



# H O M E O W N E R S I N S U R A N C E

Quick Guide

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**CAUTION:** Homeowners' Insurance, like the Personal Automobile Policy is a controlled class of insurance. That means that each state determines what coverage should be included in a policy form. The forms are substantially similar from state-to-state and from company-to-company within each state. Individual insurance companies may decide to offer enhancements to the mandatory requirements.

The information contained within this Quick Guide is based upon a typical policy. Check with your insurance agent as the coverage may vary within your state or between insurance companies doing business where you reside.

# Homeowner's Insurance

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Whether you are in the process of purchasing a home or considering changing insurance agents or companies, there is one major decision you will have to make: "How much insurance do I need?" Your lender, for example, requires homeowner's insurance on your property with coverage only equal to the current outstanding balance of your loan. The lender is just looking to protect its investment in your property in the event of a total loss.

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## How Much Coverage Do You Need?

Is insuring the property for the amount required by the lender enough? Before we answer that question we need to look at four different measures of the value of your home:

1. Mortgage balance
2. Market value
3. Replacement cost
4. Actual cash value

### **Mortgage Balance**

The Mortgage Balance is the amount outstanding on your loan. From the lender's standpoint, this is the value of your dwelling. This value does not in any way relate to the actual cost of replacing your home in the event of a total loss and should never be used as the limit selected for the dwelling.

### **Market Value**

Simply put, the market value is the cost one would pay for a home and property when the seller is not being forced to sell the property and the buyer is not under any special urgency to make the purchase.

### **Replacement Cost**

The most critical value from an insurance standpoint is the replacement cost. This amount is the dollar value it would take to rebuild your home with like kind and quality of materials at the current construction costs for your local area. This is the amount you should be insuring your house for.

The difference between market value and replacement value is simple. Picture a hypothetical house in a quiet neighborhood built across the street from a public park. Now imagine that exact same house, but this time place it across the street from a garbage dump and with a major highway running behind the property. In both cases the replacement cost will be exactly the same, but the market value will vary dramatically. The policy is structured to enable you to rebuild on the same site a substantially similar structure, replacement cost is the measure of that value.

### **Actual Cash Value**

The final value a homeowner's policyholder must be concerned about is actual cash value (*a.k.a. depreciated value*). Actual cash value (ACV), simply stated, is today's cost to repair or replace a dwelling minus functional depreciation. Depreciation is the reduction in an item's worth as it gets older. For example the roof on a dwelling should last for 20 years. Thus, if it costs \$20,000 to replace a ten-year-old roof destroyed by a fire, the actual cash value of that roof is \$10,000.

$$\frac{\text{Age of roof} = 10 \text{ Years}}{\text{Expected life span} = 20 \text{ years}} = .50$$

Replacement cost \$20,000 x .50 = \$10,000 actual cash value

In this case, the homeowner has received the benefit of the roof for 50% of its anticipated useful life. The company would only pay \$10,000 to replace a ten-year-old roof, even though the cost of such a replacement is \$20,000.

While almost all homeowners' policies will pay for replacement cost, they will only do so if the amount of insurance carried is equal to 80% of the replacement cost at the time of the loss. If it is determined that the amount of insurance carried in the policy is less than the required 80% then the settlement of a loss will be made on the actual cash value basis. This can be financially devastating to the homeowner in the event of a significant loss.

**SUGGESTION:** Your insurance agent has a number of tools at his or her disposal to assist you in determining the replacement value of your home.

**IMPORTANT NOTE:** Even if your home decreases in value due to market forces in your area, the cost of replacing that home will most probably increase each year, as the cost of construction and materials goes up. Your insurance company may increase the amount of your insurance each year based upon a cost of construction index for your local area. Remember, if you make modifications to your house that would increase the cost of rebuilding, let your agent know. They can help you determine how much additional coverage you might need based upon the new construction.

In today's real estate market, you may find that the replacement cost of your home is less than the outstanding balance on your mortgage. This is because your mortgage is based upon the total market value of your property, while the insurance is only concerned with the replacement cost.

In most cases your insurance agent will resolve this problem by obtaining coverage with some form of

guaranteed dwelling replacement cost provision. The terms of this added coverage can vary from company to company, but in general it is an agreement to provide protection above the stated limit for the dwelling in amounts equal to 25, 50, or even 100% of the listed replacement cost for the dwelling. For usually a nominal fee, you don't pay the full cost for this added protection unless you actually use it in the settlement of a loss. A guaranteed dwelling replacement cost endorsement will almost always be satisfactory in those instances where the replacement cost of a dwelling is less than the outstanding balance of the loan.

