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Adjusters International Disaster Recovery Consulting

FROM THE EDITOR

Cosmetic Damage Presenting New Insurance Dilemma

The widespread damages caused by volatile weather that seems to be the norm nowadays are clearly documented in media of all types. What's not always as clear, however, is the extent to which the damages actually destroy a property or part of it — or harm its appearance more than its function.

While traditionally, most property owners have expected reimbursement from their insurance company in either case, that could be changing as insurance carriers seek ways to limit or modify their exposure — claiming that the effects of these widespread losses are wreaking havoc with their loss ratios.

The matter is still unfolding and its resolution will have significant consequences for policyholders and insurers alike.

In our two companion articles, veteran claims professional and respected author Robert J. Prah, CPCU, offers the latest insight into this emerging issue.

Sheila E. Salvatore
Editor



Cosmetic Damage Exclusion Stirs Controversy Homeowner and Commercial Property Policies Affected

By Robert J. Prah, CPCU

Recently introduced property endorsements have created spirited controversy among agents, adjusters and insurers. The endorsements concern roof damage, where claim frequency and severity are on the rise, due in large part to volatile weather conditions across the country. In essence, coverage for solely cosmetic damage from wind and hail in homeowner and commercial properties may be eliminated if insurers choose to use these endorsements. In addition, there is an option to provide coverage for roof damage on an actual cash value (ACV) basis, rather than on a replacement cost basis.





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Seemingly, this is a reaction by insurers to deal with the increasing volatility of weather events which are causing havoc with insurers' loss ratios. Obtaining approval for rate increases is time-consuming and not always successful. In lieu of rate increases, insurers reason that the use of these endorsements can reduce their loss experience without raising rates on insureds. It seems fitting, though, that since there is a reduction in coverage, it may be appropriate to offer some reduction in premiums — but that is not entirely certain as yet.

The two rating organizations that draft standard policy forms and policies for property/casualty insurers, the American Association of Insurance Services (AAIS) and Insurance Services Office (ISO), have both filed cosmetic damage endorsements.¹

What is Cosmetic Damage?

Cosmetic damage is damage that affects the appearance but not the function of the roof,

which is to serve as a barrier from weather-related damage. It is physical damage such as marring, denting or pitting that affects the appearance but not the intended function of roof surfacing, which is to prevent the penetration of water into the dwelling or building.

ISO and AAIS Endorsements

The ISO endorsement contains two options.² The first gives insurers the option of covering a building on a full replacement cost basis, but limits the valuation on roof surfacing to actual cash value (ACV); that is, with deduction for depreciation. The second option is the cosmetic exclusion, which is defined as marring, pitting or other superficial damage from wind and hail that alters the appearance of the roof but does not prohibit it from functioning as a barrier. If the roof still functions

as intended, no coverage applies. Initially, the ISO endorsement applies only to commercial property policies.

AAIS has introduced three endorsements³ which, in addition to roofs, encompass exterior wall surfacing and exterior doors and windows. The endorsements apply to homeowners policies, not commercial property. One endorsement excludes cosmetic damage to exterior wall surfacing, roof surfacing, and exterior door and window surfacing. The other two endorsements provide actual cash value coverage for roof damage — one applying only to damage by wind or hail, with the other applying to other perils as well.

The AAIS cosmetic damage endorsement defines cosmetic damage to mean physical damage such as marring, scratching, denting, pitting, discoloration, or other condition that affects the appearance of property but does not impair the property's ability to keep weather-related or other elements from entering to the same extent that it did before the marring, scratching, etc., occurred.

Thus, if the appearance of the roof is affected by hail damage, say from dents or scratches on the roof surface, but no leakage occurs, coverage would not apply. The roof still functions for its intended purpose. This is a significant departure from current claim handling practices where in such cases the roof likely would be insured on a replacement cost basis and replaced, provided the insured meets the 80 percent insurance to value requirement and damage was sufficiently widespread to warrant replacement.

These endorsements are available on an optional basis from the standpoint of the insurer. It is unclear whether insurers will use these endorsements extensively or just in states with a high frequency of hail losses.

Agents and insureds need to be aware of and understand the limitations if these endorsements are attached to their policies. Additionally, insurers have a responsibility to inform their insureds in clear, understandable language how these endorsements limit their coverage.



