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Functional Replacement Cost

History and Application of Available Coverages

Paul O. Dudey, CPCU

The evolution of replacement cost insurance has an interesting history. In the early 20th century, underwriters were reluctant to offer the coverage, and did so quite selectively, requiring professional appraisal of the property to be insured.

Initially, insurers used what was called "depreciation" insurance, which applied over the top of actual cash value (ACV) insurance and covered the difference between ACV or depreciated value of the insured property and its cost to replace new. For example, given a building that would cost $100,000 to replace new, but was depreciated 30%, the ACV would be 70%, or $70,000, and the depreciation would be 30%, or $30,000. In the event of a loss, the ACV coverage would immediately pay the depreciated value of the loss: 70%. Then when repairs had been completed, the depreciation coverage would pay the other

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Editor's Note

Since the early 1900s, replacement cost insurance has been a valuable and necessary coverage. However, for older structures with expensive, ornate or obsolete features, coverage to replace these with like, kind, and quality was exorbitantly expensive, prohibiting many from purchasing the coverage.

In order to make coverage affordable for these types of properties and allow for replacement in the event of a loss for both building and personal property, functional replacement cost was created. This coverage allows for replacement of expensive and obsolete items with less expensive and more modern and state-of-the-art work.

In this issue, insurance expert Paul O. Dudey analyzes the history and application of this coverage.

Stephen J. Van Pelt, Editor

30% of the loss, to complete the full cost to repair the damage.

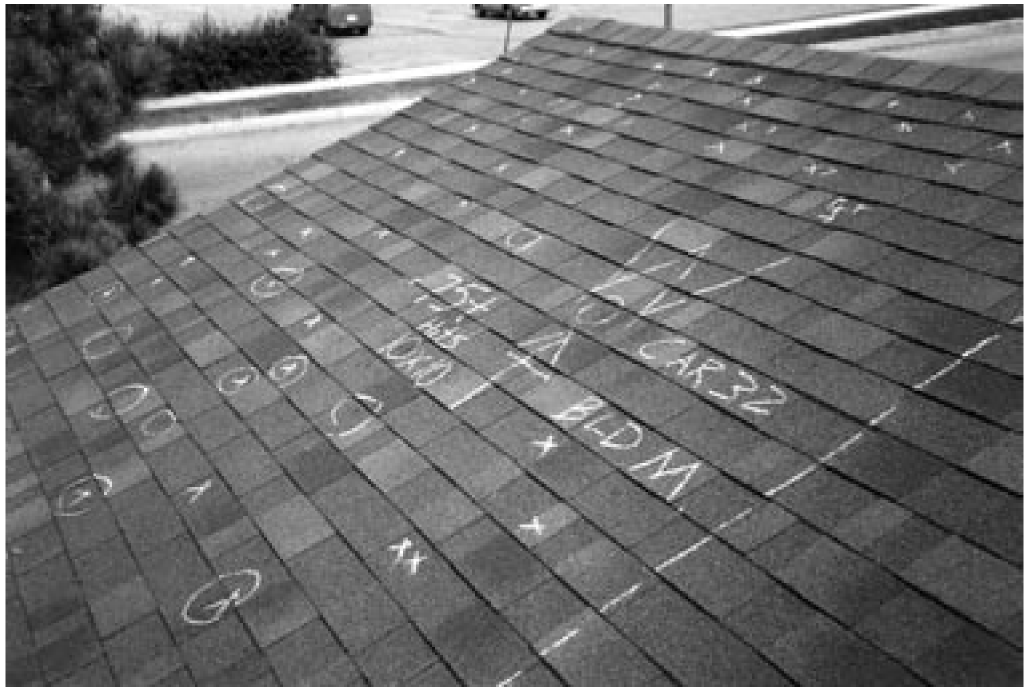
But depreciation is a rather arbitrary concept and can even vary among different parts of the same structure. So when two different insurers were used on each of the two coverages, disputes could arise as to the extent of depreciation and the amount of the loss each insurer should pay.

As insurance buyers began to see the value of replacement cost coverage, the market expanded and insurers started to combine the ACV and depreciation coverages into a single item known as replacement cost insurance. Besides simplifying the coverage, this also eliminated the aforementioned disputes.

As the market expanded, insurers also found that they could safely underwrite replacement cost insurance on a wide basis and could even add it as a basic part of homeowners and commercial property policies, with an 80% or higher insurance to replacement value requirement.

