



Independent Insurance Agents & Brokers of Louisiana

9818 Bluebonnet Boulevard • Baton Rouge, Louisiana 70810

phone 225.819.8007 fax 225.819.8027
www.iiabl.com



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Technical Advisory

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Subject: Agreed Value Option in Commercial Property

Background: The Agreed Value Option (AVO) is an alternative to coinsurance in the ISO Building and Personal Property Coverage Form (CP 00 10). Agreed Value can be used with buildings or personal property, on either an actual cash value (ACV) or replacement cost (RC) basis.

Main Points: See examples below which illustrate how coinsurance and the Agreed Value Option function. Throughout the discussion, only buildings are used in the examples, although the information would apply equally to personal property.

Part 1 - Coinsurance

One fundamental problem with coinsurance is that compliance is based on the actual value of the building at the time of loss, while the policy is written based on the estimated value at inception.

In many cases, the estimated value may be supported by information the insured received from a contractor, appraiser, estimator/costimator worksheet or software, or other reliable sources. Yet there are myriad reasons the estimated value may not be accurate at the time of loss, such as: (1) estimated value was based on prior policy; (2) valuation calculation/estimator software was inaccurate; (3) contractor's/appraiser's calculation was inaccurate; (4) the landlord or tenant made substantial upgrades during the policy year, and these increased values were not added to the policy midterm. (An alternative for a landlord is to exclude the value of TIB from the value of his building, using endorsement CP 14 20 Additional Property Not Covered.)

(Important note: From an E&O perspective, the insurance practitioner should never attempt to determine the value of any property, except through the use of industry standard or insurer-specific methodology, such as worksheets or software.)

Therefore, where the insured provides the insurer with valid information placing the estimated value of the building at \$1,000,000, and the insured elects to purchase \$1,000,000 of insurance, and the insurer has no reason to believe the limit isn't accurate, the coinsurance provision will still be based on the value of the building at the time of loss, irrespective of the estimated value and the amount of insurance carried. Here is the coinsurance provision in the ISO Building and Personal Property Coverage Form:

CP 00 10 06 07

F. Additional Conditions

The following conditions apply in addition to the Common Policy Conditions and the Commercial Property Conditions.

1. Coinsurance

If a Coinsurance percentage is shown in the Declarations, the following condition applies.

a. *We will not pay the full amount of any loss if the value of Covered Property at the time of loss times the Coinsurance percentage shown for it in the Declarations is greater than the Limit of Insurance for the property.*

Instead, we will determine the most we will pay using the following steps:

(1) Multiply the value of Covered Property at the time of loss by the Coinsurance percentage;

(2) Divide the Limit of Insurance of the property by the figure determined in Step (1);

(3) Multiply the total amount of loss, before the application of any deductible, by the figure determined in Step (2); and

(4) Subtract the deductible from the figure determined in Step (3).

We will pay the amount determined in Step (4) or the limit of insurance, whichever is less. For the remainder, you will either have to rely on other insurance or absorb the loss yourself.

Comments: The shorthand calculation for coinsurance compliance – based on steps (1) and (2) above – is “amount carried divided by amount required” (“AC ÷ AR”), or simply “did over should.” It is important to note also that the coinsurance percentage is applied to the actual value of the property at the time of loss, and not the estimated or assumed value of the property at the time the coverage was written.

In the examples below, assume the following facts:

\$1,000,000 estimated/calculated value of the building at policy inception

\$1,300,000 actual value of the building at the time of loss

Example #1:

Limit of insurance calculation at policy inception:

\$1,000,000 estimated value of the building (can be ACV or RC)
_____ x 80% coinsurance
\$ 800,000 amount of insurance indicated
\$ 800,000 amount of insurance carried ("AC")
\$1,300,000 actual value of the building at time of loss

Coinsurance compliance calculation at time of loss:

\$1,300,000 actual value of the building at time of loss
_____ x 80% coinsurance
\$1,040,000 amount of insurance required ("AR")

Coinsurance penalty calculation at time of loss ("AC ÷ AR"):

\$800,000 ÷ \$1,040,000 = .769

Loss payment:

\$500,000 x .769 = \$384,500 (less deductible).

Loss payment in a total loss = \$800,000 (with \$500,000 underinsurance)

Comments:

(1) Regardless of how the estimated value of the building (\$1,000,000) was determined at policy inception, coinsurance compliance is based on the actual value of the building (\$1,300,000) at the time of loss.

