

Cardinus Advisory Notice #2 - Insurance Rebuilding Valuations and Underinsurance - What are the issues?

Introduction

Most of us take for granted that the buildings we live in and own are sufficiently covered by our buildings insurance having the common attitude in life that 'it will not happen to me'. Except of course, life is not that simple and insurance claims are made all of the time. Most are settled without any great issue but that is not always the case.

Our experience, borne out of actual revaluations carried out on behalf of clients over the past few years, suggests property insurance values are seldom correct with a good number underinsured by 20% or more.

This report is based on the views and experiences of our specialist consultants and information obtained from other experts, which we feel, will have applications for your organisation as you seek to protect your own property assets or those that you are responsible for managing or insuring.

Background

It has been our experience, to date, that very few properties are insured at their full rebuilding value. We have found there to be a wide variation between current sum insured and the measured valuation figures and whilst a few properties were overvalued the vast majority were found to be undervalued. Overall and across thousands of properties, properties were, on average, found to be undervalued by 20%.

Interestingly an article published in the Insurance Times on 25th March last year reported that a Norwich Union* property survey found 86% were significantly underinsured. Mike Colmans, property owners underwriting manager for Norwich Union*, said: "Having accurate sums insured on a property is vital to guarantee receiving the full amount in the event of a claim. As many as 50% of claims for damage to buildings are being settled below the cost of reinstatement, which could have a significant impact on property owners who would have to fund the difference themselves.

Previously, property owners would have had the option of borrowing money to meet the surplus cost but given the economic climate and limited access to credit this now may not be possible. Therefore a significant shortfall in the claim settlement could mean that the owner would have to sell their property at a greatly reduced price.

Having a professional valuation carried out on a property will ensure it is valued for the correct amount. Often valuations are undertaken for bank or sale purposes and these may not accurately reflect the total cost of rebuilding a property."

Clearly the risk here is that were there to be a major insurance claim and the property was deemed to be undervalued, insurers might apply an averaging clause and thereby only contribute to a part of the costs.

In the August 2009 edition of Flat Living the following article reported:

"The economic recession has led to significant reductions in the market values of buildings. This has led some property owners to question whether there has been a similar reduction in reinstatement values and whether building sums insured should be similarly reduced.

Whilst tender prices are fairly stagnant and have fallen in most regions, material and labour prices have continued to increase. In effect, contractors are reducing their margins to win new business and will look for every opportunity



to make up lost margins when on site. Already adjudications are increasing as contractors become more claims conscious.

With listed and high value buildings, reinstatement work will usually call for specialist tradesmen, who are often in short supply and not subject to the same recessionary factors affecting the building industry in general. In addition, materials sourced from abroad, may be subject to costly exchange rate fluctuations.

In short, sums insured should not be reduced without taking appropriate professional advice. Whilst clients are looking for savings in these troubled times, it is important that this is not at the expense of reduced insurance cover. If there is underinsurance, any claim payout could be significantly reduced to such an extent that the building cannot be adequately reinstated.

Property owners and others who manage buildings may not have sufficient reserves to deal with the consequences of underinsurance and a bank loan to cover the cost may now be more difficult than ever to secure. Moreover, Management Companies, Directors, Trustees and others who are responsible for arranging insurance cover may find they are liable if they have not taken steps to arrange and maintain adequate insurance cover.

Good broker and managing agent advice and the importance of an up to date reinstatement cost assessment cannot be underestimated."

What are the issues of not insuring for the full rebuilding value? Let us look at an example.

Consider a block of 30 apartments with a current sum insured of £3,600,000. If we assume the rebuild value was actually £4,320,000 (in other words it was undervalued by 20%) and a claim was made at a cost of £2,500,000 then, if insurers applied an averaging clause - saying the cover was only 83.33% of the true building value, the settlement made by insurers might be just £2,083,250 – leaving a shortfall of £416,750 that would have to be met by the residents collectively.

In this example residents faced with such a bill, which equates to almost £14,000 each, would doubtless ask why the shortfall arose.

Whilst there is no intention to be alarmist it is, in our opinion, a potentially shocking thought that many buildings appear to be underinsured and the financial risks do not bear thinking about – which is why many of our clients arrange revaluations on a regular basis.



Q. So what is an averaging clause in an insurance policy?

An averaging clause looks at the sum for which the building is insured against the actual current rebuild costs (taking into account demolition costs and professional fees etc.) and considers the difference in percentage terms. A claim can then be limited by that percentage, as illustrated in the above example.

Q. Who is responsible for the shortfall?

The lease will normally determine who is responsible for insuring the buildings for their correct rebuilding value and who might therefore be responsible for any shortfall in the event of underinsurance.

In some cases there is potential for the flat owners to sue the company responsible for insuring the building. In the case of a Resident Management Company or a Right To Manage Company, that could mean a case in negligence against the Directors of that Company if no formal insurance revaluation had been conducted.

How often should a professional valuation be conducted and what is taken into consideration?

It is generally considered good practice to have a professional revaluation carried out every 3 years and this should also include buildings built within the last three years if a professional valuation has not been carried out.

In the case of modern buildings where developers have established the sum insured, our experience has shown that many buildings are substantially underinsured. Factors that may not necessarily have been taken into account can include:

- Debris removal costs
- Architects and surveyors fees
- The cost of meeting local authority requirements in the event of re-build
- VAT

A professional valuation will be an assessment of the total reconstruction cost of the premises based upon a 'total loss' scenario.

This would typically include:

- An on-site inspection and measurement of the property. This may also extend to include peripherals such as boundary walls, gates and fences and hard standing)
- Landlord's fixtures and fittings (i.e. alarms and lighting)
- Fees and demolition (including an allowance for construction costs, professional fees, planning fees and demolition costs)
- VAT

With regard to VAT, this is a complex area and some valuers will remain 'silent' or suggest reference to an accountant or insurance professional for advice.

In general terms, the building of a new single dwelling or residential block is zero rated for VAT. However, the vast majority of claims are not for a total loss and therefore VAT is applicable to rebuilding costs.

It is also important to consider the VAT status of the policyholder and/or claimant. Many property owners or landlords are not registered for VAT and it is most likely that insurance claims made by tenants within a residential block are also not registered for VAT and therefore unable to claim back this aspect from HM Revenue and Customs.

Other considerations

Q. Assuming our building is underinsured – say by 20% does that mean premiums will increase by 20%?

Not necessarily. Whilst premiums will increase as the sum insured increases, the percentage rise in the sum insured will not necessarily be reflected in the percentage rise in premium. Premium is not only driven by the sum insured but by the claims loss ratio – the cost of claims suffered as a percentage of the premium paid. The greater the value of claims suffered compared to the premium paid the greater the premium rate in following years as insurers seek to recover margins or worse recover losses.

Clearly if the property is undervalued then the premium will go up accordingly but as the margins improve there may be opportunity to negotiate a rate reduction. In that case a building sum insured increase of 20% may not reflect in a 20% increase in insurance premium.

It should be remembered that it is a policy condition under all insurance policies that the building is insured for the correct rebuilding cost and that this is the responsibility of the insured to set.

Where to get help?

Help and advice for the production of an insurance rebuilding valuation may be sought from Cardinus through our UK-wide team of Competent People.

*Norwich Union has since changed its name to Aviva

