

The Underinsurance Problem: Coinsurance Penalties for Commercial Properties

Getting accurate property values may be even more important than you realize. When properties are underinsured, the coinsurance penalty can apply when a claim is paid. As a result, business owners may not get the payout they expected. To avoid unpleasant surprises, brokers and property owners should be aware of how coinsurance penalties apply at the time of loss.

The Importance of Accurate Property Values

Commercial property insurance rates are rising. MarketScout's Market Barometer shows that commercial property rates increased 9% in the third quarter of 2021, with significantly greater rate hikes in certain areas with high risk.

Faced with these higher rates, some property owners may be looking for a break. Because higher limits contribute to higher rates, some property owners may be tempted to secure limits that are lower than the actual value of the property. However, underinsuring a property in this way will trigger the coinsurance clause, a common feature in many commercial property insurance policies. As a result, experiencing a total loss and not having sufficient coverage to rebuild is not the only risk – although that is certainly a risk that deserves attention. The coinsurance clause means that even claims that are lower than the coverage limit can be penalized.

How the Coinsurance Penalty Works

Insurance is a means of transferring risk, but the policyholder must accept some financial responsibility. This is often done through the premium, which is the cost of owning insurance, and the deductible, which is the out-of-pocket cost associated with filing a claim. Coinsurance is yet another method.

In health insurance, coinsurance often refers to a percentage of the cost that the insured must pay when receiving care, often referred to as a co-pay. In property insurance, coinsurance works differently, although it can still be viewed as a percentage of the cost that the insured must pay under certain circumstances.

Here's how it works: . A coinsurance clause requires the policyholder to maintain a certain level of coverage. It might be 100% of the value of the property, but often, it's only 90% or 80%. If a policy has a 90% coinsurance requirement and the property is worth \$1 million, the policyholder needs to purchase coverage with a limit of at least 90% of \$1 million. That's \$900,000. But what if you don't have that much coverage? What if your limit is, for example, only \$675,000?

If the policyholder fails to meet the coinsurance requirement, a coinsurance penalty will apply when a claim is filed, regardless of the size of the loss.

The Coinsurance Formula

As Investopedia explains, the coinsurance formula requires you to divide the actual amount of coverage by the required amount of coverage. The result is multiplied by the loss, and this is the amount of the reimbursement.

Applying the formula to the example above, we divide the actual amount of coverage (\$675,000) by the amount of required coverage (\$900,000). This gives us a result of .75, or 75%.

This amount is then multiplied by the loss to arrive at the reimbursement amount. If the loss is \$100,000, we multiply \$100,000 by .75 to get a reimbursement amount of \$75,000. The policyholder is responsible for the remaining \$25,000 as well as any deductible – even though they purchased coverage limits of \$675,000.

Of course, this is just an example. The actual numbers depend on the coinsurance requirement, the value of the property, the amount of coverage you purchase and the amount of the loss. Also, it's important to note that the deductible also applies.

Determining Property Values

Although some business owners may be willing to accept the coinsurance penalty in exchange for lower limits and lower rates, others may be caught off guard by this clause. To avoid getting stuck with an unexpected coinsurance penalty, it's important to understand the coinsurance requirement.

- Check your policies for a coinsurance clause. Make sure you understand what the coinsurance requirement is and when the coinsurance penalty will apply.
- Determine the value of the commercial property. An accurate estimate is vital – especially now while values are skyrocketing.
- Update the value as necessary. Over time, the value of the property may change. It's important to update coverage accordingly.

Do you need help with coinsurance penalties, property values or other property insurance issues? Contact us for assistance.



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