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INSURANCE CLAIMS PAYMENT PROCESS IN THE GULF COAST AFTER THE 2005 HURRICANES

HEARING

BEFORE THE

SUBCOMMITTEE ON
OVERSIGHT AND INVESTIGATIONS

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED TENTH CONGRESS

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INSURANCE CLAIMS PAYMENT PROCESS IN THE GULF COAST AFTER THE 2005 HURRICANES

Wednesday, February 28, 2007

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON OVERSIGHT
AND INVESTIGATIONS,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 2:33 p.m., in room 2128, Rayburn House Office Building, Hon. Melvin L. Watt [chairman of the subcommittee] presiding.

Present: Representatives Watt, Waters, Lynch, McCarthy, Klein, Mahoney; Miller, McHenry, and Roskam.

Also present: Representatives Melancon, Jefferson, Taylor, and Thompson.

Chairman WATT. Let me declare this hearing of the Subcommittee on Oversight and Investigations to order. I want to thank everybody for being here and apologize to you all that we were hung up on the Floor with votes.

But that's the bad news; we are starting late. The good news is that votes are over for the day and we won't be interrupted again, so we should be able to proceed through all of our testimony and questioning without delay again.

Without objection, all members' opening statements will be made a part of the record, and there are some members who have asked to sit on the dias with us and be able to ask questions, so I would ask the subcommittee members to consent that the following members be allowed to participate in today's hearing after all of the sitting subcommittee members: Representative Richard Baker; Representative Ginny Brown-Waite; Representative Bennie Thompson; Representative William Jefferson, who will testify and then come to sit here; and Representative Charlie Melancon. And if any of the other witnesses want to join us, we'll do a supplemental unanimous consent request to make that appropriate.

Under the rules of the committee and the subcommittee, the subcommittee chairman and the ranking member will be recognized for 5 minutes each to make opening statements, and then other members who wish to speak, up to a total of 15 minutes per side, will be recognized. So I'm going to recognize myself, but before I get on the clock, let me just thank the members who are here. I had planned, if we had had a full complement of members, to intro-

duce all of them since this is our first subcommittee hearing since the subcommittee has been completed.

Just for everybody's information, I won't go through a full introduction, but Representative Luis Gutierrez is on the subcommittee, as well as Representative Maxine Waters, Representative Stephen Lynch, Representative Emanuel Cleaver—although I understand he's going off of the subcommittee to do another special project—Representative Nydia Velazquez, Representative Michael Capuano, Representative Carolyn McCarthy, Representative Ron Klein from Florida, Representative Mahoney from Florida, and Representative Wexler from Florida. And, of course, the chairman of the full committee is an ex officio member of the subcommittee.

I'll yield to Mr. Miller to just go through his list of members on the Republican side.

Mr. MILLER. Thank you, very much. We have with us today Patrick McHenry. Ed Royce should be joining us shortly. Ron Paul, Steven LaTourette, Gresham Barrett, Tom Price, Michele Bachmann, Peter Roskam, and Spencer Bachus, who is the ranking member of the full committee, will also be attending today.

Chairman WATT. Thank you. I'll now recognize myself for a 5-minute opening statement, which may go a little bit longer, but I hope not.

Today's hearing will examine the insurance adjustment process in the Gulf Coast area after the 2005 hurricanes. Hurricane Katrina was the single most insured disaster in the United States with privately insured losses of about $40 billion. It resulted in approximately 1.7 million private insurance claims with the vast majority of those claims coming from Louisiana, Mississippi, and Alabama. Although the insured losses from Hurricane Rita were lower than Hurricane Katrina, Hurricane Rita was also expensive, with privately insured losses of almost $5 billion from about 381,000 claims, the seventh most expensive in history.

After this unprecedented destruction, the National Flood Insurance Program (NFIP) paid out more than $18 billion in claims. The substantial claims that resulted from Hurricanes Rita and Katrina far exceeded the premium income to the Flood Program, and NFIP has borrowed most of the $18 billion paid out in claims from the U.S. Treasury.

The Federal taxpayer has a financial interest in how the NFIP operates and specifically how the claims payment process works. I recognize that insurance matters are generally covered by the States, but the Financial Services Committee has jurisdiction over the National Flood Insurance Program, and Congress acted three times last term to approve additional borrowing authority for the National Flood Insurance Program to enable it to pay claims.

Having given that factual backdrop, let me set some ground rules, address some of the questions that have been addressed to me by colleagues, interested parties, and the press, and frame the issues in the following way:

First, what is our subcommittee's role in this process? In this hearing, and in every hearing or investigation we conduct this year, let's keep in mind that the Oversight and Investigations Subcommittee is not a legislating committee. Our sole purpose is to get the facts and build a factual record. If we do our jobs thoroughly

and fairly, whatever legislation might be appropriate will be based on the facts, but it will be done by another subcommittee, the full Financial Services Committee, or elsewhere.

Second, what do we know already? Well, there are a number of things that various people will tell you that they know about this subject but the only thing I'm prepared to say that we know for sure—and this is where I would like all of our subcommittee members to start—is that everybody I've talked to in the process is unhappy.

Our citizens, our constituents, are unhappy. The one thing that many of them know is that their claims were not paid in a timely fashion, and they blame private insurers, the National Flood Insurance Program, or anybody else that they can find. They know that their claims were not timely paid. The Members of Congress from the Gulf, our colleagues, are unhappy because their own experience and their constituents' complaints indicate that there was not only a breach of the levees that were designed to protect them, but there was a breach in the insurance coverage, adjustment, and payment process that was supposed to compensate them.

Third, private insurers are not happy. They'll tell you that they were just honoring the provisions of their insurance contracts. For a better understanding of their position, I commend to the subcommittee members a thoughtful article from the February 24, 2007, New York Times, which suggests that a confluence of acts of God, voters, the press, trial lawyers for classes of civil litigants, the threat of criminal action, activist judges, and self-interested politicians at the Attorney General, U.S. House, and Senate levels conspired or at least coalesced to make private insurers the victims.

Fourth, the National Flood Insurance Program is unhappy. There has been some suggestion that they rolled over and paid claims that shouldn't have been paid by the Program or that should have been paid by private insurers. Most of the Program's flood insurance premium dollars are now going to pay interest on the $18 billion that was used to pay claims.

Finally, taxpayers could end up being very unhappy. If we can't sort through this, and if it's not fixed, they could be left footing the bill and, what's more, a similar result could occur after future disasters. Everybody is unhappy, and I think that's the case, and why we need to be here today. And everybody is pointing fingers or blame at someone else.

Our job in this subcommittee is to document the facts, and today's hearing is the start of that process.

Finally, I've been asked, is this the only hearing we will have? I think it's clear that there will be other hearings, and I want to make it clear that those hearings, and the whole process, will be fair. I don't start with any preconception of where we'll get to or where we'll end up. I will tell you that I intend to do as many of these hearings as we need to, to get a full record for somebody to take action.

There will be an effort to identify possible solutions, but we need to know the facts first. I thank the witnesses for being here to start the process. And I now yield 5 minutes to the gentleman, the ranking member, Mr. Miller.

Mr. MILLER. Thank you, Mr. Chairman. I'll try not to repeat a lot of what you discussed because there's a lot of facts we have in this that we will be gleaning through this hearing. But today the subcommittee will consider the performance of our insurance system in fulfilling it's obligation in the aftermath of Hurricanes Katrina and Rita in order to provide a factual foundation from which to legislate or improve the system.

In 2005, hurricanes caused an unprecedented amount of damage to residential, industrial, and commercial property. It's important to note that while some insurance claims from these storms have yet to be resolved, more than 95 percent of the claims have been settled.

For unresolved claims, the recourse of policyholders is either mediation or adjudication. Such processes are in place to ensure that every case can be resolved fairly. From the initial approval of the insurance policies by the State insurance commissioner, to the claims settlement process, one thing is clear. Even during a time of tremendous strain, our insurance system operates as it was designed.

This is not to say that we are satisfied with the design of the system. Rather, the problems we have witnessed indicate that we must improve the system. It is not working the way that we would want it to work.

I do not believe that this hearing should be used as a forum to blame private insurers. If we don't agree with the outcome, then let's change the rules and reform the system. If we want to assess blame, let's start by looking at the opportunities that we, as a Congress, have missed in the past to improve our system.

As many of you know, I have been an advocate for reform of the insurance system for many years. The system as we know it is plagued with inefficiencies. If there ever was an impetus to reform it, it is now, when we have seen the shortfalls of our system exacerbated during a time of great strain.

I also do not believe that this hearing should be a forum to reject the benefits of private insurance in favor of expanded government and increased taxpayer exposure. I have, along with other members of this committee, participated in efforts to reform the National Flood Insurance Program and, importantly, to modernize our National Flood Maps.

While some might think an expansion of the NFIP would be beneficial in resolving some of the insurance system deficiencies revealed in the aftermath of the 2005 hurricanes, I must also refer you back to the last NFIP markup we had in this committee when some wanted to mandate the purchase of flood insurance in areas of our country where there was no basis to require it in order to make the program solvent.

I am here today, as I was at that markup, to tell you that this is the not way to capitalize an insurance fund. A fundamental tenant of an insurance is to spread the risk, but we shouldn't be spreading it to people whose homes will likely never be flooded.

The NFIP is currently solvent. The program is almost $20 billion in debt to U.S. taxpayers. We shouldn't be mandating that people pay for flood insurance when they don't need it, and we shouldn't

be asking the taxpayers to foot the bill for a broken program any more than they already are.

As we move forward, I urge my colleagues to remain mindful that a vibrant private insurance market will help expedite recovery in the Gulf area. Recovery cannot take place if there is no insurance market. We must ensure that we do not inadvertently drive liquidity and capital out of these hurricane-prone areas. If we do that, we have only succeeded in harming the future of the communities that we aim to help in this hearing.

Thank you. I yield back.

Chairman WATT. Are there any other members who would like to be recognized for an opening statement for 2 minutes?

Okay. The gentleman is recognized for 2 minutes.

Mr. ROSKAM. Thank you, Mr. Chairman. I very much appreciate the opportunity to participate in this hearing today, and I particularly appreciate you, Mr. Chairman, for laying out the ground rules on what it is that we're going to be considering: number one, the subcommittee's role; and number two, the notion that everybody is unhappy. I accept the premise that everybody is unhappy, but I want to urge a little bit of caution.

I come from Illinois, which is a good State from an insurance perspective. Illinois and the regulators there and the industry is robust, and when insurance companies compete, consumers do very well.

I think the tone and tenor of the hearing is important because I think we are in a position where we, in the Congress, need a robust insurance industry in this particular marketplace that has so much at risk. We must be careful not to create, either through harsh language or overly aggressive regulation, an environment where the insurers say, "Look, we're going to walk away; we don't need this hassle." We know that capital is fungible, and capital goes to where capital can excel, so I think that we need to be very, very careful.

By analogy, we had a situation in Illinois where it became very difficult in the practice of medicine in southern Illinois, south of Springfield, Illinois, about half of the State, to the point at which many physicians said to the plaintiff's bar, "You win, we lose, we are leaving", and it created a great deal of adversity.

It seems as we move forward we need to put this into context; 95 percent of these claims have been settled. And really is there anybody among us in Congress who can claim that we have that 95 percent success rate in their own districts? I certainly can't, and I think we need to focus on this 5 percent, or I've heard even the number as low as 2 percent, of those claims that really need special attention.

So Mr. Chairman, I yield back the balance of my time and very much appreciate the tone that you've set.

Chairman WATT. Ms. McCarthy, do you care to be recognized for an opening statement?

Okay. Thank you. Ms. McCarthy has been a long-time opponent of opening statements. She probably didn't even want us to make opening statements.

Let me ask your unanimous consent to submit for the record a copy of the February 24, 2007, article from the New York Times

that I referenced in my opening statement. I think the members will find it interesting, and it kind of lays out a whole different perspective on this.

Let me thank our member witnesses for being here and indicate that in the interests of their time, and in the interests of preserving the subsequent witnesses' time, we will have their testimony and not have questions and answers. And then either of you, or any of you, who wish to join us up here, we'd be delighted to have you.

So let's see. Who will be going first? Oh, okay. We're going from the right to the left, okay. Our good friend and colleague, Representative Bobby Jindal from the great State of Louisiana, is recognized for 5 minutes.

Mr. JINDAL. Thank you very much, Mr. Chairman, Ranking Member Miller, and the rest of the committee members. Thank you for providing me the opportunity to testify. I would seek unanimous consent to submit my longer written comments for the record.

Chairman WATT. Without objection, we're going to give unanimous consent to have all of your written statements made a part of the record.

STATEMENT OF THE HONORABLE BOBBY JINDAL, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF LOUISIANA

Mr. JINDAL. Thank you, Mr. Chairman. Eighteen months ago, in August and September of 2005, Hurricanes Katrina and Rita devastated the Gulf Coast region of the United States, including large land areas in my home State of Louisiana.

In the southern portions of Louisiana, the storm surge swept across the coastal areas causing extensive property damage. In my district in the City of New Orleans—you'll hear from my colleague as well—levees failed, and flood waters swamped homes and businesses for several weeks before the water was finally pumped back into Lake Pontchartrain.

Hurricane Katrina was the most significant natural or manmade disaster to affect the United States. The effects of the hurricane completely destroyed and made uninhabitable an estimated 300,000 homes. This far surpasses the residential damage of Hurricane Andrew. It surpasses the combined damage of the four major 2004 hurricanes—Charley, Frances, Ivan, and Jeanne.

The Federal Government aided businesses and individuals struggling to purchase terrorism insurance after the September 11th terrorism attacks, and we believe the people of Louisiana deserve the same help. With more than 53 percent of our country's population living in the 673 coastal counties and parishes, it is critical that we provide access to affordable insurance for these areas.

In many coastal areas, insurance prices are a growing problem because of steadily rising rates. For south Louisiana and several of our Gulf States, we're in the midst of an insurance crisis. Louisianans are still haggling with their companies over settlements and payments a year-and-a-half after the storms. These problems are normally resolved within 3 months after a natural disaster.

Even further though, however homeowners and businesses are unable to rebuild because of high premiums and difficulty in getting insurance altogether. Since the 2005 hurricanes, many policies in the greater New Orleans area have gone up more than 50 percent, and insurance costs have gone up an average of 12 percent across our entire State.

Obtaining insurance is difficult because only a handful of companies are writing property insurance in the State. In fact, 10 of the top 25 property insurers do not do business in the State. Those companies that remain are striving to eliminate hurricane coverage from their portfolio. There are immediate reports that insurance companies are attempting to cancel insurance policies of those who weren't even affected by flood or wind damage caused by the 2005 hurricanes. In short, Louisianans are paying more for less insurance, if they can even get it, which is hampering our recovery from the storms.

A couple of specific examples. State Farm Fire and Casualty Company, the largest residential insurer in Louisiana, has 32 percent of the market. It has stated that it will not write new hurricane coverage, also known as wind and hail insurance policies in south Louisiana.

Allstate accounts for 20 percent of all homeowner's policies and has been the State's second largest provider of insurance. It's implementing a Statewide 5 percent deductible on hurricane coverage. According to news reports, Allstate does not plan to write new hurricane protection policies in much of Louisiana. Currently, our State's commissioner of insurance is investigating allegations that the company is arbitrarily canceling homeowner policies in the State.

Louisiana Citizens Property Insurance Corporation is the State-run insurer of last resort. It's currently our third largest insurer, and it is writing more policies than ever before. They write 1,000 policies per day, but they expect to write between 60,000 and 200,000 policies over the next year. But the premiums, by law, are costly, are priced above the marketplace. Without competition from the private sector, market forces are not working to drive down insurance rates.

The bottom line is that extraordinarily high insurance premiums will put those small mom and pop shops or the young entrepreneur permanently out of business. People in south Louisiana will not be able to afford to rebuild.

The insurance crisis is a classic chicken-or-the-egg problem. If the property owner rebuilds, in accordance with Federal law, he must obtain property insurance before settling on the property with a loan from a mortgage company but we, in south Louisiana, are having difficulty getting the insurance needed to go to settlement because companies are refusing to issue new policies in this area.

I have several examples in my testimony, so I won't go through all of them. There was a recent example. An insurance saleswoman in New Iberia, Louisiana, left, scrambling to find insurance within 2 weeks of transferring her policy to a house she had just finished building. Her wind and hail, hurricane coverage was canceled. The mortgage company threatened to make her return the loan money unless she got a new policy.

She was an industry insider, so she was familiar with every company that writes insurance. She was rejected by all but Citizens. When she finally was lucky enough to get insurance, her premiums went from $900 to $3,000 a year for the same coverage she had bought simply 2 weeks ago, 2 weeks before then.

We can go through it again. There are several examples. On the commercial side, HRI Management has a portfolio of properties worth $200 million. Before Katrina, their coverage cost $500,000, including a 1 percent deductible, or roughly $1,000 per property. Two days before the policy's renewal date, the insurance company told them the new policy would be $2.5 million, including a 5 percent deductible, and would provide only $50 million in hurricane coverage. Without competition, the company has limited choices: either put up with absurd premiums, risk foregoing insurance altogether if they're not being financed by a bank loan for their properties, or move their business to another location.

We must ensure that the residents of our State have access to reasonably priced insurance and are not forced to live uninsured. Unfortunately, for example, tragically, many of the residents in St. Martin Parish whose homes were destroyed by a tornado right after Valentine's Day had recently dropped their homeowner's insurance due to the rising insurance costs after the hurricanes.

It was reported in one local paper that a 90-year-old widow on a fixed income who owned her home outright was faced with that dilemma. She could pay for food, medicine, and other needs, or use that money to pay for her increasing insurance premiums. She chose the former. Now she must rebuild her home after it was destroyed by the tornado without the help of insurance. This is completely unacceptable. Something has to change.

I'd like to the leave the committee with one last thought. Insurance companies argue that it is too risky to issue policies in south Louisiana in coastal areas. But I must point out two things. One, if the levees in southeast Louisiana had been built to withstand a category three hurricane, as we had been told they were, the area would not have had the extensive damage. We would not have had—certainly we would have had destruction after Hurricanes Katrina and Rita, but it would not have been nearly as extensive as what we saw.

We're even now having cases of people who didn't have damage from the storms losing their coverage. There's certainly an understandable concern on the part of insurance companies to manage their portfolios. They need to ensure their long-term solvency and stability; that is certainly in everybody's best interests. However, in 2006, while insurance companies were defending their decision and not issuing new policies in Louisiana because they can't afford to issue this market according to them, they were also delivering a record $44.8 billion in profits even after accounting for the claims of policyholders wiped out by Hurricanes Katrina and Rita.

From 1999 through 2005, the industry saw its profits nearly double from $22 billion in 1999 to $43 billion in 2005, while adding $100 million to its surplus reserve. It doesn't seem right that insurance companies are making record profits while Louisiana residents cannot afford their premiums.

Our residents have been through so much. We cannot rebuild our State unless our people move back. They cannot do this while insurance remains either too expensive or simply not available. We can't reasonably expect people to return home to rebuild their businesses.

While we cannot go back in time to fix the present, we can take steps to brighten the future. I applaud this committee, Mr. Chairman, the members of this panel for undertaking examination of insurance practices in the Gulf Coast in the aftermath of Hurricanes Katrina and Rita. Thank you for your attention to this very serious problem which threatens the recovery of my State.

[The prepared statement of Mr. Jindal can be found on page 56 of the appendix.]

Chairman WATT. I thank the gentleman for his testimony. You've set a precedent of doing 5 minutes in 8½ minutes, but we're trying to be understanding here.

The gentleman from Louisiana, Mr. Jefferson is recognized for 5 minutes or 8 minutes, but don't go overboard, now.

STATEMENT OF THE HONORABLE WILLIAM J. JEFFERSON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF LOUISIANA

Mr. JEFFERSON. Thank you, Mr. Chairman. If it had not been Bobby Jindal speaking, it would have been 10 minutes to get that much material in.

Good afternoon, Mr. Chairman, and members of the committee. I am deeply grateful to you and to the other members here for the attention you have given to this matter.

The matter before us today regarding insurance claims payment processes in the Gulf Coast after the 2005 hurricanes obviously has a great effect on the rebuilding and renewing of our entire region and, of course, the City of New Orleans and its surrounding communities.

It is necessary that we hold these insurance companies responsible and make them pay for the services that they guarantee their customers. Since the great storm that hit New Orleans and the Gulf, insurance companies have seemingly done everything in their power not to be fair and equitable to the very citizens who need them most, the very citizens who for decades have been loyal customers.

Bobby has gone through a lot of the numbers about the disaster costs of the storm: more than half of the New Orleans population has yet to return; and there have been more than 200,000 deaths, more than 200,000 homes destroyed, and 600,000 jobs disrupted. And Mr. Chairman, you've also noted that the 1.7 million private insurance claims leaves unaccounted 975,000 of them. And you cited the categories, commercial losses, $18 billion, homeowner policy claims, $17 billion, and $5 billion auto and other claims.

Information gathered from the Louisiana Department of Insurance shows that 61 percent of the total insurance claims from Katrina came from homeowners. However, of all the money that has been paid out thus far, only 39 percent has been to homeowners.

Bobby has already mentioned the $44.8 billion in record profits in 2005 even after the storm, an 18.7 percent increase, and in 2006 the profit margin was even higher, $60 billion. With all of these profits, the insurance companies still feel it necessary to deny claims of thousands of our people and not to insure old and new residents in the region.

Private insurance companies have not covered many damages that they should have and allowed the Federal Government, through the National Flood Insurance Program, to handle most of the claims. Making a distinction between wind-driven damage and damage from flooding, they have shifted financial risks from the business community to government and to individual homeowners.

Courts in Louisiana are flooded with litigation against insurance companies because most residents feel it is the only way they can recover anything from insurers. In fact, in the eastern district of Louisiana, there are 5,175 Katrina-related lawsuits; 95 percent of those are homeowners against insurance companies.

Gene Smith, who is the chief deputy clerk of courts for the eastern district of Louisiana, states that typically the courts have a docket of about 3,000 cases for the year. Now there are over 3,900 pending cases dealing with homeowner's insurance cases alone. This does not include those who filed in State court, nor does this number reflect every party in the multiple claim and class action suits.

Many insurance companies in the area have planned to stop writing new policies for homeowners and commercial businesses altogether. The Louisiana Insurance Department had to issue emergency rules to suspend insurance companies from canceling or not renewing residential policies or commercial policies on commercial properties, of course. However the emergency rule expires tomorrow.

Robin Halverson, a Lott & Bloom real estate agent, was actually living in her by-water home by the end of 2005 and had completed repairs on her home by December of that same year. She received a letter from Allstate stating that her policy was to be canceled because the house was abandoned and in disrepair.

The Louisiana Department of Insurance has received more than 100 complaints from customers who are being terminated at the end of Emergency Rule 23. The complaints all come from one insurance company and it appears that many other insurance companies will follow suit. The department is saying that there is no reason for many of these people to be dropped from their insurance company records.

Higher premiums are a big strain on the real estate market back home. Premiums have risen tremendously. Ms. M. Sharpie, a resident of the West Bank area, of Algiers Insurance says her premiums have risen 100 percent. Ms. Sharpie had only minor damage on her home in an area of the City that was not as damaged as most parts of the City were. Nonetheless, her insurance company felt it necessary to double her insurance premiums.

She is also feeling the strain in her career as a real estate agent. Ms. Sharpie feels that many people want to move or come back to New Orleans but obtaining insurance makes it unaffordable. Two popular areas she knows most people want to move back to are

Gentilly and Lakeview, however the only option potential buyers have now is Louisiana Citizens, which is already higher than the private market.

The Louisiana Citizens Property Insurance is the State's insurer of last resort, a non-profit organization that had to be established by the legislature because applicants were not able to procure coverage through the market. The rates through this group are typically 10 percent higher than the private market and even this is not always available.

And now it appears that since most insurance companies aren't going to write hurricane policies at all, they'll all have to be written to Louisiana Citizens, which means necessarily they'll be higher than the market there was before.

Additionally officials of the Louisiana Realtor's Association, a State trade association that assists members with business and real estate matters agrees with Ms. Sharpie. They state that insurance premiums have risen anywhere from 30 percent to 400 percent. A resident who purchased a $150,000 home before Katrina would pay $1,200 a year typically for insurance. That same resident today could be expected to spend $5,000 per year.

The high price of these premiums that extend across the State looks to cripple the real estate market in the State of Louisiana. Since it's required for one to get insurance with a home purchase, and many insurance companies are not writing policies, the insurance industry is making it doubly impossible to rebuild the region.

Coupled with the increased difficulty obtaining a home mortgage—with not only rising but even the unavailability of insurance providers, it makes building our region back a mere impossibility. This is not only applicable to the homebuying market but spills over into the rental market as well, in the form of higher rent because of the high insurance requirements.

HRI was mentioned by Representative Jindal a minute ago, but I'll state it a little different way. It's a New Orleans-based real estate development company and it's not alone. In building buildings back home before the storm, the cost for insurance was $400 per unit, more or less, depending on the size of the unit and so on, but the same unit today of a certain size that they were referring to would cost $1,800 per unit if insurance were available to buy. Additionally, this particular building is not in a flood zone. That's an increase of 450 percent.

Some of the best-case-scenario estimates did not do much better. The increase there would be about 300 percent. However, these numbers did not include higher and new deductibles on storms and the base deductibles. A representative from HRI also states that this story is typical amongst developers.

There are countless examples of Gulf Coast citizens who were literally and figuratively left in the lurch by their providers. In order to rebuild and renew the great City of New Orleans, the Gulf Coast region, and most importantly, its people, it is vital that we make that transition back to their homes as seamless and as easy as possible.

I'd like to once again thank Chairman Watt and the members of this subcommittee for their continuing efforts and their service. It will be necessary for all of us to continue to work together to re-

quire a better response by the insurance industry and to make our people who have faithfully paid their premiums over the years whole again.

The largest impediment to the rebuilding of our region, I will repeat, is not going to be FEMA or any of these other things we've talked about so much. It is going to be the availability and the high price of insurance coverage.

Thank you, Mr. Chairman.

Chairman WATT. Thank you for your testimony. Representative Gene Taylor from Mississippi is recognized for 5 minutes.

STATEMENT OF THE HONORABLE GENE TAYLOR, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MISSISSIPPI

Mr. TAYLOR. Mr. Chairman, I'd like to call you and the committee's attention to the home of Corky and Molly Hadden. This is what it looked like on August 28, 2005. This is what it looked like the afternoon of Monday, the day after. Corky and Molly had $650,000 worth of homeowner's insurance on that home, but 17 months after the event of that storm, they've been paid nothing.

This is the home of Jody and Betty Benvenutti. It is about 180 years old, and had survived who knows how many hurricanes in its life. This is what it looked like the day before the storm. This is what it looked like the day after.

Jody is in the insurance business, so he wisely bought a lot of insurance for that home. He had $586,000, which he thought was the full replacement value, but 17 months after the storm, he's been paid nothing.

What do they have in common with a U.S. Congressman, a United States Senator, a Federal judge, and thousands of other people, the people who built their houses to spec, who paid their Federal flood insurance policy, and had a homeowner's policy, because in hurricane country you don't know whether it's going to be the wind or the water that gets you so you hedge your bets with both. And like thousands of other people in the weeks after the storm, one after another were told by their private insurers, "We're not going to pay you."

See, I think that contributed to a massive fraud against folks like Corky, against folks like Jody, but against the taxpayers, too, to Mr. Miller's point. See, under the Federal, "Write Your Own Program", we allow the Federal insurance companies to write the policy. That saves the Nation the trouble of having people to write that policy. We pay them a premium for that.

The problem is that we also allow them to adjudicate the claims. We let State Farm, Nationwide, USAA, and others go out to a piece of property like the Benvenutti's, and like the Hadden's, and determine how the house was destroyed. Now in some instances, in very limited instances, people stayed behind and actually lived to tell about it. And in those limited instances where a person could give a sworn testimony that they saw their house blow away before the water got here, they were paid, but not very many people lived to tell that story; most people got the heck out of there.

So for the people like Corky, and for the people like Jody, who got out of there as they were instructed, they got nothing. The in-

surance companies conspired to defraud them. They conspired to defraud the taxpayer. And let me tell you how.

Within weeks of the storm, State Farm and others issued memoranda to their claims adjusters that whenever they could see wind and water had been there, to blame all of the damage on water. That creates two problems. Number one, for those people with homeowner's policies, the wind damage that obviously occurred in the 5 hours of hurricane-force winds that hit their houses before the storm surge got there is being totally ignored.

To Mr. Miller's point, they have a responsibility under the law for a fair adjudication of that claim. So when a company issues a memorandum to their inspectors to ignore wind damage, and blame it all on the water, they are by their own admission sticking the taxpayers with bills that State Farm, Allstate, Nationwide, and others should have paid. That's where the fraud against the taxpayers comes in.

So, Mr. Chairman, what I'm going to ask your committee to do is—there are claims adjusters who walked away from quarter-of-a-million-dollar-a-year jobs, which in south Mississippi is a lot of money.

There are actually two sisters by the name of Rigsby, and they walked away from their jobs because they were so disgusted, on a day-after-day basis, with having to go tell people that they knew had houses that were damaged by wind—they'd blame it all on the water so that they only got the flood insurance policy and none of the wind policy. They were so disgusted with that action done by their employer, E. A. Renfro & Company, which did work for State Farm, that they walked away from their jobs and said, "We're not going to do this anymore."

I'd like you subpoena the Rigsby sisters. I'd like you to subpoena the people from State Farm and Allstate and Nationwide. How can they pass out a memorandum? After already promising our Nation that they would have a fair adjudication of the claims, how can they send out a memorandum to their own employees saying, "Blame it all on the water and that way the taxpayer has to pay."

I'd like you to look into the antitrust. Again, they are exempt from the antitrust laws, so is it really fair that State Farm can call up Allstate and call up Nationwide and call up USAA and say, "You know what, if you don't pay claims, and you don't pay claims, then I won't have to pay claims." Under the existing law, that is allowed. It's wrong as all get out, and it should be illegal.

So Mr. Chairman, lastly I would like our Nation to look into all perils insurance. To Mr. Miller's point, if you've checked in California, you'll notice that 53 percent of all Americans live in coastal America. So what happened in Mississippi could happen in Maine, has already happened in New York, and has already happened in North Carolina. It happened four times in Florida in 2004, so it really could come to California one day. And is this how you want your constituents to be treated? Is this how you want the taxpayers of the whole Nation to be treated? If they're going to pull out of coastal America on a State-by-State basis and say, "We're not going to protect homeowners anymore from anything other than theft or fire", then maybe there is a vacuum that our Nation ought to fill, just like in the 1960's when our Nation stepped in to provide Fed-

eral flood insurance because the private sector didn't want that job anymore. Since half of all Americans are affected by this, isn't it time for this Congress to look into it?

Mr. Jindal and Mr. Jefferson did an excellent job of talking about how much the rates have gone up just for people who still want to get fire insurance, still for people who want to get theft insurance.

And think about the irony here. We, as a Nation, tell people you have to have insurance if you have a federally backed mortgage, and yet we're saying on the flip side that we, as a Nation, are incapable of regulating insurance, so we're going to let the States do it. Therefore, there are 50 different standards for what's right and wrong, plus when you throw in the territories.

There's a lot that needs to be changed with this. I would ask you to put yourself in the shoes of these folks who after 17 months haven't gotten a dime, who built their houses the way they should have, who paid their premiums, who, when the Nation said, you need to get the heck out of here, got out of there, and because they weren't there to witness the destruction of their homes, didn't get a dime.

Mr. Chairman, I've laid a lot on your plate, but I know you're more than capable of making all this happen. Thank you for this hearing.

Chairman WATT. Well, we thank you. We thank all three of you for your testimony, and I think we're more than capable of documenting what has occurred. Then hopefully, we'll have some ideas for the other committees and subcommittees about some responses that need to be taken also. And we assure you that we will do our best to document and to get all sides of what has occurred.

So we thank you so much. As indicated earlier, we are not going to subject the Congressional Member witnesses to questions and answers. We feel like we have access to them on the Floor of the House, in the halls, and we can get questions answered from them. And so we will use that off-the-record access to them to get them to address this.

Mr. TAYLOR. Mr. Chairman, I do have a more thorough statement that I'd like to include for the record.

Chairman WATT. Without objection your written statement, all of the written statements of all three of the witnesses will be submitted for the record, the full written statements.

[The prepared statement of Mr. Taylor can be found on page 61 of the appendix.]

Chairman WATT. Thank you so much. And we'll now call up our second panel.

Let me once again thank the member panel for their testimony, and thank the second panel for being here with us today. I apologize once again for the late start, but some things we don't have control over. There are a lot of things we don't have control over, and votes are certainly one of those things.

Allow me now to introduce the second panel, and I will make one introduction and ask my colleague, the ranking member, to make an introduction, and then allow Mr. Taylor to introduce his Attorney General from Mississippi.

So our first witness will be David I. Maurstad, am I pronouncing that correctly?

Mr. MAURSTAD. Yes, sir.

Chairman WATT. Maurstad, who was appointed Director of FEMA's Mitigation Division and Federal Insurance Administrator in April of 2006, and previously held both positions in an acting role beginning in June 2004. In this position, Mr. Maurstad provides leadership for some of the Nation's leading multi-hazard risk reduction programs, which seek to secure the homeland from natural hazards. These areas of oversight include the National Flood Insurance Program, the National Earthquake Hazards Reduction Program, the National Dam Safety Program, and the National Hurricane Program.

In his position, he has worked closely with public and private risk managers as well as leaders in government, industry, research, and academia. Previously, he served as Regional Director of FEMA Region Eight beginning in October of 2001, where he coordinated FEMA's prevention, preparedness, and disaster response and recovery activities in Colorado, Montana, North and South Dakota, Utah, and Wyoming. And prior to that he was the lieutenant governor of Nebraska, a position in which he was elected in 1998, and previously served in the Nebraska unicameral legislature.

He has nearly 25 years of experience as an insurance agent in Nebraska, was mayor of Beatrice, Nebraska, is the first locally elected official and insurance agent to head the National Flood Insurance Program, and holds a bachelor of science degree in business administration and an MBA degree from the University of Nebraska in Lincoln, Nebraska.

I now recognize the ranking member for an introduction of our second witness.

Mr. MILLER. Thank you, Mr. Chairman. I am going to try to make a very lengthy bio very short because it is extremely lengthy and the man is extremely qualified.

Robert P. Hartwig is president and chief economist of the Insurance Information Institute. Since joining the III in 1998 as an economist, Dr. Hartwig has focused his work on improving the understanding of key insurance issues across all industry stockholders, including media, consumers, insurers, producers, regulators, legislators, and investors. As president of the III, he provides assistance to thousands of stories annually and covers all aspects of print, television, radio, and news media, while also responding to thousands of requests for III member companies and other constituents.

The institute is generally recognized to be the most credible and frequently used single source of information and referral for the widely diverse insurance industry. Its board represents companies from all areas of the industry, including life insurers. In addition, some 20 other insurance organizations contract with III for media services.

Dr. Hartwig previously served as director of economic research and senior economist with the National Council of Compensation Insurance, NCCI, in Boca Raton, Florida, where he performed rate and return in costs of capital modeling and testified at worker's compensation rates hearings in many States. He also worked as a senior economist for the Swiss Reinsurance Group in New York and is senior statistician for the United States Consumer Product Safety Commission in Washington, D.C.

He is a member of the American Economic Association, the American Risk and Insurance Association, and the National Association of Business Economics and CPU Society, and serves on the board of directors of the Independent Insurance Agents and Brokers Association of New York.

In 2005 to 2006, Dr. Hartwig served on the State of Florida's Task Force for Long-Term Homeowner's Insurance Solutions, and that's about a third of the bio, so I will stop at that for the sake of time.

Chairman WATT. And Mr. Taylor is recognized to introduce the Attorney General.

Mr. TAYLOR. Mr. Chairman, I'd like to introduce our State's Attorney General, Jim Hood, who, among his many accomplishments most recently did, I think, a phenomenal job of looking into the allegations against the insurance industry that I just laid out, the fraud against individuals, and the fraud against corporations.

His work has resulted in at least one of the companies trying to reach a settlement with the people who were left with nothing. And to give you some idea of how well he did his job, part of that settlement was that the company asked that whatever criminal investigation against that company would have to be dropped as a part of that.

So I very much applaud him for doing what our U.S. attorneys should have been doing. I think he's done an excellent job of protecting the consumer, and protecting the taxpayer, and we're honored to have him here today.

Chairman WATT. Without objection, the written statements of all three of these witnesses will be made a part of the record.

And we will recognize Mr. Maurstad for 5 minutes for his testimony.

STATEMENT OF DAVID I. MAURSTAD, DIRECTOR AND FEDERAL INSURANCE ADMINISTRATOR, MITIGATION DIVISION, FEDERAL EMERGENCY MANAGEMENT AGENCY, U.S. DEPARTMENT OF HOMELAND SECURITY

Mr. MAURSTAD. Good afternoon, Chairman Watts, Ranking Member Miller, and members of the subcommittee. I am David Maursted, Mitigation Division Director and Federal Insurance Administrator for the Federal Emergency Management Agency.

The large number of claims and severity of flood losses from the 2004 and 2005 hurricane seasons are unprecedented in the history of the NFIP. The challenges these storms have presented to the Mitigation Division, particularly the 2005 hurricane season's, have never been encountered on this scale before. Today I'll address the NFIP's financial status, mention some accomplishments, and point out some opportunities to strengthen the program.

The NFIP makes affordable flood insurance available in communities that adopt and enforce measures to reduce their vulnerability to flooding. From 1968 to 2004, the NFIP paid out $15 billion to cover over 1.3 million claims. Hurricane Katrina alone resulted in claims totaling $16.3 billion to date.

It is likely that the 2005 flood insurance costs will exceed $20 billion, including interest already paid on borrowing from the U.S. Treasury. Congress has increased this borrowing authority three

times since Katrina to the present limit of $20.775 billion, allowing nearly all of the 2005 flood claims to be paid.

That's more than 180,000 Gulf Coast residents on the road to recovery due to our private sector partners, our Write Your Own insurance companies, as well as claims adjusters and agents who fulfilled their responsibility to help NFIP policyholders begin rebuilding their lives.

With over 5.4 million policies insuring more than $1 trillion in assets, the NFIP collects more than $2 billion annually, yet we expect interest on our borrowed funds to reach $720 million this year. If future claims meet historical averages, the program will need new loans every 6 months just to cover semi-annual interest payments.

Needless to say, under current loan arrangements, it's unlikely the NFIP will ever be able to retire this debt. Financial matters aside, I'm proud of how the NFIP and the insurance industry worked together after Katrina, using new information and innovative approaches to help Gulf Coast flood policyholders when they needed it most.

The NFIP Summary of Coverage and the Flood Insurance Claims Handbook helped them through the claims process. We quickly resolved Katrina and Rita claims with streamlined adjustment and claims processes, but not at the expense of quality control.

From the beginning, FEMA general adjustors and claims staff were in the field conducting random and on-demand reinspection of damaged structures. We also reviewed sample sets of claims filed to ensure the integrity of the process. This is in addition to the regular adjustor monitoring we perform, to operation reviews, biennial audits and audits for cause.

The GAO and the DHS Inspector General are investigating the quality of our flood claims handling, and we are cooperating fully.

We learned from Katrina and we are sharing this knowledge with States as we help them educate and train agents who sell flood insurance.

We're also working with affected communities to make sure they rebuild wisely. For instance, FEMA provided affected areas with updated flood hazard data to help guide reconstruction. This guidance must be used for all rebuilding activities involving FEMA hazard mitigation and public assistance grant programs because it doesn't make sense to spend tax dollars to rebuild to outdated standards only to face similar damage when the next storm comes along.

