Replacement Cost Really Isn't: Understanding Property Valuations

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Session Topics

- Values Assignable to Property
- Key Insurance Valuation Concepts
- Defining “Values” Applicable to Insurance
- Replacement Cost
- Ordinance or Law (Building Codes)
- Property Value Options
- How to Develop Property Values

Values Assignable to Property

Values Assignable to Property

The Amount For Which It Can Be Sold

What An Expert Thinks It Is Worth

The Value The Individual Places On The Property

Values Assignable to Property

Depreciated Value:

- Obsolescent depreciation
- Economic depreciation
- Accounting depreciation

Values Assignable to Property

The Value For Tax Purposes

The Remaining "Use" Value

The Cost To Replace The Property With Something Just Like It

The Cost To Replace With Something Functionally Equivalent

Key Insurance Valuation Concepts

Indemnification

- "The contractual obligation of one party (the insurance carrier) to return another party (the insured) to essentially the same financial condition enjoyed before the loss without improvement or betterment."

How is Indemnification Accomplished

Paying “the lesser of…”:

- The “value” of the lost or damaged property;
- The cost of repairing or replacing the lost or damaged property;
- The agreed or appraised value;
  - Use of the “Appraisal” process; or
- The cost to rebuild or repair with other property of like kind and quality (LKQ).

Valued Policy Statutes

- **Purpose**: Avoid any argument of over insurance by requiring the insurance carrier to pay the policy limits in the event of a total property loss. The covered causes of loss and property types vary by state.

- Effect:
  - May alter the application of the “indemnification” provisions in the CPP.
  - Requires the carrier to avoid over-insurance on real property.

Valued Policy States

- Arkansas
- California
- Florida
- Georgia
- Kansas
- Louisiana
- Minnesota
- Mississippi
- Missouri
- Montana
- Nebraska
- New Hampshire
- North Dakota
- Ohio
- South Carolina
- South Dakota
- Tennessee
- Texas
- West Virginia
- Wisconsin

Modified Valued Policy States

- Massachusetts
- North Carolina
- Wyoming

Defining “Values” Applicable to Insurance

(Fair) Market Value

- Definition: The value agreed to by a willing buyer and a willing seller.
- Rarely an "insurance" value, unless the government gets involved.
- Could be considered the value assigned by the commercial property policy to "stock" that has been sold but not delivered.

Actual Cash Value

- Definition: Replacement cost new on the date of the loss LESS ***physical*** depreciation. Or is it??

- The customary/historical valuation method in commercial property insurance coverage.

- Note that it is NOT defined in any standard form.

Establishing Actual Cash Value

- Four possible ways to establish the ACV:
  - Broad Evidence Rule
  - Fair Market Value
  - RC – Depreciation

Broad Evidence Rule Considerations

- Market value;
- Replacement cost;
- Physical depreciation;
- Original cost;
- Useful life factors;
- Condition of the property;
- Location;
- Use;
- Intended use;
- Assessed value;
- “Offer to sell" value; and
- Offers to purchase amounts.

Replacement Cost

Defining “Replacement Cost”

- An optional coverage in the CPP(G.3.)

- The cost to replace damaged/destroyed property with new property of like kind and quality. The valuation is at the time of the loss.

Replacement Cost and the Principle of Indemnification

- Does replacement cost violate the Principle of Indemnification because it places the insured in a better condition that prior to the loss (new stuff for old stuff)?

Barriers to Replacement Cost

- Actual repair or replacement
- Ineligible property
- Coinsurance
- Governmental Problems

Ordinance or Law (Building Codes)

Effect on Replacement Cost

- Insureds think “replacement cost” means they will get a new building for the old one.

- Gaps in the unendorsed commercial property policy that makes this incorrect

- If an insured building suffers “**major damage**,” the unendorsed CPP will pay the replacement cost on the damaged portion, but it will not cover the results of the enforcement of any building codes.

What is "Major Damage"

- Defined as: "The amount of damage necessary to cause the local jurisdiction to require the entire building be brought into compliance with the current building codes." Or, "The point at which 'grandfathered' status is removed."

