MARKETS IN FOCUS
Real Estate

Insurance Pricing &
Market Update

Q2 2021

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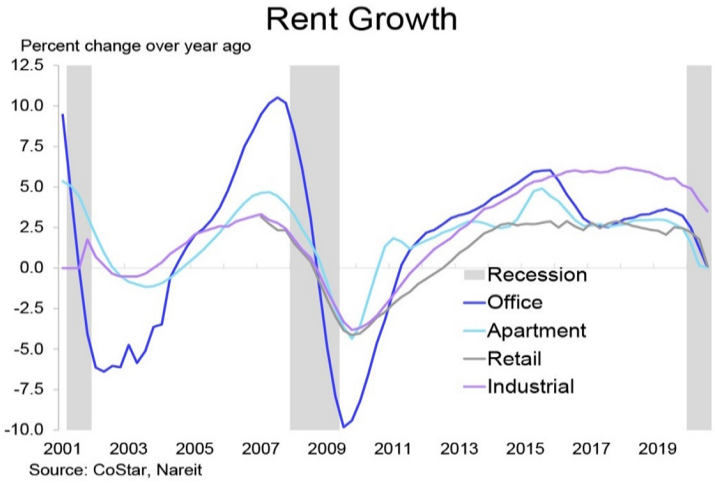
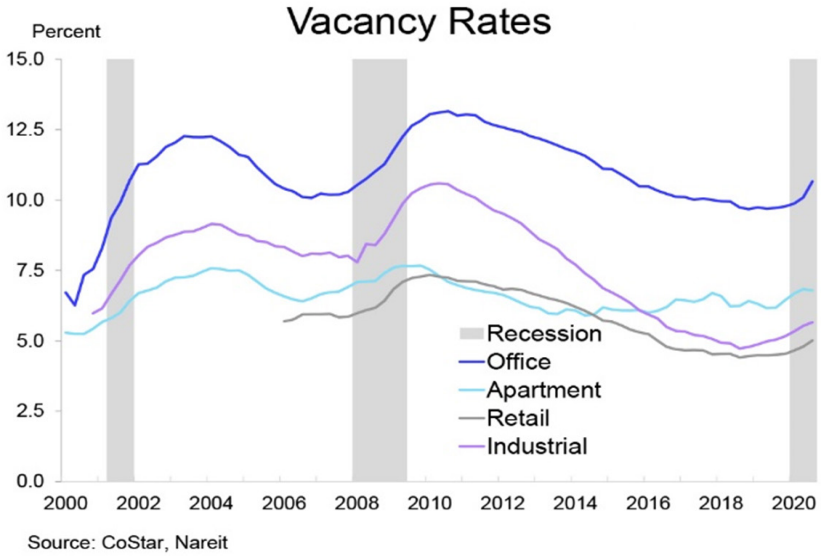
Introduction

2020 was a difficult year for the US commercial real estate industry, particularly for the office space sector, which, on average in the US, saw an 80 basis point increase in vacancy rates and no increases in rent year over year. Due to the COVID-19 global pandemic and resulting recession, the year was full of challenges for all segments in the real estate space: rising vacancy rates, reduced rents, employee temperature checks, mask requirements, halting of residential evictions, and declining financial health of tenants.

As of late, the sector has also been adversely impacted by a significant increase in construction costs due to shortages in labor, rising costs of raw materials, and delays due to global supply chain issues. This has resulted in shrinking margins and longer timelines on new projects. Moreover, most REITs were negatively impacted by declining rent payments and future investment projects becoming delayed or stalled. Though the residential and industrial sectors appear to be showing a little more resiliency in 2021, many (particularly in the office and retail sectors) are wondering how long the trends of remote working and vacancies as a result of financially impacted companies will linger into 2021.





