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Terrorism's Impact on Insurance

The Rippling Effects of Insurance Uncertainty on Commercial Real Estate

Highlights

- In aftermath of September 11, issue of whether organizations decentralize or not polarized planners into two separate camps; passage of time suggests merits in both arguments
- Decentralization initiatives of several lower-Manhattan tenants not only validates concept, but suggests the strategic importance of real estate in higher levels of corporate policy
- There are very logical reasons for companies to cluster in urban cores including economies of scale and access to a high quality labor pool, however such clustering models also have distinct limitations, including managing turnover, and disposition of excess space in soft economy
- Dispersal seems to be a logical solution, however, a properly executed dispersal strategy involves elements beyond site location, including management control and IT issues
- Long-term nature of real estate time horizons provide decision makers with time to formulate robust plans
- Joint Federal report in US provides basic planning template for organizations to use when considering decentralization
- Change cannot occur overnight, therefore, short term administration of real estate including auditing of leases, and analysis of neighboring tenants needs to be conducted, before wider-scale panning initiatives can be put into place

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Introduction

Recent initiatives to decentralize have been accelerated due an awareness of the human element within organizations. Prior to September 11, 2001, business continuity planning failed to adequately recognize the importance of people, and therefore the emphasis of this field focussed on the preservation of data. Corporate strategists are now aware of the implications of terrorism or epidemics on people, and have accordingly crafted elaborate decentralization plans. Beyond the human element, however, there are also financial implications owners and users must be aware of in a post-September 11 environment. One of the more significant financial issues to arise is the uncertainty associated with the insurance industry, specifically the skyrocketing insurance rates for centrally located real estate assets. This paper explains the central issues associated with this uncertainty, and therefore provides real estate planners with the knowledge of an additional set of variables to consider when making real estate decisions.

Background

The availability of a reliable real estate finance industry is a critical factor in the commercial real estate industry as a whole, and its success is directly tied to the ability to secure insurance for the properties that are funded. Consider the following factors that measure the magnitude of the impact of finance on commercial real estate:

- As of February of 2002, the commercial real estate finance industry in the US estimated the total outstanding commercial mortgage debt in the US equalled $1.7 trillion
- The real estate finance industry provides a strong tax base for local government funding
- In the US, it creates hundreds of thousands of jobs and contributes 11% to GDP making it the 4th largest industry contributor to that category after manufacturing, tertiary and government
- Most large commercial loans are reassembled as bonds - more popularly known as mortgage-backed securities (CMBS); these vehicles are literally backed by the mortgages of commercial buildings; investors in this $270 billion market typically include pension funds, insurance companies and other institutions
- In 2001, the volume of large loans totalled $73.8 billion, $72 billion of which became CMBS

The End of "All-Risk" Policies

The interrelatedness of real estate finance and insurance is indisputable, and insurance has the potential to exert the greatest impact on the future of the industry going forward. Prior to September 11, insurance companies routinely assumed the risk of terrorism via "all risk" insurance policies. Because the risk of foreign terrorism was infinitesimally small, insurers did not consider the cost of providing such coverage significant because historically terrorist attacks in the United States did not impact industry. The only prior instances of terrorism on US soil were the Oklahoma City bombing in 1995 (as it was a federal building, it was self-insured by US Government); and the 1993 World Trade Center bombing. In the months that had followed September 11, the insurance industry had virtually eliminated terrorist coverage from all risk policies.

Time has proven that the demand for terrorism insurance coverage is perhaps the most significant rippling effect of the attacks. The attacks provide a clear example of what the impact was on the insurance industry. Estimates of the total insurance claims to survivors, property owners, businesses and airlines are in the range of $30 billion to $70 billion, although consensus estimates fall within the range of $35 billion to $55 billion. Shortly after the attacks, the insurance industry reported that it had approximately $300 billion in available capital for all property and casualty claims. Thus, a conservative estimate pins the cost of the attacks to no less than 10% of the total pool of insurance funds in the US. This is a staggering figure, and for this reason, insurance and reinsurance companies have indicated they will no longer cover acts of terrorism.

Terrorism's Arbitrary Nature

One of the key problems exacerbated by terrorism is that there is not probabilistic model that can effectively determine a particular level of risk. In a pre-September 11 world, large US-based rating agencies such as Fitch, Moody's or Duff & Phelphs would provide the guidelines establishing insurance rates for commercial property. They would begin the process by creating a risk profile based on factors including structure height, proximity to a transportation hub, city or suburban location, profile of tenants, and how highly it is regarded as a national symbol. Although organizations such as these may be able to price the risk of corporate bankruptcy, or they can purchase insurance against the risk of a building burning

down, they have no training in how to assess and price the risk of terrorism.

