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Bulletin

Helping you **identify** and **manage risk**

Understanding Insurance to Value

Canadians have seen unprecedented challenges over the past two years – from COVID-19 and its evolving complications to increased catastrophic weather events – causing supply chain issues and decreased economic activity.

As a result, building materials and labour costs have increased at an astonishing rate. Statistics Canada’s data as of October 2021 shows an average composite increase in non-residential construction costs of 8.3% (based on eleven census metropolitan areas across the country) in the last year.

What does this mean for policyholders?

Most commercial insurance policies provide coverage on a **"Replacement Cost"** basis, which means the cost to repair or replace all property that is lost, damaged, or destroyed as the result of an insured event. For buildings, this means rebuilding (replacing) the property to the same design and quality as the original, in accordance with current building bylaws, applicable codes and regulations, up to the limit stated in the policy, referred to as the **"limit of insurance."** Partial losses would be managed in the same way, covering the cost of repairs, restoration or rebuilding of the part of the property that was damaged or destroyed. It is critical therefore that the limit of insurance you select for your building is sufficient to cover the full replacement cost of the property.

This is commonly referred to as **"insurance to value."**

What is insurance to value?

Simply put, insurance to value means having a sufficient limit of insurance to cover the cost of replacing property which has been lost, damaged, or destroyed in its entirety, and there are potentially significant consequences should you fail to maintain an appropriate limit of insurance. This is because property insurance premiums are calculated based on a property's actual replacement cost. It is certainly possible to save money on insurance premiums by under-reporting values, generating short-term cost savings, however, this approach is detrimental in the long-term. There are substantial penalties that result from **"under-insurance"** and **"co-insurance"** if your property is damaged or destroyed and you are looking to your insurance policy to respond.

Setting the right limit of insurance for buildings

Before discussing the effects and impact of under-insurance and co-insurance, let us consider the various factors that need to be assessed and included when calculating and setting an appropriate limit of insurance for a building. These include the cost of demolition and clearing debris, current construction costs, including labour and materials, changes to building codes and compliance with applicable bylaws, cost of permitting, architect and engineering fees and annual adjustments for building cost inflation.

The safest way to ensure a building is insured to value is to have an up-to-date appraisal completed by a licenced professional. Appraisals should be completed every five years, with inflationary increases applied to building values and policy limits annually when your building insurance policy is due for renewal.

The impact of building construction inflation

Having calculated an accurate replacement cost for your building, it is equally important to adjust this limit on an annual basis to account for any building cost inflation that has occurred.

What Should Be Included in a Replacement Cost Building Calculation?

- → Cost of demolition and clearing debris
- → Current construction costs including labor and materials
- → Changes to building codes
- → Cost of permitting
- → Architect and engineering fees

The average annual increase in non-residential construction costs across Canada between 2011 and 2020 was estimated at between 2.5% and 3% per annum. When considering the compound effect of such an increase over a ten-year period, it is easy to see how you may have insufficient building limit, and equally how you may be unaware of this until a loss occurs, only to find yourself under-insured.

Example :

Consider a building with a calculated limit of insurance of $1,000,000 in 2011. Calculating construction costs ten years later in 2020 for the same building (using non-residential building construction price indices from Stat's Can) would result in a limit of insurance that is closer to $1,400,000. The compound impact of inflation alone over time may leave a property under-insured by almost 40%.

What is under-insurance?

Under-insurance means having an insurance policy with a coverage limit that is insufficient to cover the cost of replacing, repairing, or rebuilding the property in the event of a loss.

What is co-insurance?

Property insurance premiums are calculated based on the property values reported to the insurance company. For insurance to be equitable for both you and your insurance company, the amount of insurance purchased, or **"limit of insurance"** must be equal to the current replacement value of the property insured. If the limit of insurance is less than the actual value of the insured property, then the insurance company has not received sufficient premium to cover the risk, and you may be penalized as a result.

In such circumstances, a co-insurance clause – which is common in most commercial insurance policies – may be triggered. Co-insurance applies when the limit of insurance is less than a certain specified percentage of the actual correct replacement value of the property insured, usually 90%. If the co-insurance clause applies, you can only collect on the portion of the loss equal to the amount that the limit of insurance bears to the actual value of the property.

Example :

Suppose your building was valued at $1,000,000 by a licensed appraiser in 2011, and assuming the average annual construction cost inflation rate in Canada over the last 10 years was 3%, the current replacement value of your building is now approximately $1,400,000. If you have failed to increase your limit of insurance year-over-year, you could be under-insured by as much as $400,000. Based on the current replacement cost for your building of $1,400,000, the minimum limit of insurance required if your policy has a 90% co-insurance clause is $1,260,000 (see formula 2), so in this example, you are under-insured.

If your building is totally destroyed, then you can recover the full limit of insurance – reported of $1,000,000, however, you would then be self insuring the balance of $400,000.
Now, let's say that your building wasn't totally destroyed, but rather, you suffered a partial loss of $500,000. In this scenario, you will be entitled to collect up to $357,000 (see formula 1), less any applicable deductible, as per the co-insurance clause.

As you can clearly see, it is vitally important to obtain a building appraisal from a licenced professional on a regular basis and to discuss with your insurance broker any adjustments that may be necessary to the appraised value on an annual basis because of construction cost inflation.

Formula 1 : Loss Recovery Formula

$$\frac{\text{Limit of Insurance}}{\text{Actual Property Value}} \times \text{Loss (less any applicable deductible)} = \text{Amount recoverable}$$

Formula 2 : Co-insurance requirement formula

$$\text{Value of Property} \times \text{Co-insurance percentage} = \text{Minimum insurance amount required}$$

ABOUT ECCLESIASTICAL INSURANCE

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