

Co-Insurance Penalty - What is it and how to avoid it.

By Susan Gropp

In the past 18 months, the most frequently asked question to our underwriting and account executive teams is, "What is the replacement cost value of a home we are purchasing in Mayberry, USA?" A question that has nothing to do with re-sale or market value and everything to do with the Co-Insurance Penalty Clause found in the majority of the property insurance forms that cover these investment opportunities.

So, what is a Co-Insurance Penalty? A Co-Insurance Penalty is a penalty assessed by a carrier for under-insuring the replacement cost of a property. Most policies require that a property be insured for at least 80% of the replacement cost of the damaged item. In determining the amount of insurance required to equal EIGHTY PERCENT (80%) of the full replacement cost of the property at each location insured, do not include the value of land or excavations, foundations, supports, underground pipes, flue, drains, and wiring which are below the surface of the ground.

The penalty assessed will vary from carrier to carrier. One carrier may simply pay the claim at actual cash value instead of replacement cost. Other carriers may have a formula which will dictate what is paid out depending on the how under-insured the property is and the amount of damage the property sustained. An example of a formulated calculation is below:

Coinsurance Calculation Example

Insured Property Information:

Replacement Cost Value (RCV): \$500,000

Coinsurance (Amount of Insurance) Required: 80% (of RCV)

Deductible: \$1,000

Amount of Loss: \$50,000

Inadequate Limits of Coverage

Amount of Insurance Carried - "Did" \$350,000

Amount of Insurance Required (RCV x Coinsurance) – "Should"

• (\$500,000 x 80%) \$400,000

Coinsurance Penalty Calculation Factors

- | | |
|---|-------------|
| 1. Did / Should (\$350,000 / \$400,000) | 1. 0.875 |
| 2. Loss Amount | 2. \$50,000 |
| 3. Deductible | 3. 1,000 |

Coinsurance Penalty Calculation: (1. x 2.) – 3. (0.875 x \$50,000) - \$1,000

Amount of Payment (From Coinsurance Penalty Calculation Above) \$42,750

Amount of Coinsurance Penalty (ignoring deductible) \$6,250

Loss Amount – Payment Amount (before deductible) \$50,000 - \$6,250 =
\$43,750.

The carrier may also elect to pay the greater of the actual cash value of the damages or the proportion of the settlement as computed above.

Co-insurance is checked for on each claim. The adjuster will run a report to determine the replacement cost of the damaged property less the items which the policy dictates be deleted from the valuation. This report is then checked against the total insured value of the property to be sure that the report valuation is within 80% of the total insured value of the property.

While carriers may assess co-insurance penalties in different ways, as you can see, a co-insurance penalty can be quite financially devastating. It can inhibit you from rebuilding the property to the state it was in previously without a significant amount of additional funds from the insured. Don't be caught off-guard by a co-insurance penalty. Make sure your properties are insured up to 80% of their replacement cost.

And how do you do that with materials and labor cost skyrocketing in many areas of the country? We strongly suggest you ask a trusted General Contractor in the area of where you are purchasing homes to give you his latest estimate. We also suggest you regularly check in with them and document those estimates in your insurance or loan file in case you need that information when speaking with a claim adjuster at a later date.

For more information, please visit www.nreia.arcanainsurancehub.com. And, as always, we hope this information was beneficial to you. However, please review your current policies with your insurance agent to get their professional advice on this important clause and any other terms or wording you are not familiar with.

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