



Avoiding Underinsurance – Why an Accurate Sum Insured Is Vital (but Often Neglected)

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It often becomes evident when reading the claim reports of insured companies that have suffered severe fire damage that the sums insured in the underlying policy were not assessed sufficiently to pay the policyholder full and adequate compensation.

Insurance experts in the U.S. report that quoted sums insured (or loan to value ratios as they are more commonly known there) are often only 60% of the actual insured value. The situation is no different in other countries. In Germany, for example, an expert in the calculation of sums insured recently said that the average degree of underinsurance was approximately 20% – with a very wide range in some cases.¹

Although there are numerous books and articles dedicated to the correct calculation of sums insured, no manageable standard has yet been established. The theoretical principles are known, yet they are difficult to put into practice and doing so often involves considerable time and expenditure which many companies wish to avoid. It cannot be ruled out that insureds accept underinsurance on the grounds of costs and efficiency.

In practice, the sum insured for buildings can be determined at a mostly reasonable cost. With newer buildings, the construction costs can be used to calculate a reference value with the corresponding appreciation index. It is significantly more complicated and difficult to determine the sum insured for plant, machines and consequential damage, such as business interruption insurance. For example, the anticipated future development of the company must be considered when determining the amount of business interruption insurance cover. As a rule, the usual key operating, financial and accounting figures can only be used on a limited basis.

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About This Newsletter

Created for our clients, our Property Matters publication provides an in-depth look at timely and important topics affecting commercial and personal lines of property insurance.

This article highlights various aspects of calculating sums insured and provides a checklist with suggestions to put into practice when underwriting.

The basic principles of calculating sums insured

There are different types of sums insured in the insurance sector, including:

- New replacement value (NRV)
- Actual cash value (ACV)
- Fair market value/book amount
- Reinstatement value
- First loss sum
- Loss limit sum insured

In almost all insurance markets, compensation is commonly based on the new replacement value in the event of a claim. Compensation is paid in the amount that must be spent to replace or restore an item of identical type, quality and functionality in new condition. The policyholder is to be recompensed to make it as if no loss had occurred. The new replacement value is defined as the costs incurred to obtain a replacement of identical type and quality. The new replacement value is often equated to the reinstatement value that normally consists of the costs of procuring a similar item and the ancillary procurement costs such as planning, approval and installation costs.

Another compensation agreement is based on the actual cash value. The actual cash value is the value of an item at the time of the loss. To determine the actual cash value, an amount is deducted from the new replacement value of an item to factor in the use, age and condition of the item. Payment of the actual cash value should enable the policyholder to obtain a reasonable replacement for the destroyed or lost item. However, determining the loss of value through the use and age of the damaged item is not without its problems. Insurance policies, therefore, often contain supplementary provisions which state that the new replacement value will be used as compensation if the actual cash value does not fall below a certain defined percentage (e.g., 40%). When a policy is based on the actual cash value, it must be taken into consideration that components at the original price are normally used in repairs in the case of a partial loss, resulting in a higher claims expenditure than if a used repair component of the same type and quality had been used.

Here, the fair market value is the sales revenue (for the item or old material), which could have been attained by the policyholder before the loss occurred. Compensation is based on the fair market value if the item was no longer in use or no longer usable before the loss occurred.

There are also other provisions, e.g., concerning compensation for securities or bank books.

The significance of the sum insured

Besides its significance to the policyholder, the sum insured is critically important to the insurers, inter alia, as part of:

- The calculation and determination of payable premiums
- The calculation and determination of the probable maximum loss
- The calculation and determination of underwriting capacity
- The determination of reinsurance

The sum insured also plays an important role in the statistical calculation of the necessary insurance premium. Initially, the loss ratio is calculated based on the accumulated sums insured of all underwritten risks for one type of operation in one portfolio in a defined period, e.g., ten years, as well as the losses occurred in that period. The loss ratio serves as a benchmark and shows what premium income would have to be generated at the very least to be able to pay compensation for all incurred losses in that type of operation from a statistical perspective. Factoring in administrative costs and the expected profit of the insurer, the technical insurance premium, which must be attained is then derived from the loss ratio.

Regarding non-proportional insurance/reinsurance, the sums insured also affect the necessary layer premium through the loss distribution curves obtained from statistical data.

