REAL ESTATE & HOSPITALITY PRACTICE

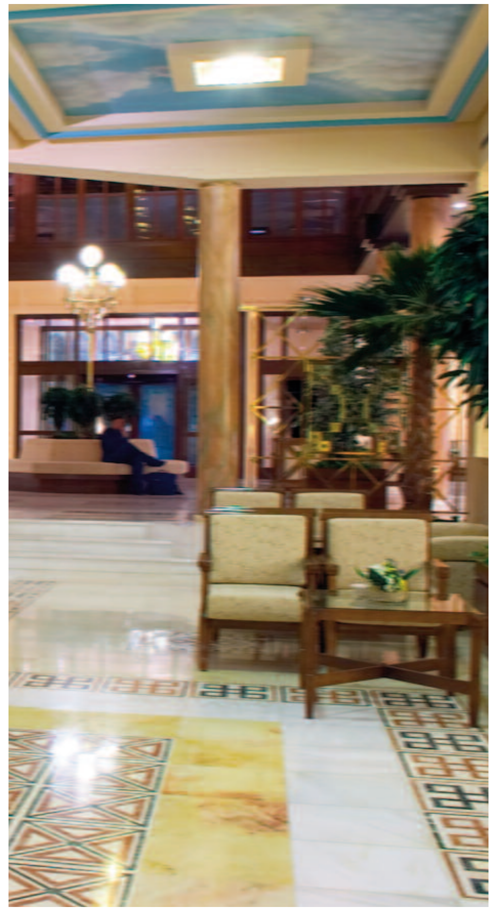
Willis

VIEWS

September 2008 www.willis.com

THE VIEW AHEAD

Predicting the future of the real estate insurance marketplace in the middle of hurricane season may or may not be foolhardy, but it certainly offers a clear reminder of why virtually everything written about our industry includes some version of the same caveat: like the weather, it can change overnight. When we began drafting this piece, the toll from Hurricane Gustav was still unclear, and Hanna, Ike and Josephine were queued up in the Atlantic. Now Texas is struggling in the wake of Ike. Yet the market forces at play seem strong enough for us to hazard a prediction: even given the increase in major losses that 2008 has brought in comparison to the previous two years – including the $6 to $16 billion in damage Ike will ultimately cause – we believe the market will remain soft.



We see two driving factors. First, the 2006 and 2007 policy years were two of the most profitable in the history of Property and Casualty insurance, bestowing on carriers abundant capital that is readily turned into insurance capacity. Second, the slowing economy is reducing the demand for insurance – as economic downturns usually do.

"All the signs are that I don't think the soft market is going to last a long long time...but it does not seem to be something that is going to end in a few months," said Willis Chairman and CEO Joe Plumeri in a recent interview with the *Financial Times*.[1] Plumeri went on to say that catastrophic losses in the range of $50-$100 billion would "accelerate" market stabilization, but even losses of that magnitude would not transform the market overnight.

Insurance buyers budgeting for 2009 can expect a buyer's market, although the percentage of decline may diminish, and may even plateau. And already it's caveat time – but the caveat here goes beyond weather. The factors that likely will have the greatest impact on anyone's experience in the marketplace remain individual loss experience, risk quality and exposure to catastrophe. As the market begins to show signs of change that will ultimately bring an end to the current soft market, the task of risk differentiation will become increasingly important as buyers of insurance seek optimal protection at an optimal price.

The first sign of marketplace change may be the results reported by insurers and reinsurers so far in 2008. "That party is over," Warren Buffet wrote in his annual letter to shareholders earlier this year when discussing the phenomenal results his company Berkshire Hathaway and many others enjoyed in 2007. "It is a certainty that insurance industry profit margins, including ours, will fall significantly in 2008."[2]

Several carriers are reporting significant profit declines through the first half of the year. Travelers reported a Q2 profit decrease of 25%, attributed to increased claim payments and falling premiums.[3] Chubb said second-quarter profits fell 34% amid "industry-wide price declines and a surge in claims tied to the record number of tornadoes in the period."[4] The Hartford's net fell by 13% as "investment troubles mounted and property-casualty insurance earnings and premiums fell."[5] As for reinsurers, first-half results were "dismal," attributed to falling prices, subprime write-offs and lower investment income.[6]

The net effect of reduced earnings at the carriers will be to stabilize the markets and level off premium reductions. Carriers, of course, have varying exposures, as do insurance buyers. Exposure to investment losses in the wake of the ongoing credit crisis varies widely – the most notable example of course being AIG. Some insurers will be able to absorb the losses with their 2006-07 surpluses more effectively than others. The marketplace will also vary according to line of insurance.

