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FALL 2023

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NAREIM dialogues

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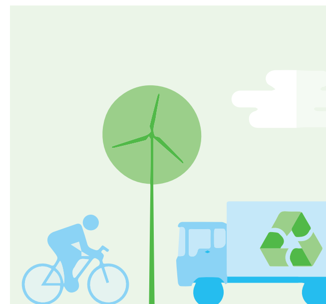
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INSURANCE *in a* brave new world

In an era of climate catastrophes, the insurance market has responded with volatility. Incumbent renewals are uncertain, prices have skyrocketed and insurers are pulling out of high growth Southeast and Southwest markets.

For real estate investment managers, this means traditional valuation and risk models no longer serve their purpose. The markets have changed permanently, with insurance having the potential of making or breaking a deal. NAREIM spoke with **BGO**, **Continental Realty Corporation** *and* **PCCP** *on getting the capacity needed, the importance of educating deal teams and crafting a story, and what it takes to self-insure.*

By Zoe Hughes and IvyLee Rosario

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PARTICIPANTS

Haley Donato
Senior Vice President, Asset Management & Finance, **Continental Realty Corporation**
In her role, Haley directs CRC's asset management, disposition and debt teams for both multifamily and retail. During her nearly 12-year tenure at CRC, Haley has built and grown the teams that cover those core functions. Haley also has oversight of CRC's data science and business analytics platform and the firm's insurance programs. She sits on CRC's Investment Committee and Executive Committee.

Ryan Severino, CFA
Chief Economist and Head of US Research, **BGO**
Ryan is responsible for global and regional economic research, analysis and forecasting as well as property market research, insights and forecasting. Prior to BGO, Ryan served as Chief Economist at JLL and before that served as Senior Economist and Director of Research at REIS. He is currently Adjunct Professor of Finance and Economics at Columbia University and New York University.

Mona Sullivan
Vice President, Insurance Risk Manager, **PCCP**
Mona has more than 15 years of commercial insurance and risk management experience specializing in professional & management liability, property and casualty liability. She has worked with the AON Risk Management Outsourcing (RMO) team on several contracted opportunities supporting a variety of special project needs. She currently holds a Georgia Property & Casualty Brokers License.

This summer was marked by blistering heat, wildfires, flash floods, hail and ice storms around the globe. Describe how climate change is affecting the property insurance environment for each of your firms. Let's start with renewals.

Haley Donato, Continental Realty Corporation: Our Property Program renewed on March 1st, which feels like an eternity ago based on all that has happened in the insurance markets this year. Our entire portfolio is under one shared and layered master program with a TIV [total insurance value] of around $2.5 billion. We have roughly 15% of our exposure in Florida and another 10%–15% in in the coastal Carolinas, so we certainly felt the pressures of the market's sensitivity to more climate-prone areas. We do have the benefit of being both retail and multifamily, so the diversification in occupancy types helps to improve our risk from an underwriter's standpoint.

All told, we had a challenging renewal in terms of premium pricing like everyone else. But we were able to get the full limits that we sought for both wind and flood, and we were able to maintain our existing deductible structure. As a March renewal, I think we were ahead of some of the more severe capacity constrains the market saw in late spring/early summer.

Mona Sullivan, PCCP: PCCP has a June 1st Property/Casualty renewal. We also felt the pressures of the market's sensitivity in more climate-prone areas. Florida and Texas were the most challenging. We generally stressed the advantages of our national diverse occupancy types with underwriters. One item that assisted our renewal was we already had Bermuda and London markets on our insurance program. We were generally able to secure full limits and maintain our existing deductible structure, with a handful of outliers.

What did you see with pricing?

MS: PCCP has multifamily properties on both coasts, specifically in Florida and California. We generally felt the impact of both the hurricane and earthquake exposures. Overall, I'm very pleased that our renewal premiums were better than I would have imagined. We experienced double-digit increases. I believe PCCP was able to demonstrate to all our current and prospective insurance markets the benefits of our strong claims-handling

procedures, revised contract review processes and various risk mitigation efforts that I have implemented.

