Insurance Coverage Issues

Memo relating to recent closed transaction:

While attempting to complete a loan transaction a borrower questioned why the lender required the property owner/borrower to obtain full replacement cost coverage on a rental dwelling, rather than a fractional amount that would save you money.

The property consists of land, physical structures, appurtenances such as fencing, patio covers, and garage. While considering hazard insurance it is understood that the land will not burn down or disappear in an earthquake. As part of the application process an appraisal was obtained to determine market value of the entire property. The lender requested that the appraiser supply a replacement cost analysis segregating the value of each component including the land (opinion of site value,) replacement cost of the dwelling, appurtenances, garage, site improvements, and landscaping. Usually, the appraiser will subtract depreciation for the age, wear and tear (physical, functional, external) coming up with a net adjusted INDICATED VALUE BY COST APPROACH.

Lenders use this calculation to determine the required replacement cost of all components excluding the value of the site. Also, most lenders require replacement cost coverage. This is a property insurance term that refers to one of the two primary valuation methods for establishing the amount the insurer will pay in the event of partial or total loss. What it cost to reconstruct as new is the replacement cost. The other method is actual cash value coverage where the insurer will only cover the amount of the loss after depreciation is considered. The replacement cost may be $500,000, but the depreciated value is $250,000. Some owners will skimp and take the risk with cheaper coverage, but any prudent lender would automatically require replacement overage.

Sometimes there may be a deviation between what the appraiser estimates as the replacement cost and what the insurance company estimates. This needs to be negotiated among the lender, the insurance company and the borrower. The difference may be substantial. Let's assume that the appraiser says the replacement cost is $1,000,000 but the insurance carrier says that it is $500,000. Even though this is substantial the lender is going to first look at the amount of the loan outstanding to determine risk of loss. Let's assume that the loan is $600,000. The lender may agree that a $600,000 insurance policy will be enough providing the insurance carrier provides an endorsement that if the cost is higher because of current codes and zoning changes that the higher cost will be covered. This is sometimes referred to as betterments and enhancement or code compliance coverage. The cost difference between merely replacing a structure as it was originally constructed and replacing with current requirements could be as much as 100% more. There will be many required changes in property configuration based upon front and side setbacks, construction materials, parking requirements, etc. This endorsement to a replacement cost coverage policy in an add on.

Saving money by some un-knowledgeable owners/borrowers may be short sighted and have significant downside risk. Some cheaper insurance will even have what is referred to a co-insurance provision that if there is a hazard claim and the borrower is found to be underinsured then the borrower will suffer a percentage of the loss. Lenders do not want to get stuck with this.

If the borrower is going to make upgrade modifications to the property, they will also need course of construction and builders risk insurance. This is a specialized type of insurance product designed for buildings under construction that will end when the work is completed, and the property is ready for occupancy. The coverage will cover the usual fires, floods, vandalism, theft, liability and unwelcome accidents to the construction project. The coverage may be provided as an addendum to the property insurance.

If the owner/borrower plans on having a third-party contractor complete the project that contractor will provide proof of insurance for general liability, bodily injury, property damage and potential bonding. Using subcontractors adds the necessity that each sub-contractor provides their own insurance. Each subcontractor will provide a copy of workers compensation insurance for employees.

The property owner will need an endorsement for any worker's comp claim that falls through the cracks where the general or sub-contractor fail to provide overage and the trades person comes back to the property owner for coverage. This can be done by endorsement.

If the property owner is going to act as his/her own contractor they will need liability, workers compensation and additional endorsements for employees and agents traveling in their own cars to things like renting backhoes, or airless paint sprayers. Is there coverage for the rented equipment?

The property owner will also need a loss of rents coverage endorsement rather a loss of use coverage endorsement. Loss of rents coverage will reimburse the insured for the fair market rental value lost if the rental dwelling is damaged and becomes uninhabitable. Loss of use coverage is coverage for owner occupied buildings. It covers any additional living expenses, meaning any necessary expense that exceeds what the insured would normally spend.

Last, but not least, is an umbrella liability rider that can be provided on the subject property, but cheaper on the owner's occupied principal dwelling. An umbrella policy is extra liability insurance coverage the goes beyond the limits of the insured's homeowner and auto policies. It provides an additional layer of protection in this litigious and predatory world. This blanket liability coverage should be between 1 and 5 million dollars. It is not expensive and is a great value.

For the cost sensitive (cheap) property owner a great way to reduce premiums and offset the cost of additional coverage is to request a $5,000 deducible rather than a $1,000 deductible. Premiums will be adjusted downward, but the offset benefit is getting broader coverage.

My suggestions above are not all encompassing. An owner/builder/borrower needs a highly competent commercial lines insurance expert to guide them to the appropriate coverages and contingent liability coverages.

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