**SUGGESTION:** The use of a guaranteed replacement cost endorsement is a good idea even if your mortgage balance is less than the replacement cost of your home or even if you own your property free and clear.

**SUGGESTION:** If your home is over 20 years old or your community has upgraded to new building codes since the property was built, consider including an endorsement to your policy which will cover the added cost of rebuilding to meet the higher standards.

## Homeowner's Insurance Forms

There are five types of homeowner's policies where content is mandated by each individual state. While the basic coverage for each type of policy is going to be the same for each company, there are some optional variations between different carriers. Your agent can explain the differences between the various contracts to you. Let's take a look at the five basic types of Homeowners' policies:

- **HO-1:** Provides only minimal basic protection. Due to its many restrictions on coverage, it is available in only a handful of states.
- **HO-2:** Costs about 10% more than HO-1 but removes many of the restrictions imposed by an HO-1 policy.
- **HO-3:** Costs about 25% more than HO-1. As respect to the dwelling it covers everything not specifically excluded in the policy. Your personal property is insured for 16 specific types of occurrences (called perils).
- **HO-5:** Costs more than the HO 3 but covers both your dwelling and personal property for all occurrences except those specifically excluded by the policy.

- **HO-8:** Used for unique or historical structures where there is a good supply of similar homes in the local area where you could buy a replacement for a lower cost than rebuilding the damage of a loss.

**IMPORTANT NOTE:** The Classifications HO-1, 2, 3, etc are used in policies issued on forms based upon those of the Insurance Service Office (ISO). Other carriers may use forms of their own design not utilizing the ISO "HO" convention of naming. In all cases, coverage is substantially similar due to the mandated forms of protection in each state's version of the form.

There are two additional classifications of coverage for residential insurance other than those of a dwelling owner;

- **HO-4:** The "Tenants" or "Renters" policy is used by those individuals who do not own their home but rather rent the residence.
- **HO-6:** This form is used by condominium or cooperative unit owners.

## Other Insurance Issues

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All policies will include both property insurance (typically with a \$250 or higher deductible) and personal liability insurance with no deductible. Let's look at some other issues:

### Other Structures

All homeowner policy forms contain additional protection for separate buildings such as a garage or tool shed on your property. The amount of coverage is equal to 10% of the dwelling value. This amount can be increased if necessary for an additional charge. Coverage is automatic and the basic 10% cannot be eliminated. Be careful here: If you have an office or side business in a separate structure, it will not be covered by your homeowner's insurance.

### Contents Insurance

Each homeowner form automatically covers personal property with a limit equal to 50% of the dwelling coverage. A policy insuring a home for \$200,000, for example, typically provides \$100,000 in contents coverage. The policy form values your personal property on an actual cash value basis. The insured can add replacement cost protection to this property. One of the more common ways a company charges for this broadened protection is to increase the limit on personal property from 50% of the dwelling to 70%. The amount of coverage you require may vary from the 50% or 70% limit. Speak to your agent. Some insurance companies will allow for limits below 50% if it is warranted by the actual values.

### Additional Living Expense

If you need to move out of your home after a loss resulting from a covered peril your added costs to live away from your damaged property are covered by this section. The traditional coverage is limited to 20% of your dwelling limit. Some companies have opted for a newer method known as actual loss sustained. These policies do not have a specific limit for additional living expense but rather will pay all covered costs for a period of 12 months from the date of loss.

**IMPORTANT NOTE:** If you are single and buying as live-togethers, be very careful about your insurance. Some companies will cover all owners on one policy, others will not. Most carriers will now cover both parties if they are named on the deed. However, if only one individual is a titled owner of the dwelling then the other person (non-owner) needs to obtain a tenant's policy to protect their personal property and personal liability.

### Personal Liability

If someone slips and falls on your walk, your personal liability coverage will foot the bill. Coverage for \$25,000 is automatically included in all policies, but this limit is far too low to provide any realistic protection. Opt for limits of \$300,000 or more. All homeowners should consider obtaining a personal excess umbrella liability policy discussed later in this guide.

**IMPORTANT NOTE:** Many states require the purchase of Workers' Compensation insurance for your domestic household workers as part of your homeowner's policy. The rules in each state vary widely, so check with your insurance broker or state employment office to see how this affects you.

### Medical Payments to Others

Whereas the personal liability coverage requires that the Insured be legally liable for a claimant's injuries, there can be instances where someone is injured on your premises and there is no legal obligation on your behalf. (A guest cutting a finger while helping make dinner would be one example where the homeowner is not legally obligated for the injuries.) While not legally obligated for the injuries, the homeowner may still feel a moral obligation to take care of the guest's medical bills. In addition, the insurance companies recognize that, in paying for such expenses, they may prevent a more costly lawsuit from the injured parties. The limit on medical payments to others typically ranges from \$1,000 to \$5,000 per person.

