

MBA's COMMERCIAL/MULTIFAMILY  
Servicing and Technology

CONFERENCE

08

# Insurance, Insurance, Insurance

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SPEED  
LIMIT  
35

WRONG  
WAY







WAFFLE  
HOUSE









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## *Replacement Cost*



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- **WHY?**
- Property insurance policies settle losses on an actual cash value basis.
- "Actual Cash Value" means the replacement cost of property damaged or destroyed at the time of loss, minus depreciation.

- When the borrower opts for it, the replacement cost valuation replaces actual cash value.
- The replacement cost option provides coverage on the basis of full replacement cost **without deduction for depreciation** on a loss, subject to the terms of the coinsurance clause.

- Borrowers will not receive payment for replacement cost until the work has past a certain completion point (sometimes 90%!)
- Will require inspection and/or proof of repairs until the additional monies can be received.
- Business Income not immediately paid either!

- Insurance companies really don't care what the Unpaid Principle Balance is.....
- They want **I**nurance **T**o **V**alue (ITV) - the limit of property insurance purchased to equal the replacement cost of the property.
- Replacement cost for a property is determined at the time of the loss – the maximum that will be paid usually are the limits on the policy.

- Replacement cost should be determined at origination and *validated yearly* – include items only insurable under the policy.
- Statement of values and policy limits should be updated on the policy accordingly.
- “Costimators” available – be sure to express to borrower that these are approximations, not an exact science. Should not expressly tell the borrower this IS the replacement cost of their property.

## WHAT DOES INSURANCE COVER?

Insurance policies typically define Building to mean:

- A structure;
- Building components;
- Completed additions;
- Additions to the structure under construction, if not covered by other insurance; and
- Alterations and repairs to the structure, if not covered by other insurance.

## WHAT DOES INSURANCE NOT COVER?

Building does not mean:

- Land, water or air, either inside or outside of a structure;
- Bulkheads, pilings, piers, wharves or docks;
- Underground pipes, flues or drains;
- Bridges, roadways, walks or patios;
- Paved or concrete surfaces;
- Retaining walls;
- Cost of excavations, grading, backfilling or filling
- Foundations or supports of structures, machinery or boilers, below the surface of the lowest floor or basement;
- Outdoor trees, shrubs, plants or lawns; or
- Fences, radio or television antennas (including satellite dishes) and their lead-in wiring, masts or towers and outdoor signs not attached to a structure, all while outside of a structure.

- Property insurance form used when coverage is written on a blanket basis or when the insured has selected the agreed value optional coverage.
- It lists all insured locations and the buildings, personal property, and business income values for each covered item at a location.
- The form is used to develop a blanket rate and must be signed by the insured if coverage is on an agreed value basis.

- TIV is defined as the Total Insured Value of a location. Can include building, business income and even personal property.
- Large Blanket policies have a TIV limit – per location and per policy – not all policies allow the full policy TIV limit to be available to each property. Its usually limited to the Statement Of Value for that location. How many locations does this policy cover?
- Per policy TIV's usually have sublimits – especially with Catastrophic risk.
- Is that TIV shared with multiple locations that only your borrower owns? Even worse it is shared in a pool of properties unrelated to the borrower??? Beware of new wind policies on the market!
- Be conscience of locations that are close geographically that may be exposed to Catastrophic risk (a wind occurrence is considered a Named Storm).

- A property insurance provision that penalizes the insured's loss recovery if the limit of insurance purchased is not at least equal to the specified percentage (commonly 80 – 90 percent) of the value of the insured property.
- The coinsurance clause requires the purchase of a limit of insurance equal to a specified percentage a property's full replacement cost in exchange for a lower rate.

- If at the time of loss it is determined that the limit of insurance is less than the amount required by the coinsurance clause, the loss recovery will be limited to that same percentage of loss as the ratio of the insurance amount carried to the insurance amount required.

- The coinsurance provision specifies that the insured will recover no more than the amount of the loss multiplied by the ratio of the amount of insurance purchased (the limit of insurance) to the amount of insurance required (the value of the property on the date of loss multiplied by the coinsurance percentage), less the deductible.

- Said differently, the amount of the loss will be multiplied by the amount of insurance they DID carry divided by the amount the SHOULD have carried or:

**DID**

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**SHOULD X LOSS = Amount Paid**

P.S. Your HOMEOWNER policy has this same clause to it!

- Use of a coinsurance clause is the insurer's means of protecting itself against underinsurance.
- Since most property losses are partial, rather than total, insureds could purchase limits of insurance equal to only a fraction of the total value of covered property and still be fully covered for most losses.