And it will come. That's why we must continue to strengthen the program by protecting the program's integrity, improving citizens' understanding of flood risks, and reducing risks with proven mitigation practices. We should enhance these principles by eliminating discounts on pre-furn structures, strengthening mandatory purchase requirements, and improving data on flood maps.

Levee failure vastly increased New Orleans' flood claims. Improper flood map depiction of areas behind levees is one of our primary concerns. My written testimony offers recommendations on how to improve the program, and I look forward to working with this committee and others in this regard.

However there is no quick solution that will allow the program to absorb catastrophic loss years like 2005, and we're concerned about more than financial matters. Increasing risk awareness among homeowners and consumers with improved, succinct information is one of the NFIP's basic principles and is an important element of the 2004 Flood Insurance Reform Act.

As citizens learn more about the risks they face, they'll be more likely to reduce their vulnerability, making the Nation's communities safer places to live, work, and do business.

I'll be happy to answer any questions that the committee and other members might have, and thank you for the opportunity to testify.

[The prepared statement of Mr. Maurstad can be found on page 159 of the appendix.]

Chairman WATT. Thank you for your testimony. Mr. Maurstad has set a tough act for you all to follow, having finished right on the 5-minute mark, and we appreciate that.

Dr. Hartwig is recognized for 5 minutes.

STATEMENT OF ROBERT P. HARTWIG, PRESIDENT AND CHIEF ECONOMIST, INSURANCE INFORMATION INSTITUTE

Dr. HARTWIG. Thank you. Good afternoon, Mr. Chairman, Ranking Member Miller, and members of the committee. Thank you for the opportunity to discuss the important and vital role played by the insurance industry in the response, rebuilding, and recovery effort following Hurricane Katrina.

My name is Robert Hartwig, and I'm president and chief economist for the Insurance Information Institute, an insurance trade association based in New York City whose primary mission is to improve the public's understanding of insurance, what it does, and how it works.

Hurricane Katrina was the largest and most expensive disaster in the history of insurance. Claims payments to restore homes, businesses, and vehicle losses totaled $41 billion on some 1.7 million claims filed by policyholders across six States. For all of 2005, hurricane losses topped $57 billion on some 3.3 million claims.

As we know, the devastation wrought by these catastrophic hurricanes was unprecedented and so, too, was the industry's response. Some 15,000 adjusters were called in from across the country. These men and women worked tirelessly, day and night, for months, often in difficult and dangerous conditions.

For many property owners, insurance adjusters and the checks they cut on the spot where the first tangible signs of relief they had seen. Millions of American families and businesses devastated by the storms of 2004 and 2005 are back on their feet today because of the more than $80 billion paid to them by their insurance companies.

Insurers are justifiably proud of their performance. As of the first anniversary of Katrina in August of last year, more than 95 percent of the 1.1 million homeowner's claims in Mississippi and Louisiana had been settled with fewer than 2 percent of claims in dispute. Approximately half of these entered no-cost mediation programs established by insurance departments in both States where some 80 percent of claims are successfully resolved.

Throughout the Gulf, only a tiny fraction, well under 1 percent of homeowner's claims have been litigated. Claims adjustment is a highly systematic process. Adjusters work diligently to accurately assess the extent and cause of loss associated with each individual claim. If some damage is the result of an excluded cause of loss, such as flooding, the adjuster will apportion the loss accordingly.

It is important to recognize, as Mr. Maurstad has already said, that FEMA routinely conducts audits of flood claims, including claims practices, and has the authority to review any claim at any time. Consumers are also protected in every State by unfair claims practices statutes that grant State insurance regulators the authority to investigate and penalize insurance companies that refuse to pay valid claims.

The lessons of Katrina and the unparalleled destruction of the 2004, 2005 hurricane seasons include a very stark reminder that living along the hurricane exposed coast line of the United States is an increasingly risky proposition. Indeed, 7 of the 10 most expensive hurricanes ever to strike the United States occurred in the 14-month span from August 2004 through October 2005.

Risk-related lessons revealed in the aftermath of Katrina include the following. Many, if not most, coastal structures in the United States today are insufficiently well constructed to withstand the forces of a major hurricane. Homes built to stronger, industry supported standards however, have fared much better.

Flood insurance penetration rates are woefully inadequate. In parts of coastal Mississippi, for example, fewer than 20 percent of dwellings were insured against flood. The cost associated with offering insurance in hurricane prone areas will continue to escalate as coastal populations soar.

Florida's population, for example, has increased by 80 percent since 1980 with the value of insured coastal property now exceeding $2 trillion. Hurricane Katrina made clear another important lesson, that only a financially strong insurance industry can deliver the relief necessary to help communities recover from major catastrophic events.

Hurricane Katrina and the other storms of 2004 and 2005 provided insurers with valuable insights into loss reduction and catastrophe response. Since Katrina insurers have complemented their existing investments in catastrophe response with a variety of new and enhanced capabilities that speed response times while also partnering with government officials to cut bureaucratic red tape that slows those response times.

Insurance markets in most States are highly resilient and competitive. Unfortunately the operating environment that allows insurers to pay sudden and extreme losses like Katrina is now under siege in several States. Punitive, burdensome legislation and regulation accompanied by a surge in litigation is driving up costs and reducing consumer choice.

Insurance rating agency A.M. Best suggested just last week that recent legislative changes in Florida could even lead to ratings downgrades for some insurers. In Mississippi, a small number of lawsuits relative to the total number of claims filed is having an inordinate impact on the health of the marketplace. The litigation in Mississippi, initiated just 17 days after Katrina by the Attorney

General's office, followed by civil actions from trial lawyers, may have accomplished what Katrina did not, delivery of a potentially lethal blow of uncertainty to the viability of a private homeowner's insurance market in the State.

To summarize, the record $80 billion paid to 5½ million policyholders over the course of the 2004, 2005 hurricane seasons is a vivid demonstration of the vital role played by insurers in helping families, businesses, and entire communities recover from the devastation wrought by major disasters.

Unfortunately, in some States, misguided legislation and a surge of litigation have increased uncertainty to intolerable levels, leaving insurers with few options other than to reduce their exposures to these States.

To conclude, the insurance industry is committed to working in partnership with public policymakers, consumers, and businesses in developing fact-based solutions to the formidable challenge posed by Hurricane Katrina and other disasters and continuing our tradition of helping families, businesses, and communities wherever and whenever disaster strikes.

Thank you for the opportunity to address the committee today, and I'd be happy to answer any questions you may have.

[The prepared statement of Dr. Hartwig can be found on page 105 of the appendix.]

Chairman WATT. Thank you for your testimony. Attorney General Hood is recognized for 5 minutes for his testimony.

STATEMENT OF THE HONORABLE JIM HOOD, ATTORNEY GENERAL, STATE OF MISSISSIPPI

Mr. HOOD. Thank you, Mr. Chairman. I'm honored to be here today representing the State of Mississippi as Attorney General.

I'm here to tell you that there were three storms that have occurred as a result of Hurricane Katrina. One was Katrina itself. The other was the failure of the insurance industry to pay what it owed. And now we're facing incredible escalation in cost to reinsure to try to rebuild. This is the third storm that we're presently facing.

There is a great misconception out there that somehow we're trying to force insurance companies to pay for something that they didn't insure. Their public relations machine has done a wonderful job, including the Wall Street Journal, as the chairman mentioned.

We're trying to make them pay for what they did insure. They were supposed to insure for wind. As one of my assistants pointed out, a saying that came up during the initial Clinton Administration's campaign was, "It's the wind, stupid."

They're not even paying for what they insured, and they used several methods by which they have accomplished that. Let me give you an example. People down the coast—there were about 140 mile-per-hour winds. My home in Jackson, Mississippi, at that capital is about 180 miles north of the coast, and it blew the shingles off of my roof.

State Farm was my insurer. They didn't have the excuse not to pay in areas such as where I live. It blew shingles off the roof; I had my roof replaced; no problem. That's part of that 85 percent of those that they say that they have paid the claims on. They

didn't have the excuse of the anti-concurrent cause provision that they have in their insurance policies, nor did they have the exclusionary provision.

Now where the dollars become involved are those people who were hit by storm surge, which is a relatively small strip along the coastal area of the State of Mississippi. For example, State Farm has one-third of the policies along our coastal area.

They had approximately 9,000 homes that they had insured that were hit by storm surge. About 1,200 of those 9,000 wound up being just what we call slabs, nothing left, so those claims have not been settled. And when they use the term that they've been settled, that just means that they paid on them. That doesn't mean that the homeowner is satisfied with the percentage of payment that they may have given them.

So the misconception that we're trying to rewrite an insurance policy—as Attorney General of the State of Mississippi, I fired a lawsuit within a couple of weeks because I saw where they were abusing their policy provisions, one being this anti-concurrent cause provision. What that provision provides, and let me point out to you that a very independent Federal judge, who is a senior status judge, been on the bench for years, from my area of North Mississippi, had no ties to the coast, is the only Federal judge on our coast handling these cases, a very learned judge, well respected by the Fifth Circuit.

Judge Senter, in handling these cases, struck the anti-concurrent cause provision. What that provision does is it says that, well, during the testimony of the case that was mentioned about the punitive damages occurring, what the insurance companies did was they used satellite figures and determined where the storm surge reached and in essence said that, "We don't know exactly what took your house out, but we do know this from our studies, that storm surge would have taken it out anyway."

So during that trial there wasn't a Mississippi jury that decided that part of the case as far as liability. A Federal judge took it away from the jury and made a decision that the duty of an insurance company is to prove the percentage of the damage caused by the excluded peril, meaning the water exclusion. So they couldn't even prove what percentage of it was done by water through their own studies, much less what the wind did, so the Federal judge directed a verdict and put a bad faith instruction before the jury, and that's where they came down with the punitive damages. Therein lies the problem. People on the coast got hit with 140 mile-per-hour winds; you know it knocked shingles off their houses, at least, when it did 180 miles north at 100 mile-per-hour winds. Yet, when people filed the claim, they got zero; they got nothing, as Congressman Taylor pointed out, nothing.

A Federal judge with a $500,000 home gets a letter saying, "We owe you nothing." That's because of the abuse of that anti-concurrent cause provision that the Federal judge struck as being, in essence, a bait and switch. You sell someone something and then you take it all away because you know water will be part of a hurricane.

That was the reason that we filed that litigation, to get a quick answer, so it's not about the water; it's about the wind. It's about making them pay what they owe.

How did they get around paying what they owed? They have established a program called ACE. That's a handling program adopted by State Farm, and what they did with this program is to hide the double engineering reports that they had. One person even had three particular reports on one property, engineering reports, one saying water, one saying wind and water, and another one saying wind.

So they hid these engineering reports and didn't disclose it to the people. They established this wind and water protocol September 13, 2005, shortly after the storm, which requires that they—the protocol, it's a letter that went out to all their claims people. It says that if water got in the way, in essence the anti-concurrent cause provision, then you make the National Flood Insurance Program pay it off; we don't owe any.

That's what happened to the taxpayers of America. They got dumped on by the insurance companies because their adjusters were out there saying, "We're not paying for any of the wind because water was involved." And so they didn't even try to estimate a percentage that was done by wind that they owed. The National Flood Insurance Program is owed money by the private insurance industry.

I'll give you a quick example, and I'm not sure—it shows stop, but I think I have 3 more minutes.

Chairman WATT. You're over, but we're being generous with all the witnesses today, so I haven't gavelled you yet. Just wrap up as quickly as you feasibly can.

Mr. HOOD. I will finish briefly. In our remarks, we set forth some examples of people who had double engineering reports and weren't told. Those have been in the news media. I have to be careful about giving examples that—none of this information came from our grand jury investigation, which is still ongoing as far as other companies that are involved. And perhaps in this case if the settlement doesn't go through, we may be dealing with that in the future.

One last point I would like to make is how the industry—and this is why we need Congress to get involved. The industry threatens States, particularly one with 2.8 million people like the people of the State of Mississippi. State Farm, I reached a settlement with them. They indicated they were going to stay in Mississippi, that's the whole reason to reach a settlement; if I'd indicted them, they'd have left the State completely, every office shut down, and one-third of our insurance market gone.

I settled it to keep them there, but what did they do? They turned around later and left the State to threaten a Federal judge, intimidate our legislature, and to intimidate the justice system in Mississippi. And I suspect that that's what they will attempt to do here as well. They've done it in New Jersey and other States, threatened to leave. And I think their antitrust provisions need to be revoked and some regulatory authority placed over them at the Federal level.

Thank you for indulging me, and I'll try to answer any questions I can.

[The prepared statement of Mr. Hood can be found on page 122 of the appendix.]

Chairman WATT. Thank you so much. I thank all three witnesses, and we will now recognize Members of Congress, subcommittee members first, for 5 minutes of questions each.

Mr. Maurstad—I recognize myself for 5 minutes—how does this adjustment process actually work? If you have a private insurance carrier and a flood insurance policy also, who does the adjustment? And just talk us through how you work that.

Mr. MAURSTAD. If the company is the State wind pool and covers the wind, and the flood program covers the flood, then we have an agreement with the State of Mississippi, the State of Alabama, the State of Florida, and other States, a single-adjuster program where one adjuster goes out and determines what the appropriate responsibility, the appropriate liability for both the State interest in the wind pool and the Federal interest in the flood pool, and there is an agreement that we will recognize that adjuster's work.

Chairman WATT. To whom does that adjuster report? Who is he answerable to?

Mr. MAURSTAD. He is answerable to both programs, but I would say he is most answerable to the policyholder to make sure that the policyholder is treated fairly and promptly.

Chairman WATT. Well, that would be in an ideal world, but who is he answerable to other than the policyholder?

Mr. MAURSTAD. There is a preassigned, independent adjuster company in Mississippi. I'll just use Mississippi as the example. There's a preassigned, independent, adjusting firm that the State has acknowledged is going to handle these types of cases where it's the State wind pool and the National Flood Insurance Program. And so the State reimburses them, we reimburse them, but I would say that there would be joint responsibility for the actions of the adjuster.

Chairman WATT. Maybe I should get to the question a little bit more directly. Is your testimony that it's your belief that the National Flood Insurance Program didn't pay any claims that should have been paid by private insurance carriers?

Mr. MAURSTAD. I have no knowledge at this point that there have been any claims that have been paid by the Flood Insurance Program that were wind claims that should have been paid for by the private sector, so we have a rigorous program of oversight to make sure that the Federal interest doesn't go beyond its responsibility to the individual policyholders.

Chairman WATT. The distinction between this wind pool and private companies—

Mr. MAURSTAD. Well, there is a distinction.

Chairman WATT. Okay. Well, tell us what that distinction is. We're trying to get to the bottom of this so I can understand it.

Mr. MAURSTAD. Yes, sir. The wind pool, as was indicated before, is the market of last resort. When a homeowner or business owner is not able to secure coverage in the private market, they go to the State wind pool to get their wind coverage, so that's a State-run program.

You will have other circumstances where you will have a policyholder, a homeowner who has a homeowner policy or a wind policy

with one of the private insurance companies, that private insurance company is also a Write Your Own insurance company, and the Flood Program.

Now in our arrangement that we have with the Write Your Own companies, they are responsible for going out and adjusting the claim with a single adjuster so the consumer doesn't have to deal with multiple adjusters. And again that Write Your Own insurance company is responsible for making sure that they allocate to the Flood Program only damages associated with flooding.

Chairman WATT. Let me ask the question a slightly different way. Are there any of the insurers in this class that the Flood Insurance Program paid?

Mr. MAURSTAD. Mr. Chairman, I'm not sure if I understand your question. Are there any of the Write Your Own companies that were part of the class action lawsuit?

Chairman WATT. No, I'm asking you—there's a group of people whose cases were settled—I mean still in process. Did any of those people receive flood insurance payments?

Mr. MAURSTAD. I think it's very safe to say that certainly there were a number of them who had a National Flood Insurance policy. Our responsibility—

Chairman WATT. Did the National Flood Insurance policy pay?

Mr. MAURSTAD. Yes.

Chairman WATT. Okay. That's the question I was asking.

Mr. Hood, Attorney General, maybe you can talk to us about how the actual process works when one has both flood insurance and private insurance.

Mr. HOOD. To directly answer your question, about 630 cases were actually settled on the part of some private plaintiffs. Many of them had slabs on which they got no payment for the insurance company for wind—zero. That's some of the people who were zeroed out. We know that there was damage from wind. The National Flood Insirance Program paid 100 percent, you know, $150,000 on the structure, and $100,000 on the contents of those homes. So yes, there was damage that was caused by wind that was not paid and the percentages, we don't know the answers because of that private settlement.

Chairman WATT. Okay. I'm out of time, but is there a point at which—for those individuals where you paid a claim and it was subsequently determined either through litigation, settlement, or otherwise—the Flood Insurance Program will be reimbursed for any part of what it paid?

Mr. MAURSTAD. Our obligation under the policies—

Chairman WATT. I just asked you a simple question—will the Flood Insurance Program be reimbursed for any part of what is paid in those circumstances?

Mr. MAURSTAD. No, I would say no, because again, it's my belief that the Flood Insurance Program only paid for the damage that was associated by flood or the policy limits.

Chairman WATT. Notwithstanding a determination by a court and/or a settlement, you're saying it's your belief that you didn't pay any claims that you shouldn't have paid?

Mr. MAURSTAD. None have come to my attention.

Chairman WATT. All right. Mr. Miller is recognized for 5 minutes.

Mr. MILLER. Following up on that question, I guess the thing that I'm a little bit confused about is that when you pay a claim associated with a flood, and the house is wiped off the foundation, you obviously turn policy limits. I'm assuming it's how you settle it. Would part of those policy limits include something that might have been damaged by wind that you didn't know about, like—I mean your policy limit has to include the roof, it has to include windows, it has to include siding, and it has to include whatever else might normally be damaged during a hurricane or a wind storm. How do you differentiate what might have been damaged and back that off of your settlement versus what was damaged by flood?

Mr. MAURSTAD. Mr. Miller, that's a very good question, and you're right on target. But I would start out by saying that storm surge is a part of the flood, so if the storm surge caused damage to the roof for example, that you wouldn't normally think—

Mr. MILLER. Well, if the house is wiped out, it did damage the roof.

Mr. MAURSTAD. That's correct. And that's part of the covered responsibility of the flood insurance program. But what we did was go through and do a calculation, number one, to make sure that the damage to the home in fact didn't exceed the policy limits because we're only going to pay what the damage was or the policy limits.

But in most cases with the underwriting information that was available, with either physical observation or knowing that all that there is is a slab, you can do a calculation and come to a good estimate that—

Mr. MILLER. Mr. Taylor's comments were very, very good and I appreciated those, when he talked about the roof being blown off and that wasn't handled by the casualty company, you know, that it was just passed. Was there some deduction made on flood because you figured part of it could be attributed to wind damage?

Mr. MAURSTAD. No. Again, in the case of the flood policy, we would pay for all damage caused by the storm surge regardless—it could be the roof, and we can't differentiate that it could be and the policy doesn't differentiate that it could be covered elsewhere. The responsibility of the policy is to pay for the damage caused by the flooding or the storm surge.

Mr. MILLER. Thank you for that. And Mr. Hood, Attorney General Hood, your comment—and I guess when I made my statement, maybe some people misunderstood what I was trying to say. I think there are some deficiencies within the insurance industry, as far as how the States handle it and how the Federal Government looks at it. And there's some crossover, and there's something missing because what we had in your case was a Federal judge reversing a State approved policy because your State approved policy had anti-concurrent clause in it. Is that not correct? And that sounded like that was what you said that the policy had in it and that's what the insurance industry used as a basis for not settling on a claim and passed it on to flood. Is that an accurate statement on my part?

Mr. HOOD. Yes, sir. But the policy violated hundred year State law on proximate cause.

Mr. MILLER. But did your State insurance commission approve insurance policies?

Mr. HOOD. Yes.

Mr. MILLER. That's what I was trying to make a point of in my statement, that we have two things occurring here. You have a Federal judge ruling that something might not be appropriate or was improperly included within a policy, which I'm certain you had a reason for doing that. Yet you have a State insurance agency saying, yes, that's part of the policy.

Now whether the insurance industry bases their assessment against the homeowner for insurance based on that, I mean I've been in the building industry for 35 years, longer than that, I'm getting older now that I think about it. But my liability policy has all these exclusions, and when an insurance company writes me that policy, they base that assessment against me, how much I'm going to pay them, based on what they're covering.

And in California, I'll tell you, if you have a liability policy as a builder, they don't cover town homes and condominiums and they don't cover hillsides, they don't cover subsides. They don't cover all those things. They write me that policy knowing that, and I guess my concern, and Mr. Watt, what we need to look at—and I've been arguing for 8 years in Congress about options that we might have as a Federal Government in oversight of the insurance agency considering all the different regulations, all the different States have, and they're all applied differently, is that we have States writing policies that include anti-concurrent clauses, which the insurance companies obviously are basing their rates on that clause because they're considering what their liability might be when this happens with a major hurricane.

But I'm not saying who's right, I'm not saying who's wrong, but it looks like there's a problem and that a Federal judge has to overturn a State insurance agency for writing a policy that some insurance company based their risk on.

Now Mr. Hartwig, you said some interesting things, and one thing that was brought up was profit by the insurance industries, and I don't know what's excessive, and I don't know what's not excessive. But I know that States, the way they allow their insurance companies to assess premiums to people, in California, they're not going to allow the Gulf Coast risks to be assessed against California, nor is—I'm assuming Mississippi or other States are going to allow an earthquake risk, a fire hazard risk in California being assessed against them and their policies.

So I'm just curious how the insurance companies do in the States that had the hurricane. I mean was there a profit in those States when this thing was said and done?

Mr. HARTWIG. It's a very good question, Mr. Miller. In States where hurricane activity occurred in 2004 and 2005, let me give an example of the State of Louisiana. In Louisiana, Hurricane Katrina wiped out 25 years worth of homeowners premium and every dime of profit ever earned in the history of the State. In Mississippi, 17 years worth of premium were wiped out, along with every dime of premium ever earned in the State.

By law in all 50 States, and as we've already discussed, insurance is regulated at the State level, fundamentally the rates in each State must reflect the experience of that State and that State only. So as you've rightly pointed out there can be no subsidy for homeowners in Mississippi or Louisiana from, say, homeowners or drivers or worker's compensation policies in the State of California. That would certainly be patently unfair. And in the same way, we wouldn't expect in some other part of country that there would be a subsidy coming from the States of Florida or Louisiana.

Mr. MILLER. I know my time has expired, and I thank you. There are so many questions to ask and so little time to do it.

Chairman WATT. We may do a second round, so we may come back to you. The gentlewoman from California is recognized.

Ms. WATERS. Thank you very much, Mr. Chairman. Quickly, Mr. Maurstad, I think you made the statement that the Flood Insurance Program does not deduct for wind, and I think I heard that the private wind insurers deduct for water. What did you mean by that? Do you—

Mr. MAURSTAD. What I meant—thank you for letting me clarify. What I meant to say is our obligation is for the damage caused by floods and/or storm surge in the case on the Coast. And we can't—so whatever damage was assessed that was caused by those two perils, that's what we have to pay, or the policy limits. And so we don't really get beyond determining what was damaged, other than what was damaged by the flood or the storm surge.

Ms. WATERS. Well, I know. That's what I thought you meant. If you knew, or if there was some indication that some of that damage was caused by wind, you would not be paying that portion?

Mr. MAURSTAD. Well, we couldn't pay for that, because the policy doesn't allow for damage caused solely by wind to be picked up by the Flood Insurance Program.

Ms. WATERS. But as I understand it, you could have damage that occurred by both—some by water and some by wind. Are you telling me you do the assessment, you have the information, you just pay the water, you don't pay the wind, or you don't take any of that into consideration? If you have some coverage there, you pay everything?

Mr. MAURSTAD. If we—if there is damage that's caused by both flood and wind, we are obligated to pay for that damage.

Ms. WATERS. Oh, so they do. Okay. Thank you. That clarifies that. Let me just ask Mr. Hartwig, as I understand it, company officials talked with each other. There was instruction to adjusters, and that basically what the insurance companies did is what we don't allow others to do. We normally call that collusion. But since the insurance companies are exempted from the antitrust laws, they can talk to each other. Are you aware, or do you know if it is common practice for insurance companies to talk with each other, and particularly in the case of Katrina and Rita, was there conversation? Were there any meetings? Did people get together? Did they talk about how they were going to handle this?

Mr. HARTWIG. Absolutely not.

Ms. WATERS. I didn't hear you.

Mr. HARTWIG. Absolutely not. There is no law in the land that allows insurance companies to get together and conspire to not pay

claims or to fix rates. There's a misconception out there about the so-called McCarran Ferguson Act, a 62-year-old piece of legislation that provides a very, very narrow exemption from antitrust laws. What that Act does is it allows insurers to pool historical loss information and then project that information for the purposes of setting rates at some point in the future.

The impact of this is basically to allow smaller insurers, which on their own don't have the same size database as the big national companies in order to develop statistically actuarially sound rates. It allows them then to compete with the larger companies.

So, to give you an example, in the State of Mississippi, you have, for instance, in the area of auto insurance, I believe 46 out of the 47 auto insurers in that State have less than a 2 percent market share. It's exactly those types of companies that benefit from that very narrow—

Ms. WATERS. All right. I just want to make sure that I understand what you're saying, because Representative Taylor has taken a very close look at all of this. But if you're telling this committee that you are absolutely sure—and you said absolutely not, that there was no discussion among insurance companies about how they were going to handle these claims, that there was no—and I'm not even calling it collusion—no discussion, no sharing of information, no coming together, no instruction at all by a combination of two or more, then I'm going to put that in the record.

Mr. HARTWIG. Ma'am, I am absolutely unaware of any such conversations having ever occurred. Insurers do not—

Ms. WATERS. Okay. That's different. You're not aware of it. You don't know that it didn't take place?

Mr. HARTWIG. I'm not aware of it.

Ms. WATERS. All right. That's good. What do you think about the repeal of the exemptions from—what is it? McCarran Ferguson? Senator Lott says that perhaps we should all be taking a look at that.

Mr. HARTWIG. Well, as I just mentioned earlier on, McCarran Ferguson is a very narrow exemption under the antitrust law, which again allows basically one thing to happen and that is the pooling of historical information.

Ms. WATERS. So you think that it should not be interfered with, it should be left as it is?

Mr. HARTWIG. That's correct.

Ms. WATERS. It should not be repealed?

Mr. HARTWIG. It would have a negative impact on competitive—

Ms. WATERS. Okay. Quickly, on the 92 percent claims that have been settled, would you explain to us what "settled" means? Does that mean that there were some claims that were closed that didn't get a dime? Does that mean that there were claims that were closed where people are very unhappy? Does that mean that everybody got something? What does that 92 percent settlement that you talked about mean?

Mr. HARTWIG. For the record, as of the first anniversary of Katrina, the number is 95 percent.

Ms. WATERS. Oh, excuse me. Ninety-five percent.

Mr. HARTWIG. And I believe the number is even higher now.

Ms. WATERS. All right.

Mr. HARTWIG. But the term "settlement" essentially means this. That the insurer and the insured, the policyholder, have reached an agreement as to what will be paid. A sum has been paid. It means that the insurer—

Ms. WATERS. So none of them did not get anything? None of them were zero payments?

Mr. HARTWIG. A claim that was completely excluded, for example, because it wasn't covered under the policy to begin with wouldn't be in these statistics to begin with.

Ms. WATERS. But you talked about the agreement between the insurer and the claimant. And you're saying that there was an agreement that nothing was owed. Is that right? Zero in some cases?

Mr. HARTWIG. A claim that is not compensable under the policy to begin with never rises to the definition of a claim. When a claim is—

Ms. WATERS. But a claim in our—my humble opinion, whether we beat the strict definition, if someone said, I've been paying my premiums for 10 years. My house was damaged, and I think you owe me something. We consider that a claim. Now you don't, evidently.

Mr. HARTWIG. We consider it a claim when there is some damage that is compensable under the insurance policy.

Ms. WATERS. My time is up.

Chairman WATT. The gentlelady's time is up, but we'll do a second round, so—

Ms. WATERS. Thank you.

Chairman WATT. Okay. The gentleman from Illinois, Mr. Roskam.

Mr. ROSKAM. Thank you, Mr. Chairman. I want to just follow up briefly on Mr. Miller's point, because I think that really, as I'm listening, is sort of the main point. What we have here is a disputed insurance contract essentially, and Mr. Hood, I'm directing this towards you. So the pending litigation essentially is regarding the use of the—what is the term of art that we've talked about? The nonexclusionary?

Mr. HOOD. Anti-concurrent clause.

Mr. ROSKAM. Anti-concurrent clause. And so, the—Mr. Miller's point was that that has been—that was approved by the State. It was allowed to be offered, and now you're challenging it based on—it's not a fraud theory, is it? What's your theory?

Mr. HOOD. There are several consumer protection laws applicable. All States would apply to this issue as well, I would think. Consumer protection, ambiguous provisions, void as against public policy, it violates State law.

Mr. ROSKAM. Okay. So then as we're moving—and that's really an open claim. I mean, the Federal judge is going to make a decision, or the circuit court judge—the district court judge has made a decision, and I assume it's on appeal?

Mr. HOOD. Yes, sir, that's correct.

Mr. ROSKAM. Okay. And then the larger question is, how do you create the environment where companies want to come in and do business in your State? That's really the rub of it. And you're not suggesting that State Farm, for example, has an obligation to do

business in your State or that they somehow violated the settlement agreement, are you?

Mr. HOOD. As far as the settlement agreement in Federal district court—

Mr. ROSKAM. Well, I assume the settlement agreement that you structured?

Mr. HOOD. They entered into a State court order in State court agreeing to go establish a class and have it approved by the Federal court. There's a hearing going on right now in Federal court about that, so it's not—we're unsure at this point whether they're going to be able to get it approved on their terms.

But as far as the anti-concurrent clause provision goes, I suspect, you know, you only challenge laws when you have such catastrophic events as this. The California earthquake, you probably wouldn't have an anti-concurrent clause provision because you don't have water in that situation.

But were it to be challenged in other States just simply on the consumer protection laws, I suspect in all 50 States it may very well fail. Because what you're doing is you're selling someone something and you're giving them nothing. Because in a hurricane, storm surge causes 85 percent of the damage, and if you try to put in the fine print—and nowhere in these policies—nowhere—do they ever say the words "storm surge."

If you try to take that away without notifying the consumer and take away 85 percent of the damage from a hurricane, it's sort of akin to a bait-and-switch, so I suppose that consumer protection laws in all States may apply.

And, Mr. Miller, that goes back to your question of how do they assume risk in those States. I think most companies in Mississippi other than State Farm didn't abuse that provision. They didn't push it. They didn't zero people out. Some paid something to stay away from bad faith jury instructions. And so others did not necessarily use that, as did State Farm.

Mr. ROSKAM. Let's assume for the sake of argument that the appellate court upholds the district court ruling, and I assume the order reads, you know, essentially void—you know, voids the contracts under a public policy argument, which is essentially what you're suggesting—then, how do you move forward and create an environment where carriers want to come in and insure your insureds? See, I don't have this problem.

And I mentioned this in my opening statement. I come from a State where people want to do a lot of business and where insurance companies are—they're kept on a short regulatory leash, but it's not ridiculous.

And I've been involved in my previous—before I came here, in terms of litigation, and have had some of these battles as it relates to, you know, how an insurance policy is interpreted, and I've been very aggressive in how those have been construed, and you win some and you lose some.

But it strikes me that what will end up happening here, if you're successful all the way up the food chain, is that you're going to get to the point where Mr. Miller suggested, okay, they just rewrite all the policies. And you win in the short run. Claimants win this 5 percent or whatever it is, which is your job as the attorney general.

But you can win the battle and lose the war, right? You can get to the point where a large carrier says these people are high maintenance and complicated, and we're not going to go into jurisdictions where people—and I'm not suggesting any bad faith here on the part of the judge or whatever, but, you know, it's getting like everybody is a claimant or knows a claimant, and so they kind of may feel, how do you get a fair shake in this area? We're not going to go into jurisdictions that are going to take our insurance contracts and act like they're an etch-a-sketch and rewrite them for us?

And how do you then as the policymaker, or how do you as the chief law enforcement officer in your State, create the environment where a carrier says that's a place we want to do business? Because taxpayers in my area don't want to subsidize coastal living in your area.

Mr. HOOD. Yes, sir. There are several answers involved in your question as far as—that's why I reached a settlement with State Farm, was to keep them in Mississippi. Because, you see, after a storm, all the companies want to flee, especially one like this. And so our objective was to keep as many there as possible, and that's what they had indicated that they would do is stay in Mississippi. Because you really—I mean, if you don't have insurance, you can't rebuild, even if you get the money, you know, you can't rebuild. So we realize that. We want to create that market. But as to the issue of what the Federal judge did, I suppose there again, these policy provisions are not tested. They're approved by an insurance commissioner who's not a lawyer, has no idea of what the separate branch of government, our courts, have established as proximate cause. You can't enter into an illegal provision in a contract. You can't contract to kill someone.

So if this provision violates State law, and I would respectfully submit, even in Illinois, where State Farm is located, they're probably—their proximate cause law would be violated by these anticoncurrent cause provisions. So it's not void as against public policy. That was one of the issues you asked that I raised in State court. The Federal judge issued it as violating a long-standing State proximate cause provisions.

And so to create an environment to keep them there is what we're trying to encourage them to do, and that's why we're asking Congress for something, because they can punish Mississippi. That's why they pulled out. They pulled out because of that judge's decision, but it only affects storm surge areas where those provisions apply, just down on our coast.

It doesn't affect northern Mississippi where my good friends that sell the insurance for them are being punished because they can't sell new policies for State Farm. It was meant to punish Mississippi and to make an example and to scare us into doing things.

State Farm's 9 months in those six—they made $6.8 billion net profit. That's more than the Federal Government gave us, and thank goodness for what you all did of sending us money to try to help rebuild, but we're just now getting that money on the ground.

And so we settled this to try to complement that, to allow people to rebuild. And we want those companies to stay, and we're trying

to do all we can to encourage them to stay, but be punished by them.

Chairman WATT. The gentleman's time has expired. The gentlelady from New York, Mrs. McCarthy, is recognized for 5 minutes.

Mrs. MCCARTHY. I thank you. Listening to this, I certainly hope, Mr. Hood, that when you go back and everything is kind of settled down, that you'll start reaching out to other attorneys general throughout the State and have them change how the language is written. I've been reading since I got here, and you'd have to be a genius to figure out what's insured and what's not insured. I mean, you really do.

I know when I came back from New Orleans, I looked at my insurance policy. I'm inland, and I had no idea whether I needed flood insurance, but I wasn't going to take the chance. I found out I actually did need flood insurance, which brings me back to FEMA. I was told that FEMA was redoing all the maps along the areas. And I was just wondering, has your budget for 2008 increased differently from 2007 so that you'll have the money to bring up the flood maps? Because from what I understand, a lot of people didn't know they were in a flood zone.

Mr. MAURSTAD. We are in the midst of, I believe, the third year of a 5-year flood map modernization effort. It's a billion dollar effort by the Congress. It's $200 million a year, along with approximately $50 million from the National Flood Insurance Fund to update our maps.

The Gulf Coast area was in the process of being updated. In fact, some parts of the Mississippi coast, and some parts of the Louisiana coast were within a couple of months of having new preliminary maps provided to the communities to start the adoption process.

Clearly, the hurricanes changed the coastline, changed the dynamics, and we are continuing in the process and have the funding in place to provide new digital flood maps for the Gulf Coast area. We're hopeful to have—

Mrs. MCCARTHY. With that, are you working with the right government—you know, mortgages. Are you—how are you telling people you need to get flood insurance, especially if they have a government-backed mortgage?

Mr. MAURSTAD. Sure.

Mrs. MCCARTHY. Shouldn't that be mandatory, by the way?

Mr. MAURSTAD. It is mandatory in the 1 percent annual chance high risk area, and it is mandatory for all federally backed mortgages. Of course, there are people with other than federally backed mortgages, people without mortgages who aren't—

Mrs. MCCARTHY. I don't see people along the coast in these mega homes having a government mortgage for some reason.

Mr. MAURSTAD. Any federally backed mortgage. And so it's the responsibility of the lender community to make sure that those that are under the mandatory purchase requirements of the Federal law, that they in fact, the person receiving the loan does have a flood insurance policy. But there are many areas that were outside the 1 percent annual chance that were affected by this storm, because it was a greater than a 100-year event.

To get to your question, what are we doing, we have a public education and outreach and awareness program, Flood Smart, to try to get people more attuned to what their risk is. That's an obligation I mentioned in my testimony of the program. And that takes all of the partners; the lenders, the real estate, the insurance agents, the insurance industry, and local elected officials who adopt flood plain management. It's all of our responsibility to make sure that people who are supposed to have a flood policy in a high risk area do have that policy.

Mrs. MCCARTHY. Thank you. Mr. Hood, I'm just wondering, in your State, and I don't know how it even works in my State of New York, who picks those—we have an insurance commission, and they go over, if the insurance company comes in and says all right, here's the wording, who picks the the commissioners, and who's watching them? And why are they accepting the kind of language that even probably a very well educated person wouldn't be able to figure out what the heck they're talking about?

Mr. HOOD. That's—in Mississippi, it's an elected insurance commissioner, and I think in the majority of States, it is an elected position, and it's his or her duty to approve those contracts as they come in.

Mrs. MCCARTHY. Does that mean that person has to run for office?

Mr. HOOD. Yes, ma'am.

Mrs. MCCARTHY. Does that mean that person has to raise a lot of money?

Mr. HOOD. Yes, ma'am.

Mrs. MCCARTHY. No, I'm not going to ask that question. I'll get in trouble.

Mr. HARTWIG. Ma'am, just for the record, the majority of insurance commissioners in the country are appointed. I think there are only about 11 or so who are elected.

Mrs. MCCARTHY. But that's the point. Because I know in New York they're actually appointed. The whole thing comes down to I'm actually wondering who is actually protecting the consumer.

Because again, I've been reading this for probably a couple of months since I came back from—and you can't make sense. I went to my insurance agent, who I've had since I was 18 years old, and I said, all right. Tell me what I have? Because, blindly, I thought he was protecting me. And I asked him what I had, what am I covered?

And then I started, to be very honest with you, because most people don't go through—you know as well as I do, if you take out insurance, this is what you're getting. And the further back you go, because I did look at my insurance, the smaller the print, and you have to figure out what each word means. The average consumer is not going to do that, and they will not. So a lot of things are hidden in here. All right. Consumer beware. Fine. That means our committee or other committees on financial services can certainly try to make that a difference on the Federal level.

But I hope that, Mr. Hood, you do go back and start talking to the attorneys general, because to me, as far as I'm concerned, I met with our insurance companies back on Long Island, and I said, "Listen, I know that you you're concerned about—you know, be-

cause we're Long Island. It's water. We had heard they were thinking of pulling out, and I met with all of them. No, we're not pulling out, you know, we haven't had a hurricane. We did a press conference so we could reassure my constituents and other constituents in the New York area. In 10 days they announced that they were—stopped writing, and were going to start pulling out. No New York again. They're only allowed to pull out 4 percent a year. So every year, they are pulling out. And personally, I think it's obscene what they're doing.

With that, I yield back the balance of my time.

Chairman WATT. I thank the gentlewoman. Mr. Mahoney from Florida is recognized for 5 minutes.

Mr. MAHONEY. Thank you, very much. I just have a couple of questions. I represent a district, Florida 16, which has eight counties, and up until that fateful morning in August when Katrina slammed into the Gulf Coast, it was the site of the single biggest natural disaster in North America. My district has been hit no less than 4 times in 2 years, and one of my communities, Punta Gorda, is still missing about 70 percent of its downtown as a result of a hurricane. So this is something near and dear to me. Mr. Hartwig, I believe you were giving some statistics about the year that Katrina hit, as far as what happened in the States of Mississippi and Louisiana. Could you repeat that to me in terms of what the loss was and—

Mr. HARTWIG. In terms of the amount of premium that was washed away?

