



REALTORS® Commercial Alliance Series

HOT TOPICS—

ANSWERS TO CURRENT BUSINESS ISSUES

COMMERCIAL REAL ESTATE INSURANCE: MEETING THE CHALLENGE

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Why should I be concerned about terrorism and natural disaster insurance?

2007 may become a historic year for commercial real estate professionals. Two key insurance issues will come before Congress in the months ahead – terrorism insurance and natural disaster insurance – which could significantly impact profit margins on many commercial real estate deals.

Many commercial real estate professionals believe these two issues don't directly impact their businesses. That's no longer true. Both issues have grown to international proportions. The fact is manmade and natural disasters will challenge economic, political, and business agendas in other countries – and here in the U.S. – for a long time to come.

With so much at stake, it is important for all commercial real estate practitioners to understand the issues and prepare to speak out. This Hot Topic has been prepared by the REALTORS® Commercial Alliance of the National Association of REALTORS® to arm members with timely information about the controversies, positions and actions that will shape the national agenda on terrorism and natural disaster insurance in 2007.

Since 9/11, and the hurricanes of 2004–2005, the National Association of REALTORS® has been a leader in representing the interests of our members regarding terrorism and natural disaster insurance. We have actively developed positions, offered testimony before key congressional committees, written opinions used for advocacy efforts, hosted symposia, partnered with other commercial real estate organizations, and worked collaboratively with insurance industry representatives and other business interests to bring balance to legislation. We will continue to give voice to our members' interests throughout this decisive year and beyond.

TERRORISM INSURANCE

Why is legislation for terrorism insurance a priority in 2007?

Terrorism risk poses an evolving risk and the potential losses are incalculable. For years, commercial insurance

for acts of terrorism was implicitly included in property and casualty coverage. But that changed with the terrorist attacks on September 11, 2001. Suddenly, the concept of a foreign terrorist act on U.S. soil became a horrifying reality. The tragic cost in lives was unprecedented. The cost to businesses, an estimated \$40.2 billion, was also devastating.

Within weeks of the disaster, reinsurers withdrew from the market, leaving direct insurers with no mechanism to manage their risks for this peril. As a result, direct insurers largely withdrew from offering any terrorism insurance coverage and capacity plummeted. Insurers that remained combined high costs with policy restrictions that translated into less coverage at much higher prices. Insurance companies justified these actions by claiming that there was no longer adequate capital in the private market to cover the financial risks associated with future acts of terrorism. At the same time, lenders continued to require commercial real estate owners to carry insurance for terrorism disasters. The lack of availability and affordability for the coverage began impacting real estate deals, including the complete cancellation of a number of projects in major metropolitan areas. Ultimately, the issue was raised before Congress.

In 2002, the federal government enacted the Terrorism Risk Insurance Act (TRIA) to begin resolving the underlying problems. The government's objectives in legislating this policy were twofold: to ensure that terrorism insurance was available to all businesses and to allow time for the reinsurance market to expand its capacity to cover potential terrorism losses in the future.

To accomplish these goals, TRIA set up a federally backed reinsurance mechanism to backstop direct insurers for acts of terrorism. The model defined a "trigger point," at which level the federal government would step in and cover significant portions of the total accumulated insured damages from a foreign-sponsored terrorist event (or events). Implementing this federal backstop meant that direct insurers would not be forced to bear all the risks and costs of future terrorist events – costs that could conceivably wipe out private market capital and bankrupt the insurance industry.

With the backstop in place, insurers were required to make “conventional” terrorism risk coverage available to policyholders under the same terms and conditions of other property-based coverage. The program also applies a backstop to a number of other coverage lines including nuclear, biological, chemical, and radiological perils as well as workers compensation.

TRIA was scheduled to sunset in 2005. As the expiration date approached, Congress considered extending the program. TRIA succeeded in restoring market capacity and making terrorism insurance broadly available to businesses. However, it was clear that the reinsurance market had not developed the capacity to cover losses for a large-scale act of terrorism. At the end of 2005, President Bush signed the Terrorism Risk Insurance Extension Act (TRIEA), which authorized continuation of TRIA for two more years. In an effort to induce growth in private market capacity, the new legislation reduced the government’s risk by increasing the federal trigger level for the backstop and increasing the level of insurers’ deductibles before federal intervention kicked in.

TRIEA is scheduled to expire at the end of 2007. It is expected that legislation, creating a permanent backstop solution will be both controversial and a high priority for the 110th Congress. Fourteen other nations recognize that markets cannot underwrite this risk, and each has a permanent terrorism insurance law.

What happens if TRIA expires?

