“Underinsurance” May Be Florida’s Next Big Insurance Crisis

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Trying to save money by using real estate market value to estimate property insurance replacement costs can not only put a policyholder at financial risk, but is not consistent with the method for computing a recovery for property damage under Florida law.

As news spread throughout Florida of a recent class action lawsuit in which inflation of property replacement cost estimates was alleged against Citizens Property Insurance Corporation, it has become more important than ever for property owners to understand the difference between market value, which is used to determine the selling price of the home, and rebuilding and replacement costs, which determine the amount of insurance required for full protection of the property involved.

Florida Governor Rick Scott recently signed HB 1101, which will require the State-run insurer to accept the lowest replacement cost estimate from sources such as estimating software, certain certified real estate appraisers, engineers or contractors, effective July 1, 2012. Intended to enable policyholders to better control their premiums by requiring Citizens to accept the lowest of these replacement cost estimates, hence a lower premium, the new law could actually result in property owners being surprised by extra costs if their coverage turns out to be inadequate to cover a sustained loss.

In these difficult economic times, before property owners avail themselves of HB 1101’s provisions in an effort to save money on their property insurance, they should be forewarned that doing so may have serious financial repercussions that could not only affect them, but also the neighborhood and community as a whole.

Technically, “replacement cost” covers the repair or replacement of damaged property with materials of similar kind and quality with no deductions taken for age, wear and tear, and other factors that might diminish the property value. On the other hand, “actual cash value” coverage factors property depreciation into total or partial damage claims payments.

Certified real estate appraisers, who are generally more accustomed to valuing a property based on market conditions, rather than property replacement cost, generally rely on software or other standard methodologies to determine material and construction costs. The Uniform Residential Appraisal Form, which is used in many residential property sales, can set forth up to three different approaches to valuation, including a cost estimate. However, it should be noted that Fannie Mae does not require a cost approach to value in its residential appraisals and, in fact, some appraisals do not include the cost approach because it is not deemed a credible indicator of value.

Contractors, another valuation estimating source option under HB 1101, often have their own templates for providing estimates and bids. They typically consult with multiple competing suppliers and sub-contractors in formulating their bids. On such a granular level, the costs can vary greatly by contractors and materials suppliers, often based on personal experience.

According to the Insurance Information Institute, the cost of construction in South Florida has far exceeded inflation. A significant percentage of Florida’s residential properties were not built to the current, more rigorous code standards. Thus, when repairs are made, ensuring their adherence to the new standards will almost always increase repair or replacement costs.

According to modeling experts, a $5 billion hurricane event may cause construction costs to increase by 5 percent, whereas a $40 billion catastrophe may cause the same costs to increase by five times that amount. Those who experienced the aftermath of Hurricane Wilma may anecdotally suggest that these percentages are low.

Especially in the wake of a disaster, this “demand surge” pricing factor often results in dramatic price increases in construction materials and labor caused by many policyholders vying for the same existing supply. Thus, the cost to rebuild a home can greatly exceed its real estate value.

Under the new law, even if policyholders pick the correct replacement cost valuation estimate today, that same amount may not be enough to cover claims tomorrow. This will leave them underinsured, since the amount paid may still be insufficient to repair or reconstruct the damaged property even if the insurer pays the policy limits.   For most of us, recovering from a disaster is difficult enough without learning too late that a gap in property insurance protection exists. To prevent unforeseen financial hardship, a periodic policy review is strongly recommended as the years pass, because the true cost of disaster can never be accurately known until after it happens.