Your Mortgage Balance: The Wrong Way to Determine Your Insurance Needs

Although the housing market is in the midst of a prolonged slump, some experts believe prices are still higher than they should be. At least in the short term, homebuyers will take out large mortgages against their homes. Unfortunately, the mortgage amount sometimes brings the lender into conflict with the homebuyer's insurance company. For example, the mortgage may be for $200,000, but the insurance company may be willing to insure the home for only $175,000. The lender will often threaten to not hold the closing if the borrower does not buy an insurance amount equal to the amount of the mortgage. This obviously leads to a very anxious homebuyer who has many other things to worry about. Who is correct here?

Most insurance policies provide coverage for the home on a "replacement cost" basis. This means that, if a covered cause of loss damages the home, the company will pay the cost to repair or replace it without deducting any amounts for depreciation. However, the company will pay the least of:

- The amount of insurance covering the building;
- The cost of replacing the damaged portion of the building with materials of similar kind and quality and for similar use; or
- The necessary amount actually spent to repair or replace the damaged building.

Assume that a fire completely destroys the home mentioned previously. The homeowner bought $200,000 coverage to equal the mortgage amount. The most the insurance company will pay is $200,000 (the amount of insurance) or the reasonable cost of labor and materials to rebuild the house, whichever is less. If the contractors can rebuild it to a state reasonably similar to its prior state for $175,000, that is the amount the company will pay.

The mortgage, however, is based at least in part on market value. Market value reflects what someone is willing to pay for the house and related structures (garage, swimming pool, gazebo, etc.) and the land they sit on. The price someone is willing to pay for a building may be very different from the cost to rebuild it, because that price contemplates factors (school district, proximity to workplaces and shopping or bodies of water, etc.) that have no relationship to the cost of labor and materials. In addition, market value includes the value of the land, something no homeowner's insurance policy covers, since land does not burn, explode, or otherwise suffer insurable damage.

While it is understandable that the lender wants to see its investment protected, requiring a borrower to insure up to the mortgage amount helps no one other than the insurance company. The lender and the homeowner will never collect more than the cost of rebuilding no matter how much more insurance the homeowner buys. The insurance company, however, gets to collect the premium for $200,000 worth of coverage but will never have to pay out more than $175,000.

Many states have laws or regulations that prohibit mortgage lenders from requiring borrowers to buy amounts of insurance greater than the cost of replacing the house. Arizona, California, Florida, New York, Tennessee, North Carolina and Virginia are just some of the states that restrict lenders' insurance requirements. New York's regulation, for example, prohibits mortgage lenders from requiring a borrower to "obtain a hazard insurance policy in excess of the replacement cost of the improvements on the property as a condition for the granting of a mortgage loan."

Homeowners should review the amount of coverage on their homes with their insurance agents at least annually. The importance of having enough coverage continues long after the home purchase. However, it is equally important not to buy more coverage than necessary.