



ISSUE PAPER

Subject: Natural Disaster Catastrophic Insurance

Issue: 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. Policymakers are grappling to find the appropriate role for the federal government to play for insurance coverage of natural catastrophes. Natural disasters include hurricanes, tornados, severe thunderstorms, hail, winter storms, flooding, wildfires and earthquakes.

Background: 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 National Flood Insurance Program (NFIP) are included for this period. A catastrophic insurance event is defined by the Insurance Service Organization (ISO) as an event resulting in insured losses of \$25 million or more. 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 and has put a tremendous strain on state-operated insurance pools that serve as the insurer of last resort in these areas. The calm 2006 hurricane season has done little to ease insurance pricing going into the 2007 renewal season.

The 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 or windstorm insurance. Addressed below are prevailing insurance market conditions that have created the insurance availability and/or affordability crisis in some parts of the country.

- **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

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United States. 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 10 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

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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.

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 have been 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 can also include 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 5% 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, non insurance renewals of commercial and multifamily properties in hurricane prone areas have been common.

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

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Status: On March 27, The Subcommittee on Housing and Community Opportunity held a hearing on natural disaster catastrophic insurance. During this hearing, state regulators, Congress members, and insurance company and policy holder representatives addressed the challenges facing natural disaster catastrophic insurance. Legislation under consideration by Congress is summarized below:

H.R. 330, the Homeowners' Insurance Availability Act of 2007, introduced by Rep Ginny Brown-Waite (R-FL) would allow private insurers to purchase, at auction, reinsurance contracts directly from the U.S. Treasury to cover natural disasters that are equal to or greater than a one-in-100-year event.

H.R. 91, the Homeowners Insurance Protection Act of 2007, introduced by Reps. Ginny Brown-Waite (R-FL) would make states with catastrophe funds eligible to purchase reinsurance from the federal government.

H.R. 164, the Policyholder Disaster Protection Act of 2007, introduced by Congressman Bobby Jindal (R-LA), amends the Internal Revenue Code of 1986 to provide for the creation of disaster protection funds by property and casualty insurance companies for the payment of policyholders' claims arising from catastrophic events.

S. 928, Homeowners Protection Act of 2007, introduced by Senators Bill Nelson (D-FL) and Mel Martinez (R-FL) would make states with catastrophe funds eligible to purchase reinsurance from the federal government.

Additional catastrophic insurance legislation is likely to be introduced later in the 2007 session. These bills have been referred to Committee for action. No action is anticipated on these bills in early 2007.

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