

### Advice to Commercial Property Owners – Setting the correct sum insured on your buildings

Version: 25<sup>th</sup> May 2006

CB/GEN/020

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#### Underinsurance

As a commercial property owner who leases out your property to tenants, one of the major risks to your business is **underinsurance**.

Unlike most people who insure their buildings, commercial landlords are unique in that they cannot accept cash settlements. The reason for this is due to the lease wording.

In a commercial lease, the landlord's covenants relating to insurance are fairly universal. The landlord must:

- Insure for the specified risks
- Insure for the full cost of reinstatement including
  - Removal of debris
  - Architects and surveyors fees
  - VAT (where appropriate)
- Apply all of the claims money to reinstating the building

The final point is the reason why cash settlements are normally not available to landlords.

As an example, lets say the correct sum insured should be £10,000,000 but the building is only insured for £9,000,000, then the insurance company would normally only pay 90% of any claim, leaving the landlord to make up the difference out of his own pocket. It may be possible for the landlord to negotiate a lease surrender with the tenant, but it could be costly as the tenant is in a strong position and would demand a considerable sum of money in compensation.

How can you avoid this problem? There are several issues which should be considered.

#### Valuations

The wise landlord would always commission a valuation from an RICS valuer every three years. The cost of this is not very great and Rowlands & Hames has facilities with local RICS valuers at preferential rates for its clients. Some leases may contain a clause which makes the tenant responsible for the cost of a valuation every three years.

You should always use a specialist insurance valuer. Many landlords rely on the insurance figure given by the sale valuer when the building was purchased but this cannot be relied on as the sale valuer is not an expert in establishing the correct cost of reinstatement and often underestimates by 10-20%.

#### Removal of debris

Twenty or 30 years ago, the cost of demolishing and removing the debris following a fire would add about 5% to the cost of reinstatement. Nowadays with modern materials, the concerns surrounding asbestos, waste legislation and the spiralling cost of disposal, the correct figure would be at least 11.5%. This would increase the cost of reinstatement in our example from £10,000,000 to £11,150,000.

## Architects and Surveyors Fees

The increase in fees over the same period has been more modest, rising from 7.5% to 8.5% of the reinstatement figure. This would increase the reinstatement cost by £850,000 to now £12,000,000.

## VAT

Thanks to the Finance Act 1987 commercial property owners do not have to pay VAT on redevelopment or rebuilding of their existing properties providing they charge VAT on the rents. However, if a landlord decides not to charge VAT on the rent of a particular building, he must pay VAT on the cost of redevelopment/rebuilding and should therefore include VAT in the sum insured on that property. If this is the case, then our example building should now be insured for £13,750,000.

## Basis of settlement

Many property insurance policies are issued with a 'Day One' basis of settlement. With this, the insured selects an inflation figure, and, provided that inflation of the reinstatement cost by the time of the claim is no more than that figure, any material damage claim will be paid in full, provided that the initial sum insured represented the full cost of reinstatement on day one of the period of insurance. If there is any underinsurance, then the benefit of the 'inflation proofing' is lost and Average would apply i.e. you would be responsible for the proportion of under-insurance.

Our preferred basis of settlement is 85% Average. This would pay any claim in full up to the sum insured provided the sum insured was at least 85% of the correct figure at the date reinstatement occurs. This allows for a measure of underinsurance and index linking the sum insured would take care of inflation. You should note that the index linking of the sum insured does not cease at the date of damage but continues until the date of reinstatement. Whilst this does not detract from the need to insure for the correct amount, it at least gives some leeway re the Average clause.

## Have you updated your Building Sum Insured recently?

This table shows the effects of inflation on reinstatement costs in recent years:

Year Sum Insured Was Last Increased	UK as a Whole		North West	
	Annual % Increase In Rebuilding Costs	Cumulative Increase Required	Annual % Increase In Rebuilding Costs	Cumulative Increase Required
2000	7.6%	50.6%	8.55%	56.55%
2001	7.06%	40.0%	6.06%	44.22%
2002	7.69%	30.8%	8.57%	35.98%
2003	2.04%	21.4%	4.74%	25.25%
2004	10.5%	19.0%	11.05%	19.58%
2005	2.26%	7.7%	2.26%	7.68%
2006 (forecast)	5.3%	5.3%	5.3%	5.3%

You can see the effect of inflation over even a short period.

Remember, underinsurance is a major business risk for commercial landlords so it's important that you consider all these factors.

## **How Rowlands & Hames can assist you**

If you wish to discuss your own situation please contact your usual Account Director who will be pleased to assist.

Please contact your usual Rowlands & Hames by telephoning 01253 594211, via email to [mail@rowlands-hames.co.uk](mailto:mail@rowlands-hames.co.uk) or via our website at [www.rowlands-hames.co.uk](http://www.rowlands-hames.co.uk).

**Please contact Rowlands & Hames for further information.**

**Rowlands & Hames Insurance Brokers Ltd.  
277 Dickson Road, Blackpool, Lancashire, FY1 2LG  
Tel: 01253 594211 Fax: 01253 358481 Email: [mail@rowlands-hames.co.uk](mailto:mail@rowlands-hames.co.uk)**

[www.rowlands-hames.co.uk](http://www.rowlands-hames.co.uk)

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