National Tooling & Machining Association
NTMA
PRECISION

Business Management Advisory

For Precision Custom Manufacturers

IN08 **File: INSURANCE**

COINSURANCE: HOW DOES IT WORK AND WHAT SHOULD YOU DO ABOUT IT?

SUMMARY

The coinsurance clause has been in use in fire insurance policies for well over 50 years. However, it is frequently misunderstood by property owners and is looked on by many with suspicion. Many people are under the impression that an 80% coinsurance clause in their policies merely means that they will collect only 80% on any losses and that this is the justification for the materially-reduced premium rate. That's not necessarily the case. Knowing the current value of your property and its contents - and periodically reviewing those values - can save you thousands of dollars in case of a catastrophe. This BMA describes the hows and whys of coinsurance so that you can use it to its full advantage in your business.

HERE'S HOW COINSURANCE OPERATES

In the event of a total loss, the insured will collect "actual cash value" up to the full amount carried. But, this is not necessarily true in the case of partial losses, which are far more common than total losses.

If you have your property insured for the prescribed percentage (80% or 90% is commonly used) of its true value, you will collect in full for all losses up to the limits of the amount specified in your policy.

But, if either deliberately or unknowingly, you insure your property for say only 60% of its value, for example, you will collect only 60/80 or 3/4 of any partial loss up to the limits of the policy. In the event of total loss, you will collect the full amount of the insurance carried and, of course, will bear 40% of the loss, in this case, yourself.

The following examples will illustrate the operation of the 80% Coinsurance Clause:

1. Where insurance exceeding 80% of the value is carried:

Your Property Value	$100,000
80% Coinsurance Required	80,000
Actual Insurance Carried	90,000

All your losses up to $90,000 will be Paid in Full.

2. Where insurance to 80% of value is carried:

Your Property Value	$100,000
80% Coinsurance Required	80,000
Actual Insurance Carried	80,000

For losses exceeding $80,000, the face value of your policy ($80,000) is paid. For losses up to $80,000, you will receive full payment.

3. Where insurance of less than 80% of the value is carried:

Your Property Value	$100,000
80% Coinsurance Required	80,000
Actual insurance Carried	50,000

For losses exceeding $80,000, the face value of the policy ($50,000) will be paid. But for any partial losses under $80,000 you will receive payment in the proportion that $50,000 bears to $80,000, or 5/8 of the partial loss.

For example, if you had a $50,000 loss and were insured either deliberately or unknowingly for less than the 80% of value as you agreed to do under the 80% Coinsurance Clause, such as 5/8 as shown in example 3 above, you would receive payment of only $31,250 even though you actually carried $50,000 insurance.

UNDERVALUATION MAY BRING HEAVY LOSS

Most owners would not deliberately insure for less than the 80% of value in an 80% Coinsurance Clause. But in many cases, heavy losses have resulted from a failure by the owner to realize the insurable value of the contents of the plant.

Most of the severe losses not covered by insurance in recent years have occurred because owners thought they had enough insurance to fulfill the coinsurance agreement in their policy. But, either because they didn't revise their appraisal periodically or because they didn't include all the property covered by the policy, they were caught short of having adequate coverage and, as a result, suffered severe losses.

THE COINSURANCE CLAUSE

There are various percentages available for use with the coinsurance clause, but 80% is generally used. If you feel confident about the accuracy of your evaluation of your property, 90% coinsurance can be used to reduce your premium. The 80% clause does not provide that the loss recovery is limited to 80% of the loss. It does not require that 20% of all risks must be assumed by the owner. The sole requirement is that the owner must at the time of the loss have an amount of insurance which is not less (it may be more) than 80% of the actual value of the property insured.

KNOWING ACTUAL CASH VALUE VITAL

In the coinsurance clause in your policy, you will find the words, "Actual Cash Value," but you may not find a definition of this phrase. The Actual Cash Value is the cost of replacing the damaged property minus depreciation. In the case of your real property, the determination of replacement cost or actual cash value is easily accomplished by keeping an up-to-date appraisal of the building. The problem of determining the actual cash value of its contents is more acute and it is here that the more severe losses, not covered by adequate insurance, have occurred.

WHAT ARE "CONTENTS?"

It is necessary for the plant owners to understand fully the extent of the coverage provided by the contract and to determine what is included in the "Contents" coverage. The word "contents" in your fire insurance policy includes furniture, fixtures, machinery, tools, work in process, cost of electrical work, cost of arranging and setting the machines, cost of water and air lines, the personal tools and apparel of your employees, inspection equipment, inventory of machine parts and production parts, material handling equipment, raw materials, operating and maintenance supplies and the tool crib and its inventory. It can also include improvements and betterment to rented property. It ordinarily includes customers' goods, goods on consignment, goods held in trust or storage and goods held for repairs, to mention the more obvious.

It is extremely important to know just what is covered by fire insurance policies and what is excluded. Present general practice is to include the personal property of others (customers and employees) which is in the building. And if the owner is not willing to pay for insurance of customers' goods, and specifically has them excluded (which may prove to be unwise) - and even though the exclusion is brought to the attention of the customer, who takes out his or her own policy - the owner may still find that after the customer has been paid for any loss, the insurance company will successfully sue the owner for reimbursement because of his or her liability as a bailee (holder of goods in trust) for the customer.

While it may look as if you can't win, there is a fire legal liability policy to protect you in such cases which usually costs only half as much as the direct fire insurance rate. Or you can make sure your fire insurance amount is high enough to cover all contents on the basis of the coinsurance clause.

PERIODIC REVIEW ESSENTIAL

Because values are constantly rising in a period of inflation, and because improvements and betterment are continually being made, it may be prudent to add a margin of safety to any estimates of value compiled at the time the insurance policy is written. If an 80% coinsurance clause is used, The American Appraisal Company (whose bulletins are the basis for some of the material in this BMA) stresses the advisability of carrying 90% as a safety factor, but this extra margin and added costs should not be necessary if the owner remembers to do these things:

- Have the values surveyed at least once a year.
- Include an adequate allowance for the customers' goods that may reasonably be expected to be on the premises at any one time.
- Periodically make the necessary revisions in the policy required by changes in the property or changes in the price levels.

If the owner does not know the values, coinsurance can prove very costly in event of a loss; but if the owner keeps abreast of values and complies with the coinsurance clause in the policy, coinsurance can provide a very worthwhile saving in insurance premiums.

This BMA was reviewed by NTMA Staff.