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What is insurable value for flood insurance?

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Real estate appraisers that are engaged to estimate insurable value must pay close attention to the use of the insurable value estimate. Insurable value may be represented by replacement cost, reproduction cost or a modified version of either.

Flood insurance is required for properties located within a Special Flood Hazard Area (SFHA) on National Flood Insurance Program (NFIP) maps. The SFHA is the area where the National Flood Insurance Program's floodplain management regulations must be enforced and the area where the mandatory purchase of flood insurance applies. The SFHA includes Zones A, AO, AH, A1-30, AE, A99, AR, AR/A1-30, AR/AE, AR/AO, AR/AH, AR/A, VO, V1-30, VE, and V.

All flood insurance is administered by the Federal Emergency Management Agency (FEMA) as part of the National Flood Insurance Program. Flood insurance requirements in all states are identical. FEMA's Mandatory Purchase of Flood Insurance Guidelines (the Guidelines) state that the insurable value of a building is the same as 100% replacement cost value (RCV) of the insured building, which is defined as "the cost to replace property with the same kind of material and construction without deduction for depreciation."

FEMA's guidelines also provide that lenders should avoid creating a situation in which the insured pays for more insurance coverage than the NFIP would pay in the event of a loss. Linking insurable value to RCV is not practical in all cases. In cases involving certain residential or condominium properties, insurance policies should be written to, and the insurance loss payout usually would be the equivalent of, RCV. However, in cases involving nonresidential properties, and even some residential properties, when the insurance loss payout would normally be based on actual cash value, which is RCV less physical depreciation, insurance policies written at RCV may require an insured to pay for coverage that exceeds the amount the NFIP would pay in the event of a loss. Therefore, it is reasonable for lenders, in determining the amount of flood insurance required, to consider the extent of recovery allowed under the NFIP policy for the type of property being insured. This allows the lender to assist the borrower in avoiding situations requiring the insured to purchase coverage that exceeds the amount the NFIP will pay in the event of a loss. Lenders need to be equally mindful of avoiding situations in which, as a result of insuring at a level below RCV, they underinsure property.

In calculating the amount of insurance, the lender and borrower may choose from a variety of approaches or methods to establish the insurable value. They may use an appraisal based on a cost approach, a construction-cost calculation, or any other reasonable approach, so long as it can be supported considering the extent of recovery allowed under the NFIP policy for the type of property being insured. Insurable value for flood insurance purposes may differ from the coverage provided by hazard insurance in that adjustments may be necessary since most hazard insurance policies do not cover foundations.

So what exactly is "insurable value" for flood insurance purposes? Prior to the adoption of the Guidelines, "appraised value" was the term used and thus the required standard. The problem with using the term appraised value was that it was often mistaken with "market value." Appraised value for flood insurance purposes and market value have two very different meanings. Insurable value has nothing to do with market demand, location or comparable sales. Insurable value reflects the cost to rebuild a property.

So what is the best way to determine insurable value? Hazard insurance valuations provide a close estimate but are not an exact representation of insurable value. Hazard insurance does not give a dollar per dollar value for anything below ground. Rather, the industry standard is anywhere from 20-50 cents on the dollar. The reasoning behind this is that generally anything below ground is protected from perils such as tornados, wind and hail and unlikely to sustain damage. Thus, a hazard insurance value is not a true reflection of what it takes to rebuild a property. Flooding is a truly unique hazard that often causes damage to foundations. Flood insurance therefore should be carried at coverage levels at least equal to or even more than the hazard insurance on a particular property.

The cost approach is used to determine the insurable value for flood insurance. The amount of flood insurance must be at least the lowest of: 1) the outstanding principal balances of the loan(s); 2) the maximum amount of coverage available under the NFIP for the particular type of building; or 3) the full insurable value of the building and/or its contents, which is the same as the 100% replacement cost value.

So what method should be used to determine insurable value for flood insurance? As previously discussed, market value is out, hazard insurance value is not exact, and 100% RCV meets or exceeds the minimal compliance requirements. For properties located within a Special Flood Hazard Area, appraisers should estimate insurable value based upon replacement cost new.

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