All lenders have standard insurance requirements and compliance procedures. For all but the largest most profitable borrowers insurance is essential to ensure they remain financially viable and able to satisfy their obligation to lenders. Tangible collateral is subject to total losses due to a myriad of hazards and every enterprise has activities that may result in litigation that takes up management’s time, incurs significant defense costs, may result in a large award to the plaintiff and may damage the enterprises reputation. Insurance is a cost effective way of protecting collateral and the balance sheet from fortuitous loss thus giving a lender greater confidence in loan repayment and in protection for the banks vicarious liability. Confidence in loan underwriting translates into lower frictional costs and greater flexibility in terms benefiting both parties.

The reality of lender insurance requirements and compliance.

Much has been written about insurance requirements and the challenge of verifying that insurance is in place and remains so during the term of the financial obligation. The reality is that many lenders have outdated requirements and ineffective compliance mechanisms. The compliance responsibility is often delegated to a credit department independent of the banks Risk Manager. Too often it is determined that the cost of viable compliance is greater than the benefit. The same standards may be used for every loan and the person responsible for ensuring compliance may not have any experience with insurance. As recent as last month a major bank used an insurance requirement document dated 1983. The terminology on the requirement has not been used in the insurance industry for more than 25 years. Insurance is not a commodity it is a highly complex contract that must conform to specific activities. Forms change every year and for every different category of insured.
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New data to consider in the cost benefit equation.

Lack of attention to the changing insurance market recently resulted in a major uninsured occurrence estimated to cost borrowers and potentially their lenders up to $18 billion dollars. Chinese Drywall caused major damage to homes and commercial buildings. The insurance policies required by most lenders have excluded the cause of loss, pollution, since 1986. The pollution exclusions found in most traditional insurance policies since that time have been widely discussed and litigated. There is no excuse for not understanding insurance company’s intent – they do not intend to pay a pollution claim and will decline coverage if they can.

Attorneys will raise creative policy language interpretation in an attempt to force coverage for the Chinese Drywall event, but the policies clearly express the intent of insurers to exclude these types of claims. Other remedies will include actions against contractors and building material suppliers, but in most cases these same pollution exclusions are on their policies and the taking the assets of small contractors and suppliers bring little relief. Other potential sources of redress include the manufacturer in The People’s Republic of China and the German Company that contracted with the manufacturer for the product. These actions will be time consuming and expensive and even if successful, neither party has the assets to satisfy a loss of this magnitude. Some lenders purchase mortgage impairment insurance to protect their interest specifically to address the potential that insurance required of borrowers will not respond, but once again it is likely these mortgage impairment policies exclude pollution. None of this is a surprise to Risk Management professionals.

This horse is out of the barn, will someone now close the barn door? Is this loss large enough for lenders to re-examine their loan risk management and insurance practices?

Lenders may determine that a single unusual loss is unlikely to repeat and excusable since no one could have predicted it. But the Chinese Drywall loss is not unusual except in size. And even then it is not unprecedented. A very similar loss scenario arose 25 years ago when legal actions alleged injury from toxic fumes from formaldehyde in building materials. The major differences between the Chinese Drywall and the formaldehyde losses are that the earlier losses were alleged against domestic manufacturers and the policies 25 years ago did not all have the current “absolute pollution exclusions”.

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Close the barn door.

What can lenders learn and what can they do?

- The traditional insurance markets aversion to pollution related claims is well known and clearly expressed as exclusions, definitions and conditions in their policies.
- There have been two (formaldehyde and Chinese Drywall) similar and potentially catastrophic pollution related claims now excluded by the policies required by standard lender insurance requirements.
- Smaller losses of the same type are common and there is no evidence that future loss potential has been mitigated.
- Responsible risk managers in many industries have filled the pollution coverage gap by buying readily available policies specially designed to insure environmental risks. A well capitalized specialty market with many insurers, broad forms, high limits and competitive premiums is willing and able to protect environmental risks.

There’s a storm on the horizon.

Any borrower who owns, rents, sells, buys, works in, works on, builds, maintains, or sells building components to a building that people frequent has a mold loss exposure. There is no coverage in property or general liability policies for large claims arising out of mold. In fact, a mold loss may negate coverage for an otherwise covered proximate cause.

Absolute statements such as the one above are typically unwise, but equivocation in this matter is more so. Risk professionals paying attention to trends see an oncoming storm of high frequency, potentially high severity losses on the horizon and though available, most insureds are not buying the necessary insurance because they have not been properly advised and they are not required to.

