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Making S.M.A.R.T. Financial Decisions

Homeowners Insurance

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On October 20, 1991, I was home with my wife, our two daughters, a friend, and the four-year-old daughter of our neighbor, Lynn. We had heard sirens, and smoke was blowing down from the hill above us. A little after noon, the smoke got so thick it blocked the sun. We decided to leave. Just as we were leaving, Lynn showed up in a panic. She had been out shopping, and when she tried to drive home, she ran into a huge traffic jam at the bottom of the hill. She thought we should drive out the back way. Her one-year-old son and his babysitter joined us, and we left with three cars, five adults, four children, two cats, and a dog. After driving less than two blocks, we realized that we were driving into the fire, so we turned around and joined the traffic jam at the bottom of the hill.

That evening, we watched on TV as our neighborhood burned. Nearly 3,000 homes in the Oakland hills were destroyed, but we got lucky. The fire was stopped 200 feet from our house. After the fire, my neighbors learned a lot about homeowner's policies-- how some policies are better than others and how the fine print doesn't matter until things go wrong.

So let's talk a bit about how homeowner's policies work and how they vary. Your home is probably your most valuable asset. It needs to be insured. If you have a mortgage, your mortgage company will require you to have a homeowner's policy, but don't let them pick a policy for you. Shop for your policy. Doing so is likely to save you a lot of money and get you the right policy.

When comparing policy prices, be sure to compare apples with apples. Do the policies cover the same risks? Do they have the same limits? Do they have the same deductibles, the same replacement cost rules? If one policy is for actual cash value and the other for full replacement cost, they are not the same. The one with full replacement cost is better, and it's going to cost more. Compare prices of policies with the same features.

Generally, the less insurance you buy, the lower the premiums. However, you shouldn't insure your home for less than what it's going to cost you to rebuild. If the insurance company determines that you are insured for less than 80% of replacement cost, you may not get paid in full, even on smaller claims such as a fire that damages but doesn't destroy your home. You should insure your home for 100% of what it would cost to rebuild. This may be more or less than current real estate values. You can get estimates of rebuilding cost from local builders. Alternatively, your insurance agent is likely to have a computer program that estimate your rebuilding costs based on the size, location, and features of your home. Now, don't let the agent cut corners. You want the true replacement cost, and ask for and keep a copy of the agent's calculations and estimate. Low balling your policy limits is not the way to save money on your homeowner's insurance. If you want to save on your premium, take as large a deductible as you could afford to pay. If you have a claim, a large deductible is going to cost you more money, which you can pay out of your emergency fund, but in the long run a high deductible is likely to save you money.

OK, you need to buy a homeowner's policy with a high enough policy limit to rebuild your home. You also need to know that insurance policies use different methods to calculate what you are owed if you have a claim. There are actual cash value policies and replacement cost value policies and guaranteed replacement cost policies. If your home is damaged or destroyed, an actual cash value policy will pay you the cost of rebuilding, minus depreciation. So, for example, suppose that your 15-year-old roof was destroyed in a storm and needs to be replaced. Let's say the roof was rated to be good for 25 years, so the insurance company figures you've already gotten at least half the value from it. If you have an actual cash value policy, you'll probably get paid less than half the cost of replacing your roof with a new one. If you have a replacement cost policy, the insurance company will pay the entire cost of replacing your destroyed roof, up to the limits of your policy. And if you have a guaranteed replacement cost policy, the insurance company will pay the full cost of replacing your roof, up to some amount above your policy limit, such as 125%. Now, a roof is not likely to cost more than your policy limit, but if your entire house burns down, rebuilding might cost more than your policy limits, especially if your policy is old and the limit hasn't been properly adjusted for rising building cost.

Actual cash value and replacement cost value policies also use different methods to determine how much an insurance company is going to pay if your stuff is damaged, lost, or stolen. Using the actual cash value method, the insurance company pays you about as much as you could get selling your stuff on Craigslist or eBay. Suppose, for example, you paid $800 for your brand-new TV five years ago. If you have an actual cash value policy, your insurance company is not going to give you $800 for the loss of that old TV. Maybe they'll give you $300, maybe less. With a replacement cost value policy, the insurance company will pay you what it costs for you to replace your old TV with a new TV with similar features. Naturally, the replacement cost value policies are more expensive than the actual cash value policies because insurance companies end up paying out more money when there are claims filed. In either case, however, the insurance company is going to have a dollar limit on how much it will pay in total for lost or damaged property. Sometimes there are maximum limits for different categories of property, such as computer equipment, so read your policy carefully in advance. Know what's covered, what's not covered, and whether your insurance company is going to value your property at actual cash value or replacement cost value. And what are the limits on what they'll pay you?

Most home owner's policies also provide coverage for loss of use. If, for example, you need to move out of your home because of a fire, your policy may pay for you to rent a place while your home is been repaired or rebuilt. Homeowner's insurance also provides liability insurance and medical payments to other people if they are injured in your home or on your property, for example, if a friend or visitor slips on your rug and breaks her wrist. It's important to know that your family and housemates are not covered by the liability insurance and are not eligible for medical payments from your homeowner's insurance if they are injured on your property.

There are two different ways that homeowner's policies specify what risks are covered-- named perils coverage and all risks coverage. Named perils policies are less expensive because they only cover risks, or perils, specifically named in the policy-- obvious things like fire, lightning, and theft and a few less common risks such as volcanic eruption, a peril that doesn't keep me awake at night. All risks policies don't really cover all risks. They cover everything except for things that are explicitly excluded. Nevertheless, all risk coverage is better than named perils coverage because more things that can damage your home are covered. While volcanoes don't keep me awake at night, I do sometimes get woken up by earthquakes. Standard homeowner's policies do not cover earthquakes or floods. You need separate policies for both. And while most homeowners policies cover wind damage, if you live in an area susceptible to hurricanes, you may need special windstorm coverage.

Homeowner's policies have standardized forms. The most common are HO2, HO3, and HO5. HO2 is the most basic, HO3, the most common, and HO5, the most comprehensive and the most expensive. When you compare prices on policies, you want to be sure that you're comparing policies offering the same coverage. While policies with the same form have similar coverage, they might not be exactly the same. When comparing two policies, the big questions to ask are, are the policy limits the same? Do both policies cover specific named perils? Or do both policies cover all risks except the same specifically excluded perils? Do both policies insure your home for actual cash value, for replacement cost value, or for guaranteed replacement cost? Do both policies insure your property for named perils or for all risks except excluded perils? Note that some HO3 policies will insure your house for all risks except excluded perils, while only insuring your property for named perils. Do both policies insure your property-- your furniture, clothing, jewelry-- for the same limits and the same valuation method? Note that some policies use replacement cost value for your house, but actual cash value for your property. Be sure to compare apples with apples when shopping for any insurance policy. And before you buy, read your policy slowly and carefully. Pay attention to details. If you don't understand something, ask your insurance agent to explain it clearly. You may also be able to find helpful explanations for insurance terms on the internet. Know what you're buying before you buy it. As some of my neighbors who lost homes in the Oakland fire could tell you, you don't want to find out that you have less insurance than you thought you had after your home burns.