PROPERTY

Property markets are competitive. The industry remains challenged, however, by the need to develop catastrophic loss capacity for exposures to substantial windstorm damage. For these risks, the market is firm, though year-over-year pricing in general has seen modest decreases. For California Earthquake coverage, the absence of large seismic events has allowed rates to decline in most cases year over year.

In terrorism coverage, risks in central business areas with above average exposure are finding capacity adequate, thanks largely to the government backstop provided by TRIA and its legislative successors. The perception of underwriters regarding these risks depends on several factors: is the risk of iconic stature? Are large numbers of people exposed, as in a major sports stadium? Does the potential exist for broad rippling economic impact (e.g., bridge and tunnels)?

For risks without catastrophic exposure of either the natural or man-made varieties, the Property market can be exceptionally soft, and year-over-year premium reductions should still be available. One indication of insurer attitudes is the trend toward multiyear policies.

CASUALTY

Capacity for General Liability, Auto and Excess Liability is abundant and rates are dropping significantly, in many cases, year over year. Several carriers are aggressively pursuing these lines of coverage, and competition is often fierce for the accounts that control their risks and have favorable loss experience. Excess capacity is available from many carriers and Excess programs can offer substantial capacity using various carriers at very competitive rates.

WORKERS' COMPENSATION

Workers' Compensation constitutes the largest single piece of the insurance industry – over 50% of the Casualty market. California constitutes the largest single piece of the Workers' Compensation market in the U.S., and reforms in the state have had a major impact, reducing California rates by 65% in the last several years.[7] This trend may be ending, however. The state's Workers' Compensation Insurance Rating Bureau has filed for a 16% rate increase "based on increasing medical costs for claims for the years 2006 and 2007," according to a bureau spokesman.[8] Some insurers have indicated that they believe other states will follow suit to reflect steadily increasing costs of care. Most major carriers write Worker's Compensation. If results in this line deteriorate, all lines will be affected. Renewed emphasis on claims management is probably in order, including utilization review, case management and return-to-work programs.

In addition to rising medical costs, some believe the rising unemployment rate (which reached 6.1% in August, the highest level in five years[9]) will have a major impact, bringing about an increase in both

claim frequency and the length of time injured workers remain out. During economic downturns, Workers' Compensation claim frequency often rises as some workers, afraid of losing their jobs and salaries, may look to Workers' Compensation as a source of support that for many is higher than the amount paid under unemployment insurance mechanisms.

ENVIRONMENTAL

Environmental coverage has been relatively immune from soft market pressures, but, according to a report in *National Underwriter*, "increased competition – on top of declining demand, due to a slowing economy – have combined to prompt significant price drops." The report goes on to quote Willis Environmental Practice Leader Mike Balmer: "It's a buyer's market...in pricing terms we are looking at certain program reductions of 25% to 30% – something not seen in the past."[10] Market penetration, at about 20%, may expand as a result of increased affordability and the growing importance of environmental considerations in the construction industry (see the comments on green construction below). As expectations for environmentally friendly materials and design grow, so may the impetus to assess and transfer these exposures.

CYBER RISK

The demand for coverage for cyber exposures is also likely to increase. One factor is the announcement in August that the U.S. Justice Department charged 11 with stealing 40 million credit and debit card numbers from nine retailers. U.S. Attorney General Michael Mukasey said, "This is the single largest and most complex identity theft case that has ever been charged in this country." He said the indictment "highlights our increasing vulnerability to the theft of personal information." Mukasey said the scheme could ultimately cost citizens billions of dollars, and that some people may not learn they've been victims "for months or years."[11] We have seen an increase in requests for cyber coverage from organizations that store credit card information. The marketplace appears ready to respond.

EMPLOYMENT PRACTICES LIABILITY

The Employment Practices Liability (EPL) market is a contradictory place these days. The market is attracting more entrants and the competition is driving down rates, but at the same time claims are increasing significantly. According to the Equal Employment Opportunity Commission (EEOC) 2007 Report[12], total claims rose 9% in 2007, the largest annual increase since 1993. Retaliation cases rose to record levels. Race-based cases hit their highest levels since 1994. With the economy in decline, observers expect EPL claims related to terminations and downsizing to increase, but markets are not leaving yet. This space bears watching.

