Replacement Cost – How it is Determined and How Your Policy Responds

One of the most often misunderstood issues when it comes to insurance on your rental properties is replacement cost. There are many factors to consider when reviewing the insured values of your properties, a few of which we'll outline below. We know that it's not that exciting, but if you take the time to read the below, we hope that you'll have a better understanding of your risk.

What is replacement cost, anyway?

Let's start with the definition – Replacement Cost in a property policy provides for new property of like kind and quality to replace covered property destroyed or lost due to a covered peril.

Ummm. Ok. But what does that mean? It means that if you have a loss, the insurance company will replace the damaged property with the same type materials and finishes as were on the home before the loss. Keep in mind that often a claim is settled first on a depreciated basis (Actual Cash Value or *ACV*). Once you've replaced the damaged property, you will receive the difference between the replacement cost and the ACV value. Insurance companies do this because under the contract definition of replacement cost, you have to actually replace the damaged property in order to receive a replacement cost settlement.

Why do I even need Replacement Cost? I only paid a fraction of what I'm being made to insure this property for.

You may not – and keep in mind *replacement cost has nothing to do with the market value of your property*. However, if you have debt on a property, then more than likely your lender will require that you have replacement cost.

Most property losses are partial losses. If you did not have replacement cost, then you may not have an adequate settlement to get your rental property repaired and income-producing again. This could cause you to come out of pocket or your lender to step in and remedy the situation. Remember - by having an insurance policy, you are simply transferring your risk of loss from you to the insurance company. For them to give you the proper coverage at affordable rates, they must have a realistic basis on which to base your premium. They do this by using valuation methods that will be addressed later in this Q & A.

Keeping with the theme of partial losses – it is important to know if your policy contains a coinsurance clause. Coinsurance is an entirely separate, but related, conversation. If you have coinsurance, then insuring for the proper value becomes vitally important. See our Q & A **Coinsurance – What You Need to Know** for more information.

Replacement Cost is determined <u>at the time of loss</u>.

After you have a property insurance loss, a claims adjuster will visit your property and evaluate the property's characteristics (factors including age, condition, exterior construction, interior finish, square footage, and original year built) in order to determine the pre-loss value of the entire structure – not just the area affected by a loss. This calculation is the foundation on which the insurance company will begin their settlement negotiations.

If Replacement Cost is determined at the time of loss, how is my insured value determined when I buy my policy?

Good question. The insurance industry uses many different methods for determining the value of your property. The important thing to understand is that in order to have replacement cost, you must adhere to the method that your insurance company uses to determine this value. A widely accepted valuation tool is the Marshall & Swift/Boeckh (MSB) system. MSB is used not only by the insurance industry, but also by the appraisal and construction industries. In fact, if you look at a property appraisal, you will often see MSB referenced in the fine print. The MSB process is a comprehensive look at the characteristics of a property and the factors that go into a MSB report are geographically specific down to the zip code level.

You mentioned there are many ways an insurance company determines the replacement cost. What are a few others?

In addition to MSB, some insurance companies will use a per square foot calculation to determine a minimum value for your property to qualify for replacement cost. Additionally, a company may take a qualified appraisal or a qualified reconstruction estimate from a licensed contractor. It is important that you understand how your insurance company is determining value.

How does my realprotect *policy work?*

We're glad you asked. Because of the program that we've put together, we utilize a per square foot approach. Your policy contains a clause that requires you to insure for a minimum of $75 per square foot for all reported square footage above grade (excluding basements, finished or unfinished). By insuring for at least $75, you will have no penalty for coinsurance and you will receive a replacement cost settlement.

It is important to note that the maximum your claim will be settled for is the amount that you have declared on your dwelling schedule. For example, if you insure a property for $100,000 and there is a loss that costs $120,000 to replace, then the maximum your policy will pay is $100,000. Also, remember the previous question about value being determined at the time of loss? The actual square footage of the house will be determined at the time of loss as well – so it is imperative that that the proper square footage be reported for each and every property you have insured with us.

What if I want or need to insure for more than $75/Foot?

If you feel like $75/Foot is not an adequate amount of coverage for you to rebuild your property, then we can increase coverage to any amount you feel necessary to properly cover your exposure. In addition, we can also assist in determining the replacement cost of your property by modeling your specific properties in the MSB system, which we have access to. For any property that you'd like an MSB report run for, simply complete our **Replacement Cost Worksheet.** We know that in different geographic areas the cost to rebuild is more than $75 per foot. However, in order for your policy to provide replacement cost and waive coinsurance, then that is the minimum factor required.

What if I want to insure my property for less than $75/Foot?

Under the **realprotect** program, you can insure for whatever amount you would like. However, be aware that insuring for less than $75/square foot may affect your coverage and the out of pocket expenses you face in the event of a loss. We do understand that real estate investing is a yield-driven business and that insurance is an expense that all investors are looking to control. Remember - your cost of risk is not only the premiums you pay to your insurance company, but it is also the out of pocket amounts you'll have to pay in the event of a loss.

With the above information, we hope that you now more fully understand how replacement cost works and how your new policy with **realprotect** will respond in the event of a full or partial property insurance loss.

If you have any additional questions, please let us know.