Storm Warnings

Insurance needs in the wake of disasters

By Mark Olshaker

Back in the 1990s, I was hired to write an IMAX film entitled Stormchasers, about the men and women who pursue and study "big weather." We went to India to observe the annual monsoon. We went to Oklahoma to meet with tornado chasers. And we went to South Florida to visit the National Hurricane Center. I remember asking the center's director, Dr. Bob Sheets, what would be his worst professional nightmare. "That's easy," he replied. "Category Five, direct hit on New Orleans." This was a full decade before Hurricane Katrina, for which the entire Gulf Coast region was woefully unprepared.

The same afternoon, producer Greg MacGillivray (*To Fly* and *Everest* among his many credits) and I drove down to Homestead to survey the effects of Hurricane Andrew, which had devastated the Miami-Dade area more than a year earlier. It still looked like a war zone and seared in my mind for all time the destructive potential of these monster storms. "Just think about it," the city manager said to us, "during Andrew, coconuts were flying through the air with the force of cannonballs. Roofing nails were ripped out and flew like bullets."

It was impossible to avoid the fact that what makes hurricanes, tornadoes and fires so riveting on the big screen translates to life-threatening danger, misery and appalling loss to those affected on the ground. And we need look no further than the tragedies of Katrina and our own business sector for the lessons recent storms reinforced to asset managers about the critical importance of planning before the disaster hits. And the prime component of that planning is insurance.

"The first time you talk to your insurance company should not be when you're filing a claim," states Matt Hammer, managing advisor for Baldwin Krystyn Sherman Partners, insurance brokers in Tampa, FL.

"It's a people business. They want to be able to collaborate with you and help you with your insurance and disaster planning."

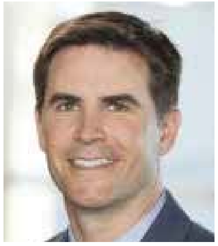
Matt Hammer

BKS stresses an interactive approach with its clients, and this includes an ongoing dialogue between property owners and their insurance company's underwriters. "Insurance can be one of the most expensive line items in asset management. An emotional connection is important in the mix, and brokers should be proactive in encouraging that relationship," said Hammer.

By any standard, 2017 was an unusual and challenging year for the property insurance industry, specifically the third quarter, when Hurricanes Harvey, Irma and Maria struck Florida, Texas, the southern coast, Puerto Rico and its island neighbors, and created well over $100 billion in damage and loss claims.

"We have more than 60 properties in Florida, so it didn't matter which way Irma went – we were going to get hit," Doug Selin, executive vice president for property management of Southport Financial Services, commented during a panel on "Insurance Procurement and Risk Mitigation Strategies" at the NH&RA Asset Management Conference in June.

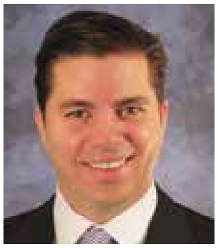
There is some good news, though, if we can call it that, according to the panel's moderator, Hammer's associate Chris Huber, BKS's business development director. "The amount of supply of insurance is still robust, so there was not that much hardening of the market."



Chris Huber

The Multifamily Insurance Market

That market, however, has plenty of complications for the multifamily and affordable housing owner and operator. "We are dealing with a market cycle that is extremely tough for multifamily owners," says Ted Brown, executive vice president of Lockton, Inc., the world's largest privately held, independent insurance broker. He is one of the executives who oversees Lockton's 120 multifamily unit owner clients, about a third of whom have tax credit or affordable components. "It's important to understand the way insurance companies underwrite and how they make money." He describes an insurance business model based on the "combined ratio" concept: the collected premium payments, minus business expenses and claims payouts. "For the last ten years, it was in the 70 to 80 percentiles. In 2016, it started to climb into the 90s and in some cases got to 100 or above. We knew we were going to see a market correction."



