NAHMAnalysis

News and Analysis of Breaking Issues in Affordable Housing

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Property and Liability Insurance
Update and Status

As many members know all too well we have a developing problem with Insurance. Prior to the events of September 11, 2001 insurance costs were headed up in one of the periodic market cycles that we have seen several times over the past 20 years. The events of 9-11 have only served to accelerate the changes, most particularly on the cost and coverage fronts.

Last Friday we, along with all the other industry "*usual suspects*[1]" spent the better part of the morning in an initial meeting with a number of Senior HUD staff, led by Fred Tombar the acting Deputy Assistant Secretary to get the issues out on the table and begin dealing with possible solutions. As you can imagine with an issue this broad and complex we did not reach any conclusions, but we did have an opportunity to lay out all the issues that have developed since last October.

This was the first of what will be a series of meetings as we try to craft a solution to the problems that we are presently confronted with. What follows is a summary of our discussions, and detail on the issues we have brought to HUD, it is organized by topic from our agenda last Friday.

Premiums

Anyone who has had to renegotiate an insurance policy in the last six months knows that premiums are headed up very sharply. From the research we have so far premium increases of 35% to 400% are not uncommon. The median increase for 2002 over 2001 appears to be in the 80% to 100% range. There is a considerable variance in premium increases, those properties in costal areas and those with claims histories are being hit hardest. In the conventional side of the market "trophy" properties, both office and residential, are being clobbered on the liability coverage, and in some cases properties in New York, Chicago, and other large cities are finding some coverages unavailable at any price. Rural properties are conversely not affected nearly as much as those in major metro areas.

[1] The "Usual Suspects" is a standing working group consisting of NAHMA, NLHA, NAHB, IREM, AAHSA, NMHC/NAA, and the Mortgage Bankers Association.

For the bulk of the Section 8, 236, RHS, and Tax Credit portfolio's there are limited options to get rent increases to cover these costs.

For the time being HUD is not going to revise any of their current policies on rent setting. We suggested revising current rent setting policies to allow those properties with rents below the comparable rents to pass thru insurance increases on a dollar for dollar basis. Until they finish studying the effects of such a policy and get it priced out, HUD is not considering changing any of its rent setting policies.

George's Spin - There is concern within HUD that last year's emergency utility payments ended up being a windfall for too many owners. The current administration is not going to move ahead with any modifications to the current system until they study the effects, and find the money to fund the change, which will take some time. Overall it appears that you will have to find funding to cover the increased costs within your current income stream or in an owner advance to the property. The present HUD decision makers are not going to come charging in with a plan to address the increase without a lot of study first. The thinking within HUD seems to be that with market based pricing in effect, and OCAF's at 4% this year (when they finally issue them) the cost increases will be picked up this year and next as rents begin to move up in the conventional sector, and no special program or program change is necessary.

We also suggested splitting the OCAF studies into two parts, each 6 months in length, and issuing OCAF's no more than 90 days from the end of the study period. We were told nicely but firmly that there is no chance of that happening given the current staffing levels.

If your property is already at market rent levels, there is no presently available way to address the cost issues other than to put the property into the Mark to Market program. In short, the owner will have to either stand the increases from his pocket until the market adjusts itself or put the property into M2M. The only exceptions to this general rule are the Preservation Properties which are governed by their use agreements and the 202's which are not capped at market. A few older long term Section 8 contracts with budget basing still exist, the bulk now have less than two years to run, and pricing those over market will push them into M2M at expiration.

Coverages, Exclusions and Technical Mortgage Defaults

Coming up with the money to cover the increased premiums in most cases is only part of the battle. The other half of the problem is making sure that the coverage meets the requirements of the agency writing the mortgage, HUD, USDA-RHS, or a state agency. In recent days we have heard of instances where both HUD and RHS staffers are calling owners reminding them that there are minimum deductible and coverage requirements. The whole area of technical defaults is difficult. One - if the market is not offering the coverage you can't buy it, and that news does not yet seem to have spread to everyone. Two - if the cost of the coverage is prohibitive, forcing the issue could push the property into monetary default as well.

Deductibles - are headed up sharply, renewal policies typically are being offered with deductibles in the $25,000 to $50,000 range. In costal and hail prone areas, deductibles for those events are even higher, in the 2% to 5% of total building value range. On a modest 125 unit property in Florida the 5% retention is setting the deductible for a Hurricane at about $400,000 in a lot of cases. The properties that have been most affected so far are those in FEMA Tier 1 Hurricane Zones[2]. It appears that deductible buy downs are available, but the cost is running at roughly 10% of the buy down amount per year. So if you have to buy down from $400,000 to $25,000 the premium will be $37,500 a year, or 10% of the $375,000 difference. The same is increasingly true of properties in Tornado Alley (Kansas, Oklahoma, Texas, Nebraska) for Hail Damage.

In very general terms a deductible above $25,000 is a technical default on a HUD or RHS mortgage. The usual practice until now has been in those instances where the deductible is above $25K the owner will need to post a letter of credit with the Mortgagee to cover the Mortgagee's exposure.

