FINANCE AND TERRORISM RISK 3

TERRORISM RISK THREAT TO LENDERS

This chapter discusses the potential retained risk that real estate lenders may be exposed to by the current condition of terrorism insurance. The specific intent of this chapter is to help the building finance community utilize its considerable influence on the building industry to encourage investments in terrorism risk mitigation.

The building finance community distinguishes between two major areas of lending activity: single-family residential and commercial/multifamily. The residential sector is less affected by terrorism risk considerations. However, since the WTC attack federal officials have issued specific warnings for elevated terrorism risk in shopping malls, banks, and multifamily housing.

Building Finance Community

While many owners are unwilling to make the extra expenditure now required for terrorism risk insurance, lenders prefer to require adequate cover for all relevant perils. To date, apartment lenders have taken the most relaxed view because it is most difficult for apartment owners to pass through the added insurance costs to tenants. Exposed owners might perceive risk, but most owners do not voluntarily want to pay for the insurance. Commercial building owners and lenders take a stricter view. They issue temporary waivers, but require insurance when loan balances are over a certain threshold (e.g., $10 million) and for trophy properties or properties that are identified as having higher risk due to location, building tenant, or historic/national recognition.

Each sector consists of its own array of financial interests:

- Loan originators
- Loan servicers
- Secondary markets
- Bond markets

The commercial/multifamily sector includes: loan originators, loan servicers, life insurance companies, pension funds, the multifamily secondary market (Fannie Mae and Freddie Mac), Wall Street, and financial institutions as direct lenders.

Lenders Concerns

Building lenders and loan servicers are concerned about the adequacy of property insurance to cover potential loss of the asset and the potential default of the borrower. Lenders are also concerned with other types of insurance—workers' compensation, liability, and business interruption—as they relate to the solvency of the borrower.

Both assets and borrower solvency are threatened by terrorism risk. The terrorist acts of September 11, 2001 resulted in pervasive uncertainty in the insurance markets regarding insurance associated with future terrorist attacks. The commercial/multifamily real estate industry is very concerned about the availability of terrorism risk coverage as it relates to the asset value and financial health of borrowers. The Terrorism Risk Insurance Act of 2002 ensures the current availability of basic terrorism insurance, but significant questions remain as to the comprehensiveness of the coverage and whether a viable terrorism insurance market will develop in the future.

Terrorism Impact

The potential impact of terrorism risk for the real estate finance industry lies in six key areas:

Loss of asset (collateral). The traditional approach to asset risk on the part of lenders is to require the borrower to purchase adequate insurance cover for all relevant perils. The terrorism risk exclusions following the WTC attack presented a major problem for lenders. Their profit is based on extending more loans but without insurance cover new loans also expand their credit risk.

Default of borrower. The primary concern of the lender is the ability of the borrower to meet the conditions of the loan. Protection of the underlying asset is of key importance to maintaining the business operation of the borrower in addition to providing collateral for the loan. Terrorism risk includes modes of attack that will directly damage the building such as bomb blast and arson as well as those that may not physically damage the building such as biological, chemical, or radiological attack. Such 'nonbuilding' threats can destroy the borrowers ability to pay and can deny access to the asset for extended periods of time. Even without physical damage, asset value can be destroyed.

Rating of securities. In the case of mortgage backed securities for both residential and commercial real estate the value of the security is influenced by the evaluation of rating agencies. These ratings take into account a range of risks, which will necessarily include terrorism risk. The exposure of the underlying assets to terrorist attack and the extent of related insurance coverage will influence securities ratings. Perception of portfolio risk affects rating of securities: securities based on a single asset in a "high risk" location will receive a lower rating. Securities based on multiple or dispersed assets are generally less negatively affected by terrorism risk. Aside from New York City and Washington DC, the cities of greatest concern for terrorism are Los Angeles, Seattle, Chicago, Houston, and Atlanta.

Retained risk. In the aftermath of the WTC attack and the terrorism risk exclusions, many lenders chose to temporarily waive insurance requirements. This action was deemed necessary to continue real estate financing and to foster new construction in the economy. However, waiving the terrorism insurance requirement left the lenders exposed to an as yet undefined risk. Lenders have traditionally relied on the insurance industry to price and provide coverage for such risks. In this case the lack of consensus on terrorism risk pricing and the withdrawal of the reinsurance industry have left lenders in an awkward position. Even with TRIA, lenders remain concerned with risks related to domestic terrorism, attacks involving chemical, biological, or radiological materials and the designation of terrorism events by the Secretary of the Treasury.

