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CHARACTERISTICS AND SIGNIFICANCE OF THE SUM INSURED IN THE CZECH REPUBLIC

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Abstract

The sum insured of insured assets is one of the basic significant characteristics of insurance policy quality and is the ceiling amount of insurance benefit in the case of an insured loss. It is one of the parameters specified in the policy and affects the premium amount. The sum insured relates to the insured value of the asset. It is the highest possible loss which can occur to an insured loss and it is decisive for determining the sum insured. The policy holder determines the sum insured so that it corresponds to the insured value of the insured asset at the time of insurance policy signing. The policy holder is fully liable for setting the sum insured. The aim of this paper was to analyze the quality of the underwritten insurance according to the determined sum insured. Source data for the paper included critical analysis of literature based on valid Czech legislation and on general terms and conditions of insurance of individual insurance companies. The paper contains an analysis and comparison of types of insured values of assets for insurance needs on the Czech insurance market. An induction method applied to a real-life insurance case was used for explanation of the relationship between the sum insured and paid-out insurance benefit. The paper clarifies the significance and characteristics of the sum insured in the Czech Republic. The conclusion is that viewing insurance only from the angle of the premium amount is completely incorrect. Savings on the premium at the expense of reduction of the sum insured implies a risk of not renewing company operations or a living in a family house in case of an insured loss.

Key words: insured value, sum insured, insurance benefit, under-insurance, over-insurance

1. INTRODUCTION

Each policy may be judged in terms of a variety of parameters agreed upon in the insurance contract. These parameters, for instance, include insurance hazards, insured object, the sum insured, the benefit threshold, loss participation as well as the annual premium. The sum insured for the insured objects is one of the fundamental significant indicators of quality of the insurance agreed upon. The very issue is often not treated with due seriousness by both individuals and legal entities. The sum insured has a direct effect on the insurance benefit to be paid by the insurance company in the event of an insured case. The premium depends on the parameters of the insurance contract and, of course, on the sum insured itself. The fact tends to lead certain entities to reduce the sum insured with a view of reducing the premium.

An inappropriate sum insured, regardless of whether misdetermined due to a lack of knowledge of the issues at hand or due to premium savings, amounts to a risk of underinsurance for the beneficiary in the event of an insured loss. Underinsurance brings about, for the individual or legal entity, a reduced insurance benefit, which affects operation of companies and households. Clipped benefits are not the purpose of insurance and they represent a significant risk of non-renewal of operations of the company in the wake of an insured loss. The purpose of property insurance is to obtain funds required for a repair or re-acquisition of the damaged object and, for the company, renewal of operations in the wake of an insured loss.

The objective of the present paper is to underline the importance of the sum insured in property insurance. For the sake of simplification, the issue is related to the insurance of real estates. The paper assesses the quality of insurance in terms of the sum insured while stressing the importance thereof, which often tends to be undervalued. It explains the effects of underinsurance on the operations as undertaking by both companies and households. The issue is often misconceived by Czech policy holders. The policy holder and the insured person are not familiar with the importance of an appropriate sum insured and the effects of a wrong determination thereof in the event of an insured loss.

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2. FUNDAMENTAL TERMS

2.1. Meaning of Act no. 37/2004 on Insurance Contracts

Act no. 37/2004 Coll. on Insurance Contracts and the amendment of certain related laws, as amended (hereinafter referred to as the Insurance Contract Act) has been valid since 1 January, 2005. It is an entirely new law applying to the field of insurance and amounts to the most important legal standard in the field. The act regulates relations between parties to the insurance established on the basis of an insurance contract. The insurance is identified as private insurance.

The reason that led to the emergence of the Act was the increased legislative activity in the field of insurance legislation relating to the accession of the European Union by the Czech Republic. The need arose to ensure compatibility of the domestic and European legal systems, which underlined the importance of legal relations in insurance and of insurance itself (Hora, et al., 2004, p. 59). The Insurance Contract Act seeks to regulate the relations between partakers in the policy established on the basis of an insurance contract. The Insurance Contract Act introduces a score of terms, relations, rights and obligations that were absent in the previous edition of the law and that had to be incorporated in the terms and conditions of insurance by the insurers (Hora et al., 2004, p. 60).