2021 Insurance Market Outlook

Many of the market factors leading to the further hardening of the insurance market in 2020 are still in effect in 2021, with the US still in a low interest rate environment and 2021 storms already breaking records: February's Winter Storm Uri was the costliest winter storms in history and inflicted $18B in estimated insured losses. As such, carriers will continue to place an emphasis on generating revenue through more rigorous underwriting practices; underwriters will closely scrutinize business performance, occupancy rates, retentions, pricing, as well as reduce limits and capacity.

This is particularly true for admitted carriers, causing a shift towards placing more business in the E&S market. These carriers are often better equipped to implement pricing and policy language that is more in line with the current risks in the market. It is expected that larger property and umbrella/excess programs in the real estate space will require more carriers to achieve desired limits in 2021 as carriers that once provided $15M to $20M layers will now offer reduced $5M to $10M layers.

+ **Property** – There is a significant infusion of capital into the property market in the past 6 months as newly formed Bermuda and London E&S carriers and recapitalized US E&S carriers helped stabilize pricing and capacity. Despite the additional capital, rate increases are still expected, especially for companies with poor loss history. While admitted carriers and carriers impacted by Uri look to rebalance their portfolios, the additional disciplined capital entering the space is looking to take advantage of firm market conditions and utilize E&S policies to achieve more advantageous pricing and policy language.

+ **Admitted and E&S carriers** are weary of insuring property exposed to catastrophic storms (such as coastal properties) and are simply declining submissions with wildfire exposures. Additionally, many carriers seek to increase All Other Peril deductibles and add or increase convective storm deductibles in higher-risk locations like Texas, Oklahoma, and Colorado, even if an account has favorable loss history.

- **Builders Risk** – Like other markets, builder's risk policies are seeing increases in pricing and retentions not only due to significant losses as a result of large fires but also an increased frequency of smaller claims. Large wood frame, modular construction, and renovation projects are proving to be the most challenging projects due to the higher frequency and severity of claims in these sectors. Additionally, due to delays in projects, many insured are seeking extensions, which can be problematic for carriers.
- **Casualty** – Capacity in the casualty market continues to be very tight in the real estate space, as the casualty market did not see the influx of capital that the property market did. Many companies in the real estate space are finding it difficult to obtain more than $1M or $2M in General Liability limits and are finding that umbrella/excess carriers are only willing to expose $5M within the first $10M of excess limits. There is generally more carrier appetite above the $25M attachment point, but even excess of $25M we are seeing a greater need for quota share and layered participation.
- **In response to COVID-19**, many General Liability carriers are adding communicable disease exclusions and habitability exclusions, which are claims related to landlords failing to maintain "habitable" properties. Formerly, habitability exclusions were typically only seen in California in response to multiple multi million-dollar awards to tenants in the state. Fears of these claims spreading to other states has resulted in the widespread use of exclusions.
- **Primary and Excess/Umbrella underwriters**, in general, are very concerned about "nuclear verdicts" and if an insured's loss history is indicative of a potential large loss. As such, casualty underwriters are requiring longer history of loss information as well as more details related to losses and any subsequent changes made to prevent future loss.

Surety Market Update

After a decade-long soft market, the COVID-19 pandemic acted as a catalyst in tipping the scale in the surety markets. The overall economic uncertainty coupled with concerns within specific industries has led to enhanced scrutiny in surety underwriting standards. While ample capacity remains available for adequate to strong credit risks, the tightened underwriting conditions are worth noting.

Early concerns about COVID-19's impact on the real estate development and construction industries were incomprehensible to the surety industry; however, these industries were deemed an essential business throughout most of the country, allowing developers and contractors to continue operations. Additionally, the industries were supported by Paycheck Protection Program (PPP) loans, which helped provide financial stability. These factors coupled with the reopening of the economy allowed these businesses to weather the initial COVID-19 crisis. Surety companies' concerns of the impacts of the pandemic have tempered, resulting in stabilized and adequate surety capacity.