HD: We were actually oversubscribed a bit in the final days leading up to our renewal so we were able to push a little bit on pricing and terms, but it still came out well above expectations we may have had in the fourth quarter of 2022.

Our retail portfolio is a nice counterbalance to our multifamily portfolio, which is a more challenging product type for carriers. In addition to our 9,000 apartment units owned and managed, we have almost 8 million square feet of retail with a national footprint. Our product type diversification and geographical diversification make our portfolio more attractive from a risk standpoint.

Our loss history is also very strong — top decile among our peer group. Losses have always mattered in insurance pricing, but in a really challenging market, a long-standing track record of controlling our losses had a very big impact on pricing.

Can you comment on how much rates increased in 2023?

HD: This is a question we get asked often as people are trying to mentally reconcile how their outcomes stack up. The truth of the matter is that it is really hard to use an apples-to-apples pricing comparison across various programs for a variety of reasons: portfolio concentration in occupancy and geography, limits carried relative to TIV, deductible structures, loss histories, reported values… the list goes on.

This year, more than ever, the property insurance markets saw a sizable disparity in pricing increases between CAT[catastrophe]-prone areas and non-CAT areas. I've read industry publications showing increases between 25% and 50% for CAT-exposed portfolios with 'minimal loss history' and as much as 2x–3x for heavy CAT portfolios with 'poor loss history.' It's a huge range of reported outcomes — again making benchmarking quite challenging.

GETTING CAPACITY

In this volatile environment, what makes a good manager to underwrite and get the capacity needed?

HD: Aside from the characteristics of the portfolio you're insuring, there are a handful of important focus points that I believe have made us a better or easier risk to underwrite. First, we are self-managed — that matters a lot to markets. Our standout loss history is, in part at least, due to operating our own real estate and having a hands-on approach to risk management. Every time I meet with carriers they really focus on our self-management. It is important for underwriters to know that the insured is the same firm that makes the day-to-day decisions.

MS: Insurance companies typically underwrite to the story that you present to the marketplace. Representing your firm with the best possible underwriting presentation is essential.

When I joined PCCP as their first Vice President, Insurance Risk Manager, I worked very closely with PCCP's construction and operational consultants by putting them at the forefront of implementing better contract review processes and identification wording. Second, I streamlined how we utilize our insurance brokers, including setting more frequent comprehensive and strategic meetings.

Third, I revisited how insurance is 'viewed' within PCCP. We determined that employees could benefit from more education around insurance. I added risk and insurance concerns to every checklist, conference call and line item where possible. Lastly, I took a hard look at our relationships with our insurance markets, focusing on what could be leveraged and what had actual value.

Partnerships with your insurance markets is very important. Many of our markets were willing to continue the relationship. I believe this was because they either recognized the new processes and procedures that were being implemented, and/or they recognized me and my team from past projects. So, it's all about the partnerships and relationships you retain and the risk story that you tell.

HD: I totally agree with Mona's point there — insurance is a relationship business and how you present your story to the marketplace is critical. We spend a tremendous amount of time on our presentation materials and we make a point of meeting with as many markets as possible in-person. That means traveling to New York, Atlanta and London to meet with dozens of carriers at each renewal. We also work very hard to have very clean, thorough data on our Statement of Values to ease some of the administrative aspects for underwriters.

On the point of relationships, I think we saw that matter even more this renewal [this past March]. It's easier to do

business with people when there's a working relationship in place and that has an exaggerated effect in a very hard market. Almost all of our incumbent markets renewed with us, but some had to downsize their limits or move up to a higher attachment point because of market conditions. Because of this, we did have to expand our stack with some new carriers, as I know many did in this renewal.

Adding new carriers can create additional considerations: for one, new markets generally quote higher than the incumbent markets that already know you, understand your risk and have hopefully benefited from strong historical performance. The second consideration is the complexity it adds to the stack. Each new carrier is another policy form to negotiate to ensure concurrency all the way up the stack.

Mona, did you see an increase in the number of markets to get what you needed?

