Insurance Marketplace Newsletters
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TERRORISM AND INSURANCE – A PERSPECTIVE FOR LENDERS AND BORROWERS

Over the past 12 years, Alpha has assisted 21 commercial real estate lenders in over $50 billion of transactions by making a risk management assessment of the subject property and then specifying appropriate insurance requirements whose documentation is subjected to an insurance audit.

The firm successfully dealt with such diverse problems as an historical building whose replacement cost far exceeded traditional insurance replacement cost provisions, to an escape clause in a major tenant's lease which would not have triggered full rental income reimbursement.

Since 9/11, the problem of insurance coverage for potential terrorist attacks and concomitant damage has not lent itself to ready solutions. The CMBS market and managing boards of (mostly foreign) banks have insisted on coverage to the extent it may not be available or the related cost could render a deal uneconomical. The sources of coverage are as follows:

Terrorism not excluded on an "All-Risk" Policy
The number of carriers who no longer exclude terrorism coverage can be counted on the fingers of one hand and some or most of these will disappear when July 1 reinsurance treaties come up for renewal.

Monoline coverage
Four companies now offer stand-alone policies:

AIG, although they recently declared a moratorium in Manhattan due to an aggregation problem.
Lloyd's
Berkshire Hathaway
ACE

For trophy buildings capacity is limited, coverages are thin, rates are high and deductibles can be so high as to render the policy almost meaningless. For example, for a $500 million pair of buildings, the owners were offered $100 million in total limits, subject to a deductible equal to 2% of the total insured value, or $10 million per occurrence.

Federal government reinsurance Lenders just do not want to expose themselves on non-recourse loans where the borrower has no coverage for terrorist acts. Turning the faucet off has already started to impact the construction industry, where even bridge financing is no longer readily available.

The U.S. General Accounting Office, in its recent testimony before the U.S. Senate Committee on Banking, Housing and Urban Affairs, has properly cited selected insurance programs established by federal statute, such as:

- The Price-Anderson Act of 1957, providing coverage for catastrophic nuclear accidents.
- The Overseas Private Investment Corp., formed in 1971, providing insurance against overseas political risk.

- The National Insurance Development Program, authorized in 1968, providing insurance against urban riots and civil disorder.
- The National Flood Insurance Program, also in 1968, providing coverage in critical flood plains.

Other nations have also initiated government-sponsored insurance programs covering terrorist acts (the United Kingdom, Israel), earthquake (Japan), and selected catastrophic events (Switzerland).

This is not a question of the free market as these forces cannot operate without hard data. If the Bush Administration and both Houses of Congress are truly concerned about economic stimulus, they will hasten to neutralize the dampening effects of the current terrorism exposure.

The Senate proposal S.1751 makes more sense than the House version (H.R. 3210) and of the several amendment offered, the Daschle and Schumer proposals make the most sense.

Carve-outs

When one borrower could not put together the required limit, we suggested a corporate guarantee which was eventually given to seal the deal. In another case, an individual owner agreed to carve out the non-recourse aspect of the loan vis-à-vis terrorist damage as the subject property was not considered to be a likely target.

Caveat: As these insurance policy limits are policy year aggregates (similar to California Earthquake or Caribbean Windstorm), one must review limits purchased against the total insured values of all the properties covered thereunder. This scenario may make more sense for a lender's diverse and substantial portfolio and we are exploring this approach on behalf of some of our lender clients. For example, a $5 billion portfolio may purchase a $500 million policy applicable to any property in the portfolio. The cost to the lender may be less than to a borrower and may be passed along in the form of say, 20 to 50 basis points, depending upon the property's location.

Collateral coverages

Any proposed insurance policy must be carefully scrutinized with respect to the following collateral coverages:

Rental Income
Cancellation Provision
Civil Authority
Ingress/Egress
Off-Premises Service Interruption

Summary: This is not an easy problem but there may be creative solutions.

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