Module 6

Determining Amounts Payable

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Chapter 6

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Learning Objectives

- Obj I – Replacement Cost and Actual Cash Value
- Obj II – Other Valuation or Loss Settlement Provisions
- Obj III – Applying Coinsurance and Other Insurance-to-Value Provisions
- Obj IV – Applying Property Insurance Limits and Deductibles
- Obj V – Settlements Involving Other Insurance
- Obj VI – Appraisal Provision

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Replacement Cost and Actual Cash Value

Objective I

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Property Valuation

- Property is almost always valued at replacement cost or actual cash value (ACV).
  - Replacement cost – cost to replace damaged property with new property.
  - ACV – considers decline in value.
- Policies specify the valuation basis for property that is lost or damaged.
  - Insurers can repair or replace property, but they usually make settlements in cash.

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Replacement Cost

- Replacement cost is the cost of replacing property with new property of like kind or its functional value.
  - Like kind and quality – determines replacement cost using comparable product.
  - Functional equivalent – determines replacement cost using current construction methods and materials.

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Replacement Cost

- Replacement cost provisions violate the principle of indemnity.
  - Insurance policies should only compensate insured for losses.
  - Insured that has sustained a loss to used property and replaces it with new property has profited.
- For this reason, until the insured has replaced the property, they only receive ACV settlement.

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Actual Cash Value

- Loss settlements can be based on ACV.
  - Homeowners policy – ACV common with personal property.
  - Commercial policy – ACV common with both buildings and personal property.
- Approaches to ACV:
  - Replacement cost minus depreciation.
  - Market value.
  - Broad evidence rule.

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Replacement Cost Minus Depreciation

- Depreciation represents any loss of value.
  - Straight-line – takes equal amount of asset's cost as an expense each year of useful life.
  - Accelerated depreciation – applied when an item depreciates rapidly when first purchased and then more slowly in subsequent years.
  - Decelerated depreciation – occurs slightly for a period of time then increases rapidly.

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Replacement Cost Minus Depreciation

- Rate at which a particular item is depreciated depends on what it is and how it is used.
  - Physical wear and tear is the most obvious cause of loss of value.
  - Object's age usually corresponds closely to its extent of physical wear and tear.
  - Obsolescence is the loss of value caused by changes in technology or fashion.
- Most insurers publish guides for their adjusters indicating useful life of various assets.

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Market Value

- Some courts determined ACV is market value.
  - Amount at which a knowledgeable buyer would be willing to buy an item.
  - Knowledgeable seller would be willing to sell.
  - Neither party is under unusual pressure.
- Useful when there is no real replacement cost.
  - Antiques, works of art, and other collectibles.
- Property insurance policies apply only to the structure, making the land's value irrelevant.

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Broad Evidence Rule

- The broad evidence rule is a court ruling.
  - Requires all relevant factors be considered when determining actual cash value.
- Factors to consider:
  - Replacement cost.
  - Obsolescence.
  - Income that can be derived from property.
  - Other related factors.

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Practice

- In the case of a property insurance policy insuring a building, the value of the underlying land is:
  - A. Irrelevant.
  - B. The amount a willing buyer would pay a willing seller.
  - C. The appraised value based on property tax records.
  - D. A percentage of the value of the building.

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Other Valuation or Loss Settlement Provisions

Objective II

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Settlement Provisions

- Standard loss settlement provisions:
  - Cash settlement – replacement cost or ACV.
  - Repair or replacement of property.
- Provisions applicable to special cases:
  - Agreed value.
  - Pair or set clause.
  - Selling price.
  - Invoice price.
  - Original cost.

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Agreed Value

- The agreed value loss settlement method requires the insurer to pay an agreed amount.
  - Commonly used when insuring an item of property whose ACV or replacement cost would be difficult to determine.
- This settlement method is often found in inland marine and ocean marine policies.
  - Scheduled personal property endorsement to homeowners policy may also provide agreed value loss settlement.

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Agreed Value

- Scheduled Personal Property Endorsement (With Agreed Value Loss Settlement) – scheduled personal property is covered on an agreed-value basis.
  - Endorsement to homeowners policy.
- Under this endorsement, when a scheduled item has only partial damage, the agreed amount must be paid by the insurer.
  - Insurer can offer to sell the damaged property back to the insured.

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Pair or Set

- Property policies often contain a pair or set clause.
  - Value of property may be diminished when part of a set is damaged.
- Pair or Set Clause allows insurer to:
  - Repair or replace any part of a pair or set to restore it to its value before the loss, or
  - Pay the difference between the property's actual cash value before and after the loss.

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Selling Price

- Selling price endorsement provides coverage based on an inventory's selling price.
  - Would include seller's normal markup above replacement cost.
  - Normally, inventory is insured for replacement cost or ACV.

