THE IMPORTANCE OF UNDERSTANDING REPLACEMENT COST VALUE

Homeowners insurance policies are a recurring annual purchase required as a part of your mortgage, but all too often homeowners don't necessarily consider the adequacy of the amount of coverage provided. An important aspect of sufficiently protecting a property is obtaining a policy that settles at Replacement Cost Value (RCV) and automatically adjusts each year based on current market conditions. Fortunately, RCV is the default coverage calculation on a standard HO-3 homeowners insurance policy and provides reimbursement for property damage after a covered loss based on the cost to repair or replace the property considering the then-current price of building supplies and labor. It's important for homeowners to maintain coverage at least equal to RCV, rather than Actual Cash Value (ACV) coverage, as the latter provides reimbursement for property damage by determining the replacement cost value and then deducting depreciation, based on age or use. ACV thus does not provide the homeowner with full indemnity for their property in the case of a loss, thus impacting their equity in the home.

Coverage amounts, and the accompanying premiums, have been increasing for policies with RCV coverage over the last few years above the historical annual average of 2% to 4% as a result of rising material and labor costs. Material and labor prices started increasing as a result of COVID-19 pandemic-related restrictions and associated supply chain disruptions, and these have subsequently been compounded by inflationary pressures and labor shortages. As an example, average building material costs increased 8.9% from Q1 2022 to Q2 2022.[1]

The 2022 CBRE U.S. Construction Cost Trends forecasts a 14.1% year-over-year increase in construction costs by year-end 2022 as labor and material costs continue to rise, after which escalation should stabilize to the 2%-4% range in 2023 and 2024.[2] However, market conditions continue to change rapidly, and it's difficult to forecast exactly what will happen. Rising interest rates are negatively impacting new housing demand, but the reconstruction required as a result of Hurricane Ian is likely to drive higher demand for construction materials.

Homeowners insurance companies' rates have been approved for rate increases in almost every state, with an average nationwide rate increase of 4.48%, based on S&P data spanning January 1, 2022 to May 18, 2022. The rate increase amounts vary by state, with California expected to see the highest increase at 15.3%, followed by Washington at a 12% increase. Other states are expected to see very minimal increases, such as Michigan, Kansas and New York.[3] All in all, many homeowners will find that their premiums will increase as a result of coverage amount increases and carrier rate increases.

WHAT DOES ALL THIS MEAN FOR MORTGAGE SERVICERS?

» The average homeowner will likely encounter higher premium rates as their homeowners insurance policy renews
» They may also encounter potential issues with availability of coverage, especially in states such as Florida where six property insurers became insolvent in 2022, even before the catastrophic damage wielded by Hurricane Ian
» For mortgagors with escrowed loans, servicers are likely to see insurance-related escrow shortages and monthly payment increases due to these higher premiums
» Servicers may also see increased churn with insurance policies as customers shop for more affordable options, which can lead to multiple premium disbursement requests within the same policy year

It cannot be emphasized enough that RCV coverage for homeowners insurance policies is an important tool to adequately protect a property. Mortgage servicers will undoubtedly see their customers continue to experience rising homeowners insurance premiums as more expensive material and labor costs lead to corresponding premium increases. And while it's important that mortgage lenders understand RCV and its impact on insurance premiums, it's equally important to have a strong insurance tracking partner to help navigate the multiple risk scenarios in today's homeowners insurance environment.

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