Fundamentally, legislators and business professionals across all industries agree that to protect our national economy, the long-term solution for terrorism coverage must depend upon stronger private-market financial capacity. But controversies abound regarding whether or not the federal government should be involved in a long-term solution. Three key questions dominate the dialogue:

1. Can the reinsurance market cover losses from a large-scale terrorist act in the future or will a federal backstop be needed?

Despite pressures to increase their capacity, reinsurers remain reluctant to cover terrorism losses. Current reinsurance capacity is nowhere near the level needed to

Nuclear, Biological, Chemical and Radiological Terrorism

Some of the most nefarious, challenging – and costly – scenarios imagined for terrorist acts involve nuclear, biological, chemical, and radiological (NBCR) attacks. Unfortunately, it is nearly impossible to estimate the cost of risk associated with these types of terrorism because of their unpredictable nature and indeterminate scope. The anthrax attack against the U.S. postal system in 2001 highlighted another problem with nuclear, biological, chemical, and radiological attacks – insurance claims are likely to exceed the value of the real estate affected. Despite the fact that the federal program provides a backstop for nuclear, biological, chemical, and radiological perils, little to no coverage for these types of terrorism is commercially available for businesses except where mandated under workers compensation policies. The National Association of REALTORS® strongly believes that any evaluation of terrorism insurance coverage in the future must include solutions for making nuclear, biological, chemical, and radiological coverage available to policyholders.

protect the economy without a federal insurance backstop. The Reinsurance Association of America estimates that there is only \$6 billion to \$8 billion in private-sector terrorism reinsurance capacity available to cover foreign acts of terrorism. Yet, estimates for potential losses from a single terrorist act have exceeded \$100 billion.

That leaves only two options: either the federal government acts as the reinsurer-of-last-resort or the cost of terrorist attacks falls to its victims.

2. What are the likely consequences to businesses and the economy if TRIA is allowed to expire?

In today’s environment, allowing TRIA to expire could have serious repercussions for businesses, particularly those in commercial real estate. In a statement submitted to the Congressional Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises in September 2006, the National Association of REALTORS® stated that “the expiration of TRIA will result in a dramatic run up in terrorism insurance premiums and a complete lack of coverage in certain

markets.” A study released by the RAND Corporation in 2005 supports this position. The study suggests that without TRIA, premiums would likely rise and take-up rates (the number of businesses purchasing coverage) would decline.

Without a federal backstop, the danger of returning to market conditions that existed after 9/11 and prior to TRIA’s enactment create great challenges for small businesses and large real estate property owners who worry that they won’t be able to secure the policy limits they need to satisfy lenders. The matter is significant – in January 2007, 84 percent of commercial mortgage balances would have been at risk if real estate owners could not have acquired terrorism insurance. Without terrorism coverage, the risk is shifted to lenders, shareholders, pensioners and bondholders.

In addition, the RAND Corporation’s Center for Terrorism Risk Management Policy concluded in a recent study that potential terrorist targets could include a broad range of office buildings, and retail centers—not just “trophy” office buildings, government buildings, and embassies. Terrorists could launch a series of relatively small attacks in addition to a single, large one. Unlike natural catastrophe risks, there is no terrorism “season” or “zone.” As a result, the imperative for commercial real estate coverage becomes more important throughout the country. Without adequate coverage, commercial real estate owners will be forced to bear more of the risks and costs of terrorist attacks.

The National Association of REALTORS® believes that without adequate coverage, financing options will once again become limited and could jeopardize real estate transactions and new construction and negatively impact the price of commercial real estate and the overall economy.

3. Is there a viable long-term solution?

While some insurers remain focused on an extension and expansion of the current program, a number of groups are trying to devise solutions that integrate a federal backstop with increased participation by private markets. One example of this is a plan put forward by The Real

Estate Roundtable in 2006 – called Homeland Security Mutual (HSM). The HSM plan recommends either the creation of a state-chartered mutual reinsurance entity or a “pooling” mechanism residing in the U.S. Department of Treasury. HSM seeks to create a layer of private capital between primary insurers and the federal government. The program achieves continuity to the marketplace so that policyholders can get the coverage they need, while diminishing the role of the federal government – and taxpayers – in the terrorism risk insurance market. Using defined triggers, claims would be paid first through private insurance industry capacity, then through the HSM pool and, lastly, through federal backstop participation. Under HSM, a federal terrorism risk program would continue for a limited time as the pool accumulates, but would eventually be shifted to this new mutual reinsurance entity.

Many elements of this model mirror effective solutions used in TRIA, such as program triggers, industry risk retention levels, and caps on liability. But the most important difference is the addition of a layer of capital, which ensures that total costs from a terrorist event are more evenly distributed between the private and public sectors.

