"Perspectives on Natural Disaster Insurance"

Testimony of

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Introduction

Good afternoon Chairwoman Waters, Ranking Member Biggert, and distinguished members of the Subcommittee. My name is Malcolm N. Bennett, and I am President and Founder of International Realty and Investments, a real estate company specializing in property management and residential real estate sales and investments in Los Angeles, California. This afternoon I am here on behalf of two trade associations that represent the private apartment industry—the National Multi Housing Council (NMHC) and the National Apartment Association (NAA). NMHC and NAA represent the nation's leading firms participating in the apartment industry. Their combined memberships include apartment owners, developers, managers, builders and lenders.

The National Multi Housing Council represents the apartment industry's largest and most prominent firms. NMHC members are the principal officers of these organizations. NAA is the largest national federation of state and local apartment associations, with 190 affiliates representing nearly 50,000 professionals who own and manage more than six million apartments. NMHC and NAA jointly operate a federal legislative program and provide a unified voice for the private apartment industry.

We commend you, Chairwoman Waters, for your leadership in holding this hearing to discuss industry and congressional perspectives on the market conditions for catastrophic insurance coverage that are challenging property owners across the nation today. I appear before the subcommittee as a California multifamily property owner and manager trying to provide affordable housing in these times of unprecedented natural disasters and escalating costs. I also speak on behalf of my industry colleagues with national property portfolios that include Gulf Coast and East Coast apartment communities who continue to face enormous challenges in obtaining insurance coverage in the aftermath of the 2005 hurricane season relative to pricing and capacity for property insurance.

Our membership is extremely concerned about the future stability of the insurance market and its ability to withstand the continued occurrence of catastrophic events, whether the result of a natural disaster or of terrorism. Policyholders need some assurances that the resources will be available to cover the risks both now and in the future. As Congress continues its deliberations on how best to address this critical issue, we welcome the opportunity to participate in this discussion. We feel strongly that any federal initiative should include relief for the commercial real estate sector as well as the residential homeowner. Previous policy debates have focused primarily on the homeowner, not recognizing the needs of multifamily property owners and other commercial real estate interests.

The Impacts of Hurricane Katrina are Felt Beyond the Gulf Coast

The major catastrophe losses of 2005 from Hurricane Katrina had a devastating impact on the property insurance market in many states across the country. Even California felt the ripple effect of skyrocketing premiums, reduced limits, higher retained risk and higher deductibles for earthquake insurance. While most of the attention has been focused on windstorm coverage associated with hurricanes, insurance carriers include earthquake events in the same risk pool as tornados and hurricanes. As a result, property owners like me in California are impacted much like those located on the East Coast.

It is somewhat frustrating because as policyholders, we have limited control over any of the factors that shape the marketplace for catastrophic property insurance. Other than employing mitigation measures to harden our properties against damage during a weather event, there is very little the policyholder community can do to influence the pricing and capacity of insurance coverage. It would be easy to lay blame on the insurance carriers for the marketplace conditions policyholders experience today. However, it appears there are other contributing factors that determine the availability and pricing of catastrophic insurance. First, insurers rely on loss modeling to underwrite risks. However, as we now know, these models significantly underestimated the losses of 2004 and 2005 and have been reworked, forcing insurers to take a more conservative view of their risks and how they allocate their capacity in catastrophic areas. Second, the insurance company rating agencies have revised their capital criteria and by more closely scrutinizing carrier's catastrophic exposures, they are forcing some carriers to reduce the number of policies they write. Third, and probably the most direct link to the price increases, is that reinsurers are providing less coverage to their insurers and at much higher prices, thus impacting the insurer's ability to offer coverage to its policyholders. Some carriers are pulling out of markets altogether or limiting business to renewals only.