Mr. MAHONEY. Yes.

Mr. HARTWIG. I believe in the State of Louisiana it was 25 years worth of homeowners' insurance premium and every dime of profit ever earned, and in Mississippi it was 17 years.

Mr. MAHONEY. Okay. And that was in 2005?

Mr. HARTWIG. Correct.

Mr. MAHONEY. Okay. In 2005, when the dust was all settled, what were the profits to the homeowners insurance industry nationwide?

Mr. HARTWIG. Nationwide, including every type of insurance sold everywhere in the United States, all 50 States, was $43 billion approximately that year.

Mr. MAHONEY. And that's homeowners insurance?

Mr. HARTWIG. No. That's every type of insurance.

Mr. MAHONEY. What do you mean by every type?

Mr. HARTWIG. That would include all types of property casualty insurance, everything from worker's compensation to auto policies to commercial general liability policies.

Mr. MAHONEY. Do you know the answer—let me ask you this question—do you have a number on what profits were made on homeowners insurance?

Mr. HARTWIG. In which year?

Mr. MAHONEY. In 2005.

Mr. HARTWIG. In 2005 on a national basis, it would have been a negative number, but I don't know the figure.

Mr. MAHONEY. Okay. And over 25 years, is it a negative number?

Mr. HARTWIG. Over 25 years in terms of underwriting profit, yes, it's a large negative number.

Mr. MAHONEY. So—

Mr. HARTWIG. Homeowners business, yes, on a national basis, if you went back 25 years, has actually been a money losing proposition for property casualty.

Chairman WATT. Would the gentleman yield for a second?

Mr. MAHONEY. Yes.

Chairman WATT. Are you saying that insurance companies are making their money on investments as opposed to premiums?

Mr. HARTWIG. Insurance companies do make some money on investments. However, homeowners insurance has been racked by many major catastrophes. If you go back not just to 2004, 2005, you can go back to earthquakes in California, you can go back to Hurricane Andrew, which at the time was the largest disaster in history. And again, it doesn't make a lot of sense to look at these numbers on a national basis.

Chairman WATT. I'll yield back to the gentleman.

Mr. MAHONEY. Yes. Let me ask the question a different way. What you're testifying to today is the fact that if you took all the premiums and the money that you made investing in this premiums versus the losses in homeowners insurance, that it's a net negative number for the insurance industry?

Mr. HARTWIG. That's correct, yes.

Mr. MAHONEY. Over the last 25 years?

Mr. HARTWIG. Yes it is, sir.

Mr. MAHONEY. Okay. And so the next question is, is why does the industry—why do people stay in the industry of providing homeowners insurance if it's a money-losing proposition?

Mr. HARTWIG. In some States, it's not a money-losing proposition. I'm giving you the numbers in the aggregate. For example, in a State like Illinois, it's a profitable proposition. But, particularly in the last 15 to 20 years, it's become a very, very difficult situation, particularly in the more catastrophe-prone areas of the country, and that has a tendency to drive up the overall loss numbers on a national basis.

In many States it can be profitable. However, the size of the catastrophes are so large, particularly since, really if you go back to Hurricane Hugo in 1989, which is now quite some time ago, the losses in aggregate exceed the actual premiums and investment income.

Mr. MAHONEY. Okay. Let me ask you another question, Mr. Hartwig, given the fact, what you're saying now is the fact that a handful of storms over the last 25 years has resulted in wiping out the profits of the homeowners insurance portion of your industry?

Mr. HARTWIG. There were, I think, 29 named storms in 2005. I believe there were about 18 or 19 in 2004. There have probably been over 100 named storms.

Mr. MAHONEY. But those 29 storms have basically wiped out the profits for that portion of your industry?

Mr. HARTWIG. The profitability in the insurance industry is going to be something that is both cyclical in nature and volatile.

Mr. MAHONEY. I'm just looking for a yes or no. I mean, you said that homeowners insurance in the last 25 years has been a money-losing proposition, correct?

Mr. HARTWIG. In the aggregate, yes, on a cumulative basis.

Mr. MAHONEY. Right. And I'm just saying that basically these are coming from a relatively small number of storms, right? That has wiped out the profit.

Mr. HARTWIG. In relative terms, it seems that the number is growing.

Mr. MAHONEY. Okay. No, but I'm just—you know, I just want to make sure that I understand what we're talking about here. So I guess the next question I'm asking you is, is that, well, obviously it says that it's very important where you write and where you don't write, because if you write in the right places, you can make money, and if you write in the wrong places, like in my district, you can't make money?

Mr. HARTWIG. Well, actually, the reality is, is that if insurers are given the right conditions, they can operate under very risky conditions.

Mr. MAHONEY. Okay. So that's my next question, which is, given the situation where we need to have an insurance industry and people who the average American's investment in their home is their single biggest asset, and the fact that the insurance industry is, you know, an American industry and we're all Americans and we need to make sure that we help people, what would you recommend from the insurance industry's perspective to be able to provide coverage to people in these higher risk areas?

Mr. HARTWIG. I'm glad you asked that question, because that's a very fundamental question facing the country today, not necessarily just in areas prone to hurricanes, but across the country.

What we need to do in this country is redouble our efforts to strengthen building codes, for example, and Florida has been a leader there, but there's much more that can be done. Places like California have also done a lot in terms of retrofitting.

We need to provide coastal dwellers with incentives to retrofit and to mitigate their homes against disasters, and not only does that preserve their homes, of course, but it preserves lives.

Better land use policies would be another way to go. We do have in this country, despite the fact that we've been raked by hurricanes, we have an extraordinary amount of development in very, very vulnerable areas. And so, as I mentioned during my testimony, there's currently about $2 trillion worth of insured coastal exposure in Florida. But despite the insurance issues that we've heard about today, that continues to grow at about a 10 percent annual rate. So, land use policies are very important, because otherwise, we're on the steady, upward trajectory towards ever greater losses.

And of course, we need a commitment by legislators, regulators, and others to allow risk-based pricing to prevail everywhere across the country, including areas prone to mega disasters.

Mr. MAHONEY. Would you yield me 1 more minute?

Chairman WATT. I ask unanimous consent for 1 additional minute for the gentleman.

Mr. MAHONEY. Okay. Really quickly, I'd like to ask the Attorney General, Mr. Hood, what do you think, based upon your most harrowing experience that you've just gone through? What would you recommend that we should do from a consumer perspective to

make sure that we're providing adequate homeowners insurance coverage for people in our States?

Mr. HOOD. I think we either need to have an all-risk policy and require the private companies to write it in all areas of the Nation in order to be licensed anywhere in the Nation, or we do what Congressman Taylor has suggested, having a Federal program to pick them both up. Because there is a natural conflict of interest when you send out an adjuster who is working for both, allegedly, to dump off on the taxpayer.

So I think we need fundamental reform in that area.

Mr. MAHONEY. Thank you.

Chairman WATT. Let me, in the interest of fairness, ask unanimous consent that a chart—maybe I should just put the whole report in, since I don't want to appear to be unfair.

I ask unanimous consent to submit for the record a document prepared, the title of which is "Property Casualty Insurance in 2007: Overpriced Insurance, Underpaid Claims, Declining Losses and Unjustified Profits," in which there is a chart on page 19 that indicates that—that gives the profit and loss ratios for the top seven property casualty insurers and indicates that the industry net income for 2005 was 48.8 percent—I'm sorry—$48.8 billion.

And in the interest of fairness to Mr. Hartwig, I was looking at your testimony to see if you had submitted any information to justify the numbers that you were giving us, and noticed that you did not attach any to your testimony. But in the interest of fairness, I would invite you to submit whatever report you're working from, and we will enter that into the record also.

I'm only interested in getting a fair picture here, and I'm not trying to get into a debate about whether insurance companies are making profits or not making profits.

Mr. HARTWIG. And I'll be happy to supply that information, which will show insurer profitability over a very long period of time, and just for the record, for the 19th consecutive year in 2006, the property casualty insurance industry reported a lower return on equity in aggregate than did the Fortune 500 group.

Chairman WATT. Well, that's fine. The report I'm looking at goes back to 1987, and the only negative year for the industry, according to this report, was 1992, of $2.7 billion loss for the industry.

Mr. HARTWIG. Well—

Chairman WATT. Every other—no, I'm sorry, 2001 was the other negative year, $6.7 billion loss. But the facts will be as they are. Both reports, whatever you submit, and this report, will be in the record, and it will help us to try to get a more balanced perspective on what we have. So we thank you for submitting that.

We have now completed the first round for the committee members, and we have already approved a unanimous consent request to allow nonmembers of the subcommittee to ask questions. And I would now recognize Mr. Melancon for 5 minutes for questions.

Mr. MELANCON. Mr. Chairman—and I wasn't in the room when we started the initial—this hearing on this committee or this panel. As the Oversight Committee, are we doing swearing in of witnesses and panel?

Chairman WATT. We have not.

Mr. MELANCON. We have not? Okay. Mr. Hartwig, I guess let me ask you a few questions if I can. Insurance business is risk takers and pooling of moneys to share—to cover losses and expenses. Is that correct?

Mr. HARTWIG. That's correct.

Mr. MELANCON. Okay. Through the years as you go, and I've looked at some of the returns—the statements on companies, when in fact you had hard markets, soft markets, profits were made either in the insurance business because you raised rates, or in the investment side because you had dropped the rates, and so you could lose 105 percent as long as you made your money on the investment side. And is that not an uncommon practice?

Mr. HARTWIG. Insurers do earn, attempt to earn money on the investment side of the equation. Of course, we have to make it through days like yesterday where the stock market drops 400 percent—400 points. But it's also important, of course, that insurers day in and day out do their job in terms of quality underwriting.

Chairman WATT. Just for the gentleman's information, I wanted to start the hearing with a moment of silence for the stock market yesterday.

Mr. MELANCON. Yes, 2001 wasn't pretty, and if this keeps up, it won't be pretty again. So I guess what I'm looking at and thoughts that I'm having is this. During those soft markets, if homeowners insurance is a loss leader or a problem for insurance carriers, why in fact are they discounting their rates in competition with each other to go buy more business? Because that's what they're doing by lowering their rates.

And when the market is hard, they're bringing them up, they're restrictive on what they want to write. And part of the problem, if you're correct in what you say that the losses in Louisiana would have been over the last 25 years of premium, is that not because the insurance companies are playing games with their rates and then doing investment side earnings?

And had they stayed at actuarially sound rates, which was a term that used to be used about 25 years ago, actuarially sound rates, and put the reserves away rather than paying dividends to the stockholders and bonus packages and severance packages to their executives and getting into this reinsurance market which allowed them instead of putting a million dollars in reserve to put a quarter of a million, and then use the three-quarters of a million in hopes that they wouldn't have the losses, reinsurance would take it, and then they could disburse profits again?

So the question or the point I'm trying to come to, to find out is, had they kept actuarially sound rates and not played the game of up and down competition based upon what the stock market and investments were doing, would those numbers be the same in losses in the States of Louisiana and Mississippi?

Mr. HARTWIG. Insurers have made every effort to keep their rates actuarially sound. They are regulated in such a way at the State level. They have to charge rates that are adequate by law. They can't be excessive, but they must also by law be adequate. They are also independently reviewed in terms of their total financial situation by ratings agencies.

We are one of the most regulated industries in the country, both in terms of rates, but also in terms of solvency. So—but occasionally, there are changes in the risk profile of parts of the country, such as the Southeast, where we're being told by the leading minds in meteorology that the next 15 to 20 years are going to be characterized by more frequent and more severe storms.

So what that means is insurers are going to have to adjust to that higher plateau of risk, and part of that adjustment means that rates will need to be commensurate with that risk, but it means many other things, many of the things I mentioned earlier on in terms of further strengthening of homes and encouraging mitigation.

Mr. MELANCON. And that's all well and fine, but agents are encouraged by companies to discount and to go find those risks, to write the volumes and to produce the volumes so that they can have the volumes they need. Now what happens to me in Louisiana, and it happens in every other State, is that the agents are as threatened by the insurance companies' threats to pull out, because that's their livelihood, as Mr. Hood said. And so they're out there, and they don't want you to do anything to them.

Now I've always been a State's rights person, but I'm starting to wonder whether that's the right position to be in. And I've always been against Federal control. But—and I don't have a problem with regulations at State level.

But what I do have a problem with, and I guess the question is, is you're taking pooled money. I'm Zurich Insurance, I'm Cigna, I'm INA, whatever, you're taking pooled money, not necessarily subsidized by any other area of the country, if you are doing actuarial rates.

If you were doing actuarial rates, then your rate structure for the Gulf Coast or the coastal areas of this country should have been adequate, particularly over the long run, to cover the losses. Is that not correct?

Mr. HARTWIG. I think that if insurers had perfect knowledge of the future, which they don't, which the greatest minds in meteorology don't, which the regulators in the States of Mississippi and Louisiana do not, then it is impossible to forecast with complete accuracy what expected losses are. Effectively what you're saying is how come we didn't foresee the day and date and the magnitude of Hurricane Katrina? I don't believe that's a reasonable thing to request of insurers. But what we can do is gather the evidence, gather the science and adjust our rates and our underwriting so that we can provide for a better environment in a sound and financially secure insurance industry that can operate in these areas.

Mr. MELANCON. Now, Mr. Chairman, if I could then. The 2 years that you talked about that were statistically losses, if we could take a look at what the stock market performance was, if you could get the staff to do that, look at that and see what the rate structures, if we could get that from the insurance companies, the Insurance Institute, and let's see were they discounting more, was the market performing higher, so were you not taking discounts to buy business? I mean, that's—and that's an industry thing. I was on that side at one time.

Mr. HARTWIG. First of all, this notion that agents, for example, are encouraged to produce nothing but volume is completely incorrect.

Mr. MELANCON. I beg to differ.

Mr. HARTWIG. Anybody can produce volume. The question is, can you produce volume profitably? In other words, can you wisely underwrite your business? No company can survive on a volume-based model on its own.

In terms of the investment income situation, State regulators explicitly require insurers to incorporate the expected returns on the investment portfolio for the benefit of policyholders. I worked for many years in a rating context and testified at rate hearings around the country, and that was my job to actually estimate what the offset factor was for investment income, because by law, it accrues, at least in the area of worker's compensation, to the policyholder.

Chairman WATT. The gentleman's time has expired, and I recognize Mr. Taylor for 5 minutes.

Mr. TAYLOR. Thank you, Mr. Chairman. Mr. Chairman, I want to enter into the record two letters, both claim to be signed by the same claims adjuster, that involve a couple standing over there, and that would be James and Jo Dell Beckham.

In the first letter, the agent who is doing the adjusting for State Farm says: "Hurricane Katrina demolished the structure, the superstructure of the residence such that only the concrete slab of the home was left. High winds and flooding forces from Hurricane Katrina were both significant in structure to the damage. There was significant physical evidence"—"There is insufficient physical evidence to determine the proportion of the wind versus water surge."

A couple of days later, another form shows up. It's allegedly signed by the same person. It says: "Storm surge from Hurricane Katrina destroyed the residential building." This was signed by Paul Monie.

Only one problem, Dr. Hartwig, Paul Monie says he never signed that second letter, that he had submitted it as a fraud, with a fraudulent signature of his, and that fraud went on to be quoted by State Farm when they wrote the Beckhams and said, "Based upon the results of the discussion, site inspection and investigation, it has been determined that damage to your property was caused by flooding, rising water, tidal surge."

Now that is an agent hired by State Farm, who submits a form that says these folks' residence was destroyed by a combination of wind and water. The second letter comes out that he claims is a forgery, and State Farm denies their claim based on this. I'm just curious. As a part of the Insurance Information Institute, how would you classify that?

Mr. HARTWIG. Sir, I can't—

Chairman WATT. And before you respond, let me just do a couple of things for the record. Let the record show that the people to whom Representative Taylor referred are here with us today.

Mr. TAYLOR. Would you raise your hands, please, Mr. and Mrs. Beckham? Thank you.

Chairman WATT. And, without objection, we will enter both of those things into the record.

Now, Dr. Hartwig?

Mr. HARTWIG. Thank you. Obviously, I have not seen these letters, and I cannot comment on any specific claim involving any specific company.

Mr. TAYLOR. Okay. If I may. I did pass to you a copy of a memorandum that State Farm sent out to their employees shortly after the hurricane, and I'm quoting: "Damage to property caused by flood waters with available flood policy. Where wind acts concurrently with flooding to cause damage to the insured's property, coverage for the loss exists only under flood coverage."

Now that is instruction from headquarters Illinois to claims agents down in south Mississippi. It's really a question for both you and the head of the Flood Insurance Program. I'm curious when you said on behalf of the Flood Insurance Program that there was wind and water, and you're going to pay. Because I'm wondering what's your legal authority to make that statement?

And let me walk back. The director from the Insurance Institute says that, you know, claims were paid expeditiously. In many instances, claims were paid that day. You know, it's kind of funny, because I remember when the two ladies from State Farm came to my property, and I walked them about 300 yards from where my house used to be, and showed them pieces of my roof then asked them to count the steps back to my house.

And I said, okay—and I purposely asked them not to say a thing. And then we got back to my house. I said, okay, ladies, what did you see? After showing them my tin roof about 300 yards from where my house used to be, the first words out of their mouth were, "We see no evidence of wind damage." To which I asked them, what were the floating characteristics of tin? And I offered to walk them over to the bay, throw a piece of tin in there and show that it didn't float. Which tells me that in one instance, State Farm had already told those ladies, blame it all on the water.

And we have a Federal agency that's supposed to be responsible for looking out for the taxpayer saying, yes, let them stick it to the taxpayers. I mean, I shouldn't be surprised. After all, this is an agency that paid $16,000 per trailer to haul a travel trailer from Purvis, Mississippi, down to the coast, about 60 miles, plug it in, hook it up to a water hose and hook it up to a sewer tap. I mean, it's not like you guys have distinguished yourselves as good stewards of the Federal dollar.

But on the flip side, in this instance, you are literally the puppets of the insurance industry. You have a responsibility to the Federal taxpayer—and I have to admit I have mixed feelings on this. I think it's great that people got their flood policies. They needed that. In fact, National was the only insurance agency that was really fair with people down there.

The flip side is, I think the taxpayers got stuck with bills that State Farm, Nationwide, USAA, and others should have paid. And I'm appalled that no one in your agency was looking for things like this gentleman's forged engineering reports. Can you think of any other Federal agency where someone can send the Nation a bill for

$100,000, $150,000, or $250,000 and nobody ever looks to see if we really have to pay it? But that's what you did.

Well, you said you didn't find any discrepancies, to which I want to ask, how many times did you look? And did you look very hard? And did you bother to look into this instance? And I'd like both of you to answer those questions.

Mr. MAURSTAD. Well, let me start, sir, I mean, we take very seriously our responsibility to only pay what the program is responsible and obligated to pay for the damages caused by flooding under the flooding policy. We take it very seriously. We have a very rigorous program of oversight in place.

We—and so I don't—

Mr. TAYLOR. Would you walk us through that policy? Because I didn't—as a citizen, I saw zero evidence of that oversight.

Mr. MAURSTAD. Well, there are a number of ways that we did it. I included it in my testimony, my written testimony, and alluded to it in my oral testimony. We have—assignment of the liability of the policies is a part of the responsibility of the random selections that are done to oversight the policies by general adjusters representing the program. We do random audits.

We do—whenever requested by either the policyholders, but the insurance companies sometimes go out and review to make sure that the amounts are being appropriately paid. It's handled in audits of the company's performance. So there are a number of ways, and I will provide you with the detailed oversight that we have in place to make sure that what you're talking about does not occur. It would be a violation of the arrangement between the write your own companies and the National Flood Insurance Program.

It's also a very—from the company's point of view, even though this was a large disaster, still a very small part of their overall operations. And they have told me on many occasions, they're not going to risk their reputation and their brand on small items such as we're talking about here—

Mr. TAYLOR. Mr. Maurstad, if I may.

Mr. MAURSTAD.—notwithstanding your individual claim, the circumstances are that there are processes in place, and there's no incentive for the companies to get caught with their hand in the cookie jar.

Mr. TAYLOR. Well, to that point, Mr. Maurstad, and I'm going to go back to my individual circumstance. Those ladies were prepared to give me, and did give me a check that day. Can you think of any other Federal agency that allows a private company to write a $200,000 check that day without anyone looking over their shoulder?

Chairman WATT. The gentleman's time has expired, so I'm not going to let him ask another question, but I'm going to let these two gentlemen respond.

Mr. MAURSTAD. There might not have been anyone looking over their shoulder that day, but that file would be reviewed, and it would be made certain that they didn't pay for more than what you should have been paid under your National Flood Insurance policy.

Mr. TAYLOR. But you accepted their statement that—

Chairman WATT. The gentleman's time has expired. I'm sorry.

Mr. MAURSTAD. Let me—if I could just conclude, because I gave a slightly insufficient answer. If I could elaborate just a bit.

Chairman WATT. Well, I don't want to cut you off, Mr. Maurstad, but what you are saying now seems to be inconsistent with what you said before. Because I gave you the opportunity to tell me whether The National Flood Insurance Program had overpaid any claims. You say that you're not looking at it on a daily basis, but that you're reviewing later, and you determined that none of these claims were overpaid. So it seems to me that you are already on the record on this question.

Dr. Hartwig, there was another question that I can't remember what it was that you've been called on to respond to. If you remember the question, we'll get your response.

Mr. HARTWIG. I don't remember what it was either.

Chairman WATT. But we need it quickly.

Mr. HARTWIG. Well, let me just respond this way, that insurers make every effort to pay every amount that is due under the terms of the insurance contract for the types of coverage for which people purchased that policy. And so insurers and adjusters work diligently to make sure that occurs.

And getting back to the numbers, again, $41 billion, the lion's share of that being in the homeowners area, is really a demonstration of the fact that our insurers are doing that. And let me just put things in proportion. Even in the cases of slab claims, for instance, in the majority of those cases, to my knowledge, insurers were paying money as well. So, this notion that there was some sort of blanket denial of various types of claims is untrue.

Chairman WATT. Thank you. The gentleman from Mississippi, Mr. Thompson is recognized for questions for 5 minutes.

Mr. THOMPSON. Thank you very much, Mr. Chairman. Attorney General Hood, as you know, I represent a portion of the district that received some damage from Katrina, and I know that you have been investigating a number of claims with respect to Hurricane Katrina. And you know that there are several Congressional committees who are looking at many of the issues. Have you shared with the local U.S. Attorney's Office in Mississippi your work?

Mr. HOOD. Yes, Mr. Chairman, we have tried to work with them. The example that Congressman Taylor just gave about the forgery, the forged engineering report, one said it was wind, the next one says it was water. If I'm correct about that case, that's a situation where I think the forgery actually occurred in another State. We needed the Federal Government engaged and involved in working on these type of cases, as well as the National Flood Insurance program issue, as to whether or not we taxpayers had to shoulder costs that should rightfully have been paid by the insurance industry.

And part of the numbers that we've been talking about, the profits, and why they've increased and actuary tables, one of the things that the companies have adopted is this ACE program State Farm was sold by McKenzie Consulting out of New York.

What it's done is—State Farm is just an example. Allstate purchased it and others have done it as well. In 2002, State Farm returned 70.6 percent of the premiums to their policyholders. After

implementing some of this ACE program, it went in 2005, they were only returning 51.6 percent, the most catastrophic year in history.

What they're doing is, they're using these engineers, these so-called independent engineers, and what those are doing at this program is they jettisoned all their adjusters, their engineers, and they were able to use someone who is supposedly independent when they do 85 percent of their business just for State Farm.

Mr. THOMPSON. Would you be willing to share your work with this committee and other Congressional committees as we go forward in looking at this?

Mr. HOOD. Yes, sir. And there were examples I had that I was unable to disclose because of grand jury secrecy. We have those documents and would be happy to share them with the committees.

Mr. THOMPSON. Mr. Chairman, if I might add, would it be in order for a request to go to the Attorney General to ask him for the benefit of his investigative material?

Chairman WATT. We plan to leave the record open from this hearing for 30 days to submit additional questions, and we will consider any question that is submitted to us for submission to the witnesses. I won't necessarily commit to ask it, but we'll certainly consider it.

Mr. THOMPSON. Thank you, very much. General Hood, State Farm and other insurance companies have portrayed themselves as being besieged by Katrina victims who did not buy flood coverage and now want someone to pay for their flood damage. Isn't it true that State Farm and other insurance companies are using any and all means to refuse to pay claims made under wind policies for wind damage?

Mr. HOOD. Yes, sir, Mr. Chairman. That's exactly what our point is. It's a misconception that we're trying to change the policy somehow. We're just trying to make them pay for what they owe under the wind policies.

Mr. THOMPSON. Mr. Hartwig, in your testimony, you state that an adjuster should apportion the loss if some damage was a result of an excluded loss such as flooding.

Mr. HARTWIG. Correct.

Mr. THOMPSON. Sir, if I take—so if I take that you would not disagree with the practice of denying the coverage for wind damage completely just because a portion of the damage was caused by water?

Mr. HARTWIG. If I understand your question correctly, I think you're asking if the insurer would deny the claim completely just because of some presence of water. The answer to that would be no. That would not be practice in the industry.

Mr. THOMPSON. And to your knowledge, there's no such practice?

Mr. HARTWIG. I am not aware of such a practice.

Mr. THOMPSON. With respect—have we put this in the record yet? Mr. Chairman, just, again, Mr. Taylor has just reminded me that this memorandum that the industry uses says just the opposite.

Chairman WATT. Without objection, we'll submit that for the record. You need to give me a copy of it so that we can get it to the clerk.

Mr. THOMPSON. And I'll yield the balance of my time to Mr. Taylor for further follow-up.

Chairman WATT. I'm afraid your time has expired, but with unanimous consent, we'll give Mr. Taylor 2 additional minutes. By unanimous consent, Mr. Taylor is recognized on Mr. Thompson's time for 2 additional minutes.

Mr. TAYLOR. Mr. Maurstad, I really would like to get back to this because as someone who knows a heck of a lot of people who fall into this category, again, I want to, on behalf of all of them, express our thanks that the only agency that was fair with people was the National Flood Insurance Program. I did not receive a single complaint from a single south Mississippian that their flood insurance wasn't paid.

What troubles me is the apparent and total lack of oversight on the part of your agency as to whether or not the taxpayers had to pay claims that should have been paid by the private industry. I have shown you a memo where a claims adjuster says his name was forged on a fraudulent document. I can get all of that as a Member of Congress. I have to believe that your agency could have found that, looked into that instance and determined whether or not the taxpayers were stuck with a bill, in the case of this company, that State Farm should have paid.

I don't recall a single—south Mississippi is a community. We all know each other. Not much happens that people don't tell me about. I can't think of a single constituent of mine who said, you know, the folks from the National Flood Insurance Program came by my property today to see if there was a fair adjudication of their claim, whether it was wind or water. Not one.

Now again, so when you're telling me you're looking to see if we were treated fairly, I see no evidence of that. And that troubles me, because the same year that those guys made $44 billion in profit, our Nation lost $20 billion in flood insurance. I don't think it's a coincidence.

Chairman WATT. The gentleman's time has expired, so ask a question and Mr. Maurstad can respond.

Mr. MAURSTAD. Well, Mr. Taylor, I mean, the program is designed as a public-private partnership. There is a legal between the write your own companies and the program that if breached we would seek every remedy available to us to make sure it was right.

But the situation, and what is key is whether or not in your situation—you indicated, I believe that you said they wrote you a check, the Flood Insurance program wrote you a check for $200,000. That $200,000 represents the damage that was caused by flooding, that the policy that you purchased is obligated to pay you for. And that's what the program did throughout the Gulf Coast, a hundred and eighty-some thousand times.

We do have a rigorous program for oversight to make sure that there are not common practices of the write your own companies discharging their responsibility on the Flood Program. We take that very seriously. That would be an egregious act for the Flood Program to do that. And again, it's not to my knowledge that it did happen. What did happen is in situations like you indicated, and which I'm glad, quite frankly, did occur, because we wanted policyholders to receive what they were obligated by the Federal Govern-

ment as quickly and as fairly as possible, and that's what the focus is on, notwithstanding what the insurance wind companies are obligated for under their policies. We focus on the National Flood Insurance policy, making sure that the damages from flood are paid to policyholders.

Mr. TAYLOR. Mr. Chairman, I'd like to ask unanimous consent for 1 more minute.

Chairman WATT. Do I hear any objection? Is this your last question?

Mr. TAYLOR. Absolutely.

Chairman WATT. The gentleman is recognized for 1 additional minute.

Mr. TAYLOR. Mr. Director, you made the statement that where wind and water exist, the law says that the flood policy will pay. I would like to see where that is in the code, and if it is indeed the case, then I think you need to be spreading that message to people in coastal America, because they may not need to go through the heartache of having a State Farm or an Allstate or a Nationwide tell them no. They may not need to pay a policy if you're going to do that, but there definitely needs to be a clarification. I'm not so sure you're talking within the bounds of the law, but if you are, I would like to have that publicized well so that people in coastal America can make that choice for themselves.

Mr. MAURSTAD. And I will get that for you, but as a point of clarification, I'm going to use the example of a roof. If that roof is damaged by both storm surge and flood and wind, the policy is obligated to pay for the damage associated by the storm surge and the flood.

Chairman WATT. Okay. Without objection, we're going to go an additional round for subcommittee members only and restrict the time on this round to 3 minutes for each subcommittee member. And I recognize the ranking member for 3 minutes.

Mr. MILLER. Thank you. If any egregious act occurred on any part of an insurer, they need to be held accountable. I think there's no doubt about that. Mr. Hood, there's been talk of collusion. Did each of these insurance companies handle the claims in the same identical way where you think they went out and talked and just came out and this is how we're going to do it? Is there any evidence of that at all?

I mean, I know you're unhappy with some—the way it was done, but is there—I mean, is it like a bunch of little Xerox copies, they all met behind a room and everybody went out and did the same thing?

Mr. HOOD. Our investigation, and I can't really talk about other targets other than those that have been publicly disclosed, being State Farm, but most didn't zero people out with that anti-concurrent cost provision.

Mr. MILLER. Okay. So they were different. Mr. Hartwig, how many claims do you think go through the State-run mediation satisfactorily, and is the State system working in this regard and the proper market conduct exams being conducted? And, you know, if not, do we need more criminal prosecutions and lawsuits because they're not being handled properly?

Mr. HARTWIG. Well, with respect to mediation, thousands of claims are being run through those systems in both Louisiana and Mississippi, and if I go back to Florida in 2004 with those storms, I believe a total of about 12,000 claims went through that particular system.

Now, mind you, while 12,000 may sound like a large number, that compares to about 2.3 million claims in that State that year, so it's a very small number, and about 90 percent of those were resolved successfully. In Louisiana and Mississippi in 2005, that number is about 80 percent. So it's a good system. It's a system that works.

Mr. MILLER. It does work.

Mr. HARTWIG. It's a system that's much more certain than litigation. It's one that brings about resolution and closure much more expeditiously and with much less cost. For instance, a trial lawyer typically takes a third of the typical award.

In terms of oversight, there is a tremendous amount of oversight in the system, again, consumers are protected at every level through various Unfair Claims Practices Acts and other acts that apply to the transaction of insurance.

Mr. MILLER. Mr. Hood, you talked about basically vague, ambiguous language within policies and such that were difficult to enforce. Was that a correct statement I heard from you?

Mr. HOOD. I don't recall—

Mr. MILLER. You talked about some—I wrote down ambiguous provisions within the policies that were hard to enforce. And I noted that, because that was really problematic to me, because the problem I've had and I've been stating all along is, you have basic insurance commissioners or the Office of Insurance Commissioners have to approve all of these.

And I'm just a poor builder, but I know any contract I ever do, if it's vague and ambiguous, it's not enforceable. And surely some insurance commissioner in Mississippi has got an attorney. And if they're passing out and stamping insurance policies that are vague and ambiguous, shame on them. If they're stamping insurance policies that Federal judges have to remove clauses from, shame on them.

And I feel sorry for Mr. Taylor and others who have lost their home and such, but maybe we need to start looking in several directions instead of just looking in one direction for fault here, that if insurance commissioners, and that's the problem I've had with as many agencies we have throughout this Nation to determine policies and regulations they're going to place on the business sector that they have to comply with and people spend more time often and money in compliance than they do trying to do their job.

But you need to look maybe internally, and I—you know, you need to represent the people of your State. I'm not criticizing you for that at all. But maybe you need to look back internally. And if your insurance commissioner or their agencies are approving polices that are not enforceable or vague and ambiguous, maybe you as the attorney general need to look back on Mississippi and correct that in the future. I mean, that's where I'd go.

But, I mean, we can't just blame one side in this.

Mr. HOOD. These policies are pretty much standard in California or all—

Mr. MILLER. Yes, but you approve them within your State. You don't approve California's. You approve Mississippi's.

Mr. HOOD. That's correct. But there again, you can't put a provision in a contract that's illegal. You can't make a contract—

Mr. MILLER. But I can put a provision in that is not ambiguous.

Mr. HOOD. That's correct.

Mr. MILLER. And you used the word "ambiguous" when it came to settling a claim, because I wrote it down, because that really bothered me. And when I talked to the chairman before, I was concerned about the regulations we have that are not working throughout this country and it's been demonstrated in the Gulf States that there's a problem.

Mr. HOOD. We submitted a bill in our State legislature shortly after Katrina went through. It was a consumers insurance bill of rights that required standard language, and maybe the ambiguity came when I was discussing their failure to place in their water exclusion the words "storm surge." And under law—

Mr. MILLER. Additional 30 seconds?

Chairman WATT. Without objection.

Mr. MILLER. My concern is that it's like you've been in a bar fight. Well, we do things when we're in a bar fight we might not otherwise do because we're angry. There are a lot of people in your State who have been hurt because of a major disaster, and there are a lot of insurance companies that lost a lot of money, and, you know, they're trying to turn a profit, too.

People on both sides are looking at this thing trying to determine how to come out. I just pray that what you do in your State doesn't create this exodus of the private sector. Because if you do that, you can put all the language you want to into law that says we're going to protect the people. But if they can't get anybody to write a policy on it afterwards, then you're not protecting your people.

And Mr. Chairman, I thank you for the additional time. I yield back.

Mr. HOOD. California—

Chairman WATT. I think he was just lecturing you rather than—

Mr. MILLER. I was lecturing.

Chairman WATT. He never asked a question, so I'm not going to allow you to answer the nonquestion. Mr. Mahoney is recognized for 3 minutes.

Mr. MAHONEY. Thank you, Mr. Chairman. This has been very enlightening for me today because I didn't realize for the last 25 years that the property and casualty industry has been a losing money proposition. So I appreciate, Mr. Hartwig, of you telling me that the insurance industry has been doing this as a public service for the American people.

And as such, it makes me ask the question, which is, in the State of Florida, you know, one of the things our insurance commissioners are trying to do is they're trying to figure out how to incent the insurance industry to stay in and to provide services, their services to the people of the State.

And one of the things that happened in the State of Florida as an incentive was the idea that we should provide insurance compa-

nies the ability to operate "pup" companies or subsidiary companies in order to operate in the State. And my question, Mr. Hartwig, to you is, if it's already a money-losing proposition, why would there be a need for an insurance company to operate a subsidiary in a State?

Because in my simple way of looking at insurance is that the bigger the pool, the more people that are, you know, contributing to it, the safer it is for both the insurance company and the person receiving the insurance in terms of making sure that the claims are being able to be paid. Why would these insurance companies in the State of Florida and other States operate in subsidiaries as opposed to operating just as a nationwide company?

Mr. HARTWIG. A couple of things. First, your first comment, the industry operating as a public service entity, that's not been the case. When I talked about the fact that there's been consistent losses for 25 years in the aggregate, I was referring specifically to homeowners insurance.

But in terms of "pup" companies—

Mr. MAHONEY. So homeowners insurance has been a loss leader or a public service?

Mr. HARTWIG. Not a loss leader. It's been a money loser.

Mr. MAHONEY. Okay. And why would the industry continue to operate if it loses money?

Mr. HARTWIG. Again, as I said earlier on questioning, that in aggregate, that has been the case, but not in every State. And in some States like Florida, they've had a disproportionate impact.

Mr. MAHONEY. Okay. Thank you.

Mr. HARTWIG. In terms of "pup" companies, if people aren't aware of what "pup" companies are, effectively, they are subsidiaries of insurance companies that operate in a single State typically. And the question is, is why would an insurer do such a thing?

There are a variety of reasons they might do it, in part because usually these operations are set up in States where the risk characteristics of operating there are significantly different from the overall business. So, Florida homeowners insurance would be a good example of that. You might have a separately capitalized company. It has its own set of rates and underwriting guidelines, and you run that company differently than you would operate a homeowners insurer, say, in Indiana, Illinois, or Ohio.

So the difference in the business is sufficiently great that it needs to be handled differently, and that is basically tied to the risk associated with operating in that State.

Mr. MAHONEY. But that being the case, isn't one of the benefits of having a subsidiary company to be able to protect the parent in the particular case of a catastrophic loss business event that would threaten the welfare of the parent company? I mean, isn't that one of the benefits of subsidiary companies?

Mr. HARTWIG. The benefit and the rationale is to isolate the risk. And it is very important that insurers keep in mind their obligations to their millions and millions of policyholders across the country. It is the case that no insurer can afford to be brought down by its experience in a given State. And I think it's extremely important. I mean, one thing we've talked about here a lot about is in-

surer profits. And there seems to be, I don't know, a need or desire to drag these profits as close to zero, if not a negative number, as is humanly possible.

The reality of it—

Mr. MAHONEY. So you are agreeing that one of the things is to protect the insurance company from being brought down, as you said?

Mr. HARTWIG. Part of the rationale for a "pup" company is to isolate that risk.

Mr. MAHONEY. Okay. That's my understanding.

Chairman WATT. The gentleman's time has expired. I'm being stricter with the time, because we must clear this room for another meeting.

Mr. MAHONEY. I appreciate it, Mr. Chairman.

Chairman WATT. I recognize myself for 3 minutes, just to ask a couple of questions to clarify.

Mr. Maurstad, Dr. Hartwig said that one potential solution to some of this might be encouraging mediation of claims. I have a memo that the National Flood Insurance Program apparently sent out which basically prohibits Write Your Own principal coordinators or participants from allowing mediation.

It says that your office apparently thinks that allowing any State entity to engage in this process would subject all of you to State regulation. Is that your position?

Mr. MAURSTAD. Yes. We do believe that there are constitutional—

Chairman WATT. Okay. If it were clarified in legislation, would that be helpful, in your opinion?

Mr. MAURSTAD. Well, that would reduce one of the objections to it. I mean, part of it is that 99 percent of our claims are handled without any legal recourse at all, and it's a resource issue as to whether or not that's the only way that a claim can be handled. The Reform Act of 2004 required and we've put in place the appeals process for policyholders. So, in this case—

Chairman WATT. In other words, you have other objections other than the fact that it was subject you to State regulation?

Mr. MAURSTAD. Yes.

Chairman WATT. Why don't you submit whatever other objections you have so that we have that information and can make it a part of the record so that when people look at it and other subcommittees consider possible solutions to what we are trying to do here, we have a balanced approach on that?

Now I'm going to ask one more question of Mr. Hartwig, because I'm a little concerned that this hearing has maybe been misrepresented, and I just want to use this to send a strong message to those out there who may be inclined to misrepresent what we're trying to do here.

The ranking member told us, Dr. Hartwig, that you were invited because you were an expert in insurance, and then I get a memo that was sent out by representatives of State Farm saying that you are here testifying on behalf of the insurance industry. My question to you is, are you here testifying on behalf of the insurance industry?

