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The HO Undervaluation Problem



Bill Wilson

Abstract

According to the experts, a majority of homes are undervalued by at least 25% on average. Magazines and newspapers are replete with articles about insureds who suffered major losses only to discover their homeowners insurance was grossly inadequate to fully compensate them. Who's to blame and what can we do about it?

I recently revisited a magazine article (*SmartMoney*, Feb. 2002) about a couple who suffered a major fire loss only to discover that their home was inadequately insured. When they bought the property six years prior, they paid \$158,350 for a property with an appraised value of \$175,000. Based on these numbers, they claim that their agent came up with an insurance amount on the home of \$140,000, well below what they allegedly thought the true replacement cost was.

According to the couple, the agent responded, "You just don't understand the 'game'." The policy at that time was issued on a guaranteed replacement cost basis without a cap, so they alleged that the agent told them that the valuation didn't matter that much because they'd get full replacement cost regardless and he was saving them premium.

Move forward six years and one essentially total loss. What the couple discovered was that their latest renewal policy included a cap of 120% "guaranteed replacement cost" on their now Coverage A limit of \$146,000, for a total of about \$175,000 coverage on a home that, due to increased construction costs and improvements, would actually cost \$250,000...a shortfall of \$75,000.

To make matters worse, their Coverage C amount was \$109,500 and, due to additional values in antiques and jewelry, their actual contents values were in excess of \$300,000, moving their total uninsured loss to well in excess of \$250,000, along with their \$1,300 a month mortgage that they must continue to pay.

To make a long story short, their department of insurance interceded and gained them an additional \$55,000, still well short of that needed. As a result, they had to raid a 401(k), an IRA, and several credit cards to make up the difference. And, of course, the insurer nonrenewed at the end of the policy period.

According to the National Association of Home Builders, construction materials costs (cement, drywall, lumber, nails, etc.) have skyrocketed in the past two years. While everyone is aware of the increase in gasoline prices at the pump over the past two years, few people are aware that the costs of construction materials have increased 2-5 times more than gasoline prices. Last year, lumber prices increased 27% and scrap metal prices (used to make nails and other construction supplies) increased 80%. In an *LA Times* article last month, local plywood prices had increased over 47% during the past year according to Marshall & Swift/Boeckh. Some homes that were built two years ago for \$125 a square foot may now cost

over \$200 per square foot to rebuild.

In an October 2004 press release, Marshall & Swift/Boeckh reported that **61% of U.S. homes were undervalued by an average of 25%**. They attribute much of the problem to the antiquated use of a square footage valuation method rather than a total component estimating technique. In some cases, according to MS/B, as much as **73% of an agency's book of homeowners business may be undervalued by an average of 35%**. Clearly this indicates that many homes may be insured for less than 80% of their replacement cost, which could lead to claim settlement penalties for partial losses and ultimately to E&O claims against agents.

The solution is to better educate customers on the likelihood that their properties are undervalued. Reliance on market price, property tax appraised value, mortgage amounts are irrelevant to the cost of replacement of a home. Likewise, simplistic methods such as square footage and room count are no longer appropriate. More accurate methods must be used on at least an annual basis, in conjunction with inflation guard coverage, to keep policy limits up to date with escalating construction costs. Likewise, insureds must be surveyed at least annually for improvements and betterments and acquired personal property that should be scheduled.

For more information about component-based modeling valuation techniques, check out these web sites:

- [Marshall & Swift/Boeck](#)
- [ISO HomeValuetm Property Replacement Valuation System](#)

Finally, this problem is not limited to personal lines. Marshall & Swift/Boeckh, in another press release last year, indicated that **75% of commercial buildings could be undervalued by an average of 40%**. For more information on commercial lines valuation issues, check out the two-part VU article "[Valuation Methods Don't Measure Up.](#)"

Subscriber Response

What is your opinion? As an agent, what measures do you take to ensure that your clients' properties are adequately insured? Send your feedback to Bill.Wilson@iiaba.net and we'll publish them here. If you like, include your name, agency and city/state and we'll give you credit.

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