In the event of a claim, the correct sum insured makes it possible to settle the claim quickly and reasonably and can, therefore, minimise potential loss consequences.

Although the policyholder is often left to determine the necessary amount, the insurer should also have a significant interest in the accuracy of the sum insured. In practice, provisions, whereby the insurer accepts responsibility for the accuracy of the sum insured, are few and far between.

In summary, the correct calculation of the sum insured represents a fundamental parameter within the context of property insurance for both the policyholder and the insurer.

The effects of inaccurate sums insured

Apart from the fact that the policyholder is not compensated fully for a claim when the sum insured is too low, inaccurate sums insured can have other effects:

- The insurer calculates too low a premium for a risk, i.e., it does not have sufficient premiums relative to the exposure to be able to pay a claim. An underinsurance clause is normally included in the insurance policy to counteract this situation. If the sum insured is lower than the actual insured value immediately before the loss occurs, compensation is only paid for the loss proportionally based on the ratio between the quoted and actual insured values.
- The underwriter assesses the exposure to the insurable risk as lower and agrees to an excessively high underwriting capacity. This also correlates with the assessment of the maximum loss. For example, an insufficient assessment of the maximum loss due to excessively low sums insured can cause the insurer to consider the expected loss profile unfounded in addition to the excessively low assessment of exposure. As such, both can also affect the purchasing and structuring of reinsurance, potentially forcing the insurer to cover part of the loss itself in the case of an erroneous assessment.
- In the long term, the systematic, incorrect calculation of sums insured in a larger portfolio could result in insufficient loss ratios and excessively high or low basic premium rates. As stated above, premiums are normally determined based on statistical data. The totality of all quoted loss amounts for a certain type of operation is considered relative to the totality of all quoted sums insured. If, for example, the quoted sums insured are lower than the actual reinstatement/restoration costs, this approach results in excessively low loss costs which will cause the necessary premium rates to be underestimated. See example 1 below:

Example 1: The reported sum insured is 1 million and the loss is 2 million. Using the correct sum insured of 2 million as a basis, a loss ratio of 1‰ would be necessary. However, since the reported sum insured of 1 million is too low, only half of the loss costs actually necessary are calculated, i.e., the premium calculated for the risk is 50% too low.

- The effect of the statistically incorrect calculation of the loss costs is exacerbated by the application of loss distribution curves in the calculation of non-proportional

insurance. In such a case, the priority is assumed to be more favourable than it would be had the actual sum insured been used (the compression effect), i.e., partial losses reach the attachment point more quickly. See example 2 below:

Example 2: The sum insured is 10 million, the reinstatement value is 15 million, the layer is 5 million excess 5 million for 100% of the risk. For instance, when a Ruthie A loss distribution curve² is applied, an underlying basic rate of 0.2% leads to a layer premium of 2,200 for the layer of 11% of the basic premium. Had the actual sum insured of 15 million been used as a basis, 15.4% of the total premium would be attributable to the layer, i.e., 4,600. The result is that a sum insured that is 50% too low leads to a 110% inaccuracy in the premium estimate.

- For non-proportional insurance policies, locations which the insurer considered irrelevant to the layer due to their excessively low reported sum insured, could experience a larger loss than expected, potentially even surpassing the priority. In the absence of an underinsurance clause this could trigger a compensation payment even though the insurer did not receive any premiums for it.
- Maximum loss scenarios and estimates are important criteria for an underwriter when it comes to assessing exposure. If the quoted sums insured are too low (something normally only discovered when a claim is filed), the underwriter will underestimate the risk exposure, causing the insurer to commit too much underwriting capacity or obtain insufficient reinsurance cover.
- For the insurer, miscalculations might occur in its cumulative assessment, especially with natural hazards cover.

However, there are also certain problematic aspects for the policyholder:

- The loss assessment and payment of compensation are delayed as extensive investigations are initiated to determine whether the sum insured actually corresponds to the reported insured values.
- Excessively high insured values can cause the policyholder to pay a high insurance premium. Excessively low sums insured generally lead to gaps in coverage and pose the risk of insufficient compensation being paid in the case of a loss. It becomes problematic

to determine the sum insured, for example, when values fluctuate strongly during an insurance year. To avoid the risk of underinsurance, the policyholder should, in this case, base the sum insured on the extreme value.

