



CLIENT ADVISORY

Property Insurance

December, 2011

Older Properties May Require New Approach

Overview

Savannah is a unique community from a variety of perspectives. For tourists, we offer pedestrian-friendly green squares and architectural wonders dating back to the 1700s; for college-bound students, Savannah has a growing number of higher education institutions; for commerce and industry, our fair city is home to one of the largest and busiest ports in the nation.

From an insurance and risk management perspective, Savannah offers just about as many unique twists and turns when it comes to properly insuring residential, commercial and institutional properties. A 200 year old home in the Historic District requires different insurance consideration than a five bedroom home on the Islands. A turn-of-the-century commercial building on Bay Street poses different “what if” scenarios in the event of a fire loss than a 50 year old manufacturing facility on Savannah’s west side.

In Savannah, one of the most common issues facing owners of high value historic properties is how to determine appropriate limits for property insurance purposes.

Property Valuation Methods

Whether the structure is residential or commercial, there are three common valuation methods: Actual Cash Value (ACV), Replacement Cost (RC) and Functional Replacement Cost. Each valuation method serves a specific purpose for the property owner as well as the insurance company.

Actual Cash Value is essentially the property’s construction cost less physical depreciation (*wear and tear*). Some commercial property owners use this valuation as a means of controlling insurance costs for non-critical structures. Conversely, insuring a primary residence under ACV terms is rarely recommended as the insured limit would mostly likely not be sufficient to rebuild the home to pre-loss condition.

SNAPSHOT:

Functional Replacement Cost may be an appropriate cost-control strategy for insuring high value historic properties, but policyholders must understand details before implementing.

Replacement Cost, in general terms, is the amount required to re-build the structure to its original condition before the damage. Some insurance policies pay up to the policy limit to replace damaged structures while others may actually pay 120% to 140% more than the insured limit due to increased construction and material costs.

Functional Replacement Cost is a third valuation option. In Savannah, this coverage form is used quite frequently (*or should be*) by owners of high value historic properties, both residential and commercial. This valuation method allows for replacement of expensive and obsolete items with less expensive and more modern state-of-the-art work.

Definition:

Functional Replacement Cost allows for replacement of expensive and obsolete items with less expensive and more modern state-of-the-art work.

Functional Replacement Cost also eliminates the coinsurance clause and the Ordinance or Law exclusion, two important insurance considerations for all policy holders, particularly those with older buildings.

For older structures with expensive, ornate or obsolete construction features, coverage to replace these with “like, kind, and quality” can be exorbitantly expensive. Insuring a 174 year old bed and breakfast inn at current construction costs and methods may seem reasonable to the property owner; however, without the functional replacement cost endorsement, the insurance company may consider the true replacement cost to be the much higher (*outrageously higher*) in the event of a major loss. If the policy is issued on a replacement cost basis and contains a coinsurance clause, the higher property valuation could result in a dramatically lower settlement offer than the inn keeper is expecting.

Functional Replacement Cost can make property insurance affordable, but it requires the policy holder to understand what will occur in the event of a major loss. While replacing lathe and plaster walls with wallboard or plywood may actually be a positive outcome, removing elaborate woodwork or replacing ornamental gargoyle drainage systems with aluminum drains and gutters may be less than desirable. Using composite shingles in lieu of expensive roof tile may be totally unacceptable.

Determining When Functional Replacement Cost Is Appropriate

The key to determining if Functional Replacement Cost is an appropriate option for your property is to work out the reconstruction details before a loss. Essentially the policy holder, broker and insurance company will need to determine, in advance, a value for the property based on specific re-construction assumptions which are agreeable to all parties.

While the above discussion was a superficial explanation of property insurance valuation options, it provides a good foundation for additional discussions with your insurance broker. Whether you are a homeowner, a business owner, a real estate investor or a commercial property developer, understanding the unique “*risk profile*” of your property will help you make informed insurance decisions.