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The pitfalls of price: How do prop. owners save money by reducing expenses, including insurance costs?

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In today's economy, with tenants either just surviving or closing their doors (which in reality are your doors as the building owner), how do commercial property owners save money by reducing expenses, including insurance costs?

There are ways to reduce your insurance costs, but you need to get good advice to help you avoid having a loss turn into a financial catastrophe. Too many owners look at their annual insurance premiums and decide that coverage amounts and limits need to be reduced to lower costs, but by doing so the owner may be exposed far more to loss than the premium savings could possibly offset.

Most commercial policies are written under coinsurance forms, meaning that in exchange for lower rates the owner agrees to insure the property to a greater percentage of its value. The failure at the time of loss to be insured to that greater percentage will result in a coinsurance penalty, which effectively will be a reduction in the amount of the insurance recoverable by the same percentage by which you are underinsured.

As an example, you have a building with a replacement value of $5 million and your policy requires that you maintain insurance to 90% of the replacement cost (RC), or $4.5 million. You decide you need to lower your insurance costs by 10% so you lower your coverage amount to $4 million. Six months later, you suffer a loss that destroys 50% of the building. What happens?

During that six months, the combined building material and labor costs increase by 5%, making the RC now $5.25 million, meaning that you now need to be insured to $4.725 million to avoid penalty, but at an insured value of $4 million you are under insured by 15% for coinsurance purposes (and 24% for RC purposes in the event of a total loss).

The cost to repair/replace the damage would be 50% of $5.25 million, or $2.625 million, but your loss calculation will be reduced by the 15% by which you are under insured, or $394,000, making your recovery $2.231 million.

You will be far better off insuring to value but perhaps increasing your deductible, using an occurrence limit on a blanket policy, or other method which may expose you to more participation in the loss, but a participation that can be quantified and accepted prior to the loss instead of receiving a nasty surprise after the loss.

Another area of concern is the elimination of or reduction in Loss of Rental Income coverage. This coverage will pay for the amount of rental income actually sustained as a result of a covered loss to the property. If portions of your property are vacated, and you are no longer receiving rental income for them, a covered loss to the property will not result in the loss of income for those vacant portions, so it is acceptable to reduce the Loss of Rental Income limit, accordingly. You must remember to reinstate the limit when those portions are reoccupied, however.

The other part of the Loss of Rental Income picture that is often overlooked is that it, too, is typically a coinsurance form, although it can sometimes be written as an Actual Loss Sustained form for 12 consecutive months without specifying a limit. The ALS form is preferable to the Loss of Rental Income coinsurance form because it does not limit the recovery to a preset limit, but both of these forms can present an unwanted, unanticipated problem: what if the amount of time necessary to rebuild and retenant the property exceeds 12 months?

A serious building loss can result in unexpected delays throughout the permitting process which can contribute to an unwanted and unanticipated stretching out of the reconstruction time. That same serious loss can give tenants the option of terminating their leases in some cases, so one cannot necessarily count on having tenants at hand once the building is repaired/rebuilt. Thus, the actual loss of rental income can quickly exceed the 12 months under the ALS form or the 100% coinsurance amount under a rental income form. While, in this economy, contractors may be more readily available and able to start projects more quickly, that situation may not continue to exist and that, coupled with other factors such as those mentioned above, needs to be taken into consideration when determining the appropriate amount and duration of the rental income coverage.

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