

Terrorism and Community Association Insurance

In the wake of the terrorist attacks on America September 11, much has changed in the world, including the insurance industry. Shock waves are rippling throughout the global industry, and losses from the incident will cost insurers an estimated \$40 to \$70 billion. (In past large catastrophe losses, early industry estimates have typically proven to be too low.) By

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comparison, Hurricane Andrew, previously the worst disaster in American history, cost the insurance industry \$19 billion.

What effect will these attacks and possible future attacks have on community association insurance? This is a huge question without a definitive answer at this

point. While the ultimate impact is uncertain, market analysts are forecasting a broad range of what to expect, with premium increases anywhere from 30 percent to 300 percent.

Market relationships, line of business, risk evaluation and control, brokerage expertise, and reinsurance costs and capacities will undoubtedly play significant roles in determining whether premium increases are on the low or high side of the current forecast.

In any event, it is relatively certain that community associations will feel the impact of these terrorist acts to a degree yet to be determined and should budget for higher premium levels and deductible expenses.

What was happening in the insurance industry before the attacks?

Prior to September 11, the insurance marketplace was going through a fundamental change that was causing community associations to pay more for insurance. Insurance companies are not non-profit organizations—they must make money, either by investment income or underwriting profit, to remain



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financially viable. With return on investments continuing to diminish, combined with increased expenses and adverse loss experience, insurance companies have been forced to focus on underwriting profit.

Until September 11, the property and casualty insurance industry continued the expected transition to a hard market in a predictable fashion. This was characterized by a diminishing number of companies offering coverage for multi family residential buildings, including community associations, and those continuing to provide coverage tightening underwriting guidelines and increasing pricing and deductible levels.

The market was “hardening,” which means that insurance premiums were on the rise. Higher premiums and deductibles, more coverage exclusions and limitations, and fewer market alternatives characterize a hard market.

The terrorist attacks of September 11 abruptly ended the transition. The market is now “hard.”

What is happening in the industry now?

The commercial insurance industry is clearly one that will never be the same. It has been forced to reexamine the way it analyzes risk.

Prior to September 11, insurers and reinsurers typically did not consider terrorism as a part of their underwriting process. Since the essence of insurance is providing coverage for a *known* risk,

the uncertainty inherent in terrorist acts makes insuring against them nearly impossible. Models to price the risk with confidence simply are not available, and the company that makes the wrong guess would be ruined.

The bottom line of this uncertainty will be higher reinsurance costs and likely coverage exclusions and limitations specific to acts of terrorism.

What is reinsurance and why is it important?

In order to protect their financial situation, insurance companies buy their own insurance for the policies they write. This is called “reinsurance.” Reinsurance costs have been rising significantly for nearly two years. As insurance companies attempt to maintain an already fragile underwriting profit level, a substantial portion of this increased expense was passed on to the consumer.

The terror attacks have already caused a tightening of the reinsurance market, and primary carriers will likely pass increased costs to their policyholders. Reinsurance capacity problems could drive prices even higher and necessitate more restrictive coverage.

The bottom line is that future insurance premiums and coverage will rest in large part upon the decisions of reinsurance treaty renewals effective January 1, 2002, and decisions made in Washington to develop a terrorism reinsurance program. Many insurance companies are now in the process of negotiating reinsurance terms,

and costs for treaty renewals effective January 1. Indications at this point are that increased costs could be dramatic, and increased exclusions and limitations, including terrorism, should be expected.

What are the insurance implications of the attacks?

The insurance ramifications of the disaster are far reaching. The insured loss will be spread among hundreds of insurance and reinsurance companies around the world. Losses will come from various coverages, including the following:

- **Property and liability losses** sustained by the insurers and reinsurers of the airlines, the World Trade Center, surrounding buildings, and tenants of the buildings;
- **Worker’s compensation coverage** for injuries sustained by workers in the World Trade Center, the Pentagon, and other surrounding buildings;
- **Auto insurance** losses for cars damaged by falling debris and those destroyed in underground parking garages;
- **Business interruption losses** sustained by the insurers of the businesses in the World Trade Center and surrounding buildings;
- **Property losses for computers, furniture, and other contents** sustained by the insurers of the businesses in the World Trade Center and surrounding buildings;

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- **Contingent business interruption insurance** for the general “interruption of commerce” these acts caused other businesses;
- **Potential liability exposure** for the insurers of the World Trade Center and surrounding buildings for not promptly evacuating all employees;
- **Directors and officers claims** that could arise from otherwise uninsured business losses;
- **Life insurance claims** associated with the tragedy; and
- **Homeowners property damage** for damage to personal property and any condo/co-op properties in the surrounding area.