REAL ESTATE MEGA TRENDS

Hotel and real estate insurance buyers must not only navigate the general insurance marketplace, but must be aware of the impact of key industry sector trends on coverage issues. Mega trends include:

- Increasing replacement costs
- Green construction
- Financial stress and its impact on maintenance
- Increasing foreign ownership
- Declining real estate sales activity

INCREASING REPLACEMENT COSTS

While the credit crisis is sending the market value of real estate downward, the insurable replacement cost of most buildings is rising. The U.S. Bureau of Labor Statistics reported recently that construction materials costs, including fuel costs, rose 10.4% over the previous year; highway construction materials went up 18.9%.[13] Since 2003, the cost of construction materials has risen 39%, more than double the general inflation rate over that period.[14] Fuel costs are only part of the reason. Steel, copper, drywall and concrete costs have gone up, in part because of the weak dollar and in part because of competing demand from Asia. The impact on insurance is felt in replacement cost valuations. Replacement costs must reflect actual costs for coverage to be complete. Any organization facing a renewal should be sure to carefully review building replacement costs in advance of the renewal submission process.

GREEN CONSTRUCTION

The trend toward sustainability in buildings continues unabated. (See the previous issue of *Views*.) More insurance companies are amending their offerings to include coverage provisions that respond to the needs of green buildings. Some carriers are offering rate credits for LEED®-certified buildings. (LEED stands for Leadership in Energy and Environmental Design and is the acronym for the rating system of the U.S. Green Buildings Council.) Others are considering offering these credits. Green buildings are generally considered better risks. Green construction, with its emphasis on energy efficiency, grows only more popular with the rising cost of energy – from $3 per square foot to $3.50 per square foot, according to one global real estate company.[15] In tough economic times, landlords have a hard time passing along increased energy costs to tenants, giving even greater incentive to reduce energy costs. As more builders offer green construction services, the cost of going green goes down and the return on investment improves. The insurance benefits of going green can only serve to support the general industry trend.

FINANCIAL STRESS AND ITS IMPACT ON MAINTENANCE

Many companies purchased real estate at historically low cap rates with the expectation that property values would continue to escalate and rental revenue would also increase. As raising rents becomes increasingly difficult in the current economic environment, debt service is becoming problematic for some who purchased at the top of the market in 2007.

As real estate companies look for financing, balance sheet lenders are, in many instances, replacing the commercial mortgage-backed securities (CMBS), market, which has almost disappeared. Balance sheet lenders, who generally do not securitize loans and tend to hold onto loans for a period of time, along with other financing sources, are seeking lower loan-to-value ratios, more conservative loan covenants, particularly debt service ratio. Some lenders are beginning to once again ask for recourse in the loan agreements.

The credit crunch is also resulting in fewer projects being built, as construction loans are more difficult to obtain at favorable terms. Some projects have stopped midway, as the developers have found themselves unable to secure additional necessary financing. Build-to-suit projects are comparatively easier to finance, especially in contrast to spec projects, where financing is particularly hard to obtain.

Insurance underwriters are becoming aware of the financial stress some real estate companies are under and are beginning to look closely at each insured's financial condition. They generally want to underwrite companies in sound financial condition to ensure premium paying ability, the ability to maintain properties and the likelihood the company will stay in business. Carriers generally look for long-term relationships.

INCREASING FOREIGN OWNERSHIP

The decline of the dollar, along with the transfer of wealth to oil-producing nations, has led to increased real estate investment across national borders. This trend toward cross-border real estate investment makes it important for all parties involved in insurance transactions, carriers and brokers alike, to understand and respond to the unique issues markets present around the globe.

DECLINING REAL ESTATE SALES ACTIVITY

Several factors reduce sales of real estate assets. Differing perceptions of market values on the part of buyers and sellers make agreement on terms more difficult, if not impossible. The scarcity of capital for acquisitions that followed the virtual elimination of mortgage-backed securities, plus the imposition of stricter underwriting standards by financial institutions, have made the task of finding funds for acquisitions extremely difficult.