But two problems soon emerged with this coverage:

1) The coverage became the equivalent of a guaranteed roof replacement contract—as soon as a roof with a 20-year life span began to age slightly, it would take only a slight wind or hail storm to inflict



Functional replacement cost allows replacement of expensive and obsolete items with less expensive, more modern, and state-of-the-art work.

enough damage to require complete roof replacement, because the damaged area would not match the older roof sections.

2) On many older properties with expensive and obsolete features such as lathe and plaster walls, elaborate hand-carved woodwork, roof features such as gargoyles, or expensive clay tile roof covering, the cost to replace exactly would be prohibitively expensive, and with an 80% insurance requirement, the cost of insuring the property to value was more than most insureds would want to pay.

The first problem still exists, but insurers have learned to deal with it, although premiums and loss ratios—especially on the homeowners classes—have risen substantially.

For older properties, underwriters solved the problem by writing what is called functional replacement cost insurance, which allows replacement of expensive and obsolete items with less expensive, more modern, and state-of-the-art work. Lathe and plaster walls are replaced with wallboard or plywood, elaborate woodwork is removed, gargoyles are removed—or if needed, replaced with drains and gutters—expensive roof tile is replaced with shingles, and so on, all at much lower cost. For personal property, obsolete or outmoded machinery is replaced by less expensive state-of-the-art equipment.

The Insurance Services Office (ISO) offers three functional replacement coverages—homeowers, commercial buildings, and commercial personal property.

Homeowners Policies

For homeowners policies, homeowners form *HO 05 30 10 00 functional replacement cost loss settlement* can be used with the basic homeowners forms *HO 00 02*, *HO 00 03*, and *HO 00 05*. It is used to convert the homeowners replacement cost coverage of each of these forms to functional replacement cost coverage. It replaces building coverages A and B and offers the following definition of functional replacement cost: Functional replacement cost means the amount which it would cost to repair or replace the damaged building with less costly common construction materials and methods which are functionally equivalent to obsolete, antique, or custom construction materials and methods used in the original construction of the building."

The form makes clear that in determining the amount of insurance needed to meet the 80% functional replacement cost insurance requirement, the value of the following properties is not to be included: "excavation, footings, foundations, piers, or any other structures or devices that support all or part of the building, which are below the undersurface of the lowest basement floor, or those supports below the surface of the ground inside the foundation if there is no basement," and underground flues, pipes, wiring, and drains.

The form also provides that if the ACV of the damage is less than the functional replacement cost, the insurer will pay no more than the ACV until the replacement is complete, except that if the cost to functionally repair the damage is both less than 5% of the amount of insurance in the policy and less than $2,500, the insurer will pay the full cost to repair whether repair is completed or not.

The insured may initially disregard the functional replacement cost feature and settle the claim for ACV, and then make an additional claim for functional replacement cost recovery, provided the insured notifies the insurer of their intent to do so within 180 days after the date of loss.

The form also provides that the 80% building insurance requirement of these forms applies to functional replacement cost, thereby reducing the amount of insurance required for full replacement considerably and making the insurance more readily affordable for the owners of older homes, yet still making possible the full recovery of the cost to put the building back if damaged, without requiring the insured to make expensive out-of-pocket outlay to cover the substantial depreciation on an older home.

This form does not specify any application to household goods, but since there is no 80% insurance requirement on household goods, recovery of replacement cost is provided whenever conventional replacement coverage is provided on household goods, so there is no problem on recovery even on older household goods.

Commercial Buildings

For commercial buildings, ISO offers form *CP 04 38 10 00 functional replacement valuation form*. This form is considerably more detailed and complicated to use than the homeowners form. It begins with a schedule that must be completed listing premises, building, and limit of insurance.

This schedule forces the establishment of the value of older buildings in advance of a loss, and with co-insurance eliminated, the premium is reduced substantially. The only problem is the requirement that the insured recognize the high cost of putting back the old out-of-date materials and determining what to do instead and arriving at a reasonable valuation for its replacement with more modern materials and construction methods—in effect, adjusting any possible loss in advance by establishing the value for each building listed in the schedule.

The endorsement provides that in event of loss or damage to any of the scheduled buildings, if the insured contracts within 180 days to restore the damaged building to the same occupancy and use, the insurer will pay the least of the following:

1) The building limit of insurance shown in the schedule;

2) In event of a total loss, the cost to replace the damaged building on the same site (or on a different site if required by ordinance of law) with a less costly building that is functionally equivalent;

3) In event of partial loss, the cost to repair or replace the damage with less costly materials, if available, in the same architectural style, plus the amount spent to demolish and clear the site of undamaged parts of the building; and

4) The amount actually spent to repair the building with less costly materials, if available, and to demolish and clear the site of undamaged parts of the building.

