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CMBS: Assessing Katrina

Flood Insurance Limits Are a Concern

Highlights of This Issue

- Many properties affected by Katrina may have inadequate insurance.
- The insurance adjuster's determination of cause of damage (hurricane versus flood) may have a material effect on collection of insurance proceeds and thus ultimate loan recovery. Many properties may be severely underinsured for flood.
- Properties located in high-risk flood zones that have purchased flood insurance may be severely underinsured for damages as a result of a \$500,000 cap on federal flood insurance or sub-limits on private flood insurance.
- Properties outside high-risk zones (mid- to low-risk) may suffer significant shortfalls in insurance coverage because (a) they may not have flood insurance and (b) "all-risk" insurance typically does not cover losses as a result of flooding.
- Insurance proceeds may be used to prepay mortgage loans without penalty.
- We anticipate related delinquencies and negative rating consequences as a result of expected losses and uncertain recovery.
- While losses are devastating for affected areas, and may be acute for specific assets, overall, CMBS investor losses will be mitigated through diversity and structural enhancements.
- CMBS servicers will likely make principal and interest advances for loans secured by properties in declared disaster areas.
- The multi-peril losses present a dynamic and challenging platform for assessing damage and analyzing insurance coverage.
- Long-term prospects for economic viability may weigh heavily on decisions to rehabilitate or raze properties.
- Servicers charged with maximizing net present value of assets may find pursuing insurance proceeds more efficient than rehabilitating real estate.

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A Framework For Assessing Insurance

Many properties affected by Katrina may have inadequate insurance.

- Properties located in high-risk flood zones that have purchased flood insurance may be severely underinsured for damages as a result of flood. Shortfalls may result from a \$500,000 cap on federal flood insurance or sub-limits on private flood insurance.
- Properties in outside high-risk flood-zones (mid- to low-risk) may suffer significant shortfalls in insurance coverage because “all-risk” property and casualty insurance typically does not cover losses as a result of flooding¹.
- The insurance adjuster’s determination of immediately preceding cause of damage (hurricane verses flood) may have a material effect on collection of insurance proceeds because many properties may be severely underinsured (if insured at all) for damages as a result of flood.

Some loans will experience significant losses.

We would not be surprised to see some loans experience significant losses based on inadequate insurance.

■ Generic CMBS Requirements

With respect to Katrina, the most important generic CMBS insurance requirements include (a) hazard or “all-risk” insurance for windstorm damage and (b) flood insurance for rising waters and coastal waves. (Table 1). The CMBS flood insurance requirement is generic, flexible and subjective, as it reflects the need for specific insurance based on detailed asset analysis. Typical flood insurance requirements may read something like this:

*Properties located in high-risk flood zones must obtain flood insurance in an amount equal to the **lesser** of the outstanding principal balance or the maximum limit of coverage available under the federal flood insurance program or such other amount as required by lender.*

- The maximum limit of coverage available under the National Flood Insurance Program (NFIP) is only \$500,000 for commercial structures.²
- High-risk flood zones (100-year flood) are those that have a 1% chance of being flooded every year. High risks zones (as designated by FEMA maps) are known as “Zone A” for risks associated with tiding flooding and “Zone V” for risks associated with coastal waves. See Appendix for more flood related definitions.

The minimum flood insurance requirement (effectively \$500,000 on only high-risk assets) may be insufficient for complete insurance coverage³.

We anticipate many smaller balance loans will have obtained the minimum \$500,000 federal flood insurance. We also expect to see some borrowers on larger loans who may have obtained more than the minimum CMBS flood insurance requirement, particularly when a borrower is able to obtain blanket flood insurance for a portfolio of assets through economies of scale.

¹ Although an endorsement may be purchased separately, many borrowers in mid- to low-risk flood areas may choose not to purchase the endorsement.

² An additional \$500,000 for commercial contents may also be available. Federal flood insurance is capped at \$250,000 for residential properties. We discuss the federal flood insurance program in following sections.

³ A higher threshold is not necessarily enforced because in some cases a greater degree of insurance may not have been available at commercially reasonable rates (if at all).

