

## Mold: Katrina's Linger- ing Legacy

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### ■ Summary

Several years ago, in the wake of numerous lawsuits that resulted in substantial damage awards, many property and casualty insurers stopped providing coverage for claims alleging damages caused by mold. In light of the likelihood of the long-lasting effects from the extensive flooding in New Orleans and other areas affected by Hurricane Katrina, Fitch Ratings believes it is appropriate to restate its expectations regarding mold. These include:

- Site assessment guidelines for properties where loans are being originated for commercial mortgage-backed securities (CMBS) securitization need to have a specific mold inspection requirement.
- Such inspections should be performed by qualified professionals.

Fitch also expects issuers to encourage borrowers to insure for mold risks in any region where that additional coverage is available.

### ■ Mold Evaluation

As a key rating assumption, Fitch supposes the presence of mold will increase the loss experienced on a property in default. The existence of mold as an environmental problem is not a new issue. It has been addressed in the past by environmental consultants typically engaged to evaluate properties whose mortgages are to be securitized in CMBS transactions.

Over time, as settlements in many mold-related lawsuits reached into the millions of dollars, most insurers chose to eliminate mold coverage in their standard property and casualty policies. Other insurers have simply stopped doing business in states where high rates of mold are detected, such as states with warm, damp climates like those in the region hit by Hurricane Katrina. However, some insurers are offering coverage in separately issued policies or in conjunction with other environmental insurance policies.

The mold exclusion in property/casualty and environmental policies places an added burden on Phase I environmental and engineering site inspections. The need for thoroughness on the part of the consultants is apparent.

In addition to liability claims from third parties claiming health issues, certain kinds of mold can result in portions of income-producing properties being shut down or even in the condemnation of an entire property. While hotels and multifamily properties are most at risk of being closed because of mold contamination, office properties have also faced such prospects.

A major downtown office building in New York City is currently being torn down because of contaminants, including mold, which resulted from the attack on the World Trade Center.

Given the likelihood of mold contaminating collateral in the Gulf states affected by Katrina, along with the higher probability that insurance coverage for mold-related claims was not available to borrowers in those states, Fitch anticipates an increase in defaults on existing collateral in the affected locations.

## ■ Insurance and Escrows

Because of the possibility of a loss of income due to mold contamination, Fitch expects that loan originators will ensure that their Phase I or engineering site assessment guidelines include a specific and thorough

mold detection component. In reviewing third-party reports, Fitch expects to see specific references to mold inspections, along with detailed recommendations from the consultants outlining appropriate actions required to correct any suspected problems.

In instances where loans on properties with existing mold conditions are being included in a transaction before remediation is complete, originators are expected to require that borrowers either reserve 150% of the estimated cleanup expenses or secure a letter of credit for that amount.

Fitch expects loan originators to encourage borrowers to purchase additional insurance to cover mold claims from companies carrying, at minimum, an 'A' rating.