Ted Brown

As part of that correction, "The industry tolerance for risk in multifamily housing is changing. Along with energy and agribusiness, multifamily is considered a loss-prone business sector. You're always going to have fires and all the other risks that come with what is essentially a city in microcosm. In 2016, there were significant losses due to hail and wind in Texas, Oklahoma, Colorado and Kansas. Then in 2017, we saw catastrophic losses from Northern and Southern California wildfires, Mexican earthquakes and the Florida and Gulf Coast storms. That was a $135 billion loss year, the largest in recorded history."

The 2016 claims were based on what the insurance industry calls "attritional losses," while the 2017 ones were catastrophic losses. This is more than a mere semantic distinction. Brown explains that for catastrophic loss coverage, insurance companies rely on reinsurance, underwritten by about six major companies worldwide. "When reinsurers have to increase their premiums by nine or ten percent, the [regular] insurance companies have to replace a certain amount of profitability, and that means returning to strict, traditional underwriting and changes to the deductible."

One of the key lessons from the NH&RA panel is that planning makes a critical difference. "We had hurricane preparedness procedures in our manual for what to do before, during and after," Selin said. "It helped in limiting the damage, plus we have an established stable of vendors and a construction company."

The Latest Innovation: Computer Modeling

Most climate scientists agree that as the planet warms, weather will tend more toward extremes and superstorms will become more frequent. But that is not the only change playing out in the insurance industry, particularly for property owners in regions with major storm exposure like Florida and the Gulf Coast. The means of underwriting and evaluating risks has fundamentally transformed, with significant implications for property owners and asset managers.

"Historically, insurance was underwritten with a basic approach and only a few variables," Hammer explains. "Now, there are more than 60 inputs."

Those inputs are factored through a process known as storm, property or catastrophe modeling. "Storm model-

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Asset Management

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ing is a way for insurance companies to predict how your property fares against different storm scenarios," Hammer continues. "They use it to factor how much to charge, and if you [use a similar program—there are several established ones available], it provides you with the ability to know how much insurance you need.

"With more than 60 different characteristics used for the modeling data, you will have to hire a specialist. But it will give you a very accurate outlook on what your portfolio would look like in the event of a once-in-ten-year event, a once-in-a-century event, and so on. Storm, or catastrophe modeling, takes a scientific approach to risk, which is important, because that's how underwriters work. Modeling software will be adjusted on a continual basis and even take conditions, such as El Niño, into consideration."

Hammer notes that the traditional underwriting process uses only rudimentary data that did not describe all component of the building and property. "Most brokers take the old school approach, not going through the extra steps. But the quality of the data directly impacts the quality of the results. The standard deviation [from a completely accurate assessment] could be $5 million. And insurance companies always err on the high side. Computer modeling reduces the standard deviation and gives underwriters a better comfort level of what they should be asking for. So, brokers who use modeling in-house can negotiate on behalf of their clients with leverage."

Computer modeling can also help determine the capital return on investment from "hardening the target" by installing stronger roof connections, increasing drainage capacity or other upgrade measures.

What Coverage Do You Need?

Hammer cites three levels of coverage:

1. *Actual Cash Value* takes into account depreciation and, in the event of a claim, pays out what the property is currently worth.
2. *Replacement Cost* is based on what the property would cost to replace with like kinds and quality of materials.
3. *Ordinance and Law* coverage bridges the gap between the replacement cost of the property as built and the requirements of any new ordinances or building codes instituted since then.

He also points out that in the event of a major storm, there is likely to be a "demand surge" for labor and materials since many properties in the area will be needing repair or rebuilding at the same time. A *margin clause* in the insurance policy will address the increased adjustment in the cost.

Building fire (as opposed to wildfire), while just as serious a risk to life and property, is not likely to trigger demand surge, since it usually involves only one apartment unit, building or, at most, a property complex, rather than a devastated area. Hammer said an insurance company will look at the types and extent of fire protection in determining rates, such as smoke detectors, sprinklers and suppression systems, proper maintenance of dryers, the building's smoking policy and how far it is to the closest fire station. "The more mitigation features you can include, the better. But modeling will not be as big a determining factor with fire."

