



## Construction Cost Increase Factors and The Importance of Insuring to Value (ITV)



**C**hubb realizes that the best people to determine home replacement costs are the actual contractors who build the types of homes that we insure. As a result, our home appraisers are in regular contact with nearly 4,000 contractors, restoration specialists and high-end homebuilders throughout the United States. We update our research annually on a local basis, taking into consideration the costs of materials, labor cost increases, building trends, new products and overall construction costs. Our findings verify many of the industry statistics published in 2006:

### REAL ESTATE VALUES VERSUS CONSTRUCTION COSTS – WHY THE DIFFERENCE?

When asked about how much a home is worth, the first thing that comes to mind is real estate value. And in today's real estate market, the common trend is that home values are decreasing. In fact, the National Association of Realtors (NAR) reports that through the end of the third quarter 2006, the average market value of single-family homes across the United States decreased 1.9% over this same period of time in 2005. However, the NAR also reports that several markets are still experiencing increases in values of 10% and greater. While real estate value is one indicator of the value of a home, the cost to reconstruct or rebuild a home, especially after a loss, is more directly impacted by the cost of materials and labor than real estate value – which is affected by costs such as land value, depreciation, location and economic trends.

### HOME CONSTRUCTION COSTS CONTINUE TO RISE.

According to Marshall & Swift/Boeckh, LLC, annual cost changes increased an average of 8% from September 2005 to September 2006. In October 2006, *Engineering News Record* reported that skilled labor costs increased 3.5%, while common labor costs increased 4.2% over the prior year. Of course, these percentages vary across the country, so national construction cost averages can't be used to determine costs involved in building custom homes or reconstructing older homes where materials must be matched and workmanship is more specialized. This is why Chubb develops information that reflects local construction costs, rather than costs based on a nationwide estimator.

### WHAT ARE SOME EXAMPLES OF CHANGES IN BUILDING MATERIAL COSTS OVER THE PAST YEAR?

An article published in the *Engineering News Record* (September 25, 2006) reported that the cost of materials found in residential construction reflected the following annual changes through July 2006:

Copper Pipe and Tube	+99.8%
Wire and Cable	+40.3%
PVC Products	+19.6%
Gypsum Products	+21.5%
Cement	+10.9%
Paint	+7.6%
Fabricated Steel	+7.2%
Bricks	+7.2%
Plywood	-4.7%
Softwood Lumber	-7.0%

(continued)



While lumber currently reflects some decrease in cost, it was just two short years ago when it increased nearly 30% – keeping it one of the most significant costs in home construction.

The article also cites a survey completed by Pinnacle One, a Phoenix-based company stating that on average, builders expect construction costs on their projects to increase another 11.3% in 2007, with most citing oil, gas and steel prices as the major drivers on project costs.

#### **THE IMPACT OF NATURAL DISASTERS.**

When a natural disaster such as a hurricane, earthquake or tornado strikes a region, the demand and costs of building materials tend to increase dramatically within that region. A rising demand in one section of the country creates a shortage for other parts, which directly results in a materials cost increase. As a result of hurricane Katrina in 2005, materials costs in the New Orleans area immediately increased and leveled off recently, but still remain an average 15-18% higher than before the hurricane.

#### **AS CONSTRUCTION COSTS CONTINUE TO RISE, A MAJORITY OF U.S. HOMES ARE UNDERINSURED.**

Despite rising construction costs, Marshall and Swift/Boeckh reported that 58% of U.S. homes are underinsured by an average of 21% (Marshall Swift/Boeckh September, 2006).

#### **HOW DO HOME IMPROVEMENTS OR RENOVATIONS AFFECT A HOME'S REPLACEMENT COST?**

Projects such as finishing a basement, remodeling a kitchen or adding a room can cause the actual replacement cost of a home to increase beyond what is listed on the insurance policy. However, nearly 60% of homeowners fail to notify their insurer and update coverage. *In order to ensure appropriate insurance coverage, homeowners should notify their agent or broker if substantial home improvements have been made within the past few years.*

#### **RECONSTRUCTION COSTS INCLUDE MORE THAN JUST THE BUILDING BEING REPLACED.**

The replacement cost for rebuilding a home that suffers a major loss must include the builder's profit and overhead, which averages 10-20% of the building costs or more for larger, more ornate homes. An architect's fee averages 10-15% for new construction or additions and renovations, which must also be considered. Decorating and designer fees might be as much as 20% of the total cost of construction, since custom interior designs have to be replicated. Extra fees may be included for rebuilding in urban areas or in exotic locations. With reconstruction, there is also a need to work with and match existing materials. Details of reconstruction may also require special skills, which lead to increased costs.

#### **HOW IS THE REPLACEMENT COST OF A HOME ESTIMATED TO DETERMINE THE AMOUNT OF COVERAGE NEEDED?**

Chubb's complimentary home appraisal service can help homeowners estimate the cost to rebuild a home after a covered total loss, with similar materials and craftsmanship. Chubb is the only insurer with over 200 in-house employees worldwide dedicated to appraising homes. Chubb appraisers have local expertise in or near all major markets, and we perform more than 60,000 on-site visits annually. With experience in local construction methods and pricing as well as valuation methods for custom, architecturally unique and older homes, our appraisers will estimate a home's replacement cost and make recommendations to help prevent the loss of life and property. Other insurers estimate replacement cost over the phone or via computer program – without a physical visit to the home.

#### **WHAT ARE SOME OPTIONS FOR HOMEOWNERS INSURANCE?**

Many insurers no longer offer "guaranteed" replacement cost options, or they provide the coverage at an additional premium and cap coverage at 25% more than the home's replacement cost. Unlike competitor policies, Chubb's *Masterpiece*® Deluxe House policy continues to offer an Extended Replacement Cost option (uncapped in most states), which pays to rebuild a home in a covered loss, even if the cost to do so exceeds the policy limit.

*For more information contact your Chubb marketing specialist or appraiser.*



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