SERVICING MANAGEMENT®

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The Fallout Following The 2005 Hurricanes Is Readily Apparent

Some insurance companies trying to limit exposure have stopped writing policies or limited the number of policies they write in high-risk areas.

BY RON WISER

Even if you do not service a single loan within 1,000 miles of the U.S. coastline, your borrowers and your servicing department are going to feel the effects of last year's hurricanes.

Coastal homeowners as far away as New York are having trouble renewing their homeowners policies, homeowners in Florida are flocking to a state-sponsored wind insurance program that needed a $1.7 billion bailout and homeowners as far away as California are paying higher insurance premiums due to rising reinsurance costs.

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Borrowers who normally have no trouble complying with their lender's insurance requirements are suddenly not able to do so because they cannot find coverage or cannot afford the coverage they can find. When they do finally find coverage, there is often not enough money in the escrow account to pay for the new policy, so servicers have to raise monthly payments - which always generates a host of angry calls from borrowers.

In some cases, the use of lender-placed insurance has risen in response. However, in the second half of 2006, the same factors that have created an insurance crisis in the primary market have begun to influence the lender-placed market. Lender-placed insurance companies face challenges finding reinsurance and are suffering because they have not been able to raise regulated rates quickly enough to reflect current risk.

In response, lender-placed insurance companies are carefully monitoring how much insurance they are writing in coastal areas. Many companies have stopped writing flood business because of the massive number of claims due to flood losses last year.

Taken together, those trends may place servicers in the same situation as the borrowers they serve - having to pay a lot more money for lender-placed insurance, if they are successful in finding the insurance that they need.

State of the industry

How did we get into this situation, and what can servicers do to cover themselves? The easy answer is that we had some horrific hurricanes in the past two years. Florida was hit by four hurricanes, followed by Katrina and Rita in 2005. During those two years, the insurance industry paid out $33 billion in claims.

When the insurance industry suffered what its models had predicted were 1-in-500-years events twice in two years, it began to question its risk assumptions and, therefore, its pricing.

While natural disasters affecting the coastal states were the wakeup call to the insurance industry, the same possibility of catastrophic destruction also exists in almost all states. Floods and tornadoes occur inland, wildfires and earthquakes occur in the west, volcanoes still erupt in the northwest and winter storms hit our northern states.

In the wake of the 2004/2005 hurricanes, insurance companies began rethinking their decisions to do business in coastal areas. A study by Ceres, a national nonprofit coalition of investors, environmentalists and public-interest organizations interested in climate change, found that seven private insurers left Florida last year even though they won substantial rate increases.

On the Gulf coast, states responded to the exodus of insurance companies by offering a last-resort wind pool - a solution that California used in the earthquake market. State-run insurance companies have helped pick up the slack, as more than 600,000 Florida and Louisiana homeowners have had their policies

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canceled or not renewed.

Florida's state-run Citizens Property Insurance Co. now has about 1.5 million policy holders. Even though Citizens is required by law to charge higher premiums than private insurers do, the company still posted a $1.7 billion deficit in 2006, and Florida homeowners pay insurance surcharges to fill that hole.

Even in inland areas of Florida, homeowners are being forced to turn to Citizens. The Tampa Tribune reported that half the company's 810,000 policy holders are in the pool because they are in older homes, mobile homes or areas prone to sink holes - all risks that private insurance companies are no longer willing to take in some areas of Florida.

Mississippi's wind pool suffered a $745 million hit due to Hurricane Katrina - $100 million of which was paid back with a federal block grant.

But the problem is not limited to the Gulf states. Instead, it is a concern for all states with coastlines. In Massachusetts and New York, private insurers have cancelled coverage for more than 80,000 coastal homeowners in the past two years, even though it had been decades since the last major hurricane hit the region.

In South Carolina, insurers are doubling and tripling rates at the same time they are decreasing coverage, pumping up deductibles as high as 10% (Fannie Mae and Freddie Mac allow deductibles of up to 5%), canceling policies or simply leaving the area. Condominium coverage is particularly hard to find, and premiums in that market have risen as much as 700%, according to the National Association of Insurance Commissioners.

Insurance rates are high and rising, but insurance is still a good deal compared to the out-of-pocket cost of repairing damages or replacing a home that is completely destroyed.

The insurance companies leaving coastal areas are doing so because their adjusted risk models predict that more storms are on the way. And despite the devastation, homeowners continue to build high-price homes in areas at high risk for damage, expanding the value of property in need of good hazard and flood insurance. New York and Florida each have nearly $2 trillion in coastal property exposure.

Insurance companies looking to limit exposure simply stop writing new policies or limit the number of policies they write in those areas. Unfortunately, primary insurance companies are not the only ones reconsidering the risk of insuring coastal areas.

Reinsurers, which have long given private insurers the ability to lay off their risk, are not interested in expanding their investments in U.S. coastal markets. While it is true that there is more capital coming into the reinsurance market, the demand is still outstripping the supply. Reinsurers are asking primary insurers to absorb more risk or to pay rates that have doubled or tripled.

At the same time, insurance companies are finding it harder to place excess risk, and a rating agency change has forced them to post more capital to retain their ratings.

A.M. Best, which supplies ratings to the insurance industry, has added to its capital analysis a stress test that estimates how well an insurance company could withstand a mega-storm like Katrina. Because of that decision, some insurance companies may have to post more capital to maintain their current rating.

This year, as insurance companies renewed their reinsurance (called "treaties"), reinsurance prices went up significantly because of the past two years' hurricanes. To an insurance company, those losses are a cost of doing business, and they have to pass those costs on in their rates.

However, because insurance rates are regulated, companies cannot make changes overnight. They either get the rates changed to reflect the realities of the reinsurance costs and ratings changes or they put the brakes on writing business.

Insurance companies are also responding to lawsuits filed by trial lawyers and attorneys general who want insurers to cover storm-surge damage caused by Katrina.

Mississippi Attorney General Jim Hood asked the Chancery Court of Hinds County, Miss., First Judicial District, to declare void insurance contract provisions excluding coverage of loss or damage caused directly or indirectly by water, whether or not driven by wind. He also argued that the affected homes were not in the federal flood plain and that they were damaged by Hurricane Katrina, without which they never would have flooded.

While early decisions appear to favor the insurance industry, later decisions could have an important effect. If hazard insurance companies were forced to pay for water damage, their total claims would skyrocket.

Even if the homes in Mississippi were located in a special flood hazard area and eligible for the National Flood Insurance Program (NFIP), the attorney general might still be filing suit. The rate of homeowners who purchase flood insurance is quite low.

Congress, meanwhile, continues to examine ways to improve federal flood insurance programs. The House and Senate have passed separate and different bills aimed at improving flood insurance and making sure every homeowner that needs it is aware of the coverage.

If we continue to have good luck - with no major hurricanes making landfall during 2006 - many of these issues might mitigate by next year. Anything can still happen. But by December, we are through this year's hurricane season, and as companies renew their reinsurance contracts, a relatively calm hurricane season may translate into better terms for 2007. SM