Mr. HARTWIG. I'm here to testify on—as an expert within the insurance industry.

Chairman WATT. All right. That's—

Mr. MILLER. May I make one quick point?

Chairman WATT. Sure.

Mr. MILLER. I selected him because I looked at his resume as chief economist of the Insurance Information Institute. Our side believed he was most qualified and knew more about insurance than anybody we could bring before this committee who was not working for any insurance company.

Chairman WATT. And I absolutely respect that. The point I want to make here is that I don't think anybody who's been here the course of this hearing today would suggest that I, as the Chair, have not framed the issue in the most balanced way that it could possibly be framed.

And I'm going to submit for the record, by unanimous consent, this memorandum to the Great Lake Zone employees from some senior vice president who first of all says that—undermines Mr. Hartwig's testimony by saying that he's here representing the insurance industry, and then undermines the impartiality that we have tried to proceed under by representing that no one from State Farm nor any other insurance carrier has been invited to testify. We're going to get to that.

But if you all would tell the folks at State Farm, I see some of their representatives in the audience, that if they're expecting to get a fair hearing, they don't get it by trying to sabotage the hearing process that we have. We can't do everything in one day, but I guarantee you, by the time we get to the end of this process, we will have heard from everybody in this process who wants to be heard.

And just to prove that, I'm going to ask unanimous consent to submit for the record statements that today were submitted by the National Association of Realtors, a statement of Gilbert Randolph LLP on behalf of the Mississippi Center for Justice and William Quigley, Professor of Law and Director of the Loyola Law Clinic, and Gillis Long, Poverty Center, Loyola University, New Orleans College of Law, a statement of the Mortgage Bankers Association, a statement of Jeffrey Rose from Lake Shore, Mississippi.

I just want to close this by making it clear that we are going to continue to try to build a factual record in this subcommittee, and anybody who goes out of here and suggests that somehow we're on a witch hunt or they haven't been asked to testify or won't be allowed to testify, please ask them to call me before they send out these memoranda to their employees, because I don't appreciate it.

Now the Chair notes that some members may have additional questions for the panel, including the members who do not serve on the committee but who participated in the hearing today. Without objection, the hearing record will remain open for 30 days for members to submit written questions to these witnesses and to place their responses in the record.

Without objection.

This hearing is adjourned, and we want to thank the witnesses for appearing and testifying, and I've been asked to request that

you all kindly exit as quickly as possible to accommodate the next meeting that's taking place in the room.

Thank you so much.

[Whereupon, at 5:25 p.m., the hearing was adjourned.]

A P P E N D I X

February 28, 2007

OPENING STATEMENT OF
CHAIRMAN MELVIN WATT
AT THE HEARING

"Insurance Claims Payment Processes in the Gulf Coast after the 2005 Hurricanes."

BEFORE THE SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS
OF THE
COMMITTEE ON FINANCIAL SERVICES

February 28, 2007

Today's hearing will examine the insurance adjustment process in the Gulf Coast area after the 2005 hurricanes.

Hurricane Katrina was the single most expensive insured disaster in the United States, with privately insured losses of about $40 billion. It resulted in approximately 1.7 million private insurance claims, with the vast majority of those claims coming from Louisiana, Mississippi and Alabama. Although the insured losses from Hurricane Rita were lower than Hurricane Katrina, Hurricane Rita was also expensive, with privately insured losses of almost $5 billion from about 381,000 claims, the 7th most expensive in history.

After this unprecedented destruction, the National Flood Insurance Program paid out more than $18 billion in claims. The substantial claims that resulted from Hurricanes Katrina and Rita far exceeded the premium income to the program. NFIP has borrowed most of the $18 billion paid out in claims from the U.S. Treasury. The Federal taxpayer has a financial interest in how the NFIP operates and specifically how the claims process works.

I recognize that insurance matters are generally governed by the States, but the Financial Services Committee has jurisdiction over the NFIP and Congress acted three times last term to approve additional borrowing authority for the NFIP to enable it to continue to pay claims.

Having given this factual background, let me set some ground rules, address some of the questions that have been addressed to me by colleagues, interested parties and the press and frame the issues in the following way:

First, what is our Subcommittee's role? In this hearing, and in every hearing or investigation we conduct this year, let's keep in mind that the Oversight and Investigation Subcommittee is not a legislating committee. Our sole purpose is to get the facts and build a factual record. If we do our job thoroughly and fairly, whatever legislation might

be appropriate will be based on the facts. But it will be done by another subcommittee, the full Financial Services Committee or elsewhere.

Second, what do we know already? Well, there are a number of things that various people will tell you that they know. But the only thing I'm prepared to say that we know for sure (and this is where I would like all Subcommittee members to start) is that everybody I've talked to in the process is unhappy. Our citizens, our constituents, are unhappy. The one thing that many of them know is that their claims were not timely paid. They blame private insurers, the Federal Flood Insurance Program and the system for all the finger pointing and blame shifting.

- The members of Congress from the Gulf, our colleagues, are unhappy because their own experiences and their constituents' complaints indicate that there was not only a breech in the levees that were designed to protect them, but there was also a breech in the insurance coverage, adjustment and payment process that was supposed to compensate them.

- Private insurers are unhappy. They'll tell you that they were just honoring the provisions of their insurance contracts. For a better understanding of their position, I commend to the Subcommittee members a thoughtful article from the February 24, 2007 New York Times, which suggests that a confluence of acts of God, voters, the press, trial lawyers for classes of civil litigants, the threat of criminal action, activist judges and self-interested politicians at the Attorney General, U.S. House and Senate levels conspired (or at least coalesced) to make private insurers the "victims."

- The Federal Flood Insurance Program is unhappy. There's been some suggestion that they rolled over and paid claims that shouldn't have been paid by the Program (or that should have been paid by private insurers). Most of the Program's flood insurance premium dollars are now going to pay interest on the $18 billion used to pay these claims.

- Finally, taxpayers could end up being very unhappy. If we can't sort through this and if it is not fixed, they could be left footing the bill and what's more, a similar result could occur following future disasters.

Third, now that we know that everybody is unhappy and pointing the finger of blame at someone else, where do we go from here? Our job is to document the facts. Today's hearing is the start. There will certainly be others and I intend for them to be conducted fairly and even-handedly. But let me be clear – we will follow the facts where they lead us. There will be an effort to identify possible solutions. But we need to know the facts first.

We thank the witnesses for being here to start the process.

House Committee on Financial Services: Oversight and Investigations Subcommittee
Hearing on Insurance Claims Payment Processes in the Gulf Coast after the 2005 Hurricanes

Statement of Representative Bobby Jindal
February 28, 2007

Chairman Watt, Ranking Member Miller, and Financial Services Committee members --- Thank you for providing me the opportunity to testify before your Committee.

Eighteen months ago, in August and September 2005, Hurricanes Katrina and Rita devastated the Gulf Coast region of the United States, including large land areas in my home state of Louisiana. In the Southern portions of Louisiana, the storm surge swept across the coastal areas, causing extensive property damage. In my Congressional district and in the City of New Orleans, levees failed and flood waters swamped homes and businesses for several weeks before the water was finally pumped back into Lake Pontchartrain.

Hurricane Katrina was the most significant natural or man made disaster to affect the United States. The effects of the hurricane completely destroyed and made uninhabitable an estimated 300,000 homes. This far surpasses the residential damage of Hurricane Andrew, which destroyed or damaged approximately 80,000 homes in Florida in 1992. It also exceeds the combined damage of the four major 2004 hurricanes, Charley, Frances, Ivan, and Jeanne, which together destroyed or damaged approximately 85,000 homes. The federal government aided businesses and individuals struggling to purchase terrorism insurance after the September 11th terrorism attacks and the people of Louisiana deserve the same help. With more than fifty-three percent of our country's population living in the 673 coastal counties and parishes, it is critical that we provide insurance to these areas.

In many coastal areas, insurance prices are a growing problem because of steadily rising rates. For South Louisiana and several of the Gulf States -- we are in the midst of an insurance crisis. Louisianans are still haggling with insurance companies over settlements and payments a year and a half after the storms -- these are problems that are typically resolved within three months after a natural disaster strikes.

Even further, homeowners and businesses are unable to rebuild because of high premiums and difficulty in obtaining insurance altogether. Since the 2005 hurricanes, many homeowners' policies in the greater New Orleans area have gone up more than fifty percent and insurance costs have gone up an average twelve percent statewide. Obtaining insurance is difficult because only a handful of companies are writing property insurance in the state. In fact, ten of the top twenty-five property insurers do not do business in the state. Those companies that remain are striding to eliminate hurricane coverage from their portfolio. There are also media reports that insurance companies are attempting to cancel insurance policies of those who were not even affected by flood or wind damage caused by the 2005 hurricanes. In short, Louisianans are paying more for less insurance (if they can get it) which is hampering recovery from the storms.

State Farm Fire and Casualty Company, the largest residential insurer in Louisiana with about thirty-two percent of the market, has stated that it will not write new hurricane coverage -- also known as wind and hail insurance policies -- in south Louisiana. Allstate, which accounts for twenty percent of all the homeowners' policies and has been the state's second largest provider of insurance, is implementing a statewide five percent deductible on hurricane coverage. According to news reports, Allstate does not plan to write new hurricane protection policies in much of Louisiana. The state's Commissioner of Insurance is also investigating allegations that the company is arbitrarily canceling homeowner policies in the state. Louisiana Citizens Property Insurance Corporation, the state-run insurer of last resort and currently the third largest insurer, is writing more policies than ever before. The company writes 1,000 policies per day and expects to write between 60,000 and 200,000 over the next year. But, premiums attached to their coverage are costly. Without competition from the private sector, market forces are not working to drive down insurance rates. The bottom line is that extraordinary high insurance premiums will put mom and pop shops or the young entrepreneur permanently out of business and people in South Louisiana will simply not be able to afford to rebuild.

The insurance crisis in Louisiana can be explained as a classic chicken-and-egg problem: if a property-owner rebuilds, in accordance with federal law, he must obtain

property insurance before settling on the property with a loan from a mortgage company. But South Louisianans are having difficulty obtaining insurance needed to go to settlement because companies are refusing to issue new policies in this area.

This was the recent experience of an insurance salesperson from New Iberia, Louisiana who was left scrambling to find homeowner's insurance within two weeks of transferring her homeowner policy to a house she had just finished building. Because her wind and hail hurricane coverage was canceled, the mortgage company that financed the construction of her new home threatened to make her return the loan money unless she obtained a new hurricane policy. As an industry insider she was familiar with every company that writes homeowners' insurance in Louisiana -- she was rejected by all but Citizens. While she was lucky to obtain insurance to go to closing on her new home, her premiums increased from $900 to $3,000 a year for the same coverage she had bought two weeks before.

Furthermore, in certain situations policyholders are being dropped from insurance companies because they haven't held a policy with the company on the same property for a certain number of years. Imagine a case where John Doe has been a customer of insurance company A for 25 years. Year after year John Doe faithfully paid his insurance premiums without ever filing a significant claim. Two years ago, John Doe transferred his policy when he purchased a new home and is now being told by insurance company A that he is being dropped because the policy is "too new."

Though exact numbers are hard to predict, experts anticipate that in 2007, roughly four policyholders in every ten will find themselves in the same boat as John Doe and searching to find insurance that covers hurricane damage. This is because as of January 1, 2007, post-hurricane restrictions on insurance companies were lifted and insurance companies are now able to start the process of canceling wind and hail coverage for policies less than three years old. The remaining sixty percent of homeowner policies in Louisiana cannot be dropped because the homeowner bought their insurance more than three years ago and under state law, those policies cannot be changed.

On the commercial side, extraordinary insurance rates are equally an impediment to rebuilding. For example, a locally-based real estate development company, HRI

Management, has a portfolio with properties worth around $200 million. Before Katrina, the company's coverage cost $500,000 and included a one percent deductible or roughly $100,000 per property. Two days before the policy's renewal date, the insurance company told HRI the new policy would be $2.5 million, include a five percent deductible and provide only $50 million in hurricane coverage. Without competition in the insurance industry, the company has limited choices: put up with absurd premiums that offer little coverage, risk forgoing insurance altogether if the properties are not financed by a bank loan, or move the business to another location where insurance is not a scarce and unaffordable commodity.

We must ensure that the residents of our state have access to reasonably priced insurance, and are not forced to live uninsured due to insurance companies exponentially raising their rates. For example, many of the residents in St. Martin Parish whose homes were destroyed by a tornado right after Valentine's Day had recently dropped their homeowner's insurance due to the rising insurance costs after Hurricanes Katrina and Rita. As reported in one local paper, a 90-year-old widow on a fixed income and who owned her home outright was faced with just that dilemma - pay for food, medicine and other needs or use that money to pay her increasing insurance premiums. She chose the former and now must rebuild her home after it was destroyed by the tornado without the help of insurance. That is absolutely unacceptable, and something has to change.

I would like to leave the Committee with one last thought. Insurance companies argue that it is simply too risky to issue policies in South Louisiana and coastal areas threatened by harm from future hurricanes. I must point out that had the levees in Southeastern Louisiana been built to withstand the magnitude of a category 3 hurricane as Louisianans had been led to believe, the area would not have sustained the extensive property damage that was inflicted after Hurricane Katrina passed. The scope of property damage in Southeastern Louisiana can be attributed to the failure of the levees in New Orleans -- not from the hurricane itself.

There is an understandable concern on the part of insurance companies to manage portfolios in a manner that balances their exposure to claims in so called "high-risk" areas with so called "safe policies" that in all likelihood will not result in significant claims being

paid. This helps ensure long-term solvency and stability in the insurance market which is in everyone's best interest. However, in 2006, while insurance companies are defending their decision to not issue new hurricane policies in Louisiana because, if they are to be believed, they cannot afford to enter this market, insurance companies were delivering a record $44.8-billion in profits even after accounting for the claims of policyholders wiped out by Hurricanes Katrina and Rita. And, from 1999 through 2005, the insurance industry saw its profits nearly double, from $22.2 billion in 1999 to $43 billion in 2005, while adding almost $100 million to its surplus reserves. It does not seem right that insurance companies are making record profits while Louisiana residents cannot afford their premiums.

The residents of our state have already been through so much in the last 18 months, and it is unacceptable to ask them to triple or quadruple their insurance costs when so many are still rebuilding their lives. We cannot rebuild our state unless people move back to the area, and this will be a challenge if insurance costs remain as high as they are now. We cannot reasonably expect people to return home when they cannot even afford to live in and invest in preventative measures for their own homes.

While we cannot go back in time to fix the present, we can take steps to brighten the future. I applaud this Committee and the members of this panel for undertaking an examination of insurance practices in the Gulf Coast in the aftermath of Hurricanes Katrina and Rita.

Statement

of

U.S. Representative Gene Taylor
Fourth District, Mississippi

before the

Financial Services Committee
Subcommittee on Oversight and Investigations

regarding

Insurance Claims Payment Processes on the Gulf Coast

February 28, 2007

Thank you, Chairman Watt, for conducting this hearing and opening an investigation of insurance fraud after Hurricane Katrina. I am very grateful to you, Chairman Frank, and Chairwoman Waters for hearing my concerns and agreeing to pursue these important matters within the Financial Services Committee.

I will summarize my statement, but, if there are no objections, I would like to submit my full written statement for the record, to include copies of insurance documents and fraudulent engineering reports. These are samples of a much larger problem. I have additional documents on my website and will be happy to provide them to the committee.

After Katrina, several insurance companies conspired with engineering and adjusting firms to commit fraud against their policyholders and federal taxpayers.

Company officials instructed adjusters to assign all damages to the federally-backed National Flood Insurance Program in cases where wind caused much of the damage.

Engineering firms cherry-picked data and manipulated evidence to favor insurance companies.

Insurance, engineering, and adjusting company managers, who never laid eyes on the damaged properties, reversed the observations and conclusions of the engineers who conducted on-site damage assessments.

In light of these facts, I respectfully request that the Financial Services Committee take action on three specific issues, all of which fall under the Committee's jurisdiction. First, I ask the subcommittee to conduct a **full** investigation of the fraud against consumers and taxpayers so that the responsible parties can be held accountable for their actions.

Second, I look forward to working with you on a flood insurance reform bill to eliminate the conflict of interest that currently allows insurance companies to defraud U.S. taxpayers. To such ends, Congress should prohibit any company that participates in the

flood program from using anti-concurrent causation language to underhandedly bill taxpayers for wind damage.

Third, I urge the Committee's consideration of H.R. 920, the *Multiple Peril Insurance Act*. This bill – cosponsored by both Democrats and Republicans – would create a new option within the flood insurance program to allow property owners to purchase wind and flood coverage in one single policy.

As you know, the flood insurance program contracts with insurance companies to allow the companies to sell flood policies, which are guaranteed in turn by the federal government. The so-called "Write Your Own" Companies also agree to adjust the flood claims. As a cost-saving measure, NFIP allows the company to use a single adjuster for both claims. Any person with a shred of common sense can tell you that this practice creates an obvious conflict of interest. The current arrangement presents insurance companies with an easy opportunity to manipulate claims in order to bill the federal government and save insurance companies and their shareholders a great deal of money.

The contract between the insurance company and the flood insurance program requires the company to represent the interests of the federal government *and* its own interests when adjusting claims. The federal regulations state explicitly that "the primary relationship between the Write Your Own Company and the Federal Government will be one of a fiduciary nature, i.e., to assure that any taxpayer funds are accounted for and appropriately expended." (44 CFR 62.23(f))

The federal regulations also state that "the entire responsibility for providing a proper adjustment for both combined wind and water claims and flood-alone claims is the responsibility of the Write Your Own Company." (44 CFR 62.23(i)(1))

Some insurance companies did not act in good faith to fulfill their fiduciary duty to federal taxpayers when adjusting combined wind and water claims after Hurricane Katrina. State Farm, Allstate, Nationwide, USAA, and other insurers adopted procedures that, *a priori*, attributed all damage in the surge area to flooding and then forced homeowners to prove otherwise.

Mississippi Insurance Commissioner George Dale issued a bulletin one week after Katrina, declaring that the insurance companies had to pay wind claims unless they could prove that flooding was the cause. The companies ignored the bulletin, and the state did nothing to enforce it. As a result, thousands of Mississippians had no choice but to sue to get their insurance companies to honor their contracts. Mississippi Attorney General Jim Hood also filed suit and began a state investigation.

Seventeen months after Katrina, U.S. District Judge L.T. Senter, Jr. affirmed in *Broussard v. State Farm* that the insurance companies have the burden of proof. State Farm had not proven its case. In response, the company ran to the *Wall Street Journal* editorial board and claimed that this was a radical ruling. In reality, insurance companies have always had the burden of proof when denying a claim, be it in Mississippi or any other state.

While several companies denied claims for wind damages inside the surge zone, State Farm was the most aggressive in its efforts to defraud their policyholders, using a network of selected contractors to act as accomplices.

On September 13, 2005 – two weeks after Katrina hit Mississippi – State Farm issued a directive from its headquarters in Bloomington, Illinois in a document titled "Wind-Water Claim Handling Protocol." The Wind-Water Protocol instructed State Farm adjusters that "[W]here wind acts concurrently with flooding to cause damage to the insured property, coverage for the loss exists only under flood coverage, if available."

In effect, the Wind-Water Protocol declared that State Farm's wind insurance would not pay for damage caused by wind when they could blame any amount of damage on flooding. Where wind and water both caused damage, adjusters were directed to bill the federal government and, by extension, taxpayers for the full loss if the property was covered by flood insurance.

State Farm's so called "anti-concurrent causation clause" should be called what it really is – a concurrent fraud clause. **Its purpose is to cheat both policyholders and taxpayers at the same time.** Any attempt to enforce this clause is a bad faith violation of the company's fiduciary duty to federal taxpayers under its contract with the National Flood Insurance Program.

State Farm will argue that it paid more than $1 billion in Katrina claims in Mississippi and settled more than 95% of its claims. Those numbers only help to prove the fraud that they categorically deny.

State Farm and other insurers paid wind claims in all 82 counties in Mississippi, as far as 300 miles inland. According to the insurance industry's own data, Katrina's winds caused billions of dollars of structural damage far beyond the storm surge area. Yet, near the coastline, where the strongest hurricane winds pounded homes for four to five hours before the storm surge, insurance companies manipulated the adjustment process to deny wind claims.

I urge the subcommittee to seek the testimony of Cori and Kerri Rigsby. The Rigsby sisters were claims adjusters working for E.A. Renfroe and Company. Renfroe worked exclusively for State Farm. The sisters were disturbed by the fraud being committed by State Farm and Renfroe officials, so they copied incriminating documents and gave them to federal and state law enforcement officials. The Scruggs Law Firm represents the sisters in a *False Claims Act* filing against State Farm and Renfroe. That federal fraud case is still active.

In response, Renfroe filed a retaliatory suit against the Rigsby sisters and obtained an injunction that required the sisters to return the copies of documents they provided to state and federal investigators. Because of the Renfroe suit, the only documents currently available to the public are those that are included in the *False Claims Act* filing.

These documents clearly demonstrate that Renfroe and State Farm covered up engineering reports that concluded – in the most explicit terms – that damage was caused by wind. Claims managers who never laid eyes on the damaged properties pressured engineers to revise their observations and conclusions. In some cases, claims managers sent a second engineer to write a report more favorable to State Farm.

The Rigsby sisters photocopied an engineering report with a handwritten note attached that said, "Put in Wind file – DO NOT Pay Bill. DO NOT discuss." That report concluded that first floor damage had been caused primarily by wind. State Farm hid that report and ordered a second report. The second engineer blamed the damage on flooding.

The Rigsby sisters report that, within days after Katrina, State Farm coached its adjusters to pay the policy limits on flood insurance without a site inspection or an engineering report. In sharp contrast, State Farm required an engineering report before paying any wind claims.

Each engineering firm was provided with an analysis by Haag Engineering of Dallas. State Farm and Haag have a long history together that includes bad faith judgments in the courts of several states. Most recently, State Farm, Haag, and Renfroe were found to have acted in bad faith to deny coverage of tornados in Oklahoma in 1999. Because of that verdict and the many complaints about Haag after Katrina, State Farm has been forced to temporarily suspend working with Haag.

Haag's Katrina report makes the ridiculous claims that the NOAA Hurricane Research Division overestimated the wind speeds by 25 percent, and that the U.S. Navy Meteorology and Oceanography Command missed the timing of the storm surge by one hour. Haag based its flawed conclusions on inland wind data because wind towers on the Mississippi Gulf Coast were knocked out by high winds. The Navy spent more than a month analyzing all available weather and ocean data to recreate Katrina's surge, but Haag dismissed the Navy's findings based on an amateur video filmed from a hotel parking garage.

Rimkus Consulting Group of Houston also investigated wind claims for State Farm and other insurance companies. Rimkus established an office in Ridgeland, Mississippi, near Jackson, about 150 miles inland. Rimkus engineers would conduct on-site assessments and email their reports to Ridgeland.

The Merlin Law Group has documented several cases in which the engineer who inspected the home site concluded that damage was caused by wind, but Rimkus staff in Ridgeland changed the observations and altered the conclusions in the reports without the knowledge or consent of the engineers who saw the properties first-hand. A few of the affected homeowners are here today to offer their accounts of Rimkus' fraudulent practices.

I encourage you to invite testimony from the engineers whose reports were revised without their consent. I have attached two Rimkus cases to my statement, but there are

several more on my website. These are only a few of the cases that clearly document the pervasive fraud perpetrated on homeowners and U.S. taxpayers alike. There are many more cases where the adjustment process was manipulated to defraud policyholders, but the fraud cannot be documented at this time.

Again, I thank you for holding this hearing and initiating this investigation. I look forward to working with you to ensure that consumers and taxpayers are protected from these fraudulent insurance practices in future disasters.

Supplemental Materials to Testimony of Rep. Gene Taylor

Committee on Financial Services

Subcommittee on Oversight and Investigations

February 28, 2007

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Date: September 13, 2005

To: State Farm Claim Associates handling CAT PL in the Central and Southern Zones

From: Property and Casualty Claim Consulting Services

Subject: Wind/Water Claim Handling Protocol

**********ACTION REQUIRED**********

Summary
Because of the combination of wind and water damages many homes sustained from Hurricane Katrina, the following materials have been developed and are intended for use as a guide for handling various wind and/or water claims in Louisiana, Mississippi and Alabama.

Action
The protocol below outlines the process that should be used for determination of coverage in those locations.

Protocol Detail
Each claim should be handled on its merits. A causation investigation should be conducted and appropriate claim file documentation is required. Any available information should be considered in making a coverage determination. This information will include, but is not limited to:

- Evidence gathered at the on site inspection. This includes documentation of physical evidence such as water lines, an examination of the debris, and an analysis of the physical damage to the structure.
- Evidence gathered at neighboring locations.
- Data obtained from reports describing damage to the area.
- Information from witnesses and policyholders.
- Input from experts that may be retained to provide guidance.

The damage to insured properties will fall into the following categories and should be handled as detailed below:

- Damage to the property was caused by windstorm.
- Damage to separate portions of the property can be attributed to either windstorm or excluded water.
- Damage to the property was caused by excluded water; with no available coverage.
- Damage to the property was caused by flood waters; covered by an available flood policy.

PLAINTIFF'S EXHIBIT C

GUICE JUDY v SFFCC

GUICJ00000179PROD

State Farm Wind-Water Protocol

Damage Caused by Windstorm
When the investigation indicates that the damage was caused by windstorm, the claim will be handled under the applicable provisions of the involved property policy. Consideration should be given to determine if a hurricane deductible or a windstorm or hail exclusion endorsement is involved and the claim handled accordingly.

Damage to Separate Portions with Distinguishable Wind or Excluded Water
Each type of damage should be documented in the claim file. The claim representative should calculate the separate damage attributable to each peril and handle the adjustment accordingly. In those cases where the policyholder has policies for both a windstorm and a flood, payments should be issued under the applicable policy.

Damage Caused by Excluded Water
When the investigation indicates that the damage was caused by excluded water and the claim investigation does not reveal independent windstorm damage to separate portions of the property, there is no coverage available under the homeowners policy pursuant to the following language in *Section 1 Losses Not Insured*:

"2. We do not insure under any coverage for any loss which would not have occurred in the absence of one or more of the following excluded events. We do not insure for such loss regardless of; (a) the cause of the excluded event; or (b) other causes of the loss; or (c) whether other causes acted concurrently or in any sequence with the excluded event to produce the loss; or (d) whether the event occurs suddenly or gradually, involves isolated or widespread damage, arises from natural or external forces, or occurs as a result to any combination of these:

c. Water Damage, meaning:
(1) flood, surface water, waves, tidal water, tsunami, seiche, overflow of a body of water, or spray from any of these, all whether driven by wind or not . . ."

Other Losses Not Insured may be applicable, including 2.c.(2) & (3), 3.(a), (b) & (c).

Damage to Property Caused by Flood Waters with available Flood Policy
Where wind acts concurrently with flooding to cause damage to the insured property, coverage for the loss exists only under flood coverage, if available. The flood damage claim should be handled consistent with the terms of the flood policy providing coverage as outlined in Operation Guide 71-06..

Claims where the causation investigation is ongoing
Payment can be made under a reservation of rights for ALE or Loss of Income under the property policy until the final coverage decision is made. The policyholder should be advised in writing that:

- The investigation is ongoing.
- No coverage decision has been made.
- In the event it is determined that there is no covered damage, no further payment will be made on ALE or Loss of Income.
- They may undertake an independent investigation.

All claims in this category must be reviewed by the Claim Team Manager before a final decision is made. Management should be involved in any claim where it is deemed necessary to retain an expert to assist in the determination of causation.

For More Information
Any question on this protocol should be directed to your Claim Team Manager.

C. P & C Claims Executive
Southern Zone Executive & Claim Managers
Central Zone Executive & Claim Managers
P & C Claims Directors and Consultants
Catastrophe Services Claim Managers
Catastrophe Services Section & Team Managers
Zone Section Managers

October 12, 2005

State Farm Insurance
Mr. Cody Perry, Claims Adjuster
1909 East Pass Rd.
Gulfport, MS 39507

Re: Hurricane Damage Assessment Investigation
Insured: Thomas & Pamela McIntosh
Date of Loss: 8-29-2005
SF Claim No. 24-Z178-602/24-BX-4847-7
FAEC Case No: 530-0088-05-25

Dear Mr. Perry,

Forensic Analysis & Engineering (FAEC) is pleased to provide the following report of our engineering investigation and evaluation of the reported damage to the residence located at 2558 S. Shore Drive in Biloxi, MS.

We initially received this assignment on October 4, 2005. FAEC performed a field investigation of the subject insured residence on October 7, 2005. [illegible] assignment we we[illegible] porch to the dining [illegible]

This s[illegible] this matter.

BACK[illegible]

On the [illegible] y of Biloxi, was in[illegible] hurricane when [illegible]

FAEC [illegible] if the damag[illegible] or a combin[illegible] During our on site [illegible] inspection.

Put in Wind file – DO NOT Pay Bill

Do not discuss

SITE OBSERVATIONS

The following are the observations made during FAEC's inspection of the structure:

- The home has a north-south orientation with the front of the house facing east to South Shore Dr. The home is on a waterfront lot on the Tchautacabouffa River.

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McIntosh-A 1st Report with State Farm note 4

- The first floor elevation is approximately 20-21 feet. The watermark line in the house is approximately five and one-half feet above the main floor interior flooring.
- The roof was damaged at the peak and right front sections. Ceilings were damaged.
- The doors and windows were all missing.
- All debris had been cleaned out of the house.
- According to Mr. McIntosh, a neighbor - Mr. Mike Church - reported that houses were blown apart and debris was thrown into the McIntosh house at approximately 8 AM and the floodwater began rising at 11 AM.
- The lower front right corner of the house wall was missing – approximately three studs.
- The back porch had a wooden deck and arbor destroyed.
- An outdoor metal storage shed was missing.
- The detached carport originally had nine columns. Several of these were found severely damaged.
- Large oak trees were felled in a northwesterly direction. Limbs of a live oak tree in the backyard of the subject residence had fallen.
- Observations of the area are consistent with the findings of this property. There were numerous tall tree failures in the northwesterly direction.

CONCLUSIONS

Based upon the information that has been presented to FAEC and evidence gleaned during our inspection, FORENSIC ANALYSIS & ENGINEERING CORPORATION has made the following conclusion concerning the damage to the structure.

- The tree failures in the northwesterly direction are the result of the winds out of the southeast from the approaching hurricane.
- The roof, door, carport, and window damage was caused by wind and wind driven debris.

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- It is FAEC's opinion that the interior damage of the structure is primarily the result of the failure of the windows, walls, and doors due to wind.

The conclusions and opinions presented in this report are based on the results of FAEC's field investigation of the subject residence, as well as our analysis of the available wind and localized water level data and upon all of the other associated information that we have gathered during the course of our investigation efforts to date. If additional information or facts become available which materially affect these stated conclusions and opinions, then, FAEC reserves the right to amend or change its opinions and conclusions as needed.

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t has been our pleasure to perform this structural engineering analysis for you. We trust that our efforts will meet with your approval and that this report meets its intended purpose. Please call if you have any questions concerning this report or if I or any of FORENSIC ANALYSIS & ENGINEERING CORPORATION'S staff can be of further support.

Respectfully submitted,
FORENSIC ANALYSIS & ENGINEERING CORPORATION

Brian Ford

Brian Ford, P.E.
Senior Principal Structural Engineer
Mississippi P.E. License No. 08770

As it is the practice of FAEC to emphasize and ensure the technical quality of its work through peer review, the content of this report has been reviewed by the undersigned to ensure that all stated conclusions and supporting facts are technically consistent and meet the requirements of current engineering and scientific principles.

FORENSIC ANALYSIS & ENGINEERING CORPORATION

Robert K. Kochan, President

Robert K. Kochan, ME, DABFET, FACFEI
Principal Technical Consultant

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October 20, 2005

State Farm Insurance
Mr. Cody Perry, Claims Adjuster
1909 East Pass Rd.
Gulfport, MS 39507

Re: Hurricane Damage Assessment Investigation
Insured: Thomas & Pamela McIntosh
Date of Loss: 8-29-2005
SF Claim No. 24-Z178-602/24-BX-4847-7
FAEC Case No: 530-0088-05-25

Dear Mr. Perry,

Forensic Analysis & Engineering (FAEC) is pleased to provide the following report of our engineering investigation and evaluation of the reported damage to the residence located at 2558 S. Shore Drive in Biloxi, MS.

We initially received this assignment on October 4, 2005. FAEC performed a field investigation of the subject insured residence on October 18, 2005. In this assignment we were tasked to inspect the damage to the left front wall from the front porch to the dining area and determine if it was from wind, water or both.

This summary report is being submitted in fulfillment of our assignment in this matter.

BACKGROUND

On the morning of August 29, 2005, the Mississippi coast, including the city of Biloxi, was impacted by Hurricane Katrina, which was classified as a Category-4 hurricane when it made landfall.

FAEC performed a field investigation of the subject residence to determine if the damage to the front wall of the residence was caused by wind, floodwater or a combination of both. Mr. McIntosh was present during FAEC's inspection. During our on site examination of the subject damage, FAEC was able to complete our inspection.

SITE OBSERVATIONS

The following are observations made during FAEC's inspection of the structure:

- The home is oriented so that the front faces east towards S. Shore Dr. The back yard abuts Big Lake at the south end of the Tchoutacabouffa River.

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McIntosh - B 2nd Report - No mention of 1st.

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- There appears to be roof damage to the peak, north side and the southwest ridge area. The extent of this damage was not discernable as those areas had "Blue Roof" tarps covering them.

- The damage on the second floor consists primarily of floor damage.

- The damage to the first floor is extensive and includes floor, wall and ceiling damage.

- A witness, Mr. Craig Robertson, who is the owner's yardman, was at the site doing clean up work. He stated that prior to the storm he assisted in placing protective measures over the windows for the owners. He stated that shortly after the storm, he was at the house and had found that some of the upstairs doors, which led out to a balcony, had blown open and allowed water to enter the second floor which damaged the floor and ceiling below. Observations were consistent with his statement.

- There were abrasion marks on a decorative column and the inside of French doors that lead from the dining room of the first floor out to the front porch. When Mr. Robertson was questioned on the cause of these, he was unsure, but stated that there was a brick wall on the south end of that room that had blown into the house and there was lumber in that room after the storm. He also commented that part of a neighbor's roof from across the cul-de-sac was in front of the carport, which was immediately south of the subject residence and outside of the mentioned brick wall. He mentioned that another part of that roof was in front of the north end of the porch. Observations of the exterior porch columns, which also show signs of abrasion for a distance of about 4 ft. above the porch floor. This again is consistent with part of a roof structure rubbing against the columns while being carried by water. At the point where it was said that the debris stopped (north end of porch) several trees showed abrasion marks similar to the porch columns.

- The first floor elevation is estimated to be between 15 and 20 feet. Exact information was not available.

- Mr. Mindy Briscoe, the neighbor to the north of the subject house, stated that he had about 2-feet of water in his house. His floor elevation appears to be about 2 ft. higher than the subject house which would indicate that the water level in the subject house approached 4 ft above the first floor. An observation of light debris in nearby trees was consistent with this estimate of water level.

- The windows and doors at the back or west side of the house were not present. Their condition after the storm was not determined.

- Observations of nearby properties indicate significant damage and there were numerous tree failures in the northwesterly direction.

CONCLUSIONS

Based on the information that has been presented to FAEC and evidence gleaned during our inspection, FORENSIC ANALYSIS & ENGINEERING CORPORATION has made the following conclusions concerning the damage to the structure:

- The tree failures in the northwesterly direction are the result of the winds out of the southeast from the approaching hurricane.

- There appears to have been damage to the structure by wind as evidenced by missing shingles on parts of the roof structure. Damage to the second story floor and first floor ceilings was predominately caused by wind and intruding rainwater.

- The damage to the first floor walls and floors appears to be predominately caused by rising water from the storm surge and waves.

House plans were not made available as to the construction of the left corner wall (entry from porch to the dining room). This corner has two walls. The east wall remains with French doors to the porch. The south wall was stated to be brick and it is unknown if doors were in that wall. The east doors would receive some protection from floating debris by the porch columns. It is understood that some lumber came in through the south wall into the dining room and that the bricks had fallen into the room. It is the opinion of FAEC that the damage to this wall was predominately due to waterborne debris hitting the wall.

The conclusions and opinions presented in this report are based on the results of FAEC's field investigation of the subject residence, as well as our analysis of the available wind and localized water level data and upon all of the other associated information that we have gathered during the course of our investigation efforts to date. If additional information or facts become available which materially affect these stated conclusions and opinions, then, FAEC reserves the right to amend or change its opinions and conclusions as needed.

It has been our pleasure to perform this structural engineering analysis for you. We trust that our efforts will meet with your approval and that this report meets its intended purpose. Please call if you have any questions concerning this report or if I or any of FORENSIC ANALYSIS & ENGINEERING CORPORATION'S staff can be of further support.

Respectfully submitted,
FORENSIC ANALYSIS & ENGINEERING CORPORATION

John B. Kelly

John B. Kelly, P.E.
Principal Structural Engineer

JOHN B. KELLY
REGISTERED PROFESSIONAL
ENGINEER
8739
STATE OF MISSISSIPPI

John B. Kelly
OCT. 20, 2005

As it is the practice of FAEC to emphasize and ensure the technical quality of its work through peer review, the content of this report has been reviewed by the undersigned to ensure that all stated conclusions and supporting facts are technically consistent and meet the requirements of current engineering and scientific principles.

FORENSIC ANALYSIS & ENGINEERING CORPORATION

Robert K. Kochan, President

Robert K. Kochan, ME, DABFET, FACFEI
Principal Technical Consultant

November 21, 2005

State Farm Insurance
Mr. Clark Martin, Claims Adjuster
1909 East Pass Rd.
Gulfport, MS 39507

Re: Hurricane Damage Assessment Investigation
Insured: Mr. Minh Nguyen
Date of Loss: 8-29-2005
SF Claim No. 24-Z451-170/24-CC-2102-7
FAEC Case No: 530-0091-05-25

DEC 01 2005

Dear Mr. Martin,

Forensic Analysis & Engineering (FAEC) is pleased to provide the following report of our engineering investigation and evaluation of the reported damage to the subject residence located at 6613 Sundown Avenue in Biloxi, MS.

We initially received this assignment on October 4, 2005. FAEC performed a field investigation of the subject insured residence on October 25, 2005. In this assignment we were tasked to inspect the subject home to determine if wind or tidal surge damaged the residence.

This summary report is being submitted in fulfillment of our assignment in this matter.

BACKGROUND

On the morning of August 29, 2005, the Mississippi coast, including the city of Biloxi, was impacted by Hurricane Katrina, which was classified as a Category-4 hurricane when it made landfall. The hurricane's winds and rising water caused excessive damage to structures along the gulf coast.

Hurricane Katrina also damaged weather stations and water level gauging stations along the Mississippi coast. Therefore, accurate wind and water level data are not available. In order to assist in evaluating damage, FAEC has synthesized data from the Hurricane Forecast Advisories and Hurricane Public Advisories available at noaa.gov, and from a report prepared for State Farm Insurance companies by Weather Data, Inc.

By interpolation, this data shows that at landfall wind speeds reached 115 to 130 miles per hour at Gulfport, Biloxi, Ocean Springs, Gautier, Pascagoula, and other areas east

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Nguyen-A Original on-site report 11

of Gulfport. Winds at this level define a Category 3 storm on the Saffir/Simpson scale, and some structural damage to small residences and utility buildings, damage to roofing material, door and window failures, and a minor amount of curtainwall failures would be expected. The Weather Data, Inc. report indicates maximum winds at this location were approximately 100 to 110 miles per hour.