Inclusion of ordinance of law coverage is important with older buildings because building laws and ordinances imposing onerous requirements for land use and rebuilding are more apt to apply to older structures.

If the insured does not claim in this manner, recovery is limited to the smallest of the following:

1) The limit shown for the damaged building in the schedule;

2) The “market value” of the damaged building, exclusive of its land value (market value is defined in the endorsement as “the price which the property might be expected to realize if offered for sale in a fair market.”);

3) The amount it would cost to repair or replace the damage with less costly materials, if available, in the same architectural style, less allowance for physical deterioration and depreciation.

This endorsement differs from standard replacement cost coverage, where you only have to notify the insurer of your intent to rebuild within 180 days, as opposed to actually contracting the work in that time period. From state to state there are several variations on this language in functional replacement cost policies, so close examination is necessary to determine how to notify the insurance company in the event of a loss.

The ordinance of law coverage is not additional insurance, but instead applies along with the basic coverage for the applicable limits. So where compliance with any ordinance of law to rebuild following a loss could be expected to be expensive, the insured should increase the limit of insurance to take these additional costs into account.

The endorsement also has an "other insurance" clause which states that the coverage will share pro rata with any other insurance covering on the same plan, but will apply as excess but for no more than the stated limit of insurance with any other insurance not on the same plan.

Ordinance of law coverage, a frequently overlooked coverage with conventional building insurance, replaces the ordinance of law exclusion found in the basic building policy. Inclusion of this coverage is especially important with older buildings because building laws and ordinances imposing onerous requirements for land use and rebuilding are more apt to apply to older structures.

Ordinance of law coverage applies whenever ordinance of law regulates the demolition, construction, or repair of buildings or establishes zoning or land use requirements at the premises and is in force at the time of loss, and the loss involving ordinance of law is covered in whole or in part under the policy.

The ordinance of law coverage is not additional insurance, but instead applies along with the basic coverage for the applicable limits. So where compliance with any ordinance of law to rebuild following a loss could be expected to be expensive, the insured should increase the limit of insurance to take these additional costs into account.

Not covered under the ordinance of law coverage are any of the following:

1) Repair costs in excess of the minimum required ordinance of law costs to restore the property to the same intended occupancy, unless otherwise required by zoning or land use law;

2) The cost to test for, monitor, clean up, remove, contain, treat, detoxify, neutralize, or in any way to respond to or assess the effects of pollutants;

3) Any ordinance of law costs you were required to comply with before the occurrence of loss and had not yet been complied with.

The endorsement also contains an example of the adjustment of an ordinance of law claim in which two causes of loss, one covered and one excluded, are involved.

Commercial Personal Property

For commercial personal property, ISO offers form *CP 04 39 10 90 functional personal property valuation other than stock*. This form also starts with a schedule that must be completed. It lists premises, building number, description of personal property, and limit of insurance.

For the property listed in the schedule, the limit of insurance is the only limit applicable to the property. The coinsurance clause of the policy does not apply to this property.

In effect, this calls for establishing the present day value of obsolete or outmoded personal property in advance of any loss, so that it can be replaced with property of current design up to the limit established in the schedule.

In the same way as with the building coverage considered above, in the event of property loss or damage, the insured has 180 days (unless there is agreement otherwise) to contract for repair or replacement of the items shown in the schedule for the same use. If this occurs, then the insurer will pay the smallest of the following:

1) The limit of insurance shown in the schedule for the damaged item;

2) The cost to replace on the same site the lost or damaged item with the most closely equivalent property available; or

3) The amount you actually spend that is necessary to repair or replace the lost or damaged item(s).

If the insured does not make a claim as described above, the insurer will pay the smallest of the following:

1) The limit of insurance shown in the schedule for the item(s) lost or damaged;

2) The "market value" (the price which the property might be expected to realize if offered for sale in a fair market) of the lost or damaged property; or

3) The amount it would cost to repair or replace the damaged item(s) with materials of like, kind, and quality, less allowance for physical deterioration and depreciation.

Paul O. Dudey

Conclusion

While functional replacement cost helps to reduce premiums by allowing for the replacement of expensive and obsolete features with less expensive and more modern work, keep in mind that you must ascertain the value of older structures and items prior to a loss and the costs associated to rebuild or replace with newer, more modern work.

It should be noted that not all insurers follow ISO forms. When independent forms are encountered, they should be checked carefully for possible differences from the coverage described in this article.

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