INFLATION AND INSURANCE

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Valuation of Commercial Property

In the event of a loss, the primary concern of insureds is typically how much they will be able to recoup from their insurance policy. Remember, most agent's errors and omissions claims arise from not having adequate limits on the property policy.

Valuation of property refers to how the financial value of an insured property is determined. The valuation is what is used in setting a limit of insurance when the policy is written but for payment of claims for lost or damaged property valuation is determined at time of loss.

VALUATION TECHNIQUES MOST OFTEN APPLIED

- Actual cash value
- Replacement cost
- Functional replacement cost
- Value of tenant’s improvements and betterments

VALUATION

- Actual Cash Value – State Laws May Vary
  - Fair Market Value – price a willing buyer would pay to buy property from a willing seller in a free market.
  - Replacement Cost Less Depreciation – cost to replace property at the time of the loss minus its physical depreciation,
  - The Broad Evidence Rule – a judicious application of either of the above to the unique circumstance of claim, whichever is more favorable to the insured.

VALUATION

- Replacement cost (RC)
  - Most commonly used valuation method
  - Cost to repair/replace with like kind and quality at today's dollars
  - No depreciation
  - "New for old" – would seem to violate the principle of indemnity where the insured is made whole after a loss not giving "new for old" but it grew in popularity due to the practical limitations of ACV in financing loans for the acquisition of property.

VALUATION

- Functional Replacement Cost
  - Sometimes the replacement of property is simply not feasible or not desired.
  - A value is based upon the amount needed to buy or rebuild property that will serve the same purpose as the original.
  - Typically, lower than the cost to replace with like kind and quality.

VALUATION

- Value of Tenant's Improvements and Betterments
  - Commercial tenants leasing property sometimes make their own improvement and betterment to the property – lighting fixtures, wall coverings, walls, etc.
  - Legally and practically becomes part of the building which the tenant does not own but does have a use interest in the I&B.
  - This is addressed in the policy.

THE PURPOSE OF COINSURANCE

Most building property losses do not result in a total loss. Knowing this insureds may be inclined to lower the amount of property insurance. Being underinsured could result in financial ruin after a catastrophic event for an insured but it could also negatively affect how carriers forecast their loss payments.

In order to avoid this most insurers will include a coinsurance clause.

VALUATION

- Coinsurance – Widely Misunderstood Until Loss
  - Principle basically says that in exchange for a reduced rate the insured must agree to maintain a specified relationship between property values and amount of insurance.
  - The purchase and continued maintenance of a limit of insurance that complies with the coinsurance requirement of a policy is necessary to avoid a coinsurance penalty at time of claim.
  - Coinsurance percentages may be 80%, 90%, or 100% and apply to either the actual cash value or replacement cost of the property, depending on the valuation used in the policy.

VALUATION

- Coinsurance – Widely Misunderstood Until Loss
  - A primary problem with the coinsurance clause is the timing of the penalty.
  - Policy limits are selected when the policy is written.
  - The amount that should have been carried by the policy is determined at the time of the loss.
  - Factors such an inflation and improvements made to the property can increase the value during the policy period.
  - Periodic reviews of property and limits are important to avoid a penalty.

INSURED'S AND INSURANCE COMPANY'S BENEFITS OF COINSURANCE

- Insured's Benefits
  - It encourages the insured to adequately insure their property.
  - It lowers premiums, making purchasing more insurance more economical.
- Insurance Company's Benefits
  - It provides better premium levels per risk insured.
  - It prevents the purchase of insurance for the payment of smaller losses only.
  - Knowing the true property exposures within an insurer's portfolio allows for better rate accuracy over time.

LOSS SCENARIO WITH AN 80% COINSURANCE REQUIREMENT

A building with a value of $1,000,0000 must be insured for at least $800,000. By agreeing to do this the insured will get a reduced rate.

The following are examples of loss scenarios of both adequate and inadequate limits of insurance.