(2) In this example, had the insured suffered a total loss, the maximum payable would be the policy limit of \$800,000 – leaving an uninsured loss of \$500,000.

Example #2:

Limit of insurance calculation at policy inception:

\$1,000,000 estimated value of the building (can be ACV or RC)
_____x100% coinsurance
\$ 1,000,000 amount of insurance indicated
\$ 1,000,000 amount of insurance carried ("AC")
\$1,300,000 actual value of the building at time of loss

Coinsurance compliance calculation:

\$1,300,000 actual value of the building at time of loss
_____x100% coinsurance
\$1,300,000 amount of insurance required ("AR")

Coinsurance penalty calculation at time of loss ("AC ÷ AR"):

\$1,000,000 ÷ \$1,300,000 = .769

Loss payment:

\$500,000 x .769 = \$384,500 (less deductible).

Loss payment in a total loss = \$1,000,000 (with \$300,000 underinsurance)

Comments:

(1) Carrying 100% of the estimated value of the building does not eliminate the coinsurance penalty, in cases where the actual value of the building at the time of loss is greater than the estimated value.

(2) In the event of a total loss, policy pays \$1,000,000 with \$300,000 uninsured loss.

Example #3:

Limit of insurance calculation at policy inception:

\$1,000,000	<u>estimated</u> value of the building (can be ACV or RC)
<u> x 80%</u>	coinsurance
\$ 800,000	amount of insurance indicated
\$ 1,000,000	amount of insurance carried ("AC")
\$1,300,000	<u>actual</u> value of the building at time of loss

Coinsurance compliance calculation:

\$1,300,000	<u>actual</u> value of the building at time of loss
<u> x 80%</u>	coinsurance
\$1,040,000	amount of insurance required ("AR")

Coinsurance penalty calculation at time of loss ("AC ÷ AR"):

\$1,000,000 ÷ \$1,040,000 = .961

Loss payment:

\$500,000 x .961 = \$480,500 (less deductible).

Loss payment in a total loss = \$1,000,000 (with \$300,000 underinsurance)

Comment:

(1) One method often used to provide a cushion in case the actual value of the building is significantly greater than the estimated value is by writing the full estimated value of the building at inception, but using 80% coinsurance.

(2) Compare the methodology in this example with that in example #2. The full estimated value was written using 100% coinsurance, and there was a coinsurance penalty of .769, with a payment of \$384,500.

(3) In example #3, by writing 100% of the estimated value, but using only 80% coinsurance requirement, the coinsurance penalty is .961, with a payment of \$480,500.

(3) In the event of a total loss, policy pays \$1,000,000 with \$300,000 uninsured loss.

Part 2 – Agreed Value Option

The Agreed Value Option (AVO) in the ISO Building and Personal Property Coverage Form (CP 00 10) can be used to mitigate some of the adverse effects of the coinsurance penalty, as illustrated in Part 1 – Coinsurance. However, the AVO is not a silver bullet which completely eliminates all problems associated with underinsurance. While the AVO suspends the coinsurance provision for a specified length of time (usually for the policy term), it contains an insurance-to-value (ITV) requirement that essentially functions like 100% coinsurance. In addition, the AVO does not increase the overall limit of insurance, in the event the actual value of the building is greater than estimated. That is, it does not provide “guaranteed replacement cost coverage” in excess of the limit of insurance.

It is important to note that the insurer’s acceptance of the values shown on the SOV does not guarantee that this is the actual value of the building. Rather, the insurer is only agreeing not to recalculate the actual value at time of loss, as required by the coinsurance provision.

In order to use the Agreed Value Option, the insured must submit a Statement of Values (“SOV”) to the insurer (ISO CP 16 15 07 88, or the ACORD 139, or equivalent). If the insurer accepts the figures submitted, then the Agreed Value Option can be used.

The Agreed Value Option (AVO) appears in the Optional Coverages section of the Building and Personal Property Coverage Form (CP 00 10), as follows:

CP 00 10 06 07

G. Optional Coverages

If shown as applicable in the Declarations, the following Optional Coverages apply separately to each item.