The arbitrary nature of terrorism makes it very difficult to predict either the magnitude or likelihood of future attacks, and this it what makes it a particularly sticky issue. Since terrorism cannot be predicted with any degree of accuracy, the cost of insurance needs to price that uncertainty, and in this case, the cost becomes prohibitively high. As the implications of this market imperfection is realized, institutions are carefully scrutinizing their portfolios for geographic concentrations in high-risk areas. From an investment point of view, larger institutions are now faced with the likelihood that lending institutions will now be more closely examining their portfolio concentrations, and therefore, they will be diversifying their portfolio strategy to somehow neutralize the risk.

Who Bears the Risk?

Insurance uncertainty imposes significant implications. The absence of adequate insurance protection is a barrier to conducting business in commercial real estate. For instance, lenders require owners of commercial property to obtain insurance coverage (because the property serves as the principle loan collateral); in the wake of the terrorist attacks, most insurers of commercial property have either refused coverage or are pricing such coverage so high as to render the real estate deal uneconomic. This also imposes a negative impact on property owners whose policies may be up for renewal, as the lack of terrorism coverage can actually place property owners in technical default on their loans. The problem comes full circle after a loan goes into default upon maturity for failure to sell or refinance; at this point, the lending institution's only recourse is to recoup on the value of the collateral. But what is the value of real estate if potential purchasers are unable to secure financing? Without coverage, it becomes difficult if not impossible for real estate owners to purchase, sell or operate properties, refinance existing loans, or sell commercial mortgage-backed securities, and it significantly hampers the market's ability to underwrite large commercial loans, particularly for high profile, downtown properties.

The following anecdotes illustrate how insurance uncertainty can affect real estate financing:

- A survey by The Bond Market Association in the US revealed that large lenders have placed on hold or cancelled more than $7 billion or 10% of the 2001 large loan volume in commercial

mortgage loans; the primary reason for this has been the inability of borrowers to secure terrorism insurance

- The criteria for lending has drastically changed, for example in 2001 a large US lender, Column Financial closed 549 loans totalling $5.8billion; the smallest of these was $1 million, the largest, $480 million; prior to any definitive resolution to this crisis they amended their policy such that they would not consider any loans in excess of $50 million without full terrorism insurance coverage, and they will meticulously scrutinize any loans in excess of $20M if they have terrorism exclusions
- Several Manhattan high-rise projects with a collective value of about $1 billion have lost funding because terrorism insurance could not be obtained
- High rise buildings in New York, Washington, Chicago, and Los Angeles are extremely difficult to finance w/out terrorism coverage; if another attack occurs in the future, it has the real possibility of shutting the markets down

What makes this discussion more distressing is the fact that the ultimate risk is not borne by the property owner, or the lenders, but the average investor. Simply put, the average investor ultimately provides the capital required for real estate funding through vehicles such as RRSPs, fixed-income funds, pension plans, and rainy-day funds. Because pension funds and life insurance companies have significant portions of their investors' money tied up in commercial real estate and commercial mortgage-backed securities, if there a downturn in the commercial real estate industry takes place, average people will be affected.

Addressing the Uncertainty

Because a definitive insurance solution has yet to be formulated, the market has reacted in several adverse ways including the exclusion of terrorism insurance altogether, offering coverage with lower limits, and dramatic increases in insurance premiums from 50% to 300%. A senior official with a prominent Canadian institutional investor stated that rates in Canada have risen anywhere from 40% to 600% (there is a direct correlation between proximity to a CBD and increase in insurance premium). In the US, there are now warnings of a full-blown crisis that threatens both the insurance and the commercial real estate industry. Because of the market's inability to reconcile this flaw in the market it will likely be a problem ultimately inherited by government. Many people in these industries have called on the US Congress to enact legislation that would provide a federal backstop for terrorism insurance and bring

insurance premiums down to more realistic and affordable levels. This would be achieved through the creation of a government-backed insurance program that would stabilize premium prices and force the provision of terrorism coverage.

Some of these problems were finally addressed in the US on November 26, 2002, when President Bush signed the Terrorism Risk Insurance Act of 2002 (TRIA). Unfortunately, this failed to or inadequately addressed several key, a fact that will inevitably signal long-term change in the industry. The problems with the program are summarized below:

- It has been put in place for a period of three years (until the markets can determine a better solution); however most loans are longer than this
- It covers foreign but not domestic terrorism; the problem here is that it may take time to determine exactly where terrorism occurred and thus places a hold on any potential act
- It permits exclusion for biological and chemical terrorism; if a chemical attack takes place, it will cover the cost of replacing, say, an HVAC system, but will not cover bodily injury or harm
- It introduces what could become extensive internal procedures for certifying covered acts of terrorism and thus present serious timing issues for insurers and servicers; foreign-origin acts of terrorism are only covered if they are certified by the Treasury Secretary as foreign; without certification, there is no coverage; therefore if the cause of a tragic event is a mystery and certification is delayed, it can have a critical effect on the timeliness demands of real estate related cash flows
- It fails to guarantee affordable premiums for terrorism insurance, although they are now working toward some kind of resolution of this factor.

