THE ULTIMATE GUIDE TO UNDERSTANDING COINSURANCE

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Coinsurance Clause and How It Works

INTRODUCTION

Coinsurance provides a carrot and stick approach to encourage insureds to carry adequate insurance to value.

First, the insured receives a substantial premium credit if the insured purchases adequate insurance.

Second, if, at the time of loss, the amount of insurance on the policy doesn’t meet the minimum amount of insurance required, the loss settlement is significantly reduced.

All property rates are built with a credit for the insured carrying a minimum of 80% to value.

An additional rate credit applies if the insured agrees to subject itself to 90% or 100% coinsurance.

On the other hand, the rate is surcharged if an insured decides not to submit to the coinsurance condition.

As a further incentive, certain property extensions in the coverage form or policy apply only if the insured selects the coinsurance condition.

Because promises are easy to make and difficult to keep, the insured must incur a penalty when the upfront promise, for which the insured received premium credit, is not kept.

HOW TO EXPLAIN COINSURANCE TO AN INSURED

The insured may find understanding coinsurance difficult. In that case, the following explanation might help.

Insurance policies are promises of utmost good faith. The insured believes the insurance company will keep its promise in return for the premium paid. The insurance company believes the insured has been honest with the information provided on the application. The premium the insured pays is based on statements made on the application. When a promise is made, there must be consequences when it is broken.

The property premium is calculated using the limits supplied with the understanding that they are accurate. If they are not, the premium is not sufficient. If enough insureds misrepresent their values, the insurance company does not collect enough in premiums to keep its promises to pay. Rather than voiding a policy because of inadequate values, the insurance company chooses only to penalize the insured and essentially say, “Because you didn’t keep your part of the bargain, we will honor only part of ours.”

THREE SPECIFIC TYPES OF COINSURANCE

Three specific types of information are needed to determine if a coinsurance penalty applies:

- The value of the covered property *at the time of loss*

Note: The covered property's value as of the inception date is irrelevant.

Example: The Bailey Hardware property coverage form insures stock and other business personal property. On the inception date, the value is $75,000. However, Bailey knows that their values fluctuate over the year and selects a limit of $90,000 with 80% coinsurance in anticipation of increased values. At the time of a fire three months into the policy term, the total value of stock and other business personal property is $125,000. The fire loss is $50,000. The value used to determine if the coinsurance penalty applies is the $125,000 value at the time of loss, not the $75,000 value as of the inception date.

- The coinsurance percentage selected

As stated above, the coinsurance percentages available are 80%, 90%, or 100%. In some cases, the insured can select no coinsurance but doing so requires a rate surcharge instead of a credit. There is no surcharge or credit for 80% coinsurance because that is the coinsurance percentage used to develop loss costs. 90% coinsurance receives an additional 5% credit while 100% coinsurance receives an additional 10% credit.

- The limit of insurance does not have to be the value multiplied by the coinsurance percentage.

The limit of insurance should reflect the maximum expected value of the covered property during the policy period. The insured should consider writing coverage on a reporting form basis or use the peak season endorsement if significant fluctuations in value are likely or if values peak at specific times.

Related Articles:

Value Reporting Form Peak Season Coverage

The insured may insure for the 100% value but write the coverage at 80% coinsurance or 90% coinsurance to be more certain to avoid a coinsurance penalty.

Example: The Bailey Hardware limit should be $100,000. This is based on the $125,000 value at the time of loss multiplied by 80%. However, Bailey selected a $90,000 limit at 80% coinsurance. This means that a coinsurance penalty will be applied against the loss settlement.

CALCULATING THE PENALTY

There is a five-step formula to determine the coinsurance penalty:

Step 1: Determine the value of the covered property at the time of loss.

Step 2: Multiply Step 1 by the coinsurance percentage.

Step 3: Divide the limit of insurance for the location and coverage by Step 2.

Step 4: Multiply the amount of loss by Step 3 before applying the deductible.

Step 5: Subtract the deductible amount from Step 4.

The insurance company pays the lesser of the amount determined in Step 5 or the limit of insurance. The insured is responsible for the remaining loss amount.

Example: In this case, Bailey Hardware incurs a coinsurance penalty calculated as follows:

Step 1: The value at the time of loss is $125,000.

Step 2: $125,000 X .80 = $100,000

Step 3: $90,000 / $100,000 =.9

Step 4: $50,000 x.9 = $45,000

Step 5: $45,000 – $1,000 = $44,000

The insurance company pays $45,000. The remaining $5,000 is Bailey Hardware's responsibility.

