

Commercial Mortgage
Special Report

Issuer U.S. CMBS: Windstorm Insurance — Gone With the Wind?

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■ Summary

Although the 2006 Atlantic hurricane season has been lighter than originally forecast, U.S. commercial real estate (CRE) values in coastal areas still may suffer as insurance companies continue to minimize their loss exposure to hurricane-prone areas by increasing premiums, raising deductibles, dropping coverage amounts, and even dropping coverage altogether as a result of the most active and most expensive hurricane season in 2005.

■ Effects of 2005 Hurricane Season

The 2005 hurricane season was considered to be the most active hurricane season ever, with its three largest storms (Katrina, Wilma, and Rita) responsible for approximately \$45 billion in insurable losses. In 2006, as a result of these catastrophic losses, insurance companies began to place caps on windstorm coverage and even dropping coverage all together. Fitch Ratings' chief concern is that as a result of this contraction, windstorm insurance policies along some coastal areas are becoming commercially unavailable, possibly echoing in severity the terrorism insurance issues of late 2001/early 2002.

Earlier this year, as the 2006 hurricane season approached, commercial mortgage-backed securities (CMBS) servicers noticed a sharp increase ranging between 25% and 400% (in some cases higher) in windstorm insurance premiums. Fitch believes that if this increase extends beyond the 2006 season, it will translate into serious cash flow stress for CRE properties, particularly those where premium increases cannot be passed directly through to tenants. Fitch is concerned that if premiums and coverage do not return to more normal market levels, the resulting stress on cash flows may be severe enough that a property can no longer support its full debt service, thus increasing the likelihood of payment default.

Additionally, as premiums have increased, the same has happened to policy deductibles. Fitch has seen increases of up to 10%–15% of replacement value for new policies, compared with 2%–5% in those traditionally underwritten in the market. This has prompted some CMBS lenders and servicers to require borrowers to provide guarantees to cover the difference between the two deductibles to mitigate the additional risk.

■ 2006 Losses Less Than Expected

As the 2006 hurricane season draws to a close, real estate owners, lenders, and insurers are likely breathing a collective sigh of relief. After last year's record 28 hurricanes and tropical storms, the National Weather Service predicted another big season for 2006: up to 17 tropical storms, with approximately nine or 10 expected to develop into hurricanes and four to six categorized as major hurricanes.

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Fortunately for all, only nine Atlantic storms developed, with most remaining at sea. Only tropical storms Alberto and Ernesto directly hit the U.S. mainland. Alberto produced heavy rain across Florida, North Carolina, and Virginia, causing moderate flooding in some areas and an estimated \$565,000 in total damage. Ernesto delivered heavy rains across its path, especially in the Mid-Atlantic states. Damage in Virginia was estimated to have been approximately \$118 million, with total damage unknown. A third tropical storm, Beryl, brushed Nantucket Island, MA.

In fact, the 2006 hurricane season has been so benign there has not been another named storm since Hurricane Isaac in late September. Scientists largely cite two primary factors for the mild season. First, a shift in atmospheric pressure over the Atlantic steered most storms away from U.S. coastlines. Second, the arrival of a new “El Niño” climate pattern disrupted systems in the Atlantic and Caribbean with shearing winds before they could form into storms or hurricanes.

However, the benign 2006 hurricane season has done little to offset the strain on windstorm insurance capacity. Part of this disconnect is likely the result of the general scientific consensus that among other climate-related factors, currently this part of the world is in what is known as a cycle of high storm activity. Supporting this assertion is the fact that the number of category 4 and 5 hurricanes has doubled in the past 35 years.

■ Fitch’s Windstorm Policy

Given the dramatic increases in windstorm insurance premiums over the past six months, Fitch has been focused on ensuring the proper reflection of these increased premiums in banker cash flow underwriting. Additionally, despite the stress currently present in the market, Fitch has advocated strict adherence to traditional insurance requirement language for loan documents, pooling and servicing agreements, and standard representations and warranties. Any deviation of such could have a direct affect on credit ratings.

Traditionally, mortgages secured in CMBS transactions carry property and casualty (P&C) insurance coverage equal to the full replacement cost of the property. The majority of P&C insurance policies include wind as a covered peril, except those properties located in close proximity to the coast. These exclusions differ by insurance provider and their relative

risk appetite. For example, some insurance companies exclude wind for properties located within 20 miles of the coast, others 100 miles. When wind is excluded, a separate wind policy or rider needs to be purchased.

Fitch assesses windstorm risk to all properties located within 20 miles of the Atlantic Coast and Gulf area and areas of Hawaii, Guam, Puerto Rico, and the Virgin Islands (along with any non-U.S. territories in tropical storm locations included in U.S. CMBS securitizations). In general, Fitch contends that coverage equal to the lesser of the loan amount or full replacement cost of the asset is necessary to adequately address the risk of losses related to windstorm damage. However in some distinct circumstances (strictly case by case), a probable maximum loss (PML) study can be used to determine the required coverage. Currently, there is little standardization of such reports in the market. Ultimately, Fitch would like to see more oversight by industry groups to make these reports more consistent and reliable.

If Fitch were to accept coverage based on a PML study, at a minimum the following factors should be considered:

Are the companies engaged to perform the windstorm analysis reviewed annually by the Florida Hurricane Commission (the commission)?

Even though the commission was created to address insurance capacity issues in the residential market, the review of the models still has an indirect benefit for commercial modeling. The inputs involved related to the storms themselves (intensity, frequency, and directional approach, among other factors) are the same for residential as they are for commercial properties. Therefore, Fitch prefers the employment of companies that are consistently reviewed and improving their models. Other states, including South Carolina and Hawaii, use the commission’s findings for their own windstorm purposes. For 2006, the commission has listed the following companies as having received its annual reviews:

- AIR Worldwide Corporation.
- Applied Research Associates, Inc.
- EQECAT, Inc.
- Risk Management Solutions, Inc.

Are PMLs calculated based on a 10% chance of exceedance in a 50-year exposure period or a 475-year return period?

Hurricane frequencies should be modeled with both short- and long-term frequencies in mind.

Do all inputs into the PML analysis reflect at least a 90% confidence interval?

A 90% confidence interval should be applied to both the exposure period and data inputs regarding the class of structure.

Are there significant limitations in scope associated with the analysis?

For example:

- Is loss associated with storm surge included in the analysis?
- Is a demand surge contingency included in the expected loss estimate? Demand surge represents construction labor and material price volatility associated with local demand.
- Were detailed building plans and specifications available for the review? The lack thereof would certainly question the accuracy of the report.
- Was the property inspected on site, or was the analysis derived from a desktop review?

A thorough physical inspection of the building and property topography is critical to a meaningful report.

Is the insurance coverage based on the PML times the replacement cost? What is the maximum deductible allowed?

At a minimum, 1.5 times PML coverage is viewed favorably by Fitch.

■ What Does the Future Hold?

Given the real losses experienced in 2005, the importance of adequate insurance coverage has been reinforced for the CMBS market. By allowing origination practices to make significant deviations from traditional requirements and practices, the market risks shifting windstorm-related losses from property insurance providers and equityholders to CMBS bondholders. While PML studies can in some distinct cases offer some relief to the current capacity issue, they fall short as a broad fix given their current lack of consistency in both method and scope. Fitch remains concerned that if the increase in premiums and deductibles experienced by windstorm policyholders is prolonged, there will likely be an increase in defaults of existing loans and a significant contraction of CMBS origination in hurricane-prone areas.

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