Earthquake Deductibles and Deductible Buy Downs: Do You Know Your Liability in the Event of a Loss?

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Earthquake coverage for property assets in high hazard areas is often subject to a percentage deductible rather than a specific flat dollar amount. The deductible will typically range from 2% to 5% based on several factors, including age of the building, type of construction (i.e., frame, masonry or steel), and soil conditions.

Policyholders often don't have a clear understanding of how percentage deductibles are calculated until after they suffer a loss. There are two reasons for this. First, there is no specific industry standard for earthquake deductible wording. Slight variations can have a material consequence on how much an insured will be responsible for in the event of a loss. The second issue is that the earthquake deductible clause can be rather complex and many policyholders don't understand exactly how a percentage deductible will be applied.

Let's look at a hypothetical example to illustrate how a percentage deductible would be applied. ABC Real Estate Company owns an office building in the high hazard central business district of Seattle.

- The building has an insurable replacement cost of $100,000,000 and an annual rental income of $10,000,000.
- ABC has a property insurance policy with a limit of $110,000,000, covering the building and rents.
- The policy has a sublimit of $50,000,000 for earthquake subject to a 3% deductible.
- An earthquake causes $10,000,000 in building damage and $1,000,000 in loss of income due to rent abatement, resulting in a total loss is $11,000,000

ABC presents a claim to the insurance company for the damage to the building and loss of rents. What will ABC's deductible be?

a. $330,000. 3% of the loss ($11,000,000 x .03 = $330,000)

b. $1,500,000. 3% of the earthquake limit purchased ($50,000,000 x .03 = $1,500,000)

c. $3,300,000. 3% of the total value at risk ($110,000,000 x .03 = $3,300,000)

The answer is C. The insurance company will pay $7,700,000 and ABC will be responsible for $3,300,000. Most carriers' deductible clause states that the deductible percentage (3%) will be applied to the total values for the location ($110,000,000). However, every insurer uses its own particular wording, so it is important to review the specific language of your own policy.*

While the ABC example is fairly straightforward, many loss adjustments involving earthquakes and percentage deductibles can be more complicated due to the absence of industry-wide standardized deductible clauses. For instance, what if ABC Real Estate owned a corporate office park with four buildings in a campus setting? Would the deductible be applied separately to each building or would one deductible be applied to all four buildings damaged by a single earthquake? It would depend upon the insurance carrier's definition of location. This further illustrates the importance of a close, careful reading of your deductible clause, as well as definitions within the insuring agreement of your policy. How the deductible wording is crafted can have a significant impact on your out-of-pocket liability in the event of a loss.

Deductible Buy Downs

An earthquake deductible can be a significant expense for property owners; in our example, we quantified the deductible at $3,300,000 for ABC Real Estate. While some companies have a tolerance for large deductibles, many others would prefer to lower the deductible amount that they are responsible for, especially in our current economy. Net operating income is down on most assets at the same time that property owners face increased operating costs and uncertain financing availability for reconstruction after a loss. There are options available to buy down your large deductible.

For example, ABC Real Estate could purchase a separate deductible buy down policy to reduce its deductible exposure to a more manageable dollar amount. They could structure a policy that addressed their deductible with a $3,300,000 limit and $1,000,000 deductible, thus reducing their out-of-pocket deductible to $1,000,000. The premium for a deductible buy down policy would depend upon the quality of the property asset and the cost for this coverage can vary greatly.

If you can finance your deductible expense over time through the mechanism of insurance, the deductible buy down policy might be a viable solution. In most cases, real estate companies are able to include the premium cost in their CAM charges rather than earthquake deductible expenses, which are not typically a part of the additional rent clause in leases. This solution can be especially attractive for condo unit owners, who can use deductible buy downs to reduce their exposure to a large assessment for reconstruction after an earthquake. The premium cost is financed over time and shared among all unit owners.

Although the focus of this article is earthquake, the same percentage deductibles and buy down deductibles can apply to other perils, specifically wind and flood, for assets or buildings in high hazard areas for hurricanes, tornadoes or floods. For instance, buildings in close proximity to the coastline in southeast U.S. will be subject to a percentage deductible for wind damage.

Property deductibles can be complex, often confusing, for policyholders. Our recommendation is to review the wording in your policy with your broker, and then apply the language and percentages to your company's actual assets. Analyze the deductible amount that you will be responsible for before you experience a loss. If the deductible is not what you expected or think it should be, ask your broker if there are alternatives to reduce your exposure.