While many apartment owners expected the 2005 hurricanes to affect their 2006 insurance renewals, apartment property risk managers say the reality far exceeded their worst case expectations. Significant cost increases and rapidly diminishing capacity were common themes cited throughout 2006 renewal periods by both risk managers and insurance industry experts. As a result, property owners with catastrophic exposure such as severe wind and earthquakes, reported significant cost increases ranging from 100-400 percent and reduced policy limits in 2006. The 2007 renewals have not yet been assessed but it is expected that even if the market begins to stabilize, prices will certainly not return to the pre-Katrina levels.

California Earthquake Insurance

My real estate portfolio is limited to California where earthquake insurance presents the biggest challenge to property owners. The 1994 Northridge Earthquake event changed the marketplace for earthquake insurance. These changes are similar to what we saw after 9-11 and what the Gulf Coast and East Coast are now experiencing after Katrina. Prior to this event, coverage was readily available and reasonably priced. These once-in-a-lifetime events wreck havoc in the marketplace and cause insurers to reevaluate the level of risk they are willing to take and whether to leave certain markets or price accordingly for the limited capacity

As you know, commercial as well as homeowner property insurance policies do not include coverage for damage caused by earthquakes. Coverage can be purchased as a separate policy or an endorsement, but its high cost has resulted in very small take-up rates. Homeowners in California have a slight advantage over commercial property owners. They can buy coverage through the California Earthquake Authority (CEA), the privately funded and publicly administered program created by the General Assembly after the Northridge earthquake. Unfortunately, multifamily properties are excluded from this program and can only purchase a policy in the private insurance market. As a small business owner and manager of multifamily units, I have chosen not to purchase earthquake insurance for my properties because I cannot absorb the added cost in my business operation. The only way I could afford this insurance would be if I raised rents to cover the increased costs associated with this insurance coverage. I am not willing to create a financial hardship for my residents. Apartment owners, especially those with older properties, are continually faced with the increasing operating costs required to maintain and upgrade properties so that residents can enjoy a safe, decent and hopefully affordable home. The costs of catastrophic insurance coverage currently exceed a level that is business practicable and threaten the supply of affordable housing in California and storm-prone areas.

Larger apartment owners with national portfolios face the same operating cost challenges. It is not uncommon for apartment owners of properties utilizing the Low Income Housing Tax Credit (LIHTC) program to choose not to purchase earthquake insurance unless it is required by their lender due to the exorbitant cost. Unlike market-rent properties, these properties offer no rent adjustment option to offset the added cost because the rents are based on local household income levels. This is also true of other federally subsidized programs such as the Section 8 program. For the properties that purchase this insurance due to lender requirements, the owner assumes the additional cost, perhaps at the expense of some property improvements. The uninsured properties remain at risk to Mother Nature, leaving the owner as well as the lender exposed. In the event of a large-scale earthquake, many of these affordable assets would have no source of funds to rebuild, thus removing properties from the already limited inventory of affordable housing. Unfortunately, that leaves a significant percentage of California property owners exposed to the ongoing threat of an earthquake and subsequent destruction.

Market Reaction to 2005 Hurricane Season and Impact on Policyholders

The 2005 hurricane season not only broke records for the number of named storms—26 compared to the 1933 record of 21—it also set records in terms of insurance losses. 2005's losses of $61.2 billion were the worst year ever in the United States. (Source: Insurance Information Institute) While weather experts predicted 2006 to be an active season, calling for 17 named storms, the season ended rather quietly with Mother Nature sparing property owners and insurance carriers, at least for now.

However, another kind of disaster was felt during the 2006 renewal cycle, as most apartment firm owners were presented with one of their most challenging years ever in the insurance market. Portfolios with catastrophic (CAT) exposure, including Florida and the Gulf Coast/Houston area (wind storm), California (earthquake) and certain central business districts (terrorism), saw up to 400 percent price increases for some layers of insurance. The-first quarter renewals in March of 2006 reported almost daily changes in pricing, and swiftly deteriorating capacity with analysts predicting a worsening situation by the 2nd quarter renewals. Risk managers sought to move up their renewals in an effort to secure the coverage they needed before capacity totally dried up. Florida property owners reported paying as much as $1,400-$1,500 per unit for the same coverage they paid $400-$500 just a year before. Texas policyholders reported similar experiences in pricing and availability of coverage. Insurance experts reported that carriers were simply not willing to take as much risk as in previous years. It became widely accepted that even at the exorbitant cost and lower limits, a property owner was lucky to have obtained coverage at all.