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Invoice Price

- Transit policies often use invoice price when valuing shipments.
  - Selling price of the goods.
  - Policy also pays for freight that was prepaid or guaranteed to the carrier.
- Amount of loss can usually be determined quickly and without dispute.

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Original Cost

- Original cost – tenant's improvements and betterments are sometimes settled based on the unused amount of the original cost.
  - Improvements become landlord's property at end of lease term.

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Practice

- Michael had two custom made lanterns, one located on each side of his driveway in the front of his house. One of the lanterns was stolen, and it cannot be replaced. Information regarding the lanterns:
  - Original cost of lanterns - $2,000 for the pair
  - Actual cash value of one lantern - $1,000
  - Actual cash value of lanterns as a pair - $4,000
- Assuming Michael has an HO-3 policy, how much will the policy pay him?
  - A. $1,000.
  - B. $2,000.
  - C. $3,000.
  - D. $4,000.

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Applying Coinsurance and Other Insurance-to-Value Provisions

Objective III

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Coinsurance

- Coinsurance clauses encourage insureds to carry adequate insurance.
  - Insured must carry insurance of at least a specified percentage of the property's value.
  - Most common percentage is 80%.
  - 90%-100% are also available in exchange for a reduced premium.

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Coinsurance

- Coinsurance formula:
  - Loss payment =

$$\frac{\text{Amount of insurance carried}}{\text{Amount of insurance required}} \times \text{Loss}$$

  - Amount is then reduced by the deductible.

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Coinsurance

- The coinsurance provision is applied separately to each type of property covered.
  - Building – provision applies separately to each building unless blanket coverage exists.
  - Business personal property.
  - Property of others in insured's custody.
- Blanket insurance covers one or more types of property in one or more buildings.
  - The word "blanket" is added to the statement of coverage in the declarations.

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Coinsurance

- Flat policies are not subject to coinsurance.
  - Property policy without a coinsurance clause.
- Some insurers will delete the coinsurance provision in exchange for a substantially higher premium.

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Agreed Value Optional Coverage

- Agreed Value optional coverage suspends the Coinsurance condition.
  - Insured must obtain insurance at an agreed value listed in the policy.
  - Insurers require proof of agreed value before writing coverage.
- If limit of insurance equals or exceeds agreed value stated in the declarations, losses will be paid in full up to the limit of insurance.

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Businessowners Policies

- BOP provides for replacement cost valuation, if insured carries insurance equal to at least 80% of replacement value.
  - This is an insurance-to-value condition, not a coinsurance condition.
- If insurance is less than 80% of replacement cost, insurer will pay the greater of:
  - Actual cash value of property.
  - Proportion of the cost to repair or replace, after applying the deductible.

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Homeowners Policies

- Insurance-to-value provision in homeowners policies is similar to businessowners policies.
  - Only applies to property insured under Coverage A and B.
- If the limit of insurance is at least 80% of the replacement cost, the insurer will pay replacement cost up to policy limit.

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Practice

- Joe and Vera purchase a home for $200,000 that has a current replacement cost of $175,000. They have an unendorsed HO-3 – Special Form policy with a Coverage A limit of $150,000. A tornado rips through their neighborhood and completely destroys their house. Ignoring any deductible that may apply, how much will Joe and Vera’s insurer pay for their destroyed house under the policy?
  - A. $125,000.
  - B. $150,000.
  - C. $175,000.
  - D. $200,000.

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Applying Property Insurance Limits and Deductibles

Objective IV

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Policy Limits

- Policy limits are normally the maximum that can be paid on a claim.
  - Endorsements exist providing for payment of full cost to replace property, even if payment exceeds the policy limit.
- Special limits of liability exist in many policies.
  - Limits on specified classes of property.

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Policy Limits

- Endorsements relating to policy limits:
  - Inflation guard – increases limits annually by an inflation factor.
  - Peak season – increases limits during the period described in the endorsement.
  - Homeowners policy – increases limit when a total loss occurs to the residence.
- Other provisions can reduce the policy limits.
  - Special limits of liability adds limits for items such as cash ($200) and watercraft ($1,500).

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Repair or Replace Option

- In almost all property policies, the insurer has the option to repair/replace the damaged property rather than paying a claim.
  - Strictly the insurer's choice.
- Many insurers have relationships with furriers, jewelers, and similar merchants.
  - Insurer can obtain discounts.
- Repair/replace option makes it more difficult for insured to profit from a claim.

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Deductibles

- Deductibles are included in most property policies.
  - Require insured to share in the loss.
  - Eliminate insurer's obligation for small losses.
  - Lowers premiums for insured.
- Most insureds should choose the highest deductible they can comfortably afford.