The Advisories also predicted storm surge and tidal flood levels of 18 to 22 feet, and up to 28 feet depending on local conditions. Considering currents and wave action, FAEC would expect flooding and wave or current damage at elevations up to 32 feet above mean sea level (MSL).

The Advisories also mention the possibility of tornados, and tornado warnings were issued, for the Waveland-Bay St. Louis area northward to Kiln and Diamondhead, however FAEC has not found any documentation or specific evidence that tornados actually occurred in this area.

The subject property appears to be within Flood Zone A9 (EL 12) on the Flood Insurance Rate Map Panel 2852560160D, and available topographic mapping of the area indicates ground elevations at the structure are between 5 and 10 feet above mean sea level (MSL).

FAEC performed a field investigation of the subject residence to determine if wind or tidal surge damaged the residence. Ms. Nguyen was not present for FAEC's inspection; however she was interviewed by phone. The sister of the insured, Ms. Minh Le, was present for the inspection. During our on site examination of the subject damage, FAEC was able to complete our inspection which acts as a basis of this report.

SITE OBSERVATIONS

The following are the observations made during FAEC's inspection of the structure:

- This house was located in an area where there was almost complete devastation. The home was oriented so that the front faces east towards Sundown Ave. The house was approximately 200 yards northeast of a bayou leading to the Back Bay of Biloxi, and was demolished.
- The house was a one story structure.
- A neighbor, Mr. Toche, thought a tornado had come through the area as a "swath of destruction" was apparent to him. There appears to be a path of destruction starting at the corner of a street about ¼ mile to the southeast of the insured home then proceeding northeasterly through a steel framed building on a golf course and continuing northeasterly for several hundred yards past the insured home to a point near where a stand of pine trees remain.

- A house slab located three properties to the south of the insured had a number of exterior wall bottom plate anchor bolts remaining in the eastern wall area, and these had been bent in opposing directions.

- In a telephone conversation with Ms. Nguyen, she told of how she escaped from her house during the storm. She and seven others made their way to the north side of the attic. At some point, something that was driven by the wind collapsed the south side of the attic and walls below. Two Vietnamese men witnessed this and told her it was the house to the south of her which flew into the south side of her house. These two men assisted these people to the ground and out to Sundown Ave. Once on Sundown Ave. the people made their way north to Lemoyne Blvd. Ms. Nguyen stated that as she headed north, she looked back and saw entire houses demolished, and the south side of her house demolished. The water level in the street was about 2 ft. at this time, and she recalls that they went into the attic probably about mid morning, possibly about 8 or 9 am. Her daughter received a head injury that required about 30 stitches. The daughter was floated down the street to safety by lying flat on some kind of plywood, readily found, pushed by those people with her.

- Observations of properties in the general area indicate significant damage and there were numerous tree failures in the northwesterly direction.

CONCLUSIONS

Based on the information that has been presented to FAEC and evidence gleaned during our inspection, FORENSIC ANALYSIS & ENGINEERING CORPORATION has made the following conclusions concerning the damage to the structure:

- The tree failures in the northwesterly direction are the result of the winds out of the southeast from the approaching hurricane. There are signs of possible tornado activity in the localized area described above.

- There was wind damage to the structure of some degree, based upon the insured's statement.

- There is evidence of storm surge in the area.

It is the opinion of FAEC that the damage to the house was predominantly caused by wind.

Our stated opinion is also based on our knowledge that the Category-3 hurricane force winds were present in this area for several hours before the rising and wind driven water would have reached the subject home's position, and that the pattern of destruction and damage to steel structures along a linear area is typical of a tornado

accompanying the hurricane. Based upon this information, FAEC concludes that the home's structure was severely damaged by the extended hurricane force winds and a probable tornado, then washed away from its foundation by the swath of the surging wind driven waves.

The conclusions and opinions presented in this report are based on the results of FAEC's field investigation of the subject residence, as well as our analysis of the available wind and localized water level data and upon all of the other associated information that we have gathered during the course of our investigation efforts to date. If additional information or facts become available which materially affect these stated conclusions and opinions, then, FAEC reserves the right to amend or change its opinions and conclusions as needed.

It has been our pleasure to perform this structural engineering analysis for you. We trust that our efforts will meet with your approval and that this report meets its intended purpose. Please call if you have any questions concerning this report or if I or any of FORENSIC ANALYSIS & ENGINEERING CORPORATION'S staff can be of further support.

Respectfully submitted,
FORENSIC ANALYSIS & ENGINEERING CORPORATION

John B. Kelly, P.E.
Principal Structural Engineer

JOHN B. KELLY
REGISTERED PROFESSIONAL ENGINEER
8739
STATE OF MISSISSIPPI

NOV. 21, 2005

As it is the practice of FAEC to emphasize and ensure the technical quality of its work through peer review, the content of this report has been reviewed by the undersigned to ensure that all stated conclusions and supporting facts are technically consistent and meet the requirements of current engineering and scientific principles.

FORENSIC ANALYSIS & ENGINEERING CORPORATION

William C. Forbes, PE, DEE
Senior Principal Engineer

December 16, 2005 DEC 17 2005

State Farm Insurance
Ms. Lisa Watcher
1909 East Pass Rd.
Gulfport, MS 39507

Re: Hurricane Damage Assessment Investigation
Insured: Minh Nguyen
Date of Loss: 8-29-2005
SF Claim No. 24-Z451-170/24-CC-2102-7
FAEC Case No. 530-0091-05-25

Dear Ms. Watcher:

Please allow this letter to address the concerns raised by the client, State Farm Insurance Co. concerning the FAEC conclusions in the above referenced case.

As I observed the site and spoke with the insured I came to the conclusion that wind was the predominant cause of damage to the structure. The rationalization behind this conclusion was based on a number of issues. While it was obvious that the storm surge affected this immediate area, other factors were also considered in the final opinion:

1. The insured gave important information in our phone conversation. According to our assignment, we were allowed to give eyewitness accounts certain weight.

2. The damage to the area was indicated in photographs. Photograph 3 is of a steel structure estimated to be about 200 yards southeast of the insured's property. The damage observed to this structure was consistent with damage that could be caused by tornado type winds.

3. Photograph 5 is of anchor bolts for the bottom plate of an exterior wall. The anchor bolts along this line are generally deflected in opposing directions which could be considered consistent with damage that could be caused by rotating winds.

4. The damage to the area seems to stop abruptly at a tree line several hundred yards to the northwest of the insured's property. Damage beyond that point appears to be greatly diminished. This is consistent with the possibility of tornado type winds.

FORENSIC ANALYSIS & ENGINEERING CORPORATION
ESTABLISHED 1966
FORENSIC ENGINEERING, PRODUCT DEFECT ANALYSIS & ACCIDENT INVESTIGATIONS
5301 Capital Blvd., Suite A - Raleigh, North Carolina 27616-2956
E-MAIL: FORENSIC @ FORENSIC-ANALYSIS.com WEBSITE: WWW.FORENSIC-ANALYSIS.com
Telephone: (919) 872-8788 (800) 224-3595 Facsimile: (919) 872-8660

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Nguyen -B Engineer forced to defend his report.

Lastly, I would add that based on field observations and statements from the insured, both wind and water must have contributed to the destruction of the house. It was my conclusion that while both wind and water contributed to the destruction of the house, it was predominantly wind that caused the initiating and major damage. This was supported, in my opinion, by those observations further elaborated above.

If you require any additional information, please do not hesitate to contact the firm.

Very truly yours,

John B. Kelly

John B. Kelly, P.E.
Principal Structural Engineer
Phone 228+282-4717

Cc: Home Office, Raleigh, NC
William C. Forbes, P.E., DEE

Rimkus Consulting Group, Inc.
198 Charmant Drive, Suite 4
Ridgeland, Mississippi 32502
(601) 898-4738 Telephone
(601) 853-8303 Facsimile
Certificate of Authorization No. E-00001307

Ms. Kimberly Riley
State Farm
P O Box 6759
D Iberville, MS 39504

Re: [redacted]
Claim No: 24245785
Insured: Beckham James & Jo Dell
Subject: Report of Findings
RCG File No: 5221438

Dear Ms. Riley:

Mr. Beckham reported that his residence was destroyed by Hurricane Katrina on August 29, 2005. The residence was located at 136 Poki Place, Diamondhead, MS. 39525

Rimkus Consulting Group, Inc. was retained by Ms. Riley on behalf of State Farm Insurance Company to evaluate the reported damage to the residential structure. We were specifically asked to determine structural damage caused by the hurricane winds versus structural damage caused by the associated storm surge and waves. Mr. Paul N Monie performed our visual inspection of the property on November 8, 2005. Weather data used during our evaluation was obtained from Compu-Weather, Inc. and the National Oceanic and Atmospheric Administration (NOAA).

CONCLUSIONS

The following conclutions were made after our site visit and a review of the field notes and photographs. Our opinions are as follows:

1. Hurricane Katrina demolished the superstructure of the residence, such that only concrete slab-on-grade and some CMU columns of the home were left.
2. High wind forces and flooding/wave forces from hurricane Katrina were both of sufficient magnitude to cause structural damage to the building.
3. There was insufficient physical evidence to determine the proportion of wind versus storm surge that destroyed the residence.

EXHIBIT "B"

Beckham-A Original on-site report.

INTRODUCTION

The residence was reportedly a two-story, wood-framed structure supported on concrete slab-on-grade foundation system. We were told by the insured that the exterior walls were covered mostly with stucco and a small potion of vinyl sidings and the roof was covered with architectural shingles. The insured Mr. Beckham was present during our inspection. For the purposes of this report, the front of the residence was referenced to face south.

Hurricane Katrina was one of the strongest storms to impact the coast of the United States during the last 100 years. After crossing South Florida and entering the Gulf of Mexico Katrina began to strengthen reaching category 5 strength hurricane and on August 28, 2005, about 250 miles south-southeast of the mouth of the Mississippi River Katrina's winds reached their peak intensity of 175 mph winds and the pressure fell to 902 mb.

According to published weather data, the highest wind gusts measured along the Mississippi coast on August 29, 2005, were 90 mph at a Keesler AFB in Biloxi, 63 mph in Gulfport, and 50 mph at Pascagoula. Winds as high as 125 mph likely occurred near occurred near the point of landfall near the Louisiana/Mississippi border, and winds likely in excess of 100 mph occurred along the entire Mississippi coast. Preliminary data from NOAA estimated winds in the Diamondhead area to be 100 to 130 mph.

Following the wind forces, a storm surge from the hurricane produced wide-spread flooding. Along the Mississippi coast there were reported storm surges of 11.27 feet at Green Pass, 12.16 feet at Pascagoula, 20 feet at the Biloxi River at Wortham, and a report of 30 feet above sea level at Pascagoula.

OBSERVATIONS

During the course of our site visit, we observed the following:

- The insured was present during our inspection and described his property to us. He said that his residence was a two story building with 3500 SF living area and 4000 SF under the roof. He showed us where his household items were found approximately 350 feet west from the residence across the bayou (water). He said his roof was not found after the hurricane, that he believes the wind had blown his roof to an unknown destination. **(Photograph 1, 2, 8 & 9)**.
- The trees at the back of the residence had scours measuring 30 feet from natural ground to the top of the scours. Some of the tree limbs and the upper potion were snapped off approximately 40 feet above natural ground **(Photograph 5 & 7)**.
- The residence was completely demolished with only the concrete slab-on-grade and damaged CMU columns left **(Photograph 2)**.
- There was a 6 feet and 8 feet concrete slab at the front and back of the main slab. The owner reported that these slabs were for the front and back porch respectively.

- The majority of the debris and destroyed parts of residence was lying on the north-west corner (Photograph [illegible]).
- There was a concrete driveway at the front of the residence. (Photograph 1).
- The residence CMU columns were demolished and some of them leaning in variable direction on the concrete slab on-grade. The square columns measured 8 feet height above the concrete slab. The slab was measured to be approximately 31 feet [illegible] long side in the east-west direction of the residence. (Photograph [illegible]).
- The insured reported that his kitchen ceramic tile counter top, a 25 feet piece iron rod, part of his office floor covering and lavatory pedestal that was all on the second floor were found across two canals approximately 450 feet west from the residence.

ANALYSIS

Weather data showed that wind speeds in the Diamondhead region were approximately 118-to155 mph, and that storm surge of approximately 25-feet occurred. Since the wind forces of Hurricane Katrina were estimated in the range of 155 mph, we cannot rule out that lateral forces from wind loads exceeded the residential structural design. The lateral pressure from wave action typically exceeds wind loads. A 130 mph wind will produce a lateral pressure of approximately 43 psf whereas a 4-foot height of water will produce a maximum hydrostatic pressure of over 200 psf, not including dynamic lateral forces from wave action.

The conditions stated above support the conclusion that the residence was destroyed by storm surge resulting from the passage of Hurricane Katrina. Flood water from the storm surge entered the residence causing damaged to the entire residence.

This report was prepared for the exclusive use of State Farm Insurance Company. and was not intended for any other purpose. Our report was based on information made available to us at the time. Should additional information become available, we reserve the right to determine the impact, if any, the new information may have on our opinions and conclusions, and to revise our opinions and conclusions if necessary and warranted. Photographs taken during our work are retained in our files and are available to you upon request. This report was prepared for our client's use, and we disavow any liability for use by others.

Thank you for allowing us to provide this service. If you have any questions or need additional assistance, please call.

Sincerely,

RIMKUS CONSULTING GROUP, INC.

September 12, 2006
RCG File No. 5221433

Paul N Monie
Consultant

Corey D. Green, P.E.
MS Reg. Eng. No. Number
Senior Consultant

Attachments: Photographs

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State Farm Insurance Companies®

February 1, 2006

State Farm Catastrophe Office
PO Box 6759
D'Iberville, MS 39540-6759

JAMES O BECKHAM SR
JO DELL BECKHAM
PO BOX 6231
DIAMONDHEAD MS 39525

RE:	Claim Number:	24-Z457-665
	Policy Number:	24-CG-3522-8
	Location of Insured Property:	136 Poki Place Diamondhead, MS 39525
	Date of Loss:	August 29, 2005
	Policy Type:	Homeowners, FP-7955

Dear Mr. and Mrs. Beckham:

This letter is a follow-up to your meeting with Claim Representative Kimberly Riley on November 7, 2006, where she discussed and inspected the damage to your property.

Based upon the results of the discussion, site inspection, and investigation, it has been determined the damage to your property at 136 Poki Place, Diamondhead, Mississippi, was caused by flooding/rising water/tidal surge.

Enclosed please find a copy of the report by the Rimkus Consulting Group, Inc.

Damage resulting from this cause of loss is not covered by your policy. Please refer to the following provisions:

SECTION I - LOSSES NOT INSURED

2. We do not insure under any coverage for any loss which would not have occurred in the absence of one or more of the following excluded events. We do not insure for such loss regardless of: (a) the cause of the excluded event; or (b) other causes of the loss; or (c) whether other causes acted concurrently or in any sequence with the excluded event to produce the loss; or (d) whether the event occurs suddenly or gradually, involves isolated or widespread damage, arises from natural or external forces, or occurs as a result of any combination of these:

   c. **Water Damage**, meaning:

Beckham-B Denial letter with revised report. 22

(1) flood, surface water, waves, tidal water, tsunami, seiche, overflow of a body of water, or spray from any of these, all whether driven by wind or not;

(2) water or sewage from outside the **residence premises** plumbing system that enters through sewers or drains, or water which enters into and overflows from within a sump pump, sump pump well or any other system designed to remove subsurface water which is drained from the foundation area; or

(3) water below the surface of the ground, including water which exerts pressure on, or seeps or leaks through a building, sidewalk, driveway, foundation, swimming pool or other structure.

Please be advised that as of February 15, 2006, all additional living expenses payment will cease. Please forward all information regarding additional living expenses to the address listed above.

This Company does not intend, by this letter, to waive any policy defenses in addition to those stated above, and reserves its right to assert such additional policy defenses at any time.

If you have any additional information regarding your claim which has not been previously considered, or if you desire any additional explanation regarding this matter, please contact Claim Representative Kimberly Riley at 866 787 8676 ext 5366.

Sincerely,

Lansing Clark Vargo
Team Manager
228 896 7938
State Farm Fire and Casualty Company

09/825/0201011

cc: 24-1429 Agent Mike Meyers

Rimkus Consulting Group, Inc.
198 Charmant Drive, Suite 4
Ridgeland, Mississippi 32502
(601) 898-4738 Telephone
(601) 853-8303 Facsimile
Certificate of Authorization No. E-00001307

Ms. Kimberly Riley
State Farm
P. O. Box 6759
D'Iberville, MS 39504

Re: Claim No: 24Z457665
Insured: Beckham James & Jo Dell
Subject: Report of Findings
RCG File No: 5221438

Dear Ms. Riley:

Mr. Beckham reported that his residence was destroyed by Hurricane Katrina on August 29, 2005. The residence was located at 136 Poki Place in Diamondhead, Mississippi.

Rimkus Consulting Group, Inc. was retained by Ms. Riley on behalf of State Farm Insurance Company to evaluate the reported damage to the residential structure. We were specifically asked to determine structural damage caused by the hurricane winds versus structural damage caused by the associated storm surge and waves. Mr. Paul N. Monie performed our visual inspection of the property on November 8, 2005. Weather data used during our evaluation was obtained from Compu-Weather, Inc. and the National Oceanic and Atmospheric Administration (NOAA).

CONCLUSIONS

The following conclutions were made after our site visit and a review of the field notes and photographs. Our opinions are as follows:

1. Storm Surge from hurricane Katrina destroyed the residential building.
2. The wind forces of Hurricane Katrina were of a sufficient magnitude to potentially cause damage to the roof coverings, soffit, fascia and siding of the residence. While this type of damage was not observed on this residence or any dwellings in the area, wind speeds similar to the wind speeds at Diamondhead have caused damage to nonstructural elements.

Engineering Report Revised at Rimkus office 24

INTRODUCTION

The residence was reportedly a two-story, wood-framed structure supported on concrete slab-on-grade foundation system. We were told by the insured that the exterior walls were covered mostly with stucco and a small potion of vinyl siding. The roof was covered with asphalt composition architectural shingles. The insured, Mr. Beckham, was present during our inspection. For the purposes of this report, the front of the residence was referenced to face south.

Hurricane Katrina was one of the strongest storms to impact the coast of the United States during the last 100 years. After crossing South Florida and entering the Gulf of Mexico Katrina began to strengthen reaching category five strength hurricane and on August 28, 2005, about 250 miles south-southeast of the mouth of the Mississippi River Katrina's winds reached their peak intensity of 175 miles per hour (mph) winds and the pressure fell to 902 mb.

According to published weather data, the highest wind gusts measured along the Mississippi coast on August 29, 2005, were 90 mph at a Keesler AFB in Biloxi, 63 mph in Gulfport, and 50 mph at Pascagoula. Winds as high as 125 mph likely occurred near the point of landfall near the Louisiana/Mississippi border, and winds likely in excess of 100 mph occurred along the entire Mississippi coast. Weather data published by Compuweather data identified the maximum sustained winds in the Diamondhead area to be 110 to 120 mph.

A storm surge from the hurricane produced wide-spread flooding. Along the Mississippi coast, there were reported storm surges of 11.27 feet at Green Pass, 12.16 feet at Pascagoula, 26 feet at the Biloxi River at Wortham, and a report of 30 feet above sea level at Hancock County. Weather data published by Compuweather data identified the storm surge height in the Diamondhead area to be over 25 feet.

OBSERVATIONS

During the course of our site visit, we observed the following:

- The insured was present during our inspection and described his property to us. He said that his residence was a two story building with 3500 SF living area and 4000 SF under the roof. He showed us where his household items were found approximately 350 feet west from the residence across the bayou (water). He said his roof was not found after the hurricane and he believed the wind had blown his roof to an unknown destination. **(Photograph 1, 2, 8 & 9)**.
- The trees at the back of the residence had scours measuring 30 feet from natural ground to the top of the scours. Some of the tree limbs and the upper potion were snapped off approximately 40 feet above natural ground **(Photograph 5 & 7)**.
- The residence was completely demolished with only the concrete slab-on-grade and damaged CMU columns left **(Photograph 2)**.

- There was a 6 feet and 8 feet concrete slab at the front and back of the main slab. The owner reported that these slabs were for the front and back porch respectively.
- The majority of the debris and destroyed parts of residence was relocated to the north-west **(Photograph 3)**.
- There was a concrete driveway at the front of the residence. **(Photograph 1)**.
- The CMU columns of the residence were missing or damaged. Some of the some of columns were listing and others were lying on the concrete slab-on-grade. The columns had moved in all directions. The columns were measured to be 8 feet above the concrete slab. The slab was measured to be approximately 31 feet x 63 feet, with the long side in the east-west direction of the residence. **(Photograph 4 & 6)**.
- The insured reported that his kitchen ceramic tile counter top, a 25 feet piece iron rod, part of his office floor covering and lavatory pedestal, which were all on the second floor, were found across two canals approximately 450 feet west of the site.
- All of the neighboring structures were destroyed.

ANALYSIS

The lateral pressure from wave action typically exceeds wind loads. A 120 mph wind will produce a lateral pressure of approximately 37 psf whereas an 8-foot height of water will produce a maximum hydrostatic pressure of over 400 psf at the base, not including dynamic lateral forces from wave action.

The conditions stated above support the conclusion that the residence was destroyed by storm surge of Hurricane Katrina. Due to the fact that none of the neighboring structures remained, and scours found on trees caused by surge in the area, it is obvious that the structure was destroyed by storm surge accompanying Hurricane Katrina.

The wind forces of Hurricane Katrina were of a sufficient magnitude to potentially cause damage to the roof coverings, soffit, fascia and siding of the residence. These non-structural elements are susceptible to wind damage. While this type of damage was not observed on this residence or any dwellings in the area, wind speeds similar to the wind speeds at Diamondhead have caused damage to nonstructural elements.

This report was prepared for the exclusive use of State Farm Insurance Company. and was not intended for any other purpose. Our report was based on information made available to us at the time. Should additional information become available, we reserve the right to determine the impact, if any, the new information may have on our opinions and conclusions, and to revise our opinions and conclusions if necessary and warranted. Photographs taken during our work are retained in our files and are available to you upon request. This report was prepared for our client's use, and we disavow any liability for use by others.

January 23, 2006
RCG File No. 5221438

[redacted]

Thank you for allowing us to provide this service. If you have any questions or need additional assistance, please call.

Sincerely,

RIMKUS CONSULTING GROUP, INC.

Paul Monie/gmp

Paul N. Monie
Consultant

Lawrence Wedderstrand

Lawrence L. Wedderstrand, P.E.
MS Reg. Eng. No. 16732
Consultant

LAWRENCE LEE WEDDERSTRAND
LICENSED PROFESSIONAL
ENGINEER
LE 16732
1/23/06
STATE OF MISSISSIPPI

Attachments: Photographs/Resume

Rimkus Consulting Group, Inc.
198 Charmant Drive, Suite 4
Ridgeland, Mississippi 32502
(601) 898-4738 Telephone
(601) 853-8303 Facsimile
Certificate of Authorization No. E-00001307

December 20, 2005

CGI Insurance Company-Littleton Group
8019 North Himes Avenue – Suite 310
Tampa FL 33614
Attention : Joseph Kahlert

Re: Claim No: 2005-002-288
Insured: James O. "Buddy" Ray
Subject: Report of Findings
RCG File No: 5221647

Dear Mr. Joseph Kahlert

Mr. James Ray reported that his single family dwelling was destroyed by Hurricane Katrina on August 29, 2005. The single family dwelling was located at 470 Beach Blvd. in Long Beach MS 39560; right on the beach at Trautman Avenue.

Rimkus Consulting Group, Inc. was retained by yourself, Mr. Joseph Kahlert on behalf of CGI Insurance Company. We were specifically asked to determine wind vs storm surge. Mr. James Overstreet P.E. performed our visual inspection of the property on Saturday December 2ndth, 2005. Mr. Ray was present for the inspection. A phone contact was made to CGI as well. Weather data used during our evaluation was obtained; included data from Compu-Weather, Inc. and the National Oceanic and Atmospheric Administration (NOAA). Several eyewitness reports will be referenced in this report. Additionally, a reference to NOAA-Hurricane Basics will be made as well.

CONCLUSIONS

The following conclusions were made after our site visit and a review of the field notes and photographs. Our opinions are as follows :

1. The home had been destroyed by a combination of Wind Gusts, Tornadoes, and Wind Driven Storm Surge. Tornadoes are referred to in NOAA-Hurricane Basics.

Ray-A On-site Engineering Report

Exhibit "E"

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2. Due to the high incidence of snapped and uprooted trees, and according to eye witness accounts, winds much higher than those considered to be "sustained" likely contributed to the structural damage to Mr. Ray's home.

3. Wind Driven Storm Surge was a major factor in the destruction of the home.

INTRODUCTION

Hurricane Katrina was one of the strongest storms to impact the coast of the United States during the last 100 years. After crossing South Florida and entering the Gulf of Mexico Katrina began to strengthen reaching category 5 strength hurricane and on August 28, 2005, about 250 miles south-southeast of the mouth of the Mississippi River Katrina's winds reached their peak intensity of 175 mph winds and the pressure fell to 902 mb.

According to published weather data, the highest wind gusts measured along the Mississippi coast on August 29, 2005, were 90 mph at a Keesler AFB in Biloxi, 63 mph in Gulfport, and 50 mph at Pascagoula. Winds as high as 125 mph likely occurred near the point of landfall near the Louisiana/Mississippi border, and winds likely in excess of 100 mph occurred along the entire Mississippi coast. Preliminary data from NOAA estimated winds in the Gulfport area to be 100 to 130 mph.

Following the wind forces; a storm surge from the hurricane produced wide-spread damage from water forces and water contamination. Along the Mississippi coast, there were reported storm surges of 11.27 feet at Green Pass, 12.16 feet at Pascagoula, 26 feet at the Biloxi River at Wortham, and a report of 30 feet above sea level at many places in Hancock County.

OBSERVATIONS

Description of property : The residence was reported to be a 1-story wood frame dwelling. The foundation was an elevated chain wall slab approximately 16 feet above sea level. The exterior walls were covered with brick and stucco. The roof was reportedly of metal. For purposes of this report, the front of the residence was reported to face South.

During the course of our site visit, we observed the following:

- Nothing remained of the home except the steps on the front/south side, and on the west side. A photograph presented to me at the time showed the stairs and brick chain wall remaining after the storm. Also presented was a photo of the home prior to the storm.

- Mr. Buddy Ray and Eye Witness A.J. Viviano (See Photo 4) posed on the west steps. Mr. Viviano is reported to have stayed in his home during the storm and

witnessed both his home and his neighbor's homes destroyed completely by wind prior to the storm surge. (See Photo/Exhibit 10)

- Other Eyewitness accounts include those from Henry Savage (neighbor), Barbara Duncan (neighbor), Tommy Moulton, and Debra Hester. See the Statements. (Photo/Exhibits 7, 8, 9, 15, and 16) .
- Mr. Ray reported that a lot of the debris from his house was found well to the west of his home, namely parts of the metal roof, parts of the tanning bed, and stucco columns.
- Looking at a photo (See Photo 3) presented to me by Mr. Ray taken after the storm on 8/29 and before my inspection on 12/2; Probably in the 10/25 time frame, the chain wall supporting the foundation, is still present. This indicates the possibility that the slab may have been usable, prior to being demolished and removed.
- According to Mr. Ray and his neighbors, there is a path of increased destruction evidenced by snapped, twisted, and uprooted trees. In this path of increased wind destruction, includes the home of A.J. Viviano and the home of Mr. Buddy Ray. This destruction path is shown on a map (See Photo/Exhibit 6) .
- Good watermarks were hard to come by with the advent of the cleanup endeavors initiated by the City of Long Beach MS, FEMA, Core of Engr's, etc....

ANALYSIS

There were a large number of snapped and uprooted trees in the immediate neighborhood of where Mr. Ray's home was situated. This indicating a present of winds much higher than those considered to be "sustained". Eyewitness A.J. Viviano reported that the wind that took his roof off, roared like a tornado for a good period of time prior to impacting his house. Tornadoes are referred to in a document known as NOAA-Hurricane Basics. On pages 12, and 14 of this document, Tornadoes spawned from a Hurricane are considered as being a major cause of wind damage.

Several other neighbors also reported major structural damage being caused by wind; Namely Henry Savage, and Barbara Duncan. See statements 7,8,9,15,16 below.

Due to the fact that major wind occurred prior to the storm surge, it can be concluded that as much as 50% of the damage was due to wind alone. With the presence of several eyewitnesses, it is possible to conclude that the dwelling was seriously structurally compromised prior to the storm surge due to wind forces, to the extent of being considered a total loss.

RCG File No. 5221647 – Ray

A typical storm surge level would have been 25 feet above sea level. With Mr. Rays slab being at 16 feet above sea level, this would have placed 9 feet of water in Mr. And Mrs. Rays home. This would certainly account for a percentage of the overall damage.

By looking at the photos of the front of the house, it is clear that demolition crews removed the slab and chain wall. (See Photos 2, 3, and 5). The possibility that this demolition crew demolished a usable slab presents itself.

This report was prepared for the exclusive use of CGI Insurance Company, and was not intended for any other purpose. Our report was based on information made available to us at the time. Should additional information become available, we reserve the right to determine the impact, if any, the new information may have on our opinions and conclusions, and to revise our opinions and conclusions if necessary and warranted. Photographs taken during our work are retained in our files and are available to you upon request. This report was prepared for our client's use, and we disavow any liability for use by others.

Thank you for allowing us to provide this service. If you have any questions or need additional assistance, please call.

Sincerely,

RIMKUS CONSULTING GROUP, INC.

James Overstreet P.E.
Consultant

Corey D. Green P.E.
MS Reg. Eng. No. 14873
Senior Consultant

Attachments: Photographs (Ref. 4592-4649)

MS-PE#10038

Rimkus Consulting Group, Inc.
198 Charmant Drive, Suite 4
Ridgeland, Mississippi 39157
(601) 898-4738 Telephone
(601) 853-8303 Facsimile
Certificate of Authorization No. E-00001307

February 3, 2006

Mr. Joseph Kahlert
CGI Insurance Company
4350 W. Cypress Street, Suite 225
Tampa Florida 33607

Re: Claim No: 2005002288
Insured: James O. Ray
Subject: Report of Findings
RCG File No: 5221647

Dear Mr. Kahlert:

Mr. Ray reported that his residence was structurally damaged by Hurricane Katrina on August 29, 2005. The residence was located at 470 W. Beach Boulevard in Long Beach, Mississippi.

Rimkus Consulting Group, Inc. was retained by Mr. Joseph Kahlert on behalf of CGI Insurance Company. We were specifically asked to determine the cause of the damage due to the hurricane winds versus the associated storm surge and the waves. Mr. James Overstreet, under the direction of Mr. Thomas E. Heifner, P.E., performed our visual inspection of the property on December 2, 2005. Mr. Ray was present for the inspection and provided information. The weather data used during our evaluation was obtained from Compu-Weather, Inc. and the National Oceanic and Atmospheric Administration (NOAA).

CONCLUSIONS

The following conclusions were made after our site visit and a review of the field notes and the photographs. Our opinions are as follows:

1. The storm surge associated with Hurricane Katrina destroyed the portion of the residence above the concrete foundation slab.
2. We cannot rule out the possibility that the high winds damaged the non-structural components prior to the destruction by the storm surge.

Ray - B Revised Engineering Report
Revised at Rimkus office 32

INTRODUCTION

Hurricane Katrina was one of the strongest storms to impact the coast of the United States during the last 100 years. After crossing the Florida peninsula and entering the Gulf of Mexico, Hurricane Katrina strengthened to a Category 5 hurricane as defined by the Saffir-Simpson scale. On August 28, 2005, approximately 250 miles south-southeast of the mouth of the Mississippi River, Hurricane Katrina's winds reached their peak intensity of 175 mph and the atmospheric pressure fell to 902 millibars.

According to the published weather data, the highest wind gusts measured along the Misssissippi gulf coast on August 29, 2005 were a 90 mph gust at Keesler Air Force Base in Biloxi; a 63 mph gust at Gulfport-Biloxi Regional Airport in Gulfport; and a 50 mph gust at Naval Station Pascagoula. Winds as high as 125 mph likely occurred near the point of the hurricane's landfall at the Louisiana-Mississippi border.

Along the Mississippi gulf coast, there were reported storm surges of 11.3 feet at Green Pass; 12.1 feet at Pascagoula; and 26.0 feet on the Biloxi River at Wortham, and reports of 30.0 feet in Hancock County.

OBSERVATIONS

The residence was a single story, wood-framed structure constructed on an elevated concrete slab supported on fill material and a perimeter wall. The exterior walls were covered with brick and stucco veneers. The roof framing was covered with metal panels. For purposes of this report, the front of the residence was reference to face south.

Mr. Ray reported that the debris from his residence was found well to the west of his property. Namely parts of the metal roof, parts of the tanning bed, and stucco columns. Mr. Ray presented photographs taken before the storm **(Photograph 1)** and after the storm **(Photograph 2)**. In the photograph taken after the storm, it is evident that only the perimeter foundation wall and concrete slab remained. The residence was demolished by the city of Long Beach between the time the photograph was taken and by the time of our inspection.

During the course of our site visit, we observed the following:

- We observed that the southern elevation of the residence faced the Gulf of Mexico and was approximately 100 yards from the beach.
- We observed that nothing remained of the residence except the steps on the southern side, and on the western side of the structure.
- We observed that there were many broken, twisted, and uprooted trees in the area **(Photographs 4, 5 & 6)**.

- Heavy debris was deposited north of the footprint of the house **(Photograph 8)**.
- Trees in the area had scrape marks and impact damage on the bark **(Photograph 5)**.

ANALYSIS

The weather data showed that the wind speeds in the Long Beach region were approximately 110 mph to 120 mph, and that a storm surge of 11-feet to 30-feet occurred. The lateral pressure from wave action typically exceeds wind loads, not including dynamic lateral forces from the wave action.

The residence was destroyed as a result of the storm surge. The proximity of the residence to the Gulf of Mexico combined with the reported storm surge for the area indicated that the residence was likely destroyed by the application of the high lateral pressures of the storm surge and the associated wave action that occurred this close to the Gulf of Mexico.

Additionally, wind speeds reportedly exceeded 100 mph, and we cannot rule out that damage from the wind caused limited damage to the non-structural building components such as the roof coverings, siding or the awnings. However, the significant damage to the structure resulted from the storm surge.

This report was prepared for the exclusive use of CGI Insurance Company, and was not intended for any other purpose. Our report was based on information made available to us at the time of our inspection. Should additional information become available, we reserve the right to determine the impact, if any, the new information may have on our opinions and conclusions and to revise our opinions and conclusions if necessary and warranted. Photographs taken during our work are retained in our files and are available to you upon request.

If you have any questions or need additional assistance, please call.

Sincerely,

RIMKUS CONSULTING GROUP, INC.

James Overstreet

James Overstreet (PA)
Consultant

Thomas E. Heifner

Thomas E. Heifner, P.E.
Mississippi Reg. Eng. No. 7727
Senior Consultant

THOMAS E. HEIFNER
REGISTERED PROFESSIONAL
NO. 7727
2-3-06
ENGINEER
STATE OF MISSISSIPPI

Attachments: Photographs

Insurance Claims Payment Processes in the Gulf Coast after the 2005 Hurricanes

Written Testimony of

Robert P. Hartwig, Ph.D., CPCU
President & Chief Economist
Insurance Information Institute
New York, NY

United States House Financial Services Committee
Subcommittee on Oversight and Investigations

Washington, DC

February 28, 2007

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Good afternoon Mr. Chairman and members of the Committee. Thank you for the opportunity to discuss the important and vital role played by the insurance industry in the response, rebuilding and recovery effort following Hurricane Katrina.

My name is Robert Hartwig and I am President and Chief Economist for the Insurance Information Institute, an insurance trade association based in New York City whose primary mission is to improve the public's understanding of insurance: what it does and how it works. Our members consist of insurers and reinsurers that operate on a global scale and account for more than 60% of the premiums written in the United States.

Hurricane Katrina was the largest, most expensive disaster in the history of insurance. Claims payments to restore homes, businesses and vehicle losses totaled $40.6 billion on some 1.74 million claims filed by policyholders across six states. For all of 2005, insured losses from all hurricanes reached $57.1 billion arising from 3.3 million claims **[Figure 1]**. It is a remarkable fact that seven of the ten most expensive hurricanes ever to strike the United States occurred in the 14 month interval from August 2004 through October 2005 **[Figure 2]**.

These staggering numbers illustrate the magnitude of the threat posed by hurricanes to people who live in coastal regions, the financial resilience of the insurance industry and the economy of the United States.

The enormous challenge posed to the nation by natural catastrophes calls on all of us to address it with reason, not rancor; facts, not fiction and as partners, not partisans.

My testimony today will address four major issues:

- The insurer response to Hurricane Katrina and the key role of insurance in helping homeowners, businesses and communities recover from disasters;
- The lessons learned from that extraordinary and tragic event;
- The enhancements that have been made to insurer catastrophe response capability based on those lessons; and

- The current regulatory, legislative, and litigation-related obstacles that are raising costs and reducing choices for consumers.

Insurance Industry Response to Hurricane Katrina

As we know, the devastation wrought by these catastrophic hurricanes was unprecedented. So too was the industry's response. Some 15,000 adjusters were called in from across the country. These men and women worked tirelessly day and night for months throughout the 1,400 mile arc from the Florida Keys to East Texas, often in difficult and dangerous conditions.

For many property owners, insurance adjusters and the checks they cut on the spot were the first tangible signs of relief they had seen. Millions of American families and businesses devastated by the storms of 2004 and 2005 are back on their feet today because of the more than $80 billion paid to them by their insurance companies.

Insurers are justifiably proud of their performance in both 2004 and 2005. As of the first anniversary of Katrina in August 2006, more than 95 percent of the 1.1 million homeowner's claims in both Mississippi and Louisiana had been settled, with fewer than 2 percent of such claims in dispute **[Figure 3]**. Approximately half of this small proportion of overall claims sought redress through no-cost mediation programs established by insurance departments in both Louisiana and Mississippi. Both programs report that approximately 80 percent of cases heard are resolved successfully. Across the Gulf, only a tiny fraction—well under one percent—of homeowners claims have been litigated.

Claims adjustment is a highly systematic process. Indeed, a recent Louisiana Department of Insurance examination of a leading insurer found that its claims adjustment process was neither "arbitrary" nor "capricious" and that in the small number of cases when delays did occur they were due to "severe problems, impediments, roadblocks and hindrances" caused by the storms.

Adjusters work diligently to accurately assess the extent and cause of loss associated with each claim. If some damage is the result of an excluded cause of loss,

such as flooding, the adjuster will apportion the loss accordingly, with the insurer paying the share of the losses covered under the terms of the policy purchased by the property owner. If the property owner also has a flood insurance policy issued through the National Flood Insurance Program (NFIP), then the share of losses that are attributable to flood damage (including storm surge), will be paid through the NFIP, subject to policy limits. The NFIP conducts routine audits of flood claims (including claims practices) and has the authority to audit and challenge any claim at any time.[1] The partnership between the NFIP and private insurers has worked smoothly for many years, providing families and businesses with the funds they need to recover more quickly, efficiently and with greater consistency than if the claims were adjusted separately.

Consumers also are protected in every state by "unfair claims practices" statutes that grant state insurance regulators the authority to investigate and penalize insurance companies that refuse to pay valid claims. There are also consumer protection laws in every state, and these apply to insurance transactions as well. Finally, state courts provide a judicial remedy for contract violations and for torts committed by insurers.