ADDITIONAL COINSURANCE REQUIREMENT EXAMPLES

A way to remember the coinsurance penalty formula is DID / SHOULD X Loss. The amount of insurance carried (DID) is divided by the amount that SHOULD have been carried. This resulting percentage is multiplied by the amount of loss to determine the amount the insurance company pays. The following examples illustrate how the penalty is developed and applied.

Example 1 (Adequate Insurance)

$750,000 property value at time of loss

80% coinsurance percentage for the coverage

$600,000 limit of insurance carried (DID)

$500 deductible

$75,000 amount of loss

Step 1: The value at the time of loss is $750,000

Step 2: $750,000 X 80% = $600,000 (SHOULD)

Step 3: $600,000 / $600,000 = 1.00 (DID / SHOULD)

Step 4: $75,000 X 1.00 = $40,000

Step 5: $75,000 – $2,500 = $72,500

The insurance company pays the amount of loss minus the deductible. The insured is not a co-insurer because it maintained adequate insurance to value.

Example 2 (Inadequate Insurance)

$750,000 property value at time of loss

80% coinsurance percentage for the coverage

$500,000 limit of insurance carried (DID)

$2,500 deductible

$75,000 amount of loss

Step 1: The value at the time of loss is $750,000.

Step 2: $750,000 X 80% = $600,000 (SHOULD)

Step 3: $500,000 / $600,000 = .833 (DID / SHOULD)

Step 4: $75,000 X .833 = $62,250

Step 5: $62,250 – $2,500 = $59,750

The insurance company pays $59,750. The insured becomes a co-insurer for the remaining $12,750 as well as being responsible for the $2,500 deductible. This is the penalty for not maintaining adequate insurance.

Example 3 (Over-insurance)

$750,000 property value at time of loss

80% coinsurance percentage for the coverage

$700,000 limit of insurance carried (DID)

$2,500 deductible

$75,000 amount of loss

Step 1: The value at the time of loss is $750,000

Step 2: $750,000 X 80% = $600,000 (SHOULD)

Step 3: $700,000 / $600,000 = 1.167 (DID / SHOULD)

The calculations stop at this point. A coinsurance penalty does not apply when the percentage is 1.00 or higher. On the other hand, the insured does not receive a bonus or additional consideration for over-insuring because insurance is a contract of indemnity. The insurance company pays $75,000 – $2,500 = $72,500.

BLANKET INSURANCE

Most insurance company rules require using a 90% or 100% coinsurance clause in conjunction with an annual statement of values when coverage is written on a blanket basis. Blanket coverage applies to two or more coverages or two or more separate buildings or fire divisions for a single limit of insurance.

Related Article: Blanket Property Insurance

However, when blanket insurance is written subject to a coinsurance percentage, the percentage selected applies to every item of property included in the blanket. As a result, and in order to calculate the penalty, the value of every item of property within the blanket must be determined at the time of loss in order to calculate the penalty (if any). This applies even if the loss involves only one item.

Example:

The property values at time of loss are:

- $275,000 Building at Location 1
- $100,000 Personal Property at Location 1
- $75,000 Personal Property at Location 2
- $450,000 Total Values

90% Coinsurance for the blanket

$350,000 Total limit of insurance carried

$1,000 Deductible

$85,000 Building amount of loss

$20,000 Personal Property amount of loss

$105,000 Total loss

Step 1: The values at the time of loss are $450,000.

Step 2: $450,000 X 90% = $405,000 (SHOULD)

Step 3: $350,000 / $405,000 = .864 (DID / SHOULD)

Step 4: $105,000 X .864 = $90,720

Step 5: $90,720 – $1,000 = $89,720

The insurance company pays $89,720. This is its share after applying the coinsurance penalty and further reduced by the amount of deductible.

VALUATION OF PROPERTY

Coinsurance can apply based on either actual cash value or replacement cost valuation. If it is used with replacement cost valuation, the insured must review the values regularly and keep them as current as possible. An automatic percentage increase should be used for buildings. Personal property should be subject to regular inventory checks to maintain proper insurance to value and to avoid underinsurance. Allowing a policy to renew "as is," almost guarantees a coinsurance penalty for being underinsured if a loss occurs.

AGREED VALUE COVERAGE OPTION

Agreed Value is a coverage option available with the Building and Personal Property Coverage Form. It requires that the insured and the insurance company agree on the full value of certain property before a loss occurs. Any covered loss is adjusted based on that agreed value. When the Agreed Value Coverage Option is used, the coinsurance condition is waived because the agreed value arrangement supersedes and replaces coinsurance.

Note: The agreed value is subject to time limitations. The expiration date of this valuation agreement is entered on the declarations. This gives the parties the opportunity to review the amount selected periodically to determine if it is still adequate.