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Deductibles

- Types of deductibles:
  - Flat deductible – deductible stated as a specified dollar amount.
    - Common with homeowners policies.
  - Percentage deductible – deductible expressed as a percentage of some other amount, such as the amount of insurance.
    - Windstorm or hail deductible in HO policy.
  - Split deductible – applies different deductibles for different causes of loss.

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Absorbing a Deductible

- A deductible is sometimes applied to the actual loss before applying any coverage limits.
  - Absorbing a deductible.
  - Although common, the practice is never specifically stated in an insurance policy.
- Principle applies to both commercial property and homeowners coverage.
  - To absorb a deductible, the excess loss amount must exceed the deductible amount.

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Practice

- Which one of the following statements is correct regarding deductibles?
  - A. Deductibles eliminate the insurer's obligation for small losses.
  - B. As deductibles increase, premiums also increase.
  - C. Most homeowners policies have a split deductible.
  - D. Commercial property policies typically have a standard $5,000 deductible.

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Settlements Involving Other Insurance

Objective V

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Overlapping Coverages

- More than one insurance policy sometimes covers a loss.
  - Overlapping coverage usually occurs inadvertently.
  - An adjuster should identify overlapping coverage when investigating a claim.
- Policy conditions typically address overlapping coverages.

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Overlapping Coverages

- When taking statements, a claims rep can ask claimants if they have other insurance that might cover the claim.
  - If overlapping coverage occurs inadvertently, the Other Insurance provision prevents the insured from being overcompensated.
- Overlapping coverage may be part of a fraudulent claim.
  - Claim should be investigated like other suspicious property claims.

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Other-Insurance Provisions

- Other-insurance provisions in a policy address overlapping coverage.
  - Pro rata share method – each insurer pays based on pro rata limit of liability.
  - Primary/Excess method – one coverage is primary.
- These methods are used in the ISO Commercial Property Conditions Form.

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Proportional (Pro Rata) Share

- Under the pro rata share method, each insurer pays based on pro rata limit of liability.
  - Payment by policy limits.
- Example – Cov. A = $75,000; Cov. B = $25,000.
  - If loss = $40,000, amounts that would be paid separately would be:
  - A = ($75,000 / $100,000) x $40,000 = $30,000
  - B = ($25,000 / $100,000) x $40,000 = $10,000

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Primary/Excess

- Insurance policies might indicate that one coverage is primary.
  - Claim is paid from primary policy first until limits are exhausted.
  - Excess coverage pays the amount over the primary coverage.
- Without an Other Insurance condition indicating coverage is excess, the adjuster should treat existing coverage as primary.

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Resolving Disagreements

- It is preferable for insurers to resolve coverage disagreements through compromise.
  - Resolution in court can be expensive.
- First step in formal resolution is usually arbitration.
  - Binding – insurers are bound by decision.
  - Non-binding – if one or more insurers do not accept the result, litigation will proceed toward a court resolution.

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Practice

- Kyle and Tom have a building they insure under two separate insurance policies. Policy A has a limit of $200,000 and Policy B has a limit of $400,000. If the insurers use the proportional-share method and a covered loss worth $120,000 occurs, Policy B will pay:
  - A. $0.
  - B. $60,000.
  - C. $80,000.
  - D. $120,000.

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Appraisal Provision

Objective VI

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Appraisal

- Appraisal provision provides a means to resolve disputes regarding value.
  - Provision is not used to resolve issues relating to coverage or policy language.
- Appraisal provision uses the word "demand."
  - If either party makes a demand, the other has no choice but to submit to the appraisal.

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Selecting an Appraiser

- Appraisal provision states each party will choose a competent appraiser within a specific time frame.
  - Either party could question an appraisal award if incompetent appraiser is chosen.
- An appraiser with a strong conflict of interest should never be selected.
  - In some policies, the appraisal provision states the appraisers must be disinterested.
- Appraisers then choose an umpire.

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Appraisals

- Policies stipulate that each appraiser separately set the amount of loss.
  - Most policies require the appraisers to submit any differences to an umpire.
  - Any agreement between two of the three parties sets the amount of loss.
- Once an appraisal has been set, it is binding on all parties.

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Appraisals

- The final consideration in the appraisal relates to costs and expenses.
  - Each of the parties to the appraisal must bear their own appraiser's costs.
  - Parties equally share the umpire's cost and expenses.

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Practice

- Which one of the following statements is correct regarding the role of the umpire in an appraisal?
  - A. The umpire is chosen by the two appraisers to resolve disputes regarding the amount of the loss.
  - B. The umpire is chosen by the two appraisers to resolve coverage disputes.
  - C. The umpire is chosen by the insurer to resolve disputes regarding the amount of the loss.
  - D. The umpire is chosen by the insured to resolve coverage disputes.

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