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INSURANCE

Downsizing coverage

Commercial building owners fight rising premiums by insuring for less than property values

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Commercial building owners facing skyrocketing property insurance premiums for limited coverage in South Florida have found a money-saving tactic — covering only likely hurricane damage instead of a building's full value.

Owners calculate so-called probable maximum loss (PML) by weighing a percentage of a building's replacement cost plus its age, location and construction to determine potential structural damage in a major hurricane. The owner then insures only for that amount.

"Think about it. In the event of a windstorm, your whole building doesn't go down," said Mary Dubas, investment director for Principal Real Estate Investors, a subsidiary of Principal Financial Group in Des Moines, Iowa. The investment firm makes $500 million in commercial property loans annually in Florida.

Dubas and others figure insuring based on probable maximum loss is a win-win for everyone. Property owners get a price break, insurers absorb less risk, and lenders who accept the logic won't declare owners in default for failing to have coverage on full building values.

"I guarantee there is a good portion of loans that are in default right now," said Manny Chamizo III, commercial director for Fortune International Realty in Coral Gables. "Lenders are going to have to allow borrowers to take a bigger portion of the risk. Five percent deductibles aren't affordable anymore."

Skylake 1380 Ltd. negotiated with its lender for a higher deductible and a break on the required insurance amount when it paid $10.7 million for the Skylake Professional Plaza building in North Miami last month, Chamizo said.

But even that wasn't enough.

Chamizo, a former insurance broker, ended up spreading the coverage risk among state-run insurer Citizens Property Insurance, Firemen's Fund and Lloyd's

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Manny Chamizo III says lenders will have to allow building owners to cut insurance coverage to affordable levels.

of London to obtain $7.5 million in coverage.

The price tag was $187,000 on coverage that would have cost about $46,000 two years ago. The 65,000-square-foot building had no previous storm damage but is located in the eastern part of Miami-Dade County and predates the tougher building codes approved after Hurricane Andrew in 1992.

A prior insurance carrier for seller HHH Ltd. gave an informal quote of $250,000, Chamizo said.

"This is a textbook case of what can happen when the market hardens," he said.

Throughout South Florida, property owners, lenders and insurers face similar balancing acts.

At Principal, Dubas said the company weighs its borrowers' needs with the security requirements of its funding sources.

Using probable maximum loss, "you might get wet and have tenant-improvement costs, but you won't lose garages and concrete footings," Dubas said. "We're new at it, but the PML might be 5 to 35 percent of reproduction costs."

Principal recently calculated the expected maximum loss on a Boca Raton office building at 20 percent of the building's $50 million value. She declined to identify the building or owner.

The owner was able to obtain $10 million in windstorm coverage for the building, but the fire and casualty coverage was more than twice that at $23 million.

"We came to the conclusion that $10 million of windstorm coverage is OK," she said. "Most lenders in their loan documents have language that says insurance must be acceptable to the lender. It doesn't say that the building's wind or fire or casualty insurance coverage has to be 100 percent of its value."

If lenders truly required insurance coverage equal to building values, they would have to declare too many property owners in default for inadequate coverage right now, said developer and broker Barry Ross, president of RossMatz Investments in Davie.

Though Ross uses PML to estimate coverage on individual buildings, the company's 15 properties totaling about 2 million square feet of space are covered under a blanket policy.

"How likely is it that a Category 5 storm will wind its way to every one of our properties?" he asked. "We spread the risk differently."

Even so, RossMatz's premium for $130 million worth of property jumped from $750,000 last year to $3.5 million this year.

On the other hand, developer Malcolm Butters of Butters Development and Construction in Deerfield Beach has a $100 million blanket policy with an undisclosed national insurer.

When the insurer said it wouldn't cover Butters' new 35,000-square-foot office warehouse building at the Lyons Technology Center in Coconut Creek, Butters used PML estimates with lender Wachovia and the insurer to convince both that less insurance would be just fine.

"We were able to convince them that on a $3 million loan, we only needed $1.6 million of insurance," Butters said.

Butters figured the building's windows and rooftop air conditioning units would fail in a Category 4 or 5 hurricane, but the tilt-wall construction would stand firm. Furnishings are minimal because the building has only 20 percent office space.

A Wachovia loan representative who handled the deal didn't return phone calls by deadline.

Old concept

PML is hardly new, Principal's Dubas said.

The tactic has been used in earthquake-prone areas of California for almost two decades. Insurers and lenders there use PML and seismic tests to calculate quake damage similar to hurricane modeling here.

On big commercial accounts, PML is used to figure the combined risk to a client's property portfolio, said Gary Van der Voort, area chairman of Arthur J. Gallagher in Miami, one of the state's largest insurance brokerages. It bills itself as the fourth-largest worldwide.

"An owner with 10 buildings in Miami that are all the same used to be viewed as good because it was a better spread of risk," he said. "Now it's worse because all 10 will be expected to be hit in a Category 3 to 5 storm."

Owners with properties spread across several counties used to be considered better risks.

Now "the carriers figure it'll be a heavier hit on that account anywhere in Florida," Van der Voort said. "We have a few accounts with substantial losses in each of the last seven storms because they have property all over the state."

Still, he offered some solace.

The insurance market will cool if more wannabe storms like Ernesto fizzle, he said.

"If we go a whole year without a storm, things at least will level off," he predicted. Though insurers will see unprecedented profit after unprecedented losses the last two years, it'll become easier to get insurance. Rates may not drop except for large clients, but they're not likely to keep rising so rapidly.

"After a second year without losses of any major consequence, it'll generate more competition," Van der Voort said. "That starts to lower the prices."

Ernesto, which turned out to be a weakling of a storm, was really a good thing, he said. ◆

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