Who supports federal intervention?

Supporters of a federal role as the reinsurer-of-last-resort include:

Many insurance and reinsurance industry groups concede that a government backstop makes sense, either until the private sector grows its capacity or indefinitely. They point out that there is no evidence that the private market would or could develop capacity if TRIA expires. There is a growing consensus within the insurance industry that without a federal reinsurance backstop, insurers will largely exclude this type of coverage from their policies in the future.

Businesses, most notably in the commercial real estate, hospitality, manufacturers, public utilities, stadium owners, and most American businesses, believe that the relatively large size of terrorism risks will always require a government backstop if our economy is to retain any stability following a major terrorist attack.

The Coalition to Insure Against Terrorism, comprised of over 80 industry associations and American businesses representing the policyholders who must purchase terrorism risk insurance, delivered Congressional testimony in 2006 stating that “an effective homeland security program must include provisions to ensure long-term availability and affordable terrorism risk insurance to safeguard the assets of businesses, which fuel the nation’s economy.”

Are there any arguments against federal intervention?

There are a number of policymakers who oppose extending a government reinsurance program, because they believe this role is best served by the private market. However, there is no evidence private markets can develop adequate insurance market capacity without some type of federal backstop.

NATURAL DISASTER INSURANCE

What makes natural disaster insurance important in 2007?

In the past decade, the U.S. has experienced an unprecedented increase in the frequency and intensity of natural disasters. In fact, eight out of the top 10 property and casualty losses in U.S. history occurred between 2000 and 2004. High underwriting losses from recent mega-disasters, such as Hurricane Katrina, have driven some insurers out of the market altogether, while others have opted to cancel existing policies or significantly raise premiums. Commercial real estate professionals in some regions of the country now face the same lack of availability and affordability for natural disaster insurance as they do for terrorism insurance.

The main reason our nation is struggling with this challenge right now is because of the unprecedented number of natural disasters that have occurred over the past few years and the unparalleled costs for damages that resulted. *The Wall Street Journal* reports that, overall, the insurance and reinsurance industries have held up their obligations and reimbursed policyholders for covered damages. But despite the limited geographic reach of these disasters, exorbitant costs have consumed virtually

all the private market capital reserved for this coverage. Essentially, the storehouses have been depleted and there isn’t enough capital left to cover the next natural disaster that hits the same areas. That’s why some insurers have pulled out of these markets, premium costs have skyrocketed, and policy restrictions are tighter than ever.

The insurance industry has a history of business cycles that fluctuate between years of adequate or excess reserves (which lead to reductions in premium prices) followed by years of inadequate reserves (which lead to increases in premium prices). The actions taken by insurers today are not new. What does differ is the level of cost that can be incurred in a short period of time. The outcomes of recent mega-disasters have demonstrated that the private sector and local and state governments are not equal to the task of paying for the damages caused by multiple mega-disasters. For example, a repeat of the 1906 San Francisco earthquake would cause an estimated \$400 billion in damage in today’s dollars. This new realization is what is driving increased pressures for a federal role as a reinsurer-of-last-resort.

The National Association of REALTORS® is working in conjunction with other interests to engage Congress to define a comprehensive natural disaster policy.

No one is better poised to offer an opinion on this issue than Kevin McCarty, Florida’s Insurance Commissioner, who has extensive, first-hand experience dealing with the aftermath of Katrina. At a National Symposium on Federal Natural Disaster Policy hosted by the National Association of REALTORS® in September 2006, Mr. McCarty opined, “If I can leave you with one message today, it is this: natural catastrophes are a national problem that requires a national solution.”

During his presentation, McCarty argued that state resources are not sufficient to handle a mega-catastrophe and that the impact goes well beyond insurance coverage issues. “When a catastrophe hits, it affects far more than insurance companies and the victims of these events. It places stress on the homebuilders market, the banking market, land development markets, real estate values, community tax bases, unemployment rates, and ultimately affects the economic security of all Americans,” he stated.

What are the alternatives for a federal role in natural disaster insurance?

During the 109th Congress, a variety of bills were introduced to address part or all of natural disaster insurance issues in Congress. Generally, the recommended policies fall into two camps: one that supports a federal backstop and one that doesn't. Proponents for a federal role believe that some risks are too large or unpredictable to be insurable. They recognize that the magnitude of mega-catastrophes may soon exceed the ability and capacity of private insurance markets to respond effectively. They also cite existing federal programs to insure against natural disasters, such as the National Flood Insurance Program and the Federal Crop Insurance Program. These and other approaches may be considered during the 110th Congress.