Another consideration is determining the deductible figure. For owners of multiple properties in a given area, this can be a complicated question. For example, in last year's Florida and Gulf Coast storms, many owners suffered damage at a number of properties, but not enough to meet the deductible figure at any one property.


Beverly Hanlin

There are differing ways of looking at this situation. At the conference panel, Beverly Hanlin, director of asset management for the National Housing Trust, said, "We renewed our policy in May 2017. We brought the deductible down to $100,000 and increased our liability umbrella total to $15 million. In Florida, there was not enough damage [at any property] to file a claim. We were lucky. We had concrete construction wind-impact windows, secure roofs."

Flooding is a separate issue that needs to be addressed on its own. Hanlin described an affordable housing property just outside of Orlando where a backup caused four feet of water to build up, resulting in a million-dollar flood loss. "Insurance was really important," she said.

Brown notes that the liability insurance market has remained "fairly stable."

Eighty-five percent of flood insurance originates with the federal government's National Flood Insurance Program (NFIP), but Huber says the private market is gradually gaining ground. Critical in determining premiums is whether the property is in a designated flood zone. Appealing that designation involves complex surveying and other analyses, and the results can go either way. Some owners have their assets removed from flood zone status, while others end up paying more. "We have property in Virginia that sits in a flood plain," Hanlin recalled. "We had elevations shot [to determine whether it actually was], but it ended up costing us more. And if this building floods, believe me, you all need to get on the ark!"

Habitability

Habitability is a critical issue in catastrophe coverage, as was made agonizingly clear by the Rehabilitation Center at Hollywood Hills, FL disaster in which 12 elderly residents died when Hurricane Irma knocked out power for air conditioning. The Hollywood Police Department classified the deaths as homicides, and civil wrongful death suits were filed, as well. Hammer stresses the importance of asset managers knowing their responsibilities to older tenants and the standards of care regarding relocation. All of this comes into play during a disaster and the recovery effort.

"You must document all resident communications and notices for storm and evacuation notices," he said. "And if there is an evacuation order, get waivers signed by those who choose to stay and assume the risk."

Hammer notes that some carriers are trying to eliminate coverage for habitability because of all the liability issues involved, including the definition itself, while Brown believes, "Any insurance company worth its salt should understand the necessity of coverage for extra expenses. If you don't move [your residents in an emergency], you're going to get sued, and then the company is in for even more expense."

"Your strategy should be paying attention to the actual terms of the policy and having your broker walk you through the implications of each provision," said Hammer. "A summary is not enough. We pay attention to all details – all forms and endorsements."

In addition to their standard insurance, Brown recommends that his clients "finance for risk," which means budgeting for fairly predictable losses, like small fires, snow or hail damage and leaks; it is almost like self-insurance. "That way, you're not constantly 'trading dollars' with your insurance company, since they have to build in a profit for every risk they insure. We guide our clients through that evaluation."

Relationships and Planning

"Relationships are extremely important," Brown stated. "This is not just a commoditized business. We have to manage each other's expectations. A lot of times we earn business because expectations have been set too low and clients don't understand how the business works. If you do, it helps you negotiate.

"We start the renewal process about 90 days ahead. This gives you the opportunity to discuss mutual concerns with the carrier."

Which brings us back to the first lesson. "Having a sound disaster response plan in place is critical," said Brown. "If you have a fire or even a shooting on your property, operationally, how are you from a risk-control perspective? Train your staff and know how you're going to communicate with residents. The worst case is when a property manager doesn't know how to respond."

As Hanlin put it, "Your broker should be your best friend. I'm always playing insurance games with him, saying, 'What if this happens?' 'What if that happens?"

And as Hammer summed up, "The more you pay attention, the better the results are going to be." TCA

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