# Coinsurance Example

- **Example:**
- The **Replacement Cost of the Property** is **\$250,000**
- The **Insurance Limit** is **\$100,000**
- The **Coinsurance Percentage** is **80%**
- The **Amount of Loss** is **\$ 40,000**
- The **Deductible** is **\$ 250**

# Coinsurance Example

- **Step (1): How much Insurance SHOULD have been carried  $\$250,000 \times 80\% = \$200,000$**
- **Step (2):  $\$100,000$  was carried so the ratio of DID divided by SHOULD is  $\$100,000 / \$200,000 = .50$  or 50%**

# Coinsurance Example

- **Step (3):** The **Loss** is **\$40,000** so how much do they get? It's **\$40,000** x .50 = **\$20,000**
- **Step (4):** Subtract the **deductible** and this is how much the check is for **\$20,000** – **\$250** = **\$19,750**
- The **Loss Payment** is **\$19,750**. The remaining **\$20,250** is not covered.

**How do you avoid coinsurance??**

# Avoid the Penalty !



# Two Ways to Avoid the Penalty

- One is to insure to at least the required percentage of the value of the insured property. If the limit of insurance is at least the stipulated percentage of the value of the covered property (at the time of loss), there is no coinsurance penalty

- The other way to avoid a coinsurance penalty is to activate the agreed value coverage option in the form. The agreed value coverage option suspends the coinsurance clause until the date specified in the declarations, usually until the next policy anniversary date.

- The concept underlying agreed value coverage is that the insurer accepts the agreed value as an adequate portion of the total insurable value of the property to which the provision applies.
- Since this issue has been resolved prior to loss, there is no need for the coinsurance clause protecting the insurer against the possibility of underinsurance. Therefore, the insurer essentially suspends the coinsurance condition until the expiration date indicated.

- The lower the percentage the better it is.
  - 80% coinsurance is better than 90%.
  - If carrier will not remove coinsurance, or add agreed amount, see if coinsurance can be lowered.

100% coinsurance is the WORST.  
Don't let an agent tell you "100%  
coinsurance means no  
coinsurance."!!

- Location of property.
- Configuration of the property.
- Construction type.
- Loss mitigations (sprinklers, central fire alarm).
- Upgrades to property.

# Any Questions?



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*Windstorm Insurance Issues*

**Bernie Brown, President, Insurance Advisors**

## IMPORTANT ISSUES CONCERNING WINDSTORM INSURANCE

### 1. Definition

- “Named Storms” (i.e. Hurricanes)
- Tornadoes and Hail in Midwest?

### 2. Amounts and Types of Coverage

- Capacity Available
- RC v. ACV

## IMPORTANT ISSUES CONCERNING WINDSTORM INSURANCE (continued)

### 2. Deductibles

- Per Occurrence (3% - 5% is norm)
- Unit Deductibles

### 3. Probably Maximum Loss (PML) Studies

- What are they?
- Individual assets (not acceptable by Moody's)
- Portfolio of assets (accepted in many cases)

## IMPORTANT ISSUES CONCERNING WINDSTORM INSURANCE (continued)

### PROGNOSIS FOR WINDSTORM INSURANCE

- COST
- AVAILABILITY

DEPENDS ON HURRICANE ACITIVITY AND INSURER  
PROFITABILITY

# Insurance, Insurance, Insurance

## *Carrier Ratings*



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## AM Best

### ■ Alpha

✓ A++ and A+	Superior
✓ A and A-	Excellent
✓ B++ and B+	Very Good
✓ B and B-	Fair
✓ C++ and C+	Marginal
✓ C and C-	Weak
✓ D	Poor
✓ E	Regulatory Supervision
✓ F	Liquidation
✓ S	Rating Suspended

## Financial Size Category (FSC) – Roman Numeral In Millions:

<b>I</b>	<b>Less than 1</b>
<b>II</b>	<b>1 to 2</b>
<b>III</b>	<b>2 to 5</b>
<b>IV</b>	<b>5 to 10</b>
<b>V</b>	<b>10 to 25</b>
<b>VI</b>	<b>25 to 50</b>
<b>VII</b>	<b>50 to 100</b>
<b>VIII</b>	<b>100 to 250</b>
<b>IX</b>	<b>250 to 500</b>
<b>X</b>	<b>500 to 750</b>
<b>XI</b>	<b>750 to 1,000</b>
<b>XII</b>	<b>1,000 to 1,250</b>
<b>XIII</b>	<b>1,250 to 1,500</b>
<b>XIV</b>	<b>1,500 to 2,000</b>
<b>XV</b>	<b>Greater than 2,000</b>

## Rating Modifiers/Affiliation Codes

**u – under review**

**s – syndicate**

**pd – public data**

**g – group**

**p – pooled**

**r - reinsured**

## Not Rated Categories (NR)

**NR-1 : Insufficient Data**

**NR – 2: Insufficient Size and/or  
Operating Experience**

**NR – 3: Rating Procedure N/A**

**NR – 4: Company Request**

**NR – 5: Not Formally Followed**

**The alpha rating is derived from an in-depth evaluation of a company's balance sheet strength, operating performance and business profile.**