FORMULA

- Coinsurance Formula

  <u>Limit of insurance</u>

  Value of property x coinsurance x loss = Covered – Deductible Percentage

  Adequate Example <u>$800,000</u>

  $800,00 x $100,000 = $100,000 - $1,000 deductible

  Inadequate Example <u>$500,000</u>

  $800,000 x $100,000 = $62,500 - $1,000 deductible

VALUATION

- Replacement Cost May Be Purchased On Various Property
  - Buildings and permanent machinery, fixtures, and equipment that are covered with the building.
  - Business personal property including furniture, fixtures, machinery, and equipment.
  - Merchandise and stock if the including stock option is shown as applicable in the declarations
  - Tenants Improvement and Betterments.

VALUATION

- Replacement Cost May Not Purchased On Certain Property
  - Personal property of others
  - Contents of a residence
  - Works of art, antiques, or rare articles, including etchings, pictures, statuary, marbles, bronzes, porcelains, and bric-a-brac
  - Stock unless it includes stock on the declarations.
  - There are also two additional conditions regarding TI&B.

VALUATION

- Agreed Value
  - This coverage provides for a predetermined amount to be paid in the event of a total loss to the described property. Upfront agreement between the insured and the insurance company on the fixed value of the property.
  - Coinsurance does not apply to Covered Property to which this Optional Coverage applies. However the rules state the insured must carry an amount equal to 80% of the building's value or 90% for risks written on a blanket basis.
  - Insured must complete the Statement of Values endorsement – CP 16 15 – at the beginning of the policy term and with each renewal.
  - If the expiration date for this Optional Coverage is not extended, the Additional Condition Coinsurance is reinstated and this Optional Coverage expires.

VALUATION

- Inflation Guard
  - Automatically increases limits for designated property, either completed buildings or personal property, by a predetermined annual percentage.
  - May be used on policies written on either a specific or blanket basis.
  - If there is a midterm loss, the limit of liability is increased on a pro rata basis, from either the effective date of the policy or the effective date of the last change in the limit.

INFLATION GUARD EXAMPLE

The applicable limit is $100,000.

The annual percentage increase is 8 percent.

The number of days since the beginning of the policy year (or last policy change) is 146.

The amount of increase is $100,000 x .08 x 146/365, which equals $3,200.

NOW WE KNOW HOW PROPERTY IS VALUED LETS ASSESS THE OPTIONS

- Specific Insurance
  - Applies a specific limit to a building or personal property at a single location.
- Scheduled Insurance
  - Policy shows separate limits of insurance applied to individually listed properties.

NOW WE KNOW HOW PROPERTY IS VALUED LET ASSESS THE OPTIONS

- Blanket Insurance
  - Takes the value of all reported properties – this may also include personal property of others and tenants improvements and betterments.
  - Total limit is available to pay losses regardless of what property or location suffers the loss.
  - Makes it easier to manage and provides the insured more room for a mistake when estimating the valuation of their properties.
  - Insured will have 100% of coverage at each location as long as they carry the required minimum coinsurance clause –usually 90%.

MARGIN CLAUSE

- Limitation on Loss Settlement – Blanket Insurance (Margin Clause) CP 12 32
  - Discourages policyholders from intentionally undervaluing properties.
  - Requires insured to attach a statement of values. Also requires the replacement cost or actual cash value of the properties covered under their policy.
  - Places a limitation on the payment of a loss at any one location.
  - Percentage of the amount shown on statement of values.
  - Typically an amount over 100%.

LOSS EXAMPLE USING THE MARGIN CLAUSE

Blanket property limit (based on 90%)	$945,000
Value of building #1 on the Statement of Values	$500,000
Margin Clause percentage	115%
Maximum amount payable for building #1	$575,000
Amount of loss to building #1	$600,000
Deductible	$2500
Loss payment	$575,000

WHAT ABOUT INVENTORY THAT FLUCTUATES?

