



Risky Business

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By Paul Rosta, Contributing Editor

Along with widespread misery, the recession has brought multifamily owners a few small benefits. Insurance premiums costs, to name one category, have fallen across the board. In its annual “Apartment Cost of Risk Survey,” published last November, the National Multi Housing Council found that the average cost of property insurance—which accounts for almost three-quarters of the typical owner’s insurance outlays—slipped 5 percent from 2007 to 2008.

Premiums in other categories have also dropped, according to the NMHC study. General liability premium costs fell from \$42 to \$36 per unit year-over-year, an average 14 percent decline. And worker’s compensation costs slipped 10 percent as deductibles were rising 20 percent. It is probably too soon to tell whether the decline will continue at the same pace this year, but owners are unlikely to experience a spike in rates any time soon. “The insurance industry has continued to soften,” notes Kathleen Felderman, managing director and national real estate practice leader for Aon Corp.

Welcome as those price cuts are, determining the right scope and limits for coverage is as complicated—and as vital—as any decision an owner makes. Insurance brokers, lenders, equity partners, and even Fannie Mae all have their say, but in the end, the owner must make the call. Sorting out risk management issues can leave even the most experienced and well-intentioned owner somewhat bewildered. The complexities of insurance policies can tempt risk managers to make cost the deciding factor. But, according to veteran insurance executives, trying to cut costs by skimping on coverage limits is itself risky business.

“Some owners just look at the price and don’t really understand their coverage,” contends Bob Landis, senior vice president and director of asset management for Raymond James Tax Credit Funds. The affiliate of Raymond James syndicates financing for multifamily projects that qualify for tax credits. Landis contends, “You have to be really careful, or you can get burned pretty [bad].”

As part of his fiduciary responsibility to the investors he represents, Landis must keep his eyes peeled for anything that might threaten a property’s eligibility for tax credits. If an under-insured property gets hit by a fire or a natural disaster, for example, its value to the investor would drop if an insurance policy falls short of covering replacement costs. Late last month, Landis sent out form letters to the local general partners in several affordable housing developments around the country. The correspondence, which Landis characterizes as friendly reminders, will let project owners know that their coverage could be falling short.

Insurance and risk management strategies, like most components of property management, must be tailored to each asset’s situation. Adding to the challenge are the multiple layers of factors. Climate

and geography tell much of the story—potential exposure to hurricane damage on the Gulf Coast or earthquakes on the West Coast, for example. Those hazards shape local building codes that evolve over time and introduce further nuances.

Layered on top of those factors are the expectations of lenders and equity partners. Fannie Mae strongly influences insurance strategies through its requirement that insurance for property damage maintains a \$25,000 deductible for each event.

To illustrate the nuances of figuring out the right levels of property management coverage, Felderman likes to cite the hypothetical example of a Los Angeles apartment community built in 1990. Since then, the earthquake-prone city has continued to fine-tune its building codes in the wake of a devastating 1994 temblor. If this 1990-vintage building were partly damaged by fire or other disaster, the insurance policy would presumably cover the cost of those repairs.

But there is a twist. Besides repairing the damage caused by the fire, the owner would also be required to retrofit the community to current city codes. Those standards have changed during the two decades since the property was constructed. Felderman poses a pointed question to the owner of a property in this situation: is the policy's limit high enough to pay not only to fix the damage, but also to bring the undamaged part of the building up to code?

Sharing the risk

Among the standard categories of insurance—property damage and owner liability for harm to residents, for example—some new trends are taking hold. A growing number of owners are requiring applicants to carry renters insurance because a standard policy includes liability coverage. That provision protects owners against damage or injury that may be caused by the resident.

In 2007, 24 percent of owners surveyed by NMHC required the coverage. One year later, that percentage had nearly doubled to 44 percent, and though 2009 figures are still being gathered, risk-management professionals believe that the number of owners mandating coverage is still on the rise. Standard limits are \$50,000 or \$100,000. Whether the shaky economy is influencing applicant decisions on this front, the mandatory liability coverage does not seem to be discouraging residents. "If anything, it's helped the take rate," asserts Steve Hein, vice president, Assurant Specialty Property.

Although determining insurance coverage policies can be a daunting task, property managers have more power to reduce their risk profiles—and insurance premiums—than they sometimes exercise. Aon's Felderman sees plenty of room for improvement in this area. "Many companies aren't doing the basic blocking and tackling," she argues. Too often, she says, owners of multifamily assets, as well as other real estate property types, overlook risk-management fundamentals. One obvious step, Felderman says, is having a good property management manual—and using it. And nothing beats walking the property regularly. By wearing out some shoe leather, the property manager dramatically raises the odds of catching and eliminating potential sources of damage, disaster and injury. Safety steps can be as simple as putting the kibosh on the use of grills on outdoor balconies. "That's going to play well with insurance companies," Felderman relates.

Some innovative insurance products are intended to ease the impact of the struggling job market on residents and owners. One option recently added to renters insurance provides a temporary rent subsidy in case a resident is laid off. In early 2009, Dallas-based Riverstone Residential teamed with Security Properties and its insurance partner, Assurant Specialty Property, to introduce its Pink Slip

Protection program. Riverstone residents may buy coverage that picks up a major share of the rent payment for up to two months if the resident becomes unemployed. Helping residents stay in their units through a tough time can also benefit owners by enhancing occupancy, asserts Hein of Assurant Specialty Property. “We’re making it more affordable for residents, reducing turnover,” he says. Although the program is still too new to draw comparisons with previous cycles, Hein reports that the Pink Slip program is winning a favorable response from residents and ownership alike.

Although risk management is usually associated primarily with insurance, other innovative strategies to reduce owners’ financial exposure are emerging. One such area is security deposits. In many markets, higher vacancy has led owners to slash deposit levels, greatly reducing their value as risk-management tools. During the recession, an alternative has gained momentum. Rather than making the resident pay a security deposit, the applicant has the option of purchasing a surety bond.

Unlike a deposit, the bond is non-refundable. The tradeoff for the applicant is that the bond costs only a fraction of a conventional deposit, which can influence an applicant’s decision about when—and even where—to move. “The biggest [concern] to the resident is, ‘How much does it cost me to move?’” notes Rich Schreiber, president of Livingston, N.J.-based SureDeposit, which has provided surety bonds to more than 4,000 multifamily rental properties, encompassing some 1 million units. “For as little as \$85, top-rated applicants can buy a bond instead of paying a \$500 security deposit. A price discount that deep encourages residents to move earlier than they might have otherwise,” Schreiber explains. That, in turn, will start the flow of rental payments sooner.

The service works in conjunction with all major resident screening services and the cost of the bond is adjusted to match the applicant’s credit. “We don’t want customers to change their screening of applicants,” Schreiber explains. An applicant with a less than first-rate credit record might be offered the opportunity to provide some cash along with the security bond. Since the bond is offered as an alternative, the conventional security deposit can be raised to market levels. If the resident defaults on rent payments, SureDeposit promptly reimburses the owner for the value of the deposit. Schreiber reports that the recovery rate in cases of default is up to 300 percent greater than it is for conventional security deposits.

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