

## **MBA's COMMERCIAL/MULTIFAMILY FINANCE**

# Insurance: The Impact of the Hardening Insurance Market

MBA Insurance Regulatory Group

The following information is intended to provide information and market experience regarding the current state of the insurance market, the impact it has on closing, servicing, insurance professionals, insureds, and lenders. The purpose is to present information regarding the insurance markets, the reasoning behind the hardening insurance market and the various impacts the hardening markets has on various stakeholders — insureds, insurance brokers, insurance companies, originators, lenders, and servicers.

This document represents the efforts of MBA's Insurance Regulatory Group to memorialize current insurance market conditions and the events that have unfolded to create the hardening insurance market and the different ways to approach the lack of affordability or availability of insurance coverage to the insureds. **This document is for informational purposes only and is not intended to provide legal advice or serve as a substitute for a proper formal procedure by the Servicing Company.**

## About MBA

The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 280,000 people in virtually every community in the country. MBA represents all segments of the real estate finance industry, uniting the interests of diverse stakeholders, from Main Street to Wall Street, spanning all aspects of real estate finance, including commercial, multifamily, and residential. Our membership of 2,300 companies includes all elements of real estate finance: mortgage banking companies, insurance companies, commercial banks, thrifts, REITs, securitization conduits, and others in the mortgage lending field. As the leading advocate for real estate finance, MBA represents and serves our members through advocacy, networking opportunities, news, data and leadership. For additional information, visit MBA's website: [mba.org/cref](http://mba.org/cref) or contact us at [cref1@mba.org](mailto:cref1@mba.org).

# Hardening Insurance Market: Definition and Impact

A hardening insurance market can be classified as an insurance market that is experiencing many factors such as (1) increased premiums for the same coverage; (2) limited availability of insurance coverage; (3) increased deductibles, coverage restrictions and carriers not being willing to write coverage for risks — particularly catastrophic risks such as flood, wind and earthquake. A hardening insurance market generally impacts all lines of insurance — property including windstorm and flood as well as liability coverage, including general liability and excess/umbrella coverages.

The impact of a hardening insurance in the commercial lending, servicing as well as for the insurance brokers and agents are vast. We will discuss these impacts and the downstream effects in this white paper.







**INDUSTRY NOTE:** The trend in the insurance market is likely to continue through 2022, although the rate of increase should begin to moderate by late 2021. Any prediction, however, is clouded by ongoing uncertainty.



# Insurance Market Update

## THE MARKET TODAY

Q2 2020 renewals saw some of the largest price increases since 2003, led by Umbrella/Excess Liability, Directors and Officers Liability, Property and Commercial Auto. Insurance carriers are turning back to underwriting to drive profitability vs relying on underwriting income in years past. This has resulted in:

- A. Rate increases, sometimes very significant
- B. Restrictions on terms and conditions
- C. More stringent underwriting guidelines
- D. Increased insured monetary responsibility (deductibles, retentions, etc.)
- E. In the most severe cases, carriers exiting entire classes of business

## PROPERTY AND CASUALTY MARKET

The firming pricing landscape of 2019 gave way to a new reality in 2020 as insurance markets reduced capacity, tightened terms, and delivered some of the steepest premium increases on record. Already struggling with unsustainable loss activity, the market was forced to confront many challenges:

- A. COVID-19
- B. Rolling shutdown of the global economy
- C. Historically low interest rates
- D. Natural catastrophes
- E. Civil strife

## EXCESS LIABILITY MARKET

Excess Liability has been one of the hardest hit markets in the past 8-12 months. All of the drivers impacting the entire insurance market impact the Excess Liability market coupled with increasing claim severity and nuclear verdicts have caused Excess Liability insurers to pay claims at levels that were not seen previously. This led to the determination that Excess Liability books of business were underpriced.

In the Excess Liability market, there is an unprecedented market correction via price increases and capacity reduction. In light of this action, it is becoming increasingly

common for clients in the habitational real estate space, particularly those in challenging jurisdictions and moderate to poor loss experience to see up to triple digit rate increases.

## RISK PURCHASING GROUPS

With the drastic turning of the market, Risk Purchasing Groups (RPG's) are making widespread changes. Many of these programs have been unable to secure the same amount of capacity (limits) as they had previously due to insurance carriers being unwilling to participate in their programs any longer. Changes in the programs are including but not limited to (1) restriction of the classes of business that they will insure and (2) entirely nonrenewing accounts.

## PURCHASING AND BINDING INSURANCE COVERAGES

Due to the hardening market, the timing of binding insurance coverages is becoming even shorter and premium quotes are being received close or on the insurance renewal date. There are a variety of contributing factors to the last-minute binding of coverage including:

- A. Insurance underwriters are seeing a huge uptick in the volume of submissions and may not be staffed accordingly to allow for timely quoting of insurance coverages.
- B. Reinsurance treaty renewals have an impact on both timing and volume of insurance binding.
- C. Underwriters require more information to provide pricing, which takes longer to both receive and review.
- D. Availability of Excess and Surplus (E&S) limits is drastically changing.
- E. The approval process takes longer internally at the carrier(s) due to a hard market — there is increased scrutiny. Historically, underwriters like to “wait and see” how other markets are coming in from a pricing standpoint as there is increased scrutiny from an underwriting standpoint.