The following terms significant for the issues covered by the present paper can be found in the Insurance Contract Act.

2.2. Fundamental Terms Covered by the Act

An insurance contract is a contract on financial services whereunder the insurer undertakes to provide the agreed-upon benefits in the event of an insured loss and the policy holder undertakes to pay premium to the insurer.

An insured loss is a random event described in detail in the insurance contract to which the contract refers, associated with emergence of the insurer's obligation to provide benefits.

An insurance hazard is a possible cause of emergence of an insured loss.

An insurance value is the highest possible financial damage that may occur as a result of an insured loss.

A current price is the price of an article immediately prior to the insured loss; it shall be calculated from the new price of the article and brought closer to the degree of wear or other kind of depreciation or valuation of the article that has occurred as a result of a repair or modernisation of the same or in any other way.

A new value is the value at which, at a given time and at a given place, the identical or equivalent article of the same type and purpose can be acquired.

Premium is the payment provided for private insurance.

Included in the insurance contract are the terms and conditions issued by the insurer. The policy holder must be demonstrably familiarised with them prior to the conclusion of the insurance contract.

For insurance against loss and damage (damage insurance), the Act specifies the upper benefit threshold. The benefit is limited by a upper threshold. The upper threshold is determined by the sum insured or the benefit threshold. For private property insurance the upper benefit threshold is determined by the sum insured. The sum insured is determined on the basis of a proposal submitted by the policy holder and is determined in the insurance contract in such a way that it corresponds to the insured value of the insured property at the time of the conclusion of the insurance contract. When concluding the insurance contract, the insurer is entitled to review the value of the insured property. If the sum insured cannot be determined at the time of the conclusion of the insurance contract, the upper insurance coverage benefit threshold shall be determined as proposed by the policy holder.

Loss participation is defined as the threshold determined in the insurance contract. If the damage amount exceeds the threshold determined in the insurance contract, the insurer will not provide any benefit.

Overinsurance exists wherever the sum insured exceeds the insured value of the property. The policy holder or the insurer may suggest that the sum insured is reduced along with the parallel reduction of the premium for the upcoming insurance period following the change concerned.

Underinsurance exists wherever the sum insured, at the time of the insured loss, is lower than the insurance value of the insured property. The insurer shall then reduce the benefit in such proportion in which the sum insured stands with regard to the actual amount of the insurance value of the insured property.

2.3. Damage Insurance and Forms Thereof

Property insurance belongs to damage compensation. This type of insurance has been newly introduced in the Insurance Contract Act. Damage insurance is private insurance, which seeks to provide damage compensation as a result of an insured loss.

For damage insurance, the benefits depend on the amount of the resultant damage, while the mutual quantitative relations between the benefit and damage are taken as the starting point. In this context, the reference is to specific need coverage. The compensation amount is given by the following relation

$$\textbf{benefit} \leq \textbf{damage.}$$

The purpose of damage insurance is compensation of loss incurred. The prerson insured cannot receive from an insurance company a benefit in excess of the damage. The insurance cannot result in enrichment as it solely seeks to provide compensation of any loss incurred.
The relation between the benefit and the damage is referred to as insurance protection intensity (i):

$$\mathbf{i} = \frac{\textbf{benefit}}{\textbf{damage}}$$

If:

$\mathbf{i = 100\ \%}$ ⇨ **full insurance**
$\mathbf{i < 100\ \%}$ ⇨ **underinsurance**

Damage insurance takes the following forms:

a) Pure interest insurance does not involve the sum insured. Under this type of insurance, the damage is fully covered. The benefit equals the damage. For this insurance form, no risk of underinsurance exists.

b) First risk insurance is also referred to as pure interest insurance from time to time. The sum insured gives the upper benefit threshold. The insurance protection intensity depends on the determined sum insured. For this type of insurance, no risk of underinsurance exists.

c) Full value insurance is the fundamental form of property insurance. The benefit depends on the insurance value (value of insured property). The value of the insured property must be determined beforehand with regard to any changes in economic conditions during the insurance period. The sum insured gives the upper benefit threshold (which is given by the indicated insured property value) and the insurance protection intensity as underinsurance may occur. Underinsurance occurs if the sum insured is lower than the insurance value. If the policy holder negotiates the sum insured at a level lower than the actual property value, they will pay lower premium and at the same time, will be cut short of the benefit in the event of an insured loss (Ducháčková, 2003, p. 39 – 44).