Additionally, points of discussion frequently arise between the parties:

- In some cases, the policyholder, broker and insurer all have different understandings of how the various elements of a sum insured are set out in a policy and should be interpreted when a claim is filed.
- The policyholder, broker and even the insurer often do not have the necessary expertise and time to appraise the insured values in detail. Therefore, potentially necessary items are not taken into account when the sum insured is calculated.
- With older buildings, facilities and machines, repairs and reconstruction after a loss are normally significantly more expensive as replacement parts might no longer be available, facilities/machines of the same type and quality might be out of production, or the techniques necessary for restoration might no longer be available.
- The sum insured is often calculated based on the operational and accounting values and methods known within the business (e.g., GAAP). Fixed costs, which can also be insured are not taken into account in this context and are, therefore, not factored into the calculation of the sum insured.
- In practice, the sums insured are often determined at the start of a business interruption or property policy. The fact that turnover, growth, changes in profit, and additions or disposals of material assets can change dramatically over the term of the insurance policy is often overlooked. When a claim is filed, this can trigger discussions about the insured value and the compensatory payment.

- As part of business interruption insurance, the indemnity period is often estimated optimistically before a loss occurs. The indemnity period is the amount of time that is ideally required to put the policyholder in the same financial position as if it had not suffered any loss. Before a loss occurs, the evaluation of existing alternatives and mitigation options after a loss is often optimistic too. If, after a loss, the indemnity period proves to have been underestimated or alternatives overestimated, the result is underinsurance with all of its serious consequences.
- Changes to the general economic conditions of the business to be insured are not factored into the calculation of the sums insured, e.g., stronger demand/turnover/earnings of a business, potentially due to the launch of a new product.

A recurring problem with claim settlements is that the originally quoted new-build values for buildings and purchase prices for new equipment ultimately prove to be too low when a claim is filed. Often, the reason is that discounts or other concessions obtained as part of the original purchase or construction are not taken into consideration.

In the case of a loss, the damaged facilities, machines and/or buildings have to be repaired, replaced or restored as quickly as possible. At such a point, the original discounts and concessions cannot normally be expected to be obtainable again; additional costs might even be incurred. This means that the payable costs in the case of a loss are significantly higher than the costs of a planned, long-prepared investment. The relevant machines or facilities may no longer be in production or spare parts might no longer be available, resulting in a single necessary made-to-order item causing significant, additional expenditure.

Additional costs are also frequently incurred by stricter requirements and operating licences such as additional safety measures required by regulatory authorities. The loss is also made more expensive by bottlenecks in terms of personnel,



restoration and repair firms, installation companies (e.g., for sprinkler or fire alarm systems), or the non-availability of infrastructure. These items would also have to be taken into account when calculating the sum insured.

Historical listed buildings and facilities are especially problematic. Often, there isn't information available about what a restoration of identical type and quality would cost in the present day since the materials and craftsmanship methods used at the time are no longer available or only available on a very limited basis. The restoration costs that are necessary only become evident in the case of a loss.

Potential solutions

Even if the consequences of an incorrectly calculated sum insured normally affect the policyholder, both the broker and the insurer could take more of an interest in helping the policyholder select the correct sum insured and providing advice. The parties involved have a wide range of options at their disposal including sum insured expertise, sum insured calculation tools and benchmarking procedures. Specifically:

Sum insured expertise

Involving an expert (e.g., to determine the value of the building/facility/inventory) is certainly the best and most reliable method of determining the correct sum insured. This expenditure is often avoided, however, as it requires a considerable time investment with a significant financial cost to the policyholder. When sum insured expertise is available, insurers normally waive the defense of underinsurance.

Sum insured value calculation tools

Today's data processing methods have made it possible to develop tools to help determine the sum insured. Sums insured calculated in this way are normally based on average statistical values from a range of comparable risks that use algorithms and any other available characteristics to estimate the value of the item in question and recommend an appropriate sum insured. However, it must be noted that these tools cover only partially some of the detailed and specific characteristics of the item being assessed as the calculation is based on statistical average values and therefore does not factor in, for example, exceptionally high-quality or rudimentary equipment.

