Property Insurance: Coinsurance

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"Don't Let Me Be Misunderstood"

~Song written by Bennie Benjamin, Gloria Caldwell, and Sol Marcus, first recorded in 1964 by singer/pianist Nina Simone

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Let's play Coinsurance Quiz. Answer true or false to the following statements:

- Coinsurance is a condition that may be found in more than one type of insurance policy.
- The need for a coinsurance provision in all insurance policies is the same.
- The use of a coinsurance provision in an insurance policy is universally understood.

The answers are true, false, and false. How did you do?

Coinsurance clauses are found in many insurance policies, such as commercial property, dwelling forms, homeowners, federal flood, health insurance, and at times even directors and officers liability policies. But, while the clause or requirement is called "coinsurance" in each type of policy, the use and effect on the insured may be very different. The coinsurance requirement in a property insurance policy may become a significant reason for insurance recovery that is less than the insured expected. This is why a risk management professional should hear the melody of "Don't Let Me Be Misunderstood" (http://www.youtube.com/watch?v=9ckv6-yhnIY) whenever the term "coinsurance" is discussed in any insurance policy, especially any form of property insurance.

Coinsurance Concept

Coinsurance requirements differ by insurance policy type to reflect the insurer's and/or insured's specific need. In health insurance, it may be used as a means of risk sharing between insured and insurer as a means to lower the insured's monthly premium cost. For example, covered expenses above the deductible may be shared 80 percent insurer/20 percent insured until a policy-stated total is reached. If the total was $2,500, then the insurer would assume $2,000 (80 percent of $2,500), while the insured's portion would be $500 (20 percent of $2,500). This arrangement is sometimes referred to as a "corridor deductible."

In a directors and officers liability policy, the insurer may use it as a risk sharing technique to get "skin in the game" from the insured organization and/or director and/or officer. It may be used to reduce the annual cost of the policy, an arrangement that is similar to that used in health insurance.

Coinsurance in property insurance is a means for insurers to obtain rate and premium equality. Property insurers must have a standard in which to apply expected losses based on past loss experience over an entire underwriting book. This is accomplished by getting the exposure base (total insured value for building, contents, and business income) on a common basis for all property insurance insureds: replacement cost, actual cash value, and actual loss sustained. Rates are applied against a specified percentage (100, 90, or 80 percent, for example) of the value to the insured: building, contents, or business income. Rate deviations are applied against the base (manual) rate to reflect size of deductible, construction, occupancy, and loss control standards.

A "coinsurance" condition in a property insurance policy is analogous to the need for a standard definition of "payroll" to compute workers compensation premium. All workers compensation insurers use the same "payroll" definition established by workers compensation rating bureaus such as the National Council on Compensation Insurance. This way, all workers compensation insureds report their insurable exposure (payroll) on the same basis. This allows an insurer to start its premium rating basis on an equal basis for all of its insureds—expected losses can be applied to develop a payroll rate. Rate deviations are then applied to reflect deductible (if any), premium discount, and other factors, including adequacy of loss control (rate credit or debit).

How It Works

Property coinsurance clauses may differ by insurer, especially if using an independently filed policy form, although coverage intent may be the same. The examples used in this article are based on current Insurance Services Office, Inc. (ISO), policy forms. The reader is cautioned to read the property insurance policy to ensure that the coinsurance clause is the same as that *expected* and *understood* by the insured and the broker/agent.

Direct Damage: Commercial Insurance

First, the insured must set the direct damage coverage limit, which is based on how loss is to be settled: replacement cost or actual cash value (replacement cost less depreciation equals actual cash value). Next, the coinsurance percentage for building and contents must be determined since coinsurance requirements start at 100 percent and provide the greatest rate credit at this percentage of limit to value, but the insurer may allow the insured to go as low as 80 percent. The best way to establish insurable value is by use of a recent appraisal of the building and/or contents or by use of a prior appraisal that can be brought current (trended) through inflation factors provided by the appraiser or the insurer. A "guestimate" process may not provide the accuracy needed to establish credible value and the insured limit, which may result in a coinsurance penalty, as will be explained later.

