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WARNING!!!**Drastic Changes in the Earthquake Insurance Marketplace Will Bust Your Clients' Budget!****Ernie, are you prepared?**

Ernie Langston
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Dear Ernie,

Things are rocking and rolling in the earthquake insurance market place right now due to major structural changes about to take place. As a result, you and your clients could be in for a bumpy ride with budgets busting at the seams if you do not start getting ready to act now. I don't need to tell you that your associations are already under significant financial pressure as it is, due to current financial hard times. You know better than anyone, living with it, dealing with your clients' problems day in and day out. The good news is that with a bit of forethought and some creative professional help you can minimize or avoid much of the pain that these new developments will bring to those caught unaware.

Here is the problem:

The insurance rating agency, A.M. Best, is under enormous pressure right now to clean up its act and toughen its scrutiny of insurance companies. This came about because A.M. Best, the agency that tells us the financial strength of insurance carriers, made several bad calls recently, most notably the failure of AIG. As a result, A.M. Best is now doing things differently and the ratings should become more dependable and therefore more credible to all that rely upon them. Now, in the end this overhaul of A.M. Best will be a good thing. However, in the near term certain insurance companies will be forced to make many changes in how they do business in order to maintain their current A ratings. These changes will cause shrinkage in availability, which in turn will drive rate increases.

Companies offering catastrophe insurance will be the most widely affected by this latest turn of events. A.M. Best is going back to these companies and telling those that are over extended that they need to increase their reinsurance, decrease their catastrophe exposure or face being downgraded. With the unhinging of AIG, the reinsurance that is available for catastrophe insurance companies has shrunk and that which remains is significantly more expensive. This being the case you can be assured that companies are going to be canceling risks and reducing their exposure on the larger risks. With the basic law of supply and demand with demand staying the same and supply shrinking the prices will rise.

What does this mean for your association?

The pinch will be felt the worst by those associations that are built on bad soil, older buildings, and very large associations.

Let's take a closer look at each scenario and how to mitigate problems for each possible situation;

Large Associations

These associations are going to have a special set of problems they need large amounts of earthquake insurance and it takes multiple insurers to provide full limits of coverage. The portion of the insurable value that falls within what insurance companies call Probable Maximum Loss (PML) will be much more expensive and each company will be willing to put up significantly less of this type of coverage. This will be most problematic for associations who insure the 'old school' way with a traditional policy with a 10 to 15% deductible and purchase the full remaining building value behind it. Due to the hardening of the market, this method of insuring large risks will become hard to place and prohibitively expensive.

Think back to the year after Katrina and you get an idea of what is to come. For the portion of the value that fell within the probable maximum loss carriers were offering the paltry sum of only 5 million or 10 million of coverage. That meant that you had to add additional carriers that were significantly more expensive than what you previously were paying per million of coverage. Not only that, but to add insult to injury, those carriers that you previously were using cut the amount that they were willing to offer.

Here's what will happen if things play out. Let's say you have an association with a \$40 million insurable value and the building has a 30% probable maximum loss therefore you have \$12 million inside of probable maximum loss and \$28 million outside of probable maximum loss. Now suppose this past year you had 3 insurers that covered the whole risk (the first layer taking 10 million, the 2nd layer taking 10 million, & then a 3rd layer taking the balance, or possibly a 2nd carrier taking \$32 million). All bets are off this year. Most probably you are now going to need 4 or 5 carriers to get the very same coverage and the cost will be significantly higher than the previous 2 or 3 layer structuring.

So, what can you do if faced with this situation?

We have come up with a creative but very feasible solution to this problem. The trick is finding a way that will allow you to purchase as little coverage as possible within probable maximum loss from traditional insurers. The larger the portion of the risk the association retains starting with dollar one the cheaper the premium will be. The portion of the risk that the association retains can be offset by each individual owner purchasing Loss Assessment Coverage from the CEA. Each owner can purchase up to \$75,000 of this coverage.

Let's take a 200 unit complex with an insurable value of \$40 million located in the San Fernando Valley. The cost of all of the owners purchasing this coverage will run $\$300 \times 200 = \$60,000$. For that you have just picked up the \$10 million of coverage. This \$60,000 should be significantly cheaper than what the association will be paying for \$10 million of traditional commercial insurance. The association now only needs to purchase \$30 million of coverage. Now, assuming it was built after 1976 and that it has a 30% probable maximum loss or less, which is the norm for this type of building, the association will need to purchase \$28 million outside of probable maximum loss and \$2 million within probable maximum loss to insure the balance. Whereas currently you might only need one company to insure the whole \$28 million, now you will need two or three insurers to insure the full value. The good news is that the cost outside of PML should stay fairly stable so you might be paying \$1,500-2,000 per million instead of \$1,200-1,500 per million. The total cost for this alternative will only be \$45-50,000 for insurance and another \$60,000 for the owners to purchase the CEA coverage. On the other hand, if you were to insure the traditional way with much of the premium left inside the PML you could end up paying as much as \$150,000-\$200,000 for the same amount of coverage.

Smaller Associations

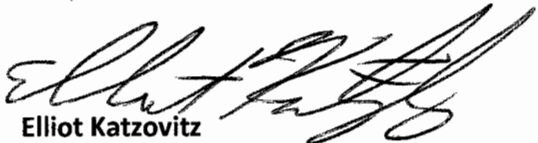
Unfortunately smaller associations that are located in areas that have problem soil like Santa Monica will see coverage availability dry up again, like it did after Katrina. When the most competitive carriers hit their capacity in your area and are unwilling to write new business or renew the business they have already written you need to find a new carrier. Most agents are going to be forced to a) tell you they can't find you coverage or b) offer you an outrageous Lloyds of London proposal. Given the inflated premiums that Lloyds charges it amounts to basically the same thing both ways and you are left between a rock and a hard place. Luckily, there are a couple of high quality specialty markets available for risks such as this. An example of this is the CIBA program which has been around since 1993 and which utilizes the underwriting facilities of only the most stable and financially secure carriers available. Programs such as this will not only still have capacity when others have hit their limits, but will also be significantly cheaper alternatives to Lloyds of London. Your typical Farmers or State Farm agent will not have access to any of these programs. As an independent broker, we can provide a safe haven from all the madness by offering such programs that will not bust your budgets.

For those that suffer from soft story construction there is very little we can do. If the building is of decent quality on good ground or has been retrofitted to meet earthquake codes, then as a specialist we will be able to negotiate coverage where others cannot. To aid in this negotiation we made need a PML study done to show how much exposure really exists for the association. By painting the association in the best possible light we might be able to get coverage where otherwise it would be declined.

We take our duty as your broker and risk manager seriously and therefore wanted to make sure that you are made you aware of this potential crisis before you are blindsided. As specialist in earthquake coverage we are prepared to assist you in helping your associations maintain their budgets and continue to creatively contain costs in these difficult economic times.

Please call me with any questions or concerns you may have (310) 945-3000.

Best Regards,



Elliot Katzovitz
CEO Elliot Katzovitz Insurance Agency, Inc.