Most of the proposals for federal participation in natural disaster coverage involve a three-layer plan: policies sold by primary insurance companies; state or regional catastrophe pools that provide reinsurance; and a national mega-catastrophe fund that provides a federal backstop for large-scale insured losses.

Three interesting proposals add new dimensions to the dialogue. One plan suggests an amendment to the federal tax code that would allow insurers to set aside reserves that would accumulate on a tax-deferred basis in order to pay for future catastrophic losses. Two other proposals call for the creation of "personal disaster accounts" or "catastrophic savings accounts" which would allow property owners to accumulate savings on a tax-free basis to cover potential future catastrophic losses.

What arguments are made by opponents of a federal role in natural disaster insurance?

Opponents of federal legislation believe that the private sector and the free markets are in the best position to manage natural disaster risks for those who choose to insure privately. They argue that the solution to this problem is not more government involvement and regulation, but less. By relaxing existing regulatory constraints and stringent tax policies, private markets would be stimulated to devise creative solutions to the problem of who pays for mega-catastrophes. Opponents

also criticize the examples presented by the federal crop and flood insurance programs for their inherent difficulties in assessing the government's true risk, and, therefore, establishing fair premium rates for those exposures.

In general, the insurance industry supports a federal role in natural disaster coverage. In testimony to the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises in September 2006, David Daniel, representing the Independent Insurance Agents and Brokers of America, articulated his group's support for a "limited and appropriate" role for the federal government to help increase insurance availability and affordability in disaster-prone areas. This includes establishment of a clear, well-structured mechanism that encourages the private sector to handle as much of the risk as possible. Federal involvement would only be triggered as a last resort.

It is important to note that proponents and opponents of federal legislation do agree that any solution must include a substantial risk mitigation process to eliminate as much risk as possible in advance of any future catastrophic event.

Presently, the National Association of REALTORS® doesn't have a position on a federal backstop for natural disaster insurance.

What does a federal role in natural disaster insurance mean to my business?

In the aftermath of Hurricanes Katrina, Wilma, and Rita, along with the hurricanes of 2004, the housing market in Florida and the rest of the Gulf Coast has suffered like never before. Research indicates that housing markets in areas hit by hurricanes prior to 2004 generally recovered within about 12 to 18 months to at least the same level of property values as was evidenced before each hurricane. That's not the case in the Gulf Coast today. Nearly two years after Katrina struck, both residential and commercial property values remain depressed.

One other important aspect of this debate affects all businesses and individuals in the country, and centers on a more philosophical question. Should states outside of disaster-prone areas be required to help pay damages from

a mega-disaster in another geographic area, or should each state create private reserves to cover any potential natural disasters that are likely to strike within their borders? What portion of mega-disaster costs should be shouldered by victims and what portion, if any, do we take on as a society? There are no simple answers to these questions. Good arguments can be made for and against both sides of this issue. Clearly, more dialogue is needed to crystallize a predominant opinion.

What can I do to protect the interests of commercial real estate practitioners?

Your future as a commercial real estate professional will be directly impacted whether the legislation is passed – or passed over – in the 110th Congress. The National Association of REALTORS® will continue its leadership initiatives in these areas, but it is important for you to be prepared so that you can participate effectively in grassroots advocacy at key junctures throughout the year.

We encourage all commercial real estate practitioners to:

1. Keep up with the issues. Just go to the National Association of REALTORS® Government Affairs Web page (www.REALTOR.org/government_affairs.com) for updates on the debate, policy statements, recent legislative activity, and more.
2. Examine your coverages. Make sure you take a look at your current property and casualty coverage levels for terrorism and natural disaster insurance. Find out what your carrier might do if TRIA expires. Learn the issues associated with state, local, and regional policies that shape your disaster insurance coverage; search 'state issues' on REALTOR.org to access the State Issues Tracker. Let state associations and National Association of REALTORS® know of significant changes.
3. Talk with local representatives. Take the time to converse individually or at public events with government officials, insurance industry representatives, and influential local business leaders to make sure your interests and concerns are on their radar.

4. Find out more. Watch for more communications from the National Association of REALTORS® about everything from the international agenda for effective terrorism insurance models to specific policy and financial trends in natural disasters and the insurance industry's response in your part of the country.

5. Be prepared to act. Watch for information from the National Association of REALTORS® about participating in grassroots advocacy efforts when legislative issues move out of committee and toward a vote.

Where can I find more information?

For more information about terrorism and natural disaster insurance issues, including the National Association of REALTORS® most current policy statements and efforts on behalf of commercial real estate practitioners, please go to the Government Affairs page at the National Association of REALTORS® Web site: www.REALTOR.org.

The REALTORS® Commercial Alliance would like to thank the following people for sharing their expertise.

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