US Real Estate & Hospitality Market Update

FALL/WINTER 2023

Gallagher

Insurance | Risk Management | Consulting

Introduction

Will 2024 be an improved year for insurance operating expenses?

That's the common question owners, investors, developers, and managers are asking when it comes to the continued premium rate hikes impacting commercial real estate. The answer is complicated and it's a function of higher interest rates luring reinsurance capital to other investments, thus putting pressure on the amount of risk insurers are willing and able to assume. Ongoing weather-related events, including convective storms, flooding, wildfires, and freezes, coupled with third-party litigation funding, have driven up the cost of property and liability insurance. The hardest hit are the Tier 1 states, California, and traditionally wood frame asset classes. Liability claims for multifamily, student housing, SFR, and hospitality continue to accelerate as well.

So what can be done to contain expenses?

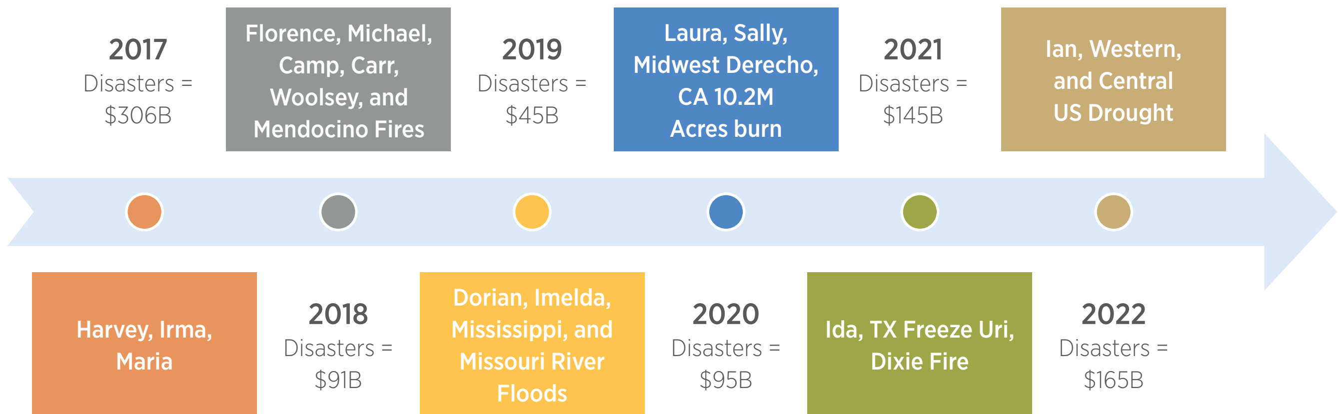
Clients are exploring captives, alternative risk transfer vehicles (pre-funded property and liability deductibles), utilization of reinsurance, specialty facilities, reduction of property catastrophe limits, and negotiations with lenders to accept higher deductibles. Everything and anything is on the table and we believe all options should be identified and explored.

The following market update is intended to give a snapshot of the trends we are seeing around the country. Every risk is different and the loss history, quality of the assets, and management's engagement in operations all play a material role in the outcome. We welcome your thoughts, questions, and comments.

PROPERTY

Similar to the real estate market, the insurance market is cyclical. Historically, difficult insurance markets last roughly 2–3 years before the pendulum swings the other way. However, what started as a firming property market in 2017 has proven to be a difficult six years. The period 2017–2022 has shaped what we expect insureds will encounter for the remainder of 2023 and into early 2024.[1]

How did we get here? US billion–dollar disasters



Sources 2-7

Valuation frustration

Renewal results are directly tied to the quality of information in market submissions. Despite desperate industry attempts to correct pervasive undervaluation, a recent study revealed that 67% of buildings are still underinsured by an average of 64%.[8] Inadequate insurance to value is magnified by natural disasters as multiple (re)insurers end up paying billions of dollars, to reconstruct thousands of buildings, at values they never charged premiums for, all at once. Insureds can expect valuation to be front and center in renewal discussions for the foreseeable future. Real estate insureds should be prepared to provide rent rolls to substantiate business income values. Perceived undervaluation invites coverage restricting terms and conditions such as Actual Cash Value, Margin Clause, and Occurrence Limit of Liability Endorsements.

Deductibles

Underwriters continue to apply upward pressure to all types of deductibles. Coastal Tier 1 Wind–exposed assets can expect percentage deductibles as high as 10% to 15%. In the Midwest and South Central, where wind/hail deductibles of 1%–2% are now standard, we have observed insurers pushing hard for increases. In the most loss-prone geographies, like North Texas, we have seen values as high as 3% and 5%. $150k to $250k Water damage deductibles for mid- to high-rise buildings should be expected. Insureds who take advantage of water leak mitigation technology might aid their broker in negotiating the lower end of this range.

Rates

Property rates continue to rise, especially for challenged asset classes like multifamily and hotels. Double-digit rate increases are still prevalent and most severe for CAT-exposed assets with loss prior history. As restrictive underwriting continues, more and more insureds are finding themselves in the excess and surplus lines market. Additionally, more insurers are required to meet the desired capacity of programs. Both of these changes come with added costs.

Builders risk

Wood frame construction continues to be in the most challenging pocket of the market. Underwriters are demanding strong site security measures to mitigate the possibility of loss.

CASUALTY

The national casualty market has been relatively stable throughout 2023. While we still observe rate increases, overall market conditions have become more predictable and less volatile. We have observed the most change in the umbrella/excess liability lines of cover.

