optima INSURANCE SOLUTIONS

KNOWLEDGE SERIES 01

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Right Sum Insured in Fire Policies

It is generally seen that every corporate at some point of time, has felt the need to know the methodology of arriving at the correct sum insured so that the dreaded 'under-insurance' factor or the Average Clause is not applied when a claim is reported. This is an oft repeated question asked almost universally in all kinds of seminars, meetings and particularly at the time of renewals.

We shall try to give a very simple version of various theories so that it is easily understood by one and all; be it the persons who procure insurance or the ones who practice insurance.

We shall begin the series by writing first on adequate Sum Insured for Buildings.

It is essential to note that the cost of land is not a part of S.I. in a Fire policy and so is generally plinth and foundation. Therefore, the Sum Insured would essentially be the built up value of super structure. Plinth and Foundation can, however, be part of Sum Insured for the Earthquake risk.

The value of the building should ideally include the following :

i. Floors and walls

ii. False roofs and ceiling

iii. Value of Embedded items in walls/roofs.

E.g. pipes, electric & telephone wiring and anything else of similar kind.

The following basis can be used to arrive at the value of building and its usefulness in each case is explained alongside;

i. **Original Cost :**

It is relevant only for the first year of insurance and obviously not for sub-sequent years.

ii. **Book value :**

A book value has no relevance to insurable value except, of course, in the first year of insurance.

iii. **Market Value :**

The guiding principle is determining the amount at which the building of same age and condition can be bought or sold. The steps taken in the **Proper sequence are :**

a) Determine the present cost of similar building.

b) Deduct, of course, cost of land, plinth and foundation.

c) Deduct finally for depreciation due to age and usage.

iv. **Reinstatement Value :**

It is, in effect, the value of similar new property without taking into account the depreciation. This reinstatement value clause enables building owners to avoid financial strain on their own resources in the event of a loss.

For arriving at the cost of construction of buildings, CPWD rates are the best guides. National Buildings Organization publish escalation indices every year which should be used for arriving at insurable value. Final step would be to adjust for depreciation from the estimated current replacement cost.

We now make a comparison of the four methods discussed above :

30 years old Building; original cost in 1975, the year of construction = Rs. 10, 00,000.

The following parameters have been taken into account for arriving at the above figures :

i. The Book Value has been calculated @ 10% depreciation per year on diminishing value basis.

ii. The Reinstatement Value has been calculated after applying average 10% escalation per year.

iii. The Market Value is calculated by applying 2% depreciation on straight line basis on Reinstatement Value.

By following this methodology, it would therefore become clear that the market value or the reinstatement value, as the case may be, can be correctly fixed and the fearful consequences of an under insurance can be easily avoided.

While insuring for values less than the actual value (whether Re-instatement Value or Market Value) would invite proportionate reduction in claim amount via the condition of Average in Fire Policies; insuring for value more than the actual value shall give no advantage to the insured in the event of a claim because of the principle of indemnity but also results in wastage in extra premium paid on higher Sum Insured.

Year	Original Cost	Book Value	Reinstatement Value	Market Value (Depreciated Value)
1975	10,00,000	10,00,000	10,00,000	10,00,000
1985	10,00,000	3,87,420	20,00,000	16,00,000
1995	10,00,000	1,29,180	30,00,000	18,00,000
2005	10,00,000	45,042	40,00,000	16,00,000

Please send queries on anoop.harjani@optima.co.in