

# Real Estate Valuation in Insurances – Know the Hows and Whys

Cromwell MANALOTO, Italy

**Key words:** real estate, valuation, insurance, claims, damages

## SUMMARY

Your house. Your home. Your investment.

The epitome of any real-estate investment is definitely your first-bought house. In fact, it is also the most expensive. So to say, any new proprietor focuses on how to secure and protect his new asset. It is his primary concern to find an adequate insurance policy that would first and foremost safeguard his investment against accidental events and damages, and of course, would privilege his right for compensation.

To address this need, most banks nowadays, offer a conventional insurance policy alongside mortgage plans. Other insurance products are also available to give a client major tranquility. Additional options can be included to suit the need of the proprietor.

This report focuses on the different methods of valuation of real estate valuation, mostly residential and especially those primarily used by insurance agents and claims adjusters. These techniques are the monoparametric comparative evaluation and cost-approach method. We will also talk about what are the factors that influence a real estate market value, determines the increase of value with respect to the concept of "ordinary" or, in some cases, a sensible decrease.

## SUMMARY (Italian)

La casa è forse il bene materiale più prezioso che un proprietario possenga. Infatti, lo è anche il più costoso. E la prima preoccupazione quindi di un nuovo acquirente è come proteggere tale investimento da qualsiasi evento accidentale e qualora necessario, far valere i suoi diritti al risarcimento.

Per far fronte a questa necessità, tutte le banche dalle quali un cliente si rivolga onde chiedere un mutuo, stipulano un'assicurazione convenzionata per il fabbricato/i da acquisire. Anche se si tratta di una copertura assicurativa basilare, il proprietario ha una tranquillità e può sentirsi protetto.

Ovviamente, uno è libero ad integrare questa "sicurezza" tramite altri prodotti assicurativi idealizzati a rispondere ai propri bisogni.

Questa relazione focalizza sulle diverse metodologie di valutazione degli immobili soprattutto quelle principalmente utilizzate dai periti di parte e/o assicurativi. Queste sono la valutazione monoparametrica e il cost-approach method (costo di ricostruzione deprezzato). Verranno illustrate quali sono le caratteristiche che influiscono sul valore del mercato, ne determina l'incremento del valore relativamente al concetto di "ordinarietà" oppure, in certi casi, anche la diminuzione del valore.

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## 1. INTRODUCTION

Recent studies show that Italy is among the first in Europe for number of homes owned. However, only a few consider investing on a better security, for example, an adequate insurance policy to respond to any accidental occurrence.

But how can we say that an insurance policy has an adequate insurance coverage?

The first thing to consider, of course is the property that we want to insure. It depends primarily on a proper assessment of the value of the property, its intrinsic and extrinsic characteristics, in its maintenance and condition at the time of valuation, whether or not the real estate market is active and its location.

In the next chapters, we will discuss various estimative procedures that are commonly used in Italy, especially in the insurance field. We will also go over the current Italian real estate situation and some illustrative examples.

## 2. ITALY AND THE REAL ESTATE MARKET

The view of the real estate appraisal in our country seems to differentiate from that of other countries for two closely related conditions: the first, which relates to the “weighting” of conventional estimate done by the government with respect to current market estimates. While the other circumstance relates to the difficulty of acquiring actual market prices.

In Italy, the three common valuation methods are the market approach, cost approach and income approach. Unfortunately, all of the three methods also suffer from major lags. For example, market approach method faces shortage, or worse, absence of complete real estate information such as recent and exact contracted prices and specific characteristics that influence these prices.

Cost approach, on the other hand, suffer from shortages and often with lack of cost data related to the costs applied by most constructors; while the income approach needs to deal with conflicting information about different rent levels, rent values and capitalization rate.

The applicability of the market cost approach is limited by the lack of availability of market data and the absence of bank archive relating to real estate data, from which we can use in studying different valuation cases. The use of market cost approach is further hindered by the widespread lack of preparedness of the new valuers because of improper use of these instruments and the absence of a specialized training.

The cost approach is often applied inappropriately to estimate the price of ordinary property, for which no data are available for comparison. Its principal scope is the valuation of special properties and secondary properties without an active market. The procedure is used in the estimates based on historical cost accounting. It is also mainly used in claims adjustments in estimating building damages.