## Standard Policy Exclusions

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No policy covers absolutely every occurrence. In fact, there are a handful of standard policy

exclusions that you should be aware of. Coverage for these items can be purchased at extra cost.

## **Business Property**

Equipment used in a home business must be insured separately. Get a rider attached to your homeowner's policy.

## **Host Liability**

The increasing number of lawsuits against hosts whose guests are later involved in alcohol-related accidents has led to liability coverage through a special 'host liquor' rider. Some policies may automatically cover this under the personal liability provision of the policy.

## **Earthquakes**

The standard homeowner's insurance does not cover earthquakes, although fire damage caused by an earthquake would be covered. Adding protection for the damage caused by the quake itself can be purchased. Costs vary according to the region.

## **Floods**

The standard policy does not cover flood damage. Special flood insurance is available from the federal government or private carriers and is available through your agent. You do not have to live near a body of water to need flood insurance. A person living in a desert may be at risk of flash flooding due to rainstorms many miles away. At the same time,

someone living on or below a hill should carry flood insurance due to the risk of mudslides, another peril covered by a flood policy.

## **Scheduled Personal Property**

All policies contain sub-limits on certain classes of property such as jewelry, furs, cash, and metal ware (silverware, pewter, gold, etc.). In addition, the replacement cost provisions for personal property do not apply to items that derive their principal value from their historic or artistic nature. These limits can be increased either by a specific endorsement such as amending cover for theft of cash from \$100 to \$500 or by the listing of individual items of high value on the policy. Some of the types of property that should be listed (scheduled) on a policy include: jewelry, fine arts, antiques, stamp or coin collections, and musical instruments. This coverage used to be provided by a form called a personal property floater. However, in most cases today, coverage can be added to the homeowners' policy by adding a scheduled property endorsement. In order to be properly protected, you would need to document the values of such scheduled property by a recent bill of sale, credit card receipt, or qualified appraisal. Your agent can assist you in finding the best way to document the insurance value of the property to be listed on your policy.

## *Umbrella Policies*

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**T**here is one additional policy that all homeowners must seriously consider. Since liability lawsuits today are typically for a \$1 million or more, make sure you carry personal liability limits of, at the very least, \$300,000 to \$500,000. But even those limits will not be sufficient in the event of a claim that you might be liable for. We say "might" because you can be sued by anyone, even if you are ultimately freed of any legal responsibility for the injuries. It is wise to have a personal excess umbrella liability policy. This type of coverage is available in addition to the personal liability protection provided by your homeowner's insurance.

Umbrella limits are typically for \$1 million or more. The premium for such coverage is modest, usually \$200 to \$300 annually. Umbrella liability coverage does require underwriting and may not be available in certain situations. An umbrella kicks in when the coverage provided by your home or auto policies is used up. It also may provide coverage for some lawsuits not covered under homeowner's or auto insurance policies. Umbrella policies protect the insured against lawsuits involving:

- Bodily injury
- Property damage
- Personal injury (libel, slander, invasion of privacy).

Umbrella policies do not cover:

- Intentional misconduct
- Criminal matters

**IMPORTANT NOTE:** Not all personal excess liability policies are “umbrellas”. A true umbrella will provide excess protection when the primary limits are used up and will also provide protection in certain instances where a home or auto policy does not provide coverage. Some policies will only provide insurance when there is coverage under a primary policy. These still provide valuable protection but are not as broad as the true umbrella. One clue is to make sure the word “umbrella” is part of a policy name.

The cost of an umbrella policy is approximately \$200 to \$300 per year per million dollars of coverage.

**IMPORTANT NOTE:** Make sure this liability coverage is coordinated with your homeowner’s and auto insurance. The underlying insurance requirements will vary by company. Typically, you would need to carry personal automobile liability coverage of at least \$100,000 per person and \$300,000 per occurrence, and homeowner’s personal liability of \$300,000. The umbrella policy should take effect after these limits are met.

## How Big an Umbrella Do I Need?

You can never buy “too much” liability insurance. What you need to do is balance the absolute needs versus the cost effectiveness of obtaining higher policy limits. In selecting the combined limits of your homeowner’s, automobile, and umbrella policies you need to take into consideration not only your net worth but also your future earnings potential along with any known inheritances from which you may benefit. ♦

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**DISCLAIMER:** This Quick Guide is only presented as a non-specific overview of insurance. It contains information so that you can be better informed when you talk with a licensed insurance agent. In all cases where a discrepancy may exist between the information in this guide and the actual policy wording, the terms and conditions of the policy will always take precedence over the guide.

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