RISK MANAGEMENT LETTER

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FORECLOSED PROPERTY INSURANCE

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It is the rare bank indeed that does not have foreclosed property these days. Most banks have a great deal of foreclosed property on their books and insuring it properly and economically has become a real problem. What do the banking regulators want you to do with this property? Do you just add it to your bank's property insurance policy? Is there a specific separate insurance policy to cover this area? How do you value this property and does your insurance policy cover this value? What sort of insurance coverage should you have on this property? These are some of the questions this newsletter will try to answer.

REGULATORS

To our knowledge, the banking regulators are not specific as to the insurance coverage to be provided, only that the financial institution have a management policy for protecting these assets. The regulators will be looking for an internal policy for handling this area and will want management to 'provide insurance coverage' commensurate with this bank policy. Well, that's certainly clear enough! So, be sure your policy is basic enough to allow easy compliance. For example, including a statement along the lines of "The Bank shall insure the Actual Cash Value of the indebtedness of foreclosed property for the perils of Fire and Windstorm with at least $100, 000 of Premises Liability applying to each location of Real Property" might be appropriate. *The actual coverage purchased by the bank should be far greater than these limits (discussed later)*. The idea here is to keep management from violating its own policies.

WHERE SHOULD THE BANK COVER THIS PROPERTY?

Once you have a bank policy for protecting foreclosed property, where is the best place to provide this coverage? Until recently, foreclosed property was such a rarity that when it did occur the bank merely placed it on the corporate insurance policy. While this certainly was the easiest way to handle this exposure, it was not the best risk management move. The insurance rate for property Insurance policies are affected by insurance losses. The more losses you have, the higher your premium is likely to be. Foreclosed Property is usually not as well constructed or protected as bank property, and much more likely to suffer a loss. Therefore, a serious insurance loss on a temporary asset could result in a long term increase in the insurance costs for the bank. Insuring this area on a separate policy helps to minimize this risk. With today's larger number of foreclosed properties and larger values exposed, a separate policy may be a necessity. However, while there are several insurance companies that are now providing insurance policies specifically designed to cover this area, some insurance companies that specialize in bank insurance are offering specific endorsements to their property policies with very competitive pricing and terms. A detailed cost/benefit analysis is definitely in order here.

HOW DO YOU VALUE FORECLOSED PROPERTY?

Putting a value on foreclosed property is not as simple as it appears. Do you insure just the remaining loan book value ? How do you prove to the regulators that the outstanding indebtedness is equal to or greater than the Market Value of the property? Appraisals will help on the Market Value, but because of the current real estate market, how valid is the appraisal? Insurance companies usually base the value on the LESSER of the established market value or the cost to repair or replace the damaged or destroyed property. Low construction costs may force you to repair or replace a piece of property you just as soon get off your books. Here you are back to establishing the "Market Value" so you can compare it to the "Construction Cost". Get together with the regulators and your insurance company and come to an agreement on these values BEFORE a loss occurs. Negotiations are always much easier before a loss and insurance settlement is eased as well.

WHAT SORT OF INSURANCE DO YOU NEED FOR FORECLOSED PROPERTY?

The FIRST coverage to obtain on foreclosed property is Liability insurance NOT Physical Damage insurance. Yes, it is important to cover the asset from loss, but it is more important to cover liability this asset might cause. For example, a child wanders on to the foreclosed property, and is seriously injured. You could get sued for millions. Most insurance companies are excluding ANY liability for foreclosed property unless it is specifically listed in the policy. If you foreclose on a piece of property on Friday, and fail to tell your insurance agent until Monday, any accident that occurs on the property over the weekend will not be covered. This can be handled by having the separate foreclosed property policy you purchased (see above) AUTOMATICALLY cover new foreclosed property for 90 days or until reported. By the way, don't assume that your reporting form foreclosed property policy covers the Liability area. Most of these policies don't cover the Liability area unless specifically endorsed to do so.

Make sure your Umbrella Excess Liability policy applies to this area as well. Unless the "underlying coverage" of the Umbrella policy lists your foreclosed property policy, the Umbrella Liability probably won't be applicable to the foreclosed property area.

Of course, finally, you need to be sure your asset is covered for physical damage. You want to be certain the words "all risk of physical loss" appear in the coverage wording along with Earthquake and Flood coverage. Be careful to check for Vacancy or Un-occupancy clauses. Much of the foreclosed property in a bank's foreclosed property portfolio is vacant or unoccupied, and as such coverage can be severely reduced or eliminated.

CONCLUSIONS

Take your time with this area of coverage. The values can be VERY significant and the chances of loss are much greater than on standard bank property. However, with just a little time and effort this area can be managed successfully.

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