THEY SAY, HEARSAY, AND WE SAY

Explaining the Pitfalls of Underinsurance

By Lynne McChristian

They Say, Hearsay

"I'm insuring my home for more than I think it is worth because my insurance company tells me to have enough coverage to rebuild if my house is destroyed. But at my age, I have no intention of rebuilding. Can the insurance company force me to rebuild?"

We Say

Outside of obeying the law and paying taxes, there are few things Americans are forced to do. That seems to be the way most of us like things, and companies generally try to comply. In a homeowners' policy, for example, if a home succumbs to fire, hurricane or any other destructive force, the owner does not have to rebuild if he doesn't want to. He can take the insurance settlement and buy elsewhere — or not.

For the insurance industry, rebuilding is the mantra. However, while we are touting insuring to rebuilding costs for all the right reasons, policyholders do not understand how the claim process works when the homeowner has less-than-full coverage. When we concentrate on the worst that could happen — the total loss of a home — we miss an opportunity to illustrate what underinsurance means in a partial loss.

▲ Lynne McChristian

Florida law and a state Supreme Court decision have addressed how insurance works for those choosing to forego rebuilding after a total loss. In 2005, Florida Statute 627.7011 was amended to require insurers to pay full replacement cost coverage up front, even if the insured does not actually replace the property. Supplemental coverage is not paid if an insured does not rebuild. In *Citizens Property Insurance v. Ceballo*, the court ruled supplemental Ordinance or Law coverage applies only when additional loss costs are actually incurred. This sends a simple message to policyholders with adequate coverage who do not rebuild: A total loss will pay policy limits.

Doing the Math on Underinsurance

Giving policyholders a visual of the claims consequence of insuring to less-than-replacement cost can be more meaningful than the insure-to-value message, particularly when it comes to a partial loss.

Most insurers require replacement cost policies to be 80 percent of value. Here is an example of what happens if a policyholder is insured for less than 80 percent.

Formula

$$\text{Amount of Recovery} = \text{Value of Loss} \times \frac{\text{Amount of Insurance Carried}}{\text{Amount of Required Insurance}} - \text{Deductible} = \text{Claims Payment}$$

Example with a home valued at \$150,000, insured for \$100,000

$$\text{Loss of } \$60{,}000 \times \frac{\$100{,}000}{\$120{,}000} - \$1{,}000 \text{ Deductible} = \$49{,}000 \text{ claim payment}$$

Insured 's additional cost is $11,000 to cover this loss.

Our message to the policyholder: Failing to carry the correct amount of coverage makes you responsible for a percentage of a partial loss.

Source: Insurance Information Institute.

This offers us a communications opportunity when discussing outcomes from a partial loss with clients, especially for those who think insuring to value is overrated (pun intended). Policyholders do not understand that a partial loss plus inadequate insurance adds up to them being liable for a greater percentage of repair costs.

There will always be a certain segment of the population upon whom our message of insure-to-value will be lost, and that segment includes some of Florida's senior citizens. In fact, in today's distressed real estate market, it may be more opportunistic for claimants of any age to buy from available housing stock rather than to rebuild. We need to consider that economic reality, along with the consequences of underinsurance related to a partial loss.

Property owners are not homogeneous on many insurance issues, rebuilding included. I was reminded of this at a presentation last month with a senior citizens group. A woman in this audience said she would not want to rebuild if her home was destroyed, and asked if her insurer could force her to do so in order to get an insurance settlement. She made it clear that moving on was a better use of her time and resources than starting over in the same place. That got me looking at how we communicate about insurance and rebuilding after a disaster.

If you do a Google search on insurance and rebuilding you will find lots of material on the importance of having enough insurance to rebuild; there is far less available on how property insurance works for the underinsured.

Marshall & Swift/Boeckh's 2008 survey reported that 64 percent of U.S. homes are undervalued for insurance purposes, with the average homeowner having enough insurance to rebuild only about 81 percent of his dwelling. For a young and growing family, that may be clearly insufficient. For a senior citizen without a mortgage, it may be just fine. However, a partial loss is more likely to happen than a total loss. People do not typically walk away from a partially damaged home, so showing a client an example of the consequences of less-than-adequate insurance would be more compelling.

Telling homeowners that insuring to value helps them rebuild is a message lost on some people. However, insuring for less than full policy requirements means a claim for a partial loss will pay only a percentage of the total claim. That is a message worth perfecting — to all ages. ▲

Lynne McChristian is the Florida representative for the Insurance Information Institute. She may be contacted at 813-480-6446, lynnem@iii.org. Also, see www.InsuringFlorida.org for her insurance blog, "Straight Talk."