



REAL ESTATE

ADDRESSING THE UNIQUE CHALLENGES FACING THE REAL ESTATE INDUSTRY

2012 Property Insurance Outlook: Impact on Real Estate Margins

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Despite falling unemployment rates in three-quarters of large U.S. cities in the 4th quarter of 2011 and the auto industry posting its best annualized sales rate in two years, the signs of economic recovery and optimism have not yet translated to a bright real estate outlook in 2012. Real estate owners are preparing for a year that will yield modest returns and limited new development opportunities.

As political uncertainty continues to dominate the headlines, most commercial property owners are faced with declining or stagnant occupancies and rents that will impact profitability going into 2012. But it's not all doom and gloom across the industry; bright spots do exist in the resurging multi-family market, particularly in cities that focus on booming sectors like energy, technology and healthcare, but the overall real estate market is "facing a long grind," according to Urban Land Institute's Emerging Trends in Real Estate® 2012 report.

In order to keep profits at acceptable levels, it is more important than ever that real estate firms effectively and efficiently manage their expenses. Property insurance can account for 45% to more than 70% of a real estate firm's total cost of risk, and the property insurance market for 2012 is not without its own challenges. This may translate to a firming in pricing and reduction in coverage that could impact the already-fragile margins expected for 2012.

RATES UNDER PRESSURE

Since 2004, the property and casualty insurance market has been in a period of declining pricing and lower demand. Over this eight-year period, the nation's workforce has shrunk and sales have declined, and so has the need for insurance. This soft market has resulted in more competition from insurance companies for the limited demand, which has kept premium increases at bay.

Insurance companies judge their results based on a

combined ratio: the loss ratio (losses over premiums) indicates how they are performing with their book of business combined with the expense ratio (expenses over premiums). For the first nine months of 2011, the top 10 largest U.S.-based property/casualty insurers experienced combined ratios on average of 102.6% compared to 95.8% over the same period in 2010 (Source: Business Insurance, 11/21/11). This means that insurance companies are spending \$102.60 on expenses and losses for every hundred dollars collected in premium. Combined ratios of more than 100% have been acceptable in the past due to the investment returns insurance companies could make on the premium dollars they set aside to pay potential future claims. However, when investment performance is poor, carriers must rely on other factors to improve profitability. A combined ratio of a 100% could generate returns of 5% to 15% in years past, compared to 3% return today on a combined ratio for the entire Property/Casualty industry that is over 108%.

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Adding to the poor investment returns is catastrophic (CAT) losses in 2011 from floods, tornadoes, earthquakes, hailstorms and hurricanes. According to Munich Re, the largest reinsurance company in the world, insured catastrophe losses in the U.S. were over \$35 billion in 2011. This is a 130% increase from 2010 (see Chart - MR NatCatSERVICE, Property Claims Services) While the insurance industry continues to have adequate capital to handle these losses, carriers' profitability will no doubt be affected. All this puts pressure on insurance companies' rates and a focus on re-underwriting their book of business to improve underwriting results.

RIPPLE EFFECT ON THE MARKET

In addition to the pressure on rates, a new version of the widely used RMS-U.S. Hurricane Modeling Software, which helps insurance companies define their appetite for risk in CAT-prone areas, is now in use. More reliable data has become available in the new version, and insurance companies are beginning to adopt a more conservative

approach to the property insurance they are willing to offer to support the new levels of expected losses. Logic will tell you that if you do not have properties exposed to these natural disasters, it should not affect your property premium. But the unfortunate reality is that the effect of the new model ripples through the insurance and reinsurance market, putting a strain on capacity, which limits carriers' ability to take on more risk.

In the third quarter of 2011 and into 2012, we have begun to see the impact of all of these factors, with increasing property rates for risks with exposure to CAT losses. The rest of the property market (non-CAT) is seeing modest increases, if there has been loss activity, or at best flat renewals for risks with minimal loss activity.

BUYER BEWARE

While pricing was declining over the past eight years, insurance companies were also evaluating the level of coverage offered and restricting terms and conditions to limit the types of claims covered. Insurance carriers can retrospectively look at their book of business and determine which coverage terms have resulted in the most claims activity. Armed with this knowledge, they can draft new terms and conditions to limit their exposure, which is important at a time when pricing is declining. They can try to protect their underwriting profit by limiting the amount of claims covered by the policy.