Insurance companies strive to settle claims without any disputes with their customers. And the record is clear that in the overwhelming number of cases, that is exactly what happens. They are settled by adjusters with policyholders at the scene without the involvement of attorneys or engineers in a courtroom.

Lessons Learned from Katrina

As I noted, Hurricane Katrina was a storm without precedent in scale or scope, occurring amid a hurricane season that itself was without precedent. By definition, unprecedented events offer lessons to all those affected. Katrina was no different—with hard lessons learned by coastal residents, government at all levels and insurers alike.

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[1] Per 44 CFR 62.23(j)(2), Write-Your-Own (WYO) companies (insurers that offer NFIP flood coverage on behalf of the NFIP) are subject to operational reviews (including claims practices) at least every 3 years. In addition, FEMA also engages in routine claim reinspections on an ongoing basis, conducting a larger number of claim reinspections in the wake of large loss events. WYOs understand that any claim can be reviewed by FEMA at any time.

But the lessons of Katrina and the unparalleled destruction of the 2004 and 2005 hurricane seasons also include a very stark reminder—that living along the hurricane-exposed coastline of the United States is an increasingly risky proposition. Meteorologists predict that the number and intensity of hurricanes will remain at elevated levels for the next 15 to 20 years, even before accounting for any possible effects associated with global climate change.

From an insurance perspective the reality of a long-term crescendo of risk is a paramount concern. Key risk-related lessons revealed in the aftermath of Katrina include the following:

- Many, if not most, coastal structures in the United States today are insufficiently well constructed to withstand the forces of a major hurricane, either in terms of wind or flooding;
- Flood insurance penetration rates are woefully inadequate. In parts of coastal Mississippi, for example, fewer than 20 percent of dwellings were insured against flood. By contrast, upwards of 60 to 80 percent of homes in some Louisiana parishes had flood coverage; **[See Figures 4, 5 and 6]**
- The risk and related cost associated with offering insurance in hurricane-prone areas will continue to escalate as coastal populations continue to soar in many hurricane exposed areas and more and more vulnerable areas are opened to development. The state of Florida's population, for example, has increased by 80 percent since 1980 while the dollar value of insured coastal property now exceeds $2 trillion and is growing by some 10 percent per year. In North Carolina, the population of highly vulnerable Dare County, for example, has grown by more than 400 percent since 1960 and Brunswick County has grown by more than 300 percent. The value of hurricane exposed property along the state's 300 miles of coastline now stands in excess of $100 billion **[Figure 7]**.

There are other lessons, of course, related to the logistics of responding to large-scale events like Hurricane Katrina and I will address those shortly. But one of the most important of all lessons driven home by Hurricane Katrina and the $80 billion in combined losses from the storms of 2004 and 2005 is also one of the least discussed. That lesson is that only an insurance industry that is financially strong, sound and secure can deliver the financial relief necessary to help communities recover from major catastrophic events.

Insurance is by far the fastest, most efficient means of recovery for communities affected by disasters large and small. Unfortunately, the operating environment that allows insurers to pay sudden and extreme losses like Hurricane Katrina is now under siege in several states. Punitive, burdensome legislation and regulation accompanied by a surge in litigation is already driving-up costs and reducing choices for consumers. Worse still, these measures do nothing to reduce the actual risk faced by people living in harm's way. Put simply, neither laws nor lawsuits can diminish the real, formidable risk associated with catastrophic hurricanes or any other type of disaster. This is critical point I will return to later in my testimony.

Enhancements to Catastrophe Response Post-Katrina

Hurricane Katrina and the other storms of 2004 and 2005 provided insurers with valuable insights into loss reduction, mitigation and catastrophe response. The insurance industry's decades-long support of tougher building codes and mitigation technologies, for example, bore fruit throughout the Gulf Coast, with homes built to industry-supported standards faring far better than structures built to less stringent standards. Insurers will continue to invest millions of dollars annually through organizations such as the Institute for Business and Home Safety in order to fund additional research that will save lives and reduce property damage from future disasters.

The enormity of destruction associated with Hurricane Katrina produced response challenges to every agency and organization involved. The destruction of infrastructure hampered travel and communications throughout the affected areas, not only for residents, but for insurance agents and adjusters as well. There was often little or no gas

for adjuster vehicles, no lodging and no food. In some cases, adjusters were not allowed into the most devastated areas for an extended period of time by government authorities because of ongoing search and rescue operations or because the adjusters' health and safety could not be assured. In other instances the policyholders themselves could not be located despite every effort to do so. All of these factors slowed normal response times. Traditionally, insurers target the most badly damaged areas first, but in the case of Katrina the level of destruction denied them that opportunity.

Recognizing that speed of payments was critical, insurers issued advance payments to tens of thousands of policyholders even before having the opportunity to physically inspect the property, guided in some cases by aerial and satellite photography. In the end, despite a gauntlet of obstacles, the hundreds of thousands of claims filed were adjusted fairly and expeditiously and billions were paid to homeowners and businesses throughout the devastated region. These payments were usually the first to reach home and business owners, helping to stabilize local economies and enabling the rebuilding and recovery process.

Since Katrina, insurers have complemented their existing investments in catastrophe response with a variety of new and enhanced capabilities. Increased use of GPS-linked technologies, for example, help insurers identify insured properties even when the property has been reduced to rubble and the property owner cannot be located. Insurers are also reducing and in some cases eliminating completely paper files, so that customer service functions can be performed anywhere in the country. Some insurers have purchased additional catastrophe response vehicles. Many also now conduct pre-event surveys of business policyholders to make sure they're prepared before a storm hits. The Insurance Information Institute has even produced free, home inventory software available for download at www.iii.org, that allows homeowners to create an electronic archive of their possessions and then email that file to a location that is out of harm's way **[Figure 8]**.

Looking ahead, insurers must operate under the assumption that Hurricane Katrina and indeed the entire 2004/2005 hurricane seasons were not aberrations. If history is any guide, a disaster that will dwarf hurricane Katrina may be just a few

months to a few years away. A repeat of the Great Miami Hurricane of 1926, for example, would today produce insured losses in the $80 billion to $100 billion range. The 2007 hurricane season begins just three months from tomorrow and forecasters expect activity in the North Atlantic Basin to be 40 percent above average with elevated landfall probabilities for Category 3, 4 and 5 hurricanes along the entire East and Gulf Coasts **[Figures 9 and 10]**.

Insurers remain dedicated to providing the best claims service possible to their customers. To meet this objective, insurers after each major disaster engage in a post-disaster review process to identify successes and streamlining opportunities. One problem reported by many insurers in the wake of Katrina involved enormous amounts of bureaucratic red tape that slowed down the adjusting and rebuilding process. These delays also create opportunities for desperate people to be scammed by unscrupulous contractors and other fraud artists. Red tape exists at numerous levels, including the following:

- **Access to Disaster Zones:** At the local level, each community makes its own decisions as to when adjusters can enter affected areas, leading to an appreciable slowdown in insurer response. Insurers urge FEMA to implement procedures in conjunction with state and local officials so that properly credentialed adjusters can move quickly throughout disaster areas.
- **Adjuster Licensing:** At the state level, delays in the licensing of adjusters who are brought in from out of state are a major concern. Insurers urge state departments of insurance to establish fast-track licensing or registration procedures to accommodate these adjusters.
- **Contractor, Engineer, Architect and Building Inspector Licensing:** Hurricane Katrina demonstrated that in-state construction companies cannot handle the rebuilding or even temporary repairs needed for homes and businesses following a catastrophic hurricane. Out-of-state contractors as well as engineers, architects and building inspectors are needed. Insurers urge state agencies to establish

expedited licensing procedures for out-of-state contractors, engineers, architects and building inspectors that are properly licensed and insured in their home states.

Regulatory, Legislative and Litigation-Related Obstacles to Insurer Operations

A state's regulatory, legislative, and tort environment establish the parameters under which insurers operate and compete. The requirements for competitive insurance markets are modest, centering primarily on the ability to (i) price policies that reflect the actual risk or cost; (ii) a judicial system that upholds contract language in policies which have been approved by state insurance regulators, and (iii) a regulatory and legislative environment that is supportive of both requirements.

In most states and for most types of insurance, insurance markets are highly competitive, with dozens of insurers competing for the business of auto, home and commercial policyholders. Indeed the cost of auto, home and business insurance is actually *declining* today. Recently, however, regulatory and legislative actions and proposals in a number of states and proposed legislation at the federal level threaten to stifle competition thereby increasing costs for insurers and reducing choices for consumers.

Florida's recent legislative changes illustrate this point. Leading insurance rating agency A.M. Best just this past Friday (February 23) issued the following ominous statement about recent legislative changes in the state: *"A.M. Best views the recent legislative changes as weakening the business profile of companies with significant concentration of Florida business."*

In other words, insurers with significant exposure to hurricane risk in the state could see their financial strength ratings downgraded, potentially impairing their ability to operate nationwide. The only way for the insurers to maintain their ratings is to increase rates or non-renew current policyholders. Infusing additional capital could also preserve the insurer's rating, but such an infusion would be tantamount to throwing good money after bad.

That's because the recent actions in Florida also cancelled even previously approved rate changes even though the state's homeowners insurers are already more than $10 billion in the red since 1992.

Mississippi is another example, with its homeowners insurance market in a freefall, especially in the state's southern tier of counties. Operating in coastal Mississippi is an extremely risky proposition. The state has been the target of some of the most destructive storms in history, including mega-storms like Hurricanes Camille and Katrina.

Claims from Katrina in Mississippi alone totaled $13.6 billion. Homeowners insurance losses in the state wiped out approximately 17 years worth of premiums and every dime of profits those insurers had ever earned in the history of the state. In Louisiana, the $10.9 billion dollars in insured homeowners losses were equivalent to 25 years worth of premiums.

Expectations of an increase in the number and intensity of storms for the next 15 to 20 years compound the risk. These factors mean that property insurance in coastal Mississippi is relatively expensive—but it has nevertheless generally been regarded as a *priceable* risk. It is the actions of men, more than nature, which have crippled the market for insurance in Mississippi.

As I have pointed out, the number of lawsuits suits is very small relative to the total number of claims filed. However, they have an inordinate impact on the health of the marketplace. The litigation in Mississippi, initiated just 17 days after Katrina by the Mississippi Attorney General's Office, followed by civil actions from trial lawyers and compounded by court decisions that have retroactively rewritten the terms of regulator-approved insurance contracts, constitute an *unpriceable* risk. Litigation has pushed uncertainty past the tipping point, leaving insurers with no alternative but to reduce their presence in the state. Litigation in Louisiana is threatening to impair insurers' ability to operate in that state as well.

Remarkably, litigiousness in Mississippi may have accomplished what Katrina did not—delivery of a potentially lethal blow of uncertainty to the viability of a private homeowners insurance market in the state. Today, the only choice for an increasing

number of Mississippi homeowners is the state-run insurer of last resort, which itself went broke in 2005, forcing it to make an initial rate hike request of nearly 400 percent.

Summary

The record $41 billion insurers paid by more than 100 insurers and their reinsurers to more than 1.7 million Hurricane Katrina victims and the $80 billion paid to 5.5 million policyholders over the course of the 2004/2005 hurricane seasons are vivid and tangible demonstrations of the vital and important role played by insurers in helping families, businesses and entire communities recover the devastation wrought by major disasters.

The unprecedented nature of Katrina obligated all institutions to review preparation and response to large scale disasters. Insurers, like other affected industries and every level of government, have refined and enhanced their disaster response capabilities based not only on the lessons of Katrina, but also by aggressively integrating new technologies designed to streamline the disaster response process. Insurers are also partnering with local, state and federal agencies to cut the bureaucratic red tape that unnecessarily increases response times and leaves disaster victims vulnerable to fraud.

Unfortunately, today, the modest pre-conditions that give rise to competitive insurance markets are being eroded away in a number of states, forcing the price of insurance up and reducing choices for consumers. States such as Florida have abandoned the fundamental concept of risk-based pricing while in Mississippi the tort system has been used to require insurers to pay potentially hundreds of millions of dollars in flood losses—a type of loss for which they have never received a penny in premium.

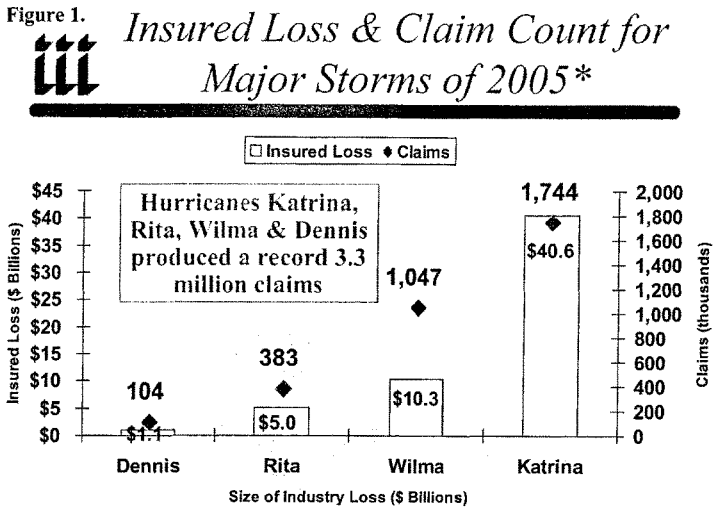
Courts' reluctance to enforce regulator approved contracts and the associated swarm of lawsuits has increased uncertainty to intolerable levels, effectively destroying insurers' ability to price risk accurately and leaving with few alternatives other than to reduce their exposure to the state.

To conclude, the insurance industry is committed to working in partnership with public policymakers, consumers and business in developing fact-based solutions to the

formidable challenge posed by Hurricane Katrina and the other disasters and continuing our tradition of helping families, businesses and communities wherever and whenever disaster strikes.

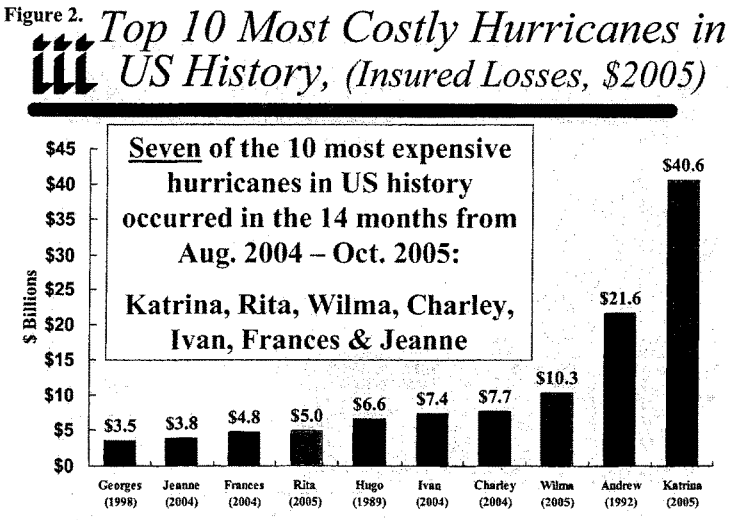
Thank you for the opportunity to address the Committee today. I would be happy to address any questions you might have.

Figure 1.



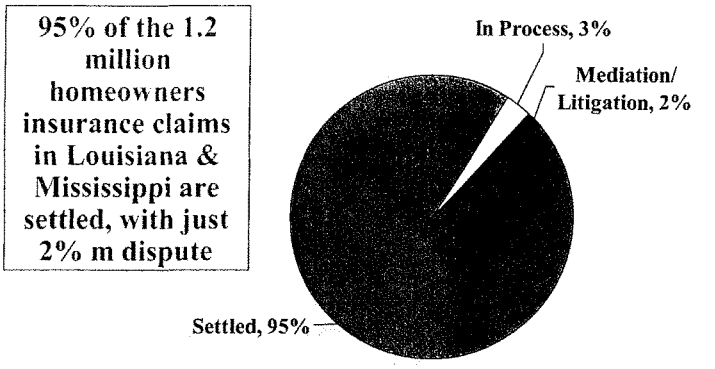
*Property and business interruption losses only. Excludes offshore energy & marine losses.
Source: ISO/PCS as of June 8, 2006; Insurance Information Institute.

Figure 2.



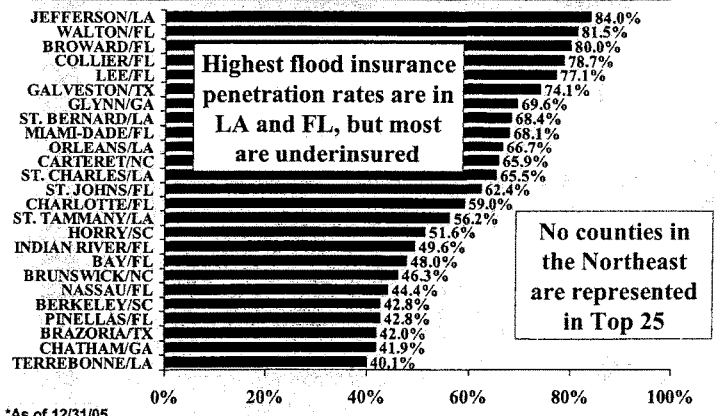
Sources: ISO/PCS; Insurance Information Institute.

Figure 3. *Hurricane Katrina Claim Status on Storm's 1st Anniversary**



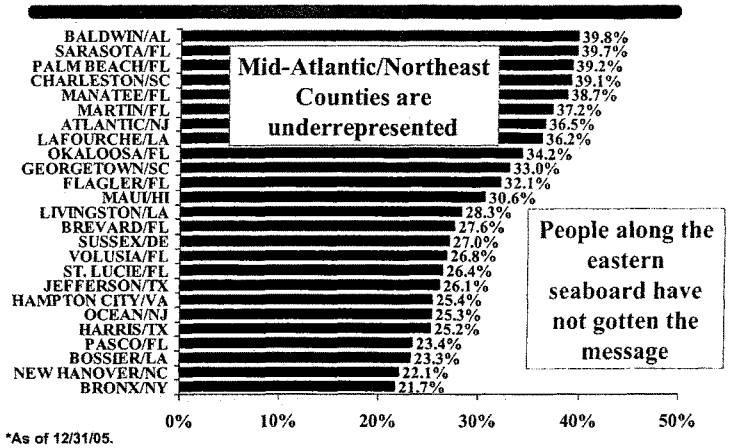
*Hurricane Katrina made its north Gulf coast landfall August 29, 2005.
Source: Insurance Information Institute survey, August 2006.

Figure 4. *Flood Insurance Penetration Rates: Top 25 Counties/Parishes in US**



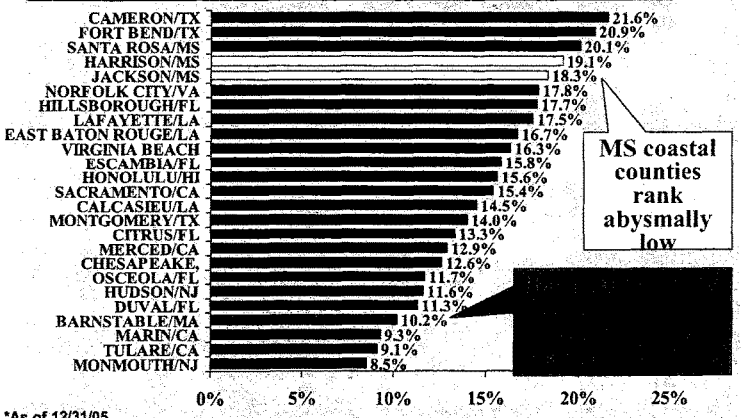
*As of 12/31/05.
Source: New Orleans Times-Picayune, 3/19/06, from NFIP and US Census Bureau data.

Figure 5. *Flood Insurance Penetration Rates: Counties/Parishes Ranked 26-50**



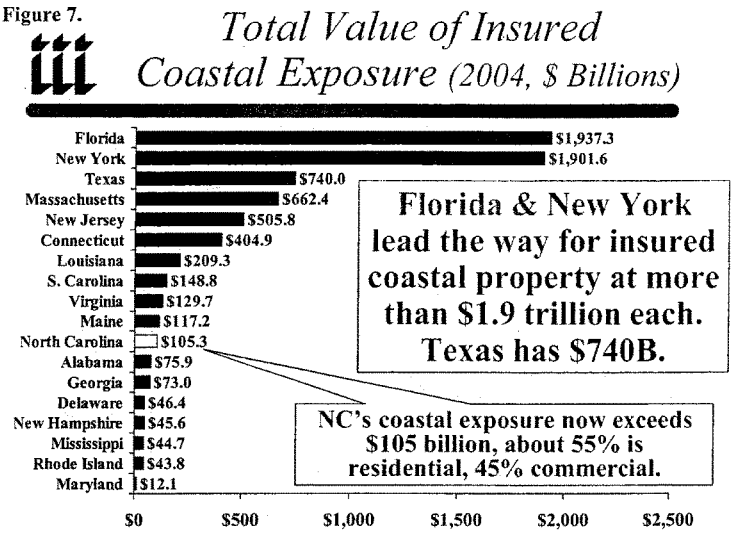
*As of 12/31/05.
Source: New Orleans Times-Picayune, 3/19/06, from NFIP and US Census Bureau data.

Figure 6. *Flood Insurance Penetration Rates: Counties/Parishes Ranked 51-75**



*As of 12/31/05.
Source: New Orleans Times-Picayune, 3/19/06, from NFIP and US Census Bureau data.

Figure 7.



Source: AIR Worldwide

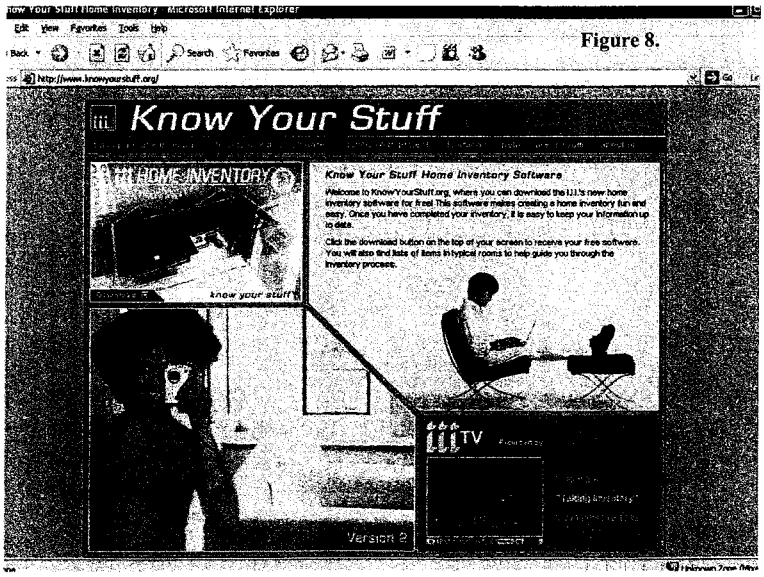


Figure 8.

Figure 9.

*Outlook for 2007 Hurricane Season: **40% Worse Than Average***

	Average*	2005	2007F
Named Storms	9.6	28	14
Named Storm Days	49.1	115.5	70
Hurricanes	5.9	14	7
Hurricane Days	24.5	47.5	35
Intense Hurricanes	2.3	7	3
Intense Hurricane Days	5	7	8
Net Tropical Cyclone Activity	100%	275%	**140%**

*Average over the period 1950-2000.
Source: Dr. William Gray, Colorado State University, December 8, 2006.

Figure 10.

Probability of Major Hurricane Landfall (CAT 3, 4, 5) in 2007

	Average*	2007F
Entire US Coast	52%	64%
US East Coast Including Florida Peninsula	31%	40%
Gulf Coast from FL Panhandle to Brownsville, TX	30%	40%
ALSO…Above-Average Major Hurricane Landfall Risk in Caribbean for 2007		

*Average over past century.
Source: Dr. William Gray, Colorado State University, December 8, 2006.

UNITED STATES HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS

INQUIRY INTO INSURANCE CLAIMS PAYMENT PROCESSES
IN THE GULF COAST AFTER THE 2005 HURRICANE

FEBRUARY 28, 2007

TESTIMONY OF JIM HOOD
ATTORNEY GENERAL FOR THE STATE OF MISSISSIPPI

Hurricane Katrina: What about the wind?

Introduction and Summary

Mr. Chairman and members of the Subcommittee:

I am Jim Hood, Attorney General for the State of Mississippi. I appreciate the opportunity to testify before the Subcommittee today on the insurance industry's response to Hurricane Katrina.

Hurricane Katrina slammed into the Mississippi Gulf Coast on August 29, 2005. Eighteen months later, thousands of residents remain displaced or homeless, not as is commonly believed, as a result of their failure to buy flood insurance, but because the wind policies they purchased were not honored. Those Mississippians who did purchase flood insurance soon learned that while flood claims were paid relatively quickly, courtesy of the federal government, claims against privately-written wind policies were denied with little or no explanation and apparently erratic or nonexistent investigation. The long-term consequences for an already over burdened National Flood Insurance Program and for a private insurer pretending that Katrina was a windless hurricane remain to be seen. The Mississippi Attorney General' s Office is indebted to the residents of the Gulf Coast who have given generously of their time and information to assist in the investigation of the man-made aspects of this disaster.

This report will focus on the following topics:

I: The efforts made by the Mississippi Attorney General's Office to protect the citizens of Mississippi from apparent civil and criminal fraud; the obstacles encountered as part of these efforts; and analysis of the mechanisms available in Mississippi to protect both policyholders and the National Flood Insurance Program from future abuse by insurance providers;
II: A sampling of the pre-textual and legal tactics used by State Farm to avoid responsibility for wind damage caused by Hurricane Katrina; and
III: Concerns for the continued economic viability of coastal regions and the insurance industry.

I. Protective measures

A. The Attorney General's challenge of the anti-concurrent causation clause. Less than a month after the storm, a civil action was brought in Hinds County Chancery Court by the Mississippi Attorney General' s Office (hereinafter "MSAG's Office") against five named insurance provider[1]; the action sought to make the insurance companies honor their policies and pay for damage caused by Hurricane Katrina, including storm surge, consistent with long-standing Mississippi law on proximate causation and contract interpretation. The MSAG's Office asked the Court to prohibit insurance companies from enforcing the ambiguous and misleading anti-concurrent causation clauses and water damage exclusions to unlawfully deny claims. Examples of anti-concurrent causation clauses used by Allstate, Nationwide and State Farm are attached as Exhibits A, B and C, and are discussed in detail below.

The proximate cause of an injury is that cause which in natural and continuous sequence is unbroken by any intermediate, controlling, and self sufficient cause that produces the injury and without which the result would not have occurred. Mississippi follows the doctrine of efficient proximate cause, which provides that if the proximate cause of a loss is a covered peril under a policy of insurance, the existence of or contribution by a non-governed peril does not bar coverage. If the nearest efficient cause of the loss is not a peril which is insured against, recovery may nevertheless be had if the dominant cause is a risk or peril that is insured against.

The Defendants promptly removed the matter to federal court, where it languished until its remand on March 8, 2006. Defendants filed a motion to reconsider, which was denied on December 26, 2006, and only then, after a fifteen month delay, was the matter sent back to the Hinds County Chancery Court. On January 23, 2007, a Settlement Agreement with State Farm only was filed with the Hinds County Chancery Court. The proposed settlement was intended to resolve the MSAG's civil suit against State Farm, and included language requiring State Farm "to establish an administrative procedure to reevaluate claims of State Farm policyholders in Hancock, Harrison, and Jackson Counties who had residential or commercial policies in effect on August 29,2005,_ ..._[that] will establish an orderly, fair and prompt resolution of claims_..._based upon criteria and guidelines approved by the United States District Court for the Southern District of Mississippi."

On January 26, 2007, the U.S. District Court denied preliminary approval of State Farm's proposed class settlement. State Farm's failure to establish an acceptable procedure for the reevaluation of claims as described above violates its Settlement Agreement with the MSAG's Office. As a result, the MSAG's Office has petitioned the U.S. District Court to enforce the state court Settlement Agreement and to allow the MSAG to either intervene in the federal action or participate in a hearing on the matter. At the time of this writing, the Court has not issued a response to these requests.

B. Launching the criminal investigation into the conduct of State Farm and its

selected vendors for adjusting and engineering services

1. Citizen complaints. After the storm, the MSAG's Office continued to field and investigate complaints from policyholders, and a pattern soon emerged. Some policyholders were frustrated that their property damage was inspected by one adjuster after another, with each adjuster offering contradictory and/or incomplete information about coverage and the assessment of the cause(s) of damage. Most complaints were directed at State Farm, which at the time seemed explainable by the fact that State Farm was the largest residential insurer in Mississippi. Residents began receiving denial letters from State Farm informing them that, "based on our investigation" coverage was denied; however, neither the State Farm agents nor members of the State Farm Catastrophe Team (hereinafter "CAT team") were willing and/or able to explain to policyholders what steps were taken in the investigation of their claim(s). Some policyholders were informed over the telephone that an engineering report or weather data had been used to exclude coverage, but they were not allowed to see the reports or data or to learn of the exact contents or persons responsible for creating them. The MSAG's Office announced publicly on March 20, 2006, that a formal criminal investigation would be conducted to determine whether or not any violations of Mississippi law had been committed by insurance providers handling Hurricane Katrina claims.

In certain instances, mistakes were made and policyholders ended up with copies of the engineering reports that State Farm never intended for them to see. For example, Rimkus Engineering, an engineering firm based in Houston, Texas that supplied engineering services for State Farm in the assessment of Hurricane Katrina claims was confronted with allegations from several of its engineers. Those engineers disavowed the signatures on the engineering reports purporting to be their own and further denied that they in any way authorized secretaries or other administrative staff within Rimkus to sign on their behalf.

Rimkus responded to these allegations by posting a rebuttal on its web site, claiming falsely that it had been assured by the Mississippi Attorney General's Office that it was not a target in any criminal investigations. My office had given Rimkus no such assurance. For its part, State Farm continued to rely on Rimkus' engineering services and continued to award them jobs despite the allegations. Many homeowners were, not surprisingly, concerned that State Farm had decided their claim based on a Rimkus report that may or may not have been signed by the engineer. However, State Farm would not share with homeowners whether or not their home damage had been inspected by an engineer at all, and if so, by whom and with what result.

2. Keeping engineers on a short leash. Rimkus was not the only provider of engineering services to State Farm following the storm; at least nine other engineering firms were used. Some were verbally promised work loads of up to 1,000 cases, although the number of jobs eventually received was much lower because State Farm ultimately stopped ordering engineering reports in all but a very few cases. Considerable investment was required of engineering firms that wanted to participate in this work, e.g. hiring additional staff, arranging for adequate housing, establishing a work space and securing a communications set-up to do the

work, etc. No good businessperson would undertake this level of investment in order to perform fifty inspections at an average of $2500 per job.

One might expect the standards of performance of the engineers under these circumstances to have been explicitly set forth in writing, but we found no evidence of this practice. Rather, the ability of an engineering firm to continue receiving Katrina cases from State Farm seems to have been most closely correlated with the extent to which their conclusions could be used to deny or at least minimize coverage. The unspoken guarantee was that as long as Lecky King, a State Farm CAT Coordinator who reviewed all engineering reports, was pleased with the report, the firm would continue to receive job assignments.

C. The McIntosh case. A particularly egregious and outrageous scenario resulted from State Farm's response to the claim of Thomas and Pamela McIntosh, residents of Biloxi, Mississippi. The couple had purchased a Homeowners policy with a hurricane deductible, and this coverage was in effect at the time Hurricane Katrina devastated their home. Their dwelling was insured for $619,6000, and their personal property was insured for $464,700. The McIntosh family filed suit against State Farm, and their trial is scheduled to take place in December of 2007.

It is unclear what degree of "investigation," if any, was done of the damage to the McIntosh home prior to the issuance of a denial letter dated September 28, 2005. The unsigned denial letter informed Mr. and Mrs. McIntosh that "damage to your property may have been caused by wind and water. We are continuing to investigate that portion of your loss caused by wind." [See Exhibit D.] However, a check for wind damage for approximately $36,000 was enclosed with the denial letter. The letter also claimed that "[b]ased on the site visit and other facts, our investigation showed that some of your property was damaged as a result of storm surge, wave wash and flood. Unfortunately, that damage to your property is not covered under the policy identified above."

This practice by State Farm of 1) making coverage decisions and/or 2) assigning a dollar amount to a particular cause of damage 3) without making an assessment of the total amount of damage regardless of cause and 4) without a determination of the proportion of damage attributable to the various causes involved was used extensively in the handling of Hurricane Katrina claims. As discussed in more detail in the following section, this expensive practice has proven to be burdensome for the NFIP and nightmarish for homeowners.

Although the conclusive language used in the McIntosh's denial letter suggests that any further investigation would be little more than a pretext, an engineer from Forensic Analysis & Engineering Corporation (hereinafter "FAEC") was nonetheless dispatched to inspect the damage in October 2005. FAEC's first report was dated October 12, 2005, and concluded that wind and wind-driven debris damaged the roof, door, carport and window of the McIntosh home and that interior structural damage was also caused primarily by wind. Clearly, this professional opinion showed that far more than $36,000 of the total damage was due to wind. This report, according to sources, was found in a State Farm CAT office with what appears to be a self-adhesive note

reading "put in wind file-do not pay bill-do not discuss." [See Exhibit G.]

At the urging of State Farm, FAEC issued a second report on the McIntosh property, this one dated October 20, 2005. This second report failed to mention the conclusions from the first report or even to acknowledge its existence. While the first report recognized the significant damage cause by wind, the second report concluded that this same damage was attributable to water. It also claimed erroneously that Mr. McIntosh had been present for the second site inspection. A second denial of coverage letter was sent to Mr. and Mrs. McIntosh from State Farm.

Shortly thereafter, Mr. McIntosh requested a copy of his engineering report from State Farm. He was told the engineering report was never finished. Then State Farm claimed to have found the report and sent him a copy of the second report, with nothing to indicate to him or his wife that a prior engineering inspection concluded they were entitled to payment on their claims.

The fraudulent conduct in the McIntosh case cannot be placed solely on the shoulders of the State Farm CAT team. State Farm's in-house counsel clearly should have known about the concealment of the first engineering report from the policyholders. On August 15, 2006, Brian Ross of ABC News brought the existence of a prior report to the attention of one of State Farm's local counsel Wayne Drinkwater of the firm Bradley, Arant, Rose & White as part of an investigation for the *20/20* broadcast program. Mr. Drinkwater claimed to have no knowledge of that report's existence. Two days later, Tamara Rennick, an in-house attorney for State Farm, contacted Mr. McIntosh about his claim. Mr. McIntosh mentioned the two engineering reports done to assess his damage. Without responding to that point, Ms. Rennick arranged for Mr. McIntosh to meet with another local counsel for State Farm, Peter Barrett of the firm Butler, Snow, O'Mara, Stevens & Cannada.

On August 21, 2006, Mr. McIntosh met with Mr. Barrett and also J. Kennedy Turner, III of the same firm to discuss his claim. Mr. Barrett explained that due to State Farm's efforts to achieve a paperless office two engineering reports did in fact exist, but that this was merely a misunderstanding in that one copy was paper and the second copy was the scanned image of the paper file copy. He did not mention that two substantively different versions of the reports existed and that the first version would have entitled the policyholders to payment. Mr. Barrett prepared a statement for Mr. McIntosh's signature; the statement attested to the policyholder's satisfaction with the way his claim was handled by State Farm. Mr. McIntosh was concerned at the impact refusal would have on his ability to obtain coverage in the future and, based on the partial information presented to him by State Farm, signed the document. [See Exhibit F.]

D. Mechanisms in place to protect Mississippi policyholders and the obstacles to relief.
The invitation of the Oversight and Investigations Subcommittee inquired as to whether Mississippi has adequate measures in place to ensure that policyholders receive proper payment of claims. The available avenues for relief have not proven to be effective in practice; in fact, the obstacles Mississippians encountered are not unique to this state and would likely be

problematic for other states affected by natural or terrorist disasters.

The following mechanisms were in place at the time Hurricane Katrina struck:

1. The Mississippi Department of Insurance. The Mississippi Department of Insurance accepts complaints from consumers. If the Commissioner is not responsive to their complaints, the only remedy citizens have is to vote against him or her in the next election cycle. The mediation process encouraged by the current Mississippi Insurance Commissioner George Dale is of questionable success. This is best evidenced by the complaints our office has received from homeowners offered approximately ten cents on the dollar for the value of their unpaid claims, as well as the fact that, even in mediation, State Farm continued to conceal the existence of multiple engineering reports for some claims.

On February 16, 2007, the MSAG's Office proposed legislation to require State Farm to continue writing new homeowners and commercial property policies in the State of Mississippi. We attempted to work with Governor Haley Barbour and Commissioner Dale to model a response after the legislation passed in Florida last month that requires insurance companies selling automobile coverage in the state to also sell homeowners and commercial policies statewide if they sell those policies in other states. As of this writing, neither Governor Barbour nor Commissioner Dale has taken any action on this proposal.

The office of the Mississippi Insurance Commissioner has inherent limitations; it is not designed to filter out and punish abuses in the application of federal programs, such as the National Flood Insurance Program (NFIP). Whether insurance commissioners in other states have the statutory authority and, if so, the practical ability to adapt their offices to undertake this sort of task following a catastrophe is questionable, as is the merit of having fifty different applications of federal programs. One of the benefits of a federal program such as the NFIP ought to be consistency of results for citizens, regardless of the state in which they reside.

2. The statewide prosecuting authority of the MSAG's Office. Reports of suspected insurance fraud are referred to the MSAG's Office by the Mississippi Insurance Commissioner, other law enforcement agencies, investigators working for private insurance providers and citizens. However, while criminal investigation and prosecution are appropriate responses to crimes against the public, the criminal justice system is not designed to enforce the proper payment of claims.

a. Our ability to reach beyond state lines is limited. In this case, the court system in Jackson County, Mississippi, already devastated by the storm and operating its clerk's office from fairgrounds until December of 2006, was responsible for the costs of bringing in out-of-state witnesses pursuant to the criminal investigation into State Farm's conduct. The District Attorney for Jackson County, Tony Lawrence, had to adjust his already heavy case load to accommodate the additional demands the Attorney General's criminal investigation placed on his office. Since State Farm used employees and vendors from all over the country to process

Hurricane Katrina claims, the MSAG's Office had to seek cooperation from the prosecuting authorities in the jurisdictions in which witnesses for the investigation could be found. In one instance, a jurisdiction refused to cooperate with these efforts, thereby allowing a State Farm employee who worked with the State Farm CAT team on Katrina claims to be able to avoid having to appear in Mississippi to be accountable to the citizens of Mississippi[ii].

As our criminal investigation progressed, we realized that some of the documented conduct may not constitute a violation of Mississippi state law, but that federal criminal charges may be appropriate. Business practices observable in the handling of Hurricane Katrina claims that have caused problems for State Farm reaching as far back as the Northridge earthquakes in California in 1994 and the rash of tornadoes in Oklahoma in 1999 raised our concerns that State Farm's response to disasters was part of a disturbing business model that could be applied in other states in future disasters.

Attorney Jeff Marr of Oklahoma City, Oklahoma, who has represented hundreds of homeowners in their claims against State Farm arising out of the 1999 Oklahoma tornadoes, has engaged in six years of vigorous discovery and litigation with State Farm and has learned that State Farm purchased a business model from the McKinsey Consulting Group and named it the Advancing Claims Excellence Program (ACE)[iii]. Ostensibly, the model was designed to promote cost efficiency and quality assurance. Substantively, the model represented a decisive shift in State Farm's views concerning the claims assessment process.

State Farm's once consumer-friendly approach to handling claims by fairly assessing the nature and degree of damages and the resulting obligations or exclusions from the policy language was redirected into a strategy to reduce "indemnity shortfall," or the overpayment of claims. A 1995 State Farm newsletter announced that ACE "has the potential of taking a billion dollars of cost out of our system every year!" Those costs seem to be taken out of the pockets of policyholders and the NFIP.

