Insurance and commercial mortgages in the new world of risk

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Abstract
Understanding the basics of commercial property insurance and how changes to the terrorism risk and insurance act will affect the insurance industry.

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THE REALITIES OF THE PAST THREE YEARS

Insurance was once the lowly stepchild of the financial industry. Formally, the last thought in financing transactions, the understanding of commercial insurance and the correct execution of the requirements between parties, have continued to evolve since 11 September, 2001 ('9/11'). Immediately following the tragedy, the insurance markets, driven by a loss of reinsurance, predictably sent notices of cancellation relative to the 'peril' of terrorism. Essentially, 'All risk' or 'Special cause of loss' forms typically included coverage for both direct and indirect damage. Direct equates to actual damage to an asset or

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personal property. Indirect damage includes business interruption, rental income loss and extra expense. When insurers excluded the resulting damage due to a loss of their own reinsurance, both direct and indirect coverage were excluded. The market response was to create 'stand alone' policies that were exceptionally limiting for both the direct damage and the rental income/business interruption coverage. In the separate 'Terrorism' forms, the assets are scheduled, and in some cases the coverage is restricted to direct damage of the real property and not the rental income/business interruption. Coverage for governmental authority and ingress/egress may also be restricted or excluded. In addition, 'nuclear, biological and chemical' (or 'NBC') contamination is generally excluded from both the 'All risk' and separate 'Terrorism' forms. This exclusion negates coverage from attacks by dirty bombs, anthrax or other contaminants. The only solution is to purchase separate coverage or to add 'biological and chemical' back into the 'Pollution legal liability' form under the definition of 'pollutants'.

From a practical perspective, lenders and borrowers should employ a common sense approach to determining the risk profile of a particular asset. The following underwriting information is the initial step in calculating potential terms, conditions and premiums:

- Complete description of asset including signage;
- Is the asset considered an 'icon' or 'trophy'?;
- Complete list of tenants and a determination of their risk profile;
- Have threats been made against the asset or any tenants?;
- Detailed security plans and protocols.

Practicality notwithstanding, lenders panicked and demanded 'stand alone' terrorism policies for virtually all assets, regardless of their true exposure to risk or the limitations found in the forms. Prior to the implementation of the Terrorism Risk Insurance Act (TRIA) of November 2002, commercial real estate owners were faced with restrictive forms (T3 and T3A), as well as premiums that easily exceeded \$0.25–1.00 per square foot strictly for the peril of terrorism. In response to the lenders' requirements, numerous owners sued both lenders and Commercial Mortgage Backed Securities servicing companies and were met with the uniform response that 'terrorism' insurance could be required, regardless of the cost. The 'stand alone' terrorism market peaked in October 2002, and with the implementation of the Federal Backstop known as TRIA, pricing quickly slid and insurers effectively removed their terrorism restrictions from the insurance policies. The 'take up' rate for all TRIA placements has stabilized at approximately 40%, with commercial real estate's take-up rate equal to more than 70%. Without a doubt, lenders have driven this coverage, and, once again, the lending and borrowing communities are facing uncertainty relative to an extension of the 31 December, 2005 expiration of TRIA.

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THE FUTURE OF TRIA AND THE IMPACT ON COMMERCIAL LENDERS

The Department of the Treasury is the 'Keeper of the TRIA Flame'. It is this department that has the responsibility to pronounce what is and is not an act covered by TRIA. To complicate matters further, there are two types of terrorism: certified and non-certified. Effectively, TRIA, or 'certified', is intended to respond to acts that are initiated by foreign-inspired insurgents. On the other side is 'non-certified', or a domestic act of terrorism. Oklahoma City is the best definition of this. In both cases, the debate as to what constitutes an act is strictly hypothetical.

At the time of writing, no final decision had been made concerning the extension of TRIA. The US Treasury Department released a report in June 2005 effectively recommending that TRIA should not be renewed as we know it. The report leaves some room for developing a public/private solution to the problem, but no one is surprised by the findings that said the government doesn't want to continue the program without changes. The most immediate concern is determining whether the markets are willing and able to provide coverage without the Federal Government's current support of TRIA. Unfortunately, Congress has until the fourth quarter of 2005 to debate and render a decision as to the extension. Although there is both Republican and Democratic support, as well as strong advocacy from the real estate industry, the General Accounting Office has signalled that it believes in a 'free market' approach to insuring the risk. This is in contrast to many European models that have traditionally provided terrorism coverage via the government. The conventional wisdom states that if TRIA is not extended, then the 'free market' can and will return to the pricing models offered by the markets prior to the inception of TRIA.

