The Value of Valuation

In today's commercial insurance marketplace, insurance carriers and underwriters are maintaining a healthy dose of skepticism with respect to reported property values – especially replacement cost values (RCVs).

For the past three years, the global marketplace has been in a state of flux and rapid transition, caused at least in part by overlapping events such as COVID-19, supply chain and transportation bottlenecks and outright disruptions, supplier shutdowns, skilled labor shortages, and regional armed conflicts. When combined with a rapid increase in money supply as government stimulus programs sought to offset spikes in unemployment, a miasma of uncertainty has grown with resulting inflationary pressures, and the commercial sector must respond as the hallmarks of stagflation loom.

The undervaluation of property is one of several very real concerns facing businesses, and traditional valuation methodologies are inspiring less and less confidence in these nontraditional times. While valuation is relevant across the financial sector, within insurance, particularly property insurance, accurately valuing property is a quintessential variable for managing and transferring risk. As a result, within the insurance market today, two primary issues related to valuation create unique challenges for both insureds and insurers alike.

+ Values have increased more rapidly than the insureds or carriers can appropriately adjust, and continuing increases are expected until the global marketplace can stabilize. The means and methods classically used to manage changes in value are not well suited for the rapid escalation displayed in recent years.
+ The insurance market is suffering losses out of proportion with premiums charged as values increase more rapidly than updated valuations can be declared to the marketplace. Those inflated real values increase the probability of higher magnitude losses, compressing more exposure and coverage into the same location. As a result, an insurer's exposure increases without the additional premium normally accompanying an increase in RCV.

Replacement Cost Value

The amount it takes or would take to repair or replace the damaged or destroyed property with new materials of like kind and quality, without deduction for depreciation and including the Insured's overhead associated with the replacement of damaged or destroyed property should the Insured participate in the repair or replacement of damaged property, all determined at the time of repair or replacement at the place of the loss.

The Impact of Inaccurate Valuations

Inflation and uncertainty have had a tremendous impact on property and asset valuations. Now more than ever, accurate valuations are in all parties' best interests.

Carriers need to be able to calculate appropriate premiums, estimate potential losses with some degree of certainty, and, in turn, optimize their portfolios for tenable business. Each of these are built on the reported values of insured property. Absorbing higher than expected losses, while at the same time charging premiums not commensurate with the actual value exposed, creates an unsustainable business model for insurers.

From an insured's perspective, systemic undervaluation creates a different set of challenges and can result in unexpectedly high risk retentions and losses, potentially also yielding unsustainable business outcomes. In addition, as an insurer's confidence in market-wide valuation wanes, insureds are vulnerable to dramatic, broad-stroke, valuation-based premium adjustments and reduced interest and participation from incumbent markets. Unfortunately, the result is often unfavorable renewal terms from incumbents, and far too often the need to recruit additional capacity from opportunistic carriers.

Further, the company's own internal risk management program and its evaluation of tenable losses must be based on accurate valuations, or else any valuation-based decisions are suspect. At very least, RCVs are the basis for performing loss estimate calculations, including estimated maximum loss (EML), which is frequently a driver in determining necessary coverage limits.

Where We Find Ourselves

The insurance marketplace is responding to this valuation situation in a few ways. Underwriters are scrutinizing reported values and valuation methods like never before. They're routinely making requests for formal appraisals and reviewing a company's valuation methodologies.

Increasingly, underwriters are pointing to the uncertainty surrounding reported RCVs as a reason to pull back offered coverage limits, increase deductibles, and, of course, raise rates and premiums.

The starting point for renewals these days includes an underwriting assumption that an insured's values are likely underestimated. A company needs to make a very compelling case to prove otherwise and making such a case is not often a quick study. Even organizations with pristine loss histories, adequate renewal preparation time, and appropriate documentation can see their renewals quickly go off track when valuation concerns and stipulations arise in the 11th hour.

Options for the Insured

Appraisals

Formal appraisals can ease underwriter uncertainty and provide a level of confidence for a risk manager. However, the cost of appraisals can be substantial, and the results of a valuation may be more than the company is easily able to accommodate in the short term. While an appraisal may be necessary, before moving down that path, risk managers should steel themselves by asking two important questions. Will the results of the appraisal be actionable? What steps will I be able to take if the appraisal comes in substantially higher? Depending on how one is able to answer these questions, appropriate planning and consideration of appraisal timing can offset some of the potential negative side-effects.