To settle a loss, the insurer will compare the policy limit (depending on the actual policy, it may be a location-specific limit for building or contents) to the minimum limit required by the coinsurance clause. The formula is fairly simple.

{Amount of Loss x (Limit of Insurance/Limits of Insurance required)} -deductible = Loss Recovery

Example: Direct Damage

An insured owns a 25,000 square foot building that is 10 years old. He asks the builder to give him an estimate of what it would cost in 2012 to build the same structure from the ground up. He is told $80/square foot for total estimated replacement cost of $2 million. He decides to insure the building to 90 percent of its estimated replacement cost value.

Scenario 1. A few months into the policy year, the building suffers a substantial fire loss, and the insured files a claim for $800,000. What is the insurance recovery after a $5,000 deductible?

The replacement value of the building as determined by independent appraisal	$2,100,000
Co-insurance requirement	90%
The co-insurance limit (insured value to insured limit)	$1,890,000
Insured limit	$2,000,000
Limit satisfies co-insurance minimum limit	Yes
Reported loss	$800,000
Less co-insurance penalty: ($2,000,000/$2,160,000)	$0
Gross Loss subject to insurance recovery	$800,000
Less Deductible	($5,000)
Net insurance recovery	$795,000

Scenario 2. The insured decided at each renewal since 2012 that his building can remain insured for $2 million. The loss settlement clause remains replacement cost. The insured does not seek any independent counsel on the building's estimated replacement cost in 2016. The building is damaged by fire in mid-2016, and repairs total $500,000. The replacement cost of the building is determined to be $2.4 million. What is the insurance recovery after a $5,000 deductible?

The replacement value of the building as determined by independent appraisal	$2,400,000
Co-insurance requirement	90%
The co-insurance limit (insured value to insured limit)	$2,160,000
Insured limit	$2,000,000
Limit satisfies co-insurance minimum limit	No
Reported loss	$500,000
Less co-insurance penalty: ($2,000,000/$2,160,000)	.926
Gross Loss subject to insurance recovery	$463,000
Less Deductible	($5,000)
Net insurance recovery	$458,000

Scenario 3. The insured decided at each renewal since 2012 that his building can remain insured for $2 million. The loss settlement clause remains replacement cost. The insured does not seek any independent counsel on the building's estimated replacement cost in 2016. The building has a fire in mid-2016, and the building is a total loss. The replacement cost of the building is determined to be $2.4 million. What is the insurance recovery after a $5,000 deductible?

The replacement value of the building as determined by independent appraisal	$2,400,000
Co-insurance requirement	90%
The co-insurance limit (insured value to insured limit)	$2,160,000
Insured limit	$2,000,000
Limit satisfies co-insurance minimum limit	No
Reported loss	$2,400,000
Less co-insurance penalty: ($2,000,000/$2,160,000)	.926
Gross Loss subject to insurance recovery (*)	$2,000,000
Less Deductible	($5,000)
Net insurance recovery	$1,995,000

(*) Why is the gross insurance recovery $2,000,000 and no co-insurance penalty? Because the maximum the insured can receive for any covered loss is the policy limit which in this example is $2,000,000. The insured is "penalized" in this insurance recovery for $400,000 since the actual loss exceeded the purchased coverage limit by this amount.

Business Income: Commercial Insurance

The process to establish the coinsurance minimum limit for business income is more complicated than that used for building and contents direct damage. The reason is that the insured must determine net income and operating expense expected for the policy year and then deduct operating expenses that would not be expected to continue during the period of interruption (prepaid freight for outgoing shipments, cost of materials that would otherwise be consumed during the manufacturing process, power that is not consumed, ordinary payroll if it is not to be continued, etc.).

