Claims 101

Thoughts On Purchasing Insurance

Education Series

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Introduction

I recently came across an article on my MSN feed titled "How to Choose the Best Home Insurance Company." While it offered some useful points, it felt like it just scratched the surface and even contained a few inaccuracies about what home insurance actually covers. I have a different perspective.

Consider this: people buy insurance to shield themselves from financial hardship if a loss occurs. And losses do occur—constantly. Many are minor, some are major, and an increasing number are catastrophic. Just look at recent examples like Hurricanes Helene and Milton. But don't forget about forest fires, tornadoes, hailstorms, and torrential downpours. Beyond natural disasters, there are also individual losses like house fires, broken pipes, leaky roofs, and break-ins.

At the end of the day, the reason you purchase insurance is simple: to get your claim paid—quickly and fairly. That's really what it all comes down to.

Now, let's dive into some of the more pressing, real-world issues you need to consider to ensure your claims are handled correctly.

My first piece of advice: stop trying to save money by choosing the cheapest policy and hoping for the best claim result. Instead, focus on finding a policy that truly fits your needs. To do this, you need to start with a personal risk analysis.

A risk analysis is your assessment of your assets, finances, tolerance for uninsured loss, and cash flow. Once you understand these factors, you can make informed decisions about which risks to transfer to the insurance company and which ones to retain yourself.

Risk Analysis

Step One: Analyze Your Property

Begin by taking inventory of your property. Do you have outbuildings, such as a fence, gazebo, workshop, or pool? Do you have a detached garage apartment or a separate in-law suite? What about valuable collections, like antiques, firearms, or silverware? In this step, you're answering important questions: *What do I own? How valuable is it? Can I afford the financial loss if it's damaged and there's no insurance reimbursement?*

Discuss these details with your agent, and keep in mind that protection varies from one policy to another. For instance, flood policies offer limited coverage for garages, and only if they're used as a garage. Coverage is capped at 10% of the building limits and is included within those limits. A significant flood could easily leave you underinsured.

Step Two: Know What You Need

Start with the basics. This includes Windstorm Insurance (which might be a separate policy for properties in hurricane-prone states), All Other Perils (AOP) coverage, and Flood coverage—even if you don't live in a designated flood zone. If you're skeptical, ask the residents of Asheville, NC, or Vermont about the recent flooding. Remember, floods are not covered under windstorm or AOP policies. And although we won't discuss it in detail, Liability Coverage is essential. It's usually included in homeowners' package policies, but if not, ask your agent to include it.

These basics—Windstorm, AOP, and Flood—are often non-negotiable if you have a mortgage, as lenders typically require them. However, tailoring these policies to your specific needs is your responsibility, not the mortgage company's.

Step Three: Analyze Your Personal Property
All policies have limitations on certain types of personal property for specific types of losses. For example, coverage for money is typically limited to $200–$500 per occurrence. Silverware and firearms are similarly restricted, especially in cases of theft. Review these limitations with your agent to understand your risks and what additional coverage options may be available to mitigate them.

Step Four: Assess Your Tolerance for Financial Loss
Insurance can get expensive quickly, so this step involves a cost-benefit analysis. You need to balance the cost of the policy with the likelihood of a loss and the potential for recovery. Some people choose to purchase as much insurance as they can afford, while others opt for the minimum and set aside savings to cover potential uninsured losses. Note, however, that this requires discipline and consistency. A combination of these two strategies can also be an effective approach.

Step Five: Plan for Uninsured Losses
This step closely aligns with Step Four. No insurance policy covers every possible loss, and some coverages require you to pay upfront before being reimbursed. Regardless of how much insurance you purchase, it's crucial to set aside funds to cover deductibles (which can be substantial for windstorm or earthquake policies), code upgrades during repairs, emergency expenses, and alternative living arrangements if your home becomes uninhabitable. Although Additional Living Expenses (ALE) are covered under most homeowners' policies, they aren't included in flood insurance.

As you build these reserves, remember: *There is no such thing as saver's remorse.*

Financial Stability

It may come as a surprise, but insurance companies often don't have significant free cash flow available for paying claims. This available cash flow, known as *surplus*, consists of assets and cash reserves on hand. While this is normal in the insurance industry, it's important to understand that insurers don't expect disasters to strike their entire customer base at once. Therefore, their total assets are rarely at full risk. However, there are exceptions, and it's important to be mindful of them.

I attended a talk by an insurance analyst years ago, and one statement stuck with me: *"If an insurance company writes a bad book of liability business, it's like terminal cancer. There are steps you can take to extend life, but they'll likely go out of business within a decade or two. In contrast, an insurer who writes a bad book of property business can be bankrupted by a single storm."*

A "bad book of property" refers to an insurer concentrating too much business in a small geographic area or a state prone to catastrophic events. This exposes the insurer to concentrated losses, which could overwhelm their surplus.

