Understanding and Explaining the Mysteries of Coinsurance

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Session Topics

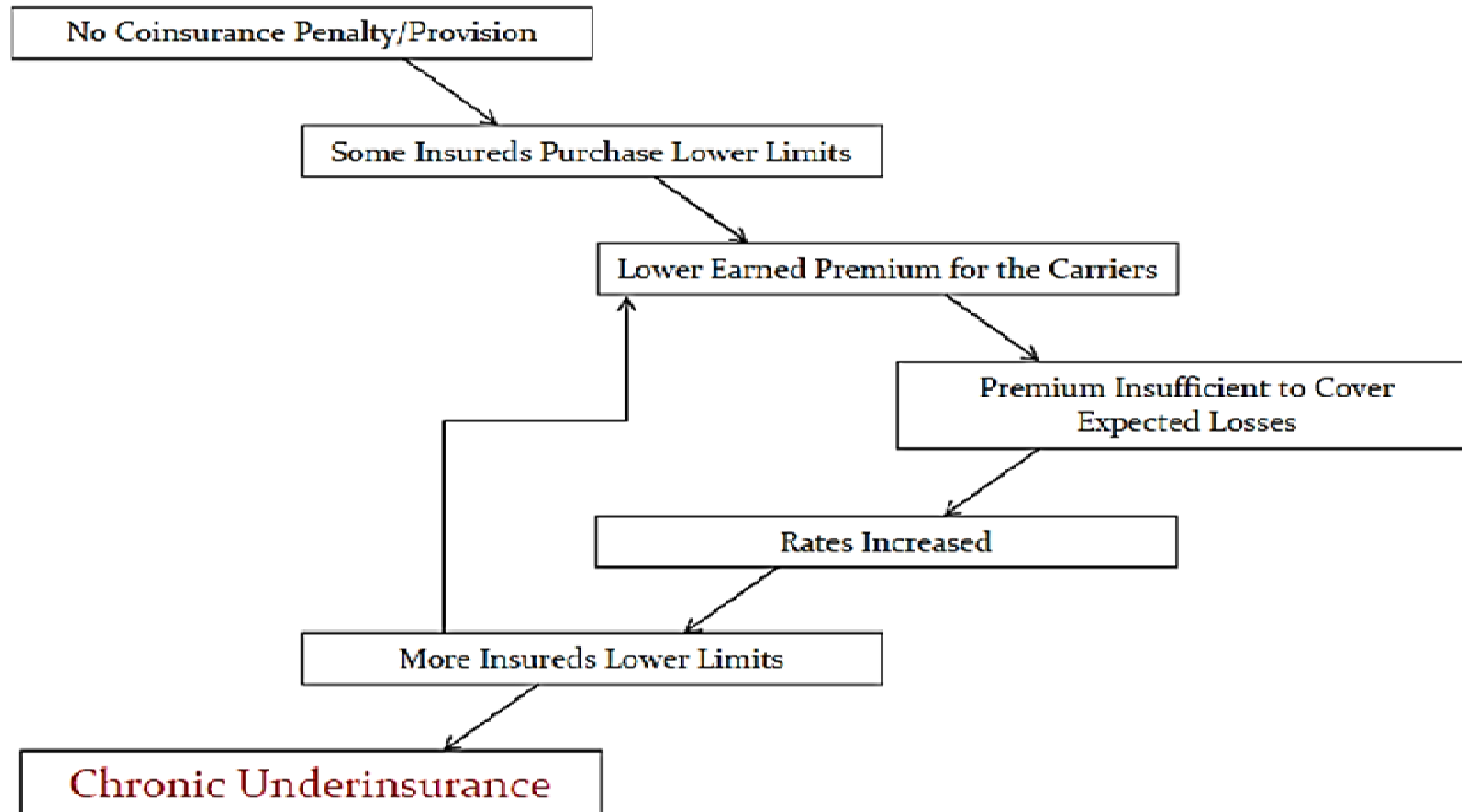
- Why Coinsurance Exists
- The Results of No Coinsurance
- Property "Maximums"
- The Insured's Opinion
- The Coinsurance Calculation
- Blanket Limits and Coinsurance
- Differences Among the Coinsurance Provisions
- Coinsurance Conditions and Ideas

Why Coinsurance Exists

Why Coinsurance Exists

- To assure that the insurance carrier receives adequate premium for the risks insured.
- To avoid chronic underinsurance and artificially high property insurance rates.
- To avoid shuttered businesses

The Results of No Coinsurance


No Coinsurance Penalty/Provision
Some Insureds Purchase Lower Limits
Lower Earned Premium for the Carriers
Premium Insufficient to Cover Expected Losses
Rates Increased
More Insureds Lower Limits
Chronic Underinsurance

Property “Maximums”

Maximum Possible Loss (MPL)

- It is possible that the entire structure could be destroyed.
- The MPL is 100% of the TIV (looking only from a direct loss perspective)

Probable Maximum Loss (PML)

A partial loss is statistically more likely; thus the PML is some percentage less than the MPL.

The PML is generally directly related to the first three factors of COPE:

- Construction
- Occupancy
- Protection

- Other terms used might include: Maximum Foreseeable Loss (MFL) or Estimated Maximum Loss (EML)

Why the Differences Matter

- Insured's with the perceived greatest differences between the MPL and the PML may purchase lower limits of coverage IF there was no coinsurance provision.

- If insureds are chronically underinsured:
  1) Rates spiral up;
  2) Insureds purchase lower limits; and
  3) The property insurance mechanism falters.