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Potential Issues/Problems

As noted earlier, the introduction of these limiting endorsements is at least a partial response by insurers to confront mounting claim frequency involving volatile weather-caused losses that adversely affect their bottom line. Frankly, mounting claim frequency (and severity) affect the entire country: from conflagrations in California; wind, hail and tornadoes in the Midwest and South; to wind, hail and hurricanes on both coasts.

Despite the insurers' rationale for introducing these limitations, they are not necessarily being welcomed by agents and insureds. There are pitfalls and problems that will confront insureds, insurers and adjusters alike. The meaning of "cosmetic damage," despite the fact that the term is defined in the policy, may still create debate and controversy. Here are some of the issues with these endorsements:

- Let's say an insured has an extensive wind or hail loss to his roof, which is 15 years old. In the absence of the new endorsements, the roof will be replaced new for old, less the deductible (assuming he has a homeowner or commercial property policy with replacement cost coverage). If the ACV endorsement is attached to the policy, payment will be made for the actual cash value of the roof, which means replacement cost less 15 years of depreciation. This means the insured

will need to pay a significant portion of the cost for a new roof out of pocket. Some may reason that an insurance company should not have to pay for a new roof when the building was already well on its way to needing a new roof. Others may reason that the cost for having full replacement cost is already figured in the premium.

- How about the insured with a metal roof? Hail dents, pits, mars and discolors the roof — but does not cause any leakage. The roof is cosmetically a mess, but no coverage is available. What happens to the market price of the building when the insured goes to sell it with a roof in that condition? (The same, of course, would apply to asphalt and other types of roofs.)
- Homeowner associations (HOAs) often have strict rules about maintaining one's property in first-rate condition. It will not necessarily matter to the HOA whether the homeowner has insurance to make necessary repairs — the bylaws may require it regardless.
- A dent or crack in a wall caused by wind or hail would not immediately lead to water intrusion from subsequent rainfall, nor would it activate insurance coverage with these new endorsements. But over time it could result in more serious and permanent damage that might have been prevented had repairs been completed at the time of loss.

Cosmetic damage is damage that affects the appearance but not the function of the roof, ...





Agents and insured need to be aware of and understand the limitations if these endorsements are attached to their policies.

- Adjusters, of course, are the messengers delivering the bad news concerning these coverage limitations to the insured. Though adjusters typically strive to avoid adversarial relationships, it will be a challenge when these endorsements are in use.

Conclusion

Since these endorsements have only recently been filed with state insurance departments, it is not yet certain what their impact will be on the insurance environment. Although it is possible that the endorsements could become the norm rather than merely an option, it is also quite possible that not all state insurance departments will approve them or that all insurers will adopt them.

Depending on agent and consumer response, insurers may decide to modify their endorsement language or offer premium discounts in the interest of public relations.

Some insurance practitioners have suggested alternative ways to improve insurer loss ratios in lieu of these endorsements, e.g., increase deductibles on roof damage caused by wind or hail, or offer two rating plans — one with the cosmetic damage exclusion and one without.

Time will tell how far the industry will go with these endorsements, how they will be received by state regulators, how they ultimately will be accepted by insureds and agents, and how the cosmetic damage exclusion may be interpreted by the courts. The reality is that insurers have a responsibility to monitor their loss ratios and respond accordingly when they believe they need to be improved to preserve the bottom line. Raising premiums, reducing coverage, increasing deductibles and offering different rate structures are some of the options insurers have. As for the endorsements, consumer and agent response likely will influence how broadly they will be applied.

¹A cosmetic damage exclusion was previously available in Texas, where hailstorms are frequent and often severe. What is noteworthy is that now ISO and AAIS have introduced similar endorsements to be used by their member companies.

²*Will Wind/Hail Cosmetic Damage Exclusion Endorsements Become the Norm?* By Amy O'Connor, March 7, 2013, *Insurance Journal*.

³Cosmetic Damage Exclusion Endorsement and Roof Surfacing Amendment Endorsements Approved. American Association of Insurance Services (AAIS), Reference Bulletin 13-0242, 10/04/2013.

