Economic Uncertainty, Costs per Square Foot, and Other Insurance to Value Concerns

February 19, 2009. Sooke, BC - Concerns surrounding Insurance to Value (ITV) and the accuracy of replacement cost calculations are now greater than ever, and these renewed concerns raise a number of difficult and important questions which need to be addressed. What is the difference between component based evaluations and cost per square foot estimates, and which is more reliable? How does the current economic situation impact reconstruction costs? What changes need to be made within the calculators in order to address these concerns, and is there a simple ITV solution that satisfies the requirements of insurance companies, brokers and consumers?

Square Foot Calculations

A new trend we have seen recently is insurance companies requiring minimum costs per square foot (sq ft) on evaluations that are submitted by brokers. This raises the obvious question of why insurance companies agree to accept (or even require) evaluations at all, if they are simply going to apply a cost per sq ft. We have recently spoken with a number of insurance companies who feel that minimum cost requirements in certain areas range from $150 to $200/sq ft, and some feel the minimum is even as high as $300/sq ft.

There are a number of fundamental problems with using cost per sq ft to determine accurate replacement costs. For starters, if a company says the cost per sq ft in a certain region or province is at least $150, this implies that every home in that area is built exactly the same, which is obviously not the case. It also implies that construction costs are identical throughout the area, which is also inaccurate. Clearly the minimum costs to build in Kelowna vs. Victoria, or Calgary vs. Red Deer, or Ottawa vs. Barrie are significantly different. Even if the cost per sq ft was regionalized, it would still imply that all homes in one of those regions (ie Kelowna) are exactly the same, and cost exactly the same amount to build.

Another serious problem with the cost per sq ft model is determining exactly what square footage should be used in the calculation. Basements and garages have significant costs associated with them, however the square footage of these features is frequently ignored when calculating the average cost per sq ft for a home, suggesting that it makes no difference to the overall replacement cost of a dwelling if it has a basement or a garage. This is obviously untrue, as a 1000 sq ft one story home with an attached garage and a basement does not have the same cost per sq ft to build as a 1000 sq ft one story home with no garage or basement. Adding further confusion to this particular method of evaluation is determining what square footage should be considered if the garage was built in, attached or detached, and if the basement is finished or unfinished.

The process behind a component based evaluation involves a detailed compilation of all the individual components that go into a particular dwelling, which are then added and calculated. Lumber, plywood, insulation, electrical wire, plumbing fixtures, windows, doors and foundations are just a few components that vary from house to house, and are accurately accounted for in a component based EvalWorks calculation. The component based methodology will account for the differences between 2 homes with the same postal code, both two stories and 2000 sq ft, where one has 5 bathrooms, 10 foot ceilings, clay tile roofing and an attached garage, and the other has 2.5 bathrooms, 8 foot ceilings, asphalt roofing and a built in garage. The cost per sq ft method will not see any difference in these homes, as they are both simply 2000 sq ft homes in the same location, and therefore presumes they cost the same to build. If a home has an in-law suite, the costs associated with the additional kitchen and electrical service would also dramatically affect the cost per sq ft. Clearly, an average cost per sq ft has absolutely no way of determining an accurate cost of reconstruction for individual homes.

6868 West Coast Road, Suite 1, Sooke, B.C. V9Z 0V2
Toll Free 1.888.833.7697 Tel 250.642.0199 Fax 250.642.0299 Web www.power-soft.com

PowerSoft
Powerline Bulletin

Economic Fluctuations

With the recent economic downturn, many brokers are asking when the evaluation estimates are going to start decreasing. On the other hand, ironically, companies are requiring replacement cost evaluations to be higher and scrutinizing the evaluation process more than ever before. Our data and research shows that regardless of the media's take on the situation, construction and reconstruction costs across Canada have held relatively steady, neither increasing nor decreasing significantly in any region over the past 6-8 months.

The fear in reacting too quickly to economic variations is the possibility that the changes, whether increasing or decreasing, may be temporary. Over time, subtle changes are inevitable, but reacting to sudden, dramatic fluctuations may have a detrimental effect on replacement costs. If the economy takes a sudden sharp dip and replacement costs immediately follow, all homes evaluated during that time will be underinsured when things return to normal in the event that the downturn was temporary. This is similar to the situation in Kelowna in 2003, when construction costs skyrocketed after the wildfires. If the replacement costs generated in the months following the fires were based on the (inflated) conditions at that time, all those homes would have been overinsured after construction costs returned to normal, following the increase in workload due to the catastrophic loss. For this reason replacement cost calculators have to be aware of the difference between blips and trends when it comes to economic fluctuations.