Rates

Susan Patelson, Casualty Leader for Gallagher's Real Estate & Hospitality practice, noted that loss-free insureds with strong risk control practices in place can expect underwriters to push for rate increases in the range of +1 to +5% on primary general liability lines. Certain habitational asset classes, like multifamily and hotels, are likely to experience rate increases above this range. Additionally, insured with losses or insureds who are located in historically difficult legal environments like the five boroughs of New York, Georgia, California, and Illinois are also likely to see rate increases exceeding +5%.

Coverage limitations

Underwriters have expressed virtually zero tolerance for loss activity when it is related to violent incidents. Casualty underwriters continue to push for exclusions related to assault and battery, where crime is an issue. Furthermore, we have observed increased pressure for exclusions related to inhabitability claims, and, in some cases, construction activity such as renovations.

Umbrella/Excess capacity challenges

During the past 3 years, we have watched the capacity for umbrella/excess liability coverage dwindle from $25 million to as low as $5 million. We have observed that most lead umbrellas now require 2–5 carriers in lieu of 1. Building umbrella/excess towers with smaller tranches of capacity can help mitigate future cost increases. Moving carriers around the tower to positions where their pricing is most efficient becomes easier.

Driving factors

Economic inflation has driven up the cost of medical procedures and treatment, which contributes to higher claim totals. Third-party litigation financing continues to plague liability insurers through social inflation. One study found that between 2019 and 2022, litigation financing grew by 42% as well as the fact that jury awards in excess of $5 million grew by 54% from 2014 to 2021.[9]

MANAGEMENT LIABILITY

Directors and officers liability

We continue to observe soft D&O market conditions. A handful of insurers have signaled that they plan to be even more competitive on smaller risks, such as private real estate, private equity, and real estate advisory firms. Due to these soft market conditions, larger insureds may be able to secure renewals with retentions as low as $100k or $50k.

Errors and omissions

Real estate E&O remains a limited marketplace. However, new entrants are challenging that notion by offering property management, construction management, and development management coverages with more competitive premiums and retentions. Most of these new insurers are only available through the wholesale marketplace distribution channels.

Employment practices liability

The market for EPL continues to soften, especially for large companies. Several players in the D&O insurance arena have begun offering EPL quotes with lower premiums and deductibles in order to meet budget gaps created by the continued softening of the D&O market.

Cyber liability

While cyber liability has been softening on the back of increased cyber hygiene by insureds, loss activity is beginning to rear its head. Major losses for U.S.-based companies have made recent headlines, with loss totals estimated in excess of $100 million.

ESG

Though the SEC has not released its long-awaited climate disclosure rules, certain jurisdictions, like California, have implemented their own. California governor Gavin Newsom was the first in the nation to enact legislation that requires companies to publicly disclose their greenhouse gas emissions. The bill stipulates that an independent third-party provider must verify the disclosure of both direct and indirect emissions. The law applies to public and private businesses that make more than $1 billion annually and operate in the state of California. While the law does provide for consistent guidance on what disclosures must be made, it lacks specific emissions targets for covered entities.

On the federal level, the Inflation Reduction Act includes several provisions specific to real estate and developers.

- The Energy Efficient Commercial Buildings Deduction (IRC 179D) expands existing tax deductions for developers considering efficient buildings.
- The Energy Efficiency Home Credit (IRC 45L) expanded the existing tax credits for developers constructing efficient housing and multi-family buildings.

Additional tax credits are available for developers and operators who install qualifying renewable energy products, including solar, geothermal, fuel cells, wind, and energy storage.[10]

REINSURANCE

Capital constraints have remained, with limited signs of new capacity entering the marketplace. Existing reinsurers are still facing mark-to-market investment losses as bond prices fall in response to rising interest rates. The relationship between supply and demand for capacity was finely balanced, but overall, buyers managed to secure sufficient capacity. We have seen a gradual uptick in Insurance-Linked Securities (ILS) driven by capital constraints in the traditional market. The issuance of new ILS structures has come with a higher price tag than traditional indemnity pricing.

For casualty lines of business, the treaty market remained calm and logical, similar to the previous renewals completed earlier in 2023. Continued concern surrounding nuclear verdicts is looming over US casualty placements, as well as placements with incidental US exposure.

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[1] https://www.uscriskcenter.com/presentations/ (Global Economic and Geopolitical Risks: Trends and Challenges Impacting Insurance and Reinsurance Markets 10/15/2023).

[2] https://www.climate.gov/disasters-2017

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[4] https://www.climate.gov/news-features/blogs/beyond-data/2010-2019-landmark-decade-us-billion-dollar-weather-and-climate

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[6] https://www.climate.gov/news-features/blogs/beyond-data/2021-us-billion-dollar-weather-and-climate-disasters-historical

[7] https://www.climate.gov/news-features/blogs/beyond-data/2022-us-billion-dollar-weather-and-climate-disasters-historical#:~:text=The%20costliest%202022%20events%20were,reaching%20or%20exceed-ing%20%241%20billion.

[8] https://www.kroll.com/en/insights/events/2023/current-trends-property-insurance-valuations

[9] https://www.swissre.com/press-release/Swiss-Re-expects-continued-growth-momentum-for-non-life-reinsurance-risk-adequate-returns-required/29ead249-e7c7-487d-be32-6dc23292b0bb#:~:text=S-wiss%20Re%20expects%20central%20themes,mainly%20by%20inflation%20and%20urbanisation.

[10] https://www.insideenergyandenvironment.com/2023/09/california-legislature-passes-landmark-climate-disclosure-laws-spotlight-on-sb-261/#:~:text=SB%20253%20requires%20companies%20with,and%20experienced%20third%2Dparty%20provider

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