



BVI Homeowners Guide

to

Understanding and Avoiding

UNDERINSURANCE

MONEY MATTERS BVI

WHAT DOES IT MEAN FOR YOUR HOME TO BE UNDERINSURED?

To be underinsured means that the value of the home insurance on your property (home) is less than the actual value of the property at the time a claim for a loss occurs.

In simpler terms, being underinsured mean that you do not have enough home insurance coverage to cover you fully if your home is destroyed.

Example of Underinsurance in action:

- VAR is \$800,000
- SUM INSURED is \$200,000 (i.e. ¼ the value)
- You are underinsured by \$600,000 (i.e. \$800,000 - \$200,000)
- If your entire home is destroyed, (i.e. the SUM INSURED/ \$200,000) your entire home, your loss amount is \$200,000
- Your settlement will be calculated as follows:

$$\begin{array}{c} \$200,000 \\ \text{(Value insured)} \\ \hline 800,000 \\ \text{(VAR)} \end{array} \times \frac{\begin{array}{c} \$200,000 \\ \text{(loss amount)} \\ \hline 1 \end{array}}{1} = \$50,000$$

- Insurance Settlement (after Deductible) = (\$50,000 - (\$800,000 VAR x .02* Deductible)) = **\$34,000**

Due to underinsurance, the settlement above is said to have been calculated using Average (The insurance term used when calculating a payout against a claim, where your SUM INSURED is less than the value.)

If your home was fully insured, Average would not apply.

TYPES OF COVERAGE AVAILABLE:

- Cost Value/ Actual Cash Value Coverage:** Reimburses you for the value of your home based on the current condition. Your insurer will compensate you based on the depreciated value of the damaged items at the time of the loss.
- Replacement Cost Coverage:** Reimburses you for the amount it will cost to rebuild your home like new, with the like kind and like quality of materials. There will be no consideration of depreciation in determining your settlement payout.

NOTE: (i) Some insurers require you to meet an 80% (or other percentage) co-insurance threshold, while others require you to purchase the full 100% (co-)insurance coverage for the value of your home.
(ii) Your policy states the amount of your Deductible. The Deductible is the amount that you as policy holder will pay out of pocket before your insurance coverage kicks in.

UNDERINSURANCE IS LIKELY TO OCCUR IF:

1. You failed to purchase adequate insurance coverage from the onset.
2. You failed to increase the SUM INSURED on your home over time (the value of your home may have increased).
3. You did not update your coverage after remodeling or making improvements to your home (since improvements will likely increase your home's replacement value).
4. You insured your property only for the mortgage loan or other loan amount.

CONSEQUENCES OF UNDERINSURANCE

1. One of the most significant consequences of Underinsurance is that your insurance settlement (no matter your claim amount) may be calculated using the General **'Average'** Clause (if contained in your policy).

Example of how the condition of Average is applied to a claim:

- VAR is \$600,000
- SUM INSURED is your home for \$300,000 (i.e. ½ the value)
- Your Loss Amount is \$50,000
- Gross settlement (before Deductible): $\frac{\$300,000}{\$600,000} \times \frac{\$50,000}{1} = \$25,000$
- Insurance Settlement (after Deductible) = (\$25,000 - (600,000 x .02*) = **\$13,000**

* 2% Deductible is a hyperthetical percentage used in the example herein.
VAR = Value At Risk/The value of your home.
SUM INSURED = The amount you insured your home for.

Once the insurer applies the Average clause based on your policy contract, they are able to reduce their pay out in proportion to your under-insurance. After all, it would be unfair to other fully insured customers for you to receive a full insurance payout, when you only paid part of the premium that would be due, rather than a full premium for full insurance coverage.

2. A failure to meet your Coinsurance (*Coininsurance is a concept whereby loss covered by the policy is spread between the insurance company and the insured*) coverage requirement (typically 80% of the value of the actual cash value or replacement cost of your home) will reduce your compensation after a loss, and result in a Coinsurance Penalty before Deductible.