Extra expense coverage is not subject to a coinsurance clause. An insured can ask an insurer to quote any limit that is deemed appropriate. Extra expense coverage when offered as coverage separate from business income may contain certain percentages such as 40/80/100 percent. These percentages are not coinsurance but a means to limit the payout of the coverage: up to 40 percent for the first month of recovery; up to 80 percent for the next month of recovery; and no more than 100 percent for the final month of recovery. It is important for the risk management professional to review any percentage used in extra expense coverage to ensure that the coverage provided meets the extra expense needs of the insured.

Example: Business Income

A manufacturer completed a business income work sheet for the recent policy period based on operating 240 days per year (after plant summer shutdown and usual employee paid holidays). The annual business income value is $8 million with an 80 percent coinsurance clause. The insured limit is $6.4 million, excludes ordinary payroll, and is subject to a one daily average value (ADV) deductible.

Scenario 1. A fire occurs and damages key equipment, and the plant must shut down for 3 months. A business income claim of $2.7 million is filed with the property insurer. What is the net insurance recovery after the deductible?

Actual net income and operating expense for 12 months	$7,900,000
Co-insurance requirement	80%
The co-insurance limit	$6,320,000
Insured limit	$6,400,000
Limit satisfies co-insurance minimum limit	Yes
Reported loss	$2,700,000
Less co-insurance penalty:	None
Gross Loss subject to insurance recovery	$2,700,000
Less Deductible-1ADV ($7,900,000/240)	($32,917)
Net insurance recovery	$2,667,083

Scenario 2. Three months after renewal, the company lands three large contracts, and net income surges to an additional $3 million in the past 5 months. A fire occurs and damages key equipment, and the plant must shut down for 3 months. A business income claim of $2.7 million is filed with the property insurer. What is the net insurance recovery after the deductible?

Actual net income and operating expense for 12 months	$10,900,000
Co-insurance requirement	80%
The co-insurance limit	$8,720,000
Insured limit	$6,400,000
Limit satisfies co-insurance minimum limit	No
Reported loss	$2,700,000
Less co-insurance penalty: ($6,400,000/$8,720,000)	.734
Gross Loss subject to insurance recovery	$1,981,800
Less Deductible-1ADV ($10,900,000/240)	($45,417)
Net insurance recovery	$1,936,383

Coinsurance issues can occur quickly if an organization experiences net profit growth that had not been expected at the time the business income work sheet was completed. This is what happened in Scenario 2. The risk management professional should compare actual net income to that forecast for the policy year on a regular basis.

Commercial Insurance Coinsurance Tools

A property insurer may waive the coinsurance requirements of the policy if requested by the insured and if the insurer believes the limit to be purchased is sufficient. This is often done by use of an agreed amount endorsement where the insurer will waive coinsurance for the policy coverage period. Sometimes insurers will provide an inflation guard endorsement to the policy in which the building and/or contents limit is increased a certain percentage at each renewal. Educating an insured on how coinsurance works may result in better selection of insured limits and lessen the potential for an errors and omissions claim again the agent or broker.

Homeowners Insurance (HO 2 and HO 3)

Some insureds may be surprised to learn that a homeowners policy, especially if based on ISO policy forms, has a coinsurance clause that can impact coverage. In ISO forms, if the damaged home is 80 percent or more of the full replacement cost, then replacement cost valuation will be used subject to the lesser of policy limit or repair or replacement cost. If the insured home fails the 80 percent coinsurance requirement, then loss is settled on actual cash value.

National Flood Insurance Program (NFIP)

The NFIP Dwelling Form (ed. 5/08) provides replacement cost valuation if the dwelling is the insured's principal residence and either the amount of insurance is at least 80 percent of the actual replacement cost value prior to loss or the coverage limit is the maximum amount available from the NFIP.

Conclusion

The concept and use of coinsurance in property insurance should not be difficult to understand if the risk management professional takes time to read a property insurance policy. The ISO commercial property and business income forms include actual examples of how coinsurance applies when the insurance is adequate and not adequate. The risk management professional needs to understand and point out to insureds that even an HO form and NFIP dwelling form have coinsurance requirements that can affect coverage. To paraphrase the song performed by Ms. Simone, "... coinsurance don't be misunderstood."

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