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What every insurance buyer needs to know about the co-insurance clause

A small golf equipment manufacturer hit the jackpot when the world's number one ranked golfer began using one of its putter models. As a direct result, the demand for its products skyrocketed, and sales more than tripled in a matter of months. The company added employees and expanded its manufacturing facility to keep up with the demand. Management understood that the rapid expansion had created new loss exposures but felt comfortable that the business insurance in place was more than adequate to protect the growing venture.

The coinsurance clause is a concept that is still highly misunderstood by many insurance buyers.

The company experienced a significant property loss due to an electrical malfunction and ensuing fire. A claim was filed with its insurance company, but to management's surprise, only half of the damages were recovered. Management was correct in thinking that the coverage in place was with a top-notch insurer; however, the insurance company explained that the full value of the loss could not be recovered because the company had understated its property values. Because of this unfortunate miscalculation, the company did not meet the requirements that were stipulated in the policy's co-insurance clause. As a result, it was penalized, and the insurance carrier was only required to provide partial coverage for the loss.

The company's management was growth focused and had decided to reinvest all the profits back into the business. This strategic business decision had left the company unprepared to self-insure for such a significant financial loss. The result was catastrophic and is something that could have been avoided had they understood the concept of co-insurance.

What is co-insurance?

The co-insurance clause on property insurance policies (buildings, contents, stock and equipment) has been in existence since about the turn of the twentieth century. It is a concept, however, that is still highly misunderstood by many insurance buyers. The provision is included as a way to assure that the insurance carrier receives the proper premium for the risk it is assuming. The co-insurance clause states that the insured must carry an insurance limit on its property in an amount greater than or equal to a certain percentage of its total value, usually 80, 90 or 100 percent. If the insured fails to carry a sufficient limit to satisfy this provision, a penalty will be applied that results in the insured becoming a "co-insurer" on the claim, thus the term co-insurance.

The co-insurance concept was developed because many insureds were deciding to purchase an amount of coverage that was significantly less than the value of their property. They were willing to do this because it is statistically far more common to have a partial property loss than a total property loss. The reasoning is "why pay the premium for full coverage when the probability is that it will never be needed?"

This rationale is flawed for two reasons. Insurance carriers establish their rates on the basis that the properties are being insured to value. A property insured closest to its actual value (100 percent) will receive a lower rate than a property insured to less than 100 percent. If the insurer does not collect the

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proper premium in relation to the property value, the policies will be underpriced, which ultimately could threaten the solvency of the insurance company. Additionally, because most insurable property losses are partial, insureds who carry the proper limits would end up paying an inequitable premium compared to those who gamble and carry significantly less.

For Example:

Both XYZ Company and Acme Widgets Company own buildings that cost $3 million to replace. They also both carry property insurance that charges a premium of $200 per $100,000 of coverage.

XYZ Company insures its property for $2.4 million, which is 80 percent of its total replacement cost; therefore, they pay an annual premium of $4,800. Acme Widgets Company insures its property for $1 million, which is 33 percent of its total replacement cost, and they pay an annual premium of $2,000. Suppose both have a partial loss of $400,000; without the co-insurance clause, they would both be paid in full for their loss, and XYZ Company will have paid more than double the premium than Acme Widgets Company.

The co-insurance clause is the great equalizer, because it provides an incentive for insureds to insure to the proper value and penalties for those who do not.

The co-insurance penalty

As previously mentioned, co-insurance percentages can be 80, 90 or 100 percent. If the insured fails to insure their property up to or above the percentage that is stated in its policy, it can be penalized in the event of a loss. Insurance companies determine the penalty through a simple calculation: Did Insure/Should have Insured x Loss = Payment

For example, let’s take a look at the hypothetical golf equipment company mentioned earlier. Their policy required that it insure 80 percent of the structure’s total insurable value at the time of loss. If the building’s replacement cost was $10 million and its contents were $5 million, the company would be required to insure them for $8 million and $4 million respectively to receive full payment for a loss.

Assume the golf equipment manufacturer insured its building for $5 million and the contents for $2 million. The fire resulted in $4 million loss to the building and $1 million loss to the contents. The insurance company’s coinsurance calculation looked like this:

Building: $5 million/$8 million x $4 million = $2.5 million payment

Contents: $2 million/$4 million x $1 million = $500,000 payment

Because the company significantly undervalued its property limits, it essentially became a co-insurer on the claim. The insurance company paid $3 million, and the manufacturer was responsible for the remaining $2 million. This was a crippling outcome for a new business that was on the verge of making it big.

The simple reality

In the wake of a disaster, no business wants to discover that it did not have the proper insurance to make it whole again. All commercial property policies have a co-insurance clause unless it was negotiated to be deleted in exchange for a higher rate. This is why it is important that business owners review their policy to determine what co-insurance percentage is stated and whether they are insuring to the proper value. This exercise, or a simple call to their broker, can be the difference between whether a business survives a catastrophe or, in a worst case scenario, has to close the doors forever.

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