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Are You Wondering If Your Home Is Underinsured? A Reader Shares His Research

REAL ESTATE TODAY

By JIM SMITH, Realtor®

My column on May 12 addressed the problem of underinsurance faced by homeowners who lost their homes in the Marhall Fire last December. It reported that, according to the Colorado Division of Insurance, only 8% of the homes destroyed in that fire had guaranteed replacement coverage in their insurance policies.

One of my readers took it upon himself to research the subject in the context of his own home close to the foothills. The rest of this week's column is his writing, which he asked me to put under my byline. When he says "I," he's referring to himself, not me.

It turns out I haven't been able to get good answers to questions. Nonetheless, here's an account of my dive beneath the surface to understand what I might expect of my house insurance in the event of a total loss due to fire, particularly wildfire:

The reporting on homeowners insurance coverage after the Marshall Fire — which frequently referenced the Waldo Canyon fire — highlighted the extent to which homeowners are underinsured for total loss of property. This spurred me to revisit our homeowner insurance replacement cost coverage. I had already raised this concern with my insurance agent last summer, and he assured me the coverage was more than enough based on the insurance underwriter's cost per square foot "replacement-cost estimator." Besides, he said, the policy has an endorsement that would cover the actual cost of replacement regardless of stipulated coverage.

Even with such assurance, we were not reassured; so several weeks ago I reviewed my policy again. Based on the average current construction cost per square foot for the Marshall Fire cited by the state Division of Insurance, along with my own estimate of the average construction cost of three new custom homes in my neighborhood, I determined that our policy's coverage was about half what we would expect the cost to be to rebuild our house in 2022. Further, on closer reading, I realized the policy endorsement covering total replacement cost would not apply if the house were not rebuilt within two years of the loss! So, I got back in touch with my insurance agent to explain that rebuilding our house in two years or less would likely be impossible, especially if the house were among many to burn down in a wildfire, and, given this limitation of the endorsement, the policy's stipulated dwelling coverage, based on the company's estimator, was only half of the what replacement cost was likely to be; so we would need to double the coverage.

Once I received the quote for the increase in coverage, I informed him that in the event our house was to be a total loss, we would probably not be willing to rebuild, thus would want to walk away (putting the lot up for sale after clearing the debris).

However, as I could find no provision for a cash-out for the amount of our coverage, I asked if we could expect the company to agree to a cash-out in lieu of replacement. His answer was "probably"! Given that uncertainty, I asked if any policy is available that would explicitly provide for cashing out. He found one company with that option for an annual premium approximately 20% higher.

The other wrinkle to this insurance rabbit hole is if the insurance company were to agree to a cash-out in lieu of rebuilding, the actual cash-out would not be the amount of coverage stipulated in the policy, but rather that amount minus the depreciation in value of the house at the time it burned down — the depreciation calculated by the insurance company's claims department.

So far, I have been unable to obtain any useful information on depreciation from insurance companies, the Division of Insurance, or the legislature, and nothing on Google that I could see.

[While depreciation may be a reasonable factor when replacing an old roof destroyed by hail, it doesn't seem appropriate to me when it comes to replacing a totally destroyed home, given that homes appreciate, not depreciate. —JS]

I am left to wonder why the insurer is not transparent about whether and under what circumstances the homeowner would be able to cash-out rather than rebuild. (While recently passed legislation regulating insurance company payouts when homes are damaged from a wildfire does require providing a cash-out option and requiring it equals replacement cost — if the stipulated coverage is sufficient — the law applies only to dwellings burnt in a wildfire that the Governor has officially declared a "wildfire disaster.")

I would wager most homeowners would be surprised to realize their insurance may not give them the option of cashing out rather than rebuilding their house after a total loss, and likewise, homeowners would be surprised to realize that if they were to be availed of a cash-out, the actual payout would be the amount of stipulated dwelling coverage minus whatever the insurer calculates the depreciation to be, without the company having to disclose its methodology.

"Surprised" is the key word, because homeowners are likely to assume their insurance will pay the full amount of their stipulated coverage in the case of a total loss regardless of whether or not they were to rebuild. Reasoning that if the company is obligated to pay that amount when rebuilding and not deduct from that amount any depreciation, then what difference should it make to the insurance company whether they pay that amount as a cash-out in lieu of re-building?

For most homeowners, their house is their most valuable asset, whose value at any point in time is based on market price, which can be validated by appraisal. I would expect my insurance company to pay me the full amount for which I'm covered regardless of whether or not I choose to rebuild. (I wouldn't necessarily expect to be paid more than the cost of rebuilding if it turned out my coverage was greater than replacement cost.)

Further, I would expect ***not*** to have any amount for depreciation deducted when either being cashed-out or rebuilding. But what we homeowners expect does not usually align with what the insurance company would do.

The most homeowners can do is to know what their insurer can actually be expected to do, and that requires they do a thorough review of their policy. Nonetheless, based on what I've learned thus far, there are a couple of modest reforms that would improve the situation for homeowners: 1) The state Division of Insurance should publish replacement cost estimates annually, which would provide the homeowner with a basis for determining the amount of necessary coverage. 2) At a minimum, policies should be transparent about whether a cash-out option is available and under what circumstances, including an unambiguous explanation of the depreciation method and formulas to be used in calculating actual cash value.

It seems only fair that homeowners shouldn't have to guess what they are buying when they purchase home insurance. As things stand at present, after a critical review of their policy many homeowners are likely to come away feeling to some extent that they have bought a pig-in-a-poke, or at least one that fails to meet their expectations.

Golden Real Estate Welcomes Our Newest Associate, Greg Kraft

Greg told me that he has been reading this column from his home in Highlands Ranch for many years. A 20-year veteran of property management and real estate in the Vail Valley, he decided that he wanted to be part of our team instead of remaining on his own. He is officially on board now and handling floor duty at our downtown Golden office most weekends and working with clients during weekdays. You can reach him on his cell phone at **720-353-1922** or via email at **gkraft48@gmail.com**.

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Jim Smith
Broker/Owner, 303-525-1851
Jim@GoldenRealEstate.com
17695 S. Golden Rd., Golden 80401
Broker Associates:
Jim Swanson, 303-929-2727
Chuck Brown, 303-885-7855
David Dlugasch, 303-908-4835
Ty Scrable, 720-281-6783
Greg Kraft, 720-353-1922