Table 1: Common Insurance Requirements

<p>Common insurance requirements for mortgage loans backing CMBS include the following:</p> <ul style="list-style-type: none">• The borrower is required to renew and maintain adequate insurance at all times for: hazard insurance (all-risk), and business interruption and loss of rents, and general liability, and other appropriate insurance (flood), and other insurance lender may reasonably require (terrorism).• The lender is named as an additional insured and as a loss payee.• The amount of the hazard policy is the lesser of (i) the replacement cost value without deduction for depreciation and (ii) the principal balance of the related mortgage loan.• The policy cannot be materially changed or modified without 30 days notice to the lender.• Properties located in high-risk flood zones must obtain flood insurance in an amount equal to the lesser of the outstanding principal balance or the maximum limit of coverage available under federal law.• The credit quality of the entity providing the insurance to be high enough to support CMBS ratings. <p>Note: CMBS loan originators will often hire insurance consultants and experts to perform a specific and individual analysis of loans and related assets to assure prudent property and casualty insurance against risk of loss insurance has been obtained based on industry standards. Not all risks are necessarily fully insured. Prudent insurance reflects location, use, design and other features of a specific property.</p>
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Damage From Katrina Requires Multi-Peril Insurance

Insurance coverage for loss as a result of hurricanes is typically provided through the components of “all-risk” property and casualty insurance. Unfortunately, such general hazard property insurance has shortcomings as it relates to damage caused by Katrina. Multiple perils caused damage: hurricane, flooding, security failures, looters, fire and mandatory evacuation. In this section we review all-risk insurance (for windstorm damage), flood insurance and related insurance with respect to Katrina.

■ “All-Risk” Insurance May Be Insufficient

All-risk insurance typically excludes flooding.

“All-risk” insurance generally covers all physical damage to a property as a result of windstorm, fire, lightning, explosion, smoke, hail, riot, strike and civil commotion, **but typically excludes flood and other water-related causes**, earth movements, earthquake, war, revolution, governmental actions, vermin, wet or dry rot, and domestic animals. Coverage for losses not included in basic “all risk” insurance may be negotiated as an endorsement or obtained through a separate policy.

Although damaged caused by Katrina’s wind and related events would be covered under hazard insurance, damage caused by coastal waves (for example Biloxi, MS) and rising water (for example, New Orleans levee breaks) would not be covered by hazard insurance, but rather by flood insurance.

Properties affected by Katrina that are located outside high-risk flood zones may not have flood insurance and may rely entirely on proceeds from “all-risk” insurance. Properties within high-risk flood-zones may have inadequate insurance.

Chart 1: Biloxi, MS



Source: Federal Emergency Management Agency

Determination of cause of loss is material.

Federal flood insurance is capped at \$500,000.

■ Inadequate Flood Insurance is a Major Concern

We are concerned that (a) insurance adjusters will determine the precedent cause of damage to be flood in many cases, and (b) many properties may be severely underinsured for flood. In this section we review both federal and private insurance options. See Table 2 for anticipated types of flood insurance for CMBS loans.

National Flood Insurance Program (NFIP)

Many properties located in high-risk flood zones may have obtained the minimum requirement - the *lesser* of the outstanding principal balance or the maximum limit of coverage available under federal law.

Federal flood insurance coverage is capped at \$500,000 per commercial structure⁴ – far from sufficient proceeds to cover the typical \$10 million conduit loan. In addition, financial losses caused by business interruption or loss of use of insured property are not covered.

Property owners may obtain flood insurance through the National Flood Insurance Program (NFIP). High-risk flood areas, or Special Flood Hazard Areas (SFHAs), are identified on Federal Emergency Management Agency (FEMA) flood maps. FEMA points out that structures located in high-risk flood areas like New Orleans have a significant (26%) chance of suffering flood damage during the term of a 30-year mortgage while only a 4 percent chance of loss from fires. FEMA also encourages property owners to buy flood insurance even if the subject property is not located in a high-risk area. Almost 25% of all flood insurance claims come from areas with minimal flood risk. For more information on NFIP, see Appendix One.

⁴ An additional \$500,000 may be obtained for contents, if specifically insured.

Even loans with private insurance may be underinsured.

