

## Avoiding Underinsurance Problems

MOST LOSSES ARE PARTIAL LOSSES. It may be tempting for an insured to try to control costs and only buy enough coverage to pay for the loss they think they could have. This practice could backfire in the event of a loss. The professional insurance agent knows that there are several reasons for avoiding underinsurance.

Most policies require that property be insured to 80% of the value to avoid a coinsurance penalty. An insured who elects to insure his property for less than 80% of the value becomes a partner (co-insurer) with the insurance company in the event of a partial loss. The insured will receive a reduced payment. This is true even if the amount of insurance is enough to cover that particular loss.

When there is a total loss, there is no coinsurance penalty, but the choice to underinsure his property leaves him with not enough insurance proceeds to replace the damaged property. The professional agent should always suggest insuring to the full replacement value as the preferred option.

In the event of a partial loss, the coinsurance penalty is applied to the loss amount. This means that the amount of insurance is divided by the amount that should have been carried. The resulting factor is applied against the loss to determine the amount of money the insured is eligible for. Using an example of a building with a replacement cost of \$100,000 and an 80% coinsurance requirement, the amount carried should be \$80,000. If the insured chooses a coverage limit of \$60,000, then in the event of a \$50,000 loss, the recovery would be 60/80

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(or .75) times \$50,000 loss which equals \$37,500. The recovery amount is further reduced by the applicable deductible. This example shows the impact of inadequate coverage.

Actual cash value policies allow the insured to purchase coverage that equals the actual cash value of the property rather than the replacement cost. In some instances, policy conditions state that if the policy limits are not sufficient, the loss settlement will change from a replacement cost basis to an actual cash value basis. Actual cash value policies may be used in cases when the insured has no intention of replacing the property in the event of a loss. Once again, in the event of a partial loss, the insured may not have enough coverage to make repairs. The agent should be sure to explain the ramifications of such choices.

There are alternate methods of providing insurance to deal with unique buildings. Functional replacement cost allows property to be insured for the amount it would take to replace the property with something that is functionally equivalent. An example might be a Victorian house that is being used as an office building. Rather than insuring the house to what it would cost to replace in the same style, the house could be insured for what it would cost to build a less expensive type building for use as office space. There is often a premium surcharge involved when insurance is based on the functional replacement cost or actual cash value method.

Helping your insureds to understand insurance to value and avoiding the potential problems of underinsurance is the mark of the true insurance professional.

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