The income approach is often deprived of the extent of its potential profitability of real estate investments, and made insignificant with the determination of income to be capitalized through a synthetic process and the standard reduction of operating costs.

In Italy, the term “ordinary destination” refers to the most frequent use in a given market, this destination is considered mainly for the purpose of evaluation, in the sense that there are not considered other possible less frequent destinations (so to say “not ordinary”).

In the case wherein two or more destinations for the property are present, the valuation should not limit itself from considering any other alternative destination, particularly, the one that assures the property its “high and best use.”

The consideration of high and best use is, in fact, essential in real estate investment choices.

At the present, estimates in Italy take the first steps towards analyzing estimation standard, which directs towards the three classical approaches to estimate real estate in their many variations.

The estimation procedures currently applied in our country are classified into synthetic estimation procedures (or direct) and analytical estimation procedure (or income capitalization). Other processes are considered separately, such as the estimate by merits. Some estimation criteria are used as actual estimate procedures in professional practice, such as the appraisal by transformation. This methodological framework is largely the result of the lack of quantitative studies on the housing market. For these reasons, it uses empirical criteria, data summaries and simplified procedures based on theoretical and methodological assumptions.

These empirical judgments do not follow formal related schemes and often does not follow rules of thumb. An expert relies primarily to his/her expertise and experience gained in the professional field. These circumstances mean that are many practical cases presenting in its empirical form, or in some cases, through indications or suggestions that the estimation methodology matures in time with extensive practice. These procedures usually have a limited scope, often providing easy and credible statements.

Synthetic estimation method applied in the prediction of the market price of the properties are: the monoparametric comparison and the estimates by typical values (stima per valori tipici), also called by merits or construction elements. Both valuation techniques intersect in different ways, giving way to informal solutions and derived procedures. Moreover, both processes may refer to the complex reality of the present real estate market.

Conventional estimation procedures are also used throughout the country and are widely applied in tax, legal and administrative assessments of building properties.

### **3. BUILDING:**

Most Insurance companies operating in Italy define “Building” as “complex construction works that constitute the entire building, or a housing unit, situated in the indicated address or location in the policy and used as a civil homes, offices or professional studio. This excludes, however, the lot where is constructed. Moreover, a “building” includes fixtures and fitting, foundation works or underground, dependencies (garage), fences and gates, boundary and garden walls, swimming pools, paints, upholstery, carpets, lifts and elevators, electrical plumbing and sanitary systems, heating and air conditioning and independent boilers heating and/or production of hot water and self-conditioning systems, given that they are all permanently fixed and installed, and any other installation that can be considered fixed and in service to the building (even the ones owned by private service providers), decorations that have no artistic value, aerial and satellite dish and centralized

radio and TV antenna.

#### **4. THE INSURED VALUE OF THE BUILDING PROPERTY**

Italy is among the first in Europe for number of homes owned, but despite the propensity of Italians to buy the house, only 38% of the owners ensures the house. In our country there is indeed a tendency to underestimate the risks related to housing and very often do not even know the content and the possibilities of home insurance policies.

The article 1908 of the Italian Civil Code states that in assessing the damage, the damaged property cannot be attributed a value higher than it had at the time of the accident.

The value of the insured good may be established in advance or at the time that a previous contract concludes. The estimate should be included in the insurance policy with an agreement clause between the interested parties (the insurance company and the client). Attaching a copy of the valuation report is an option for both but doing so renders the estimate a binding contract.

The policy, however, may be subject to appeal only for some specific causes such as, vices in the clauses, vice of consent, and simulation.

For the sole purpose of insurance, the replacement value of the building is obtained by estimating the amount needed to rebuild it, excluding the value of the land (area). If the building is constructed in whole or in part with non-typical materials, the valuation, as a rule, is carried out on the basis of the cost of new construction, with the use of current equivalent materials in use.

Particularly, the value of the building at the time of the accident is obtained by applying to a raw estimate, a depreciation (usually expressed in percentage) calculated in relation with its age, its state of preservation, its construction era, its location, its use, and any other possible circumstances.