1. Agreed Value

- a. The Additional Condition, Coinsurance, does not apply to Covered Property to which this Optional Coverage applies. We will pay no more for loss of or damage to that property than the proportion that the Limit of Insurance under this Coverage Part for the property bears to the Agreed Value shown for it in the Declarations.*
- b. If the expiration date for this Optional Coverage shown in the Declarations is not extended, the Additional Condition, Coinsurance, is reinstated and this Optional Coverage expires.*
- c. The terms of this Optional Coverage apply only to loss or damage that occurs:
(1) On or after the effective date of this Optional Coverage; and*

(2) Before the Agreed Value expiration date shown in the Declarations or the policy expiration date, whichever occurs first.

Comments:

(1) Note that the compliance provision in **G.1.a.** is based on the ratio that the "Limit of Insurance under this Coverage Part" bears to the "Agreed Value shown for it in the Declarations." In other words, the limit of insurance must equal the agreed value.

(2) This contrasts with the coinsurance compliance calculation, which is based on the ratio that the amount of insurance carried bears to the value of the building at the time of the loss multiplied by the coinsurance factor (e.g., 80%, etc.), as illustrated in examples #1, #2 and #3.

In the following 3 examples for the Agreed Value Option, the shorthand "AC ÷ AR" is also used in the calculations, as was done in Part 1 – Coinsurance. However, with the AVO, the amount of insurance required ("AR") is the agreed value, which means that the insured must carry 100% of the agreed value shown on the declarations page.

In the examples below, assume the following facts:

\$1,000,000 Statement of Values (SOV) for the building at policy inception
\$1,300,000 actual value of the building at the time of loss

Example #4:

Limit of insurance calculation at policy inception:

\$1,000,000	value shown on SOV
\$1,000,000	agreed value shown on declarations page ("AR")
\$1,000,000	limit of insurance shown on declarations page ("AC")
\$1,300,000	actual value of the building at the time of loss

Insurance-to-value (ITV) calculation at time of loss ("AC ÷ "AR"):

$$\$1,000,000 \div \$1,000,000 = 1 \text{ (no penalty)}$$

Loss payment:

$$\$500,000 \times 1 = \$500,000 \text{ (less deductible) (no ITV penalty)}$$

Loss payment in a total loss = \$1,000,000 (with \$300,000 underinsurance)

Comments:

(1) This is a textbook example which illustrates the advantage of the Agreed Value Option. By electing the AVO, the insured does not face a coinsurance penalty if the actual value of the building turns out to be greater than the amount indicated on the SOV. The use of the Agreed Value Option suspends the coinsurance calculation process, which is based on the actual value of the building at the time of loss. (See example #2.) Instead, AVO uses an insurance-to-value (ITV) calculation, which requires that the amount of insurance carried is equal to the agreed value shown on the declarations page.

(2) In example #2 and example #4, the insured carried 100% of the estimated value of the building. But in example #2, where coinsurance compliance is calculated on the value of the building at the time of the loss, a \$500,000 loss resulted in a payment of \$384,500 (less deductible). In example #4, the coinsurance calculation is suspended and replaced with the AVO requirement that the limit of insurance equal the agreed value. Since the insured met that requirement, the full \$500,000 loss was paid (less deductible).

(3) However, this example also illustrates a potential risk in using the Agreed Value Option. For the \$500,000 loss, while the insured avoids a coinsurance penalty, a total loss of \$1,300,000 will exceed the policy limit by \$300,000. In other words, while the AVO does avoid a coinsurance penalty, using the Agreed Value Option does not increase the limit of insurance. By accepting the SOV figures (\$1,000,000), the insurer is not warranting that the policy will cover a loss greater than the limit of insurance.

Example #5:

Limit of insurance calculation at policy inception:

\$1,000,000 value shown on SOV
\$1,000,000 agreed value shown on declarations page ("AR")
\$ 800,000 limit of insurance shown on declarations page ("AC")
\$1,300,000 actual value of the building at the time of loss

Insurance-to-value (ITV) calculation at time of loss ("AC ÷ "AR"):

$\$800,000 \div \$1,000,000 = .80$ ITV

Loss payment:

$\$500,000 \times .80 = \$400,000$ (less deductible)

Loss payment in a total loss = \$800,000 (with \$500,000 underinsurance)

Comments:

(1) At first glance, this is a perplexing situation. The insured and insurer agreed with the information on the SOV, that the value of the building was \$1,000,000 and the agreed value shown on the declarations page was \$1,000,000 – yet the insured carried only \$800,000. In most cases, the insurer or agency would catch the discrepancy before the policy was issued. However, one plausible circumstance might be that the policy was a renewal of the policy in example #1. There, standard coinsurance applied, with the Agreed Value Option not elected. Thus, with a building estimated value (but no SOV required) at \$1,000,000 and 80% coinsurance carried, the amount of insurance required – and carried – would be \$800,000, producing no coinsurance penalty. At renewal, assume the AVO was chosen, and the SOV supported the insurer's and insured's estimate on the value of the building at \$1,000,000. It is possible, therefore, that in processing the renewal, the amount of insurance was inadvertently left at \$800,000, producing an ITV penalty, which paid only \$400,000 of the \$500,000 loss.