- Blanket Insurance
  - Margin Clauses attached to the blanket limit policies could limit the coverage that could be provided at a particular location.
- Peak Season Limit of Insurance – CP 12 30
  - Automatically increases the limit for the insured business personal property for a limited period of time.
- Value Reporting Form – CP 13 10
  - Intended for insureds whose personal property values fluctuate in both time and amount.

IT IS NOT JUST A COMMERCIAL ISSUE

- Commercial Property vs. Homeowners
  - Coinsurance vs. Loss Settlement Provision
  - Coverage A and Coverage B both affected in the Homeowners Policy
  - Coverage C settled on ACV

LOSS SETTLEMENT RC OR ACV

- Replacement Cost
  - Building – Coverage A
  - Building – Coverage B

- Actual Cash Value
  - All Personal Property – Coverage C
  - Non-buildings – Coverage B
  - Carpeting
  - House Appliances
  - Awnings
  - Grave Markers

ENDORSEMENTS THAT MAY HELP PERSONAL PROPERTY AND CERTAIN NON-BUILDING STRUCTURES

- Personal Property Replacement Cost Loss Settlement – HO 04 90
  - Changes coverage for personal property, carpeting and household appliance from ACV to replacement cost loss settlement without deduction for depreciation. Also requires that property be replaced if the loss is over $500.

- Replacement Cost Less Settlement For Certain Non-Building Structures On The Residence Premises – HO 04 43
  - Changes coverage for Other Structures which are not buildings (such as fences, patios, driveways, and certain in-ground pools) from ACV to replacement cost loss settlement.

LOSS SETTLEMENT OF BUILDINGS – COVERAGES A & B

Building Insured For At Least 80% Of Its Replacement Cost At The Time Of The Loss

If the building is insured for at least 80% of its replacement cost at the time of the loss then the Loss Settlement Condition states that buildings under Coverages A and Coverages B will be valued at replacement cost without any deduction for depreciation in value.

Replacement cost will not be paid until repair or replacement is complete unless the loss is BOTH less than 5% of the limit of insurance on the building and less than $5,000.

Insured may also choose an ACV settlement. If the insured later decides they would like to proceed with repair or replacement of the damaged dwelling and would like to claim additional coverage, the insured must notify the carrier within 180 days after the date of the loss.

LOSS SETTLEMENT OF BUILDINGS – COVERAGES A & B

Building Not Insured For At Least 80% Of Its Replacement Cost At The Time Of The Loss

If the building is insured for less than 80% of the full replacement cost, the applicable payment will not exceed the limit of liability and will be the GREATER of:

Actual cash value of the part of the damaged building

Or

The cost to repair or replace that part of the building that was damaged, which the total amount of insurance in the policy bears to 80% of the replacement cost of the building. Basically the coinsurance formula will be used.

GREATER OF FORMULA OR ACTUAL CASH VALUE

$$\frac{\text{Limit of Liability on Policy (Did)}}{\text{Replacement Cost x 80\% (Should)}} \times \text{Loss} = \text{Payment}$$

Or

Actual Cash Value

EXAMPLE

Bob's house was damaged by a fire. He carrier $210,000 coverage on his home with a replacement cost of $350,000. The total cost to repair his home was $30,000. The actual cash value $22,000. How much will the insurance company pay?

$$\frac{210{,}000\ (\text{did})}{280{,}000\ (\text{should})} \times \$30{,}000 = \$22{,}500.$$

Formula - $22,500

Actual Cash Value - $22,000

ENDORSEMENTS THAT MAY HELP

- HO 04 20 – Specified Additional Amount of Insurance For Coverage A Only
  - Dwelling must be insured to 100% replacement cost.
  - Does not increase Coverage A but provides an additional 25% to 50% (amount selected) if needed.

- HO 04 11 – Additional Limits of Liability for Coverages A, B, C and D
  - May be available to provide an additional amount of insurance to rebuild the dwelling at time of loss.
  - Coverage will be increased to equal the current replacement cost.
  - Other coverages based on a percentage of Coverage A are also increased.
  - Premium will be adjusted for increased coverage.