
Owner builder insurance

Under-insurance

Insurance is a thorn in the sides of many owner builders. We have asked industry expert, Mark Adams from Trades Essentials, to provide some insight into the issue of under-insurance. In this case study the owner builder's name has been changed to protect his privacy.

BY MARK ADAMS

Peter, a tradesperson with many years experience, was undertaking his first owner builder project. He had decided on a fairly unconventional house design, but as he had spent some months carefully planning, he was very confident. He had planned contingencies for any challenges that may arise, or at worst he'd have the skills to manage them easily. Peter felt that his trades background gave him a good head start. And for the most part Peter was right. There were a few things that Peter didn't know though...

The sum insured

A couple of weeks before commencement of the project, Peter contacted me about owner builder insurance. He requested a quote based on an insured amount of \$220,000, advising me that he had reached this figure through careful and methodical calculations pertaining to his project cost. I spent some time explaining that the sum insured was required to be the 'replacement value,' and not the 'cost value.' Peter was advised that he should choose a figure which he believed would be adequate in the absolute worst possible claim scenario, e.g. the property destroyed just a couple of days before final completion of the project. In this event the insured amount should be enough to allow the insurer to engage a registered builder to replace the entire house. Peter advised that he felt that he was already rounding figures upwards a bit, but that he would go with an insured amount of \$250,000, just to be on the safe side.

Things start to go wrong

Peter's first claim, a few months into the project, was from extensive spray-painting vandalism damage. All in all though it was a modest claim of a couple of thousand dollars, and was paid out by the insurer without any problems.

The project then carried on as normal, although not necessarily what Peter thought to be normal. For one thing he had originally anticipated his project taking a little under 12 months; his project actually took two and a half years. And a lot changed in that time, as you'll soon see.

Things really go wrong

Let's skip forward now to Peter's second claim, which occurred a little under two years into the project. One of the structural elements of the house was a large triangular concrete platform forming a second storey balcony area. The supports for this included a number of significant vertical steel columns embedded into the extended foundation. Over one weekend, while the site was unattended, someone entered the site with (what must have been) a demolition saw and removed two of the steel columns by cutting them off at ground level.

While certainly not the strangest claim, or the most pointless crime I've seen, it did come as somewhat of a surprise to Peter. The upshot of this was that new columns had to be re-engineered (it was a custom job) and manufactured, and a large part of the

extended foundations had to be dug up and redone, not to mention the costly delays this also caused. So, while it may not sound like it, it turned out to be a fairly large claim. And here's where things started to get tricky...

After some initial delays from Peter's side of things, because he wanted to put off submitting the claim form until a few other things were done, everything went smoothly to begin with. That changed somewhat when the claim assessor appointed by the insurer went out to the project site. Most claims on construction insurance policies start with the appointment of an assessor, who is a qualified engineer or someone of a similar expert building background. In Peter's case, the very first thing the assessor did was to look at the project and say, 'This is not a \$250,000 project, it is a \$600,000 project.' This was the beginning of a pretty significant problem.

What is co-insurance?

On hearing this news I was rather alarmed for Peter, because I knew that co-insurance could be applied. In simple terms, co-insurance can proportionately reduce what you are paid out when you have under-insured your property.

For example; if you have a \$600,000 project and you insure it for \$300,000, and you later have a \$200,000 claim, you will only receive \$100,000 as a contribution to the claim since you really only insured half the project, and (presumably) had chosen to self-insure the other half (hence the term 'co-insurance').

Broker's point of view

This is around about the time that having a broker on your side can become rather useful. I was convinced that Peter had been completely genuine, albeit mistaken, in his original choice of sum insured, and had not under-insured intentionally.

Having said that, Peter did make a number of mistakes; the first of which was the initial gross miscalculation in setting the sum insured. But the second, and more easily avoided, mistake was not updating his policy as soon as he realised the insured amount was way off. There would have been a point, and one would assume fairly early in the project, where Peter would have realised this. Even had this not crossed his mind that early, it would be fair to imagine it may have occurred to Peter after the initial 12 months when he first requested to extend the insurance period.