**Servicing Companies have their own policies and procedures for reviewing insurance for compliance. This may include a proprietary insurance compliance review system, workflows, and specific timing for follow up procedures for non-compliant items. The compliance process is directly impacted by the lender and/or loan document requirements and the process for identifying and curing non-compliance.**



# Insurance Compliance: Servicing and Originations

Insurance coverage negotiation includes borrower's and agents, agents and servicers, and servicer's and lenders, to name a few. This negotiation is driven by the cost of the compliant coverage as well as availability of coverage. Borrower's work with agents to potentially lower coverage limits, increase deductibles, and/or omit required coverages to help defray rising insurance costs.

Experience in insurance is critical from a servicing and closing perspective to assure that the non-compliant items are identified. At both closing and annual renewals, lenders may be placed in a position where they accept coverage's that are not within their standards, impacting the deal, the exposure of the property to financial losses, and the establishment of a non-compliant "servicing standard" for insurance on the loan. The timing for reviews due to these complications are elongating the process at both closing and renewal.

## CLOSING

Each closing with Insurance becomes a negotiation and the potential requirement to accept lesser coverage because the coverage is not available or too costly. This leads to an increase in waivers as well as an increase of exposure to losses for the lender. Waivers could be for the life of the loan but are more generally for that policy period only. Additionally, the inability or unwillingness to obtain the required coverage elongates the insurance review process and could potentially delay the closing of the loan. It is important to note that if non-compliant coverage is accepted at closing, knowingly or unknowingly, this can be argued to be the "servicing standard" of insurance for that loan. This will lead to complications upon the renewal of the policy(ies) when the drive for compliant coverage is made by the servicing operation who is now servicing the loan.

## RENEWAL

Each renewal coverage is reviewed for compliance and the same instances that are occurring at closing are occurring at renewal. Servicing insurance compliance teams must negotiate with the borrower's, insurance agents, and the lenders on renewal deficiencies caused by inability or unwillingness to obtain coverage that is consistent with the insurance requirements for the loan. In either case, the

time to perform reviews has a very long cycle time due to the ongoing negotiations at renewal. Determining insurance loan compliance is problematic as often the lender/servicer has only the ACORD forms (28, 25, or 27) and possibly an insurer certificate, not the actual insurance policy.

## WAIVERS AND COVERAGE DEFICIENCY SOLUTIONS AND OUTCOMES

Increasing non-compliant coverage leads to additional waiver write ups for both closing and renewal requiring increased documentation from the borrower's and insurance agents to prove their case for the waiver. Additionally, servicers and closing teams should be prepared to present the case and justification to the lender with clear and concise reasoning and documented evidence of information providing justification for their decision. If approved, waivers are generally approved for the policy term only and compliant coverage is expected to be obtained at the next policy term.

In the event a waiver is not approved by the lender, there is a possibility that additional mitigating terms may be required such as a Letter of Credit (LOC) or personal guarantee. There is also a possibility that insurance non-compliance could result in a loan not being written if terms cannot be reached between the borrower and lender.





**Risk Purchasing Groups are those that are formed utilizing insureds that are engaged in similar activities or business (i.e. multifamily, senior housing), to band together and purchase insurance coverage, resulting in a generally significant premium savings because there is a spread of risk of loss across geographical location and borrowing entities.**



# Coverage Limitations and Terms: A Servicing Perspective

There are many terms and conditions that are being adjusted at renewal of the insurance policies or alternative carrier structures being arranged in order to help defray the cost of the insurance for the property.

## CAPTIVES

Captives are being used much more frequently. A captive insurer is an insurance company that is owned and control in totality by its insureds. In the past, Captives were seen primarily in the healthcare industry and these are starting to be seen on the servicing side as COVID-19 has had an exponential impact on Senior Housing and their liability programs leading to large increases in premiums. Additionally, captives for terrorism coverage are also being seen in the market. Regardless of the coverage under the captive, there is increased review, analysis and document gathering required to assure solvency of the captive.

## INCREASED DEDUCTIBLES

Deductibles are the dollar amount the insured is responsible for paying in the result of a covered loss. Increased deductibles are being seen on the property and the liability side (Self-Insured Retentions). By increasing the deductible, the insured is shifting more of the financial risk to them from the carrier. With the increased deductibles, we are also seeing the need for deductible buy down policies, which are used to make up the difference between the required deductible and the deductible on the property policy. Additional vehicles that can be utilized to make up the difference are Letters of Credit (LOC's), Cash, and Bonds.