Impact on Investing Climate

As the issue of insurance reconciliation becomes murkier, institutional investors who ultimately fund their projects using the invested capital of individual investors will likely alter their focus. Since September 11, the terrorist threat has imposed a myriad of new cost pressures and risk factors onto those who own and manage buildings. There will likely be significant net operating income and future value implications to investment-grade real estate resulting from higher operating costs (e.g. security and insurance) that are passed on to tenants as well as lower demand for this type of real estate. Investors will now look toward revamping their investment strategy to include assets from

regions or categories that may not previously have been considered.

Opinions vary on the extent to the amount of change anticipated. In an attempt to try and gauge the current mood for investment, we interviewed three senior real estate investors. One represents a large US-based financial institution based in the southeast US, the second, a loan originator from a large US-based insurance company in the US Midwest, and finally a senior manager for one of Canada's largest institutional investors. Together, they offered a range of different viewpoints and changes that have been experienced in the industry. Some of the findings are summarized in the sections below:

i) Insurance Increases:

- All agreed that the insurance premiums for real estate assets rose as properties became more centralized
- In the US, insurance rates for AAA space have experienced increases that have surpassed 300% since September 11; in Canada the increase topped 600% for the same types of assets (the irony is that Canadians have demonstrated a much greater degree of compliance to such increases, as many tenants remain content staying in their existing locations)
- This is mostly due to the fact that US leases have a greater tendency to place caps on the amount of annual increase permitted on additional rent, whereas Canada usually imposes automatic pass-through of additional costs to tenants
- General terrorism awareness among the general Canadian public is not as high in Canada as it is in the US; to many Canadians, these events took place somewhere else

ii) Notable Changes in Usage Patterns

- In the US, heightened security, and increased desire to know neighbouring tenants
- Increased concern about being located in landmark buildings of CBDs

iii) Investment Patterns

- Lenders in the US are shying away from underwriting on office in general, particularly CBD investments, however, this could be attributable to factors beyond September 11, notably the three-pronged effect of the tech bubble burst, high-profile corporate scandals such as Enron, and September 11
- Prior to September 11, the US economy was already hibernating, and tenant and credit issues were becoming

more problematic; whether its real or not, September 11 is now regarded as the flashpoint of change

- Some larger owners (REITs whose portfolios have become more diversified due to merger and acquisition activity) are sticking to a set portfolio strategy and actually divesting of assets that do not conform to that strategy; in some cases this means exiting from 2nd and 3rd tier markets and products and concentrating solely on 1st tier markets and products in CBDs; their only mechanism for managing portfolio risk is ensuring that investments are not clustered, and no two buildings are adjacent
- Pension funds in the US are generally backing away from large office asset investments
- Some Canadian funds haven't categorically stated changes to their investment strategy and remain focussed on CBD investments because these are cash cows that typically provide 35-65% of operating cash
- From the Canadian perspective, in the immediate aftermath of the attacks, people within several institutions were preparing for imminent changes in investment patterns; however, after some time they got caught up in previous patterns and their memories of the attacks began to wane; they became more preoccupied by the success of the economy
- Most of the larger transactions in Canada have taken place already moved from private companies to funds, so the immediate reaction is more difficult to gauge
- In the US there is a general recognition that redundant locations are now farther apart; often in different cities or different states

Investment Issues Going Forward

As we move forward, we will inevitably see policy makers compromising and coming up with solutions that will serve the specific needs of investors, insurers and regulators alike, however, the overall investment climate for institutional-grade real estate will be affected by a number of issues. Here is a listing of some of the more important ones:

- Over the short term, as vacancy problems due to increased tenant vacancies and compression in rents increase, there will not be a spade of foreclosures because this cycle is characterized by interest rates that are lower than they have been in many years, thus owners are able to carry properties that experience difficulty
- There was huge pause in acquisition and disposition activity in selected US markets, however, in mid-2002 there was a

noticeable spike in opportunistic acquisitions; buyers were taking advantage of either “liquidation sales” or lower interest rates

- Although decentralization may not be the specific buzz words used by institutions, there is a general recognition of the increase in redundancy and duplicity due to security and incidental risks