Cost of capital. One approach to dealing with increased risk has been to "cover" the risk with increased interest rates. This increase in the cost of capital is not desirable because it impacts the volume of lending and who receives a loan if terrorism is not covered or the cost is prohibitive.

Regulation. Financial institutions and lending institutions are subject to regulation regarding standards for lending and management of risk, including terrorism risk. Banks and financial institutions must meet the regulatory standards of the Comptroller of the Currency and the Securities and Exchange Commission.

CURRENT FINANCE SITUATION

Following the WTC attack and the withdrawal of the insurance industry from provision of terrorism risk cover, real estate finance institutions faced a serious dilemma. In the absence of available or reasonably priced reinsurance, investments and lending in major projects (those over $30 – $50 million) were delayed in what were believed to be the primary target cities of New York and Washington. Difficulty in acquiring insurance for recognized trophy buildings also impacted refinancing in some cases.

The key concern for lenders is borrower insurance coverage, so they also have a keen interest in the TRIA. The continued health of the real estate sector of the economy requires adequate and affordable property and liability insurance coverage against terrorism risk. The enactment of TRIA is an important milestone for the real estate finance industry because it ensures the availability of basic insurance coverage. However, the real estate finance industry has several serious concerns with the federal program created under the statute:

- Acts of domestic terrorism are not covered.
- It is not clear whether or how carriers will cover terrorist acts with aggregate losses below $5 million that are not reinsured under TRIA.
- Carriers are not required to notify lenders if a borrower rejects coverage under TRIA, either by affirmative statement or by failing to pay any premium for such coverage imposed by the carrier.

- Carriers are not required to offer terrorism coverage for nuclear, chemical or biological attacks if they do not typically offer property and liability insurance for nuclear, chemical and biological perils.

Following TRIA, lenders have many borrowers out of compliance with loan insurance requirements. Lender and servicer procedures vary. Some large servicers have instituted a requirement for mandatory terrorism risk coverage.

Following TRIA there have been limited reports of substantial premium increases, particularly in Manhattan and Washington DC. For the most part post-TRIA rate increases for required terrorism risk coverage have been in the 0% – 10% range, but some have been much higher.

The terrorist threat is a dynamic phenomenon. Government and commercial response to the threat is also dynamic in ways independent of the underlying phenomenon. For these reasons change is inevitable. More experience is needed to understand the nature of the threat and more time is needed to understand the implications of market and policy responses to the threat.

Key real estate finance industry associations suggest that several factors must be monitored over time:

- The Department of the Treasury rule-making process for TRIA relating to the acceptance and rejection of terrorism risk insurance by owners, and the availability of insurance for acts of terrorism not covered by TRIA.

- The declining financial strength ratings for some insurers that have produced difficulties for borrowers in obtaining coverage that complies with underlying loan documents.

- The development of a useable insurance certificate that provides an accurate and comprehensive summary for lenders and servicers of the coverage afforded by the underlying insurance policy.

What happens after TRIA? It is important to see if the insurance market for terrorism risk cover does in fact stabilize over the three year period stipulated in the Act. If the market does not find an acceptable means to price terrorism risk there may need to be a longer term federal role in this area.

LENDER RISK MANAGEMENT MODELS

As mentioned above the traditional practice of lenders has been to rely on required insurance purchase by borrowers of adequate cover for relevant perils. The breakdowns in terrorism insurance availability and risk pricing by insurers have necessitated the temporary intervention of the federal government pending the stabilization of the insurance market. Lenders are dependent on the insurance industry to transfer terrorism risk. In lieu of an insurance solution the real estate finance industry will have to consider alternative approaches to terrorism risk management. These may include addressing questions of risk identification and risk reduction directly. Tools for the assessment of terrorism vulnerability of specific buildings may be developed and introduced into the standard process of due diligence and property condition assessment, as discussed further in Chapter 5.

Each sector of the real estate finance industry (originators, servicers, secondary markets, and bond markets) may assess its exposure to terrorism risk in a particular way. Useful analogies may be found in considering how these sectors address other building risks, such as natural disasters and environmental hazards.

Each sector of the real estate finance industry should also consider terrorism risk in relation to the risks traditionally covered by the various lines of insurance.

As standards for building siting, construction, and property management are developed to address terrorism risk reduction, it will become possible for both insurers and lenders to rate buildings in terms or their exposure to terrorism.

FUTURE DEVELOPMENTS

The real estate finance industry needs tools for the evaluation of building vulnerability and for the evaluation of physical and operational measures for risk reduction. These include:

- Rapid screening methods for the evaluation of portfolios of properties
- Detailed guidelines for due diligence on individual buildings
- Legally accepted standards for risk reduction measures and management practices related to terrorism risk