MPL / PML Example

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<u>Building 1 – 1234 Main Street</u>

Construction (C):

- Masonry/Non-Combustible (CC 4)
- 30,000 square feet
- 2 stories

Occupancy (O): Office

Protection (P):

- PPC 3
- Fully Sprinklered
- Fire stops with self-closing fire doors
- Central alarm

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<u>Building 2 – 6789 Broad Street</u>

Construction (C):

- Joisted Masonry (CC 2)
- 8,000 square feet
- 1 story

Occupancy (O):

- Paint and body shop
- 100 gallons of paint stored in approved cabinet (H of O)

Protection (P):

- PPC 9
- Non-Sprinklered
- Fully open
- Local alarm

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The Insured's Opinion

How Does the Insured Feel About All This?

The insured does not care about any of this! They just want to avoid any sort of penalty following a partial loss.

- Most insureds confuse property coinsurance with health insurance coinsurance.
- Coinsurance is a way to cheat them out of more money.

The Coinsurance Calculation

The “Simplified” Coinsurance Calculation

((Did / Should) x Loss) – Deductible = Payment

- Did = Amount of Insurance Carried (IC)
- Should = Amount of Insurance Required (IR)

Developing "Should"

This is a two-part process.

- Step 1 – You must know the Total Insurable Value (TIV) at the time of the loss.
- Step 2 – Multiply the TIV by the specified coinsurance percentage

100% TIV x Coinsurance % = Should (IR)

The "Actual" Coinsurance Calculation

((Did / (TIV x Coinsurance %)) x Loss) – Deductible = Payment

- Did / IC is the amount of insurance carried – Easy (from policy)
- TIV is based on the valuation method (ACV or RCV) and is the hard part
- Coinsurance % - found in the policy
- Should / IR is easy, once the 100% TIV is known

Coinsurance Example

Insured Property Information

• Total Insurable Value (TIV):	$500,000
• Coinsurance Required:	80%
• Deductible:	$1,000
• **Amount of Loss:**	**$50,000**

Coinsurance Example

Amount of Insurance Carried (Did)	$350,000
Amount of Insurance Required (Should)	$400,000
Coinsurance Penalty Calculation: 1. Did/Should ($350,000 / $400,000) 2. Loss Amount 3. Deductible	 1. 0.875 2. $50,000 3. $1,000
Coinsurance Penalty Calculation	(0.875 x $50,000) - $1,000
Amount of Payment	$42,750
Amount of Penalty	$6,250 ($7,250 w/ Ded.

Percentage Deductibles

- Coinsurance is calculated the same way.
- The percentage deductible is based on the "Did" not the "Should"
- If the prior loss example had a 2% deductible, the total paid would be:

(($350,000/$400,000) x $50,000) – ($350,000 x .02) = Payment

(0.875 x $50,000) - $7,000 = $36,750

Blanket Limits and Coinsurance

Blanket Limits and Coinsurance

Same formula is used for Blanket Limits

Rules require the limit of coverage be 90% of total insurable value

The coinsurance calculation is based on the **total** of all blanketed property

The “Margin Clause” and Blanket Coverage

The ***Limitation of Loss Settlement – Blanket Insurance (Margin Clause)*** - CP 12 32 - limits the amount of building coverage available when coverage is provided on a blanket basis.

- 105% of the scheduled limit (0.93 rating factor)
- 110% of the scheduled limit (0.94 rating factor)
- 120% of the scheduled limit (0.95 rating factor)
- 130% of the scheduled limit (0.96 rating factor)

The “Margin Clause”

The insured receives the **lesser of**:

- Maximum available based on the scheduled limit (from the CP 16 15 Statement of Values) multiplied by the margin percentage; or
- The result of the coinsurance penalty.

"Margin Clause" Example

Blanket Values at the time of the Loss (4 buildings)	$5,000,000
Coinsurance Requirement	90%
Insurance Carried	$3,825,000
Margin Clause Percentage (CP 12 32)	120%
Deductible	$5,000

Building 1 suffers a total loss

The building is scheduled on the Statement of Values (CP 16 15) at $1,000,000

Value at the time of the loss: **$1,300,000**

How much is the insured due from the carrier?

"Margin Clause" Example

Maximum available: **$1,200,000**

- Coinsurance Calculation based on the blanket limits:
  - ((Did / (TIV x Coinsurance)) x Loss) – Deductible = Payment
  - (($3,825,000 / ($5,000,000 x .90) x $1,300,000) - $5,000 = Payment
  - (0.85 x $1,300,000) - $5,000 = Payment
  - **$1,105,000 - $5,000 = $1,100,000**

- Insured gets the **LESSER** of:
  - Maximum available limit (scheduled value x Margin Clause Percentage): $1,200,000; or
  - Coinsurance calculation result: $1,100,000

Differences Among the Coinsurance Provisions

	Commercial Property	BOP	Homeowners'
Basis of Total Insurable Value (TIV)	Actual Cash Value or Replacement Cost	Replacement Cost	Replacement Cost
Property Subject to Coinsurance	Real and Business Personal Property	Real and Business Personal Property	Real Property
Coinsurance Options	80%, 90%, 100%	80%	80% (can be endorsed down)
Application of Coinsurance	Penalty Lesser of: Limit of Insurance or Coinsurance Calculation Result	Preserves Indemnification Greater of: ACV or Coinsurance Calculation Result	Preserves Indemnification Greater of: ACV or Coinsurance Calculation Result

Coinsurance Conditions and Ideas

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- Coinsurance "encourages" insureds to carry relatively high limits of coverage compared to the statistical risk of a total loss.
- Coinsurance applies to partial losses only.
- Coinsurance is calculated based on the values at the time of the loss.
- As the coinsurance percentage is increased, the rate goes down.
- It's best to insure property at 100% of TIV but NEVER use 100% coinsurance

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