Peter's claim was looking like being around \$90,000. So given the initial assumption that he'd insured for only just over one third of the true value, we could assume he would have been lucky to get \$35,000 and he'd then have to cover the extra \$55,000 himself. Compared to the overall project value this is not a huge amount, but Peter had already blown his budget many times over up until this point, and he was really going to struggle to cover this.

Resolution

The first point we were able to address was the assertion made by the assessor that the project had a replacement value of \$600,000. I started by asking Peter what he thought of this. He advised that he'd spent at least \$450,000 on the project, so he guessed that replacement value could certainly be anywhere between \$500,000 to \$600,000. Given that he'd done a lot of the work himself, and that he knew a lot of other tradies who had 'done him a good deal' (as Peter put it), it did seem quite plausible that the \$600,000 figure was correct. But, while plausible, I felt that we could still challenge this point.

After some discussions with the insurer they agreed to conservatively assume replacement value to be \$500,000 instead. This was a good start. Now we were looking at a worst-case scenario in which Peter would be out of pocket \$40,000 instead of \$55,000.



The big win

After further discussions with the insurer I was able to convince them that Peter had at least been completely genuine in his original error when choosing the sum insured. I had maintained file notes of conversations I'd had with Peter when doing the original quote in order to back this up, which may also have helped.

With that in mind I suggested an alternative: Peter should instead back-pay premiums, for the two and a half year period that had passed by this stage, to allow for what should have been charged had the sum insured been correct to start with. I was unsure if this argument would be successful, since it generally would not be (in cases where co-insurance can instead be applied). And had the claim been any higher in value I believe it would almost certainly not have been. Where policies allow for the standard provision of co-insurance, the insurer is certainly well within their rights to take the standard approach and do so.

Through a combination of negotiation, a good relationship between broker and insurer, and quite likely a whole lot of luck, we got the insurer to agree to our suggestion. Instead of being out of pocket by \$55,000, Peter instead only had to pay an additional premium (for the two and half year period), which was significantly less than the co-insurance amount. A very big win indeed, considering how dramatically under-insured Peter had been.

As an interesting aside, this was also not taking into account the earlier claim Peter had made which, while not obvious at the time, could also have had co-insurance applied. The insurer didn't mention this fact, and we certainly didn't bring it up.

What did Peter learn?

The important lesson here is not what actually happened, because Peter was lucky, but what could have happened.

Many different possible claim scenarios would have had Peter's second claim being significantly larger in value. Had it been larger, I believe it is unlikely that the application of co-insurance could have been avoided. In fact had several factors been other than what they were, the outcome could have been very different.

While not always to as large a degree as this, many owner builders will be in a similar situation to Peter when they start their projects. Peter's over confidence was in this case possibly his biggest handicap. Most owner builders have an idea that they will save some money by owner building. And after having received a quote (or two) from a registered builder or estimator, many would also be aware of just how much they may be saving, and therefore what the replacement value should be for the purposes of insurance. If Peter had done this, he would have had a much better idea of how much to insure for. Even if Peter had no claims at all it could be argued that, by going through the exercise of getting quotes, Peter would also have had a better idea of what he was likely to end up spending himself, and could have planned the project and his budget more effectively.

What can you learn?

- 1) Get quotes from a registered builder or estimator, so you know how much to insure the project for.
- 2) Insure for the full amount.
- 3) If the plan or costing changes at any point during the project, and you become aware that you're under-insured, update your policy to correct this right away.

Remember, most cases of under-insurance will not end anywhere near as happily as Peter's did. The majority of claims involving under-insurance on construction projects will have co-insurance applied to them. Avoiding this is easy if you prepare well, know your project, and insure smart. ■

Mark Adams is an account manager with Trades Essentials. He has several years experience in the owner builder insurance market. Mark has consulted to a number of Government and commercial bodies in order to improve the quality and availability of useful information being provided to owner builders. Trades Essentials are a specialist broker for Owner Builder Insurance and can be contacted on 1300 664 923, www.tradesessentials.com.au