Next Table No. 1 resumeds Amount of Benefit in dependence on comparison the sum insured and the insured value.

Table No. 1 – Recapitulation of Amount of Benefit

Amount of Benefit	Comparison of sum insured and insurance value	Full insurance / Underinsurance
Benefit $= \dfrac{\textbf{iusured amount}}{\textbf{insurance value}} \times$ **damage**	**sum insured = insurance value**	**Full insurance: Benefit = damage**
	sum insured < insurance value	**Underinsurance: Benefit < damage**

3. SCOPE OF PROPERTY INSURANCE CONTRACT

3.1. Fundamental Insurance Parameters

Insurance companies throughout the Czech Republic offer products that may vary as regards specific parameters. If the policy holder decides for a specific insurance company, they should not forget to read carefully through the contract including the terms and conditions of insurance. This obligation is specified by the Insurance Contract Act. The policy holder, while familiarising themselves with the insurance contract and the terms and conditions of insurance, should pay increased attention to the scope of insurance.

The origins of the concept of insurance date back to antiquity. The people protected themselves against random accidents in an attempt to attenuate or remove their adverse consequences. In this context, the insurer (the insurance company) takes on itself an obligation that should an accident occur defined by the law or the insurance contract, they will provide the insured person with benefits. For property owners, solid insurance is an option of a contractual claim to funds in the event of unforeseeable accidents that may, for instance, originate from the negative effects of natural or physical forces on the property. The funds are required for the renewal of any damaged or destroyed parts of constructions (Bradáč et al., 1998, p. 672).

How should an already concluded real estate policy be assessed, then? How can the quality of the concluded policy be judged? Prior to concluding an insurance contract with a preselected insurance company, the policy holder shall choose the scope of the future policy. The scope of policy is determined by certain parameters. Most of the parameters shall be chosen by the policy holder based on the specific features of their property, with regard to their own perception of the risk and as per their financial capability.

Parameters of property insurance are summarised in Table No. 2.

Table No. 2 – Insurance Contract Parameters

Insurance contract parameters	
Insured property	Real estate selection – set of buildings or selected buildings
Insurance location	Address of the real estate or territory in the Czech Republic
Sum insured relating to the property	New price or current price
New price	Appropriate determination – prevention of underinsurance or overinsurance
Loss participation	Amount determination – percentage or financial amount
Benefit threshold	Amount determination – percentage or financial amount For certain insurance hazards, the benefit threshold is mandatory. For certain insurance hazards, the benefit threshold may be selected arbitrarily For certain insurance hazards, no benefit thresholds can be agreed upon.
Insurance hazards	To be negotiated in accordance with the terms and conditions of insurance Some insurance hazards must be negotiated as they are not included in the basic (mandatory) scope

The parameters above have a major role to play in forming the insurance price (the premium).

In addition to the above parameters, the premium also consists of:
the type and scope of client activities,
riskiness of the operations,
structural design of the site, the age and location thereof,
technical and organisational action taken to minimise any damage,
crime rate in the region,
policy duration,
frequency of damages during the past period,
frequency of benefit payments (Bradáč et al., 1998, p. 685).