The U.S. property casualty insurance industry has about \$300 billion of surplus (equity capital), so the losses associated with this event do not threaten the solvency of the industry.

“Ask the Expert” is a regular column in *Insurance Focus*, featuring an interview with an expert about an important insurance issue facing community associations. This month, our expert is Donald S. Malecki, CPCU, chairman of D.S. Malecki & Associates, Inc., an insurance and risk management consulting firm. He has 42 years of experience in the insurance and risk management field and is the author and co-author of nine books. He can be reached at 513-451-4210.

Q: What is going to happen in the wake of the attacks on the World Trade Center and the Pentagon insofar as policy exclusions are concerned? Is there likely to be an expansion of the war risk exclusion to encompass terrorism, or will creative development of separate acts of terrorism exclusions be more likely?

A: It is entirely possible that the war risk exclusion of property, marine, and liability policies could be expanded to include acts of terrorism, given that these war risk exclusions are not limited to war-like actions. Closer scrutiny of these exclusions reveals that many also preclude coverage for insurrection, rebellion, revolution, civil war, usurped power, and actions taken by governmental authority in hindering or defending against these.

However, the drafting of separate exclusions for acts of terrorism and inserting them by endorsement may be seen by insurers as being more practical and expeditious than having to revise their war risk exclusions. This approach also can give insurers some underwriting latitude, depending on the nature of the risk and its loss prevention and reduction

attitude. It may thereby enable insurers to make a charge for not adding the exclusion, unlike the war risk exclusion, which automatically applies every time a policy is issued.

While insurers are not likely to meet with objections by the insurance buying public over the insertion of these exclusions, they may be challenged where exclusions are attempted before some federal reinsurance program has been implemented, particularly now when terrorism is a reality on American soil.

Another problem confronting insurers is not to draft overly broad exclusionary wording. What the drafter needs to ponder, in part, is this: What is terrorism and when does an act constitute terrorism? The history of terrorism and the means used to put people in the state of fear, internationally, shows that terrorism is not easily defined.

In the final analysis, a terrorism exclusion in property and other policies is inevitable. How it will read, what it will encompass, and whether it will be implemented in every instance—only time will tell.

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Insurers say the claims from the September 11 attack will be paid in full. However, the fear in the industry, the Bush Administration, and Congress is that a subsequent attack could severely strain the industry by depleting industry capitalization and reserves and threatening the viability of a large number of insurers.

What should community associations do?

Community associations in general, and especially those with significant property values, should expect to feel the impact of these terrorist acts and budget for higher insurance premiums and increased deductible expenses.

Community association board members and managers should define their insurance and risk management needs, ideally by working with an insurance professional knowledgeable in establishing insurance goals, and perhaps with their attorney and accountant. Now is an ideal time to voluntarily consider higher deductibles, not only to mitigate premium increases, but as an affirmative action to reduce claim activity and maintain continued insurability in the standard insurance marketplace.

Does risk management matter?

Risk management and loss control are serious considerations for any insurance company. Loss history is of great concern to an insurer, especially with large numbers of small losses. The community association that can show an insurer a serious effort at pinpointing

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potential risks and controlling exposures, such as by eliminating or transferring them or by increasing deductibles, makes a better insurance impression.

As deductibles increase, whether by choice or insurance company mandate, so does the potential out of pocket expense for the association. Affirmative risk management to effectively mitigate this exposure is imperative to protect the financial integrity of the association.

Also, all community associations should have a disaster plan that identifies and quantifies the physical and financial resources necessary to maintain operations after a disaster. The plan details the steps necessary to avoid, reduce, or transfer loss exposures. This disaster plan should include a section on how to respond to terrorism. For more information on how to plan for disasters, please see the Emergency Preparation newsletter in the "Publication Library" section of our web site at www.usicondo.com.

What's the bottom line?

In times of uncertainty, community association board members and managers should carefully consider the advice of the insurance agent and/or company with which they work. The professional insurance agent can provide risk management advice to help plan for premium and/or deductible changes and suggest the best way to deal with current events. If you have any questions, please contact Steve Dickerson (703-739-2346 or sdickerson@usisoutheast.com) or Doug Thompson (703-739-2341 or dthompson@usisoutheast.com).

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