

BEST'S REVIEW

Insurance Issues and Analysis

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Insuring to Value

Homeowners have traditionally insured their properties at less than the replacement cost. Newer valuation methods help insurers bring more policies to full coverage.

by Ron Panko

During construction of a single-family house, New Jersey homebuilders Mary and Joseph Licata carry insurance for builders risk and general liability. But they also invite a homeowners insurance appraiser on site to estimate the amount of replacement coverage future homeowners will need.

Such early appraisals before a buyer is even identified are certainly not the norm in the competitive homeowners insurance business, but they may be part of a greater industry effort in recent years to fully insure its clients homes. Most homeowners historically don't insure their properties for the amount needed to rebuild them, but there is new evidence that the gap is narrowing.

Marshall & Swift/Boeckh, a provider of local building-cost information, said in July that undervaluation statistics for the homeowners business in the United States have improved dramatically. The company provides valuation technologies and services to the property insurance industry.

The company's newest Marshall & Swift/Boeckh Insurance-to-Value Quality Index shows that the percentage of undervalued homes has dropped to 64% from 73%, and the percentage of the undervaluation has improved to 27% from 35%. Marshall & Swift/Boeckh, based in New Berlin, Wis., has been tracking statistics in the index since the early 1990s.

The new results show the industry still has a long way to go, but Marshall & Swift/Boeckh President Robert Crine said the bulk of the improvement has occurred in the past two or three years, which indicates momentum is building as insurers embrace technology and implement changes in how they value properties. Crine estimates the industry for years had lost the opportunity to collect nearly \$8 billion more annually due to the low valuations, but that companies have earned back as much as \$2.17 billion of this annual amount due to their recent efforts. He also said more accurate property valuations improve policy retention



Special Attention: Homebuilder Mary Licata shows Chubb appraiser James Magliario window grilling in the sun room of a nearly completed house in rural New Jersey near the insurer's personal lines headquarters. Licata works with Magliario to document the features of the house, which she estimates would cost \$1.35 million to rebuild.

Appraising on Site

In late September, Chubb appraiser and Assistant Vice President James Magliaro visited a 5,700-square-foot luxury home owned by builders Mary and Joseph Licata, owners of Countryside Builders. Located on three wooded acres in upscale Tewksbury Township, N.J., the house was still under construction, but nearly complete. Mary Licata said the land was worth about \$400,000, and she estimated the replacement cost of the house at \$1.35 million.

Usually, a new homeowner or person under contract to buy accompanies Magliaro, but on this day, Magliaro was checking to see whether the unsold house was a good candidate for bringing in appraisers from his staff to update their knowledge about new construction techniques and materials. Licata served as a kind of tour guide, starting with the front-door unit, and offered her estimates of reconstruction values.

The home's entrance makes a spectacular impression. It features a solid mahogany door with an oval top framed by four rectangular and two curved windows also set in the valuable wood. Licata said the front-door unit is worth \$18,000. The door is

sheltered by a natural-stone, arched entryway, worth another \$22,000. Much of the cost of the entryway is due to the cost of labor; finding local workers skilled in the stonework craft has become more difficult over the past two or three years, Licata said.

Not counting the plumbing and wiring, the kitchen is worth \$60,000. It offers glazed maple cabinetry with antique glass, high-end appliances including a stainless-steel dishwasher with two drawers for easy loading, and a polished granite counter top that alone is worth \$4,000. Licata said kitchens in some houses can be worth \$150,000 to \$200,000. Appraisers spend a lot of time in kitchens, Magliaro said.

Like several other rooms, the dining room has wainscoting and chair rails, a 9 1/2-foot ceiling with ornate designs, and moldings worth \$30 a linear foot, 15 times more than the cost of standard molding.

The house has five bedrooms, all on the second

story, each with a bathroom. Another half bath is on the main floor. The bathroom in the master bedroom suite has a floor of limestone, a porous rock common in northern New Jersey, that gives the floor a grainier feel. The two vanities come with polished marble counter tops and cost \$5,000 each. Fixtures are polished nickel, and the spacious shower compartment is equipped with three body sprays each worth \$800.

Tray ceilings, as high as 14 feet, adorn bedrooms. One stairway is curved, which costs \$5,000 more than a straight stairway.

Throughout the house, an appraiser must consider the type of lighting and the quality of carpeting, flooring and wall coverings. The windows, many of them with grilles, are worth \$50,000, said Mary Licata.