MS: I was able to retain many of my incumbent carriers, but there were challenges in filling out capacity as the markets had shifted, limited or withdrew their limits. At the end of the day, it is a numbers game; we worked with everyone in the market.

I did have a small number of markets say, "We can't do it at all." But I believe that happens in any renewal; there are always one or two markets with less capacity because their underwriting approach has shifted.

ECONOMIC CONDITIONS

Ryan, what are you seeing from an economist's perspective?

Ryan Severino, BGO: I don't see a path to it getting better quickly, unfortunately. As an economist, I'm usually able to weigh the costs and benefits. But even for me, more on the business side, it's so upside down. We are dealing with changes we have never encountered before.

We will have to see how the rest of hurricane season plays out before we know if we are going to have some kind of recalibration next year. But underwriters are clearly planning on an increased frequency of events that used to occur at much longer intervals.

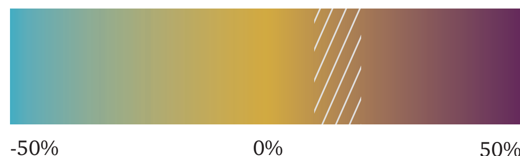
People in my circles are estimating a rough 2024, but not as catastrophically bad as 2023, and then hopefully a return to normal. But that again is all, in my view, purely predicated on the question of, are they profitable years? Is 2023 a highly profitable year and maybe 2024 as well? Will capital come back in, because as much as it's a climate change issue, it's also a supply and demand issue, and the capital has pulled out of the space.

What are you seeing and hearing from the underwriters and brokers?

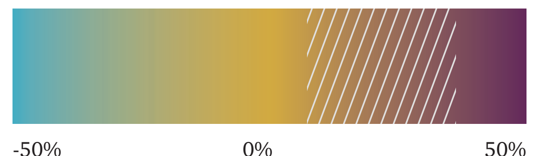
MS: With my background as a former global insurance

1. Expected property insurance rate increases in Q3 2023

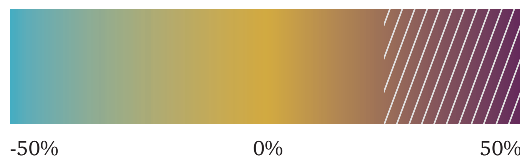
Non-CAT-exposed



CAT-exposed



Challenged occupancies and heavy loss accounts



Note: Rate ranges presented here reflect expected renewal outcomes — as of the Lockton Market Update June 2023 publication date — over the next quarter (Q3) for the majority of insurance buyers.

Source: Lockton Market Update, June 2023.

broker/consultant and global risk manager, I do not foresee the market improving anytime soon. I agree with Ryan — while 2024 may not be as catastrophic as 2023, I believe risk managers will still be faced with the same hurdles.

My takeaway from market meetings is the importance of valuation and climate change. This summer we all witnessed wildfires in Canada and across Southern Europe and insurers pulling out of California, Florida and Texas. I believe these additional roadblocks will only harden the market and keep risk managers constantly on our toes.

In my opinion, risk managers will need to put forth their best risk story in their renewal meetings. They will need to emphasize what they are doing to prepare for these climate changes that are occurring. How are they setting up their assets to mitigate these new and emerging risks? What's their business continuity plan and the effectiveness of their claims management? Do they have all the equipment and processes to put fires out quickly? I believe insurance carriers will drill down on risk mitigation and loss control efforts. I would advise every risk manager to start reevaluating their loss control measures.

RS: I agree with all of that. To add to that, we're in an environment where valuation is jumping around and somewhat opaque. We don't know if the Federal Reserve is done [raising interest rates] and what's value in a world where the Fed might not be done. What does it mean in a world where the climate is changing in ways we haven't seen and don't understand?

> “Insurance is literally making and breaking deals in the market for CAT-exposed areas.”

