WHEN PROPERTY INSURANCE RATES DOUBLE…

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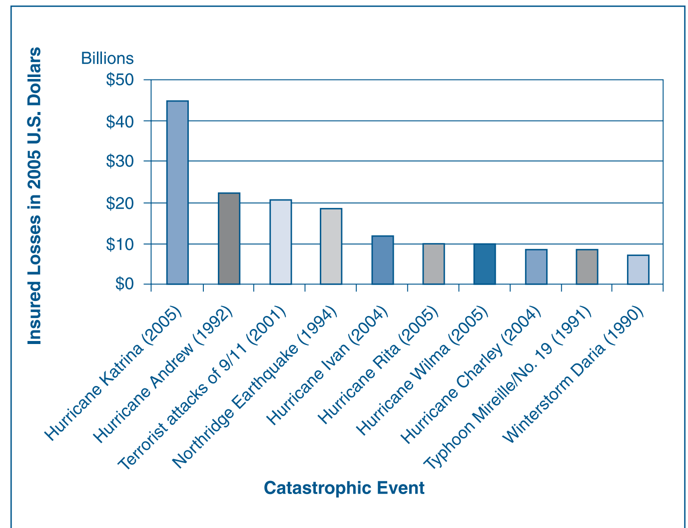
In more than 10 years of attending NCREIF meetings, I have rarely heard the topic of insurance discussed. Suddenly, insurance was a topic of discussion at the October NCREIF Annual Conference 2006. The change of heart is because insurance is starting to hit us where it counts — the bottom line.

Not that many years ago, insurance was a $0.10-per-square-foot line item on a $10.00 expense stop. When insurance doubled to $0.20, investors noticed, but at only one or two percent of total expenses, nobody made much of a fuss. In 2005, insurance for many properties in the flood, wind and earthquake markets cost upwards of $0.75 per square foot. In 2006, the cost of insurance for many of those buildings doubled to $1.50 per square foot, or more. On a $15.00 expense stop, that doubling of insurance costs made investors take notice. The worst-case scenario is when insurance is non-reimbursable! Insurance for apartments in flood, windstorm or earthquake zones can cost more than $1,000 per unit! That is why insurance was a hot topic at a NCREIF Conference for the first time in many years.

What happened? Simple economics. Catastrophic losses include earthquakes, floods and named windstorms. When there are severe catastrophic losses, the insurers (and reinsurers) become very conservative and do what they can to reduce their risk of loss. To reduce risk, they reduce capacity, tighten underwriting standards and criteria, and avoid areas of higher perceived risk. Simple economics apply and as the supply of insurance gets tighter, prices go up. Over time, if there are not additional catastrophic losses, the supply loosens and prices come back down.

Historically, insurance rates have tracked closely to major catastrophic losses. In more recent memory, losses such as the terrorist attacks of September 11, 2001, and the Northridge earthquakes triggered major increases in insurance. *(The 9/11 terrorist attacks open up an entirely different discussion on terrorism insurance, which I will leave for a different venue.)* In 2005, the United States suffered the worst hurricane losses ever, triggering the most significant catastrophic losses in insurance market history. The chart to the right shows the most costly insurance losses resulting from major catastrophes.

Ten Most Costly World Insurance Losses, 1970-2005



Source: Insurance Information Institute
Note: Property and business interruption losses, excluding life and liability losses

Hurricane Katrina caused more insurance losses than Hurricane Andrew and the terrorist attacks of 9/11/2001 combined. On top of Katrina, Hurricanes Rita and Wilma occurred in 2005 and are rated as the sixth and seventh most expensive insurance events. Three of the seven most expensive events occurred in 2005 and five of the eight most expensive events occurred since 2004. With these recent losses, it is no wonder insurance rates have been skyrocketing.

What does this mean to the insurance premiums for investment real estate and individual investors? Many factors have an impact.

Location: A major factor impacting the increases in insurance premiums is the location of your property. If you have a real estate portfolio in the Midwest, with minimal exposure to flood, windstorm and earthquake zones, you may have seen relatively small increases in your insurance rates last year. However, real estate with exposure to flood, windstorm and earthquakes saw significant increases. If that same portfolio was located in South Florida, not only would your rate have increased by double, triple or quadruple, you probably would have been forced to accept some form of coinsurance.

Renewal Date: The month your insurance policy renews has a significant impact on the actual increase you experience. In 2005, before the hurricanes hit, you may have actually experienced a decrease in insurance costs. By fall, rates were starting to increase. By January 2006, it was becoming evident that the costs were skyrocketing. And by July 2006, not only had insurance rates doubled or tripled for many insureds, some insurers and reinsurance companies had run out of capacity and stopped writing policies altogether. However, the policyholders that renewed in November 2005 are probably feeling the pain this month, as they are renewing again!

