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An "Over-Insurance" Pandemic

By George P Flanigan, MBA, CPCU and IMS Elite Expert

The widely reported correction phase of the worldwide economy, and the real estate sector in particular, is well underway. In the capital markets, asset-liability term mismatches have yielded widespread decreases in asset prices similar to the savings and loan crisis of the late 1980s. The property-casualty insurance market has also been affected.

During the past decade, insurance companies enjoyed economic windfalls from periods of inflated insurable interest in both commercial and personal lines. In the commercial lines sector, business policies were often issued with unrealistic projections for insured asset and revenue exposures. As price levels have fallen dramatically, property-casualty insurers have seen an evaporation of the abundant underwriting cash flows that occurred earlier this decade.

Financial Valuation and Property-Casualty Insurance Negotiation

There are numerous parties, including mortgage, real estate, and financial professionals, involved in real estate investment decisions. Price levels will be determined by a variety of factors, including but not limited to market metrics, cost of capital, and expected cash flow. Typically, insurance policy placement will rely on price levels determined in these negotiations. Likewise, claims negotiations will rely on representations from both financial valuation and insurance underwriting discussions.

In addition, insurers are often ill equipped to develop independent financial valuations in the negotiation process and will rely exclusively on valuations provided by the client. After all, higher valuation leads to greater insurable interest on which to develop premium levels.

Similarly, in the claims settlement process, many claimants may underestimate settlement proceeds based on inappropriate expectations of replacement costs based on real estate market data. During settlement, it is extremely important that expectations should not be developed according to real estate markets but rather according to strict interpretations of relevant policy characteristics.

Personal Lines Effects

In the personal lines segment, the primary subprime exposure would be the first-party variety. For example, a house purchased in 2005 for $300,000 (and subsequently insured with a typical homeowners policy at that representation) in a region suffering price-level declines could remain insured at 2005 price levels. From a pure underwriting perspective, this creates an opportunity for insurers to continue collecting inflated premium on property values that far exceed potential claims that insurers would be obligated to pay; hence, an "over-insurance" problem. In economics, this is an example of moral hazard; insurers have little incentive to adjust insurable interest based on price level.

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Assuming similar properties are available through foreclosure or liquidation, it is reasonable to conclude that current replacement cost would be far less than the initial purchase price. Since construction costs have decreased widely, it is logical that claims settlements will not recover the original purchase price, or even outstanding mortgage obligations. The losses will be realized by the claimant *and* the mortgagor failing to recover full principal; the claimant, or first-equity holder, will realize initial losses, which usually includes down-payment and other sunk costs.

Further, mortgage stipulations pertaining to settlement management may further limit claimants' opportunities to maximize economic value. The role of mortgage servicing firms should not be ignored since they may be contractually entitled to negotiate directly with claims administrators.

An appreciation of individual circumstances is important, as mortgage holding companies may hasten claims resolution to the detriment of policyholders. Banks facing liquidity problems are inclined to recover cash proceeds sooner. Insurers may participate, too, due to lower claims costs, and policyholders ultimately pay for insurance they never collect, regardless of actual loss activity.

Indeed, policyholders have purchased far more coverage than they likely would recover in hypothetical claim scenarios. This is in stark contrast to co-insurance clauses designed to penalize insureds for under-insurance problems. Claimants facing ongoing settlement negotiations with co-insurance applications should strongly evaluate claims administrators' assumptions pertaining to financial valuation and coverage application.

Commercial Lines Effects

The over-insurance phenomenon is even more pronounced in business insurance; builders' risk policies, liability wrap-ups, property and business interruption, and other business policies were commonly issued at inflated insurable interest during the subprime boom.

Given the optimistic expectations of many real estate projects, financial projections from recent years will prove entirely unrealistic in many cases. These optimistic forecasts were likely submitted to commercial insurance underwriters during the underwriting process.