The house has a library with a fireplace and other features worth \$25,000. There is a great room and a sun room. The full basement provides another 2,500 square feet. The future owner likely will choose



It's All in the Details: Homeowners insurers are paying attention to insuring expensive extras such as the \$40,000 mahogany and natural-stone entranceway; crown moldings that cost \$30 a linear foot, and ceiling medallions.

to finish about 60% of it with some combination of a wet bar, a kitchen/entertainment area, a home theater or media room, a bowling alley or an exercise room. Licata said 80% of homebuyers ask her to finish the basement.

An insurance appraiser looks outside, too. Magliaro said Chubb appraisers measure the outside of the house and note swimming pools, tennis courts, gazebos and sheds. An appraisal also will consider the siding on this property, cedar in areas that are not natural stone and trim work, which on this house is extensive.

On visits during which Magliaro is performing an actual appraisal, he often carries a camera to document the house's features and a laser beam to measure dimensions, including ceiling heights, said Mark Schussel, Chubb's public relations manager. Back at his office, he constructs a hard-cover book with photos and descriptions, which a Chubb agent is then able to deliver to the customer, Schussel said.





In high-value properties, Chubb takes into account fees charged by decorators, landscape designers, and lighting and sound consultants.

*Denise Melick,
Chubb Personal Insurance*

and relationships with policyholders, consumer advocates and insurance regulators.

Several factors might explain such a trend. Christopher Guidette, spokesman for the Insurance Services Office in Jersey City, N.J., said consumers themselves may be better informed because of the proliferation of information available from newspapers, magazines, the Internet and other convenient sources. Property insurance personnel have certainly been motivated to relieve budget strains of the past few years with higher premiums, and insurers may simply be doing a better job helping customers to purchase appropriate amounts. Another possible factor, he said, is that real estate prices may have surged faster than replacement costs, prompting homeowners to increase their coverage. ISO itself does not collect data on insurance to value and could not confirm Marshall & Swift/Boeckh's findings, Guidette said.

Determining the right replacement value of a house has always been a tricky task. It isn't the same as the market value of a property, most obviously because an owner need not insure the land. Construction costs, certainly part of the equation, vary by location. And as Crine pointed out, reconstruction is more expensive than construction. Reconstruction means at least part of a home is in ruins or ashes, and a builder has to work with both insurance adjusters and emotional homeowners, he said.

Add to these considerations the fact that, in most cases, the determination of replacement value is left to insurance agents in consultation with homeowners or even to homeowners themselves. And customer satisfaction the level of coverage and cost that pleases a policyholder may be more important to an agent and insurer than actually insuring for the replacement amount.

The largest writer of homeowners insurance in the United States, the State Farm Group, adheres to that underwriting model. Agent/homeowner consultation leading to customer satisfaction is the core of the underwriting process, according to spokesman Kip Diggs. We want the agent and customer to sit down and talk about needs and what they feel the home is worth so that in the event of a loss, they'll be satisfied, he said. We take the information provided to us by the policyholder and run that through our underwriting.

In special cases, State Farm may employ more detailed underwriting, such as when a home is larger than normal or when a property is appreciating in value at a fast rate. But State Farm's clientele includes a lot of middle-income homeowners.

Diggs acknowledged that some customers don't want to insure at 100% of replacement cost, and the company is OK with that as long as they are informed and aware of the potential consequences. While we encourage 100% coverage, homeowners are not under any obligation to do so, he said. Some customers, for example, say that if anything happened to their homes, they wouldn't want to rebuild at full size, Diggs said.

Overall, Diggs said that State Farm is happy with its underwriting experience, and the company wouldn't be able to say whether the Marshall & Swift/Boeckh Index statistics are accurate or not.

But for companies that tend to serve homeowners with high-value properties, insuring to value is important. That's why appraisers from the personal insurance arm of the Chubb Group of Insurance Cos. will visit and appraise houses that aren't occupied or aren't even under contract, such as those built by the Licatas, owners of Countryside Builders in western New Jersey. Such visits provide an opportunity for these appraisers to see and learn the value of new kinds of construction. When the property has a buyer, on-site appraisals also can lead to earning the business of the future homeowner, said Denise Melick, the U.S. appraisal manager at Chubb Personal Insurance. For the homebuilders, relationships with insurers such as Chubb offer a chance to improve their business prospects.

Chubb started its appraisal program in 1981 with six people as a spin-off from its commercial loss-control program. Chubb now has 230 appraisers worldwide with backgrounds in historic preservation, architecture, interior design, construction, art history and/or market valuations. Melick said these appraisers use visits to residential properties under construction to stay current on construction techniques, materials and their costs. The builders themselves, when present, can offer their estimates of replacement costs.