Private Flood Insurance

Private flood insurance may be available in excess of federal flood insurance. However, for assets **in areas prone to flooding, insurers may limit flood insurance coverage to a pre-determined amount through a sub-limit clause⁵**. For example, a borrower may be able to obtain a \$10 million all-risk insurance policy, but a \$2 million sub-limit may apply to flood damage. If the cause of damage is determined to be flood, then the borrower could collect insurance proceeds only up to the \$2 million sub-limit.

In some cases, insured parties may be unable to obtain as much insurance as they would like, but they nevertheless assume exposure to risks they deem unlikely. For example, owners may obtain flood insurance sufficient to cover potential losses on the first and second floors of the building, leaving the remaining upper floors uninsured. The risks in this strategy are that (a) rising waters exceed the second floor and (b) subsequent mold or other related damage destroys uninsured portions of the property.

Privately negotiated blanket insurance may prove among the best insurance package. Owners of multiple geographically diverse properties may have negotiated blanket flood insurance. Risk of loss is mitigated because sub-limits (while a fraction of the total portfolio coverage) may exceed the loan balance of any individual property.

Rental Loss and Business Interruption Insurance

Following damage to a property, tenants may have the right to abate rent or terminate leases, each depending on the scope of the damage or loss of use.

Loss of rent due to flood or power outage may not be covered by insurance

Business interruption or rental loss insurance generally provides the property owner with coverage for loss of income and incurred expenses for a period of twelve to eighteen months. That may not be enough time post-Katrina given the evacuation and daunting clean-up and potential damage to the local economy.

In general, in order for a loss to be covered under business interruption insurance it must be a result of a cause listed under the property and casualty insurance. If the property is not damaged by a covered cause, then insurance may not cover losses from loss of rents or business interruption. For example, property insurance may not cover loss of rents or revenue due to simple power outages. Any sub-limits related to the cause of damage (flood) will apply to business interruption.

Government-ordered evacuation of the city presents complications for assets – even those that were not damaged. Business interruption insurance may not be available.

Mold: Potentially Devastating

Open roofs and still waters expose assets to moisture, heat and high humidity – a perfect recipe for mold growth. Although mold insurance is not available in Louisiana, mold damage as a result of a covered loss (such as wind damage and flooding) would be covered to the extent of the applicable limit. The concern is that mold damage may destroy most of a building but flood insurance sub-limits would restrict available insurance proceeds.

Environmental Hazards

Water in New Orleans is toxic and extremely dangerous. Commercial real estate is likely affected. Environmental liability is a serious concern for lenders. Prior to a securitization, originators obtain environmental studies on a property-specific basis. Potential environmental hazards are identified. Assets with small identified hazards that can be contained may be included in the trust. Environmental

⁵ Larger multi-property owners may negotiate mega blanket policies that may be sufficient to cover individual properties.

insurance may be purchased to protect against risks. Hazards posed by Katrina – post securitization – may not be covered.

Table 2: Anticipated CMBS Flood Insurance

<p>We conducted an informal and preliminary review of policies and discussions with industry participants to determine the types of insurance coverage the industry anticipates it will uncover on its loans secured by properties exposed to Katrina.</p> <p>National Flood Insurance Program (NFIP)</p> <p>Many properties located in high-risk flood zones may have obtained the minimum requirement - the <i>lesser</i> of the outstanding principal balance or the maximum limit of coverage available under federal law.</p> <p>Risk: NFIP provides only up to \$500,000 of covered losses. In addition, financial losses caused by business interruption or loss of use of insured property are not covered.</p> <p>Additional Private Insurance</p> <p>Some may have contracted for additional private insurance. Borrower with larger loans may be more likely to have contracted for private insurance in addition to NFIP. However, size alone is not an indicator of coverage.</p> <p>Risk: Insurance coverage may be subject to sub-limits below the outstanding loan balance. Properties located in hurricane- and flood-prone areas will likely have relatively low sub-limits.</p> <p>Blanket Policy</p> <p>Privately negotiated blanket insurance may prove among the best insurance package. Owners of multiple geographically diverse properties may have negotiated blanket flood insurance.</p> <p>Risks are Mitigated: Sub-limits may exceed the loan balance of any individual property.</p>
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■ **CMBS Implications**

We anticipate related loan delinquencies. Master servicers will need to evaluate which assets need to be transferred to special servicing based on actual or imminent default. All loans in the affected areas will be put on watchlists.

