Editor's Note: At a recent conference, Fannie Mae's Mark Simpson, Director Property Standards, Single-Family Credit, shared how insurance industry changes offer appraisers a new opportunity to provide lenders with an additional service: replacement cost data. The data is used to determine an appropriate level of hazard insurance for Fannie loans. Fannie requires hazard insurance that settles on a replacement cost basis. For the most part, insurers are not providing this information any longer, leaving appraisers an opportunity to furnish the data to lenders using the Cost Approach.

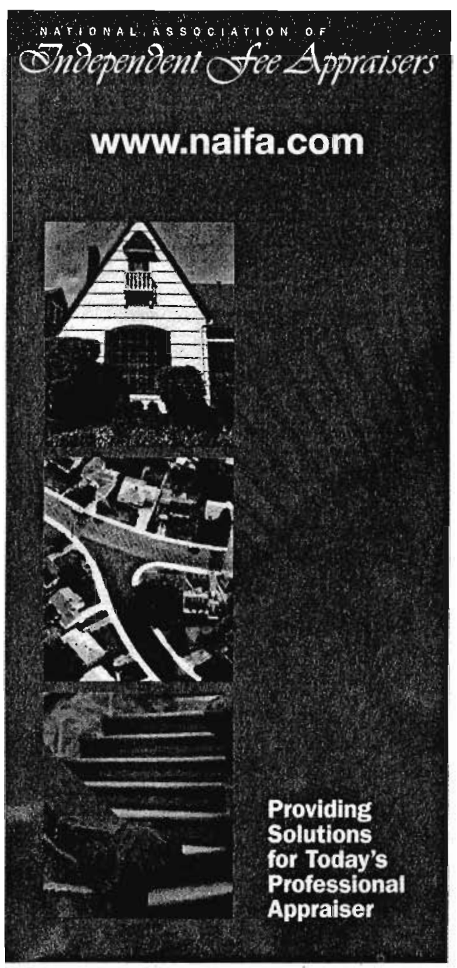
The definition of "replacement cost" is not the same for appraisal and insurance purposes, however. Below is a replacement cost "primer" from Marshall & Swift that details the differences. A recent Q&A issued by Fannie Mae offers the following guidance to lenders and helps explain why the expert hand of appraisers is still needed: "It is not appropriate for the lender simply to subtract the reported site or land value from the appraised value of the property to make that determination because that result is an estimate of the depreciated value of the improvements, not an estimate of their replacement cost." You'll find the complete Fannie Mae Q&A at *www.workingre.com*.

OREP members and WRE subscribers enjoy 10 percent off their first replacement cost report from Marshall and Swift using their new service:*www.accucoverage.com*. Members/WRE Subscribers, please email *info@orep.org* to request the M&S coupon code.

New Niche: Understanding Replacement Cost

By Gretchen Gary

Both cost approach appraisals and insurance policies use the term "replacement cost." While the term is the same what they define is quite different.



When using the cost approach, the appraiser must first identify the appropriate cost basis for the assignment and determine if the opinion of value would be represented best by the replacement cost or the reproduction cost.

While replacement cost details the cost to replace the existing structure with a substitute of "like kind" or "equal utility," using current standards of materials and design, reproduction cost is the cost to construct an exact replica in all salient characteristics of the subject property.

In general, most every cost approach appraisal features the property's estimated replacement cost new, which is adjusted to account for depreciation and land value. The common appraisal equation is as follows: replacement cost of building and other improvements minus depreciation plus land value equals replacement cost new.

Reproduction cost, far less common in modern appraisal, is closer in definition to the replacement cost represented on the insurance policy.

Insurance Replacement Cost

What is replacement cost as it applies to the insurance policy? Recommended over actual cash value, replacement cost coverage insures a home for the estimated cost to reconstruct an exact duplicate or replica of the building at current prices. The costs assume use of like kind and quality materials, construction standards, design, layout and quality of workmanship.

To clarify what the cost implies, the insurable replacement cost is better explained as reconstruction cost. Also worth mentioning, the replacement cost on an insurance policy need not account for depreciation or land value, as does the replacement cost estimate of a cost approach appraisal. After all, in the event of a total loss, depreciation and land value have no influence on the cost to reconstruct a replica of the lost structure. And depending on the local market, reconstruction cost could be more or less than the current market value of the structure.

The following are included in replacement cost new (as defined in the appraisal):

Plans, specifications, surveys and building permits; material and labor costs, including all appropriate local, provincial and federal sales taxes; normal site preparation, including finish, grading and excavation for foundation and backfill for the structures only; utilities from structure to lot line figured for typical setback (not included with mobile or manufactured

page 26, bottom ▸▸

Gretchen Gary is the Copywriter with Marshall & Swift, the leading provider of building cost data and widely recognized authority on the cost approach.

◂◂ Diversify, page 25

for a single family residence, with the average nationwide at $250-$350. Many use software that allows them to complete and issue the report onsite, with none of the time-consuming research and writing involved in assembling an appraisal report.

Home inspectors don't face the relentless pressure for values and speed either, though some report losing agent referrals when a deal is blown, due to problems revealed in the inspection. Generally, inspectors are considered the "good guy" of the transaction because their homebuyer-clients *want* to know what's wrong.

Liability

One downside of inspecting is the increased liability and cost for errors and omissions insurance—about two to three times more than appraisers pay. While it is fairly rare for an appraiser to be sued, this is not the case for inspectors, who are often squeezed by clients when something goes wrong, especially if the inspector does not establish reasonable expectations or communicate his or her findings clearly in the report. If not set straight in advance, homeowners feel they are buying a warranty, not an inspection, and blame the inspector for anything that goes wrong– even months later.

Proper training on how to inspect and how to report, a solid report and a tested pre-inspection agreement are all important tools to lower liability, which is another reason to seek good training and support.

Beginning inspectors can purchase E&O coverage through OREP for under $2,000. (For rates and more, see page CL3.) You'll find the most respected home inspection training facilities in these pages.

As for Shevlin, he is so busy he has hired and is training a home inspector to help carry the work load. Following in his footsteps, the new inspector has completed the basic appraisal coursework and is on the road to becoming licensed.

Shevlin says there is one drawback. "I've been so busy my family doesn't know me anymore," he said.

You'll find the finest schools specializing in training and support in these pages, including ITA (page CL2) and TWI (page 30). Many offer OREP members and *Working RE* Magazine subscribers reduced fees on training and products. **WRE**

◂◂ New Niche page 22

homes); contractors' overhead and profit; depreciation; estimated land value.

The following are included in replacement/reconstruction cost (as defined in the insurance policy): All the above mentioned inclusive of replacement cost new, except for depreciation and land value; current building codes; reuse of building components or mechanical systems below grade level; loss of economies of scale associated with new construction; extra costs due to site accessibility; higher labor costs and premium prices for materials; extraordinary fees and other contingencies. **WRE**

FIND RELATED STORIES ONLINE

at *www.workingre.com*, including: Cost Approach: Why Sidestepping it Can be Costly (click premium content).