The Significance of Co-Insurance

Co-insurance is arguably one of the least understood and most important aspects of your insurance coverage. Most commercial insurance policies contain a co-insurance clause that may impose significant limitations on your coverage in the event of a claim.

The co-insurance clause is used by insurance companies to encourage property owners to purchase an accurate amount of coverage. Typically, property insurance premiums are based on the limits provided to the insurer during the application process, therefore, an incentive may exist for the applicant to understate the value of their buildings and contents in an effort to keep their insurance costs down. Undervaluing your property, however, may affect the way a claim is settled, so you need to strongly consider your approach.

Setting proper building and content limits is one of the many important services that an insurance broker provides, and they are experts at helping you value your property appropriately.

Co-Insurance Explained

Put simply, the co-insurance provision in a property policy requires that you (the property owner) carry insurance equal to a minimum percentage (usually 80% or 90%) of the property's actual replacement value in order to receive full payment at the time of a loss. This clause is intended to help the insurance company trust that they receive a fair amount of premium for the risk they have assumed. For example, a building valued at $1,000,000 with a co-insurance clause of 90% must be insured for no less than $900,000. That same building with an 80% co-insurance clause must be insured for at least $800,000.

If a property owner chooses to insure for less than the amount required under the co-insurance clause, the owner is basically agreeing to retain part of the risk rather than transfer it to the insurance company. In essence, the owner becomes a “co-insurer” and will share in the loss along with the insurance company based on the percentage stated in the clause.

Example of Co-insurance in Action

Assume the main reception building at a campground has an actual replacement value of $1,000,000 and the Insured’s policy carries a 90% co-insurance clause. This means that the Insured (the campground owner) must purchase insurance on that building of at least $900,000 in order to receive full coverage in the event of a claim.

The Insured (the campground owner), however, undervalues the main reception building when applying for insurance coverage and states a value of $700,000 instead of $1,000,000. In an unfortunate turn of events, a fire destroys a significant portion of the building causing $500,000 in damages. The Insured believes the claim will be fully covered because the insurance limit they purchased exceeds the loss ($700,000 > $500,000), however, as the loss is adjusted it is determined that the building was underinsured when the fire occurred, so the co-insurance penalty is applied.

90% Co-Insurance Penalty Calculation

- Reception Building value (actual replacement cost) – $1,000,000
- Co-insurance clause – 90%
- Minimum insurance limit required (90% of $1,000,000) – $900,000
- Insured limit (based on value submitted on the insurance application) – $700,000
- Co-insurance penalty (Insured limit divided by minimum required limit: $700,000/$900,000) = 0.78
- Maximum insurance recovery (Loss amount multiplied by co-insurance penalty: $500,000 x 0.78) = $388,889

In the above example, the Insured can only expect to recover a maximum of $388,889 which leaves them on the hook for the remaining $111,111 of the loss. If, however, the building had been properly insured, they would have been able to recoup the entirety of the $500,000 loss*.

Conclusion

Co-insurance can be complicated and it has important ramifications. Your insurance policy may use other percentages or have different applications, so it is always best to speak with your Insurance Broker about how co-insurance might affect you. Your broker will advise you on how to set your property limits at a fair value so that you won't end up on the wrong side of a co-insurance calculation.

* In both instances, the total loss paid would be subject to any deductibles.

This article was provided to the BCLCA by supplier member Signature Risk Partners Inc., the managers of the Signature Park insurance program.

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