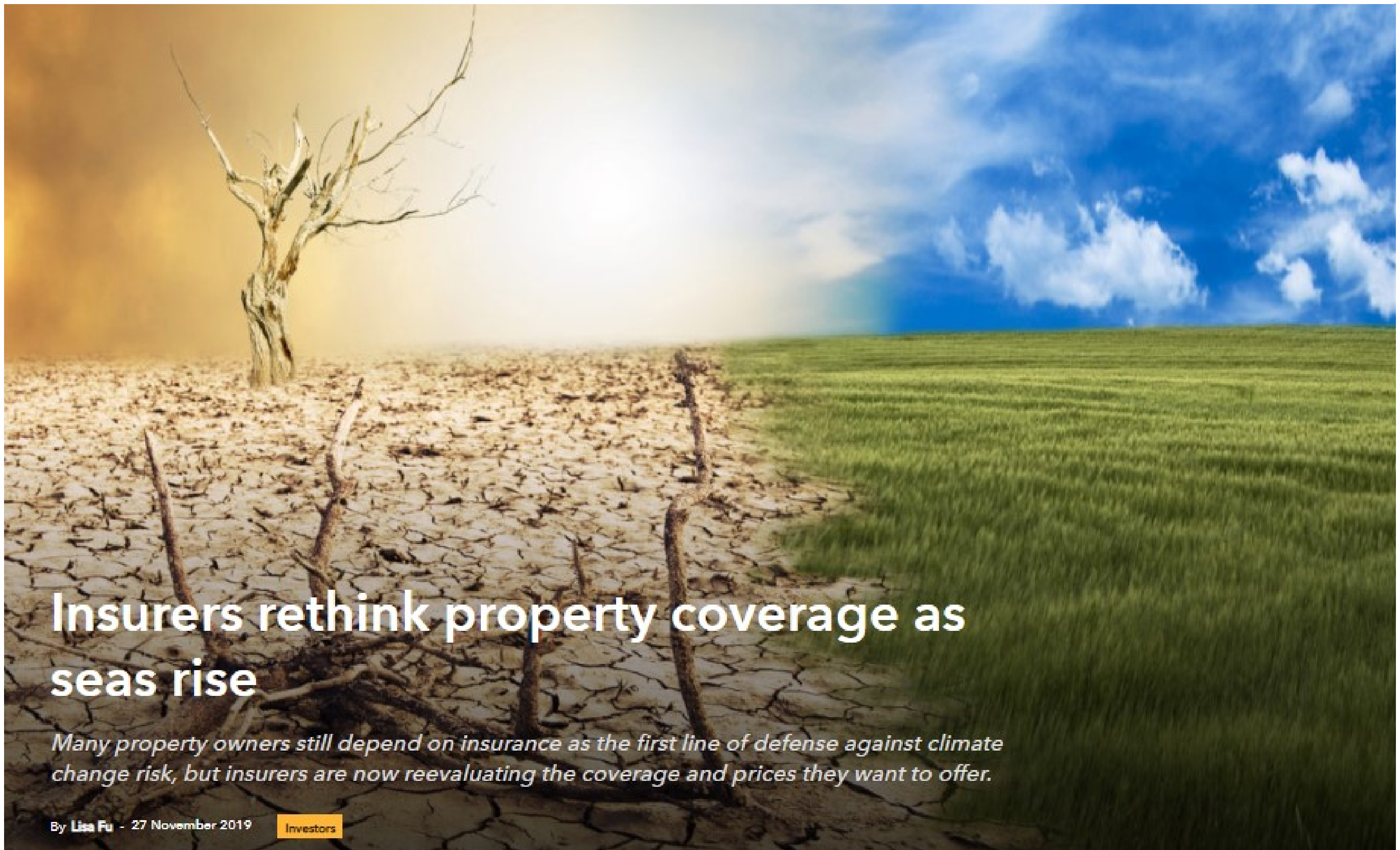

Many property owners still depend on insurance as the first line of defense against climate change risk, but insurers are now reevaluating the coverage and prices they want to offer.

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For many landlords, insurance continues to be the first line of defense against climate change related risk, but insurance companies are now reevaluating premium prices and the coverage they offer amid growing instances of climate disasters globally.

Last week, Venice experienced the worst flooding in more than 50 years, damaging historic architecture and triggering a state of emergency.