For this reason, damage value is determined by estimating the amount needed to rebuild the new parts or to repair the destroyed and damaged ones, subtracting from this result, the residual value.

Most insurance agents and claims adjusters resort to “Monoparametric Valuation” and “Cost Approach Method” as quick tools to appraise a property, calculate damages and useful in comparing a property’s insured value and its preexisting value.

##### **4.1 The Monoparametric Valuation**

In real estate valuation, the synthetic methods of estimation are usually based on market surveys, covering the market prices of real estate and commercial space. The main synthetic procedure estimate is based on the choice of a single parameter of comparison, instead of a utilizing a multitude of features. The most common consistencies or parameters used in this kind of valuation are the floor area, volume and per unit space.

The Monoparametric Valuation is largely based on a single parameter and an end-report in order to give an estimated value.

In mathematical terms, the estimated value is given by the following equation:

$$V = P \times S$$

Wherein:

V = estimated value of the property;

P = (parameter) actual mean market price per unit of consistency (sqm, cu.m, etc...);

S = consistency of the property dimension

The mean unit price is no other than an average price calculated by collecting n-numbers of readily available real estate market prices. So to say, it is the ratio between the sum of the total prices and the sum of the relative consistencies (parameters).

Furthermore, parameters can either be a technical parameter (floor area, volume, per unit space, commercial area) or an economic parameter (rent per sqm, cost per sqm).

The average price published in specialized real estate publications can be also used as the mean unit price.

Monoparametric Valuation follows a five-step procedure, which is:

- Identification and analysis of the property to be estimated;
- Market analysis;
- Data collection;
- Mean unit price calculation;
- Valuation, adjustments and conclusion/s.

#### **4.2 Cost Approach Method: The Concept of Damage and Loss Adjustments:**

Most companies defines accidental damage as the damage received by the property, caused suddenly by an external means and does not include damages resulting from wear and tear.

The determination of the damage is done separately for each category of the insurance policy. While the allocation of the value of the insured properties had at the time of the “sinistro” or accident, whether they are unharmed or destroyed, is obtained using the following criteria:

- a) For real-estate and buildings, estimation is done by estimating the total reconstruction cost of a similar building and excluding land value;
- b) For the contents, they are calculated with the replacement cost of a new or similar objects minus the depreciation value estimated on the type, quality, functionality, performance, maintenance and any other concurrent circumstances. For objects with artistic or historical values, their market value are taken in considered.

At the same time, the amount of damage can be determined:

- a) for buildings, estimating the cost to rebuild in the new parts or to repair the destroyed parts, without taking into account the demolition cost and removal of residues and subtracting the value of reusable parts.
- b) for the content of the home, insurance damage is calculated by deducting from the value that the insured property had at the time of the accident, the value of what remains at the time of the accident.
- c) with regards to glass and crystal, the total damage is given by deducting from their replacement cost, including labor, the value of recoveries, within the limit or the maximum refundable amount.

One notable form present in Italy of a valuation by cost approach is the so-called “Computo Metrico Estimativo.” This document considers both average regional or territorial prices for each phase of work and is one of the requested documents by banks for mortgages or small loans.

## 5. EXAMPLE

*(Omitted due to length and diagrams, it will be presented, however, in the TS)*

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## BIOGRAPHICAL NOTES

Geom. Cromwell Manaloto is a young Italian Surveyor of Filipino ancestry. He's a freelance surveyor, currently working as Loss/Claims Adjuster for different home and building insurance (and reinsurances) companies.

At the same time, he focuses also on Project Site Management as junior collaborator and patrimonial division for succession.

He's enlisted in the Provincial College of Surveyors of Ascoli Piceno e Consiglio Nazionale Geometri (National Council of Surveyors – Italy)

## CONTACTS

Geom. Cromwell Manaloto  
Consiglio Nazionale Geometri e Geometri Laureati  
Via Gabriele D'Annunzio 7  
Colli del Tronto (AP)  
ITALY  
Tel. + 349/1610645  
Email: [cromwell.manaloto@libero.it](mailto:cromwell.manaloto@libero.it);