Does Our Association Really Need An Earthquake Policy?

By Timothy Cline, CIRMS, Timothy Cline Insurance Agency, Inc., Santa Monica, CA

When the Insurance premiums go up, the first question Association's ask is "how important is this coverage?" Because we can't predict the future, it's difficult to answer this question. While it maybe be easy for some owners to feel that Earthquake Coverage is an unaffordable luxury, others feel strongly that earthquake coverage is an absolute necessity.

There are several things to consider before you make the decision not to purchase Earthquake Coverage.

#1 – ***"If we had a catastrophe and we were uninsured, could I afford to walk away from my investment?"***

If you have equity in your home, you need earthquake coverage. Homeowners associations that had catastrophic damage and were without earthquake coverage weren't able to rebuild. FEMA's loans to individual residents didn't provide them with sufficient capital to rebuild and the burdensome loan process involved endless red-tape and took a minimum of nine to ten months to complete.

#2- ***"Why Did Our Premium Go Up? We've had no major earthquake here in years!"***

Earthquake Insurance is a commodity and the pricing is predicated on the availability of competitively priced reinsurance. Simply put, reinsurance is the insurance that insurance companies purchase. Reinsurance costs have gone through the roof after Hurricanes Katrina, Wilma and Heidi. The massive losses in the Southeast caused a resulting shortage in catastrophe coverage across the United States resulting in significant capacity issues. Many insurance carriers previously had an appetite for earthquake risks in the past are no longer writing coverage – or if they are writing, it's based on drastically harsher terms than in past years.

#3 – ***"But Why Our Association?"***

The truth is…insurance companies know what they are doing and they do their research. They've been able to sustain themselves (in good times and bad) they know when a risk is worth taking. Rates have increased in the Southern California area, because carriers have come to the conclusion that the earthquake risk in many areas is too dangerous for them to accept unless they increase their rates. In the case of Earthquakes, insurance carriers subscribe to independent earthquake risk modeling service that map the fault lines, soil content, and seismic activity in a specific area. They use this information to estimate the "Probable Maximum Loss" or PML. If your Association has a High PML that means that professionals have determined that there is a very high likelihood in the event of a major earthquake that your Association will sustain a substantial loss. Unfortunately, the higher the PML, the higher the premium. Similarly, the higher the PML, the more necessary the earthquake coverage.

#4 – ***"Can't An Individual Owner Protect Their Own Unit? Why should the HOA be involved?"***

Shy of the Association purchasing a Master Policy, there currently isn't a way for individual unit owners to obtain sufficient coverage to fully protect themselves against damage to the building by earthquake. For example, you can't restore the interior of your unit unless the shell of the unit (floor and roof) are replaced. You can imagine the engineering problems facing you to rebuild your home unless the Common Areas were rebuilt. Individual unit owner insurance policies will not cover damage property that is not owned by the unit owner. Only if the Association purchases Master Policy coverage, will unit owners be able to address their exposure. What does that mean for individual unit owners? Probably walking away from their home – and their equity/investment.

#5 – "***How Many Associations Purchase EQ Insurance?"***

There are no published studies available nor has anything been offered by the California Department of Insurance that would document the percentage of HOA's currently maintaining protection for the peril of earthquake. Having spoken with many insurance agents/brokers in California who, like our firm, specialize in condominium associations, it appears that as many as 60% of the condominium associations maintain some form of Master earthquake coverage.

#6 – ***"What Are Alternatives To Purchasing A Master EQ Policy?"***

Because of the complexities of "common interest ownership", there are no viable alternatives. As mentioned earlier, an owner won't be able to restore their unit unless the Common Area is restored. Buying individual coverage is still important, but the potential for rebuilding is unlikely. Neither private lenders nor the Small Business Administration

(SBA) are likely to loan to a homeowners association that has failed to purchase earthquake coverage. (No lender would be willing to loan on a building that is already "fully collateralized." i.e.: In order to qualify for a loan after an earthquake, all unit owners would have to have their mortgages significantly paid off -- or own their units outright. Otherwise there would be "double mortgages" on the property and no mortgage company is going to green light that.)

#7 – "***Do Lenders Require Earthquake Insurance?"***

At this point, the only major lender that requires Earthquake Coverage is Freddie Mac. While this is only one lender, it is important to note that since 1970 Freddie Mac has purchased one out of every six mortgages. If your Association does not have Earthquake Insurance, you can still get a loan, but your choices are more limited.

#8 – "***Is there a way the Board of Directors can limit their liability?"***

Probably not -- particularly if the decision to drop the coverage was not fully disclosed to individual unit owners. While few CC&R's specifically require earthquake insurance, this wouldn't necessarily relieve the Board of Directors from potential liability if an angry unit owner (with an earthquake damaged home) felt the decision to drop the coverage was unwarranted. What is especially alarming is the fact that the Directors & Officers Liability coverage includes and exclusion relating to the "failure to maintain" coverage for the peril of earthquake. In other words, if there were to be an earthquake event and the Board were sued, there'd be no coverage under the D&O policy.

#7 – "***Can We Get Some Statistics On What Happened To HOA's With And Without Earthquake Policies After the 1994 Northridge EQ?"***

Unfortunately, there are no published studies on homeowners associations impacted by the Northridge Earthquake. We've consistently heard from property managers and condominium attorneys who assisted Boards impacted by the 1994 event that homeowners associations projects that had earthquake coverage had the resources to repair/rebuilt. Condominium associations that did not maintain coverage often walked away from their investment once it became apparent that the repair costs (and the potential assessment as a result) exceeded their equity of the average unit owner.

#8 – ***"Are their references we can use to help us evaluate the risk?"***

Your agent/broker may be able to provide you with an earthquake risk analysis provided by an earthquake risk assessment firm like Risk Management Solutions. Aside from that, there is more general earthquake risk data available at:

The U. S. Geological Study (USGS) - http://www.usgs.gov/"www.usgs.gov
The California Dept. of Insurance - http://www.insurance.ca.gov/0400-news/0200-studies-reports/0300-earthquake-study/
Risk Management Solutions - http://www.rms.com/

About the Author: Tim Cline, CIRMS, is President of Timothy Cline Insurance Agency, Inc. of Santa Monica. Tim is a past President of the Greater Los Angeles Chapter of Community Associations Institute, a former Chair of the CAI National Insurance and Risk Manager Professionals Networking Committee and currently on the President of the Los Angeles Chapter of the Independent Insurance Brokers and Agents Association.