Actual Cash Value Adjustment for Roof Surfacing

Some insurers have already introduced cosmetic damage-type endorsements in conjunction with their homeowners policies. One such endorsement indicates that if the roof is more than 15 years old and damage to roof surfacing is caused by windstorm or hail, the loss will be adjusted on an actual cash value basis with deduction for depreciation. This endorsement defines *roof surfacing* as the outermost exterior covering of the roof of the dwelling or other structure.

Property other than roof surfacing that has been damaged will be adjusted on a replacement cost basis and there will be no deduction for depreciation — subject to the policy's normal requirements. Thus, the actual cash value limitation applies only to roof surfacing. It is noteworthy that the actual

cash value limitation does not apply if the insurer determines that the covered property is a total loss. The endorsement also states that the insurer will not pay more for the damaged property, including any roof surfacing, than the *smallest* of:

- The limit of insurance;
- The cost to replace the damaged property with equivalent construction for equivalent use at the residence premises; or
- The amount actually spent to repair or replace the damaged property.



One such endorsement indicates that if the roof is more than 15 years old and damage to roof surfacing is caused by windstorm or hail, the loss will be adjusted on an actual cash value basis with deduction for depreciation.

It is noteworthy that the actual cash value limitation does not apply if the insurer determines that the covered property is a total loss.



Notification

In keeping with the insurer's responsibility to notify its insureds of important policy changes, particularly limitations in coverage, the insurer provides its insureds with such a notice. The notice indicates that there has been an important change to the policy and then proceeds to explain that if the roof is more than 15 years old, any loss to it will be adjusted on an actual cash value basis if damage is caused by windstorm or hail.

The notice also advises insureds that if the roof has been replaced at any time in the past 15 years, to contact the agent. The insured may be eligible for a premium reduction or for the roof replacement cost option. The options may also be available if the

roof is replaced in the future — and insureds are advised to contact their agent then and to retain documentation of any roof updates, such as receipts or contractor invoices, for verification purposes.

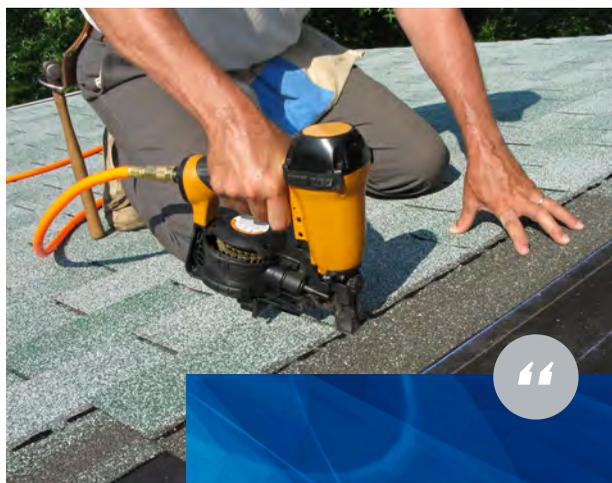
As noted in the accompanying article, adjusting roof damage on an actual cash value basis in a loss involving a homeowners policy is quite a departure from current claim handling practices. In the absence of this endorsement, damage to the roof would be adjusted on a replacement cost basis, new for old, provided the homeowner insured met the 80 percent insurance to value requirement. This is so despite the fact that the roof is more than 15 years old.



... adjusting roof damage on an actual cash value basis in a loss involving a homeowners policy is quite a departure from current claim handling practices.

Although the insurer mentions in the notice that a premium reduction may be available if the insured has replaced the roof in the past 15 years, it does not offer a premium reduction for reducing coverage for roof damage to an actual cash value adjustment basis.

The fact that we know of one insurer that has introduced this endorsement does not necessarily signal that others will follow suit. Time will tell whether such endorsements become standard or merely optional and used infrequently.



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ABOUT THE AUTHOR



Robert J. Prah, CPCU

Robert Prah has more than 30 years of experience in the insurance business, primarily in claims and claims training. He began his career as an adjuster in the New York metropolitan area and eventually became a claims manager and claims training director. He has written extensively on insurance issues, having authored two text books for the Insurance Institute of America and previously served as a columnist for *Rough Notes* magazine, an insurance trade publication.

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