



Statement for the Record of the

**United States Senate
Committee on Banking, Housing and Urban Affairs**

**Hearing on “An Examination of the Availability and
Affordability of Property and Casualty Insurance in the
Gulf Coast and Other Coastal Regions.”**

Wednesday, April 11, 2007, 9:30 AM

Introduction

In the wake of the severe hurricane damage during 2004 and 2005, many insurers have pulled out of hurricane-prone areas. This has resulted in an insurance availability or affordability crisis for both residential and commercial properties in certain hurricane-prone parts of the country. The unprecedented damage of Hurricane Katrina and the subsequent spotlight on the recovery efforts in the gulf region have triggered a reassessment of public policy by political leaders and insurance regulatory officials as to how to deal with the financial consequences of such massive property damage.

The Mortgage Bankers Association (MBA)¹ represents both the residential and commercial real estate finance industries. At the end of 2006, there was \$10.19 trillion of residential mortgage debt outstanding and \$2.95 trillion in commercial/multifamily debt outstanding. This debt finances the vast majority of single family homes, apartment complexes, office, retail and industrial buildings that house the families and businesses that are the engines for the nation's vibrant and diverse economy. Circumstances that would undermine the residential and commercial real estate finance market, such as a lack of insurance for natural catastrophes, would not only impact the residential and commercial real estate finance sectors, but these impacts would ripple through the economy as buildings and homes became more difficult and costly to finance and purchase.

Typical commercial mortgages are made on an 80 percent loan to value ratio, which means that at the time of loan origination 80 percent of the property value is reflected in the mortgage and the remaining 20 percent is owner's equity. Commercial real estate lending is typically non-recourse, meaning that in the case of a mortgage default the lender can only look to the underlying value of the property to recover its mortgage balance, not the assets of the owner. Because most commercial real estate lending is non-recourse, lenders have an acute interest in preserving and protecting asset value. In order to protect their interest in commercial real estate assets, lenders place paramount importance on requiring and verifying that uninterrupted insurance coverage is in place for the life of the loan.

While residential lenders do have recourse against borrowers (depending on state law), the reality is that most borrowers are insolvent when the loan reaches foreclosure. As a result, the lender's only true means of recovering the debt is through the property.

Natural Disaster Catastrophic Insurance Market Conditions

In 2004 and 2005, natural disasters caused a stunning \$89.0 billion in privately insured catastrophic losses. This total jumps to \$107.3 billion when loss payments from the

¹ The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 500,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 3,000 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web site: www.mortgagebankers.org.

National Flood Insurance Program (NFIP) are included for this period. The recent spate of natural disasters has caused insurance companies to reexamine their business models for insuring natural disasters. This process has resulted in insurers and reinsurers pulling out of or reducing their portfolio allocations in certain disaster prone areas of the country. This resulting insurance capacity loss has caused property insurance rates to spike from 100 percent to over 600 percent in certain coastal areas with heavy hurricane exposure, which has put a tremendous strain on state-operated insurance pools that serve as the insurer of last resort in these areas.

The distressed insurance market for natural disaster insurance has led to an insurance availability and/or affordability crisis in some states. Residential and commercial property owners have been saddled with alarming insurance price increases in hurricane prone areas. The calm 2006 hurricane season has done little to ease insurance pricing in the 2007 renewal season.

Insurance rate increases have lowered debt service coverage ratios on commercial and multifamily properties to levels that have alarmed lenders, servicers and rating agencies. Additionally, in some hurricane-prone areas, commercial real estate sales transactions, development projects and refinancings have been cancelled or put on hold due to the lack of available or affordable property insurance, especially for windstorm coverage.

Addressed below and detailed further in the accompanying MBA White Paper entitled *Natural Disaster Catastrophic Insurance – The Commercial Real Estate Finance Perspective* are the prevailing insurance market conditions that have created the insurance availability and/or affordability crisis in some parts of the country, including the Gulf Coast region.

- **Catastrophic Risk is Not Going Away** - Catastrophic risk from hurricanes, earthquakes, floods, winter storms, and wildfires provides a baseline of low to moderate catastrophic event risk for virtually every population center in the U.S. Areas with the greatest catastrophic risk are locations in the most hurricane- and earthquake-prone areas.
- **Potential Hurricane Damage Will Continue to Grow** - An important influence on the loss severity of the most recent hurricanes has been the high concentration of real estate in hurricane-prone areas. This has been driven by long-term population migration trends to coastal areas where hurricane loss severity has been forecasted to double every ten years.
- **Risk Modeling Companies Revise Hurricane Damage Severity** - The risk modeling companies are incorporating the 2005 loss frequency and severity numbers into their hurricane models. This has caused the risk modeling companies to revise upward expected losses from hurricanes by 20 to 100 percent. Insurance and reinsurance companies have modified their catastrophe pricing structures to reflect these increased loss projections.

