

Urban Land

At Issue

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Insuring Property Post-9/11

The fallout is reverberating across the property insurance landscape.

It was not just the real estate landscape at ground zero that was changed by the September 11 attacks. The impact on the industry and on commercial property owners is far reaching and unprecedented, and the ultimate costs are yet to be fully realized. Real estate owners and developers now are faced with massive increases in insurance premiums and the need to institute heightened security programs. Furthermore, because carriers are reluctant to provide terrorism insurance—particularly for properties that represent attractive targets, such as Class A high-rise office buildings, stadiums, and convention centers—some landlords may have difficulty getting commercial real estate insurance at any price.

Even before September 11, property owners were subject to rate increases of 20 to 25 percent on contract renewals as insurers sought to

recover investment losses brought on by the stock market tumble and escalating payouts triggered by several major disasters in recent years. To illustrate the size of the problem: while the insurance industry posted \$16.8 billion in net income in the first three quarters of 2000, last year it posted a net loss for the same period—for the first time ever—of \$3.1 billion. September 11 only exacerbated the problem. Although total insured damages stemming from the attacks are yet unclear, it has been estimated that they will reach levels never before seen in the industry. Some believe these losses could reach \$100 billion—more than four times those resulting from Hurricane Andrew in 1992.

To manage their own risk, insurance companies have agreements with reinsurers such as Lloyd's of London to backstop their losses and prevent financial ruin in the event of a major disaster. Before September 11, the reinsurance

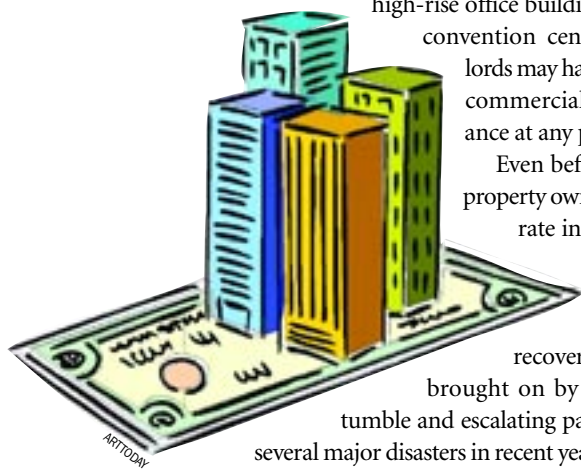
community already was reeling from a series of natural disasters; now, as reinsurers survey their projected losses from the terrorist attacks in New York, Washington, D.C., and Pennsylvania, they are raising primary insurers' premiums threefold. Further, some are now excluding terrorism coverage, leaving many carriers liable for "first dollar" coverage with no backup from reinsurers.

This scenario is particularly critical for the 30 percent of carriers whose reinsurance contracts come up for renewal later this year—after they have completed contract negotiations with their customers. If their reinsurers deny them terrorism coverage, these primary carriers will be liable for any damages resulting from an attack, except in states where they will be allowed to exclude terrorism coverage on new contracts and renewals. However, carriers operating in California, New York, and seven other states where the terrorism exclusion is not permitted have no way to protect themselves from this potentially devastating liability. Once they have signed new contracts with their customers, they cannot change the terms and conditions of these policies when their own contracts with reinsurers expire. Thus, primary carriers will be on the hook for terrorism coverage for the remaining term of the policies they have issued, which could be six months or more.

As a result, most carriers that feel vulnerable because of the type of buildings they are insuring are planning to issue conditional nonrenewals and then carefully examine all policies, losses, and the potential for loss before deciding who they will and will not cover.

Real estate owners need to recognize that when commercial insurance contracts come up for renewal, primary carriers likely will write exclusions to terrorism coverage in states where it is allowed, as well as exclusions in other potential problem areas such as mold, which is the latest hot-button issue. They also can expect their insurers to pass on to them the rate hikes imposed by the reinsurance industry. The extent of these increases will depend on factors such as geographic location, type of property, and loss history.