So, how do you, as a consumer, navigate this without dedicating all your free time to research? Here are a few things to watch for:

- **Surplus-to-Policy Ratio**: For every insurer you're considering, check the ratio of their surplus to the number of policies they hold. This tells you how much surplus they have available to pay claims. Your agent should be able to provide this information, and if not, it's publicly accessible online. Be cautious of companies with limited surplus, especially if they operate solely within one state.

- **Executive Compensation**: Investigate how much the company's executives are compensated. Excessive executive compensation can drain capital that would otherwise be used to pay claims. For instance, during a talk by the American Policyholders Association, they shared a story about a company that went bankrupt, in part because the CEO was paid $37 million to manage a $100 million book of business. In comparison, the CEO of a much larger company was paid $4 million to manage a book worth over $100 billion. Which company do you think was better managed?

Claims Philosophy

Every insurance company has a claims philosophy, and some are more consumer-friendly than others. Unfortunately, some companies—while never explicitly admitting this—seem to treat policyholders who file claims as adversaries. This mindset is evident in how they approach loss investigations, where they focus on finding reasons to deny claims rather than ways to pay them.

These companies tend to:

- Document unrelated damages and flaws during claims investigations to complicate the process.
- Demand receipts for items claimed, even when it's unreasonable to expect the insured to have them.
- Refuse to pay for items when no receipt is available.
- Hire experts whose job is to dispute coverage, rather than determine the actual cause of loss.

In the industry, these companies are well-known, but as a consumer, they can be harder to identify.

Here's what you can do:

- **Talk to your agent**: While agents may not deal with claims departments daily, they often know which companies generate the most complaints from their clients. Consider this a strong indicator of how a company treats its customers during the claims process. If you hear frequent complaints about an insurer, it's likely a sign of their claims philosophy.

Coverage

As mentioned earlier, you can end up overspending on insurance if you're not careful. It's important to purchase only the coverage you actually need. For example, let's say you've bought a new home for $300,000. You don't need to insure the home for that full amount. Part of the purchase price includes the land value, which your homeowner's policy doesn't cover. So, why pay for insurance on land when you can't claim any benefit for it? You only need to insure the dwelling and any structures on the property.

If you have significant savings, consider opting for a larger deductible. A higher deductible means lower premiums, which can result in substantial savings over time.

One important caveat to this concerns flood insurance. If your home is valued at more than $250,000, do not buy a flood policy for less than that amount. Why? The National Flood Insurance Program (NFIP) requires you to insure your property for at least 80% of its replacement value to receive the full benefit of the policy, unless you've purchased the maximum available coverage ($250,000). I've seen policies where homes are insured for $249,000 instead of the full $250,000, which exposes the homeowner to a co-insurance penalty simply because they didn't maximize their available coverage.

Exposures

Here are some potential exposures you might not be aware of:

1. **Surplus Lines**
   Surplus lines companies are non-admitted insurers licensed to operate in a state. They provide insurance in markets where traditional insurance would be unavailable. For example, Lloyd's often writes policies for beachfront condominiums that would otherwise be uninsurable. While this is a valuable option in the marketplace, surplus lines policies come with a significant risk: in Florida, they are not covered by FIGA (the Florida Insurance Guarantee Association). FIGA steps in to pay claims when an admitted carrier becomes insolvent, but if a surplus lines company fails, there is no state-backed recourse.
2. **Types of Deductibles**
   Percentage-based deductibles for windstorm and earthquake events are becoming more common, typically ranging from 2% to 5%, but earthquake deductibles can go as high as 25%. This translates to thousands of dollars of uninsured exposure. Be sure you're prepared for these deductibles, or you might find yourself scrambling for funds when you need them most.
3. **Limits on Coverage**
   Many policies limit payouts for certain types of damage. The most common limitations apply to broken pipes and mold damage. Typical limits are $10,000 for broken pipes and $5,000 for mold damage, including the cost of the investigation. Review your policy to understand how it addresses these types of losses.
4. **Actual Cash Value (ACV) Roofs**
   More policies are moving toward covering roofs on an Actual Cash Value basis. This means that after non-recoverable depreciation and deductibles are applied, you may only receive a fraction of what it costs to replace your roof.

   Between broken pipe losses and ACV roof provisions, a significant portion of the financial burden has shifted from the insurer to the policyholder—often without a substantial reduction in premiums to reflect this shift.

5. **Out-of-Pocket Costs – Additional Living Expenses (ALE)**
   Most homeowner's policies provide coverage for living expenses if your home becomes uninhabitable due to a covered loss. However, ALE coverage is usually *incurred coverage*, meaning you must pay the expenses upfront before you can be reimbursed. While some insurers advance funds, many do not, leaving you reliant on the goodwill of others or your own savings. It's important to set aside money now to cover potential ALE-related expenses.

   Important note: Flood policies do not cover ALE at all, so you will need to plan for those costs separately.

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