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Property Week - Cancellation of loan interest cover turns spotlight on insurance

The fact that insurers want to undo an arrangement that has been in place for so long is a sign of the times — they are toughening up their attitude, as, indeed, are banks.

In 1992, the insurance market, represented by the Association of British Insurers (ABI), entered into an agreement with the British Banking Association (BBA).

This agreement ensured that insurance policies on buildings covered the interest of banks that had made loans on property. It was not intended to replace specific obligations or undertakings, but rather to be a safety net for banks.

This summer, the ABI told the BBA that it intended to cancel the agreement because it had fallen out of use. Many of the original signatories, both banks and insurers, were no longer in business, it said, and many new ones were not included. The agreement will end on 30 June 2012, following a notice period starting on 1 January.

The agreement was intended for residential loans. For loans with specific arrangements in place, as one would expect on most commercial property, the cancellation should have no effect.

However, the fact that insurers want to undo an arrangement that has been in place for so long is a sign of the times — they are toughening up their attitude, as, indeed, are banks. Automatic and flexible arrangements are becoming a thing of the past. Nothing should be taken for granted, particularly when it is as important as insurance.

Bank's interest

Unfortunately, the agreement led to insurance being taken for granted — people believed it would always be there when it was needed.

That is not the case. Most policies are renewable annually and the contract finishes at the end of the period of cover. In the drive to obtain value for money, it is not surprising that property owners change insurers regularly. And, during this process, it is easy to forget to include the bank's interest.

Without the ABI agreement, or something in its place, banks may be exposed. Some European countries have statutory provisions to ensure that interest is noted automatically. But that does not get around the issue of non-renewal of a policy, and there are no specific requirements in the ABI agreement regarding that.

This leads us back to the specific insurance obligations included in most commercial property loan agreements. They are subject to much debate before closing a deal, but how often are they looked at afterwards?

Some banks have procedures in place to check that cover continues year to year. However, many do not have an efficient monitoring regime, which could leave them vulnerable to uninsured losses.

Almost worse than the inability to recover the cost of repairing damage is the shortfall in income that may occur if loss of rent is not covered — essential for servicing the debt.

It is an indictment of my profession that the documentation produced as evidence of cover is not always of the highest quality. Indeed, when undertaking due diligence, I am often surprised that borrowers or their advisers happily issue a statement to confirm that the insurance is compliant with the requirements of the loan agreement.

On further examination, it often turns out that the insurer has never seen the documentation, let alone agreed its terms, which are sometimes onerous or even impossible to comply with.

The lack of priority given to insurance mean that this type of error could have disastrous consequences.

Source:

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