An emerging theme among developers is that lenders and financiers are increasingly requiring contractors to provide performance and payment bonds via debt covenants for private projects. General contractors are also aware of the economic pressures on subcontractors. As a result, general contractors should have implemented a more robust subcontractor prequalification process, likely to include the utilization of subcontractor default insurance (SDI) or subcontractor bonds, rather than self-insuring subcontractor failures.

Despite these positive market factors, the long-term effects of COVID-19 on the industry are not yet certain. Sureties remain vigilant in their underwriting processes, but capacity remains.

NAVIGATING 2021

+ **Building Valuations** – As mentioned previously, construction costs are on the rise and as such, insureds should evaluate if their limits can adequately cover a total loss and rebuild in the current cost environment. To help confirm proper coverage, building values are being reported on a replacement cost basis using indices that detail cost trends by geographic area and type of occupancy. The indices help provide a cost trend factor in order to make more accurate property schedules. IMA service teams can help provide these indices or consult on property schedule methodology.

+ **Higher Claims in Times of Recession** – Statistics evidence a significant increase in claims (and fraudulent claims) during times of recession. In particular, there is a significant uptick in slip and fall claims against property owners. Insureds in the real estate space should especially be aware of this trend and have a plan to address these incidents.

+ **Business Interruption Assumptions** – Even though there is a lot of optimism around vaccines helping improve the economy and allowing employees to return to offices, companies should be realistic with their revenue projections when making assumptions for the purposes of business interruption calculations.

  Unlike General Liability, Workers' Compensation, and Auto policies, BI is not audited; meaning there is no reconciliation at the end of the year or credits granted for overestimating revenues. As such, insureds should be conservative on their revenue estimates since there are many factors and regulations impacting when vaccines will reach critical mass and when workers will start spending more time at the office. Additionally, many companies are looking to adopt a flexible in-office schedule or may even allow employees to permanently work from home thus resulting in less office space demand. Conversely, underreporting too much can result in being significantly under-insured if/when occupancy and rent rates return; coverage is based on a percentage of monthly estimates and trailing twelve month actuals. All of these factors should be contemplated so that insureds are not overpaying for their BI insurance but still carrying adequate coverage.

+ **Vacancy Exclusions** – Many property polices include provisions which remove or restrict coverage when a building is deemed vacant. Typically, vacancy restrictions are triggered by a percentage of occupancy for a consecutive number of days (often 60 to 90) but they can also be triggered if the building has been repurposed from its originally intended use. The day trigger can sometimes be negotiated with underwriters prior to renewal, but they are less likely to negotiate percentage of occupancy or changes in intended use. For buildings with exceptionally low occupancy, underwriters may require evidence of building safeguards (i.e. cameras, alarms, etc.) before issuing coverage. Many carriers may opt to use these exclusions given rising concerns about the numerous hazards associated with vacant buildings, including bursting water pipes, fires, vandalism, and damage caused by vagrants. However, insureds can improve their position in the market by highlighting their security programs and protection measures in place during their submission process.

+ **Higher Switching Costs** - If forced to switch from an admitted carrier to the E&S market, insureds must remember that these policies come with stamping fees and surplus lines taxes. Additionally, these policies are generally more expensive (before the additional taxes and fees) as they are designed to cover more risky lines of businesses/occupancies or provide coverage for non-traditional types of exposures.