Benchmarking procedure

Other ways of determining the necessary sum insured with reasonable effort have also been uncovered in practice. The following are but a few examples:

- **Trending method** – used to determine original prices rapidly when the valuation of the fixed assets is based on the original historical costs. As such, technological advancements and the additional costs of reconstruction at short notice are not taken into account. Therefore, it is recommended when the property to be valued is still relatively new, the items to be insured are being used in stable economies and the prices of the items are subject to little to no fluctuation.
- **Direct pricing method** – involves the determination of an item price by asking the manufacturer directly or evaluating price lists (where available). The installation costs are then an additional factor, as are any other costs incurred as part of the replacement. A surcharge might also have to be taken into account for the additional costs of reconstruction/restoration at short notice (acceleration costs). The downside of this method is that it cannot be applied to products that are no longer manufactured or available, e.g., because they have been phased out or the manufacturer has become insolvent.
- **Benchmark method** – estimates the insured value for an item by comparing known prices of similar items with similar physical characteristics and technical features. This method also requires factoring in the additional costs of restoration at short notice.

Numerous other methods are also available, yet all are based on a certain degree of uncertainty compared to an expert appraisal. Not to mention the fact that there is a trend in this globalised economy in favour of customized facilities and equipment, making it more difficult to estimate procurement times. The calculations are also made more difficult by the rapid technological progress and the complexity of restoration and replacement due to increasingly strict requirements and regulations.

Evaluation of potential solutions

If we consider the insured value of buildings, we can say with certainty that the sums insured being calculated are the most traceable. There is plenty of expertise and information available from the construction sector, even differentiated by country.³ An Internet search finds countless websites dedicated to these subjects. Such evaluations are often based on cubic metres of space or square metres and each planned use. In addition, technological progress is creating new possibilities, such as building valuations based on existing geoinformation and self-learning algorithms.⁴

It is more difficult to calculate the sum insured for facilities, machinery and other contents. Demand for standard machines and systems is declining nowadays. Instead, they are increasingly being adapted to the specific requirements of an operation or even built exclusively for special applications. Over time, it becomes increasingly difficult to check the facility index and determine a price based on the original purchase price. Ultimately, the only productive option is to ask the manufacturer directly what reconstruction would cost. Additionally, the increased efficiency and improved output of the facility or machinery resulting from the procurement of a replacement are difficult to estimate due to the rate of technological advancement.

Initially, it would appear less difficult to determine the value of the inventory and stock within the operation. The first requirement is to clarify whether the calculated sum insured is to be based on the production price or the selling price. The inventory accounts or inventory lists are normally helpful in this regard. It becomes more problematic when you have to factor in seasonal influences. The question of who is responsible for insuring the inventory can also be relevant if the warehousing has been outsourced to a third party.

In contrast, determining the sum insured for business interruption insurance is particularly challenging as it is dependent on the type of business interruption insurance desired (e.g., gross profit, gross earnings, extra expense insurance, or loss of rent insurance). Without going into further detail about the various types of business interruption insurance, suffice it to say the amount of cover of business interruption insurance has to be calculated with a degree of forethought. In the course of the insurance period, significant changes might occur due to changes in turnover, expected profit, fixed costs, or even changes to customers or the market. Another consideration is a loss that occurs at the end of the policy term. Here, cover can extend far beyond the end of the policy, in line with the indemnity period. Thus, the amount of cover for business interruption must be projected to the end of a mutually agreed upon indemnity period. Additionally, as various facilities belonging to a policyholder are connected economically and technologically, a loss can lead to consequential damage at other sites; this consequential damage might also fall within the scope of cover of the business interruption insurance policy (interdependency losses) and exacerbate the loss. Therefore, this must also be factored in when determining the sum insured.

It should not be overlooked that other items incurred in the event of a loss can also be insured (extensions/first loss items) for additional costs. These amounts are defined by the policyholder and are based on the estimation that the items will become additional expenditures in the event of a loss and will have to be taken into account. Extended liability agreements and provisional amount agreements can also be agreed as part of the insurance policy in addition to the definition of the amount of cover. Other insured items can include exchange rate fluctuations or precautionary investment agreements.