- Two Possible Rules:
  - The "Percentage Rule"
  - The "Jurisdictional Authority Rule"

The "Percentage Rule"

"Buildings damaged beyond a certain percentage of their value or square footage must be fully brought into compliance with current building codes."

Could be a Percentage of:

- Values
- Square footage

The “Jurisdictional Authority Rule”

“The authority having jurisdiction decides if the damaged building must be brought into full compliance with the current building code.”

- Very subjective.
- Methods used to establish “major damage” can vary from county to county.
- Jurisdictions could use a percentage method or a “public safety” method, etc

Who Makes the Rules

- Federal Government
- Local Jurisdictions
- Historical Societies

But enforcement is local!

Limitations to Consider

- The building codes to which the Ordinance or Law coverage applies
- What must occur before Ordinance or Law coverage responds
- The coverage limitations

Two Key Ordinance or Law Coverage Forms

- Ordinance or Law Coverage – CP 04 05
- Ordinance or Law – Increased Period of Restoration – CP 15 31

Three Key Coverage Parts

- Coverage A – Coverage for Loss to Undamaged Portion of the Building
- Coverage B – Demolition Cost Coverage
- Coverage C – Increased Cost of Construction

Coverage A – Undamaged Portion

- Pays the difference between the damage to the building (paid by the CPP) and the value of the **undamaged** portion.

- How coverage can be provided: Cannot be written on a blanket basis, scheduled only.

- Choosing limits: No limit chosen.

- Cost: Approximately 15% of the net building premium (excluding earthquake)

Coverage B – Demolition Cost

- Purpose: Cover the cost of tearing down and removing the debris of the **undamaged** part of the building.
- Providing coverage
- Choosing Limits
- Cost: (Limit/100) * Net Building Rate = Coverage B Premium

Coverage C – Increased Cost of Construction

- Pays the difference between what the CPP pays combined with Coverages A and B and the total replacement cost

- Same options as Coverage B

- Problems with choosing limits

Problems Choosing Coverage C Limits

- Coverage C pays the difference between the insurance meaning of replacement cost and the “true” (insured’s belief about) replacement cost.
- Cost estimators develop the cost to rebuild a structure to current building code.
- Contractor estimations are also based on current code
- Unendorsed CPP won’t pay to bring the building up to current code.
- One possible solution involves a lot of assumption.

One Possible Solution

- Choose a percentage of the building value (1% to 3%)
- Multiply the percentage by the value of the building
- Multiply the answer in “2.” by the age of the build

- Example: 20 year old building valued at $1 million applying the 1% per year cost average.

($1,000,000 * .01) * 20 = $200,000 Coverage C Limit

Coverage C

- Cost: (Limit/100) * Net Building Rate = Coverage C Premium
- Special provision: Building must be rebuilt within two years (E.4.a.(2)) for coverage to apply.

Property Value Options

Functional Replacement Cost

- Pays the cost to replace damaged property with something functionally equivalent. Not the same, but just as functional:
- A specific limit is assigned to the building.
- Coinsurance does not apply.
- “Market Value” is used as a gage of payment in this endorsement (if the insured does not replace the building).
- Ordinance or Law coverage is included in the coverage (all three parts).

Agreed Value

- The insurance carrier and the insured "agree" on the value of the property being insured.
- Standard coinsurance limits apply even though the coinsurance clause does not apply; however, there is a "penalty" clause (calculated like coinsurance).
- The CP 16 15 (Statement of Values) must be completed.
- Coverage can be provided on either an ACV or RCV basis.

Stated Amount

This is an inland marine term that is often confused with Agreed Value. There is no benefit to using "Stated Amount"

This is a "lesser of" provision paying the lesser of:

- The stated amount; or
- The ACV

Inflation Guard

- The amount of coverage automatically increases during the year (but it does not make the renewal coverage higher).

- The increase is prorated throughout the year.

- *But what about a multi-year policy?*

How to Develop Property Values

Methods for Developing Property Values

- Insurance Valuation Software

- Use Builder Software

- Use Tax Records

- A professional appraisal

- The Underwriter’s Responsibility

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