According to W.R. Berkley's CEO in a speech at the

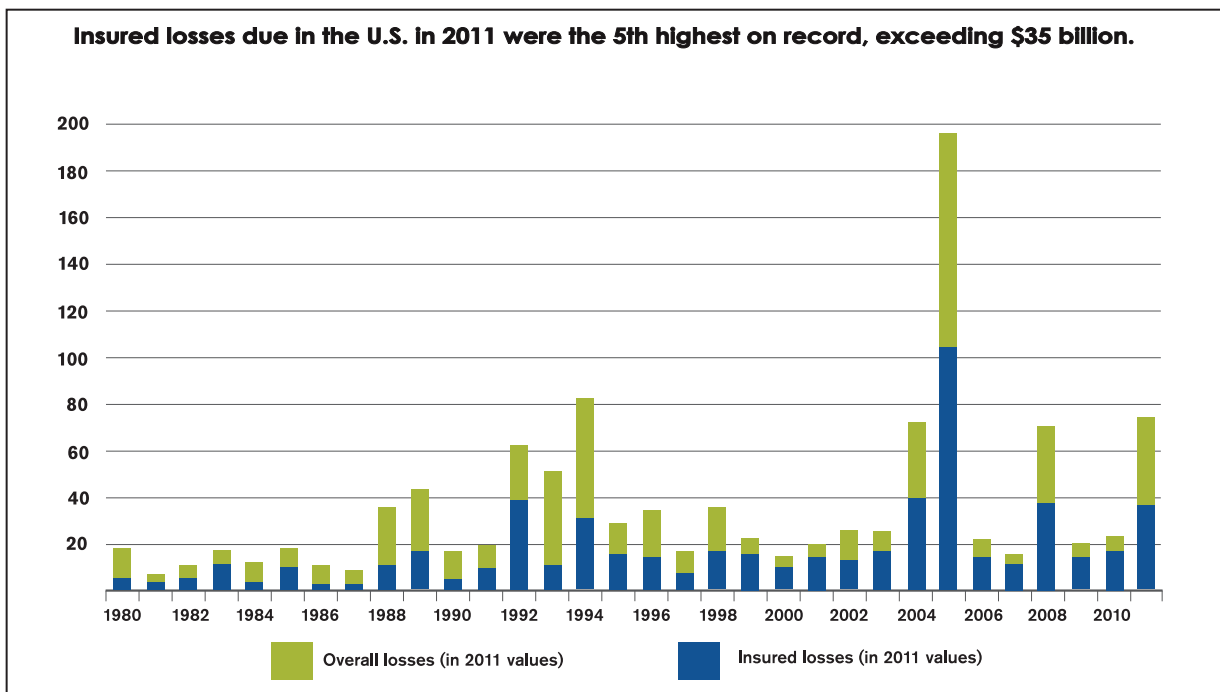
Goldman Sachs U.S. Financial Services Conference 2011, we are at the beginning of price increases in the insurance market and terms and conditions are changing, allowing business written to become more profitable (National Underwriter Online News Service, 12/7). When pricing starts to stabilize or even increase, these coverage omissions are not readily given back, which can result in a poorly constructed policy with many coverage gaps.

At a time when real estate firms are desperate to retain profits, a significant uninsured loss would be devastating. Coverage terms and conditions cannot be ignored and policies need to be carefully evaluated at each renewal to make sure they adequately address the exposures. Often times, insurance renewal negotiations are only about the rates, which can be a dangerous renewal strategy if there are limitations to covered perils, sublimits and additional exclusions that reduce the amount of protection provided.

'LOCATION, LOCATION, LOCATION' DRIVES RISK

Many real estate firms are wondering what they can do to be prepared for a change in the property insurance market. While location, location, location always reigns true for the marketability of real estate, it also can often be the driving factor for your exposure to risk. It is important when approaching the insurance market that proper analysis has been done to model your properties and segregate them by location (state, county, etc.), age, construction type and concentration, with particular emphasis on CAT-exposed properties.

LOSSES DUE TO NATURAL CATASTROPHES IN THE UNITED STATES 1980-2011



Sources: MR NatCat SERVICE, Property Claims Services



On a portfolio basis, understanding where your property values lie will better prepare you for discussions with the insurance underwriters as well as in setting the proper limits and deductibles. Risks that can emphasize the geographic spread of their properties will be viewed more favorably than a risk with a large concentration of exposures, or worse yet, a concentration of property in a CAT-exposed territory.

In addition, focus should also be on the construction aspects of the properties and investments, and improvements in protection of those properties should be made. While there is little you can do about the actual construction of the property, there are many improvements to electrical systems, fire protection, etc. that improve the risk profile of a building. New green technology is looked upon favorably in the insurance marketplace; however, care must be taken to ensure that the green components of buildings are properly covered under the insurance program. Disaster planning also becomes an important component of your overall risk management plan to be prepared to react quickly to a loss and for a speedy recovery.

COMPETITION CONSIDERATIONS

Lastly, it is typical in times of increasing prices for there to be a desire to seek competition to your current insurance carrier. While some insurance carriers see pricing increases as an opportunity to write more business more profitably, incumbent carriers typically understand your risk better. With the tightening of the market, incumbent carriers are more likely to offer consistent limits, terms and conditions than you might find with a new carrier. As long as they continue to be a partner with broad coverage provisions and supportive in claims situations, the incumbent carriers should be given the benefit of the doubt, and you should be receptive to listening to their reasoning for the increase in pricing. Often times, you will find their increases in pricing are in line with the rise in the market, and there can be a benefit to loyalty.

EXPOSURES HAVE STABILIZED

In summary, the property insurance market for real estate exposures has begun to stabilize, and CAT-exposed risks can expect an increase in rates. While decreases are hard to find in the market today, the outlook for 2012 doesn't get any better given the limited ability for insurance companies to make money in this economic environment.

Underwriting profit is key for insurance companies, so they will look to get more premium on underperforming insureds as well as being more selective in offering their capacity. Coverage terms and conditions remain the cornerstone of any insurance policy, so the buyer needs to be aware of what they are buying. The rest of the property/casualty industry is also being affected by the economy, so the property insurance market is not alone in its need to tighten the belt, but the impact is being felt first with property insurance in 2012.

BROUGHT TO YOU BY THE GRAHAM COMPANY REAL ESTATE TEAM

About The Graham Company Real Estate Team

The Graham Company has been serving the real estate industry since the 1970s. The team has over 60 years of collective experience in the insurance industry with specialty expertise in complex property placements, premises liability, contractual risk transfer and pollution legal liability. The team is staffed with the expertise to accurately tailor insurance policies to address the unique needs of the real estate industry and to implement a comprehensive risk management strategy to reduce risk. For more information on The Graham Company's Real Estate Team contact Kevin D. Smith, CPCU, ARM at 215.701.5323 or ksmith@grahamco.com.