In particular, Business Interruption (or time element) coverage may be problematic for commercial underwriters. Specifically, the "BI Period," or period of recovery to re-establish prior operations, may prove highly judgmental in claims settlements. Important considerations include *when* cash flow became impaired, and *how much* lost cash flow is realized, and *when* claimants will return to expected cash flow levels. Arguments will likely be presented that claimants will *never* achieve operating levels as depicted to underwriting, and thus should be entitled to maximum policy limits under Business Interruption policies.

Real estate ventures were commonly introduced with optimistic cash flow expectations in mind. For instance, an overly optimistic cash flow presentation made to underwriters in 2006 may be entirely unrealistic when a project comes to market several years later amid weak credit markets.

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Property losses would not only affect alleged recovery periods but would also affect projected cash flow levels; thus, losses associated with real estate ventures would be realized much sooner than otherwise.

Interestingly, mortgagors may experience moral hazard in that insured property losses will permit loss realization sooner than otherwise under normal GAAP accounting treatment. For instance, mortgagors may prefer post-fire loss reserving rather than uncertain foreclosure accounting treatment since expected losses may be realized sooner. Creating perverse incentives such as this is not an intention of typical insurance transactions, but insurance history is replete with similar examples; notably in life insurance, where the interests of the benefactor may differ from those of the policyholder.

"Master" condominium association policies reflect another nexus of inflated real property values. Starter condos were developed in many locations for $400,000 or more during the boom; thus, condominium association master policies were underwritten with a collection of *fully occupied* $400,000 properties in mind. A brief review of corresponding financing arrangements will likely reveal unrealistic developer intentions regarding future appreciation of condominium property values as well.

An interesting form of damages includes "collateral foreclosure damages," or loss of use value related to foreclosures in neighboring properties. In particular, grievances between condo owners and association managers will emerge when association managers suffer property damage related to vacant properties. A reasonable argument should be presented that but for negligence in the financing process, collateral damage related to foreclosure damage would not have occurred and the property would have been valued accordingly.

Commercial General Liability (CGL) policies apply to damages pertaining to bodily injury and property damage. Elsewhere, liability related to willful managerial wrongdoing would fall under "wrongful acts" provisions on professional and management liability policies. However, when allegations of negligence are presented against various parties in real estate transactions, and such allegations have proximately led to third party property damage (i.e. liability for collateral foreclosure damage), one can potentially trigger application of CGL policies. Furthermore, collateral economic damages would fall under vintage CGL policies on an occurrence basis.

Correction of the "over-insurance" Problem

Damages associated with the "over-insurance" problem would be estimated as follows:

1. Document review for determination of underwriting factors provided over disputed periods. This would be based on reported insurable interests used in *actual* underwriting processes.
2. Adjust exposure base to reflect realistic property values according to housing price corrections over the relevant time period. This exercise establishes hypothetical property values at certain times, *in absence of overly-inflated housing prices amidst subprime financing*. Scrutiny of coverage terms along with financial analysis should be necessary to determine hypothetical claims recovery levels.

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3. Reconcile hypothetical property values to determine accurate exposure levels *that should have been used for underwriting purposes*.
4. Apply actual rates charged to hypothetical adjusted exposure base. This should yield an adjusted hypothetical premium charge *in absence of overly inflated property values*.

These arguments can be presented to insurers either during claims settlement negotiation, class action litigation, and other legal venues. However, frequent episodes of high vacancy commercial property implies that these arguments can be used in wide varieties of insurance transactions, including but not limited to bankruptcy proceedings. Indeed, the subprime aftermath should present wide varieties of potential applications for some time.

About the author: *George P Flanigan is a consultant based out of Chicago and an IMS Elite Expert. His prior work experience includes business analysis and underwriting with both American International Group and Zurich-American Insurance Company. George holds a Master in Business Administration from the University of Chicago Booth School of Business with concentrations in Finance, Accounting, and Entrepreneurship*.

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