Exclusions - New policies are coming with a number of new exclusions attached to them. In general all acts of terrorism are now excluded. Additionally Toxic Mold claims, Airborne Pathogens [read Anthrax et. al.], and any type of health claim are often being excluded. One wag suggested in a conversation this week that the new standard being used by Insurance companies is that they will pay for anything except a claim. While it is not quite that bad, several declaration sheets we have seen this week now run to a full page of exclusions.

We had a generally productive discussion of these issues with HUD, since they are highly technical and will involve a lot of review by lawyers which is a very long process we don't expect a final decision on these issues until mid summer. We asked for HUD HQ to circulate a memo to the mortgagees and field detailing the problem and stopping any declaration of a technical default until direction has been issued. HUD is thinking about that, we will push for an early decision.

Spin contd. - If your renewal ends up with a deductible larger than $25,000 for any exposure you should expect to get a demand letter for a letter of credit to cover the exposure. This is one area where the problems will fall disproportionally on smaller owners and non profits since they will have more difficulty collateralizing a letter of credit. If you have a new property in the final stages of construction, and/or a refinancing underway, you will want to get a policy review done by the Mortgagee early, since if the coverage is not complete enough it will stop the closing dead in its tracks until the problem can be fixed.

When the dust settles on this, HUD and RHS will have to cover Terrorism exposures, there is no other logical option. The situation on Toxic Mold is less clear, but the fact remains if it is not offered you can't buy it, so my guess is that they will grudgingly accept that the Government is the guarantor of last resort on these exposures as well. The bill that was introduced in Congress to provide backstopping of losses to insurance carriers is now thoroughly dead, and will not be revived. It is going to take a while for everyone on the regulatory side of the equation to come to

[2] A FEMA tier 1 zone is any county that abuts the Atlantic, Long Island Sound, or the Gulf of Mexico.

the understanding that we have lost more than 50% of our potential insurance carriers since 9-11 and that mandating coverage does not mean it is available. Citigroup recently put Travelers Insurance on the block for a reason, it is not performing nearly as well as the other parts of the company and is dragging the value of the whole company down considerably. The same is the case at several other carriers, this problem will be several years in duration.

Mark to Market Properties -

We have known for a while that we may well have a real problem with a small number of full M2M properties. There is no legal way [that much is agreed by the industry and HUD lawyers] to put a Mark to Market property that is closed on its restructuring back into mark to market, or adjust its rents above current levels. So the options are; one, the owner feeds it until the OCAF's catch up. Or two; the property goes into default, the residents get vouchered out, the property goes into the Property Disposition pipeline, and the owner deals with the IRS.

The good news here is that the total universe of properties that can fall into this problem is about 300. We are fairly certain within that 300 only a very few will be faced with this stark choice. The bad news is that if you have one of the properties the good news is irrelevant. Fixing this problem will require legislation. We have suggested that HUD will need to ask Congress for this first and then we can support it. They are thinking about that issue.

All properties in the Pipeline since November have been covered by an OMHAR memo on insurance issues that pretty well guarantees that this problem can't occur to not yet closed M2M's.

Renewal Issues -

Buried deep inside the HUD Management Fee Handbook there is a provision requiring multiple bids for large purchases. Many renewal packages are now being presented to us with a single bid, and in many cases we are happy to have that bid. We have asked HUD to issue direction waiving this requirement for the immediate future in the case of insurance renewals. We did not get a commitment to waive on Friday, but anticipate they will issue one once they have reviewed the handbook.

Spin contd. - While we wait for this it would be a good idea to write a letter to your Servicer either HUD or CA, and notify them that you are renewing on a single bid if that is all you have, you don't want to see this as a finding on a management review, so be proactive. In general the sooner you get your broker working on renewals the better given the current state of the market.

In a related area, some Mortgagees have been adjusting escrows up sharply as renewals come in to make sure funding is in place when the policy rolls over. We even have one large Mortgagee that is pushing escrows up 30% beyond this year's renewal numbers just for safety. We have asked HUD to issue guidance discouraging prospective escrow increases, and to consider letting mortgagees run escrows short for a temporary period, and pull funds from reserves to pay for the increased escrow costs to minimize the effect of the double whammy on costs. Given how escrows work if you policy costs 35% more this year, you will actually pay 70% more the first year, 35% each to the insurance carrier and escrow.

HUD is going to look at all of these issues. There is a great reluctance on the part of some of the Senior staff who work in the underwriting area to allow reserves to be tapped for these costs unless they are very generously funded to begin with. There continues to be a concern in HUD that a number of properties don't have enough reserve money. The problem in countering that argument is that they are right in many cases. We will keep working the issue, the direction it will go is unclear.

Now that we have had one session with HUD on this issue, we will be getting with RHS next, and then begin working the same issues for Tax Credit properties.

We understand the importance of all of these issues, we solicit information and issues you may have, this discussion will be with us well into 2002.

The Lutine Bell has not struck once or twice, we will be on the gallery listening for it, and will keep you advised.