Chubb is the only insurer with as many as 230 in-house employees dedicated to appraising clients' property through on-site visits, said Melick. These in-house employees perform the vast majority of Chubb's appraisal work, said Mark Schussel, public relations manager. Other insurers use outside vendors for appraisal work, but many still do not use any, he said. The appraisers are the face of Chubb, he added. They address the insurance-to-value issue, establish a face-to-face relationship with a client, and provide customers with loss-prevention tips. Accurate determination of the amount to be insured also helps Chubb to collect the appropriate premium, so the appraisal program pays for itself, Melick added.

Schussel said that Chubb is one of only a few insurers to offer guaranteed replacement coverage with no cap, a guarantee that is available in most states.

Property/Casualty

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The company also has expertise appraising historic homes, and the National Trust for Historic Preservation has a program that promotes Chubb as an insurer, said Melick. Many historic properties are in the Middle Atlantic states, New England and Virginia. Melick said insurance costs are 50% higher for historic buildings because true replacement calls for parts from the historic era, including moldings, antique hardware and antique glass. In most states, Chubb will upgrade electrical and plumbing systems to modern-day codes, she said.

Chubb subscribes to the services of Marshall & Swift/Boeckh, which runs a database of industry data for reconstruction costs. We use their figures along with local research we do, said Melick.

Vigilant Underwriting

Crine of Marshall & Swift/Boeckh maintains that the continuous state of underinsuring in the homeowners market is largely due to lack of knowledge by homeowners. It's very difficult for homeowners to know replacement costs, he said and the insurance industry's reliance on two appraisal methods that lack precision. One, the square-foot method, considers the total area of the building, factors in the type and quality of the exterior walls, and comes up with an average national cost. Insurers then apply a local multiplier. But in that process, someone has to assign a quality level of the home, typically the agent, he said. Often the agent does the work over the telephone, and it is very subjective.

The unit-count method is similar, but also considers the number of rooms and features before applying the local multiplier. So there is a reasonable chance that an error would be made, and the house would be underinsured, said Crine. Over time, the



For years, homeowners writers lost the opportunity to collect nearly \$8 billion more annually due to low valuations.

*Robert Crine,
Marshall & Swift/Boeckh*

error is compounded. Each year, homeowners spend some \$200 billion on additions, remodeling and maintenance, but they usually don't think about informing their insurance agents or companies, he said.

Insurers in recent years, spurred by independent firms like Marshall & Swift/Boeckh, have moved away from those two prevailing appraisal methods to what Crine calls a total-component method, which may account for higher levels of insurance. Crine said the newer method is more detailed and takes subjectivity out of the equation. Information is gathered by agents, inspection companies making on-site visits, or firms like Marshall & Swift/Boeckh who telephone homeowners and gather information through a scripted interview. The latter is less expensive than on-site inspections; Marshall & Swift/Boeckh trains its interviewers at its own center, and they use a very tight script, Crine said.

Insurers also are engaging in periodic revaluations, said Crine. The industry should recognize that revaluation efforts are not once and done, he said. What they need to do is put an insurance-to-value update process into place, and do a part of their book every year. By doing that, these underinsurance statistics should continue to shrink.

Many companies are accessing some version of the total-component system through the Internet. Crine said Marshall & Swift/Boeckh offers Internet express sites and extranet sites. In the past, companies have been hampered by their legacy

internal systems, but since we could put it up on our site and maintain it for them, we have made the change simpler, he said. Even the big insurers are customers of ours. A couple of other companies provide the same kind of service.

Higher premiums have not scared off policyholders. Virtually every customer tells us their retention rate has been unaffected, and in a few cases, it has gone up, said Crine. In the past, the only time many homeowners ever heard from their insurer was when there was a bill in the mail. But now they are participating in the process, and they appreciate what the insurers are doing.

The process also can become easier for agents and an insurer's back office. In November 2002, Marshall & Swift/Boeckh entered into an agreement with insurance software developer AMS Services, Windsor, Conn., that allows AMS rating group to sell two of Marshall & Swift/Boeckh's total-component valuation products to its current rating customers. What we're trying to do is make it simpler for agents to access our component-based systems, said Crine. When integrated with a rating engine, they enter the information once and the insurer can generate a premium based on replacement cost. Crine said his company also has agreements with other software providers.

State Farm's Diggs said his company's agents use vendor-supplied tools to collect and upload insurance-to-value information, but in unusual or complicated cases, underwriters may take over that task. **BR**



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