- **Insurance Company Rating Agencies' Concerns Shrink Catastrophic Insurance Capacity** – Insurance company rating agency stress tests now take into account all natural disasters on which the insurance company has loss exposures. These stress tests include multiple disasters from different sources, such as earthquake and hurricane, occurring in the same year. Rating agencies are emphasizing overall catastrophic exposure in an insurer's portfolio and encouraging insurance companies to develop strong internal catastrophic risk management programs. This is one factor behind the reduction in catastrophic insurance capacity by both primary insurers and reinsurers.
- **Insurance Capacity for Windstorm and Earthquake Decline Precipitously** According to reporting by Aon, active wind insurance and earthquake insurance capacity have declined by 60.5 percent and 21.6 percent, respectively, between September 2005 and July 2006.
- **Catastrophic Insurance Pricing to Remain High** – Policy holders with catastrophic risk exposure may never see their insurance premiums return to pre-Katrina levels due to the increased loss expectations from hurricanes and rating agency scrutiny over an insurance company's overall exposure to catastrophic events.
- **Lack of Insurance Information Transparency** – Insurers have recently made other changes that affect the mortgage industry. The ACORD 28 and ACORD 27 forms are stand-alone documents used by the commercial and residential real estate finance industries, respectively, to serve as evidence of insurance coverage and to detail all the insurance coverage that is in place for a property. Recent changes to ACORD forms 28 and 27 introduce new disclaimers that specifically state the form is for information only and, therefore, threaten the form as providing adequate proof of insurance. In addition, changes to the ACORD forms no longer obligate insurers to notify named parties of insurance cancellations. These changes create significant contractual and insurance compliance burdens for closers and subsequently, servicers throughout the life of the loan. MBA seeks to preserve notifications to all policy insureds during the life of the loan, which is critical to effectuating information transparency and protection to property owners, lenders and investors.

Residential and Commercial Natural Catastrophe Insurance Issues

Because commercial and residential are different product categories, they sometimes face different insurance issues. Consequently, problematic insurance issues for the residential and commercial product categories are addressed separately below:

Residential Issues

- Many private casualty insurers are not writing or renewing all-peril property insurance policies or are including large deductibles for wind damage in coastal communities. When available, premium costs are tripling for residential homes in some hurricane prone areas. Florida is the hardest hit with a significant number of private policies on coastal properties not being renewed.
- Both Fannie Mae and Freddie Mac continue to require wind coverage despite private insurers exiting the market. As a result, homeowners must get wind coverage through the state sponsored insurance funds, such as Citizens in Florida. Citizens has coverage plans that include wind only or all-peril coverage. In conjunction with the higher deductibles being written, Fannie Mae and Freddie Mac have increased their maximum permissible deductible for fire, water (not caused by flooding) or wind to five percent of the policy insurance limit for dwelling coverage.
- At this time, lenders with large concentrations of their assets in coastal areas are most concerned with the rising cost of insurance. They fear that the increased cost of insurance will cause defaults. Lenders also anticipate an increase in lender-placed policies as a result of homeowner cancellations of policies. Lender-placed insurers have indicated an upward adjustment to their premiums, but have not seen a large increase in policies written yet.
- Citizens, the state sponsored insurer in Florida, currently provides wind coverage up to \$1 million on both residential and commercial properties. As a result, the majority of properties with conventional conforming and government loans can be adequately serviced by the state plan, although clearly properties with insurable values over \$1 million are forced to obtain additional private insurance, which may be hard to find.
- The growing cost of insurance in coastal areas is also leading to affordability issues for home purchases. The cost of insurance is likely to affect the affordability of many properties.

Commercial/Multifamily Issues

- Similar to the residential market, insurance company non-renewals of commercial and multifamily properties in hurricane-prone areas have been common.
- Similar to the residential market, the increase in insurance rates in hurricane prone areas has caused a hardship for commercial and multifamily property owners. Property owners that can not pass on increased insurance costs to tenants must absorb these increases, which cause their profitability to decline

and some to operate at a loss. For those tenants that must absorb the higher insurance costs, they are faced with an unexpected occupancy cost increase that will negatively impact their bottom line.

- In some coastal areas, lenders have reported they have declined to finance properties because either the lack of available property insurance or the price of property insurance has created a situation where the property no longer conforms to the lender's underwriting requirements.
- Rating agencies have raised concerns that spiking insurance rates have lowered debt service coverage ratios of some properties that are included in commercial mortgage-backed security (CMBS) pools to levels that warrant their inclusion on Watch Lists. This could potentially result in CMBS rating downgrades if the debt service coverage ratios for a significant portion of the CMBS pool decline due to increased insurance costs.
- For some low-income multifamily properties, property owners have not been able to pass on large insurance rate increases to tenants, which has caused them to choose among operating in a negative cash flow position, defaulting on the loan payment or violating the terms of the loan which require all peril insurance coverage to be in place during the life of the loan.
- Some commercial loan servicers have added staff to monitor insurance placement on properties located in hurricane prone areas. These additional costs represent a hardship for servicers because these costs are not accounted for in existing servicing contracts.

MBA Position

MBA supports private and/or public solutions that will enhance the timely availability and affordability of property insurance and conform to the following principles:

- Ensure no interruption in coverage;
- Make premiums affordable without unreasonably large deductibles;
- Make available at an affordable price insurance coverage, either owner obtained or lender placed, for every peril with the exception of the following exclusions: ordinances or laws, power failures, property neglect, acts of war, intentional losses and governmental actions. Insurance coverage for regional perils such as mudslides, flooding and earthquakes should be made available through private sector and/or public sector insurance policies at reasonable additional cost and with insurance limits adequate to the risk exposure of the property;
- Provide Evidence of Insurance that clearly provides a summary of the following to all insureds listed on the policy: perils covered and excluded, initiation and

expiration dates, coverage limits, deductibles and any sublimits or different deductibles for specific perils, such as hurricane; and

- Preserve insurers' responsibility to notify all insureds listed on the policy of coverage, cancellation of insurance, coverage lapses, gaps and renewals.

Conclusion

We greatly appreciate the opportunity to provide our perspective on natural disaster catastrophic insurance to the Committee. Through the hearing process, the Committee is actively exploring solutions to the natural catastrophe insurance availability and affordability crisis that is characteristic of hurricane prone areas inside and outside of the Gulf Coast. MBA stands ready to work with Congress to answer any questions that you might have regarding the real estate finance perspective on natural disaster catastrophic insurance issues.