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Replacement Cost and Co-Insurance: Ensuring Sufficient Limits

Replacement cost and co-insurance are two foundational concepts in property insurance.

Together, they determine whether you have enough coverage to fully recover from a loss - be it to your home, business, or vehicle. Insufficient limits can leave policyholders exposed to significant out-of-pocket expenses, especially as rebuilding costs rise. This insight explains these concepts and emphasizes why regularly reviewing your insurance limits is crucial in today's evolving risk landscape.

REPLACEMENT COST: WHAT IT MEANS

Replacement cost refers to the amount required to repair or rebuild your property with materials of like kind and quality, without deduction for depreciation. Most commercial and personal property insurance policies in Canada offer coverage on a replacement cost basis, meaning you are compensated for the actual cost to restore your property to its pre-loss condition, not its depreciated value.

For vehicles, replacement cost coverage (often called a "waiver of depreciation" or "replacement cost endorsement") ensures that if your new vehicle is stolen or written off, it will be replaced with a new one of the same make and model, or you'll receive the equivalent value as specified in your policy. However, this coverage is time-limited and subject to eligibility criteria that vary by province and insurer.

CO-INSURANCE: THE PENALTY FOR UNDERINSURING

Co-insurance is a clause found in most property insurance policies. It requires policyholders to insure their property to a specified percentage (commonly 80%, 90%, or even 100%) of its full replacement cost. The purpose is to encourage adequate insurance and ensure premiums are fair for all policyholders.

HOW CO-INSURANCE WORKS

If you insure your property for less than the required percentage of its replacement cost, you become a "co-insurer" and share in any loss. In the event of a claim, the insurer applies a penalty formula, reducing your payout proportionally to the amount you underinsured.

Payout=(Amount InsuredRequired Amount)×Loss AmountPayout=(Required AmountAmount Insured)×Loss Amount

For example, if your building's replacement cost is $1,400,000 and your policy has a 90% co-insurance clause, you must insure at least $1,260,000.

If you only insure for $1,000,000 and suffer a $500,000 partial loss, your payout will be reduced to approximately $357,000 (before deductible), leaving you to cover the shortfall.

THE CANADIAN CONTEXT: RISING COSTS AND VALUATION GAPS

Construction costs in Canada have risen steadily, with inflation averaging around 3% annually over the past decade. This means that insurance limits set even a few years ago may now be insufficient to cover full replacement costs. Without regular appraisals and updates to your policy limits, you risk significant underinsurance and exposure to co-insurance penalties.

WHY SUFFICIENT LIMITS MATTER

- **Avoiding Co-Insurance Penalties:** Meeting the co-insurance requirement ensures you receive full compensation up to your policy limit in the event of a partial loss.
- **Full Recovery After a Loss:** Replacement cost coverage only works if your insurance limit reflects current rebuilding costs. Underinsurance means you may have to pay out-of-pocket to restore your property or replace your vehicle.
- **Changing Market Conditions:** Labour shortages, supply chain disruptions, and inflation can rapidly increase replacement costs. Regularly reviewing your insurance with a licensed professional is essential to keeping pace with these changes.

BEST PRACTICES FOR POLICYHOLDERS

- **Obtain Professional Appraisals:** Have your property professionally appraised every few years to ensure your insurance limits reflect current replacement costs.
- **Review Policy Limits Annually:** Update your coverage after renovations, expansions, or significant changes in property value.
- **Insure to 100% of Replacement Cost:** While the minimum co-insurance requirement may be 80% or 90%, insuring to full value provides the greatest protection and eliminates the risk of penalties.
- **Consult a Licensed Broker or Agent:** Insurance professionals can help you understand your policy's co-insurance requirements and recommend appropriate coverage options.

CONCLUSION

The interplay between replacement cost and co-insurance makes it critical to maintain sufficient insurance limits. Failing to do so can result in significant financial hardship after a loss - precisely when you need your insurance most. Regularly reviewing and updating your coverage with professional guidance is the best way to ensure you're fully protected in today's dynamic environment.

If you have questions specific to your business, or would like additional information, please reach out to your Lloyd Sadd Advisor.

LET US HELP YOU MANAGE YOUR RISK

Edmonton: 1.800.665.5243
Calgary: 1.866.845.8330
Kelowna: 1.800.665.5243

lloydsadd.com
info@lloydsadd.com