Contractual regulations which indicate problems with sums insured

The underwriting of the insurer is based to a large degree on the information provided by the policyholder prior to the conclusion of an insurance policy or on an insurance engineer's or inspector's report of the site and its operation. It is often difficult for an underwriter to subsequently identify whether the quoted sum insured reflects the real values and circumstances.

Due to the related difficulties, the insurance industry has developed clauses in an attempt to regulate inaccurate sums insured in insurance policies. There are numerous approaches in a wide range of insurance markets. Coinsurance and margin clauses are widespread instruments in the U.S., for example, whereas Europe tends to have underinsurance clauses.

Unfortunately, the invalidation of such preventive underinsurance clauses in policies has become common practice so that, a loss might be compensated up to the sum insured agreed in the policy without the insured value being checked.

In practice, carefully examining an insurance policy can identify certain characteristics, which indicate to an underwriter that the quoted sum insured might not be consistent with the actual circumstances. The following characteristics can provide guidance on problems with sums insured, although the list is not exhaustive. If these are identified, it should lead to a specific query as to the accuracy of the quoted sum insured.

- The insurance policy does not contain any sum insured or only contains liability limits.
- The insurance policy states that the sum insured is not relevant to the calculation of the compensation, but rather merely serves to define the premium.

- The definition of the basis of the compensation (e.g., new replacement value, reinstatement value, actual cash value, restoration value) is missing or vague.
- The compensation in the insurance policy is agreed to be based upon the new replacement value whereas the sum insured represents the actual cash value.
- The sum insured has not been adjusted in recent years, e.g., turnover growth, appreciation clauses/indices and inflation have not been considered.
- The insurance policy contains high, increased liability agreements (uplifts).
- The insurance policy contains no, or insufficient, information on value distribution to individual company sites or potential reciprocal effects in cases in which various sites are covered by one policy.
- The insurance policy contains an underinsurance agreement, or it has been removed. If the underinsurance clause has not been agreed to or if it has been removed, the sum insured on which the policy is based should be treated with the necessary caution and the underwriter should verify whether it is still up to date.
- The insurance policy does not unequivocally state whether the agreed first loss sums/extensions in the case of a loss are in addition to or included in any agreed maximum limit of indemnity.

Conclusion

The calculation of sums insured has been the subject of discussion for decades. However, this has accelerated in recent years as potential sanctions that once existed when sums insured were incorrect have largely disappeared or been removed from insurance policies. Additionally, due to the growing complexity of production processes and economic links within businesses, the complexity of loss settlement is increasing, and the calculation of the correct sum insured will be waived in the event of a loss. As such, any potential state of underinsurance cannot be identified.

An inaccurate sum insured can lead to incorrect estimates of the necessary insurance premiums, the underlying exposure, the underwriting capacity, and incorrect reinsurance, which causes unexpected problems for both parties in the case of a loss. If there are no potential sanctions, it cannot be ruled out that excessively low sums insured are quoted to the insurer in order to reduce insurance premiums.

We should not neglect the long-term effects, especially when loss ratios, premium scales, probabilities of occurrence, and loss effects are determined from existing insurance portfolios and the losses occurring in that period.

Correct sums insured also play a key role in underwriting, especially when additional premium-free covers are included which then result in a significant increase in the loss when an event occurs, sometimes beyond the agreed sums insured.

It should, therefore, be a matter of course for every policyholder and insurer to make the necessary effort to verify that the quoted sums insured are up to date for the risk being covered.

Endnotes

- 1 Duff & Phelps: Back to Basics – Presentation on 18 January 2018 at “Schweiztag 2018” by General Reinsurance AG in Zurich; Risk Report 2013/2014 Risk Experts, Vienna, Austria and <https://www.riskexperts.at/geschaeftsfelder/wertermittlung/unterversicherung-als-regelfall/>.
- 2 “An exposure rating approach to pricing property excess-of-loss-reinsurance”, Stephen J. Ludwig, pages 110 ff, <https://www.casact.org/pubs/proceed/proceed91/91110.pdf>.
- 3 ECC European Construction costs, www.constructioncosts.eu; Cumming, U.S. Construction Costs per square foot, <https://ccorpinsights.com/costs-per-square-foot/>; Arcadis, International Construction Costs 2018, <https://www.arcadis.com/en/global/our-perspectives/international-construction-costs-2018/>; BKI [Construction Cost Information Centre] (publisher), Statistische Kostenkennwerte für Gebäude, Stuttgart, www.bki.de.
- 4 (In German) Rechnen statt messen: schneller zum Gebäudewert, Kathrin Berenkopf, 13.11.2019, www.versicherungsmonitor.de.