Although the program has been defended as a legitimate effort to promote quality customer service, State Farm issued a memo in 1997 directing its employees to send all ACE documents to company headquarters because "we anticipate Advancing Claims Excellence may be an issue in future lawsuits." Ordinarily, an employer would be expected to encourage its employees to familiarize themselves with the company's goals and objectives. Legitimate training and policy materials have no need to be kept from the employees who are expected to follow them.

The MSAG's Office is not empowered to bring criminal charges on behalf of the federal government. Full Congressional investigation or at a minimum an investigation by the Department of Justice is needed to completely expose the national implications of State Farm's conduct in this disaster. The MSAG's Office pledges its full support and cooperation in any such efforts.

b. E.A. Renfroe. Another example of the problem State Farm's use of out-of-

state employees and vendors poses for a state criminal investigation is illustrated by an active lawsuit in Alabama between E.A. Renfroe, an adjusting services firm based in Birmingham and two of its former employees, Cori Rigsby Moran and Kerri Rigsby, two sisters who worked with the State Farm CAT team in Katrina. (See generally E.A. Renfroe & Company, Inc. v. Cori Rigsby Moran and Kerri Rigsby, CV-06-WMA-17520S, U.S. District Court, N.D. Alabama, Southern Div.) Renfroe is an adjusting services firm based in Birmingham, Alabama that receives approximately 75% of its revenue from State Farm.

Cori and Kerri Rigsby, two sisters employed by E.A. Renfroe, were working with the State Farm CAT team during Hurricane Katrina and became concerned by the apparently fraudulent nature of some of the conduct they observed. They decided to make copies of documents they believed would be of assistance to law enforcement inquiries into the matter. Copies of these documents were provided to both the Mississippi Attorney General's Office and the U.S. Attorney's Office in Jackson.

Renfroe, without disproving the substance of the alleged wrongdoings, has since sued these cooperating witnesses for violating an employee confidentiality agreement and the Alabama Trade Secrets Act and is currently attempting to have them found in criminal contempt for refusing to return the documents. Renfroe argues that, under the terms of the confidentiality agreement, any concerns of illegal or unethical conduct must be brought to the attention of Mr. Renfroe, one of the two shareholders in the corporation. (The other shareholder is his wife.) Renfroe insists that it has no gripe with the fact that the documents were turned over to law enforcement agencies, but has tried repeatedly to get custody of the documents despite the concerns of the MSAG's Office that this would allow Renfroe to see documents intended for the grand jury during an ongoing criminal investigation.

The documents at issue consisted of electronic documents reduced to paper copies, so neither State Farm nor E.A. Renfroe were deprived in any way of documents they needed to process homeowner claims. E.A. Renfroe's proprietary interests in the documents are not entirely clear, since State Farm maintains custody of the information used and generated by the adjusters they hire from E.A. Renfroe. As part of this litigation, E.A. Renfroe had to issue a subpoena to State Farm in order to provide the Court with a sample of an E.A. Renfroe Katrina file. State Farm policyholders whose claims were adjusted by E.A. Renfroe understandably have legitimate questions concerning the ability of these purported independent professionals to exercise independent and objective judgment when those same adjusters do not seem to maintain independent files.

The MSAG's Office briefly intervened in the case to urge the presiding judge, the Honorable Judge William M. Acker Jr., to deny E.A. Renfroe's demand for the return of the documents until the criminal probe into State Farm's conduct could be completed. The MSAG's Office as a matter of policy makes concerted efforts to shield cooperating witnesses in any case from retaliation at the hands of persons or entities under investigation. As the top law enforcement agency for the state, the MSAG's Office would be remiss to ignore strong and reliable evidence

suggesting that criminal acts have been committed against the citizens of our state. We have never allowed subjects of criminal investigations to pick and choose the sources we use against them. Judge Acker was urged to consider the destructive impact such a decision would have on the ability of this or any other office to effectively investigate white collar crime.

To illustrate, in a street crime investigation, the Government's evidence may be a crack rock, shotgun, taped confession or medical report. White collar investigations, on the other hand, are by their very nature rooted in and driven almost exclusively by documents. Enron, HealthSouth and WorldCom were undone by criminal prosecutions based in part on their own documents; in fact, it is difficult to envision a set of facts in which the documents that serve as evidence in a white collar crime prosecution would not be in some way the property of the defendant at some time. The probative value of documents is premised on identifying the owner of those documents.

To date Judge Acker has denied any sort of relief either to the Rigsby sisters or the Mississippi Attorney General's Office. Thus as a practical matter, an employee confidentiality agreement between private citizens in a neighboring state may be interpreted in a way that guts the investigative powers of a grand jury in a sister state.

3. Civil action brought on behalf of the people of Mississippi by the MSAG's Office. The civil lawsuit filed by our office that the Defendants removed to federal court and was rightfully and completely remanded to state court in December 2006, but during the time the case remained idle pending remand, neither the Defendants, nor the policyholders, were able to benefit from the clarification of the application of the anti-concurrent causation clauses and water exclusions at issue in the litigation.

4. Mississippi law. Mississippi law on contracts should also have offered basic protections to policyholders, but catastrophe survivors are often unable or unwilling to undertake slow, expensive litigation against an insurance company with vastly greater resources. At the time of this writing, approximately 30,000 Mississippians are living in trailers provided by the taxpayers through FEMA. Most if not all would have preferred to receive, within a timely fashion, the contractual benefits upon which they relied to begin rebuilding their homes and lives. Litigation is, for most, a last resort.

State Farm's use of outside adjusters and engineers allowed the insurer to ignore the duty of good faith and fair dealing it would ordinarily owe policyholders under long-standing Mississippi law. Policyholders were not in a contractual relationship with these adjusters and engineers and so could not sue for breach of contract if they had any objections to the way in which these services were performed. Also, the lack of a contractual relationship was used as a justification to keep the adjusters' conclusions and engineering reports out of policyholders' reach.

Following the Mississippi Supreme Court's 2004 decision in *Mangialardi*, state joinder law has been interpreted much more restrictively, making the ability to join even two properly related

claims together substantially more difficult. Now policyholders forced to litigate also face the prospect of absorbing the costs of hiring experts to testify in each and every case. Since the affected citizens have just survived what hopefully will be the most traumatic experience of their lives and lost most if not all of their possessions and assets, they are frequently unable to pay legal retainers for representation. As a result, contingency fee arrangements are often the only way for these citizens to achieve access to the courts. The insurance industry, because of its inherently stronger bargaining position and favorable cash flow advantage, will always be better suited to participate in litigation under these circumstances than is an individual policyholder. Entangling policyholders in tedious litigation does not achieve recovery for the Mississippi Gulf Coast.

II. Tactics used by State Farm to pretend Katrina was a windless hurricane

A. The false dichotomy of "wind versus water." The most generic definition of a hurricane is a "tropical cyclone." Thus the event of a hurricane is defined by the combination of wind and water. Part of the challenge of keeping the NFIP and private insurers viable is untangling our understanding of the two forces that occur naturally together in a hurricane and either imposing a somewhat artificial division in order to allocate risk and assess damages or developing a unified approach that accurately reflects the reality of the destruction a hurricane can cause.

Much of the controversy following Katrina has been reduced to a question of "wind versus water." This simplification itself is a reflection of the insurance industry's approach to claims and has little or nothing to do with the actual experience of a hurricane. It is easy enough to neatly sort out which policyholders have purchased wind coverage, flood coverage or both. Looking at a concrete slab that used to be a family home and determining with any reasonable degree of certainty that 50% of the damage was caused by wind and 50% was caused by water is a tall order, not to be undertaken lightly by under-qualified adjusters and/or rookie, or even seasoned, engineers. Individual lawsuits filed since Katrina have inevitably featured a battle of weather experts, but the actual decisions regarding causation of damage were not made on site by professional weather experts. Soliciting the advice of adjusters and engineers to determine whether a home was destroyed by "wind or water" makes any ensuing "investigation" more closely correlated with the availability of coverage rather than the factual findings of damage.

Damage should be assessed first, then the availability of coverage. Reversing this order turns the entire premise of insurance on its head. In our investigation we found evidence that E.A. Renfroe adjusters working for State Farm were dispatched to damage sites and instructed to determine whether the damage could be categorized as a slab, "popsicle stick," or "cabana." "Popsicle stick" is industry slang for a foundation with support pilings intact; a "cabana" is industry slang for a structure that maintains some degree of post and lintel support but is otherwise a skeleton due to water washing through. Not much effort beyond riding past the property in a car and looking out the window would seem to be required to make this determination, but the fees for this adjusting "service" were passed along to the NFIP. Adjusters

were instructed that if they found the property to be in one of these three conditions, they were to request that an engineering inspection be ordered to provide additional guidance in assessing the damage. This subsumes that the adjusters were not considered qualified or sufficient to make a final determination as to the cause of damage. However, many of these adjusters at this stage, without the benefit of an engineering report and often without the benefit of proper flood training and certification themselves, would go ahead and recommend maximum payment of flood coverage and contents coverage through the NFIP.

B. An illustration. So, to illustrate, a home is insured by State Farm under a homeowner's policy for $500,000 for structural damage and $250,000 for contents; in addition the homeowner purchases $250,000 of protection against structural damage due to flood and $100,000 for contents due to flood pursuant to NFIP policies. An adjuster visits the damage, determines that maximum coverage is available under the NFIP and advises the homeowner that further investigation will be needed to assess the extent of wind damage.

In doing so, the adjusters are making a decision about the ratio of damage attributable to wind and that attributable to water, but the ratio is not based on the actual damage. It is based on the availability of coverage. In the McIntosh case, the policyholders received a denial letter at this stage. Even though that denial letter referenced the need for further investigation, the decision to deny coverage had already been made according to the plain meaning of the letter. Clearly State Farm is willing to spend the NFIP's own money with only nominal investigation, but is much more deliberate and hesitant to spend its own.

To continue the illustration, an engineer may then visit the property and submit a report of damage to State Farm. Even though the report was requested in order to assist the adjuster's evaluation, the reports were not given to adjusters. The reports were not given to the claim representatives or even openly circulated within the CAT offices. Records of whether and when engineering reports had been ordered and received were only accessible to a limited number of CAT employees, and the reports themselves were reviewed by only a handful of people.

C. Discretion in the interpretation and use of engineering reports. With notable exceptions, as in the McIntosh case, the conclusions in these engineering reports were not always sufficiently clear-cut to be easily classified as "wind" or "water" reports. The conclusions typically included descriptions of damage and ascribed some to wind, some to water, but numerical proportions were not assigned to each cause. If the engineer was not able to do that, the ability of a CAT employee to do so is dubious; yet that is exactly the sort of determination that needed to be made in order to properly assess the availability of coverage. To the extent that such a determination was not possible, particularly in slab cases, Mississippi law construes ambiguity against the insurer. Citing an engineering report as support for denial of coverage then refusing to let the homeowner see the report does not inspire much confidence in the integrity of this process. This has been a common complaint received by the MSAG's office.

Equally disturbing are the instances in which an engineering report was not used to deny the

claim. For example, reports were received and ignored; reports were received then subjected to "peer review" (which typically amounted to soliciting an opinion from a second engineering firm without mentioning the previous inspection and report); reports were requested then canceled; reports were ordered then canceled after the property inspection but before the report was done; or reports were requested then canceled then reordered.

One excuse given for this seeming lack of organization has been that the sheer volume of claims and the overwhelming devastation from Katrina was more than anyone anticipated. No one would argue against the horrific scale of this disaster. But the State Farm CAT team featured its most highly trained and experienced employees and vendors, people who worked disasters as a way of life. Given the expenses of this "confusion," State Farm might have been expected to use its existing information network to keep all CAT employees, agents and vendors informed about the status of engineering reports that were delaying decisions on claims. State Farm did not earn its position as the country' s largest insurer by making costly mistakes. **The "mistakes" and irregularities in the Katrina claims process share a common denominator; they all facilitated State Farm's practice of denying wind coverage expressly included in its homeowners' policies.**

D. Haag Engineering. Haag Engineering has worked several disasters for State Farm and depends on them for approximately 75-80% of their work. Haag Engineers were hired by State Farm to evaluate Katrina damage and were on the scene, doing inspections and writing reports prior to the issuance of Haag's "Hurricane Katrina Storm Damage Survey" issued in October 2005. Certain other engineering firms were relieved of their duties after the issuance of Haag's Survey with the explanation that, with that weather data in hand, coverage decisions could be made without the assistance of engineers. The issuance of the report did not alleviate the need for all engineering services however.

If State Farm, based on its experience with catastrophes knew weather data was forthcoming and that it would be conclusive on the causation of damage, their decision to incur the costs of using adjusters and engineers in advance of receiving such weather data does not make sense. In other words, if weather data could close a claim, why use expensive contractors whose opinions are not actually needed? Further, weather data was freely available from various governmental agencies; a legitimate reason to commission Haag to collect weather data is not self evident.

Haag's weather collection efforts should also not be described as "independent." Collecting weather data that could then be used to support conclusions in engineering reports that would result in additional job assignments from State Farm just adds another level of bias to the process, i.e., Haag had a vested interest in both the weather conclusions and the conclusions in their engineering reports.

E. No real investigation was done by State Farm.

The flaws in each step of this supposed "investigation" of a claim cannot be remedied by

arguing that no one part of the investigation was the sole basis for denying coverage. If each part is inherently deficient, the cumulative effect of them can be no better. As our investigation has shown, the efforts to ignore the role of wind in Katrina's devastation did not stop with adjusters, engineers and weather data. Legal gymnastics in the form of a wind/water protocol and the anti-concurrent causation clauses were also employed to deny coverage.

F. Legal gymnastics

1. Anti-concurrent causation clauses. Policy exclusions should be understandable to the agents selling the policies, the customers buying them, and the personnel interpreting them when a claim is made. The so-called "anti-concurrent causation clauses" and the water exclusions featured in Homeowners policies that became disputed after Katrina are excessively convoluted and confusing. Members of the Subcommittee are urged to review Exhibits A, B and C for the comprehensibility of these provisions.

In August of 2006, the Honorable Judge L.T. Senter Jr. of the U.S. District Court for the Southern District of Mississippi, Southern Division found Nationwide's anti-concurrent causation clause to be unacceptably vague in the Leonard case, pointing out that "[t]his reading of the policy would mean that an insured whose dwelling lost its roof in high winds and at the same time suffered an incursion of even an inch of water could recover nothing under his Nationwide policy_..._I do not believe this is a reasonable interpretation of the policy." An honest and realistic assessment of whether this language is likely to be applied consistently and fairly by employees and vendors with varying degrees of training and experience working under challenging circumstances, yields little certainty.

State Farm may have recognized this problem. A wind/water protocol issued September 13, 2005, instructed CAT workers, in under three pages, how to make coverage decisions. The protocol was prefaced with this explanation:

> Because of the combination of wind and water damages many homes sustained from Hurricane Katrina, the following materials have been developed and are intended for use as a guide for handling various wind and/or water claims in Louisiana, Mississippi and Alabama.

[See Exhibit E.]

Surely homeowners policies issued by State Farm already contemplated that in a hurricane, a combination of wind and water damages could and would occur. The wind/water protocol was not available for policyholders' review, but it was, by its language, designed to evaluate their right to coverage. In other words, the protocol constitutes a unilateral change in the insurance contract.

However, the anti-concurrent causation clause was maintained by the protocol. The second page of the protocol features the following language:

> **Damage to Property Caused by Flood Waters with available Flood Policy**
> Where wind acts concurrently with flooding to cause damage to the insured property, coverage for the loss exists only under flood coverage, if available...

Stated differently, the protocol dictates that if damage is caused by both wind and water, the policyholder only gets paid if they have a flood policy. If they have a wind policy, they get nothing. Thus, the anti-concurrent causation clause is applied to deny claims of policyholders who have no flood insurance, and is used to shift the burden to the federal government through the NFIP.

The insurance industry is quick to cite the need for predictability as a reason to exit the Mississippi market, but policyholders deserve predictability too. At the very least, their rights should be interpreted under the policies they sign, not protocols developed after the storm.

III. Concerns for the continued economic viability of coastal regions and the insurance industry

A. Doing business with State Farm, the "good neighbor." With over 130 million Americans living in coastal counties in 2003[iv] and the inevitability of future natural disasters, the continued viability of the NFIP is jeopardized if private insurers use federal flood policies as a form of corporate welfare to avoid or reduce liability. How can anyone properly assess whether or not an insurance company can reasonably be expected to continue to do business in coastal areas without getting to the truth of how much a private insurer actually owed, how much of that they paid, and how much was improperly passed on to the NFIP? How can anyone determine whether or not rate increases are appropriate without that information?

If private insurers are not financially able to cover the losses under the policies they write and remain solvent, then issues of market saturation and adequate reserve levels must be re-examined. The time to determine that a market is saturated is not after a disaster hits. If the premiums charged in Mississippi were not enough to cover the policies, then perhaps the inquiry should be into whether or not State Farm's actuaries anticipated implementing this scheme to maximize coverage under the NFIP when they recommended the rates in effect when Katrina hit.

According to recent press releases by State Farm, they have "handled" about 84,000 claims and paid out "over one billion dollars" in Katrina claims in Mississippi, excluding all payments made through the NFIP. [See Exhibit H.] That roughly averages out to less than $12,000 per claim and covers claims from an undisclosed number of Mississippi's eighty-two counties. The "duty to remain solvent," frequently trotted out as an explanation by State Farm employees, is not a moral obligation or the obligation of a "good neighbor," but is legally required. However, claimants in this disaster should not be denied coverage in the interests of keeping State Farm

flush with cash for the claimants in the next disaster.

Since the storm, State Farm has threatened to stop "doing business" in the state, and on February 14, 2007, announced its intention to make good on that threat. However, accepting premiums is not the same thing as "doing business" in a state. If a State Farm insurance policy is nothing more than a meaningless security blanket, then Mississippians do not benefit from having them stay in the state to collect premiums.

The last time a hurricane of this magnitude directly hit the Mississippi Gulf Coast was Hurricane Camille in 1969. Since then, policyholders have faithfully paid their premiums every year, and until 2005, the insurance companies got the benefit of the bargain. In 2005, thirty-six years later, Mississippians needed the benefit of the bargain they made with State Farm. State Farm has responded to the disaster by taking their premium dollars and leaving the state. They do not have to concern themselves with customer satisfaction because they do not intend to retain customers who actually try to invoke the protection they have paid for. State Farm will just find new customers, who will again pay their premiums with the expectation of protection.

Fundamentally, the insurance industry is about the assessment and allocation of risk. The gambling industry is also about risk. Part of what separates the two is the duty of good faith and fair dealing that, by Mississippi law, is required of the insurance industry in an effort to equalize the inherent imbalance of power between a large business and an individual who has experienced an illness, death in the family, fire, tornado, hurricane or other costs and losses for which they seek coverage.

Another distinction between the insurance industry and the gambling industry is the protection of a contract. A policyholders' rights, under an insurance contract, should not be determined without regard to the degree and type of damage or by reference to a wind/water protocol to which policyholders never agreed. A "reasonable investigation" of damage should be an actual analysis of damage done by objective professionals, not a foregone conclusion dictated by the availability of coverage.

If these duties are not observed in the insurance industry, then it is not much different from the gambling industry. A policyholder who pays premiums in good faith should have a more predictable and favorable result than a person who just drops a quarter into a slot machine at the casino. Without some changes in the insurance industry, insurance is just such a gamble.

B. Predictability. State Farm has cited the lack of predictability in the Mississippi insurance market as a reason to drop policyholders. However, some of the consequences State Farm has encountered in our state are not entirely unforeseeable. For instance, no one should be surprised that denying coverage with the explanation that hurricane winds caused no damage generates controversy. The type of misleading conduct alleged in the McIntosh case is practically guaranteed to produce outrage and litigation costs. Offering homeowners who voluntarily participate in mediation ten cents on the dollar for their claims and refusing to let them see the

engineering reports done on their property is another fairly certain way to provoke public outcry and backlash. Interpreting policies according to external, undisclosed documents and inconsistently applying contractual provisions is an invitation to trouble. We can also predict that if the insurance industry cannot concede any wrongdoing in the handling of Katrina, that the next group of policyholders affected by a disaster can expect the same treatment, as can the NFIP and FEMA.

CONCLUSION

The insurance industry cannot operate as a charity and remain solvent, but it is not unreasonable to require them to be accountable members of the business community. The need for timely, meaningful accountability of this industry is urgent. State Farm's publicity experts have done an outstanding job of spinning this situation as the protestations of Katrina victims who did not buy flood coverage and now want someone-State Farm, the federal government, anyone-to pay for their flood damage. The MS AG's Office is hopeful that our investigation will show that, in fact, State Farm pretended that Hurricane Katrina caused no wind damage, and that policyholders fully insured against wind were wronged by the various tactics employed to deny their claims. Our citizens do not want sympathy or handouts. They just want to be paid for the wind damage under wind policies. The MS AG's Office urges Congress to fully investigate this matter and pledge our full assistance and cooperation in any such efforts.

Thank you for holding this hearing and for inviting me to testify. I would be pleased to answer any questions.

Endnotes

i. The suit, styled *Jim Hood v. Miss. Farm Bureau Ins. Co. et al*, named Mississippi Farm Bureau Insurance Company, State Farm Fire & Casualty Company, Allstate Property & Casualty Company, United Services Automobile Association, Nationwide Mutual Insurance Company, and "A" through "Z" entities to be named pursuant to Mississippi Rule of Civil Procedure 9(h)

ii. The MSAG is grateful for the assistance of the following prosecutors in this investigation: The Honorable Melvin C. Wilson, Davis County Attorney, Utah; the Honorable Michael Harson, Lafayette Parish District Attorney, Louisiana; the Honorable Liz Sruz, Maricopa County Attorney's Office, Arizona; the Honorable George S. Webb, III, Commonwealth Attorney for Madison County, Virginia; the Honorable Christopher E. Connolly, District for the 11th Judicial District, Alabama, the Honorable William L. Gibbons, District Attorney General, Memphis and Shelby County District Attorney's Office, Tennessee; the Honorable Amy Klobuchar, Hennepin County Attorney, Minnesota; the Honorable Dianna Wheeler, Commonwealth Attorney for Orange County, Virginia; the Honorable Bill Cox, Hamilton County District Attorney General.

iii. Allstate's purchase of a similar program is discussed in *From Good Hands to Boxing Gloves* by David Berardinelli. Allstate has been in defiance since 2004 of an order from a New Mexico state court ordering them to disclose copies of PowerPoint slides prepared for them by the McKinsey Group. Since this business model was sold as a product to more than one customer, claims of attorney-client privilege are not properly raised.

iv. The National Oceanic and Atmospheric Administration (NOAA) stated in a March 1, 2005 report that an estimated 153 million people (53% of the population of the United States) lived in coastal counties in 2003; a figure that is only expected to rise in the coming years.

Exhibit List

Exhibit A: Anti-Concurrent Causation Language taken from Allstate Property and Casualty Insurance Company Deluxe Homeowners Policy

Exhibit B: Anti-Concurrent Causation Language taken from Nationwide Mutual Insurance Company Homeowner Policy

Exhibit C: Anti-Concurrent Causation Language taken from State Farm Fire and Casualty Company Homeowner Policy

Exhibit D: State Farm Notice of Denial Issued to the McIntosh Family September 28, 2005

Exhibit E: State Farm Wind/Water Claim Handling Protocol (Followed by a Transcript of the Exhibit)

Exhibit F: Handwritten Statement in Response to ABC 20/20 Report, Prepared by State Farm Counsel and Signed by Thomas C. McIntosh (Followed by a Transcript of the Exhibit)

Exhibit G: McIntosh Engineering Report Dated October 12, 2005

Exhibit H: State Farm Announcement Regarding Suspension of New Policies in Mississippi

Taken from Allstate Property and Casualty Insurance Company Deluxe Homeowners Policy, *Elmer and Alexa Buente v. Allstate Insurance Company et al*, Civil Action 1:05CV712 LTS-JMR, U.S. District Court, S.D. Miss., Judge Senter's Memorandum Opinion, March 24, 2006.

With respect to the insured dwelling (Section I, Coverage A) and other structures (Section I, Coverage B):

Losses We Do Not Cover...

We do not cover loss to the [insured] property consisting of or caused by:

1. Flood, including but not limited to surface water, waves, tidal water, or overflow of any body of water, or spray from any of these, whether or not driven by wind.

4. Water or any other substance on or below the surface of the ground, regardless of its source. This includes water or any other substance which exerts pressure on, or flows, seeps or leaks through any part of the residence premises.

21. Weather conditions that contribute in any way with a cause of loss excluded in this section to produce a loss.

23. We do not cover loss to property...when:

a) there are two or more causes of loss to the covered property; and

b) the predominant cause(s) of loss is (are) excluded under Losses We Do Not Cover, items 1 through 22 above.

With respect to personal property (Section I, Coverage C, Personal Property Protection):

Losses We do Not Cover...

We do not cover loss to [insured personal] property caused by or consisting of:

1. Flood, including, but not limited to surface water, waves, tidal water or overflow of any body of water, or spray from any of these, whether or not driven by wind.

4. Water or any other substance on or below the surface of the ground, regardless of its source. This includes water or any other substance which exerts pressure on, or flows, seeps or leaks through any part of the residence premises.

13. Weather conditions that contribute in any way with a cause of loss excluded in this section to produce a loss.

15. We do not cover loss to [insured personal] property when:

a) there are two or more causes of loss to the covered property; and

b) the predominant cause(s) of loss is (are) excluded under Losses We Do Not Cover items 1 through 14 above.

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EXHIBIT A

Taken from Nationwide homeowners insurance policy, *Paul Leonard and Julie Leonard v. Nationwide Mutual Insurance Company*, Civil Action No.1:05 CV475 LTS-RHW, U.S. District Court, S.D. Miss., Judge Senter's Memorandum Opinion, August 15, 2006

Section 1, Property Coverages
Coverage A-Dwelling
Coverage B- Other Structures
Coverage C- Personal Property

Property Exclusions, Section 1

1. We do not cover loss to any property resulting directly or indirectly from any of the following. Such a loss is excluded even if another peril or event contributed concurrently or in any sequence to cause the loss.

b) Water or damage caused by water-borne material. Loss resulting from water or water-borne material damage described below is not covered even if other perils contributed, directly or indirectly to cause the loss. Water and water-borne material damage means:

(1) flood, surface water, waves, tidal waves, overflow of a body of water, spray from these, whether or not driven by wind.

n) Windstorm or hail to any

(1) structure, other than a building, including the supports and screens, with a roof-like covering of cloth, metal, plastic or fiberglass, whether or not the structure is attached to a building.

(2) screens, including their supports, around a pool, patio or other areas.

(3) property lines and similar walls, including seawalls, greenhouses, hothouses, slathouses, trellis, pergolas, cabanas and outdoor equipment used to service the residence premises.

(4) structure, including property in or on the structure, which is in whole or part, in or over water.

2. We do not cover loss to any property resulting directly or indirectly from the following if another excluded peril contributes to the loss:

c) Weather conditions, if contributing in any way with an exclusion listed in paragraph 1 of this Section.

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EXHIBIT B

Taken from State Farm homeowners policy, *John Tuepker and Claire Tuepker v. State Farm Fire & Casualty Company*, Civil Action No. 1:05CV559 LTS-JMR, Judge Senter's Memorandum Opinion, May 24, 2006

Section I, Losses Insured
Coverage A–Dwelling
Coverage B–Personal Property

Section I –Losses Not Insured

1. We do not insure for any loss to the property described in Coverage A which consists of, or is directly and immediately caused by, one or more of the perils listed in items a. through n. below, regardless of whether the loss occurs suddenly or gradually, involves isolated or widespread damage, arises from natural or external forces, or occurs as a result of any combination of these:

a. collapse, except as specifically provided in Section I Additional Coverages, Collapse.

2. We do not insure under any coverage for any loss which would not have occurred in the absence of one or more of the following events. We do not insure for such loss regardless of: a) the cause of the excluded event; or b) other causes of the excluded event; or c) whether other causes acted concurrently or in any sequence with the excluded event to produce the loss; or d) whether the event occurs suddenly or gradually, involves isolated or widespread damage, arises from natural or external forces, or occurs as a result of any combination of these:

c. Water Damage, meaning:
(1) flood, surface water, waves, tidal water, tsunami, seiche, overflow of a body of water; or spray from any of these, all whether driven by wind or not;

3. We do not insure under any coverage for any loss consisting of one or more of the items listed below. Further, we do not insure for loss described in paragraphs 1 and 2. immediately above regardless of whether one or more of the following: a) directly or indirectly cause, contribute to or aggravate the loss; or b) occur before, at the same time, or after the loss or any other cause of the loss:

c. weather conditions.

However, we do insure for any resulting loss from items a., b., and c. unless the resulting loss is itself a Loss Not Insured by this Section.

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EXHIBIT C

State Farm Insurance Companies

September 28, 2005

STATE FARM INSURANCE COMPANIES
1900 E. Pass Road
Gulfport, MS 39507
Fax: (228) 604-4555

Pamela and Thomas Mcintosh
2558 S Shore Dr
Biloxi, MS 39532-3010

RE: Claim Number: 24-Z178-802
Policy Number: 24-BX-4847-7
Date of Loss: August 29, 2005

Dear Mr. and Mrs. Mcintosh:

This follows our visit to your property when we discussed the damage to your residence.

The damage to your property may have been caused by wind and water. We are continuing to investigate that portion of your loss caused by wind.

Enclosed please find an estimate for that damage and a draft in payment for that portion of your loss clearly caused by wind in the amount of $38,228.37

Based on the site visit and other facts, our investigation showed that some of your property was damaged as a result of storm surge, wave wash and flood. Unfortunately, that damage to your property is not covered under the policy identified above.

Please see the following relevant policy language.

Section I – Losses not insured

2. We do not insure any coverage for any loss which would not have occurred in the absence of one or more of the following excluded events. We do not insure for such loss regardless of : (a) the cause of the excluded event; or (b) other causes of the loss; or (c) whether other causes acted concurrently or in any sequence with the excluded event to produce the loss; or (d) whether the event occurs suddenly or gradually, involves isolated or widespread damage, arises from natural or external forces, or occurs as a result of any combination of these:

   a. **Ordinance or Law,** meaning enforcement of any ordinance or law regulating the construction, repair or demolition of a building or other structure.

   b. **Earth Movement,** meaning the sinking, rising, shifting, expanding or contracting of earth, all whether combined with water or not. Earth movement includes but is not limited to earthquake, landslide, mudflow, mudslide, sinkhole, subsidence, erosion

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EXHIBIT D

or movement resulting from improper compaction, site selection or any other external forces. Earth movement also includes volcanic explosion or lava flow, except as specifically provided in SECTION I – ADDITIONAL COVERAGES, volcanic action.

c. Water Damage, meaning:

(1) flood, surface water, waves, tidal water, tsunami, seiche, overflow of a body of water, or spray from any of these, all whether driven by wind or not;

(2) water from outside the plumbing system that enters through sewers or drains, or water which enters into and overflows from within a sump pump, sump pump well or any other system designed to remove subsurface water which is drained from the foundation area; or

(3) natural water below the surface of the ground, including water which exerts pressure on, or seeps or leaks through a building, sidewalk, driveway, foundation, swimming pool or other structure.

However, we do insure for any direct loss by fire, explosion or theft resulting from water damage, provided the resulting loss is itself a Loss Insured.

State Farm Insurance does not intend to waive any policy defenses, in addition to those quoted above and reserves its right to assert additional policy defenses at any time.

If you have additional information you would like us to consider that you have not previously submitted, or if you desire any explanation of this letter, please contact me.

Sincerely,

Claim Representative

Date: September 13, 2005

To: State Farm Claim Associates handling CAT FL in the Central and Southern Zones

From: Property and Casualty Claim Consulting Services

Subject: Wind/Water Claim Handling Protocol

***

Damage Caused by Windstorm
When the investigation indicates that the damage was caused by windstorm, the claim will be handled under the applicable provisions of the involved property policy. Consideration should be given to determine if a hurricane deductible or a windstorm or hail exclusion endorsement is involved and the claim handled accordingly.

Damage to Separate Portions with Distinguishable Wind or Excluded Water
Each type of damage should be documented in the claim file. The claim representative should calculate the separate damage attributable to each peril and handle the adjustment accordingly. In those cases where the policyholder has policies for both a windstorm and a flood, payments should be issued under the applicable policy.

Damage Caused by Excluded Water
When the investigation indicates that the damage was caused by excluded water and the claim investigation does not reveal independent windstorm damage to separate portions of the property, there is no coverage available under the Homeowners policy pursuant to the following language in *Section I Losses Not Insured*:

"2. We do not insure under any coverage for any loss which would not have occurred in the absence of one or more of the following excluded events. We do not insure for such loss regardless of: (a) the cause of the excluded event; or (b) other causes of the loss; or (c) whether other causes acted concurrently or in any sequence with the excluded event to produce the loss; or (d) whether the event occurs suddenly or gradually, involves isolated or widespread damage, arises from natural or external forces, or occurs as a result of any combination of these:

a. Water Damage, meaning:
(1) flood, surface water, waves, tidal water, tsunami, seiche, overflow of a body of water, or spray from any of these, all whether driven by wind or not . . ."

Other Losses Not Insured may be applicable, including 2.a.(2) & (3), 5.(a), (b) & (c).

Damage to Property Caused by Flood Waters with available Flood Policy
Where wind acts concurrently with flooding to cause damage to the insured property, coverage for the loss exists only under flood coverage, if available. The flood damage claim should be handled consistent with the terms of the flood policy providing coverage as outlined in Operation Guide 71-00.

Claims where the causation investigation is ongoing
Payment can be made under a reservation of rights for ALE or Loss of Income under the property policy until the final coverage decision is made. The policyholder should be advised in writing that:

- The investigation is ongoing.
- No coverage decision has been made.
- In the event it is determined that there is no covered damage, no further payment will be made on ALE or Loss of Income.
- They may undertake an independent investigation.

All claims in this category must be reviewed by the Claim Team Manager before a final decision is made. Management should be involved in any claim where it is deemed necessary to retain an expert to assist in the determination of causation.

For More Information
Any question on this protocol should be directed to your Claim Team Manager.

- P & C Claims Executive
  Southern Zone Executive & Claim Managers
  Central Zone Executive & Claim Managers
  P & C Claims Directors and Consultants
  Catastrophe Services Claim Managers
  Catastrophe Services Section & Team Managers
  Zone Section Managers

Transcript of Exhibit E

Date: September 13, 2005
To: State Farm Claim Associates handling CAT FL in the Central and Southern Zones
From: Property and Casualty Claim Consulting Services
Subject: Wind/Water Claim Handling Protocol

Action Required

Summary
Because of the combination of wind and water damages many homes sustained from Hurricane Katrina, the following materials have been developed and are intended for use as a guide for handling various wind and/or water claims in Louisiana, Mississippi and Alabama.

Action
The protocol below outlines the process that should be used for determination of coverage in those locations.

Protocol Detail
Each claim should be handled on its merits. A causation investigation should be conducted and appropriate claim file documentation is required. Any available information should be considered in making a coverage determination. This information will include, but is not limited to:

- Evidence gathered at the on site inspection. This includes documentation of physical evidence such as water lines, an examination of the debris, and an analysis of the physical damage to the structure.
- Evidence gathered at neighboring locations.
- Information from witnesses and policyholders.
- Input from experts that may be retained to provide guidance.

The damage to insured properties will fall into the following categories and should be handled as detailed below:

- Damage to the property was caused by windstorm.
- Damage to separate portions of the property can be attributed to either windstorm or excluded water.
- Damage to the property was caused by excluded water; with no available coverage.
- Damage to the property was caused by flood waters; covered by an available flood policy.

Damage Caused by Windstorm

When the investigation indicates that the damage was caused by windstorm, the claim will be handled under the applicable provisions of the involved property policy. Consideration should be given to determine if a hurricane deductible or a windstorm hail exclusion endorsement is involved

and the claim handled accordingly.

Damage to Separate Portions with Distinguishable Wind and Excluded Water

Each type of damage should be documented in the claim file. The claim representative should calculate the separate damage attributable to each peril and handle the adjustment accordingly. In those cases where the policyholder has policies for both a windstorm and a flood, payments should be issued under the applicable policy.

Damage Caused by Excluded Water

When the investigation indicates that the damage was caused by excluded water and the claim investigation does not reveal independent windstorm damage to separate portions of the property, there is no coverage available under the homeowners policy pursuant to the following language in Section 1 Losses Not Insured:

"2. We do not insure under any coverage for any loss which would not have occurred in the absence of one or more of the following excluded events. We do not insure for such loss regardless of: (a) the cause of the excluded event; or (b) other causes of the loss; or © whether other causes acted concurrently or in any sequence with the excluded event to produce the loss; or (d) whether the event occurs suddenly or gradually, involves isolated or widespread damage, arises from natural or external forces, or occurs as a result to any combination of these:

c. Water Damage, meaning:

(1) flood, surface water, waves, tidal water, tsunami, selche, overflow of a body of water, or spray from any of these, all whether driven by wind or not..."

Other Losses Not Insured may be applicable, including 2.c.(2) & (3), 3.(a), (b) & ©.

Damage to Property Caused by Flood Waters with available Flood Policy
Where wind acts concurrently with flooding to cause damage to the insured property, coverage for the loss exists only under flood coverage, if available. The flood damage claim should be handled consistent with the terms of the flood policy providing coverage as outlined in Operation Guide 71-06.

Claims where the causation investigation is ongoing
Payment can be made under a reservation of rights for ALE or Loss of income under the property policy until the final coverage decision is made. The policyholder should be advised in writing that:

- The investigation is ongoing.
- No coverage decision has been made.
- In the event it is determined that there is no covered damage, no further payment will be made on ALE or Loss of Income.
- They may undertake an independent investigation.

All claims in this category must be reviewed by the Claim Team Manager before a final decision is made. Management should be involved in any claim where it is deemed necessary to retain an expert to assist in the determination of causation.

For More Information
Any question on this protocol should be directed to your Claim Team Manager.

C. P & C Claims Executive
Southern Zone Executive & Claim Managers
Central Zone Executive & Claim Managers
P & C Claims Directors and Consultants
Catastrophe Services Claim Managers
Catastrophe Services Section & Team Managers
Zone Section Managers

(1)

21 August 2006:

I am Thomas C. McIntosh. My home at 2558 South Shore Drive, Biloxi, MS. was destroyed by Flood/Surge and wind as a result of Hurricane Katrina. The date of the destruction was on or about August 29, 2005.

I have settled my claim not only on my home but also claims under policies that covered some rental property all of which were insured by State Farm. All claims were paid according to the policies in effect and I am satisfied that the adjustment and payment under these State Farm policies was done correctly.

I have been advised that parties other than State Farm have possession of copies of my State Farm engineering report. I did not give anyone a copy of my report or authorize anyone to release my report to any third party including but not limited to any member of organization in the media industry (ABC news, The Sun-Herald, CBS news, Associated Press or any other news reporting organization). I consider anyone in possession of a copy of my report to be committing a violation of my privacy and any broadcast of any information regarding my State Farm insurance

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EXHIBIT F

(PHB)

I authorize the aggravating and offensive invasion of my privacy.

I authorize State Farm to advise media outlets such as ABC News and any other outlet having possession of my report of my concern for my privacy; and to advise any such outlet that I have no dispute with State Farm over any insurance issues relating to the adjustment or payment of my claims by State Farm.

I wish to advise that I do not now have any dispute with State Farm or anyone else regarding my insurance claims; I do not wish to be party any such dispute; I do not have any standing in the outcome of any litigation and I wish to be party to and stakeholder in such dispute or litigation. Put another way: I wish to be left alone.

