How do inflationary pressures directly affect commercial insurance?

During late 2021 and early 2022, general and construction cost inflation significantly increased due to many factors. These include the price of lumber and other materials, transportation costs, supply chain disruptions, and labour shortages affecting prices and delaying completion.

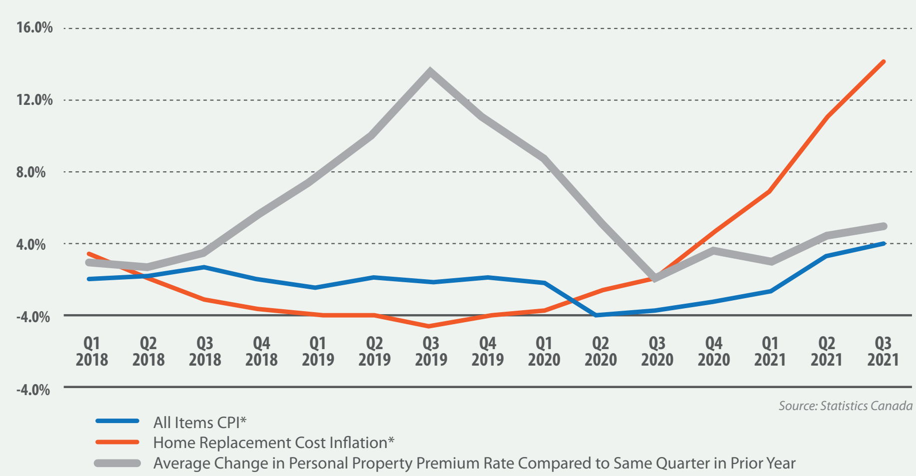
For commercial property insurance, underwriters typically review four risk characteristics when evaluating a submission and determining an appropriate premium rate: construction, occupancy, protection and exposure risks.

For example, if hypothetical risk characteristics result in a rate of 10 cents for every $100 of insurance coverage provided, a building valued at $5 million would have an annual premium of $5,000.

However, economic factors outside of an insurer's direct control, such as the inflationary pressures noted above, create premium pressure. Recent commercial market conditions have resulted in insurers taking steps to ensure premiums will adequately cover claims costs. Claims costs have also recently increased as a result of substantially higher construction and replacement costs.

The chart below compares personal property premium increases to replacement cost inflation. While similar data is not yet available for commercial property insurance, the impact of inflation on replacement costs is similar.

Average Personal Property Premium Rate Increase vs. Inflation in Canada



Canada's P&C insurance companies understand the challenges businesses continue to experience during these extraordinary times. This challenging market won't end overnight. In the meantime, we're here to work with you.

WHAT CAN COMMERCIAL CLIENTS DO TO ENSURE THEY HAVE THE RIGHT COVERAGE?

Challenging commercial markets come about when insurer loss ratios (the losses an insurer incurs due to paid claims as a percentage of premiums earned) become unsustainable – in other words, when insurers pay out more money in losses than they receive in premiums – and insurers shift to more stringent underwriting and risk selection.

Commercial customers should verify that their commercial property insurance coverage accurately reflects current property valuations or replacement cost appraisals. Speak with your insurance representative to confirm that your current policy will cover recovery expenses after a loss, considering current property repair costs, new building by-laws, additional costs for heritage buildings, and materials and labour cost inflation. Outdated valuations could leave you underinsured if repair costs exceed your existing coverage limits. You may become a co-insurer, or retain a portion of the risk, if your limit of insurance is less than 90% of the correct replacement cost valuation amount at the time of a claim.

Insurers do allow for a small variance in the replacement cost to rebuild versus the limit of insurance purchased. This co-insurance clause requires the limit of insurance be at least 80% or 90% of the building replacement cost. However, if the limit of insurance is less than 80% or 90% of the replacement cost, you could face a major penalty when it comes time to settle a claim, and you may become a co-insurer. The co-insurance clause applies to partial and total damage to a building.

HOW DOES CO-INSURANCE WORK?

For example, if a building owner has insured their building for $1 million but the actual replacement cost is $2 million, the limit of insurance is 50%.

The building suffers $500,000 in damages. As the owner has only insured the building to 50% of its replacement cost, the insurer will pay 50% of the loss ($500,000 x 50% = $250,000). The building owner is also the co-insurer, meaning they will have to pay the other 50% of the cost to rebuild ($250,000).

The co-insurance clause also applies to other property besides the building and is used in business interruption coverage.

HOW IS COMMERCIAL INSURANCE VALUE DETERMINED?

To avoid being underinsured, building owners should have an accurate replacement cost (RC) appraisal, based on all the required variables (material and labour costs, debris removal expense, building by-laws, heritage costs and others). An appraiser can look at the building and develop an RC appraisal based on today's cost to rebuild. This snapshot-in-time appraisal can be used to keep your building insurance values in line with the true cost to rebuild if you experience a loss. You may use the base appraisal for the next three years to approximate each year's cost to rebuild your building, based on a Statistics Canada Construction Price Index.

We are here to help.

IBC has insurance professionals and risk managers to help businesses navigate the insurance marketplace. Contact IBC's Business Insurance Helpline at **1-844-2ask-IBC** (1-844-227-5422) if you need help obtaining affordable insurance coverage.

IBC Insurance Bureau of Canada