In the past few months, some replacement cost software programs have implemented large, regionally specific increases to their products, raising questions about the accuracy of *all* the evaluation products. If a replacement cost calculator is not accurately generating values for a particular region or province, adding a blanket percentage is not an effective method of improving the accuracy. If the product isn't accurate and needs to be adjusted this way, how do we ensure that the product stays accurate in the future? How is a blanket increase supposed to accurately portray the differences in individual dwellings and the varying construction costs in different regions?

Plate-Line Analysis

The EvalWorks engine has never received (or required) adjustments outside of the monthly cost data updates, supplied to us by Stats Canada and our other data sources. As of January 1, 2009, EvalWorks data now also includes plate-line analysis from total loss data received from Canadian insurance companies.

The new plate-line analysis studies have assisted in improving the accuracy of our EvalWorks data and the replacement cost evaluations that are generated. To date, *every* total loss file that we have received, when re-calculated with EvalWorks in the same month as the loss, has been within 10% of the amount the insurance company paid out on the loss. That is not to say that the homes weren't underinsured at the time of the loss, as many times an evaluation was last performed two or more years prior to the loss and subsequently the payout on the loss was higher than the evaluation amount. In the situations where this has occurred, we have completed a re-evaluation of the total loss using the cost data from the same month that the loss occurred, and EvalWorks has been within 10% of the actual loss payout. This leads us to believe that the ITV problem is more likely caused by the infrequency of re-evaluations and/or the annual inflation factors applied by insurance companies being far too low.

The January 2009 EvalWorks update, incorporating plate-line analysis and insurance company total loss data, has allowed EvalWorks to be more in line with company expectations. By integrating total loss data with our existing component based cost data, we have been able to take actual loss experiences into consideration, making EvalWorks even more accurate. We hope to receive more loss files from companies in the future so we can continue to include actual loss experience in our EvalWorks calculations.

PowerSoft

6868 West Coast Road, Suite 1, Sooke, B.C. V9Z 0V2

Toll Free 1.888.833.7697 Tel 250.642.0199 Fax 250.642.0299 Web www.power-soft.com

Is There a Solution?

We believe that there is a relatively simple solution to the Insurance To Value issue that is causing so much concern for consumers, brokers and companies across Canada. PowerSoft has suggested that an impartial and independent third party, such as the IBAC or IBC should collect all the total loss files from every insurance company across Canada. The details of those losses could then be forwarded to each of the replacement cost providers throughout the year, allowing the providers to continue including actual loss experiences in the calculations. At the end of each year, a batch of losses could be provided where the payout amounts would be withheld from the providers in order to test the accuracy of each replacement cost tool. The replacement cost providers would supply evaluations on those losses back to the independent third party, who in turn could publish the results and compare the evaluation estimates from each provider to the actual amount that was paid out on each loss. We are not referring to an appraiser's estimate of what it *might* cost, but the actual payout on the loss after reconstruction is completed. A case study like this completed on an annual basis would provide a good opportunity to ensure each calculator is accurately utilizing the loss data being provided throughout the year, and the entire industry could see how the individual evaluation programs stack up against actual losses and make a determination on which products are acceptable.

Along with the new plate-line analysis, PowerSoft's EvalWorks engine is unique in a number of ways, offering exclusive features to the Canadian Insurance Industry:

- EvalWorks is owned, developed, sold and supported in Canada, utilizing 100% Canadian data, specifically designed for the Canadian Insurance Industry. There is no contractor terminology and no ability remove, manipulate or override costs that are required in the reconstruction of every total loss such as foundations, labour, and overhead and profit.

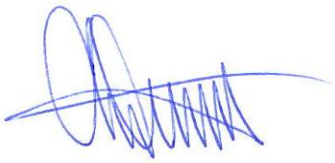
- EvalWorks considers complete material costs, local labour costs, debris removal and overhead and profit in *every* evaluation, specific to each individual house and location.

- PowerSoft has implemented a monthly cost data update schedule and an automatic update service to keep pace with changing reconstruction costs.

- PowerSoft will continue to provide both desktop and web-based evaluation products so that brokers across Canada will have access to evaluation products based on their technology needs.

If you have any questions about EvalWorks or any PowerSoft replacement cost program, please do not hesitate to contact PowerSoft at 1.888.833.7697 or visit our website at www.power-soft.com

Best regards,



Chris Lang
President and CFO

Email : clang@power-soft.com

Chris Dunn
Director, Sales and Customer Service

Email: cdunn@power-soft.com