As a result of this confusion, loans originated in 2005 have a unique exposure. Because there is no guarantee of the extension of TRIA, lenders cannot be certain that the current levels of coverage will be available after 31 December, 2005. The response by lenders has ranged from unilaterally requiring that during the term of the loan, borrowers purchase all available limits of TRIA or 'stand alone' coverage, regardless of cost, to negotiating minimum levels of coverage based on the standard of 'reasonable, customary and commercially available', which holds many interpretations depending upon one's position. This is a standard that emerged after the San Francisco Bay Area and Los Angeles earthquakes in the late 1980s and mid-1990s. Prior to those losses, lenders required earthquake limits based on little more than tradition. After the events, the markets for earthquake coverage constricted and the prices became astronomical. It was at this point that borrowers petitioned and won the 'reasonable, customary and commercially available' wording that allowed them to benchmark their limits against other owners of similar assets.

In the case of 'minimums', three strategies are emerging: the first is to tie the premium to be spent for terrorism coverage to a percentage of the 'All risk excluding earthquake and flood' premium. This is generally in the 150–300% range. Property premiums are calculated based on $100 of insurable values (real property plus net rental income). As an example, if a $50 million asset carries a 0.05/$100 rate for its real property and rental income value, the annual premium is $25,000. In the terrorism example, lenders may require that the borrower spend between $37,500 and $75,000 strictly for the 'stand alone' terrorism premium. A second strategy to be considered is to benchmark against peers and purchase annual limits in accordance with other assets. Finally, a hybrid of the first two options is making its way into loan covenants. A premium is determined based on operating expense considerations, and limits are 'backed into' based on the available premium. In all three cases, it is critical to note that insurance is an annual contract and a commodity. It is impossible to guarantee that coverage for catastrophic perils will always be available in the private market.

INSURER DOWNGRADES AND THE IMPACT ON COMMERCIAL MORTGAGE-BACKED SECURITIES FINANCING

A continuing concern is the ongoing downgrades of insurers. When Commercial Mortgage Backed Securities made their way to the financing stage in the mid-1990s, there were more than eight insurance companies with Standard & Poors AAA ratings. As of April 2005, only one remains. As a result, there are existing loan covenants that are technically non-compliant due to the downgrades. The response from the lending community has been to accept the '60% rule' for multilayered (multiple insurance companies participating in various tranches of a risk) insurance placements. In essence, the '60%' rule is an agreement between lender and borrower that at least 60% of the 'All risk excluding California earthquake' insurance capacity will be provided by insurers rated S&P AA- or better. The standard has in fact continued to decline to S&P A+ for many lenders who are cognizant of the fact that the previous requirements were unattainable. However, the question that remains is, what is the appropriate response to mid-term downgrades? If a borrower is compliant at the time of their annual property renewal, but downgrades occur during the policy period, are they in default? Are they obligated to replace that layer of capacity with a carrier that may be more expensive than the existing insurer? Are they allowed to charge that additional premium to tenants after the initial allocation? There is no clear consensus on these issues.

UNDERSTANDING THE BASICS

The irony in commercial lending is that more attention is paid to the S&P rating of insurance companies than to the actual coverage provided. Prior to 9/11, little attention was given to the issues of 'perils' (causes of loss) or the distinction between direct and indirect damage. Given the magnitude of loss on 9/11, everyone in commercial real estate is now examining terms, conditions, requirements,

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premiums and the realities of new exclusions in their insurance programmes.

Generally speaking, prior to 9/11, most insurance provisions found in real estate transactions focused on the following terms:

- Replacement cost valuation for 100% of the real property;
- Requirements that the property insurance was 'All risk' in nature;
- 12 months of rental income coverage for net-effective rents;
- Substantially low deductibles;
- Commercial general liability in an amount no less than $1 million per occurrence and $2 million in the aggregate;
- Confirmation that the 'Best's Rating' for each insurer was no less than an 'A minus VII';
- Umbrella or excess liability in an amount considered 'reasonable or customary' for that asset class;
- Verification that the lender was an additional insured on all appropriate policies.