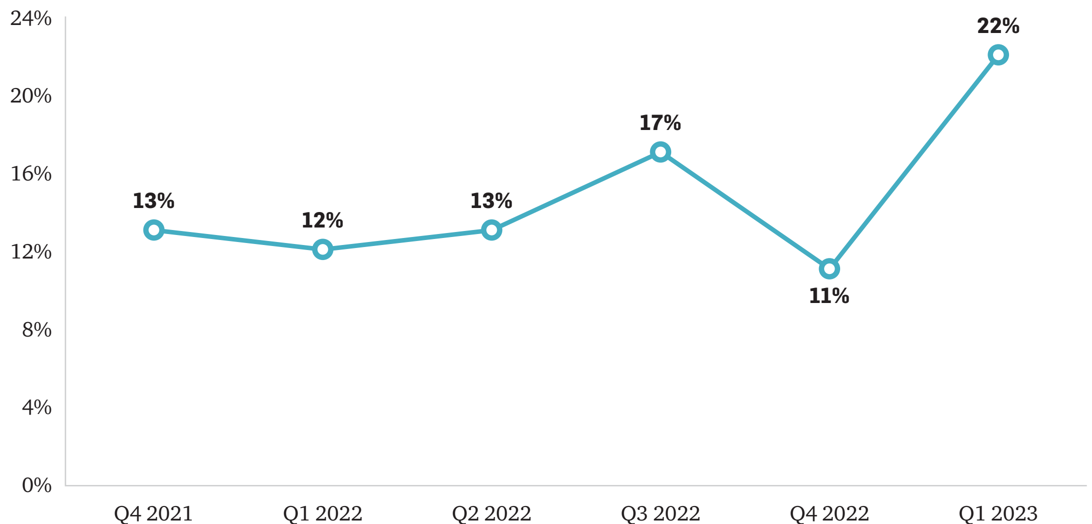
VALUATION UNCERTAINTY

How are you managing uncertainty when valuing or appraising assets?

HD: Since the beginning of the year we have not presented a deal where the insurance was not heavily reviewed and questioned by the investment committee. Up until this year, the folks that won the deals were those which would underwrite more aggressive rent growth or use floating rate debt instead of fixed rate debt.

Now, whoever can secure the cheapest insurance is winning deals. It has become such a large line item and it feels so unpredictable right now [insurance] is literally making and breaking deals in the market for CAT-exposed areas. And as insurance has taken an unwelcome spotlight, there's a lot of education that needs to be happening across the commercial real estate industry.

2. Property insurance rates have risen for 22 consecutive quarters



Source: Lockton P&C Edge Benchmarking Report, Q1 2023.

How does that change the calculus when evaluating a deal?

MS: Every time I look at a deal, I'm also looking at how this asset may affect renewal next year. I can't just check the box and say "yes" and move on because we have to look at the continuity and sustainability of our program.

The challenges are outliers that I generally consider when reviewing the insurance on a deal. Case in point, the labor laws and large court payouts — also known as nuclear verdicts — related to construction in New York have become a primary focus on many New York deals. We are also highly sensitive about crane contracts for construction deals.

I have to be a step ahead. It takes a village. My risk team is constantly evolving and evaluating how we need to move forward with new deals and renewals. We are working closely with our brokers, our carriers and our deal team.

The main questions are: How do we stay ahead of climate change and all the other risks that could happen down the line? And what is the story I'm going to paint for the markets for upcoming renewals, not only in 2024, but also in 2025 and beyond? I believe the markets will face challenges to recover from these catastrophic losses, both nationally and globally.

RS: I like your comment about cranes because I was wondering if there was an interaction between cranes and wind resulting from climate change that's going to cause

3. Example of a Florida roof geometry CAT model

	Construction class	Occupancy type	# of stories	Flat roof	Hip roof	Gable roof	Braced gable roof
Florida (buildings constructed prior to 1995)	Wood frame	Residential	Single	+M	-H	+M	+L
			2+	+M	-H	+M	+L
		Industrial/ Commercial	Single	+M	-H	+M	+L
			2+	+M	-H	+M	+L
	Masonry	Residential	Single	+M	-H	+M	+L
			2 to 3	+M	-H	+M	+L
			4+	+M	-H	+M	+L
		Industrial/ Commercial	Single	+M	-H	+M	+L
			2 to 3	+M	-H	+M	+L
			4+	+M	-H	+M	+L
	Concrete or steel with concrete roof deck	Residential	1 to 3	+M	-H	+M	+L
			4 to 7				
			8 to 14				
			15+				
		Industrial/ Commercial	1 to 3	+M	-H	+M	+L
			4 to 7				
			8 to 14				
			15+				
	Concrete or steel with metal or wood roof deck	Residential	1 to 3	+M	-H	+M	+L
			4+				
		Industrial/ Commercial	1 to 3	+M	-H	+M	+L
			4+				
	Light metal			+L	-H	+L	-L

