REALTY INSURANCES

Realty Review

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Technical Corner – Building Sums Insured

The most common method of insuring commercial buildings is on a 'reinstatement basis'. This does not mean that insurers will reinstate (i.e. restore or rebuild) a damaged or destroyed property themselves. Rebuilding a property is complex and few insurers want to be responsible for restoring the building to its original specification or for the quality of workmanship. In practice, most insurers will therefore indemnify an insured by way of reimbursing his or her outlay.

Under the reinstatement basis of cover, indemnification for damaged or destroyed buildings is determined by the cost of repair or reconstruction at the time of loss, as opposed to at the start of the insurance period. This will most likely have increased during the policy period as a result of construction cost inflation. The sum insured therefore needs to make allowance for this inflation, not only during the insurance year but also during the rebuilding period.

Under the 'day one reinstatement basis' method, the sum insured is declared as at the first day of the insurance year and an inflation provision or band is then chosen to reflect the effect of inflation.

The premium for the inflation provision is much lower in percentage terms than the actual band itself and hence this methodology represents good value for the insured. For example, the rate charged for a 30% inflation provision may only be 5% of the full rate on the declared value and hence the premium charged is nominal.

Care should be taken to accurately set the day one declared value, or the inflation provision will apply to an incorrect base figure. Ideally this should involve a full valuation inspection by a qualified surveyor, preferably at three to five year intervals. Desktop valuations or the application of a suitable building cost index can be used when renewing the cover in the intervening periods.

All things considered, when combined with professional valuations to set the correct declared value, the day one basis for insuring commercial buildings is one of the best ways to avoid underinsurance and hence the application of average (a concept that was explained in our previous e-newsletter).

The following example of the day one basis of calculating the sum insured on a building hopefully illustrates the concept more clearly.

Remember that the **sum insured** is made up of two elements:

a) the **declared value** – the cost of rebuilding the structure (including debris removal costs, professional fees, the cost of complying with public authority and other regulations, and VAT if necessary) using the level of costs that apply on day one of the annual policy period; and
b) the **inflation provision** – the percentage uplift sufficient to take into account construction cost inflation during the insurance year (in case a loss occurs on the last day of the policy period) plus the rebuilding period (which includes not just the period of physical on-site reconstruction, but the time taken on designing, gaining planning permission and tendering the project). The latter should also include a contingency period for delays outside the insured's control.

The sum insured may therefore be determined as per the following example (which is set in an economic environment of gradually increasing inflation):

Rebuilding costs on day one	£30,000,000	
Debris removal costs on day one	£1,800,000	
Professional fees on day one	£4,500,000	
Public authority / EU requirements	£1,700,000	
Declared Value	***£38,000,000***	
Inflation during 12 month policy @ 4.5%	£1,710,000	
		£39,710,000
Inflation during design, planning and tender process – further 12 months @ 5%	£ 1,985,500	
		£41,695,500
Inflation during construction – further 21 months @ 5.5% p.a. i.e. 9.6%	£4,002,768	
Total Sum Insured		***£45,698,268***

It will be noted that the inflation element above amounts to £7,698,268 or just over 20%. Whilst the insured has therefore established that the inflation provision needs to be at least 20%, as there is very little difference in premium cost between the two, we would recommend that a 30% uplift be selected to provide a degree of buffer.

On the insured's policy schedule, the figures would be written with the sum insured first, followed by the declared value in brackets, i.e. £49,400,000 (£38,000,000).