Detailed Description of Co-Insurance

In order to better understand the importance of co-insurance it helps to understand the point behind it. Co-insurance is used on property policies as a way for insurance companies to charge adequate premiums for each insured loss.

If an insured were to have a building that would cost $500,0000 to rebuild and he only insured the home for $200,000 the insurance company would not be collecting enough premium to be able to rebuild the home. In this example of a total loss, luckily for the insurance company, they wouldn’t have to. The insured is always capped by policy limits, so if an insured opted to only insure their $500,000 value\* home for $200,000 then $200,000 is what the insurance company pays for that total loss.

But what about a partial loss?

Would the insurance company have enough premium collected in this same example ($500,000 value with a $200,000 limit) to pay for partial losses. No, not if all insureds were allowed to insure their home for under 50% of its replacement value. Thus, the importance of co-insurance.

The Co-Insurance or insurance to value clause requires the insured carry a specified percentage (typically 80%, but could be 90% or 100%) of their actual building value. This ensures that the carrier will be able to collect enough premium to pay for any potential partial losses and does allow the insured to save on premium dollars, by not having to necessarily insure to the full value.

So for a home valued at $500,000 with the standard 80% co-insurance clause, the home should be insured for at least $400,000 (500,000 x 80%).

Let’s continue using the insured limit of $200,000 and now this client has a water damage loss in his master bath. He suffers $24,000 in damages to rebuild. Yes, his $200,000 limit would easily be enough to cover this loss, but we use the co-insurance formula to determine his eligibility to have the full partial loss paid.

The co-insurance formula states that if you are not insured to value we will pay only a proportion of the cost based on the value of what your limit of insurance was compared to what it should have been. We calculate the co-insurance as:

(What limit of insurance you did carry/What limit of insurance you should have carried) x The actual partial loss = Your loss payment

($200,000/$400,000) x 24,000 = 12,000.

The insured should have carried $400,000 to meet their co-insurance condition, but by carrying only $200,000 they were only at 50% of their required limit, so the policy only pays 50% of their actual loss.

If this had been an insurance to value condition and not a strict co-insurance condition, we would offer an additional loss settlement to the insured. With an insurance to value revision the insured with a partial loss is eligible for the greater of:

* The amount determined by the co-insurance formula
* The actual cash value of the damaged property

So in this example, if the damaged portion of the building building (floor coverings, floor joists, molding and wall for example) had a value of $18,000. The insurance company would pay $18,000 instead of the $12,000.

\*The term value in insurance context here means the replacement/rebuild cost of the home. Carriers use replacement cost estimates based on the unique features of the home to help the insured determine their replacement cost value.