White Paper:
The Rising Need for Wind Deductible Buy-Back Policies in the US Commercial Real Estate Lending Sector

Introduction

The past decade has witnessed a significant escalation in extreme wind events across the United States, underscoring an urgent need for comprehensive risk mitigation strategies within the commercial real estate (CRE) sector. One such strategy that is gaining widespread attention and acceptance is the Wind Deductible Buy-Back (WDBB) policy. This paper takes an in-depth look at the evolving risk landscape, the increasing need for WDBB policies, and the significant implications for commercial real estate lending.

The New Climate Reality: Increased Frequency and Severity of Weather and Climate Events

The National Centers for Environmental Information (an agency of the US government) reports a significant rise in billion-dollar severe wind events disasters in the US where overall damages/costs reached or exceeded $1 billion. According to their data, an average of 18.0 such disasters per year occurred between 2018 and 2022, compared with an average of 13.1 per year and 6.7 per year in the 2010s and 2000s respectively[1]. This points to a systemic change likely driven by factors such as global warming and changing weather patterns.

These intensified severe storm events have led to an unprecedented level of destruction, impacting human lives, businesses, and the overall economy. Since the devastation of the 2017 Hurricanes Harvey, Irma, exacerbated further by natural catastrophe losses causing global economic losses of $275 billion, of which $125 billion were insured (Swiss Re, 20222), commercial property rates have been forced dramatically upwards and risk models have been a re-evaluated. These changes are driving innovation in insurance products, such as WDBB.

The Impact on Insurance and Reinsurance Markets

The increased frequency and severity of weather and climate events have dealt a significant blow to the insurance and reinsurance markets. Insurance companies, facing mounting losses, are grappling with higher reinsurance costs as reinsurers aim to recoup their losses and adjust to higher capital costs.

In addition to weather related insurance losses, the global geopolitical landscape has further exacerbated an already scarred insurance and reinsurance market. The war in Ukraine has led to significant turbulence in the political violence, aviation, and political risk markets with the final outcomes of numerous legal cases and lengthy claims decisions yet to be made. Whilst this may appear unrelated to US property insurance costs, large losses within the wider insurance and reinsurance market reduces the available capital to insurance companies. A reduction in available capital results in increased rates across all classes as capital providers look to protect their financial returns with a reduced capital. The ripple effects of this geopolitical unrest & uncertainty has further compounded the challenges for insurers and reinsurers alike.

The Insurance Response: Narrowing Coverage and Increasing Deductibles

The increased cost of capital, alongside the increased frequency and severity of CAT losses, is presenting a hugely challenging situation. Reinsurers have responded by accepting less risk through increased cedent retentions. This has resulted in insurers seeking higher deductibles on insureds' property policies, particularly for wind perils in CAT exposed territories. This strategy serves to offset some of the losses reinsurers have incurred, ensuring a higher proportion of the risk is retained by the insured.
This shift in strategy has implications for the insured as well. With increased deductibles, the insured is required to bear a more substantial portion of the loss in the event of a wind-driven event, thereby increasing their potential financial liability.

The Impact on Commercial Real Estate Lending

These changes in the insurance industry have had profound effects on commercial real estate lending. Commercial lenders, who rely on the insured property as collateral for their loans, have grown uncomfortable with the increased risk exposure resulting from the higher insured retentions.

Ultimately, lenders need to be comfortable that if the worst happens and a wind events destroys a property with a commercial loan on it, the insured has a sufficient cash balance to pay off the loan. If not, the commercial lender may require insurance policies to transfer this risk. Unfortunately, primary property carriers are unable to offer policies with sufficiently low deductibles.

The Solution: Wind Deductible Buy-Back Policies

In response to these evolving dynamics, Wind Deductible Buy-Back policies have emerged as a promising solution. These policies offer insureds the opportunity to reduce their deductible, transferring more of the risk back to the insurer and providing lenders greater security.

For instance, if an insured property with a $1 million deductible experiences a catastrophic wind event, the insured can claim on both their primary insurance policy and their WDBB policy. The two claims should ensure that they have the necessary funds to repay their loan, providing assurance to both the insured and the lender. By reducing the potential financial strain caused by high deductibles, WDBB policies effectively bridge the gap between the insured's financial capabilities and the lender's risk tolerance.