When considering appraisal frequency, in "normal" times, appraisals might have reasonably been conducted fairly infrequently, in the realm of every five or ten years. In today's rapidly changing marketplace, that approach is unlikely to be sufficient. Here again a measure of caution is appropriate. Performing frequent appraisals could prove fruitless as values continue to change rapidly. In addition, it's possible that an unwelcome and costly precedent for frequent appraisals morphs into a standard operating practice and a potential requirement from insurers in the future.

Nevertheless, an appraisal will likely be needed sooner rather than later, and risk managers should prepare for this with short term planning around key locations and longer-term goals to address a whole portfolio. If accommodating a full appraisal prior to an upcoming renewal is impossible, planning for one the following year and relaying that intention and a well-documented plan to the underwriting marketplace can help underwriters manage internal guidelines that call for close review and justification of RCVs.

Indexing

Given the challenges associated with performing full appraisals, value indexing has been the most frequently used alternative method for maintaining up-to-date RCVs. Indexes can be straightforward to use and produce somewhat predictable results, at least when inflation and values have a stable trend. However, while an index often adjusts value in the appropriate direction (i.e., upwards), their precision and accuracy rely on the stabilized trend of inflation. In addition, values must be indexed back to a point in time when they had more certainty (e.g., the point of the last appraisal), otherwise indexing can compound valuation errors to the point where they're dangerously inaccurate.

For this and other reasons, companies should consider indexed valuation adjustments as more of a bandage than a long-term solution, to be used most appropriately when combined with periodic appraisals. Regardless, indexed-based values don't inspire the level of confidence for which underwriters are likely searching. As such, when indexing is the method of choice, companies should be prepared to fiercely defend the underlying valuations used and the historical validation of the chosen indices.

Risk Acceptance and Self-Insured Retention

Another option related to valuation is to reconsider the company's overall risk-management strategy. Utilizing self-insured retentions, accepting reduced or location-based policy limits, and adopting mechanisms like coinsurance can provide strategies that accommodate present-day uncertainty in the valuation information available, transferring less overall risk to the market until certainty can be developed or the market stabilizes enough to provide more favorable terms and conditions.

Nevertheless, the fundamental challenges and risks of inaccurate valuations remain. Even if risk is entirely retained, accurate valuations will still be important to determine how much risk the company is, in fact, retaining.

Is the Juice Worth the Squeeze?

The option of leaving valuation a "known unknown" can be tempting as companies, and even some insurers, resort to using relatively arbitrary percentage-based increases to account for inflation and associated uncertainty.

But to dismiss all the valuation challenges discussed here and simply ignore the issue until a new macroeconomic equilibrium arrives would be shortsighted. As noted above, arbitrary percentage-based increases in things like rate structure can distort baseline rates for premium calculation, and undervaluation of property can yield very misleading perspectives to management teams as they consider both operational and financial risks and manage their risk appetite.

As a first step to get their valuations on track, companies should periodically tabletop possible outcomes of a valuation exercise well in advance of performing the actual analysis. Once they understand the range of potential outcomes, the company can strategize based on an understanding of which outcomes would be transformative. This should allow them to prepare for those outcomes that would make business operations untenable and then adapt accordingly.

You're Not on Your Own

Your insurance brokerage and risk management team can help:

+ Balance the pros and cons of valuation options
+ Strategize for updating and maintaining a well-established and defensible valuation
+ Adapt current programs for short-term accommodation and long-term stabilization
+ Maintain transparency and communication with underwriters with respect to current and future valuation efforts
+ Prepare you to address underwriter questions on valuations and historical methods

The alternative, approaching a renewal unprepared for these discussions and being taken aback by the insurance marketplace's focus on valuations, willlikely lead to strife and worse outcomes.

In short, be informed in order to be prepared. Understanding the value of valuations is critical and addressing these challenges head on is the best path forward in transferring insurable risk.

For more information please reach out to:

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