

Replacement Cost vs an Actual Cash Value HO8 Policy

What is the difference between replacement cost and actual cash value?

When purchasing home insurance, it is very important to understand the difference between purchasing a replacement cost policy and an actual cash value policy (also known as an HO8 policy).

What is Replacement Cost?

A *replacement cost* policy is designed to repair damage done to your home, less your deductible.

What is Actual Cash Value?

An *actual cash value* policy is designed to repair the damage done to your home, less your deductible and less depreciation. This is an HO8 Policy.

Illustrative Example

An example will best illustrate the difference. The Smiths and the Johnsons are next door neighbors. Their homes are exactly the same size, built in the same year (1990), and have the exact same floorplan. Neither family has had the roof replaced, but the roof originally cost \$15,000. The Smiths have a *replacement cost* policy, while the Johnsons have an *actual cash value* policy.

One night in 2009 a terrible storm tears through their town, completely destroying the Smith's and the Johnson's roof. Both the Smiths and the Johnsons have a \$500 deductible, and both roofs incurred \$15,000 of damage.

Replacement Cost Claim Settlement

To replace the entire roof, the Smiths are only responsible for their deductible of \$500. With replacement cost, the insurance company will pay the full cost of replacing the roof minus the deductible - which was the value of the roof at the time of the storm. Thus the Smith's homeowners insurance policy will cover \$14,500 for repairs (\$15,000 cost minus the \$500 deductible) and the Smiths will pay the \$500 deductible.

Actual Cash Value Claim Settlement

The Johnsons, on the other hand, aren't quite as lucky. The roof on their home is 19 years old. When the roof was originally installed, it was worth \$15,000. But now, due to weather and age, it is only worth about \$7,000. In other words, it has depreciated by \$8,000. The Johnson's insurance policy will cover the damage to their roof, less their deductible and less depreciation.

The Johnsons need to pay \$8,500 to repair their roof, a full \$8,000 more than the Smiths. The insurance company will only provide \$6,500 of the cost to the Johnsons.

With an *actual cash value* policy, the insurance company is only responsible for paying damage done to the home, less the deductible and less depreciation. Thus the insurance company starts with the \$15,000 repair cost minus \$8,000 depreciation and the \$500 deductible, paying only \$6,500.

Whether you want a *replacement cost* policy or an *actual cash value* policy is your choice, but it is important to understand the difference between the two policy types. An actual cash value policy is typically cheaper, but unless your home is brand new, there is a lot more risk involved. With the knowledge of what each policy is designed to cover, you are ready to make a well-informed decision when you buy home insurance.