**The numeric rating reflects the carrier's size based on their capital, surplus and conditional reserve funds.**

## S&P

**AAA – Extremely Strong**

**AA – Very Strong**

**A - Strong**

**BBB – Good**

**BB – Marginal**

**B - Weak**

**CCC – Very Weak**

**CC Extremely Weak**

**R – Regulatory Action**

**NR – Not Rated**

**(+) or (-) after the rating show relative standing with the major rating categories**

**“pi” after the rating means the analysis is based on published financial information only**

## Fitch

**AAA – Exceptionally Strong**

**AA – Very Strong    A - Strong**

**BBB – Good**

**BB – Moderately Weak**

**B – Weak**

**CCC,CC & C – Very Weak**

**DDD,DD & D – Distressed**

**(+) or (-) Indicates the relative position with the rating category**

**Rating Outlook – is given to show the probable direction over a one to two year period. (Positive/Stable/Negative)**

**Rating Watch – notifies that there is a probability of a rating change.**

**Positive – potential upgrade**

**Negative – potential downgrade**

**Evolving – Raised, lowered or maintained**

## Moody's

<b>Aaa – Exceptional</b>	<b>Aa – Excellent</b>	<b>A – Good</b>
<b>Baa - Adequate</b>	<b>Ba – Questionable</b>	<b>B – Poor</b>
<b>Caa – Very Poor</b>	<b>Ca – Extremely Poor</b>	<b>C – Lowest</b>

**Numeric Modifiers – refer to the ranking within the group with 1 being the highest and 3 being the lowest.**

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# Insurance, Insurance, Insurance

*Business Interruption*



Paul Stare, CIC, CPCU

PPM Finance, Inc.

VP - Insurance Risk Management

Commercial Mortgage Lending

## Purpose

- Provide funds to replace lost revenue and pay for continuing operating expenses after a collateral building sustains damage caused by an insured loss
- What's covered?
  - Earnings before interest and taxes, (EBIT), that would have been earned if the loss had not occurred
  - Continuing Operating Expenses
    - Real Estate Taxes
    - Insurance Premiums
    - Mortgage Payments
    - Payroll Expenses (Can be Excluded or Limited)

- **Is there a deductible?**
  - **Generally there is a 72 hour waiting period before the insured can collect. It's not listed with the limit, it's found in the definition of Period of Restoration**
  - **Can be reduced or eliminated depending upon carrier**
  - **No waiting period for Extra Expense coverage if purchased**

## **Be Sure BI Coverage has been added to Secondary Policies**

- **Flood**
- **Wind**
- **Earthquake**
- **Equipment Breakdown (Boiler & Machinery)**

## Coverage Forms

- **Business Income**
  - **Specific or Blanket Limit**
  - **Unlimited Period of Restoration, coverage continues until:**
    - Property is restored or
    - Limit of Insurance is exhausted
- **Actual Loss Sustained (Hybrid form of Business Income)**
  - No specific limit
  - Period of Indemnity limited to 12, 18, or 24 months
- **Monthly Limit of Indemnity**
  - Specific Limit
  - Unlimited Period of Restoration
  - Monthly claims payments limited to 1/3, 1/4, or 1/16<sup>th</sup> of limit

## Limits

- **ALS (Actual Loss Sustained)**
  - No dollar amount is shown, loss payments made on basis of historical accounting records
  - Coverage period normally shown on Evidence of Property Form; most common 12, 18, or 24 months
  - **Red Flag** – Frequently a dollar limit is also shown and the Actual Loss Sustained box is “x’d”. You need to inquire if there’s a “cap” on the coverage; is it not really ALS; what’s the significance of the limit?
- **Specific Limit**
  - Actual dollar limit listed per location
  - Need to verify adequacy each renewal by checking the rent rolls and financials

## Limits (continued)

- **Blanket Limit**
  - **Blanket Business Interruption** – One dollar limit shown for all locations
  - **Blanket Property** – One dollar limit shown for all locations' buildings, business personal property, and business interruption
- **Red Flag**
  - **Whenever you incur a policy written with “blanket” limits check the policy schedule of values for factors that might impair the adequacy of the limit:**
    - **Concentration of values**
    - **Existence of a Margin Clause**
    - **Coinsurance**

## Summary

- **Coverage to provide for lost income and pay continuing expenses**
- **Coverage Forms:**
  - **Business Income**
  - **Actual Loss Sustained**
  - **Monthly Limit of Indemnity**
- **Limits can be:**
  - **ALS**
  - **Specific**
  - **Blanket**
- **Questions?**

**Terrorism**

**ACORD 28**

**Questions & Answers**

**Thank you for your attention and don't forget to  
attend the Insurance Workshop!**