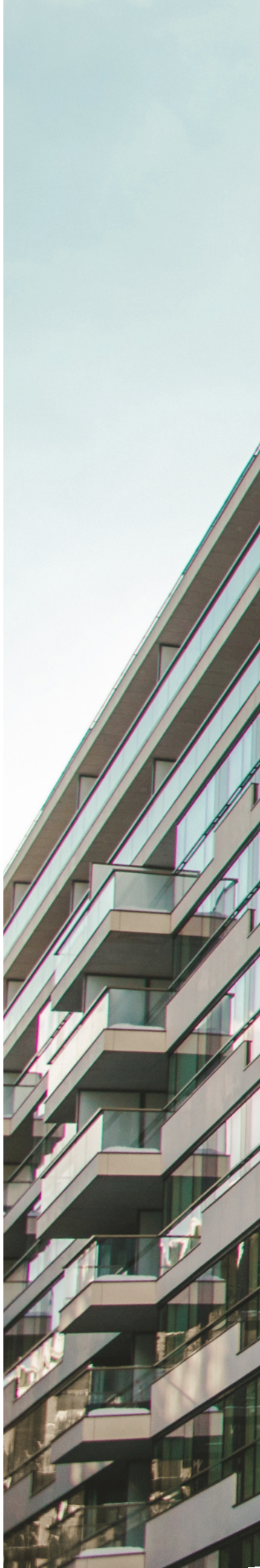
KEYS TO SUCCESS IN 2021

+ **Begin the Renewal Process Early** – The General Liability, Excess/Umbrella, and Property markets have become constrained and more difficult to navigate in the hard market. Additionally, many blue-chip admitted carriers in the real estate space are offering less capacity and more carriers are being required to achieve desired limits. Due to general price increases across all lines of coverage and all industry sectors, underwriters are being inundated with submissions as brokers and insureds look to minimize the additional costs. As such, turnaround times for quotes are increasing. In order to achieve the best results, insureds should begin their renewal processes earlier than usual as to allow for brokers to successfully canvas the market, work diligently with underwriters in detail, and negotiate the best terms.

+ **Look to Partner with Carriers When Possible** – Strong relationships with key trading partners are always important, but even more so in difficult times. This business philosophy also applies to insureds' relationships with carriers. Where possible, insureds should look to meet (even virtually) with their current and prospective carriers. This interaction not only builds rapport and allows them to put a face (or voice) to a submission by telling their company's story; it also allows for insureds to control the narrative of their risk versus letting underwriters decide. This is particularly true if there has been losses and insureds are able to explain what happened and use the opportunity to discuss lessons learned and what new practices have been implemented, as opposed to underwriters simply reading a loss run.

+ **Reevaluate the Cost to Get Buildings Rebuilt** – As mentioned previously, construction costs are on the rise due to multiple factors. This is not expected to decline as the construction industry is forecasted to see an overall increase in demand in 2021 and 2022. Insured should look to reevaluate the cost to repair their buildings in the current market prices in order to obtain adequate limits.

+ **Be Familiar with Vacancy Language** – Insureds should work with their IMA team to fully understand what triggers vacancy exclusions in order to avoid uninsured losses. Though there is general optimism around vaccines and improved economic conditions helping improve vacancy rates, insured should remain vigilant by understanding this exposure.



+ **Repurposed Buildings –** If a building has been repurposed, let your broker know immediately so that coverage can be maintained and to avoid potential uncovered claims. Nobody likes surprises when managing a claim, but communication before there is ever a claim can help limit surprises.

+ **Highlight Safeguards –** When working through submissions documents, highlight protective safeguard features in buildings and share specific details on security systems, insurance requirements of tenants, water sensors, sprinkler systems, building enhancements, and anything else that would demonstrate diligent care of property. It will be important to demonstrate to carriers that insureds are investing in their properties and doing their best to protect from total losses, vandalism, vagrant damage, theft, etc.

+ **Highlight Maintenance Program** - Share details on maintenance programs, winterization precautions, and details regarding improvements and betterments, particularly if the property is older, in an area exposed to natural catastrophes, or if occupancy has dropped. After Winter Storm Uri, many property carriers are interested in the integrity of pipes and what insureds are doing to protect their property in cases of extreme weather. Carriers may also want to ensure that properties are still receiving planned maintenance when occupancy drops, despite negative impacts to cash flow, as leaks and other problems may take more time to notice and thus cause more damage.

+ **Familiarity of State Laws –** Insureds should work to be familiar with the state laws applicable to their insurance program, risk management strategy, and operations. There can be significant differences in litigation outcomes state by state and even county by county depending on the jurisdiction.

More Than Just Insurance

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