Premium and Its Relation to the Scope of Policy and Benefit Amount

The premium amount depends on the agreed-upon scope and quality of insurance. Quality of insurance amounts to the insurance benefit. The premium and benefit are very significant for the future policy holder (the person insured) in that they affect his decisions within the policy negotiation process. The two parameters are obviously mutually dependent. The premium rate reflects the scope of the negotiated policy and, by inference, the quality of the negotiated insurance. The scope of the negotiated insurance reflects the benefits. It must be noted that the premium is as well affected by the specific insurance company in question. Insurance companies may vary based on the rates that are, to an extent determined by the insurance company. It needs to be remembered that insurance companies in the Czech insurance market differ in their services, namely with regard to the conclusion and administration of the policy or with regard to the emergence of an insured loss.

The policy holder's approach to the premium is affected, first and foremost, by their aversion to the risk and their financial capability. Generally, aversion to the risk prevails and insurance is one of the possibilities of reducing the risk. People with a negative perception of the risk are willing to sacrifice a proportion of their income in order to avoid the risk. This option is provided by insurance. An person insured has a secure source of income – the insurance provides a guarantee of an equal income no matter if an undesirable event arrives or not. (Hořejší et al, 2006, p. 137).

For a person with a negative perception of the risk, the first requirement is obtaining a steady source of income event in the event of an arrival of loss. Hence an assurance, than the benefit amount will be sufficient for them to allow the insured person to repair the damaged building or build it anew. The option is only provided by a solid policy, hence, after a thorough analysis of all parameters of the insurance contract and terms and conditions of insurance.

Sum Insured

One of the parameters determining the quality of an insurance contract is the sum insured. What is the significance of the sum insured that actually gets so little attention? The sum insured is determined on the basis of the scope of the insured property. The sum insured may be determined as a new price or the current price. If the insured person decides to opt for the current price, then, in the event of an insured loss, their benefits will be reduced by the amortisation rate.

The current price is mostly used in the following two instances for buildings. Either, the building is old and non-maintenance or it is a building that the policy holder will not seek to get renewed in the eventuality of an insured loss. If the insured person is aware of the fact that they will not seek to renew the building, they will be encourage to agree on the current price. The terms and conditions of the policy directly determine the procedure to be followed if that is the case, with the benefit paid out as per the current price.

The optimum option for property owners involves the scenario where they are appropriately insured to the new price, with the corresponding loss participation and the sum insured. The new price includes the value of all costs of the full renewal of the building at the given location and time including the price of the structural design documentation. In other words this means that – in the event of total loss, the benefit received from the insurance company and the funds obtained as a result of selling the remains should cover all costs of building a new site of the same size and design as the original building. (Bradáč et al., 1998, p. 684). The subsequent benefit will correspond to the need for unchanged income in the event of an insured loss. It is only such insurance benefit that can satisfy the insured person with an adverse perception or risk in the event of an insured loss.

4. UNDERINSURANCE

How can the sum insured be appropriately determined and undesirable underinsurance avoided? New price insurance as a type of the sum insured does not, in itself, guarantee that the insured person will obtain the actual and full loss amount in the event of an insured loss. The sum insured must be appropriately determined. Insurance companies follow their own methodologies when proposing the sum insured, providing the future policy holders (insured parties) with recommendations. However, it is the insured person that are responsible for the determination of the sum insured as per the terms and conditions of the policy. If the insured person decides to reduce the as calculated sum insured, the risk of underinsurance is imminent in the event of an insured loss. The commonest motivation for reducing the sum insured is cost savings. Such cost savings result, in the event of an insured loss, in reduced premium, which is defined as underinsurance by the Insurance Contract Act and in terms and conditions of insurance. The benefit amounts in the event of underinsurance are explained in the next chapter, which, for the sake of simplification, is based on property insurance.

