February 2023

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Mounting Insurance Premiums Vex Property Owners in Climate-Risk States

Rising insurance costs are a growing problem for commercial property owners, particularly in states with increasing climate-related risk, such as Florida and Texas, where costs are rising upwards of 50% and starting to threaten new development and property sales.

Although rates are rising nationwide, the problem is most acute in states that are experiencing a growing number of extreme weather events that include hurricanes, winter freezes and wildfires. Hurricane Ian, for example, cost upwards of $50 billion in damages as it ripped through Florida last September.

Weather-related payouts have left some insurers insolvent, while others are avoiding high-risk states. The maneuvering translates into higher rates and less coverage for property owners. "The rate environment for real estate-specific property is severely challenged, especially in Florida and Texas and along the Gulf Coast," said Danielle Lombardo, the chair of Lockton Global Real Estate, a New York-based advisory firm. "This has caused a bifurcated market between catastrophe-exposed and non-catastrophe-exposed business, with the highest double-digit increases in properties that have negative risk attributes, such as older frames, a challenged loss history or undervalued assets."

Many reinsurance companies, which property insurers use to move portions of risk off their own balance sheets, are quitting high-risk states, and those that stay are raising rates by 45-100%, Lombardo said. "Reinsurers are running away from Florida," she said. "Something has to be done differently."

The trickle down from the lack of reinsurance affects the capacity of excess/surplus carriers and managing general underwriters. Rates for property insurance in Florida—even in non-coastal areas—will rise 40-50% in 2023, and 100% increases are not uncommon, according to Christopher Conlon, director of risk management for Mahaffey Apartment Co. in St. Petersburg, Fla. Those increases are on top of 15-30% rate hikes in 2022, he said.

Not only are costs increasing but insurers are covering less wind limit on replacement costs with large increases in deductibles, new exclusions for damages such as mold or flood endorsements, and limits on payouts. That forces property owners to layer wind on top of other policies to reach the replacement cost values required by lenders. "Ownership groups must layer policies with multiple carriers up to the desired limit based on how much total insured value insurers are willing to offer," Conlon said.

Debra Morgan, managing director at CohnReznick in Dallas and a longtime multifamily investor, said that she is seeing large increases in insurance rates for properties in Florida and Texas. "One Texas community with no claims the prior four years and no increase in coverage received a 17% premium increase," she said.

Increasing Climate-Related Losses

The root of the problem is the growing number of weather-related catastrophes. According to the National Oceanic and Atmospheric Administration (NOAA), 18 separate natural catastrophes across the U.S. resulted in total economic losses of at least $1 billion in 2022. Insured natural catastrophe losses have topped $100 billion in three calendar years since 2017, which has raised concerns that insurers' models will not keep pace with the growing frequency and severity of catastrophes amid climate change.

Lombardo said that the destructive power—and excessive cost—of hurricanes is fueled by greater development and higher population density in coastal areas over the past five decades. For example, between 1970 and 2020 both the total population and population density (measured as people per square mile) of Florida increased 317%, the third-largest growth rate among U.S. states and twice the overall national growth rate, per data from the U.S. Census Bureau.

While the biggest jump in the cost of repairing properties is from weather events, other cost drivers include increases in construction costs from inflation, labor and supply-chain issues, as well as the growth in property values. Consequently, insurers are increasing scrutiny of payouts and are using third-party valuation services to assist in property-level underwriting. The challenging environment also has furthered compliance by servicers and increased waiver write-ups and submissions to lenders, said Laura Smith, a senior managing director & head of servicing at Newmark Multifamily Capital Markets.

Tabulating the price tag of weather events is an evolving field. A study on unpriced climate risk published this month in the journal *Nature Climate Change* found that the costs of potential flooding are not captured in home values. The study—performed by a team of researchers from academia, environmental organizations and the Federal Reserve—concluded that residential properties in flood zones are overvalued by $121 billion to $237 billion.

Although the study was limited to residential properties, the same risk exists among commercial assets. "(R)isks stem not only from the physical impacts of climate change but also from how property owners, private companies and public institutions respond to growing climate hazards," the study noted. "Adaptation responses will not only determine the magnitude of total costs but also whether these costs become increasingly borne by American taxpayers, or alternatively become internalized by those who are directly exposed to physical climate impacts."

Lender Reform Needed

What can be done to combat rising insurance costs? One effort involves attempting to reduce litigation in Florida, where the law makes it easy to sue insurance companies for damages. A sizable portion of property litigation nationwide is concentrated in Florida, and the state's legislature is considering legislation to tighten laws. The legislature also is debating the structure and funding of Citizens, a state fund that acts as an insurer of last resort, albeit mostly for homeowners.

A bigger issue, industry advocates say, is lender reform. Commercial property lenders usually require owners to carry windstorm insurance for the full value of the property, or at least the mortgage balance. The requirement is not burdensome where insurance is inexpensive, but as rates escalate it creates a hardship for some owners.

"This is a material operating expense increase on the smaller, affordable communities, especially when annual coverage goes from $727 a unit to $851 a unit on a community with average monthly rents of $1,100 a unit," Morgan said. Increased insurance escrow payments also have caused some borrowers to breach loan debt-service coverage ratios, and some property owners must make lump-sum payments to cover insurance escrow shortages.

Advocates say that properties are often overinsured to cover extreme losses that rarely occur. For example, most lenders require full limits for wind coverage or flood coverage for properties in FEMA-designated flood zones. Additionally, most lenders require business income coverage for flood losses on top of the National Flood Insurance (NFIP) flood coverage. Obtaining compliant flood insurance has proven to be as big a challenge for some property owners as obtaining wind coverage in hurricane-prone states, Newmark's Smith said.

Because of the lack of capacity carriers must write on wind and flood limits and the 30-40% increase in the cost of construction, Conlon said that property owners' negotiations with lenders increasingly involve non-traditional risk transfer methods such as parametric wind and flood insurance, in which they pay a set amount based on event risk as opposed to a traditional policy in which rates are based on the magnitude of losses.

Lombardo said setting rates via a true probable maximum loss methodology would significantly reduce the premium outlay and fix the supply/demand issue in the catastrophic insurance market. As an example, she said a lender might require $40 million in insurance for wind damage, while catastrophic loss models put the probable maximum loss at $10 million. The premium for $40 million of coverage might be $3.7 million annually, compared to $1.0 million for $10 million of coverage, she said, a margin large enough that it could create a delinquency or distress for some properties.

"The industry should be looking at modeled losses," Lombardo said. "Using a risk model basis instead of insured value would be a huge win for property owners."

—Paul Fiorilla, Director of Research, Yardi Matrix