Simple Example of Coinsurance penalty in action:

- VAR is \$600,000
- Your coinsurance requirement is 80% so you need to insure your home for at least \$480,000
- SUM INSURED is \$300,000 (i.e. 63%)
- Your Loss Amount is \$50,000
- Your penalty amount will be deducted from your claim amount (for example RATIO:
 $\$300,000 \div \$480,000 = .625$;
- Insurance Settlement: $.625 \times \$50,000 = \mathbf{\$31,250}$;
- Insurance Settlement (after Deductible): $(\$31,250 - (\$480,000 \times .02)) = \mathbf{\$21,650}$

3. In addition to receiving a low value settlement which is inadequate to repair or rebuild your home, another real consequence of underinsurance is the possibility of not receiving any payment at all.

Simple Example of Insufficient Insurance values:

- VAR is \$600,000
- SUM INSURED is \$150,000 (i.e. $\frac{1}{4}$ the value)
- Your Loss Amount is \$30,000
 - Gross settlement (before Deductible) will be limited to \$7,500 (i.e. $\$30,000 \div 4$)
- If your Deductible is 2%, then \$12,000 (i.e. $\$600,000 \text{ VAR} \times .02$ Deductible) must be subtracted from your settlement; In this case your settlement will be **ZERO** since your Deductible is higher than your proposed settlement.

Having insufficient insurance may put you in a position where you will have to self-fund significant repairs to your property to remedy major damage.

TIPS FOR SETTING THE RIGHT COVERAGE

- 1 - Look for a percentage next to the limit for building and/or personal property in your policy. If a percentage is listed, it means that you have agreed under contract with your insurance company that the coverage you selected is at least equal to (a) the cost value or (b) the replacement value (depending on the policy you selected) of your home which you are insuring. Failing to insure in accordance with this agreement means you will accept less than the full claim.
- 2 - Arrange with an approved appraiser to determine the replacement cost of your home. Their analysis should consider the number of rooms, the type of rooms, the quality of the construction of your home, the quality of materials, windows, cabinets, etc., and any special features in your home.
- 3 - If possible, arrange for your insurance company or agent representative to visit your home to confirm the replacement value of your home as assessed by the appraiser.

Simple Example of how VAR is Calculated:

- Livable Area: 3,500 Sq. Ft. @ \$150* per Sq. Ft. = \$525,000
- Porches: 200 Sq. Ft. @ \$45* per Sq. Ft. = \$9,000
- Garage: 300 Sq. Ft. @ \$50* per Sq. Ft. = \$15,000
- Cistern: 20,000 gals @ 1.50* per gal = \$30,000
- External Works (e.g. walkways, etc.) = \$20,000
- **Total VAR = \$599,000**

4 – Insure for a value within your co-insurance threshold (whether that is 80%, 90%, 100%, or some other value).

5 – To avoid serious financial crisis due to Underinsurance,

- (a) determine from your insurer how often as a regular maintenance effort is sufficient to appraise and revise your coverage; and
- (b) revise your coverage adequately after conducting any post-insurance improvements.

OTHER POINTS TO REMEMBER

- A. Your homeowner policy will almost always have a Deductible clause. You may be able to negotiate the Deductible percentage with your insurer prior to entering your insurance contract.
- B. READ through your policy and check for obvious errors; also seek to understand defined terms in your policy.
- C. When buying, renewing or revising your insurance coverage, ensure that you understand from your insurer what will and will not be covered AND verify that what the agent says corresponds with what is in the schedule to your policy.
- D. The BVI is prone to tropical storms and hurricanes, therefore, as a homeowner in the BVI, you should NEVER exclude windstorm coverage from your policy.
- E. Maintain an inventory of the contents you insure.
- F. Insurance is never a one shoe fits all, therefore, consider whether you also need to purchase insurance for:
 - i. Liability
 - ii. Loss of Use/Additional living expenses
 - iii. Loss of Rent
 - iv. Contents
 - v. Fire, Earthquake, Flood damage
 - vi. Other Structures on your property: retaining walls, storeroom, storage, meter house, etc.

DISASTERS CAN OCCUR AT ANYTIME



Now that you are better informed about Underinsurance, don't get caught in the elements without proper protection



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