Mold, fungus and bacteria are ubiquitous and have the potential to diminish the value of most buildings and establish grounds for litigation alleging bodily injury including the potential for class action suits. All that is needed are mold spores - found everywhere on the planet; a catalyst – moisture, found everywhere people live and build; a food source – wood, drywall and other matter commonly found wherever people live; and a delay in recognizing, or mitigating the presence of the moisture and early stages of mold growth.

Should lenders be concerned?

Hospitals have incurred mold cleanup costs exceeding $20,000,000 and are defending against allegations of negligence due to patient and visitor illness; hotels and motels have incurred liability losses exceeding $5,000,000 resulting from injury due to legionnaires disease plus loss of revenue from damage to their reputation; newly constructed hotels, motels and apartment buildings have been forced to delay opening for extended periods in addition to incurring remediation costs; office buildings have been closed as “sick buildings” though there was no direct physical damage. In addition to property owners, contractors, materials suppliers, vendors and other service providers are being sued by property owners and others alleging negligence in initiating the mold growth, or failing to adequately correct it.
Mold was a covered cause of loss in traditional insurance policies for decades. It wasn’t until new environmentally conscientious building methods changed the environment in buildings that a problem arose. Restricting heat loss and adding high capacity air exchangers has created an internal atmosphere encouraging the growth and spread of fungus and bacteria. Insurance companies, risk professionals whose data collection indicates trends and therefore early warning of looming problems, are so concerned they began adding mold exclusions to every policy they issue as early as 2002. Earlier this year a major global insurer indicated their losses are ten times premium and expense from insuring restoration contractors (those who remediate water and mold).

Fungus and mold exclusions are so broad they may eliminate otherwise acceptable causes of loss if associated with the presence of mold. Large enterprises with professional Risk Managers are looking to the environmental specialty market to purchase coverage and to require contractors and sub-contractors with whom they work to also purchase coverage. The coverage is readily available and affordable, unfortunately smaller enterprises working with less informed advisors are not yet addressing the risk. Smaller enterprises are reluctant to add costs to their insurance budget if it is not required by an outside party. Many of these businesses will incur large uncovered losses from which they will not survive and that will certainly restrict their ability to satisfy lending agreements.

**Are lenders part of the problem?**

If lenders continue to ignore ever changing hazards and how they are addressed by current Risk Management practices and Insurance they will fail to recognize that traditional insurance they currently require does not protect their borrowers from environmental risks, a risk with greater loss frequency and with individual losses equal in size to fire. This lack of attention is all the more unfortunate since knowledgeable risk professionals have readily available solutions. When traditional insurers decided they could not absorb pollution, fungus and mold losses an alternative insurance market was establish that embraces these perils with broad affirmative coverage, significant capacity and competitive rates.

If lenders are serious about mitigating potential loan defaults with insurance, they need to continually update their requirements and utilize risk and insurance professionals to evaluate appropriate risk treatment for all large, or complex lending activities. The immediate need is to include insurance for environmental risks including pollution, fungus and mold in their standard insurance requirements.

- Property Owners need site specific coverage called Environmental Impairment Liability.
- Contractors need Contractors Pollution Liability
- Professionals involved in any form of construction need coverage for their Errors & Omissions including pollution.
- More complex transactions require a professional to design coverage to conform to the risk.

Every lender is different and must determine for themselves the cost benefit of requiring borrowers to purchase insurance as a means of protecting the lenders loan portfolio. These decisions however should be made proactively and continually re-evaluated with current information and with input from Risk professionals that monitor risk trends.

Lenders often present themselves as business partners and advisors. For those who offer this service lending requirements, or recommendations, must be current, accurate and specific to the type of risk.
Lenders that determine there is insufficient benefit to require their borrowers to purchase insurance and do not consider themselves advisors must also agree that requiring the wrong, incomplete and misleading insurance and incurring any cost at all for a confused and unreliable compliance process is a waste of time and money. All parties may be better served if these lenders simply allocated these costs to paying the losses from defaulted loans and ended the practice of circulating misleading and incorrect insurance requirements.

For those lenders who determine there is value in requiring insurance, the requirements must be correct, specific to the type of risk and current. Achieving compliance is challenging and requires knowledgeable staff and persistence. Performing this task ineffectively negates the perceived value and creates additional confusion for all parties.

This may not be a task some lenders can achieve internally. These lenders can reach out to Risk Professionals with the knowledge to assist in determining how coverage should be designed for more complex transactions and consider outsourcing compliance to services with good reputations.

Do it right, or not at all! And close the pollution exclusion door, the losses are here and every lender and borrower will be effected.

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