

COINSURANCE: Be An Educated Consumer

Coinsurance is a protective mechanism used by insurance companies to make sure their pricing is adequate which forces buyers to consider a portion of their replacement cost instead of “low balling” their limits to save money. Coinsurance, simply stated, requires the buyer to purchase an insurance limit that **equals the stated percentage times the replacement cost** of the property. Unfortunately, buyers treat coinsurance too casually on property insurance limits and do not understand the impact on their business income claims.

On the property side, entities too often use the depreciated building value and then apply the coinsurance valuation thereby severely increasing the undervaluation of the replacement cost of the property. The business income confusion comes from the fact that there are two definitions for coinsurance—one for rating purposes and the other to penalize entities for underinsurance. Some people think of coinsurance as a “deductible”, but it is really a pricing and claims paying mechanism. This provision requires the business owner to insure a certain percentage of the replacement cost of property and a certain percentage of the 100% (annual) business income.

FOR EXAMPLE: 80% coinsurance for a building would be replacement cost (not the balance sheet value) of \$10,000,000, times 80%, or \$8,000,000. Business income 50% coinsurance would be 6 months of protection and as long as the proper amount was purchased, there would be no penalty.

FOR EXAMPLE: 12 months, 100% BI (gross profit) of \$10,000,000, times 50% equals \$5,000,000 required insurance. At the time of loss, the required limit is recalculated. This is always a problem as the actual sales and expenses are different from the originally estimated amounts, so business owners end up severely penalized.

Once a loss has occurred, the full import of the buyer’s decision becomes painfully evident. To put it bluntly, coinsurance really causes problems at the

time of the claim because **if the insured’s business income limit is mathematically incorrect at the time of loss, then the insured will pay that error percentage of the claim.**

FOR EXAMPLE: The policy says there is a \$1 million business income limit with a 50% coinsurance clause. This means the 100% amount would be \$2 million. If, at the time of loss, the 100% amount was \$3 million, then the limit should be \$1.5 million (which is 50% of the \$3 million) and **the insured would be penalized 33% of the claim** (\$1 million vs. \$1.5 million). One client was penalized 85% of their \$750,000 loss after having failed to revise their insurance limits or coinsurance amounts in several years.

The coinsurance penalty is cause for a lot of lawsuits and unpaid claims. **Put agreed amount on the policy and eliminate this problem. However, to do so requires a signed business income worksheet in file showing future projections of income.** No worksheet? Then coinsurance applies.

Since most ISO companies have only filed rates to go down to 50% or six-months of coverage, there are two other options available for businesses that want less than six-months protection: **Monthly Limit of Insurance** and **Period of Indemnity**, both of which have been the subject in previous newsletters.

To prevent this from happening to your company:

- Ask for agreed amount!
- Do not have coinsurance on your business income policy!
- Be aware that you **MUST complete a business income worksheet to get agreed amount.**

It should now be obvious how very important it is to be an educated consumer. What you do not know **CAN** hurt you. **Make certain you are buying the right coverages for the correct amount and discuss your needs with your insurance professional.**

As we always say:

Be prepared. Be protected.™