**INDUSTRY NOTE:** There are many factors that blend together to form insurance pricing. The impact to the individual insured can be based on property type exposure, geographic location, and loss history, to name a few.

## REDUCED LIABILITY LIMITS

Liability limits, particularly umbrella limits, are being reduced due to high premium cost. This increases the insured's and the lender's financial exposure to liability losses. These reduced limits are also leading to borrowers pursuing Captives as noted above as well as Risk Purchasing Groups.

## FINAL NOTES

This paper examined the most prevalent examples of the hardening insurance market and the impact to the various stakeholders in the process. This is not a complete listing and there are many other issues relating to the state of the insurance market in 2020 and beyond. It is meant to cast light on the issues and concerns that stakeholders — insureds, insurance brokers, insurance companies, originators, lenders, and servicers are facing in the insurance market and provide information on mitigant's that could be used to assist in the defraying of cost in an increasing premium market.

**Additional examples and information:** The Appendix that follows can provide some real and specific examples of premiums increases, loss impacts, and the overall impact of catastrophic events can have on the insurance market and premium cost.

# Appendix: Case Study Examples

## Hurricane Ike and COVID-19 Impacts:

### HURRICANE IKE

#### Case

Hurricane Ike was a powerful tropical cyclone that swept through the portions of the Greater Antilles and Northern America in September, 2008. Hurricane Ike wreaked havoc on infrastructure and agriculture — particularly in Cuba and Texas. Ike took a similar track as the 1900 Galveston Hurricane.

#### Further Details and Insurance Consequences

- A. Hurricane Ike formed 8/1/2008 and dissipated 9/15/2008
- B. Hurricane Ike occurred 3 years after Katrina, which caused one of the most dramatic insurance market shifts in a decade causing insurers to significantly limit coverage, impose % deductible and raise rates.
  - i. As a result of the extensive damage from Katrina, many insurers either refused to provide coastal wind or named storm insurance, or reduced limits.
  - ii. As a consequence, a large portion of the commercial MF stock received significant hurricane/named storm deductibles from 5%-10%?
  - iii. When Hurricane Ike made landfall with winds of 143 mph it produced \$38 billion (2008 USD) in total damage including approximately \$12.5 billion in insured losses and was the sixth-costliest hurricane in US history up to that date.
  - iv. A significant number of properties, especially frame and BV MF asset experienced damage.
  - v. Though the properties were “insured” for hurricane losses a 5% deductible during an economic recession would produce a \$1,250,000 deductible for a \$25,000,000 insured property.
- C. Many assets simply did not have the cash on hand to cover the deductible or self-insured retention.

### COVID-19

#### Case

COVID-19 impacted the world in latter part of 2019 and through 2020 as a global pandemic wreaking havoc across countries causing widespread illness and death. To combat the spread, there were mass shut downs and massive economic impact globally.

#### Further Details and Insurance and Market Consequences

In the case of COVID-19, many properties may not be occupied and are possibly fully vacant. The potential for significant losses is created under the Insurance Services Office (ISO) Building and Building Personal Property Policy. Servicers and Lenders should be communicating with borrowers regarding conditions of building occupancy and monitor building occupancy, particularly with office, manufacturing, and hospitality. Additionally, from a market and solvency perspective, there are many impacts downstream.

#### Insurance Impact

- A. After 60 days where the property is vacant the vacancy exclusion is effective (assuming 30% vacancy or less)
  - i. Excluded are Water Damage, Vandalism, Malicious Mischief, Theft and Glass breakage
  - ii. For the remaining perils there is a 15% reduction in recovery — essentially a mandatory coinsurance provision
  - iii. Lenders should check to determine if there is a vacant condition; surveillance to include Asset Management monitoring of rent rolls and inspection reports to validate vacancy status





- B. Business Income / Extra Expense
    - i. Possibly a government backstop along the lines of current backstop programs such as the Terrorism Risk Insurance Program Reauthorization Act (TRIPRA)
  - C. Deductible increases on policies may be sought
    - i. Borrower's may be asked to obtain Letters of Credit (LOC's)
    - ii. Borrowers are seeking more waivers from Lenders.
- Market Solvency and Impact**
- A. We will see waves of defaults
    - i. The first wave is seen in the hospitality industry
    - ii. The second wave is seen in the retail industry which has been struggling
  - iii. We will then see offices experiencing a paradigm shift — Many tech companies will operate with much less space; perhaps only 20–30% of previous occupancy (e.g. Google Work From Home (WFH) edict through 7/2021; 85% of SF Bay Area office workers are WFH)
  - iv. Then, if there is no change in these dynamics, we will see change in building uses; retail to warehouse, office to affordable housing/multifamily redevelopment
  - B. We will see new ways of working and managing portfolios
    - i. Many changes will be permanent
    - ii. More remote work and more cyber threats
    - iii. Servicers will continue with more use of technology