Magnitude code	Description
+H	Increases losses by >20%
+M	Increases losses by 5%–20%
+L	Increases losses by 0%–5%
	No change in loss estimate
-L	Reduces losses by 0%–5%
-M	Reduces losses by 5%–20%
-H	Reduces losses by >20%

Delta between +H and –H is 40% or more impact to loss expectation.

Rule of thumb:
For every dollar of known or expected loss transferred to an insurance company, they will charge you between 2x to 3x premium.

Source: Lockton, using RMS modeling.

more cranes to blow off buildings. If that's the case, we're going to have to recalibrate our thinking about wind resistance and flexibility. We could be in a different world with that over the next five to 10 years as the climate really starts to change.

To add to that, I think about migration patterns in this country. People are moving to places where climate change is getting objectively worse. Some states where insurers are pulling out of are some of the states where they have the biggest migration patterns. Texas and Florida are one and two in this country. People are moving there, businesses are moving there and commercial real estate is increasing there, both in terms of the physical inventory and their valuation.

It's hard to see 2023 repeating over and over ad infinitum, but as more people and businesses continue to move to those places, coupled with climate change, environmental challenges are going to persist and likely worsen. Structurally this is a different and more challenging environment than the one I started in more than a quarter century ago.

RETHINKING MARKETS

Are you rethinking deals or markets due to recent insurance pricing hikes?

RS: There aren't any markets or property types that we're avoiding per se, but it definitely changes the mathematics on things like underwriting and returns. We are playing a different ball game than the one we were a few years ago. In some markets, it is permanently different now on the cost side, and so you had better account for that when you're doing underwriting, or it would be very easy to miss return targets down the road. It's also a challenge from a macro portfolio management perspective.

HD: You called this out in earlier comments, Ryan, that the areas experiencing the largest climate change issues, are the most scrutinized by the property insurance markets and are also the highest growth markets in most cases. Maybe you are now underwriting $1,800 a door instead of $1,400 a door but you might be seeing 6%–8% rent growth today in some of those markets.

It is difficult to sort out the math in a bubble when you're considering overall investment results. Some of the ultra-high growth markets like coastal Carolinas and Florida are the most heavily scrutinized on the property side. We haven't blackmarked any specific markets, but there are forces counteracting demographic trends we like as the insurance risks can be hard to quantify.

MS: Increases in rent may not equate to how the insurance expenses may increase. Insurance costs are generally becoming a larger factor in how deals pencil out.

RS: Coming back to the point that a lot of the markets where people are going are the places where there's the most potential trouble — it's hard to write off the Southeast and Southwest if others are there and generating good returns.

If you decide you don't want to be in those markets because of insurance issues, you're making a huge bet in an asset allocation framework that might not have anything to do with the underwriting economics and demographics portfolio diversification. So that's why we're not writing off or avoiding any markets completely. But we are going into them clear-eyed about the challenges that I think are more acute than they were just a few years ago. It adds another dimension to this competitive landscape. ◆

Thinking about self-insurance

With the way trends are going in the commercial insurance market, are you looking into self-insurance?

HD: Yes. We are in the process of forming a captive. We started the process immediately following our renewal. It's a considerable investment upfront, both in time and money, but we are at a point in the market that we want alternatives outside of the commercial market.

RS: There hasn't been a need to self-insure. But the world is changing and the need to self-insure may become more prevalent.

MS: Firms with big balance sheets are often able to self-insure. One can certainly expect Fortune 300 companies to have self-insurance as a large component of their program. Currently, PCCP does not have a pure self-insurance mechanism in our program.