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Tips for Setting Property Valuations as Replacement Costs Spike

Buildings with undervalued replacement costs—and the resulting insurance to value complications—aren't a new issue in property insurance. The challenges, however, have been exacerbated by a global pandemic and natural disasters (wildfires, hurricanes) wreaking havoc on supply chain infrastructure as well as the scarcity of materials and skilled labor.

Now add into the mix a spike in catastrophic weather damage claims and a renovation renaissance inspired by people staying at home, and it's the perfect storm of high demand meeting dwindling supply. It's the exact formula for generating high prices on much-needed products...and for catching insureds off-guard by inadequate property insurance coverage.

With carriers starting to push back on valuations, it falls to brokers and retailers to make sure property owners have accurately valued their assets and understand the risks of being underinsured.

CONTACT

To learn more about how Amwins can help you place coverage for your clients, reach out to your local Amwins broker.

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Why are so many clients underinsured?

Market data would suggest that most commercial E&S portfolios are underinsured between 40-60%, depending on region and risk type.

While in some instances a carrier might push back on a valuation or set minimum coverage requirements per square foot, for the most part carriers have relied on retailers and property owners to determine the replacement valuation for covered properties. The idea is that owners and retailers have more information to better assess their unique risks.

Then, carriers price contract renewals by applying a formula based on inflation rates. This becomes problematic, however, when the replacement value of the property changes dramatically year to year—usually at a much higher rate than inflation.

While the spotlight has predominately been on commercial lines, personal lines are not immune. The chaos in the housing market has magnified the problem as competitive bidding has driven up the market value of homes, boosting current replacement costs.

What are the ramifications of undervaluation?

The most obvious impact of undervaluation is the unexpected expense of coinsurance, and potential coinsurance penalties, for the insureds.

Coinsurance Example
Business owner Bob owns a downtown building that is insured for $1.2 million. A tornado comes through town and demolishes Bob's building. It costs $1.3 million to rebuild.

Bob's coinsurance clause of his property insurance policy states that Bob is required to purchase an insurance limit of 90% of the total value of the building, which means Bob would need a policy limit of $1.17 million to be considered adequately covered. Bob has a limit of $1.2 million, so he meets this requirement.

The policy pays out the $1.2 million (minus the deductible) and Bob is responsible for the remaining $100,000 (plus deductible).

That's straightforward math—painful added expense for Bob—but it makes sense. The part that can be confusing for insureds is that most coinsurance clauses also impose a penalty if the insured has failed to purchase adequate coverage.

Coinsurance Penalty Example
Business owner George bought a building downtown 10 years ago and at the time of purchase had a professional appraisal done to determine the replacement value for the building. George purchased an insurance policy to cover the total replacement value of $5 million, and every year since, George has signed off on his renewal paperwork for the original appraised value.

One morning, George goes to work and discovers that the sprinklers malfunctioned at the building overnight causing $200,000 in water damage. George is upset, but glad he has insurance to cover the loss. He submits the claim to his insurance company, but the payment covers only a portion of the cost. George is confused because he knows he has the building insured for more than $200,000, so he calls the insurance company to inquire.

Over the past 10 years, the replacement costs for George's building have increased by 40%, making the current total replacement value $7 million.

George's coinsurance clause of his policy states that George is required to purchase an insurance limit of 90% of the total value, which means George would need a policy limit of $6.3 million to be considered adequately covered. George has a policy limit of only $5 million, making him $1.3 million shy of the requirement, and triggering the coinsurance penalty.

The coinsurance penalty of 79% is the percentage difference between the limit he did purchase ($5 million) and what he should have purchased ($6.3 million).

This 79% penalty is then applied to the amount of the water damage ($200,000) for a loss payable of $158,000 (minus George's deductible). So now George must pay the remaining balance of $42,000 (plus deductible) as a coinsurance penalty on a $200,000 claim.

With the recent spike in replacement costs, many insureds are finding themselves in the same predicament as George where they think they have adequate coverage until they file a claim.

And the ramifications for undervaluation don't just impact the insured.

Retailer's Errors & Omissions (E&O)
If a loss occurs and the insured doesn't receive the full payout due to undervaluation, the insured could make an E&O claim.

In George's case, he could make the argument that his insurance agent should have recognized that his limit didn't match current market trends and should have recommended re-valuation of his property at some point in the past 10 years.

Awareness of market trends and costs of construction are critical when placing and renewing policies—not only for your clients' benefit but also for yours.

What can you do to ensure accurate property valuations?

Improved property valuation is about creating awareness and educating insureds about the rising costs.

While you don't want to dictate an exact property value to clients, you should encourage them to appropriately value replacement costs and ensure they understand the implications of being undervalued, and thus, underinsured.

Here are some tactics you might find helpful:

1. Stay up to date on current market trends and how they might specifically impact your clients. Amwins regularly publishes articles like this to help our retail partners.

2. Position yourself as a consultant/advisor and thoroughly discuss the current market trends and potential risks for your clients on an individual basis.
   - Ask clients to consider not only market value of their property, but "How much would it cost to rebuild and replace everything?" These are often two very different numbers.

3. Use the valuation tools at your disposal and, knowing that these tools vary widely in their calculations, compare the results of several for a broader view.

4. Apply your market knowledge and your own book of business within a given area for cost comparison like those used for real estate prices.
   - Example: If a property is valued at $125/sq. foot and the other properties in the area are insured for $250/sq. foot, that is a good indication the property isn't valued correctly, and further investigation is required.

5. Encourage clients to re-appraise for replacement costs more frequently. The benefits of adequate coverage outweigh the potential for increased rates.

6. Seek advice from insurance experts like your Amwins broker who carefully monitors the market and can provide guidance for even tough-to-place risks.

Insurance to value has always been a point of contention and the increased fluctuation in replacement costs makes it harder than ever to accurately assess. While there aren't any easy answers, you can make a difference by focusing on each client's unique situation and raising awareness about the costly risks of undervaluation.

About the Author

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