Is there a need for a federal catastrophic insurance program?

Weather experts are not letting a little lull in the storm season detract from their otherwise gloomy forecast for 2007. Despite last year's mild season, experts are once again forecasting an active 2007 hurricane season. Colorado State University forecasters predict 14 named storms, of which 3 will be major hurricanes. This represents a 40 percent increase over the average storm activity measured over the period from 1950-2000, thus another reason that improved market conditions may not be in the cards for some time

It is not clear that a government solution exists to the current insurance crisis, or if one will come from the private market. What we do know is that the continued occurrence of catastrophic events, whether the result of a natural disaster or terrorism, will have a significant impact on the national economy. It seems clear that the private insurance market is losing its appetite to take on this significant risk for much longer. Anecdotal accounts of carriers pulling out of certain high-risk states worsen the already deteriorating situation.

It is very likely that in the event of a mega-catastrophe the federal government would step in and take whatever action is necessary to stabilize the markets, regardless of whether a role for them has been defined in legislation. This sentiment has prompted policymakers at the state and federal level to look at the viability of a public/private program.

The apartment industry has much at stake in this debate. Decreased capacity and pricing increases of insurance will result in higher prices for the consumers and ultimately reduce the level of available housing in certain areas. Especially hard hit will be the level of affordable housing, which is already in short supply. This is why we are encouraged by these hearings and by the recent press conferences announcing the intentions of Congress to craft a proposal to address the need for such a program. NMHC and NAA hope to lend support to those proposals we believe offer the best opportunity to ensure a stable insurance market that can withstand future natural catastrophes and offer the coverage necessary and at reasonable prices. The level of government participation is still under consideration.

We recognize it will not be an easy task to identify a one-size-fits-all solution to this problem. Arguments against federal involvement are plentiful and generally caution against the government from direct involvement in providing insurance thus stifling the development of a private market solution. It is also opined that federal subsidies only encourage construction in areas that place people and properties in harm's way. These arguments may have merit but should be carefully weighed against the goal of creating continued stability in the marketplace. Therefore, we encourage Congress to fully consider the various proposals that advance this goal including but not limited to the creation of a federal backstop to state catastrophe funds, tax exempt cat reserves for insurers, National Flood Insurance Program (NFIP) reform, and Risk Retention Act expansion. We also believe the establishment of a bi-partisan commission to examine these and other proposals may make sense, however only to the extent the Commission works in tandem with Congress and does not merely serve to delay serious consideration of legislation.

Industry Policyholder Coalition

NMHC and NAA are currently participating in a newly established policyholder coalition created for the purpose of working with Congress as it addresses this critical issue. In addition to multifamily property owners, our membership includes owners and managers of shopping centers, commercial office properties, hotels, industrial office parks, community bankers, resort developments, residential and commercial Realtors, mortgage bankers, economic development corporations, homebuilders, real estate investment trusts and many other groups representing real estate interests. It is our goal to identify and lend support to a legislative initiative that offers long-term stability in the insurance market by ensuring adequate capacity in times of severe weather events such as earthquakes and hurricanes that cannot be accommodated by the private market alone.

Conclusion

We encourage Congress to move in a deliberative and thoughtful manner rather than react in a time of crisis after another event. Congress should consider the appropriate level of federal participation to ensure adequate coverage is available and at affordable prices to the policyholders of America.

I thank you for the opportunity to testify on behalf of the National Multi Housing Council and the National Apartment Association, and wish to offer our assistance to the Committee as you continue your important work