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News Release

Construction Cost Increases Create Underinsurance Hazard for Commercial Property Insurance Buyers

New York, NY, July 28, 2004 - Remember inflation? It's back and it does so much more than just raise prices. Big increases in the cost of construction and property repair over the past year are making underinsurance a growing problem for businesses.

A company is underinsured when its insurance coverage does not adequately cover the cost of a loss. It becomes more of a problem during times of inflation because the value of the items insured rises over the course of the policy term. Insurance buyers give their insurers a list of insured values, and generally that's what the insurers will pay, even if the value has gone up and the insurance payment does not in the end cover the loss.

How steep is the increase? The cost of building commercial and industrial buildings in the US has increased 11 percent in the past 12 months, according to industry sources. The leading cause is unprecedented increases in the prices of steel, cement, petroleum products and shipping. Adding more pressure to the cost of construction materials is the construction boom occurring in China, allowing increased demand to work its marketplace magic.

To sum it up, property insurance buyers who used a year-old statement of values for their July 1 renewals could be underinsured by something on the order of 11 percent.

Inflation may raise the level of the underinsurance problem, but is not the sole cause. In the hard market of the past several years, property insurance underwriters have been strict about penalizing insurance buyers whose insurable values are understated. The most common penalty is to restrict payment on any claim to the amount reported on the statement of values. Sometimes, underwriters offer wiggle room –often around 10 percent – in cases where the amount of the claim exceeds the values reported.

Another way underwriters penalize insurance buyers is by invoking a coinsurance clause that is included in some policies. In the event a claim exceeds the insurable values, loss payments are calculated according to the following formula: the amount declared on the company's statement of values is divided by the actual value at the time of the loss. This ratio is applied to the loss amount, and the insurer pays the resulting amount. The remainder is the responsibility of the coinsurer: i.e., the insurance buyer.

Coinsurance Formula: When Claims Exceed Insurable Values

$$\frac{\text{Amount Insured}}{\text{Actual Value}} \times \text{Loss} = \text{Claim Payment}$$

$$\frac{\text{\$800,000 (the declared value of Property A)}}{\text{\$1,000,000 (the actual value of Property A)}} \times \text{\$50,000 (Fire Loss)} = \text{\$40,000 (Paid to owner)}$$

The owner of Property A must cover the remaining $10,000

In either penalty scenario, the underreporting of insurable values hurts.

What can be done about it? We recommend several strategies.

- First, and most obviously, exercise extra caution in the preparation of your statement of values. If you have several buildings of different ages but with similar occupancies, calculate the cost per square foot of the newest. Then apply a recognized cost of construction index multiplier to the cost per square foot.

Date of Construction	Cost of Construction Index Multiplier
July 2004	1.00
July 2003	1.11
July 2002	1.13
July 2000	1.20
July 1996	1.30

  Finally, apply the inflation adjusted cost per square foot to all of your similar buildings.

- Consider getting updated appraisals, starting with your largest facility and then working your way down the list.

- Consider getting business interruption values prepared and certified by a CPA who specializes in preparing accounting records for business interruption claims for insurance buyers. (Business interruption values are one of the two main components of a list of insured values; the other is physical property values.) If your business has interdependencies, prepare flow charts for the underwriters.

- Make sure your loss prevention surveys are accurate and up to date.

- Remember the first rule of underwriting: if there is a gap between the information your underwriter needs and what you provide, the underwriter will fill the gap with pictures of dead presidents – and you will be expected to provide those pictures. On the brighter side, underwriters give their best prices and conditions to insurance buyers who have a good story and tell it well. With construction costs rising, it is more crucial than ever to tell a convincing – and accurate – story on property insurance values.

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