Table No. 3. – Benefit Amounts in the Event of New Price Insurance

<table>
<tr><th>Sum insured for the insured property</th><th>Annual premium (in CZK)</th><th>Annual premium savings (in CZK)</th><th>Benefit amount (in CZK) Partial damage amounting to CZK 3 000 000</th><th>Missing funds for building renewal (in CZK)</th><th>Benefit (in CZK) Total loss amounting to CZK 6 000 000</th><th>Missing funds for building erection</th></tr>
<tr><td>New value – full insurance</td><td rowspan="2">6 000</td><td rowspan="4">3 000</td><td rowspan="2">3 000 000</td><td rowspan="2">0</td><td rowspan="2">6 000 000</td><td rowspan="2">0</td></tr>
<tr><td>CZK 6 000 000</td></tr>
<tr><td>New value – underinsurance</td><td rowspan="2">3 000</td><td rowspan="2">1 500 000</td><td rowspan="2">1 500 000</td><td rowspan="2">3 000 000</td><td rowspan="2">3 000 000</td></tr>
<tr><td>CZK 3 000 000</td></tr>
</table>

Note: For the sake of simplification, the benefits are not costed out with loss participation and residual values

Table No. 3 shows clearly that:

In the event of a partial loss, the missing funds for the renewal amount to CZK 1 500 000. As underinsurance occurred and the sum insured (the new value) has been determined at one half of the insurance value, the benefit will accordingly be reduced by half. The premium savings for one year due to the reduced sum sum insured to CZK 3 000. The comparison of the two values makes it clear that the premium savings will be used to top up the missing funds for the building renewal provided that the insurance has been concluded for the period of 500 years.

In the event of total damage, the missing funds for the new building erection amount to CZK 3 000 000. As underinsurance occurred and the sum insured (new value) has been determined at one half of the insurance value, the benefit will accordingly be reduced by half. In other words the insurance company will pay the agreed upon sum insured that corresponds to one half of the insurance value. The premium savings for one year that occurred as a result of the reduced sum insured is CZK 3 000. Comparison of the two values shows clearly that the premium savings will top up the missing funds for building reconstruction provided that the insurance has been concluded for the period of 1 000 years.

If the policy holder decides to conclude their policy with underinsurance the damage compensation in the event of an insured loss will be determined as a ratio between the sum insured and the insurance value. In this case, it is one half. The lower the value obtained from this relation (the higher the rate of underinsurance), the lower the paid damage compensation will be.

The table only shows the damage amount under the conditions of full insurance and for underinsurance. It does not contain any further financial impacts on the individual or the legal entity.

The following scenarios may apply:

1. The property is a detached private house. In the event of a loss, the family will be exposed to the risk that the family funds will not be sufficient to cover the reconstruction or construction of the building. The insurance company will only pay a half of the actual damage value to the insured person while the other half will have to be covered by the insured person using their own funds.

2. The property is let to another entity. In this case, the property owner incurs yet another financial loss, namely the lost rent during the repair or construction of a new building.

3. The property serves as a manufacturing plant of a company. In this case, the company incurs yet another loss again, namely the lost profit that will not be generated during the entire production outage. Such a scenario would further entail a loss of fixed funds that will be expended during the operation outage.

The insurance market allows insurance coverage of the second and third situation by means of an consequential loss insurance. If that is the case, the lost profit is insured as well as the fixed costs and lost rent. The condition to this type of insurance is that the insured property damage must occur first (natural disaster, theft) and only then the operation is interrupted.

5. CONCLUSION

Each negotiated policy has its parameters that modify the insurance premium and the benefit amounts provided. For a policy holder with an adverse perception of the risks, the priority is to obtain a solid policy. A solid policy means that in the event of an insured loss, the income of the insured person will remain unchanged. A solid policy means that the insured person will get back the entire damage value and will therefore be able to proceed with the repair or renewal of the damaged object. The solidity of insurance is determined by the sum insured. For property, the new value is a must in order to the insured person to be able to bring the property back to the original condition and/or continue in the business operations. A reduced sum insured (sum insured lower than the insurance value) means a lower benefit for the insured person in the event of an insured loss. The reduction is calculated on the basis of the ratio between the sum insured and the insurance value of the article. The insurance company may determine the sum insured based on their internal procedures. The person insured remains responsible for the amount, though. The prerson insured may reduce the sum insured with a view of securing premium savings. The negligible savings may however, have a negative impact for the insured person in the event of an insured loss. The impact may translate itself not only as shortage of funds for renewal or construction of property but also lost profit during operation interruption. The negative financial impact may as well subsequently bring about termination of the company operations.

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