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Insights for Your Industry™ — Hotels

PROTECTING YOUR PROPERTY

Coinsurance — *What Is It and Why Is It Important?*

What happens when a hotel, or any building owner, for that matter, fails to carry an amount of insurance that is equal to a required percentage of the value of the building? Nothing, that is, until there is a loss to the property. Underinsurance, brought about by the failure to meet the policy's coinsurance requirement, is a widespread problem in the U.S. What is coinsurance and how can it affect the settlement of a property loss?

Coinsurance is a property insurance provision that imposes a penalty on an insured's loss recovery if the limit of insurance purchased is not at least equal to a specified percentage of the value of the insured building. The purpose of coinsurance is to avoid inequity and to encourage building owners to carry a reasonable amount of insurance in relation to the value of their property.

It is well established that most building property losses are partial in that they do not result in the total destruction of the structure involved. For insureds that recognize this, there may be a tendency to play the odds and limit the amount of insurance purchased. The coinsurance provision in property insurance policies is designed to discourage this thinking. The objective of coinsurance is to reward those who insure at close to full value and penalize those who do not. Let's take an example to see how the coinsurance provision or condition is applied in a loss situation:

The Atlas hotel sustains a fire loss to eight of its 30 rooms in the amount of $100,000. The actual cash value* of the

hotel building is $1 million, but the amount of insurance on the building is $600,000. The policy contains an 80 percent coinsurance clause (which is fairly typical, but coinsurance percentages of 90 and 100 percent are also available for a reduced premium rate). With these numbers, how will the loss be settled?

The coinsurance formula is: Insurance carried divided by insurance required X the loss = amount recoverable.

Based on the example, Insurance Carried ($600,000) divided by Insurance Required ($800,000: 80% X $1,000,000) yields 75% X $100,000 (Loss) = $75,000 amount recoverable. In this case, the hotel was underinsured, that is, did not meet the coinsurance requirement and was subject to a penalty. Thus, the insured "coinsured" or shared the loss with the insurer,

*Buildings can be insured on an actual cash value or replacement cost basis. Actual cash value means the cost to repair or replace property less depreciation. Replacement cost means the cost to replace property today without deduction for depreciation. In short, replacement cost means replacing with new for old.

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paying $25,000 of the loss out of its own pocket, so to speak. Had the hotel met the coinsurance requirement of 80 percent by insuring in the amount of $800,000, there would not have been a penalty and the insured would have recovered the full $100,000 less the deductible.

Some insurance policies do not contain a coinsurance provision, and in those policies that contain the provision, coinsurance can be waived or suspended by the use of an agreed value endorsement. With this endorsement, an insured can avoid a coinsurance penalty. However, the coinsurance provision is suspended only if the insured carries an amount of insurance that the company and insured agree to be the property's actual value. With this endorsement, the insured and insurer have agreed prior to loss that the amount of insurance carried is adequate. It is important that an accurate insurance amount is established for this endorsement to be effective.

Conclusion

Insuring the hotel building for an amount that accurately reflects its value can reduce or eliminate the risk of underinsurance. Hotel management can benefit from regularly discussing their insurance program with their agent or broker, particularly focusing on whether they carry sufficient insurance so as to eliminate a coinsurance penalty in the event of loss. Hotels may also be eligible to purchase an agreed value endorsement, suspending the coinsurance provision, and that possibility should be discussed as well.

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