FIRE INSURANCE (Newsletter Summer 2005)

Media Bank

In 1688, Edward Lloyd opened a coffee house in Tower Street, London so that clients could exchange shipping news and share the risk inherent in marine trading: thus was insurance born.

Perhaps because of that informal beginning, insurance has always had a "handshake" air about it … the insured usually assuming that they have more coverage than really exists. Only in the cold light of dawn following the fire, does reality raise its head. And although only 2% of fires result in total loss, the real damage often occurs from smoke and water, often rendering it difficult to establish the state of the building prior to the fire. In our experience, insurers are very cautious now about paying out claims and will almost always check that the property was not under-insured … even on a partial claim, by commissioning an appraisal after the fire unless the insured has a recent appraisal (preferably kept off site) from a reputable company.

Fire insurance rates in Atlantic Canada have risen by about 150% since 2001, the year of the perfect storm. The terrorist attack on the New York World Trade Centre on 11th September hit the reinsurance market hard and all of us are now paying the price. At the same time the stock market's mediocre performance has robbed insurance companies of their reinvestment income. Most property owners pay between $2.50 to $7.50 per annum, per $1,000 of insured building value for coverage on the building, equipment and rental loss. Each $100,000 of "over-insurance" therefore carries a cost of between $250 to $750 annually … and it is quite usual for commercial properties to be over-insured, sometimes by 50%, because of the cumulative effect of conservatism ("better to err on the side of safety"), yearly indexing, the fact that the most popular software programs for calculating building costs include the 15% H.S.T., and because insurance coverage pre September 11th was quite cheap.

Replacement Cost New

This is the current cost of reconstructing the building on the same site with materials of like kind and quality for like occupancy without deduction for deprecation. More simply put, it is the current cost of replacing the present building with a new one, and is the basis for most fire insurance coverage. However there is no point in including the H.S.T./G.S.T. in your replacement cost insurance for a commercial building because it is a "pass through" tax and your insurer will not pay for something that you will get back from the Federal Government. On the other hand if you are insuring an apartment building, or home, you must include the tax in your replacement cost estimate because you will not get a refund from Ottawa. If you are insuring a church however, 50% of the H.S.T./G.S.T. is non-refundable and has to be included in the replacement cost estimate.

Foundations below the level of the lowest floor, buried pipes, cost of excavations, and the proportion of the architect's fees applicable thereto generally comprise 3% to 5% of the building value. There is little point including them in your replacement cost unless your policy contemplates compensating you for them. Most policies however are silent on the issue and by default include them in the insurable value. It is a good idea in any event, to include them in your coverage if your replacement building is not to be of identical design, or in the same location as the structure destroyed by the fire. Your policy may allow you to locate your replacement building on an adjacent site.

If you suffer major damage, a likely event because of smoke and water, if not the fire itself, your insurer will almost certainly check that you are adequately insured. The co-insurance clause in your policy is designed to discourage under insurance by ensuring that you bear part of the risk if you are underinsured, even if you suffer only a partial loss. For example, if your property has a replacement cost of $1.0 million, but is only insured for $0.7 million, the total amount paid out by your insurance company on a policy with an 80% co-insurance clause, assuming a $0.5 million loss, would be as follows:

$$\frac{\$700{,}000}{80\% \times \$1{,}000{,}000} \times \$500{,}000 = \$437{,}500$$

If you own a heritage building, you may be particularly vulnerable to the co-insurance provision because the building materials may no longer be available locally … may even have to be shipped from abroad. So if the building's walls are constructed of granite, ironstone, sandstone … or the floor and roof timbers are of massive construction, it may be cost prohibitive or physically impossible to re-construct the property with the same materials. In these circumstances it may be wise to secure an endorsement to your insurance policy clarifying that materials that are capable of performing the same function will be deemed to be of "like kind and quality" if the original materials are not readily and economically available.

If your building was erected before 1990 it is very likely that changes in the building code, by-laws, etc. will preclude you replacing the fire damaged structure as presently constructed. For example, the by-law may require a sprinkler system in an apartment building. Your insurer will only compensate you on a Replacement Cost New basis if you replace the building. If you do not do so, you will only be compensated on an Actual Cash Value basis. If you want to ensure that your insurance will fully fund a replacement building, you need to carry sufficient insurance … and obtain an endorsement acknowledging that your policy covers you for the upgraded replacement building.

Actual Cash Value

Due to changes in the municipal zoning by-law it may be legally impossible to rebuild a fire damaged structure, e.g. because the existing use no longer conforms with the use now permitted on the lot. Since you are unable to rebuild, your insurance company will only compensate you on an Actual Cash Value basis *even though* you may be insured on a Replacement Cost New basis.

Actual Cash Value (ACV) is defined as "Replacement Cost New (RCN) less depreciation". Unfortunately there are three types of depreciation: physical, functional and external. Deduction of all three from Replacement Cost New produces Market Value … which can also be computed by ascertaining the market value of the property and deducting therefrom the value of the land: the residual is the Market Value of the building. Court decisions on Actual Cash Value are ambivalent and appear to be case specific rather than enlightening, flip flopping between "Replacement Cost New less Physical Depreciation", and "Market Value". In general however the Court decisions appear to be guided by a reluctance to select the definition which will impose financial hardship on the insured. Increasingly too, insurance companies appear to be plumbing for the "Replacement Cost New less Physical Depreciation" formula, but it would be unwise to book your world cruise until the claim is settled. You can shorten the odds by ensuring that your building is valued on the basis of Replacement Cost New less Physical Depreciation *when you place your insurance.* This should foreclose any attempt by your insurer to opt for the Market Value standard in the event of a claim.

Building Costs

The three most common methods of calculating Replacement Cost New are (1) to guess, (2) get somebody to guess for you, and (3) use last year's guess and add 2%. All are cost effective provided that you do not guess high … or have a fire. For those of more scientific bent, we suggest accompanying the exercise with a silent plea to the Almighty. We, on the other hand, rush around with laser measuring equipment, hard hats, work boots and serious expressions recording everything that does not move. We then feed this building data (and the occasional civil servant) into our costing system. Since we are not only serious but suspicious too, we periodically test our system against local construction costs for calibration purposes, and to verify its accuracy. Once we have your building's specifications in our system, we can run annual updates, very inexpensively … unless you have altered it of course, in which event we rush around with laser measuring equipment, hard hats, work boots, etc. etc.

Our fire insurance valuations are conducted in accordance with our ISO 9001:2000 registered quality management system. We are the only firm undertaking this type of work that is so registered in Atlantic Canada We have systems in place to ensure that we produce work of a consistent, high quality … and systems in place to ensure that we do not deviate from the systems in place … and audits in place to ensure that we do not cheat. We really are very serious people, seriously.

PAMS™

If your property is enrolled in our PAMS™ Property Tax Manager program we will have the building specifications and measurements in our Compuval™ database. We pass the benefit to you in the form of a 10% fee discount.