REAL ESTATE SECTORS

RETAIL

The retail sector of the U.S. economy is struggling. "There is deep-seated pessimism in every corner of the retail landscape this year," *National Real Estate Investor* reported recently.[16] Of the 32 million square feet of new retail space that became available in Q1, only 22 million was leased.[17] In Q2, retailers closed stores and curtailed expansion plans to the extent that vacancies at retail properties hit "multiyear highs."[18]

The chief cause is obvious enough: reduced consumer spending. In addition, those retailers with plans for acquisitions or expansion have been hamstrung by the credit crisis. Vacancies mean financial stress for real estate companies, and financial stress is one of the factors underwriters consider when assessing the quality of a risk, along with loss experience, catastrophe exposures, etc. We have not seen higher premiums directly linked to vacancy rates but would not be surprised to see this trend emerge.

RESIDENTIAL

The residential sector has been affected by the decline in housing values, but in ways that may not be intuitively obvious. "Much has been made about the flood of former house owners into apartments, but we are not seeing that," said Doug Bibby, president of the National Multi Housing Council in a report in *GlobeSt.com*, a commercial real estate publication.[19] "Instead, the primary effect the housing downturn is having on the apartment sector is a dramatic slowdown in the number of renters leaving to become owners." Apartment landlords have seen vacancies increase some, largely attributed to the increase in the number of single-family houses and condos entering the rental market if they cannot be profitably sold, according to *The Wall Street Journal*.[20]

HOTELS

The fortunes of the hotel industry historically have followed the trends in the general economy. When business is slow, people travel less for business and pleasure. In the current climate, the situation has been exacerbated by the increase in air travel costs due to rising fuel prices. True to form, U.S. occupancy rates are down to about 65%, or 5% lower than last year.[21] Distant destinations are in considerably worse shape. The industry averaged a 1.2% **RevPar** (revenue per available room) gain in the second quarter, leaving many wondering how long it will be before this number turns negative.[22]

Hotels may not be able to control economic cycles, but they can do something about other uncertainties they face. Hotels are increasingly looking at the entire continuum of risk. While they continue their traditional focus on fire, security and life safety issues, they are also looking at ways to reduce Workers' Compensation claims through proper training and supervision. The goal is twofold: reduce costs, but also keep workers on the job, as finding and retaining the employees required to operate a hotel and deliver the services that guests require seems to grow only more challenging. We also see an increasing focus on food safety, cleanliness throughout the hotel and the risks associated with pandemics and cyber attacks.

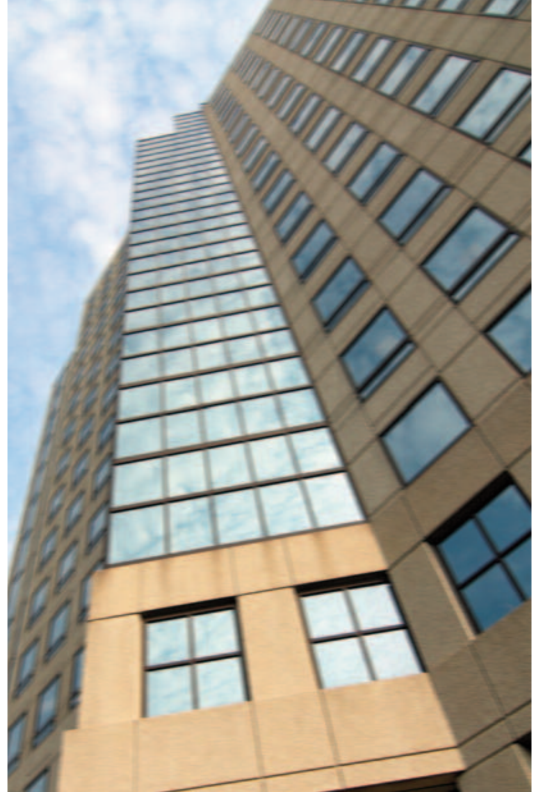
Hotels are seeking assistance in developing emergency response and business continuity plans. Such plans are seen as a way to provide improved security for guests, reduce recovery time following loss events and protect the ever-important hotel brand.

OFFICE

Office occupancy rates vary by city, but overall, the economic trend is expected to catch up with the office sector of the real estate industry. "Cutbacks in key industries such as information technology, finance and professional services have led to more than a quarter-million layoffs during the first half of 2008, which has emptied an estimated 38 million square feet of office space," according to a report in *Financial Week*.[23] The report quoted Grubb & Ellis, the real estate advising firm, as saying that office vacancy rates could reach all-time highs by the end of 2009. Rental prices are expected to flatten out. Forced sales of assets by owners caught in the credit crunch may lead to a rash of acquisitions by better funded institutional investors. "As office vacancies increase into next year, some owners of real estate assets may experience hardships," the report said.[24]

INDUSTRIAL

With retail sales declining, warehouse vacancy is on the rise. The national industrial vacancy rate, according to Grubb & Ellis, rose to 8.0% from 7.7% in Q1 2007, following six consecutive quarters in



which the rate hovered around 7.7%.[25] However, expanding international trade should buffer the industrial market from the worst effects of the economic downturn, the real estate researchers said.