The Benefits Beyond Commercial Lending

While WDBB policies have clear advantages in the context of commercial lending, their benefits extend beyond this sphere. Many insureds, even those without outstanding loans against their property, recognize the financial risks posed by high deductibles in the face of increasing storm frequency.

Businesses that rely heavily on their physical assets, for example, could find their operations severely disrupted by a catastrophic wind event. If the business is unable to cover the deductible, it may not be able to repair or replace the damaged assets, potentially rendering the business nonviable.

By purchasing a WDBB policy, these insureds can help protect their businesses and help ensure their continued viability in the face of an increasingly unpredictable climate. The policy can enable businesses to recover more quickly from a catastrophic event and maintain their operations with minimal disruption.

The Changing Risk Perception

The stark increase in wind events has prompted a shift in risk perception. Previously, insureds were content to carry a higher deductible, confident that severe wind damage to their properties was an infrequent possibility, perhaps occurring once a decade. However, with severe storms now causing damage at twice the previous frequency compared to just 20 years ago, insureds are recognizing that retaining such a large proportion of the risk on their balance sheets may no longer be viable.

This shift in perception presents both challenges and opportunities. On one hand, it increases the financial burden on insureds, who must now find ways to manage their increased risk exposure. On the other hand, it presents an opportunity for insurers to develop and market new products, such as WDBB, that address these changing risk perceptions and needs.

The Role of Stakeholders in Promoting WDBB Policies

The rising need for WDBB policies calls for active participation from all stakeholders: insurers, insureds, and lenders.

Insurers must develop and offer affordable and comprehensive WDBB policies, ensuring that they adequately cover the risks associated with wind events.

Insureds, on their part, must be proactive in understanding their risk exposure and seeking out insurance solutions that meet their specific needs.

They must also engage in risk reduction measures, such as reinforcing their properties against wind damage, to complement their insurance coverage.

Lenders must recognize the value of WDBB policies in protecting their interests and suggest that their borrowers consider such coverage. By incorporating WDBB policies into their lending considerations, lenders can help encourage wider adoption of these policies.

Conclusion: A Vital Tool in a Changing Risk Landscape

In conclusion, Wind Deductible Buy-Back policies have emerged as an important tool for mitigating risk in an era of increasing wind-driven events. They provide a much-needed mechanism for insureds to manage the financial risk associated with higher insurance deductibles, offering protection not only to the insured but also to commercial lenders.

As wind events become more frequent and severe, the demand for WDBB policies is expected to grow. Stakeholders in the commercial real estate lending sector must understand and adapt to this changing risk landscape to protect their interests and ensure the sustainability of their operations. Insureds, insurers, and lenders all stand to benefit from widespread adoption of WDBB policies. Insureds can help safeguard their businesses and properties, insurers can help manage their risk portfolios more effectively, and lenders can help secure their collateral against the financial uncertainty brought about by high deductibles.

As we look to the future, the need for comprehensive and adaptable risk management strategies will only become more apparent. WDBB policies represent a step towards a more resilient and sustainable commercial real estate sector in the face of our changing climate. They help provide the necessary reassurance and financial backing that commercial lenders need to feel secure in their investments, while also providing property owners with a means to help them recover from an unforeseen catastrophe.

In the context of our changing climate, these policies are not just a tool for risk management—they may be increasingly viewed as a necessity. As the frequency and severity of severe wind-driven events continue to rise, the demand for WDBB policies is expected to increase alongside it. Adopting these policies will help create a more resilient CRE sector, better equipped to withstand the challenges of our changing climate.

Ultimately, the widespread adoption of WDBB policies requires a collective effort from all stakeholders involved in the commercial real estate lending process. By understanding the value of these policies and promoting their adoption, we can work together to help create a more resilient and financially stable commercial real estate sector, capable of weathering the storms of the future.

The journey towards a more resilient future may be challenging, but by embracing change and innovation, such as Wind Deductible Buy-Back policies, we can navigate this shifting landscape and help secure a brighter, more secure future for the commercial real estate lending sector.

Footnotes

1. NOAA National Centers for Environmental Information (NCEI) U.S. Billion-Dollar Weather and Climate Disasters (2023). https://www.ncei.noaa.gov/access/billions/, DOI: 10.25921/stkw-7w73
2. https://www.swissre.com/institute/research/sigma-research/sigma-2023-01.html