

To help you identify clients in this category, Zurich has developed a reporting system whereby we can track a broker's Business Insurance clients who haven't increased their sums insured for fire and BI for the past three years. The confidential spreadsheet lists the client's name, policy number and sums insured. Contact your Broker Development Manager if you would like to run a report for your clients.

You might be surprised by what the report, which is available to you free-of-charge, reveals.

To assist you with your client communications on the underinsurance issue, Zurich has also developed a template letter for you to use with your clients. Contact your local Zurich office for a copy.

The good news is that if you do discover some clients whose sums insured need a substantial

increase, the timing couldn't be better in light of the current soft market conditions.

1. 2001 ABS Small Business Survey
2. ICA Non-Insurance & Under-Insurance Survey Exec Summary
3. Insurance & the Small Business Market, Cameron Research Group, 2006
4. "Businesses still struggling after Katrina", *Hattiesburg American*, 3/4/2006
5. "True value of being insured", *Sunday Telegraph*, 1/10/2006
6. Andrew Nock *Valuers*

*Keith Till is Zurich's National Broker Manager and the company's second longest serving general insurance manager. During his 40-plus years at Zurich, his roles have included sales manager, branch manager, national roles responsible for industry segments, and manager broker services*

#### Zurich's under-insurance podcast aims to educate SMEs

Zurich is developing a series of podcasts to help brokers educate their clients on topics ranging from the dangers of under-insurance to the value of good advice. You can download the first podcast in the series – 'Risky Business – The Impact of Under-insurance' – from the General Insurance Brokers page at [www.zurich.com.au](http://www.zurich.com.au). As always, we're keen to hear what you think. Email your feedback and any ideas for possible future podcasts to [z2b.feedback@zurich.com.au](mailto:z2b.feedback@zurich.com.au).



### 10 common under-insurance traps for SMEs

- 1 Underestimating the reinstatement costs of buildings (ie not allowing for the increasing costs of rebuilding and the additional costs of new building codes, heritage issues etc).
- 2 Not allowing for architect and engineer fees when setting the building sum insured (their advice may be needed if the building needs to be rebuilt following a loss).
- 3 Underestimating the replacement cost of machinery and plant (arguably worse than on buildings).
- 4 Underestimating the cost of removal of debris (even \$100,000 doesn't go a long way if you have a site with contamination issues, like asbestos roofing or damaged stock with special disposal requirements).
- 5 Keeping sums insured up to date year after year.
- 6 Having no Business Interruption (BI) insurance.
- 7 Setting inadequate indemnity periods for BI insurance and no Additional Increased Cost of Working cover.
- 8 Setting inadequate Limits of Liability within the Liability policy. (Liability claims can be reported years after the actual event, so limits need to be set that take into account the cost of future litigation).
- 9 Entering into a lease or 'contract of services' without discussing the insurance implications with their broker and legal adviser. (Many business owners inadvertently enter into arrangements that may not be insurable and impose onerous responsibilities and liabilities that can put their assets/business at risk).
- 10 Providing advice for a fee without professional indemnity insurance.



## How BI saved the day for Farage after a burglary



Joe Farage had never heard of business interruption (BI) insurance when his broker Geoff Cartwright, from Cartwright Insurance Brokers in Sydney's Bondi Junction, recommended it. And Farage admits he didn't fully appreciate the policy benefits until recently, when thieves raided his Surry Hills warehouse last October and walked away with designer fashions with a cost price of \$100,000 in the lead-up to one of the year's busiest retail periods.

actual value of the stolen goods. Thankfully, we had BI insurance to pick up the slack to the tune of more than \$70,000."

As Farage fashions are made from premium imported European fabrics, this meant having to re-order replacement material from overseas. Taking into account holiday periods in both markets, it meant Farage wouldn't realistically receive the fabric (the clothes are manufactured in the Surry Hills workshop) until well into February – four months after the robbery.

*"I used to pay my BI premiums without really knowing a great deal about what it was all about; now I see it as essential – a security blanket for my business."*

"I used to pay my BI premiums without really knowing a great deal about what it was all about; now I see it as essential – a security blanket for my business," says Farage. "The robbery occurred at a critical time in our company's expansion – when we were on the verge of opening our first Melbourne store. Without the BI insurance, I would have had great difficulty retaining all my staff and paying my overheads, let alone going ahead with the Melbourne store opening. Six months later, we're finally back in the black – back to where we started from before the burglary."



Joe Farage at his Westfield Bondi Junction store

Farage, who started his company of the same name 10 years ago, operates a wholesale and retail fashion business. He has five Farage stores in prime retail locations in Melbourne (on Collins Street) and Sydney (in the MLC Centre, Strand Arcade and Westfield Bondi Junction). He also sells clothes to premium boutiques around Australia.

At the time of the robbery, the company had been going through a rapid period of expansion that had culminated in Farage's move to new premises in Kippax Street, Surry Hills – the heart of Sydney's rag trade.

"The Zurich BI insurance turned out to be our saving grace," says Farage. "I hadn't paid much attention to our burglary sums insured as the business grew. It never occurred to me to check whether we were insured for the full value."

"At the time of the robbery, we only had a \$20,000 limit for burglary – nowhere near the

How did Cartwright, the company's broker for the past 10 years, convince Farage to take out BI insurance all those years ago? "Geoff asked me a few questions that really hit home along the lines of: 'If a fire destroyed your warehouse tomorrow, how would it affect your business? How would you pay your staff? How would you fund the move to new premises,'" says Farage. "I'm sure glad I listened to his advice."

Writer | Marie Swaney