



White Paper Summary For Natural Disaster Catastrophic Insurance The Commercial Real Estate Finance Perspective

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. 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.

These insurance rate increases have shocked property owners and have lowered debt service coverage ratios 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.

The distressed insurance market for natural disaster insurance has led to an insurance availability and/or affordability crisis in some states. This crisis has not only impacted the insurance industry; it has also impacted many of the stakeholders in the commercial real estate finance industry: borrowers, lenders, servicers, and rating agencies. The key findings of the White Paper are presented below:

Key Findings:

- **Insurance and Reinsurance Industries Remain Profitable** - Despite underwriting losses associated with the hurricane activity of the past two years, both the insurance and reinsurance industries were profitable.
- **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 most recent 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, since September 2005.
- **Catastrophic Insurance Pricing to Remain High** - Catastrophic insurance pricing may never 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.
- **Available and Affordable Property Insurance is Essential to the Real Estate Finance Industry** - Both residential and commercial mortgages require "all risk" insurance coverage to be in place during the life of the mortgage. Consequently, disruptions in the availability or affordability of property insurance seriously undermines the real estate finance industry by shifting catastrophic property damage risk from the insurance industry to the real estate finance industry which has not priced such risk into its product offering.

For additional information, please contact George Green, Senior Director, Commercial/Multifamily at (202) 557-2840 or ggreen@mortgagebankers.org. The White Paper can be found at following internet address:

<http://www.mortgagebankers.org/files/TheCommercialRealEstateFinancePerspective.pdf>