Knowledge IS Power

Misunderstood Co-insurance
Don’t be Surprised When it’s Too Late

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This is a long article but I believe it may be worth your time if you are a small-to-medium rental property owner-operator.

Arguably, all tenants and most small-to-medium housing providers are unaware of the insurance industry’s controversial and contentious “co-insurance” scheme that can significantly impact tenants and policy holders. The label “co-insurance” is misleading. One could not be faulted for thinking It means your insurance company is “sharing” the risk with another insurance company, for example, but that's not correct.

Co-insurance forces policy holders to agree, often without the policy holder’s understanding, to reduce an insurer’s payout of a claim **in addition** to the well-understood deductible. If the coverage amount is less than replacement (or rebuild) value, then the policy holder will not receive the full compensation in the event of a claim, even if it’s only a partial loss. In order to receive a full payout, a property owner must insure the property to the full replacement value even if the owner doesn’t want or require it.

For example, while a property’s market value (i.e. the purchase or sale price) might be $1,200,000, the cost to rebuild it might be $2,000,000 (“replacement value”). The owner may be a renovation expert or have significant financial resources. Or the owner may simply wish to assume the risk of a total loss and instead insure for only a partial loss. The owner decides to insure the property for $1,000,000 to reduce their costly insurance premium. They intuitively believe that a $500,000 claim will be fully covered but that’s not true. The co-insurance clause states that **the percentage of “under-coverage” will be applied to the claim**. In this case, the property was “under-insured” by 50% of the total replacement value so the partial claim will be reduced by 50%. The insurer pays out $250,000 instead of the $500,000 the policy holder was expecting, leaving the owner to come up with the balance or possibly lose the property. In many cases this reduced payout comes as a shock to the owner.

90% co-insurance means that coverage for the replacement or rebuild value of the property purchased by the policy holder must be at least 90% of the agreed-upon replacement value. 80% used to be the norm but many insurers have increased this to 90% or even 100%.

Co-insurance is a cost-saving and risk-mitigation *trick* that solely benefits insurance companies by minimizing the amount of money they have to pay out while maximizing the amount of premiums they collect. It provides no benefit of any kind for the policy holder.

And contrary to the marketing hype, supposedly-independent brokerages as well as insurers with their own direct sales force that employ a co-insurance scheme are not acting in the best interest of their clients or offering the best value for coverages. Some of these brokers may offer "Stated Value" coverage but the policy holder is still forced to insure for the property's full replacement value. This is ambiguously called ""Stated Value Co-Insurance." I asked several insurance agents why full replacement value is required and, without exception, not a single broker could tell me the business case for requiring this.

Who ultimately pays? No surprise … tenants … through rent increases. And what are the demographics of a great many renters? They're low-to-moderate wage earners who are the least able to pay these inflated premiums.

Why might co-insurance matter to you as a housing provider? Because you may get a quote from an insurance brokerage that appears to be an attractive low-cost premium. However, the co-insurance clause substantially limits the insurer's payout risk while the insured party has no clue that they aren't covered for the whole of the partial loss. Co-insurance makes a low premium quote look much better than it really is … unless you never have a loss. Of course, that's counter-intuitive to the nature of what insurance is.

Additionally, I believe that almost all tenants and most small property owners don't know that there's no law in Ontario (to my knowledge), and possibly throughout Canada, that requires a property to be insured. However, all mortgage lenders require property insurance as part of their mortgage contract. Mortgage lenders generally don't care about replacement value, although every lender has their own requirements. Lenders are primarily concerned that the full amount of the mortgage outstanding plus any "early cancellation" fees (which occurs immediately if there's a full loss) are fully covered.

Tenants would never know if a property had no building insurance. Diligent tenants living in a communal property are at the mercy of thoughtless and careless tenants (yes, there are some like that), or even vandals and arsonists (in the extreme). For example, I learned very recently of two young men caught on video camera who set fire to a garbage bin in the back of a building just for fun. It quickly expanded and "jumped" to the low-hanging awning of the building and caused $1 million in damages. Uninsured rental properties could result in a tenant losing everything (or worse) in a catastrophic event and then have no practical recourse for financial recovery.

There is an alternate option for co-insurance. It's generally called "Stated Amount," but don't confuse this with "Stated Amount Co-Insurance." Stated Amount is where you and the insurance company agree on what the replacement value is of your property and then the insurance company permits you to insure your property below that stated amount by a certain percentage. This means that in the event of a total loss you will only be paid for the “stated amount.” **However, a partial loss below the stated amount is still 100% covered.**

Stated Amount Co-insurance is smoke and mirrors. It’s a stated amount for full payout on a partial loss BUT you must still insure the property to its full (or 90%) replacement value.

In my earlier example above, the $500,000 loss would have been fully paid out under a stated amount policy of $1,000,000. However, the lowest stated amount reduction I could find was 80% of the rebuild value so the $2,000,000 property could not have been insured for less than $1,600,000. This reduction nevertheless can have a meaningful impact on your insurance premium.