Reduced Coverage: To reduce the increases in insurance costs, many real estate investors are purchasing less insurance — if their lenders let them! There are several ways this can be accomplished. First, an investor may accept a higher deductible/retention. An investor may also lower the policy limits. Another way to reduce insurance costs is to leave holes in your policy. One example may be to insure only 75% of your losses. One may also lower limits in earthquake/flood/wind policies.

One particularly painful example is that of Miami Dade Public Schools. Obviously, they have significant flood and windstorm exposure.

As you can see, Miami Dade reduced windstorm coverage

Miami-Dade Public Schools	2005	2006
Insurable value	$6 billion	$6.8 billion
Windstorm insurance limit	$700 million	$200 million
Windstorm deductible	3% of value per location with a $1 million minimum	4% of value per location with a $25 million minimum
Premium	$24.5 million	$30 million
Source: Advisen July 7, 2006		

from $700 million to $200 million, increased their windstorm deductible from 3% of value per location to 4%, increased their minimum windstorm deductible from $1 million to $25 million and the premium still increased by 22%. To say the Miami-Dade Public Schools insurance program suffered dramatically would be a significant understatement. With a limited budget that all school systems face, they had to make drastic changes to the policy to keep costs down. Plus, they simply couldn't find enough capacity to fill the entire policy limits. The school board had to participate as a coinsurer for approximately $14 million of the first $100 million in losses above the deductible!

Construction Costs and Margin Clauses: Another major factor impacting property insurance premiums is construction costs. As we are watching construction costs skyrocket around the world, costs in the hurricane regions are growing even worse. Construction resources in the hurricane region, both labor and materials, are stretched extremely thin. Another simple economics lesson: as resources thin, costs go up. The insurance markets call this "surge pricing."

The insurance markets are watching replacement costs very closely and starting to take note. Assume you have a $3 billion portfolio and a $500 million insurance policy. You also have a total loss to a building that would normally cost $30 million to reconstruct. With surge pricing, the actual loss turns out to be $40 million, which the insurance company would cover. Now let's say you had reported insurable replacement costs of $25 million to your insurance company. The insurance company is not particularly happy with the cost of claim! The underreporting of costs and the impact of surge pricing are often much more dramatic, and the differential may hurt you when filing a claim.

Two factors are impacting this situation and the compound effect is obvious. It is the insured's responsibility to fairly report current insurable costs to the insurance company during renewal. With construction costs growing as quickly as they have been, it is easy to report out-of-date costs to the insurance company. The impact of increasing construction costs is compounded by the effect of increasing insurance rates. If construction costs increase by 25% and insurance rates go up 60%, your insurance premium will actually go up 100%, due to compounding. That is the painful reality. Further, there is a contingent that believes many insureds are intentionally underreporting construction costs to save on insurance premiums.

In response to underreporting of costs and surge pricing, insurance companies are adding margin clauses to some policies. What this means is that if you report an insurable replacement cost of $25 million, and you have a 10% margin clause, your insurance company will not pay more than $27.5 million for a claim to that property… even if you have a $500 million policy! Not only does that force insured parties to be diligent in determining and honest in reporting construction costs for insurance purposes, it passes the risk of surge pricing back to the insured!

For further protection against underreporting of costs and surge pricing, the insurance companies are limiting use of blanket limits. Let's say you have two buildings with insured values of $25 million each, with a $50 million policy limit. A named windstorm causes a $30 million loss to Building 1 and a $10 million loss to Building 2 in the same occurrence. With blanket limits, you are covered for the $40 million loss. If the policy does not apply blanket limits, the first loss is limited to the reported value of $25 million.

As we all watch our insurance rates increase dramatically, we will see more and more attention paid to insurance premiums. Comparing insurance costs from property to property can be very difficult. You could have two identical buildings paying dramatically different insurance premiums. What kind of coverage do they carry? How much coverage does each property carry? Do they both have adequate catastrophic loss coverage if in flood, wind or earthquake zones? Are they both reporting accurate and honest replacement costs? Does either insurance policy have a margin clause? I have not even touched on terrorism coverage, business interruption coverage, underreporting of business interruption values, loss history, premium discounts for larger portfolios, the validity of the insurance company's catastrophic loss models and numerous other factors that impact our insurance premiums. While insurance has historically been a fairly small line item, it is not so anymore. Plan on insurance being a topic of discussion at future NCREIF meetings!

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