Landlords already are reporting renewal rate hikes of 30



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to 100 percent, and prices could go even higher, according to the December 24/30, 2001, issue of *National Underwriter* magazine. Indeed, 100 to 200 percent increases already have been reported for large properties in New York City. The Council of Insurance Agents + Brokers' fourth-quarter 2001 report, released this past January, provides an overview of rate increases for commercial property on a regional basis broken out by the past year and the past three months. For example, between January 1, 2001, and January 1, 2002, one-third of commercial property owners in the Northeast averaged increases between 50 and 100 percent, and 38 percent in the Southeast and Southwest averaged rate hikes between 30 and 50 percent. In the Pacific Northwest, 30 percent of buyers averaged 30 to 50 percent increases in the past 12 months, but a higher percentage—56 percent—experienced the same increase between October 1, 2001, and January 1, 2002. Conversely, half of the buyers in the Midwest averaged 30 to 50 percent rate hikes over the past year, but this dropped to 34 percent for the three-month period.

These increases are reflected across the board when it comes to product category. For example, a California landlord with a portfolio of 53 office and retail buildings saw premiums jump from \$373,000 in 2001 to \$559,000 in 2002 for the same coverage; a manufacturing plant in the Midwest has to pay \$5.4 million for insurance that cost \$2.1 million a year ago; and in the Northeast, an owner's rate jumped from \$250,000 to \$550,000.

For office buildings, some of the costs can be passed on to tenants through higher monthly assessments for their share of operating expenses, including stepped-up security. In the industrial sector, the increases can be passed on under "net" leases that bill tenants directly for insurance costs and other operating expenses.

Clearly, carriers are going to be much more selective about whom they insure, with many

providing full coverage only on the least risky properties, such as low-rise office buildings, small manufacturing facilities, and strip malls. Some real estate categories will be subject to much tighter coverage restrictions, and owners may have to retain more risk themselves to secure any insurance at all. Some may only be able to find insurance that provides lower coverage limits with high deductibles or premiums as many carriers try to get out of the high-risk market.

Municipality and stadium/arena coverage will be severely limited and the capacity greatly diminished. Owners of regional shopping malls or any structures where large numbers of people are likely to gather will have to be creative and layer their insurance coverage to come even close to the limits they formerly took for granted. All property owners will have to address changes in the health and safety/worker's compensation marketplace, which is mirroring the property sector's response in recognition that security issues and the potential loss of life from a terrorist attack could jeopardize any insurance company's viability.

The threat of terrorism is likely to continue for the foreseeable future, and stepped-up security remains a priority. On a par with this, especially for those who own property in segments most likely to be affected by the turmoil in the insurance industry, is the need to take steps to minimize the impact of rate hikes as contracts come up for renewal. What once was a fairly simple task will now require much more time and research; the renewal process should start at least 120 days before the contract's expiration date. It is critical to have a broker who has good relationships with a variety of insurance carriers and to arm that individual with comprehensive information about each property's claim level and loss record. These are the tools that will enable the broker to be an effective advocate in presenting a case and negotiating the best possible premium, given current market conditions.

Owners should evaluate higher deductibles, as well as the feasibility of sharing some of the risk. They also should work with their brokers to make sure that their properties are written on a "blanket" basis if possible, and discuss alternative risk transfer facilities that can be effective tools in managing the total cost of risk, such as single-parent and group insurance "captives." A captive insurance company provides a form of self-insurance in which a corporation or association organizes an insurance subsidiary to insure itself or its members.

The ripple effect of the September 11 tragedy will be with Americans indefinitely as they seek to absorb the financial and emotional damage wrought by the event. The next 12 months will be especially challenging for property owners and their insurance representatives as they try to develop reasonable solutions to their coverage needs in light of lingering confusion in the industry and the continuing threat to the nation. Because many developers cannot purchase terrorism insurance or can only do so at exorbitant rates, they have been unable to get new projects financed, which has curtailed development.

Recognizing the serious impact that the lack of terrorism insurance is having on business in general and the real estate industry in particular, President Bush has urged Congress to revisit the idea of developing a national terrorism insurance program similar to its flood insurance program. But to date, Congress has failed to do so. Still, the insurance industry is hopeful that a solution eventually will be worked out. With the promise of higher premiums, tighter underwriting, and growing investment interest in the property casualty market, carriers may find terrorism exposure less intimidating than the risks associated with hurricanes, floods, and other natural disasters, and real estate owners may again be able to get coverage at competitive rates. ■

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