In a real-world case example, the rebuild value of a property was $2,650,000. The premium with a $5,000 deductible was $6,011.73 and for a $10,000 deductible it was $5,833.00. To insure the property without co-insurance for a stated value of $2,150,000 (80% of rebuild value), the premium with a $5,000 deductible was $5,128.20 and with $10,000 it dropped further to $4,977.60. All quoted prices are before tax and quoted in March 2023.

I believe and teach that property insurance is meant to be coverage for catastrophic events, not a plan to cover costs of vandalism and maintenance. I generally opt for a $10,000 deductible since that’s a relatively small payment in the event of a $2,150,000 loss. However, the savings between the $5K and $10K deductibles were $178.73/year at full stated value and $150.60/year for the 80% of stated value. You wouldn't recover the $5,000 deductible difference from the premium "savings" for 28 years for full value and 33 years for 80% stated value.

Still, the premium in this example with $10K deductible yielded a difference of $855.00 (14.6% decrease) between 100% stated value and 80% stated value. As you’ve repeatedly seen me write, not only have you “recovered” that money for other purposes but $1 of NOI is $20 of joy, so the $855 savings is a $17,100 increase in baseline property value (at a 5% cap rate).

The insurer also stated, “*… you are covered on a loss up to the rebuild value without you having to pay anything but the deductible (because there is no co-insurance),* ” and added, “*We feel co-insurance could be misleading and lead to customer dissatisfaction at the time of claim*.”

Insurance companies are regulated but the premiums they charge don’t necessarily have any commensurate relationship with the risks they cover or even refuse to cover, and premium amounts to my knowledge don’t fall under any regulation. When insurers set up their business, they have to define as part of their license what kinds of insurance options they provide. They may actually not be empowered as part of their charter to offer stated amount insurance. Consequently, if you get push-back from an insurance broker that they only offer co-insurance and they require full replacement value, the real reason may be simply that they don’t have the regulated option to offer the more client-friendly stated amount coverage.

If that turned out to be the case then these insurance brokers and companies may not be acting in your best interests. Realtors, for example, are required by law (TRESA, previously REBBA) to put the interests of their clients above their personal interests. This is called “fiduciary responsibility” or a responsibility based on implicit trust. A breach of this responsibility is generically called a “breach of trust” and can have serious consequences for a realtor and brokerage including fines and loss of license and livelihood. I don’t know if an insurance broker’s license has the same fiduciary responsibility but if they do, it seems to me that a strong argument could be made that co-insurance brokers are putting their interests and those of the insurance company(s) ahead of their clients' interests and therefore not fulfilling their fiduciary responsibility.

There's a trade-off though, as is often the case. In this case, it boils down to the cost for peace-of-mind or perhaps a hedge against the insurance industry's most powerful tool – the "fear factor." Without full replacement cost in your "stated value" policy you'd always have the mortgage covered (your mortgage contract requires it) but in the event of a total loss or a partial loss beyond the stated value, you may not have the means to re-build the property. You could become the proud owner of a piece of land that still pays property taxes but generates no income. For a total loss, it's possible that mainstream lenders may not loan you the money to re-build your income-producing property because you're probably not a proven property developer or builder.

But at least stated value insurance coverage empowers you with the choice to decide how much risk you want to assume rather than being subjected, in the worst case, to profiteering, and in lesser cases to the whim of uninformed and sometimes haughty underwriters that don't have the requisite knowledge and skills to properly assess residential rental property risks. I've personally seen and been routinely told about many "take-it-or-leave-it" ultimatums from insurance companies and their sales channels. In my experience, a small percentage of all insurance brokers understand our rental property business, and a subset of those truly work on behalf of their clients to obtain the *best value* coverage (not necessarily the lowest premium price).

Let's be clear: most insurance agents are paid a commission. The higher the insurance premium, the more money the agent and brokerage make. And some agents and brokerages are further rewarded by their insurance companies if clients don't make a claim, which further distances insurance agents from the policy holders (and possible fiduciary responsibility).

If your insurance provider refuses to remove the co-insurance condition and won't offer you a competitive "stated amount" option, then you might want to consider looking for another insurance company that will. To date, I have only found one insurance company - Desjardins Insurance - so far that doesn't employ co-insurance. Feel free to send me an email if you'd like the contact information for the company and agent that I elected to use.

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The 78 legal clauses I added to the Ontario Standard Tenancy Agreement, a compressed Word version of the standard lease agreement, separate guarantor and parking agreements, and the application form I use can be found here: www.standardlease.ca

My 330-page book, *Landlording in Ontario*, is a superset of what I teach in the course: www.landlordingbook.com

My second book, *The Dark Side of Residential Landlording*, is a no-nonsense, firsthand, in-the-trenches, occasionally irreverent, decade-long account and compendium of the perils, trials and abuses against residential landlords; www.darksidebook.com

I teach a 6-Saturday course (total 36 hours), ***Landlording in Ontario*,** on *everything* from finding and properly assessing the value of an investment property to dealing with the "dark side" of being a landlord and adding value in uncommon ways. Full details, including extensive testimonials from past attendees, are here: www.landlordingcourse.ca. A high-resolution video recording of a past course session is here: www.landlordingvideo.com.