(2) One other possible reason that the amount of insurance carried was \$800,000, while the agreed value (supported by the SOV) was \$1,000,000 might be that somewhere along the way, the agency misunderstood the statement that "the Agreed Value Option eliminates coinsurance." With that misinterpretation of AVO, the policy in example #1 might be renewed with the AVO elected, but no change was thought to be needed in the amount of insurance carried.

Example #6:

Limit of insurance calculation at policy inception:

\$1,000,000 value shown on SOV
\$ 800,000 agreed value shown on declarations page ("AR")
\$ 800,000 limit of insurance shown on declarations page ("AC")
\$1,300,000 actual value of the building at time of loss

Insurance-to value-calculation at time of loss ("AC ÷ "AR"):

$\$800,000 \div \$800,000 = 1$ (no penalty)

Loss payment:

$\$500,000 \times 1 = \$500,000$ (less deductible)

Loss payment in a total loss = \$800,000 (with \$500,000 underinsurance)

Comments:

(1) An obvious question in this example is why would an insured knowingly insure the building for \$800,000 when the SOV indicates that the value is \$1,000,000? And what's the point of electing the Agreed Value Option here? First, prudence would certainly suggest that an insured should insure for the full value of the building, rather than risk significant underinsurance in the event of a major loss.

(2) On the other hand, example #1 presented a common situation, where standard coinsurance (and not AVO) was in place. In that example, the insured elected to carry only 80% of the estimated value of the building. Some insureds who take this approach are aware that few losses approach total-loss levels, and they are willing to save some premium dollars by carrying less insurance. In one sense, insureds are willing to self-insure any loss which exceeds the limit of insurance.

(3) The question is, can this be done when the Agreed Value Option is used? Where the SOV indicates the value of the building is \$1,000,000 can a lesser amount be the agreed value? Experts differ on this issue.

(4) One important factor in support of the notion that an amount less than the SOV value can be the agreed value is found in the ISO Manual, as follows:

ISO Commercial Property Manual

Rule 38 – Building and Personal Property Coverage Options

A. Agreed Value

1. Description Of Coverage

Under this optional coverage, the Coinsurance Clause is suspended for insureds who agree to carry a limit of insurance equal to at least 80% (for specific insurance) or 90% (for blanket insurance) of the value of their property.

(5) Some experts interpret this rule to say that an insured may elect to carry a limit of insurance that is 80% (or more) of the SOV value of the property. In effect, for insurers who accept this interpretation of the rule, where the SOV is \$1,000,000, the agreed value shown on the declarations page must be \$800,000 or higher. So with the agreed value being \$800,000, the insured would need to carry a limit of \$800,000 to avoid an insurance-to-value (ITV) penalty. At the same time, the insured is accepting a significant underinsurance exposure in the event of a loss greater than the limit of insurance. However, in a loss such as the \$500,000 loss in example #6, there is no insurance-to-value (ITV) penalty. Nonetheless, many producers and underwriters steer clear of writing a limit of insurance which is less than the amount shown on the SOV.

Part 3 – Additional Resources

The Virtual University of the Independent Insurance Agents & Brokers of America (IIABA) has the following articles posted which provide additional information and commentary on valuation issues in insurance.

["Agent Liability for Property Undervaluation"](#)

["How Much Insurance Do I Need on My Building?"](#)

["The HO Undervaluation Problem"](#)

Necessary Action: Circulate this Technical Advisory to all appropriate agency staff.

Special thanks to John Eubank, CPCU, ARM, and Bill Wilson, CPCU, ARM, for their valuable assistance with this Technical Advisory.

Please note that this Technical Advisory is intended to be educational and is not legal advice upon which you should rely. Please seek any legal opinion you may need from a qualified attorney.