These requirements are still common in many financing documents. The issue with this is that the actual nuances and perils are typically omitted. When lenders are unclear about either the perils to be insured or the property to be insured, they are effectively limiting their own right to recovery in the event of a loss. As a result, lenders and owners must understand perils, deductibles and appropriate extensions of coverage prior to committing to any financing terms.

WHAT IS A PERIL?

A peril is typically used to identify the cause of a risk. Perils can be man-made—for example, arson or an act of God (e.g. earthquake). Generally speaking, most property insurance policies focus on the perils of fire, lightening, wind, vandalism, earthquake, flood and other typical causes of loss. These perils apply to both the direct physical damage of an asset, as well as the indirect economic loss of rental income, business interruption and extra expense. *The importance of this fact is that if a peril is not insured, then no coverage is available in the event of a loss.*

When the issue of 'perils' was discussed, the requirements for 'California earthquake' often took centre stage. Many lenders do not require owners to carry either earthquake or earthquake sprinkler coverage, believing that the borrower will select another lender if they mandate the coverage. In the case of earthquake, resulting damage from the quake is excluded unless it is a fire. Some lenders require a 'probable maximum loss (PML)' analysis prior to determining whether or not earthquake coverage is mandatory. If an asset is determined to exceed a 25% PML, then earthquake coverage is required. The theory behind this is that most 'loan to value' ratios do not exceed 70%. Thus, the lender feels comfortable that a borrower will not default on the loan if the asset is impaired. The failure of this logic is in the fact that a minimum 5% deductible applies in virtually all commercial earthquake policies.

There is great confusion within the legal and financial communities regarding deductibles for catastrophic exposures. We are all familiar with the '5% deductible' for earthquake and the '2% deductible' for coastal wind. However, in seven recent continuing legal education sessions, when the following question was posed, the responses were troubling:

Does a percentage deductible, e.g. 5%, apply to:

(a) 5% of the limit of insurance purchased;
(b) 5% of the amount of damage; or
(c) 5% of the replacement cost/rental income value of the insured asset?

In all seven sessions, less than 25% of the attorneys selected the correct answer, 'C'. This is very problematic, given the conventional wisdom that a lender's interests are protected in the event of an earthquake loss. From a practical standpoint, if a loan is made on a $50 million (replacement cost) asset and a 5% deductible is applied, then the borrower is not eligible for recovery from its carrier until he or she pays the first $2.5 million of damage. This is where the issues arise: if there is not enough free cash flow to cover that expense, the deductible cannot be 'passed through' to the tenants because it is considered to be a capital expense; and if the borrower cannot borrow any more money on an impaired asset, then the lender is at great risk for default, regardless of the existence of earthquake insurance. Thus, it is of paramount importance that both lender and borrower recognize that there may be a substantial requirement for additional capital in the event of a catastrophic loss.

Another example of this is in the case of earthquake sprinkler leakage. Under the separate coverage of earthquake sprinkler leakage, terms typically state that the deductible is lower than the standard 5% deductible and may in fact be the same as the deductibles for all non-catastrophic perils. However, many people believe that in the event of an earthquake sprinkler leakage loss, they will recover their expenses. This is not the case. Once again, the perils must be clearly delineated either as a covered event or as an exclusion to avoid unwanted surprises. For any asset in California, it is strongly recommended that earthquake sprinkler leakage coverage be obtained, regardless of whether or not coverage for earthquake damage is purchased.

'MUST HAVE' COVERAGES

As previously stated, there has been a quantum shift in the way that insurers view and underwrite risks. As a result, underwriters are requiring substantially more data for effective pricing of the risk that they are taking. Because of the rising cost of insurance, it is critical that the insured and its lenders understand the risks facing the asset and purchase appropriate coverages. Commercial general liability and umbrella/excess liability are considered as 'must have' coverage. The

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limits and deductibles are a function of the occupancy, asset class and exposure. Additionally, boiler and machinery insurance is considered to be an essential coverage, given the fact that typical property insurance forms exclude coverage for mechanical breakdown and damage to electromechanical equipment, as well as the resulting loss of income.

'Pollution legal liability' is becoming a more popular coverage, as it can provide both first- and third-party protection. Many lenders are now requiring this coverage, with particular emphasis being placed on the 'Lender's single interest' form. This coverage acts to protect the lender in the event that the borrower defaults and leaves the lender with an environmentally impaired asset. Although case law has been developed to give greater protection to lenders in the event of environmentally inspired defaults, we see a trend by lenders to require this coverage if a loan is made on an asset that is subject to remediation.