Vacancy rates were hurt not only by lowered demand for goods and services but by the arrival of newly developed property in the marketplace. While the construction pipeline is narrowing, with a decline in construction starts, the pipeline is set to deliver "some 121 million square feet of space over the next few quarters, a period during which demand for that space will be lackluster, according to Grubb & Ellis, which expects the vacancy rate to end the year between 8.5% and 9.0%, below the prior peak of 10.1% in the first quarter of 2003."[26]

The threat of recession that hangs over most sectors of the economy does not appear to be affecting exports or even imports – yet. Thanks largely to the weak dollar, exports were up nearly 21% over the 12 months ending in February. Imports rose 16.4% during the same period. Rising vacancy rates will put downward pressure on rental rates, but trading activity gives a strong boost to warehousing activity, which should have a counter effect.

RIDING THE CYCLES

The insurance and real estate industries are both cyclical. They are also both impacted by inflationary trends, availability of credit and capital, the direction of interest rates, expansions and contractions in GDP, the overall performance of the financial industry and unemployment rates. They both share concerns about the enormous impact of natural and man-made catastrophes.

Both industries often have periods where credit or insurance capacity is freely available on favorable terms and costs, followed by periods when providers of credit and underwriting capacity will reverse themselves by employing what some call draconian measures. The latter periods bring significantly higher costs and retentions and much more difficulty in finding capital or insurance capacity.

It is important to be mindful of these trends and establish relationships that will help you successfully navigate good times and bad.

CONTACT

Brian Ruane, CPCU
Executive Vice President
DirectorNational Real Estate &Hotel Practice
212 915 7971
brian.ruane@willis.com

---

[1] "Willis gloom on reinsurance pricing," *Financial Times*, September 7, 2008.
[2] "Even Buffett is facing 2008 slump," *The Star-Ledger*, July 25, 2008.
[3] "Travelers Profit Declines 25%; Claims Rise, Premiums Don't," *The Wall Street Journal*, July 24, 2008.
[4] "Earnings Report," *The Star-Ledger*, July 25, 2008.
[5] "Profits Fall 13 Percent at the Hartford For Quarter," *Hartford Courant*, July 29, 2008.
[6] "First half results have reinsurers feeling gloomy," *Reinsurance*, September 2, 2008.
[7] "16% boost in workers' comp rate in works," *San Francisco Chronicle*, August 16, 2008.;
[8] Ibid.
[9] "U.S. Jobless Rate Rises Past 6%, Highest Since '03," *The New York Times*, September 5, 2008.
[10] "Environmental Risks No Longer Immune To Soft Market Pressures," *National Underwriter*, July 28, 2008.
[11] "Government charges 11 in data theft of TJX, others," *The Wall Street Journal*, August 6, 2008.
[12] "JOB BIAS CHARGES RISE 9% IN 2007, EEOC REPORTS," EEOC Press Release, March 5, 2008, http://www.eeoc.gov/press/3-5-08.html.
[13] "Contractors fight fuel and materials costs, down economy," *Nashville Business Journal*, August 8,2008.
[14] "Inflation UNLEASHED," *National Real Estate Investor*, July 2008.
[15] "Landlord over a barrel," *The Real Deal*, July 2008.
[16] "Retail Down, But Not Out," *National Real Estate Investor*, July 2008.
[17] Ibid.
[18] "Vacancies Rise at Retail Centers," *The Wall Street Journal*, July 7, 2008.
[19] "Apartments Insulated from Single-Family's Financial Woes, For Now," *GlobeSt.com*, July 25, 2008.
[20] Op. cit.
[21] "Terrible Timing for a Hotel Boom," *The New York Times*, July 31, 2008.
[22] *Crittenden Hotel/Lodging News*, September 8, 2008.
[23] "Expect near-record office vacancy rates in 2009, says Grubb & Ellis," *Financial Week*, July 21, 2008.
[24] Ibid.
[25] "Industrial vacancy inches up, but all not lost as international trade offers safety blanket," *Real Estate Weekly*, May 7, 2008.
[26] Ibid.