Flooding has become a global problem, occurring more frequently than ever before. In Houston, Texas, for example, the last three years have brought on two 100-year floods and one 500-year flood, Mary Ludgin, senior managing director and head of global research at Chicago-based private equity real estate firm Heitman. Even then, she observes many institutional investors and investment advisors continue to depend only on insurance coverage for climate change-driven property damage.

"I think it is important to note that insurance is typically a one-year contract," Ludgin says. "Just because you have insurance today does not mean insurance is going to be available, or at the same rate, as there are more regular instances of flooding or intense storms."

It is also a real possibility, Ludgin noted, that some property types will be considered uninsurable going forward if climate change-related events continue.

Climate change-driven weather events have led several insurance companies to start re-thinking the coverage and prices offered to landlords. Ludgin says she has already observed insurers pull out of provisions of certain types of insurance in certain locations, reducing the field of possible coverage. For example, there have been instances of insurers pulling out of wind provisions for properties in coastal areas.

Insurance costs are also on the rise. Global property insurance pricing increased by more than 10 percent during the third quarter of 2019, up from 3.2 percent property pricing noted in the same period last year, according to a report from global insurance brokerage and risk management firm Marsh.

Piling costs

The financial burden from insurance coverage will be felt by owners of coastal property in particular, according to environmental insurance firm Twin Elms principal Karl Touet.

Insurers Rethink Property Coverage As Seas Rise

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"I think the difficulty is going to be keeping the same rate of insurance," Touet says, recalling how one of his clients took some hard hits from storms and rising waters over the last five years making it difficult for the firm to meet insurance costs. "Even if you do have a good resiliency plan, coastal locations-waterways are going to be one of those properties that are going to have a deeper dive into what actuaries are going to be looking at and what rate companies are going to want so they can remain profitable when they have to pay for catastrophes."

As a precautionary measure, insurance companies will, at the very least, also start requesting storm resiliency plans when considering a client, he noted. This could include programming elevator banks to stop at a higher floor during off hours and storing the power supply at a higher level to mitigate flood damage. Insurer AIG, for example, paid out millions of dollars to cover flood-damage to elevators programmed to sit at the basement level after hurricane Sandy hit New York City, according to Touet.

In addition to rising property insurance premiums and deductibles, landlords will also need to procure environmental insurance – long seen as a "discretionary purchase" Touet notes – in addition to the standard property insurance. Traditional property insurance does not typically cover damages related to mold or pollution. For example, a storm could result in the release of pollution from hotels, hospitals, manufacturing companies and petrochemical refineries near water bodies, and these entities will need environmental insurance to cover any resulting damages. Insurance companies indeed pay large mold claims related to storm events; as an underwriter at AIG, he observed mold claims in hotels totaling more than $10 million-$25 million for example.

"[Landlords] have to think about what coverage they could get and what coverage carriers can provide," Touet says.

Lagging migration patterns

Though insurance costs are rising, few property owners are thinking about taking drastic action and moving away from the coast, since they still need to follow tenant demand, according to Elizabeth Krol, national client manager at engineering, environmental and energy consulting firm Partner Engineering and Science. Krol provides environmental and physical due diligence services for real estate transactions.

"Although some institutional investors are inquiring about climate risk, for the majority of property investors, coastal CRE is their goal, regardless of potential climate change impact," Krol says.

However, some institutional investors that Krol works with have asked her firm to add a resiliency component to the property condition assessments made on their target acquisitions.

Real estate investments continue in high risk areas because individuals and corporations have yet to shift their locational patterns, agrees Ludgin. However, real estate managers and investors are rarely as nimble as the tenants. When evaluating climate change risk, for example, Heitman considers the term of its own hold plus the long-term hold of the next asset buyer, which adds up to around 15 -20 years, according to Ludgin.

"We're urging our clients to understand the exposure to sea level rise in their portfolio," she says. "What their exposure is to wind, hurricanes, heat and access to fresh water."

While property insurers are thinking about mitigating risk by increasing premiums and limiting coverage, the real estate industry has yet to find an alternative line of defense against climate change risk. The challenge is also how investors and their managers can analyse the impact of such environmental issues on returns.

"When we underwrite an asset, we look at an array of income items and an array of expense items," Ludgin says. "When something is off what you're expecting, it eats into the expected return. Any change can have a meaningful impact on the returns."