We would not be surprised to see **negative rating consequences** as a result of expected losses and uncertain recovery.

CMBS investor losses will be mitigated through diversity and structural enhancements, such as advancing. CMBS servicers will likely make principal and interest advances for loans secured by properties in declared disaster areas.

Overall CMBS losses may be relatively small, but some loans may experience significant losses based on inadequate insurance. Servicers charged with maximizing net present value of assets may find pursuing insurance proceeds more efficient than rehabilitating real estate. Insurance proceeds may be used to prepay mortgage loans without penalty.

Long-term prospects for economic viability may weigh heavily on owner, servicer, controlling class, and rating agency decisions. While some may find temporary comfort with business interruption insurance paying interim debt service⁶, many are asking what the future will hold and whether assets will (a) be able to generate sufficient revenue to service debt upon the expiration of business insurance, (b) hold sufficient attraction for sale or (c) have sufficient value to be refinanced. Quite simply, the exit strategy is complex and uncertain.

⁶ Business interruption insurance may not be available to all assets, as we discuss in a later section herein.

Appendix: Flood Insurance Definitions

National Flood Insurance Program (NFIP)

A federal program established in 1968 enabling property owners in participating communities to purchase insurance protection against losses from flooding. This insurance is designed to provide an insurance alternative to disaster assistance⁷ to meet the escalating costs of repairing damage to buildings and their contents caused by floods.

Flood

A general and temporary condition of partial or complete inundation of two or more acres of normally dry land area or of two or more properties (at least one of which is the policyholder's property) from:

- Overflow of inland or tidal waters; or
- Unusual and rapid accumulation or runoff of surface waters from any source; or
- Mudflow; or
- Collapse or subsidence of land along the shore of a lake or similar body of water as a result of erosion or undermining caused by waves or currents of water exceeding anticipated cyclical levels that result in a flood as defined above.

Chart 2: Floodwall Break in New Orleans, LA



Source: US Army Corps of Engineers

100-Year Flood

The term “100-year flood” is misleading. It is not the flood that will occur once every 100 years. Rather, it is the flood elevation that has a 1-percent chance of being equaled or exceeded each year. Thus, the 100-year flood could occur more than once in a relatively short period of time. The 100-year flood, which is the standard used by most federal and state agencies, is used by the NFIP as the

⁷ Disaster assistance is typically in the form of a long term loan that must be repaid with interest.

standard for floodplain management and to determine the need for flood insurance. A structure located within a special flood hazard area shown on an NFIP map has a 26 percent chance of suffering flood damage during the term of a 30-year mortgage. Also known as Base Flood.

Special Flood Hazard Area (SFHA)

Land areas that are at high risk for flooding. These flood plains are indicated on Flood Insurance Rate Maps (FIRMs).

Mandatory Purchase

Under the provisions of the Flood Disaster Protection Act of 1973, individuals, businesses, and others buying, building, or improving property located in identified areas of special flood hazards within participating communities are required to purchase flood insurance as a prerequisite for receiving any type of direct or indirect federal financial assistance (e.g., any loan, grant, guaranty, insurance, payment, subsidy, or disaster assistance) when the building or personal property is the subject of or security for such assistance.

Zones “A”

100- year floodplains risks. Risks of flooding from rising water. Includes Zones A, AE, A1-30, AH, AO, AR, A99.

Zone A

The flood insurance rate zone that corresponds to the 100-year floodplains that are determined in the Flood Insurance Study (FIS) by approximate methods. Because detailed hydraulic analyses are not performed for such areas, no BFEs or depths are shown within this zone. Mandatory flood insurance purchase requirements apply.

Zone D

Areas where there are possible but underdetermined flood hazards. In areas designated as Zone D, no analysis of flood hazards has been conducted. Mandatory flood insurance purchase requirements do not apply, but coverage is available.

Zones “V”

100-year coastal floodplains. Risks of flooding from waves. Zone V and VE.

Zone V

The flood insurance rate zone that corresponds to the 100-year coastal floodplains that have additional hazards associated with storm waves. Mandatory flood insurance purchase requirements apply.

Zone VE

Flood insurance rate zone that corresponds to the 100-year coastal floodplains that have additional hazards associated with storm waves. Mandatory flood insurance purchase requirement apply.

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