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Sum insured underwriter's checklist

As discussed, the accuracy of the sum insured is essential to both the policyholder and the insurer. Knowledge of the underlying insurance policy is indispensable when it comes to assessing the quoted sums insured. The following aspects should be taken into consideration when underwriting:

- ✓ Is the insurance policy based on current sums insured and are these checked and adjusted regularly? If this is not the case, the last known sums insured should be indexed to factor in inflation and changes to economic values. If corporate sites outside of the domestic market are affected, exchange rate fluctuations should be factored in and the sums insured adjusted accordingly.
- ✓ Are the turnover values consistent with the scales expected for this type of operation? In the context of business interruption, for example, turnover figures and average experience values from business interruption sums can produce a usable scale compared to the amount of turnover.
- ✓ Is the indicated business interruption value consistent with the desired indemnity period? It is not unusual for business interruption insurance values to be quoted as an annual value and an additional indemnity period to be specified. In such cases, it is necessary to calculate the sum insured for the indemnity period by multiplying the annual value by the agreed indemnity period.
- ✓ Is the desired indemnity period realistic for the expected maximum loss or does it only represent a fraction of the expected duration of the business interruption? Analyses of loss reports have shown that the insured indemnity period is often not enough to rebuild the buildings/facility or restore them to the condition prior to the loss occurring. Here, it is necessary to adjust the amount of insurance based on the estimated longer indemnity period to take the increased exposure into account.
- ✓ Does the insurance policy contain sub-limits and first loss sums/extensions attributable to the property and business interruption loss in the case of a claim? This is relevant for the estimation of the maximum loss, which is important to the insurer.
- ✓ Does the agreed maximum loss liability (loss limit) include potential first loss agreements or are they in addition to the agreed maximum limit? If they are not included in the maximum limit, the compensatory payment could far exceed the agreed limit of indemnity.
- ✓ To what extent are interdependency effects covered by the insurance policy? Is there a liability limit for the agreed interdependency effects or are they also covered up to the amount of the agreed sums insured or maximum limit? Interdependency effects might also have to be factored in as part of the insurer's maximum loss estimate.
- ✓ When multiple sites are covered, is the insured value known for each site and are they spread realistically across the individual sites? A group-based business interruption insurance value with no spread across the individual sites is a problem. If the production methods are similar, it might be possible to use technical specifications to allocate a sum insured to each site. However, additional safety margins should also be factored in due to potential unknown factors.
- ✓ Have the sums insured changed over the years and have they been adjusted regularly? When policies are extended, the sums insured are often not adjusted. This leads to significant underinsurance in a relatively short period of time.
- ✓ On which definitions are the quoted sums insured based? Is the compensatory payment based on the same? When enquiries are made, it often turns out that reinstatement value/new replacement value insurance was desired in the case of a loss, yet the quoted sums insured were calculated based on actual cash value or even book value. As a rule, compensation at new replacement/reinstatement value should be excluded on an actual cash value basis.
- ✓ Does the insurance policy contain automatic adjustments, value increases and additional liabilities, which should also be factored into the calculation of the premium alongside the quoted sums insured? This can cause the compensatory payment to be significantly higher than initially expected from the agreed sums insured.
- ✓ Does the insurance policy contain underinsurance provisions or have they been removed (e.g., underinsurance clause, coinsurance provision, margin clause)? What affects do the agreed underinsurance provisions have on loss settlement in terms of the insurance benefit?
- ✓ Have maximum liability limits (loss limit) been agreed to in the policy? Have separate maximum liability limits been determined for property and business interruption insurance or is the maximum liability combined? An agreed maximum liability limit does not necessarily correspond to the sum insured. It must also be noted that further insurance cover is obtained above a maximum liability limit, e.g., with layered risks. In such cases, the underlying exposure estimate must also be expected to be incorrect.

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