Professional liability may be considered as a 'must have' coverage if the asset and its operator provide services that have an 'Errors and omissions' type of exposure. An example of this asset class is 'Assisted living', in which the borrower may be at risk for losses excluded from the general liability policy.

In the area of property insurance, there are a wide variety of policy forms, ranging from the broad 'manuscript' coverages written by the larger insurance brokers to the restrictive Insurance Services Office forms. From experience, the following list of coverages is the preferred approach to insuring the property and rental income/ business interruption exposures of a commercial property owner. These coverages are typically 'endorsed' or added to the property insurance policy, which is designed to insure both the real property and the economic loss. The rationale for having both insured under the same contract is that in the event of a loss, a single deductible would apply and there would be less confusion and cost shifting between insurers. It should be noted that due to limitations in capacity brought on by market capacity constraints and underwriting modelling, multiple insurers may participate on a single risk, thus a clear understanding of forms and their concurrency is critical. In the case of 'California earthquake', a 'Difference in conditions (DIC)' policy or policies may be purchased to satisfy the requirements for earthquake coverage. 'DIC' policies are written as a separate contract and specifically cover stated perils. As with a conventional 'All risk' form, multiple carriers may be used.

The following list is not intended to endorse, limit or function as a definitive risk management tool. It is strictly a suggested guideline for minimum property insurance compliance that lenders may require of their borrowers:

Perils: 'All risk', including:

- Earthquake sprinkler leakage;
- Ingress/egress;

- Civil authority;
- Demolition;
- Increased cost of construction;
- Contingent operation of building laws;
- Contingent business interruption (if an exposure);
- Extended period of indemnity;
- Flood if in a 100-year flood zone;
- Earthquake if asset exceeds a 30% ‘probable maximum loss’. Earthquake limit subject to negotiation;
- Windstorm.

Property insured:

- All real and personal property, including tenant improvements, landscaping, signs, wharves, piers and other structures;
- Media and computer equipment;
- Property of others in the insured’s care, custody and control;
- Contractors equipment or materials intended for installation;
- No less than 12 months of net effective rents;
- Contingent income (if any);
- Business interruption;
- Extra expense.

Valuation:

- 100% replacement cost valuation for real and personal property;
- Replacement cost in lieu of actual cash value in the event that the asset is of non-conforming use.

Deductibles:

- ‘All other perils’. Deductible subject to asset value, size of overall portfolio and financial position of borrower. This deductible is for the non-catastrophic perils—for example, fire, vandalism, non-coastal wind, etc;
- Earthquake sprinkler leakage: not to exceed 1% of unit of insurance;
- Windstorm: not to exceed 3% for named storms;
- Flood: not to exceed $250,000 per occurrence;
- Non-California earthquake: not to exceed 2% of unit of insurance;
- California earthquake: 5% of unit of insurance.

MOULD

A staple in nature, mould appears to be this generation’s answer to asbestos. Indoor air quality is one of the key topics on lenders’ minds. Because of the rash of suits claiming both first- and third-party damage from mould, most insurers are now excluding coverage for any first- or third-party damage or bodily injury claims. As with terrorism, underwriters are offering separate insurance policies. Coverage for mould is available on a more accessible basis as an extension of the 'Pollution legal liability' policies. The underwriting requirements are rigorous and include extensive questionnaires relating to the owner's maintenance programmes, indoor air quality monitoring and due diligence during acquisitions. The terms include substantial deductibles to encourage compliance with maintenance protocols. As one would expect, multi-family assets receive the highest premiums, due to the 24-hour nature of their operations. However, commercial assets are not immune to mould-related suits, and, as a result, there is increased interest in obtaining this coverage.

LOOKING TO THE FUTURE

Owners and lenders are at a coverage crossroads. The inherent desire to insure all known and unknown risk is tempered by the commodity-based nature of the insurance market. This disconnect will continue to grow as the capital markets seek certainty from a cyclical insurance industry. Thus far, there has been some compromise *vis-à-vis* terms and conditions. It is in everyone's best interest to continue to approach insurance as simply one method to mitigate risk, rather than the answer to all potential economic exposures.

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