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## Lender Insurance Requirements

*By Eric Paulos*

We live in an era of bank failures, takeovers and mergers unprecedented since the Great Depression of the 1930s. In California alone, there have been 24 bank failures since 2008, generating net bank losses of \$19.08 billion. The Federal Deposit Insurance Corporation has picked up the bulk of the tab while other banks have sometimes purchased the shares of the failing banks.

California's economy by itself would make the Golden State the world's seventh largest economy. The total amount of outstanding commercial debt held by banks in this state runs into the hundreds of billions of dollars, so it is not entirely unreasonable that banks would be diligent about checking all aspects of their collateral assets, which, of course, brings us back to the topic of insurance.

When a new bank or servicing agent takes over another bank or financial organization's book of business, the new bank will begin its housecleaning operations that were left over from the acquired bank. Regulators nip at the heels of the banks, particularly those banks who have received federal bailouts. The notoriety of the subprime mortgage crisis has placed a heightened focus on loan portfolio review.

Lenders can not unilaterally impose conditions or requirements after a loan agreement is signed, without the borrower's authorization. Despite some lenders' attempts, it is illegal to place any further burden on the borrower or mandate that a borrower insure to a figure higher than the replacement cost of the insured property (not including land value). Be forewarned though that some lenders can adhere more strictly to their minimum coverage requirements if they have a lender-approved building replacement cost survey on file. Another exception arises when a property location has been remapped, as in the example of high-hazard flood zones.

When a lender sends a demand letter indicating the coverage limit, the amount requested may simply be the same limit as what their records showed for the last insurance policy. In some situations the right replacement cost coverage for this year may be somewhat more than the prior year due to inflation factors, or it might be less if the property was over insured. Your independent insurance agent can help you deal with the lender's insurance department if there is a conflict.

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There have been a few examples of bogus insurance requirement letters sent to customers by overzealous lender insurance departments. Wachovia Bank sent letters last year to thousands of their commercial customers, advising that they had to purchase earthquake insurance. Wachovia later recanted the letter, explaining that the earthquake insurance requirement was a mistake. Provident Bank recently sent letters to their customers advising that a \$250,000 flood insurance policy on an apartment building was not enough coverage and that the borrower needed to insure for \$500,000. Non-residential commercial buildings can be insured for \$500,000 in the National Flood Insurance Program, but only a maximum amount of \$250,000 coverage is available from NFIP on apartment buildings. When flood insurance limit requirements go further than the maximum of what the NFIP provides, you are then forced to buy an excess flood insurance policy, and the rates for excess flood insurance policies are astronomical. The bank in this case also issued a letter that apologized for the additional requirement letter, explaining that they had realized after the fact that only \$250,000 of flood coverage is available on apartment buildings.

Berkadia Commercial Mortgage, a division of Berkshire Hathaway, who recently took over Capmark Financial Group, has jumped into the act also. The new bank has sent letters to their inherited commercial client base, advising some of Capmark's borrowers that they now need to purchase earthquake insurance. Their letter basically states that an earthquake insurance policy is required unless the borrower provides the lender with an engineering report showing that in the event of a 7.0 earthquake, the PML (probable maximum loss) would be 20% or less.

The purpose of my article is not to simply criticize lenders and encourage building owners to defy any request that the lender makes. When it comes to purchasing earthquake insurance for example, (and I do not offer this simply because I am an insurance agent), most Californians opt not to purchase coverage even though there is a significant risk that a big California quake could decimate their property. As a statistic, only 12% of homeowners in California carried earthquake insurance in 2008, leaving 88% going without. Although similar statistics are not readily available for commercial property owners, including apartment owners, my guess is that the proportions of those carrying earthquake coverage are probably a small fraction of those that do not carry the coverage. Certainly, if lender provisions that waive earthquake requirements cause the state's financial institutions to lose their collateral assets in a big earthquake, the results would be catastrophic to our economy.

Nevertheless, your loan agreement that you originally signed is the governing document by which your insurance requirements are based, despite whatever new conditions that the bank might try to levy down the line. What a bank's insurance department can do, however, is scrutinize the contract in order to determine if anything prevents the bank from calling for

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additional requirements, which is likely the reason that Berkadia Commercial Mortgage began contacting former Capmark customers to require earthquake coverage.

A knowledgeable, independent insurance agent can help you to parse correspondence that comes from your lender and help you to negotiate with the banks to be sure that you maintain your strongest position as a borrower.

## **About the author**

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