Ken Tarver
Witness

Thomas C. McIntosh

Dated: August 21, 2006

PHB

Transcript of Exhibit F

Initial: PAB

21 August 2006:

I am Thomas C. McIntosh. My home at 2558 South Shore Drive, Biloxi, MS. was destroyed by Flood/Surge and wind as a result of Hurricane Katrina. The date of the destruction was on or about August 29, 2005.

I have settled my claim not only on my home but also claims under policies that concerned some rental property all of which was insured by State Farm. All claims were paid according to the policies in effect and I am satisfied that the adjustment and payment under these State Farm policies was done correctly.

I have been advised that parties other tha[n] State Farm are [in] possession of copies of my State Farm engineering report. I did not give any one a copy of my report or authorize any one to relate my report to any third party including but not limited to any number of organizations in the media industry (ABC news, the Sun-Herald, CBS news, Associated Press) or any other news reporting organization. I consider anyone in possession of a copy of my report to be committing a violation of my privacy and any broadcast of any information regarding my State Farm insurance transactions to be aggravating the aforementioned Invasion of my privacy.

I authorize State Farm to advise media outlets such as ABC news and any other outlet having possession of my report of my concern for my privacy; and to advise such outlet that I have no dispute with State Farm over my insurance issues relating to the adjustment or payment of my claims by State Farm.

I wish to advise that I do not now have any dispute with State Farm or anyone else regarding my insurance claims; I do not want to be part of any such dispute; I do not have any stake in the outcome of any litigation nor do I wish to be party to or stake-holder in such dispute or litigation. Put another way: I wish to be left alone.

Signature
Ken Turner
Witness

Signature
Thomas C. McIntosh

Dated: August 21, 2006

Initials: PAB & PM

October 12, 2005

State Farm Insurance
Mr. Cody Perry, Claims Adjuster
1909 East Pass Rd.
Gulfport, MS 39507

Re: Hurricane Damage Assessment Investigation
Insured: Thomas & Pamela McIntosh
Date of Loss: 8-29-2005
SF Claim No. 24-Z178-602/24-BX-4847-7
FAEC Case No: 530-0088-05-25

Dear Mr. Perry,

Forensic Analysis & Engineering (FAEC) is pleased to provide the following report of our engineering investigation and evaluation of the reported damage to the residence located at 2558 S. Shore Drive in Biloxi, MS.

We initially received this assignment on October 4, 2005. FAEC performed a field investigation of the subject insured residence on October [illegible] assignment we we [illegible] porch to the dining [illegible]

This si [illegible] this matter.

BACK [illegible]

On the [illegible] y of Biloxi, was in [illegible] hurricane when i [illegible]

FAEC [illegible] if the damag [illegible] or a combir [illegible] During our on site [illegible] r inspection.

Put in Wind file - DO NOT Pay Bill

DO NOT discuss

SITE OBSERVATIONS

The following are the observations made during FAEC's inspection of the structure:

- The home has a north-south orientation with the front of the house facing east to South Shore Dr. The home is on a waterfront lot on the Tchautacabouffa River.

FORENSIC ANALYSIS & ENGINEERING CORPORATION
ESTABLISHED 1986
FORENSIC ENGINEERING, PRODUCT DEFECT ANALYSIS & ACCIDENT INVESTIGATIONS
5301 Capital Blvd., St[illegible] Carolina 27616-2956
E-MAIL: FORENSIC @ FORENSIC-AN[illegible] SITE: WWW.FORENSIC-ANALYSIS.com
Telephone: (919) 872-8788 Facsimile: (919) 872-8660

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EXHIBIT G

- The first floor elevation is approximately 20-21 feet. The watermark line in the house is approximately five and one-half feet above the main floor interior flooring.
- The roof was damaged at the peak and right front sections. Ceilings were damaged.
- The doors and windows were all missing.
- All debris had been cleaned out of the house.
- According to Mr. McIntosh, a neighbor - Mr. Mike Church - reported that houses were blown apart and debris was thrown into the McIntosh house at approximately 8 AM and the floodwater began rising at 11 AM.
- The lower front right corner of the house wall was missing – approximately three studs.
- The back porch had a wooden deck and arbor destroyed.
- An outdoor metal storage shed was missing.
- The detached carport originally had nine columns. Several of these were found severely damaged.
- Large oak trees were felled in a northwesterly direction. Limbs of a live oak tree in the backyard of the subject residence had fallen.
- Observations of the area are consistent with the findings of this property. There were numerous tall tree failures in the northwesterly direction.

CONCLUSIONS

Based upon the information that has been presented to FAEC and evidence gleaned during our inspection, FORENSIC ANALYSIS & ENGINEERING CORPORATION has made the following conclusion concerning the damage to the structure.

- The tree failures in the northwesterly direction are the result of the winds out of the southeast from the approaching hurricane.
- The roof, door, carport, and window damage was caused by wind and wind driven debris.

- It is FAEC's opinion that the interior damage of the structure is primarily the result of the failure of the windows, walls, and doors due to wind.

The conclusions and opinions presented in this report are based on the results of FAEC's field investigation of the subject residence, as well as our analysis of the available wind and localized water level data and upon all of the other associated information that we have gathered during the course of our investigation efforts to date. If additional information or facts become available which materially affect these stated conclusions and opinions, then, FAEC reserves the right to amend or change its opinions and conclusions as needed.

It has been our pleasure to perform this structural engineering analysis for you. We trust that our efforts will meet with your approval and that this report meets its intended purpose. Please call if you have any questions concerning this report or if I or any of FORENSIC ANALYSIS & ENGINEERING CORPORATION'S staff can be of further support.

Respectfully submitted,
FORENSIC ANALYSIS & ENGINEERING CORPORATION

Brian Ford, P.E.
Senior Principal Structural Engineer
Mississippi P.E. License No. 08770

As it is the practice of FAEC to emphasize and ensure the technical quality of its work through peer review, the content of this report has been reviewed by the undersigned to ensure that all stated conclusions and supporting facts are technically consistent and meet the requirements of current engineering and scientific principles.

FORENSIC ANALYSIS & ENGINEERING CORPORATION

Robert K. Kochan, President

Robert K. Kochan, ME, DABFET, FACFEI
Principal Technical Consultant

Text Size: A A A

Like a good neighbor, State Farm is there.

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Home > About > Media > Media Releases > State Farm® Announces It Will Suspend Writing Homeowners and Commercial Policies in Mississippi

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State Farm® Announces It Will Suspend Writing Homeowners and Commercial Policies in Mississippi

Uncertainty in State Legal and Business Environments Cited as Reason -

JACKSON, MS – Feb. 14, 2007 – Citing uncertainties in the Mississippi legal and business environments, State Farm Senior Vice President Bob Trippel yesterday advised Mississippi's Commissioner of Insurance George Dale that State Farm Fire and Casualty Company will suspend writing new homeowners and commercial property insurance in the state of Mississippi.

"We came to this decision reluctantly. But it is no longer prudent for us to take on additional risk in a legal and business environment that is becoming more unpredictable. When there's more certainty, we will reassess the situation," said Trippel.

State Farm actually grew its business in Mississippi in 2006, writing over 29,000 new homeowners policies and more than 76,000 new auto policies. State Farm currently insures 30.3% of the homeowners market in Mississippi (according to 2005 data from A.M. Best).

"We will continue to serve our existing policyholders, write new auto insurance policies and market our financial services products as long as market conditions allow, but the current legal and business environments with regard to homeowners and commercial insurance are becoming untenable," he said.

The company stated that criticisms about how it handled Hurricane Katrina claims have complicated matters. The company is concerned that provisions in its insurance policies are being reinterpreted after the fact to provide for coverages that were not contemplated when the policies were written. To date, State Farm has handled over 84,000 non-auto property claims in Mississippi as a result of Hurricane Katrina, and has already paid in excess of $1 billion in damages, excluding those payments made under the National Flood Insurance Program. Fewer than two percent of all State Farm claims associated with Hurricane Katrina have not been settled.

About State Farm

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Testimony of
David I. Maurstad
Director and Federal Insurance Administrator
Mitigation Division
Federal Emergency Management Agency
Department of Homeland Security
Before
The United States House of Representatives
Committee on Financial Services
Subcommittee on Oversight and Investigations
February 28, 2007

Good afternoon Chairman Watt, Ranking Member Miller, and Members of the Subcommittee. I am David Maurstad, Mitigation Division Director and Federal Insurance Administrator for the Federal Emergency Management Agency (FEMA) within the Department of Homeland Security. I appreciate the opportunity to appear today before the Committee to discuss the status of the National Flood Insurance Program (NFIP).

This afternoon I would like to provide a context for how the NFIP has moved forward since Hurricanes Katrina, Rita and Wilma made landfall in 2005. As you know, the NFIP was established in 1968 to make affordable flood insurance available in communities that would adopt and enforce measures to make future construction safer from flooding. From 1968 through 2004, a total of $15 billion had been paid out to cover more than 1.3 million claims.

After the June 2004 signing of the Flood Insurance Reform Act (FIRA04), the United States experienced back-to-back catastrophic hurricane seasons. The 2004 hurricane season resulted in over 75,000 claims totaling a record payment of over $2 billion dollars. That record fell in 2005 when Hurricane Katrina resulted in claims to date totaling over $16.3 billion – over eight times that of 2004 and surpassing, by over a billion dollars, the total amount the NFIP had paid out since the Program began.

Last year I informed the House Financial Services Committee and the Senate Banking Committee that we expected the total NFIP payout (claims and associated expenses) for the 2005 hurricane events to be over $23 billion. We have reexamined that projection based on actual claims and payments to date, and lowered the estimate for claims payments, related adjustment expenses, and interest paid on borrowing to approximately $21 billion.

From 1986 until the 2005 hurricane season, the NFIP has been self-supporting. During periods of high losses, consistent with the law, the NFIP has borrowed from the U.S. Treasury. The authority to borrow from the Treasury is an essential part of the NFIP's financing design by providing the necessary resources in those years where claims exceed average annual historic loss levels. This authority enables the program to borrow limited amounts from the Treasury on occasions when income is not sufficient to cover claim payments and related costs. The loans from this period have been repaid, with interest, from policyholder premiums and related fees.

The large number of claims and severity of flood losses from the 2004 and 2005 hurricane seasons are unprecedented in the history of the NFIP. The challenges these storms have presented to the Mitigation Division, particularly the 2005 hurricane season, – in terms of flood insurance claims handling, floodplain management, flood hazard mapping and mitigation planning and grants management – have never been encountered, on this scale, before.

Program claims have been resolved expeditiously. Only five months after Hurricanes Katrina, Rita, and Wilma struck the Gulf Coast, the NFIP had resolved over 70 percent of the 241,000 claims filed from these events. By the summer of 2006, we had resolved nearly all of our 2005 hurricane season flood claims – a volume that far exceeded the highest number of claims filed from any single event in the NFIP's history, and more than triple the total number of claims filed in 2004. Our industry partners – our Write-Your-Own (WYO) insurance companies, as well as claims adjusters and agents – have more than fulfilled their responsibility to help NFIP policyholders begin to rebuild their lives.

In the wake of the worst natural disaster the Nation has ever experienced, we have continued to fulfill the promises made to NFIP policyholders and communities. FEMA is proud of the NFIP's ability to provide solid customer service to our flood insurance policyholders.

This testimony will address the NFIP's financial status as well as the following matters: (a) the new materials and innovative approaches the NFIP has used to find, help, and inform Gulf Coast policyholders; (b) how the NFIP expedited adjustment and claims processes after Katrina, and the quality control inherent in such efforts; (c) the NFIP technical information available to Gulf Coast communities to help them rebuild wisely; (d) the opportunities the NFIP is pursuing to fundamentally strengthen the Program's financial underpinnings; and (e) six issues/questions articulated in the February 20, 2007, letter from the Honorable Melvin L. Watt, Chairman of the House Subcommittee on Oversight and Investigations, inviting FEMA to testify at this hearing.

NFIP Financial Status

The extremely active 2004 and 2005 hurricane seasons raised the Nation's awareness of the flood risks we all face; consequently, the NFIP's policy base has grown dramatically. The NFIP has over 5.4 million policies for homes, businesses, and other non-residential property owners insuring in excess of $1 ***trillion*** in assets. The NFIP now collects more than $2 billion annually in premiums and fees. As previously stated, from 1968 (the NFIP's inception) through 2004, the Program paid out $15 billion to cover more than 1.3 million claims. Many of these claims occurred as a result of smaller flood events that did not rise to the level of a Presidential disaster declaration and for which Federal disaster assistance was not available. Yet many of these property owners endured as much of an individual loss as those in larger events. In this regard, studies have indicated that when insurance premiums fully reflect underlying risks, insurance is the most efficient and equitable method of providing disaster assistance.

It also is important to note that NFIP rate schemes are not designed to cover catastrophic events or years. Congress intended the National Flood Insurance Program to cover claims for the "average historic loss year," plus expenses associated with administering the Program. A vast majority of the NFIP's 2005 claims, for instance, resulted from the largest levee failure in the Nation's history, an event not envisioned during the NFIP's inception, but one that must be considered as we work to strengthen this important Program.

The NFIP provides insurance at actuarial (risk-based) rates for newer construction, with most policyholders paying full actuarial rates. Structures built prior to the mapping and implementation of NFIP floodplain management requirements are considered pre-Flood Insurance Rate Map (FIRM) buildings. The NFIP charges the owners of these pre-FIRM structures – which make up 24 percent of all NFIP policies – heavily discounted rates on the first $35,000 of their structure's insured value, and full risk-based rates for the remaining insured value because adequate flood risk information did not exist when the structures were built. Those with NFIP policies covering pre-FIRM structures are paying, on average, only 40 percent

of a full risk-based premium, with the NFIP considering the remaining 60 percent as forgone revenue – a loss that is ***not*** passed on to other NFIP policyholders.

As mentioned earlier, we now anticipate that total borrowing for the 2005 hurricanes will exceed $20 billion. Annual interest on such borrowing will be approximately $800 million. The 2005 flooding events were of a magnitude far beyond the ability of policyholder premiums to cover. Since Hurricane Katrina struck the Gulf Coast in August 2005, Congress has increased the NFIP's borrowing authority three times to the present limit of $ 20.775 billion. This additional borrowing authority has been a critical element of the NFIP's ability to effectively serve our policyholders, allowing FEMA to resolve almost all of the Katrina, Rita, and Wilma claims received to date. However, under current loan obligation arrangements – with the NFIP needing new loans at least every six months to cover semi annual interest payments – it is unlikely that the Program will ever be able to retire its debt.

Innovative Materials and Approaches to Help Gulf Coast Policyholders
In the aftermath of Katrina, the 2004 Flood Insurance Reform Act was instrumental in our ability to effectively inform and help Gulf Coast policyholders, and continues to be a catalyst for programmatic success and improvement. We began implementing Reform Act changes during the 2004 hurricane season, and we improved our delivery during the 2005 hurricane season by distributing informative materials, designing innovative post-disaster systems, and implementing important training initiatives.

New Materials
Increasing risk awareness among homeowners and consumers with improved, succinct information is one of the NFIP's basic principles, and is an important element of the 2004 Flood Insurance Reform Act. FEMA, through an aggressive education and outreach campaign, is continuously designing and upgrading informational material to increase the public's awareness of flood risks and to effectively keep our policyholders informed.

For instance, immediately following Hurricane Katrina, we distributed two documents to policyholders to help them through the claims process: The ***NFIP Summary of Coverage*** and the ***Flood Insurance Claims Handbook.*** These easy-to-understand materials, developed in concert with our insurance industry partners, are being distributed to all policyholders at the time of initial purchase, policy renewal, and at the time a claim is filed. In addition, FEMA and the WYOs distributed these materials in our Joint Field Offices, Disaster Recovery Centers, and Flood Response Centers – as well as in Town Meetings – soon after Katrina made landfall. I personally handed these materials to State Insurance Commissioners in Alabama, Mississippi, and Louisiana. Also, we, along with the WYOs, distributed an informational CD containing these documents and other ready-to-print materials to field offices, State and local government offices, and the media.

Innovative Post-Disaster Systems
Also, recognizing that a significant number of Gulf Coast policyholders were displaced, FEMA implemented several systems to reach policyholders early in the claims process. These systems were particularly useful to those who are cut off from their usual sources of information and communication. For example, in the days immediately following Katrina, we cross-referenced a National Processing Service Center report of all callers who applied for disaster assistance and indicated they had flood insurance. We matched the addresses of damaged properties to NFIP policy addresses and connected insurance companies to their flood insurance policyholders. This helped the WYO Companies to reach out to their NFIP policyholders and help them immediately

when they needed it most. This system will now become standard operating procedure in future flooding events.

Training of Agents Who Sell Flood Insurance
Flood insurance training for insurance agents is a high priority for the NFIP. Reform Act training requirements were published in the September 1, 2005 ***Federal Register***, and we continue to work with the States as well as the insurance industry and related associations to inform insurance companies and agents of these requirements. To date, 31 states have implemented training requirements for agents who sell flood insurance. Additionally, FEMA has recently brought new flood insurance training material on-line. Now, insurance agents in 27 States can earn three hours of continuing education credit for successfully completing this new web-based course.

These innovative materials, systems, and training initiatives carry out the provisions and intent of FIRA04, and the desire of the NFIP to reach out – with easy-to-understand information – to policyholders as early in the claims process as possible, recognizing that the sooner claims are settled, the sooner people can start rebuilding their lives and communities.

Expedited Adjustment and Claims Processing After Katrina
Given the unprecedented number of claims, widespread destruction, and the difficulties encountered by adjusters accessing the devastated areas, FEMA is especially appreciative of our insurance industry partners as we developed and implemented streamlined adjustment and claims processes designed to effectively serve policyholders.

After Hurricane Katrina, then Rita, then Wilma, the NFIP's insurance company partners utilized state-of-the-art aerial imagery, up-to-date water-depth data, and detailed information from extensive underwriting files to rapidly identify insured properties that had been washed off their foundations, had standing water in them for an extended period, or had only pilings or concrete slabs remaining. FEMA also waived proof of loss requirements and fast-tracked claims up to the maximum insured value.

These streamlining methods substantially reduced our normal adjustment times from what the NFIP would normally see under such extreme circumstances. Furthermore, these processes provided mechanisms for rapidly resolving claims within 60 days of the event. The NFIP estimates that over 17,200 claims have been handled through our expedited claims process.

It is important to note that the NFIP's streamlined adjustment processes and claims expediting are not performed at the expense of quality control. From the beginning, FEMA general adjusters and claims staff have been in the field re-inspecting sample sets of claims in order to ensure the integrity of the process. This is in addition to our regular adjuster monitoring we perform through operation reviews, biennial audits, audits for cause, audits by the Office of the Inspector General, and Congressional inquiries.

Helping Communities Rebuild Wisely
In addition to ensuring that the NFIP's streamlined adjustment and claims processes are effective, transparent, accurate, and fair, FEMA, the Mitigation Division, and the NFIP are doing all they can to make sure that communities recover and rebuild wisely. As such, FEMA is strongly encouraging Gulf Coast communities to assess and utilize all relevant, current technical resources and information available – including updated flood hazard information – in all planning, mitigation, and rebuilding efforts.

Hurricanes Katrina and Rita had significant impacts on flood hazards in coastal Mississippi and Louisiana. As citizens in these areas continue to recover, updated flood hazard information is being provided to help guide reconstruction. For instance, FEMA has provided Mississippi and Louisiana with Advisory Base Flood Elevations (ABFEs) to help rebuilding efforts in region's most heavily affected counties and parishes. Presently, 14 Mississippi communities have adopted ABFEs or higher regulatory elevations. In Louisiana, 36 communities have adopted ABFEs or higher regulatory elevations.

The release of ABFE guidance is for advisory purposes, and will not increase NFIP flood insurance premiums or requirements. However, when ABFEs are provided to affected communities – and the information will not be developed after every event – FEMA requires those communities to use the guidance for all rebuilding activities that involve FEMA mitigation and public assistance grant programs. There is simply no sense in spending tax dollars to rebuild to outdated standards only to have similar damage when the next storm comes along.

Strengthening the Program

Significant flood events have played a major role in the NFIP's evolution: the Program was created when Hurricane Betsy carved a swath of destruction through the Gulf Coast in 1965; Tropical Storm Agnes in 1972 provided the impetus for the mandatory purchase requirements to increase participation in the program; and the 1993 Midwest Flood was the catalyst behind the National Flood Insurance Reform Act of 1994 and its stronger lender compliance requirements. It is entirely appropriate, therefore, that the catastrophic 2004-2005 hurricane seasons are generating a need to seriously consider how the NFIP can be further adjusted and strengthened.

Over the past year and a half, in testimony before the House Financial Services Committee and Senate Banking Committee, and in presentations at various events nationwide, I have outlined the following mitigation and insurance principles:

- Protect the NFIP's integrity by covering existing commitments and liabilities;
- Phase out discounted premiums in order to charge policyholders fair and actuarially sound premiums;
- Increase NFIP participation incentives and improve enforcement of mandatory participation in the program;
- Increase risk-awareness among homeowners and consumers by improving information quality; and
- Reduce risk through combinations of proven mitigation practices and explore opportunities to reduce risks through enhanced protective measures.

Now is the time to complement our mitigation and insurance principles with several NFIP enhancements. To strengthen the NFIP, and to foster our commitment to reduce the Nation's flood risks, we believe Congress should consider the following NFIP adjustments:

- Provide authority to eliminate premium discounts over time for properties built before flood insurance rate maps were in place, particularly for other than primary residences.

- Strengthen the mandatory insurance purchase requirement for Federally-regulated lending institutions to require insurance to value as opposed to the outstanding balance of the loan, and for the life of the loan, and to require more frequent and thorough portfolio reviews by lending regulators.

- Increase the penalties for Federally-regulated lending institutions that do not comply with their mandatory purchase regulatory responsibilities.

- Study the feasibility and implications of expanding the standard for mandatory purchase requirement to include properties in the 0.2% chance per year floodplain (500-year flood plain) and properties in areas of residual risk – structures protected by levees, dams, and other manmade structures. Levee failure vastly increased the number of NFIP claims in New Orleans, and the proper depiction of areas behind levees on Flood Insurance Rate Maps continues to be one of the NFIP's primary concerns.

- Provide for additional Increased Cost of Compliance (ICC) coverage – money for NFIP policyholders to bring their structures up to existing flood-related building codes-- that is in addition to available building limits. Remove the $75 cap on ICC premiums so that a variety of ICC options can be offered to the policyholder.

Finally, I would like to address the six specific questions included in the invitation letter I received for this hearing.

1. "The NFIP's views about whether all claims by write-your own (WYO) companies in the Gulf Coast area have been properly classified as water damage, in which the NFIP is responsible for paying the claim, rather than wind damage, in which private insurers would be responsible for paying the claim."

When a policy holder under either the NFIP or a private insurance company files a claim for damages under the respective policies, the insurance company assigns an adjuster to the case who will come out to the property and examine the damages and that information will be used to determine the loss and how much an individual policy holder is entitled to. This determination is based on the available evidence, which in most instances will be the damaged property itself. When a policy holder has both a flood insurance policy and a traditional homeowner's policy, each of the insurance companies must examine the property to make a determination of liability. The question that you ask only comes into play where the WYO that holds the NFIP policy also holds the traditional homeowner's policy.

In those limited circumstances where one adjuster was responsible for determining the damage eligible for recovery from both the NFIP and a traditional homeowner's policy held by the WYO, that those the NFIP has a rigorous program of oversight to ensure proper assignment of liability. Following Katrina, the NFIP ordered random re-inspection of damaged structures by third-party adjusters to affirm proper handling, as well, at the request of either a WYO or the insured, the NFIP conducted special re-inspections to verify proper handling and resolve coverage disputes, including disputes over whether damages were caused by wind or water. The NFIP is also subject to audits by the Inspector General of DHS.

2. "NFIP's positions on participating in mediation with policyholders and private insurers to settle disputed claims, particularly involving wind versus water disputes."

Following a disaster, the NFIP prides itself on swiftly and accurately resolving claims by its policy holders. This has resulted in our ability to close over 99 percent of claims without any legal procedure. Further, the 2004 Flood Insurance Reform Act passed by Congress required FEMA to publish an appeals process, which became effective on November 13, 2006. This process will enable NFIP flood insurance policyholders to appeal claim-settlement decisions of adjusters, agents, WYO insurance companies, and FEMA. We believe that this process will only further increase our ability to address the needs of our policy holders amicably, and without legal proceedings.

The NFIP encourages WYO companies to make or continue to make this alternative dispute resolution option available to policyholders. Additionally, I want to stress that mediation outside of the normal WYO claim handling process will provide NFIP policyholders an additional mechanism to resolve their flood claim – but only their flood claim. While such a process could have merit where a WYO also holds the traditional homeowner's policy, there are important separation of power issues with proposals that allow a State official to exercise authority over the Federal Flood Insurance Program. It is important to point out once more that the NFIP has long operated at a high success rate in resolving claims without litigation – success that can be directly attributed to the solid NFIP-Insurance Industry partnership.

3. "How the NFIP develops requirements for private insurers to enter into WYO arrangements and what mechanisms are available to the NFIP to monitor WYO actions in providing policies to residents."

Private insurers must meet NFIP requirements in order enter into WYO arrangements. These requirements consider criteria such as: a company's experience in the Property and Casualty arena; a company's standing with its State Insurance Department; the capability of a company's distribution system to adequately sell and service flood insurance policies; and the ability of a company's resources to meet all NFIP reporting requirements.

Code of Federal Regulations Part 44, Section 62.24 clearly delineates the criteria that companies must meet in order to participate in the WYO program. FEMA believes that these standards are reasonable indicators that a company has the experience and qualifications necessary to write insurance policies under the NFIP. To ensure that a company complies with WYO Arrangement's provisions, FEMA (a) reviews the monthly statistical and financial submissions called for by the WYO Financial Control Plan; (b) requires companies to arrange for independent biennial audits of its NFIP business; and (c) conducts underwriting and claims operational reviews. Companies with reporting errors over certain thresholds, or with unsatisfactory audit or review findings, are subject to be called before the WYO Standards Committee, composed of Federal and company executives, to outline plans for corrective action.

4. "The process by which adjusters are certified as NFIP adjusters."
Claims Adjusters must successfully pass an approved claims course every year to maintain their NFIP certification. NFIP Claims Workshops are held Nationwide from January through May to avoid interference with hurricane season, which begins in June, and is historically the NFIP's busiest time of year.

The NFIP Bureau & Statistical Agent will issue certified NFIP Claims Adjusters a Flood Certifications Card. These wallet-size cards include the adjuster's name, Flood Certification Number, and the loss categories in which the adjuster is authorized.

Qualifications

The National Flood Insurance Program (NFIP) Bureau and Statistical Agent maintains a database of NFIP qualified independent adjusters. The NFIP qualifications reflect the distinct characteristics of the NFIP coverage and adjusting requirements.

The adjuster database includes the adjuster's name and the date and location of the workshop the adjuster attended. The purpose of these workshops is to keep the adjusting community current with claims procedures required for adjusting losses under the three forms of the ***Standard Flood Insurance Policy:*** the Dwelling Form, the General Property Form, and the Residential Condominium Building Association Policy (RCBAP). For this reason, all independent adjusters who wish to be certified must submit the Adjuster Certification Application. WYO company staff adjusters should be guided by their company's procedures.

The application includes five levels of authorization. An adjuster can be authorized in one or all five categories or any combination, if the adjuster's qualifications, detailed on the application, meet the requirements shown below. The five categories are as follows: Residential (Dwelling); Manufactured (Mobile) Home/Travel Trailer; Small Commercial (General Property); Large Commercial (General Property); and Condominium. All requirements are checked and verified prior to approval.

Residential, Commercial, and Manufactured (Mobile) Homes Authorization
To be approved for Residential, Commercial, or Manufactured (Mobile) Homes losses, or any combination thereof, an adjuster must: (a) have at least 4 consecutive years of full-time property loss adjusting experience; (b) be capable of preparing an accurate scope of damage and dollar estimate to $50,000 for manufactured (mobile) homes and to $500,000 for residential and commercial losses; (c) have attended an NFIP workshop and be able to demonstrate knowledge of the SFIP and of NFIP adjustment criteria for all policy forms; and (d) be familiar with manufactured (mobile) home and Increased Cost of Compliance adjusting techniques.

Large Commercial and RCBAP Authorization
To be approved for Large Commercial or RCBAP losses, or both, an adjuster must: (a) have at least 5 consecutive years of full-time large-loss property adjusting experience; (b) be capable of preparing an accurate scope of damage and dollar estimate of $500,000 or more; (c) submit written recommendations from three insurance company supervisory or claim management personnel, reflecting adjusting experience only; and (d) provide information regarding current Errors and Omissions coverage.

5. "What monitoring mechanisms, if any or audits are being used to ensure these adjusters properly attributed damage as water rather than wind?"
As mentioned in item 1 above, the NFIP conducts random and on-demand re-inspections of damaged structures after each event, as well as routine audits of WYO open-claim files. For routine WYO audits, NFIP General Adjusters will randomly select WYOs for re-inspection, consider sets of claims, and randomly select claims for re-inspection.

On-demand re-inspections precipitate from FEMA directives or WYO requests, and typically arise if a homeowner on a block reports a flood claim, but homeowners adjacent to the claimant's property did not. Under such circumstances, a General Adjuster will investigate, which often leads to subsequent claim file reviews and/or additional inspections.

6. "The mechanisms NFIP has to prevent or minimize conflicts of interest by adjusters in attributing the cause of damage."
FEMA, through the NFIP Bureau and Statistical Agent (NFIP Bureau), has a corps of special adjusters who conduct quality control reviews of claims after every flood disaster. These special adjusters go into affected areas soon after an event to assess the exact cause of a loss, and they are available to review any disputes between adjusters and claimants. Their findings are reported to FEMA and the WYO companies for any necessary corrective action. Also, as soon as possible after a storm event, the NFIP Bureau conducts adjuster meetings to discuss the specific event and identify potential coverage issues peculiar to the effected areas.

Conclusion
The 2005 hurricane season presented the NFIP with numerous challenges on a variety of fronts and provided opportunities for fundamental structural reforms, as outlined above, that are critical to the financial viability of the program.

The proposed changes to the NFIP, when integrated into a comprehensive mitigation strategy, will improve the program's economic and financial viability. However, I want to emphasize that there is no quick solution that will enable the program to absorb catastrophic loss years as we have just experienced.

The Program's borrowing authority currently stands at $20.775 billion. Current expected claims payout is over $20 billion for the 2005 storms. Additionally, the NFIP has already paid the US Treasury over $600 million in interest on funds borrowed. The Program will continue to incur increasing interest on that borrowing.

It is also important to point out that the NFIP's fiscal shape is not our only concern. FEMA, the Mitigation Division, the NFIP, States, communities, and citizens must do better at making sure that homes and businesses in high flood-risk areas have flood insurance coverage. The requirement that Federally-backed mortgagors in high risk areas must have flood insurance helps, but property owners without mortgages, or with other than federally backed mortgages – and very importantly – renters – are not touched by this regulatory requirement.

After Hurricane Katrina, the Gulf Coast knows that such hazards cannot be eliminated. However, through a coordinated strategy of analyzing risk, reducing risk, and insuring against risk, the impacts of flooding, as well as other natural hazard events, can be dramatically reduced. FEMA, the Mitigation Division, and the NFIP will continue strengthening our partnerships at the Federal, State, and local governmental levels, as well as with non-governmental entities and the private sector, so that future flooding events can be managed through sound mitigation planning, not disaster declarations.

I look forward to continuing to work with the Committee, our NFIP WYO companies, agent groups, and other partners to implement future changes to the National Flood Insurance Program.

I will be happy to answer any questions that the Committee might have. Thank You.

FEMA

David I. Maurstad

Director, Mitigation Division and Federal Insurance Administrator

David I. Maurstad was appointed Director of FEMA's Mitigation Division and Federal Insurance Administrator in April 2006. Mr. Maurstad previously held both positions in an acting role beginning in June 2004.

In this position, Mr. Maurstad provides leadership for some of the nation's leading multi-hazard risk reduction programs, which seek to secure the homeland from natural hazards. His areas of oversight include the National Flood Insurance Program, the National Earthquake Hazards Reduction Program, the National Dam Safety Program and the National Hurricane Program. In his position, Mr. Maurstad works closely with public and private risk managers, as well as leaders in government, industry, research and academia.

Since his appointment, the Mitigation Division implemented an expedited flood insurance claims process to get money into the hands of the insured rapidly after Hurricanes Katrina and Rita; the National Flood Insurance Program enrolled its 20,000th community; the Pre Disaster Mitigation Program decreased implementation costs by over 20%, and nearly 40% of the Nation's population has received digital flood hazard maps through Flood Map Modernization.

Previously, Mr. Maurstad served as Regional Director of FEMA's Region VIII beginning in October 2001, where he coordinated FEMA's prevention, preparedness, and disaster response and recovery activities in Colorado, Montana, North and South Dakota, Utah and Wyoming.

Prior to that appointment, Mr. Maurstad was the Lieutenant Governor of Nebraska, a position to which he was elected in 1998. In addition, he had previously served as a member of the Nebraska Unicameral Legislature.

Mr. Maurstad has nearly 25 years of experience as an insurance agent in Nebraska, and was mayor of Beatrice, Nebraska. He is the first locally-elected official and insurance agent to head the National Flood Insurance Program. Mr. Maurstad holds a Bachelor of Science degree in Business Administration and an MBA from the University of Nebraska, Lincoln.

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Americans for Insurance Reform
Center for Insurance Research
Center for Economic Justice
Center for Justice and Democracy
Consumer Federation of America
Consumers Union
Foundation for Taxpayer and Consumer Rights
United Policyholders

Property/Casualty Insurance in 2007: Overpriced Insurance, Underpaid Claims, Declining Losses and Unjustified Profits

January 8, 2007

J. Robert Hunter
Director of Insurance
Consumer Federation of America
1620 I Street, NW; Suite 200
Washington, D.C. 20006
202-387-6121

Americans for Insurance Reform *is a coalition of over 100 public interest groups from around the country working to increase accountability and oversight of insurance industry practices.*

The Center for Economic Justice *(CEJ) is a 501(c)(3) advocacy and education center dedicated to representing the interests of low-income and minority consumers as a class on economic justice issues. CEJ's work focuses on administrative advocacy on insurance, utilities, and credit; the tools necessary for the poor to pull themselves out of poverty.*

The Center for Insurance Research, *based in Cambridge, Massachusetts, provides an independent voice for reform in debates about insurance, banks, financial services companies and related public policy issues around the nation. CIR focuses on national and state issues of insurance and financial services regulation in a range of areas including: mutual conversions, health care, illegal discrimination, insurance accessibility, cost reduction, quality assurance, disclosure, corporate and regulatory accountability.*

Center for Justice & Democracy *is a national consumer organization working to educate the public about the importance of the civil justice system.*

Consumer Federation of America *(CFA) is a non-profit association of 300 consumer groups, with a combined membership of more than 50 million people. CFA was founded in 1968 to advance the consumer's interest through advocacy and education.*

Consumers Union *is a nonprofit membership organization chartered in 1936 under the laws of the State of New York to provide consumers with information, education, and counsel about goods, services, health and personal finance; and to initiate and cooperate with individual and group efforts to maintain and enhance the quality of life for consumers. Consumers Union's income is solely derived form the sale of Consumer Reports, its other publications and services, and from noncommercial contributions, grants, and fees. In addition to reports on Consumers Union's own product testing, Consumer Reports with approximately 5 million paid circulation, regularly carries articles on health, product safety, marketplace economics, and legislative, judicial, and regulatory actions which affect consumer welfare. Consumers Union's publications and services carry no outside advertising and receive no commercial support.*

The Foundation for Taxpayer and Consumer Rights *is a national leader on issues related to insurance, healthcare, energy and political reform. The nonprofit, nonpartisan organization is based in Santa Monica, California.*

United Policyholders *("UP") is a not-for-profit corporation founded in 1991 as an educational resource for the public on insurance issues and insurance consumer rights. UP monitors the insurance sector, works with public officials, has a nationwide network of volunteers and affiliate organizations, publishes written materials, files amicus briefs in cases involving coverage and claim disputes and is a general information clearinghouse on consumer issues related to commercial and personal lines insurance products. UP provides disaster aid to property owners across the U.S. via educational activities designed to illuminate and demystify the claim process.*

THE PERCEPTION CULTIVATED BY INSURERS: PROPERTY CASUALTY INSURANCE IS A HIGH-RISK BUSINESS THAT IS FINANCIALLY THREATENED BY CATASTROPHIC WEATHER AND TERRORIST EVENTS

For policymakers and Americans who do not pay close attention to insurance markets, it would be easy to assume that the property/casualty insurance industry is in financial peril because of the risk inherent in offering insurance in a world where weather events and terrorism attacks seem to be more frequent and more catastrophic. After all, in recent years, insurers have had to pay claims for the losses associated with the September 11th terrorist attacks and several of the most destructive hurricanes in U.S. history.

It is not surprising therefore, that when insurance companies petition Congress for federal assistance in covering terrorism or natural catastrophe losses, Senators and Representatives are often inclined to believe that such assistance may be necessary. When coastal states (including California, in the case of earthquakes) are asked to create risk pools so that insurers have a place to steer higher risk consumers, state regulators and legislators often agree that the industry is not in a financial position to cover such risk. When insurers sharply boost premiums on the coasts, increase deductibles, refuse to renew policies or otherwise cut back coverage, policymakers often accept these steps as necessary to help the property/casualty insurance business meet the huge challenges it faces in a risky world filled with dangers that it cannot adequately measure. Many states have also been compliant when asked by insurers to reduce consumer protections in response to higher risks that insurers claim to face, such as a supposed rush by Americans to settle in coastal areas that are more dangerous. [1]

The perception, then, is that insurance has become an inherently unstable business that generates profits insufficient to compensate for the extraordinarily high risk that insurers face.

THE REALITY: LOW RISK AND UNJUSTIFIABLY HIGH PROFITS

The financial reality of the property/casualty insurance industry couldn't be more different than the carefully cultivated perception fostered by insurers. Insurers are paying out lower claims, charging higher premiums, reaping greater profits, and are more financially solid than at almost any time in history. Moreover, insurers are poised to continue to reap hefty profits for years.

Measuring the Financial Strength of the Property/Casualty Insurance Industry

The financial strength of the insurance industry is typically measured by the size of the

[1] "...The risks keep rising because...people continue to flock to places that are exposed to catastrophe," Edward M. Liddy, Chief Executive Officer of Allstate Insurance, in "The New Deal – Insurers Learn to Pinpoint Risks – and Avoid Them," Los Angeles Times, November 28, 2006.

policyholder surplus ("surplus") that it holds. Surplus is the balance sheet difference between the assets the insurers have and the liabilities insurers maintain. The key measure of solidity most analysts evaluate is the ratio of net premiums written ("net" means net of reinsurance) to surplus. "Premiums written" represents the value of premiums that policyholders pay to insurers. Premiums are a measure of the risk that insurers face, since premiums are made by actuaries as an estimate of the financial exposure, or risk, the insurer faces. Deducting the value of reinsurance from this premium amount reflects the fact that reinsurance diminishes an insurer's exposure. If an insurer makes an error in properly setting premium amounts, the surplus is available to cover the error should the error be on the low side of the actual risk observed as time passes. The ratio of net premiums written to surplus shows the riskiness of the venture. The higher the ratio, the greater the risk of experiencing a loss. For instance, if the insurer had $1,000 of premium and only $10 of surplus (a ratio of 10 to 1), a ten percent error in pricing the risk would bankrupt the insurer. If the insurer has $1,000 of surplus (a 1 to 1 ratio), the error in pricing would have to be equal to 100 percent of the premium to bankrupt the insurer. Regulators have historically frowned upon ratios greater than 3 to 1.

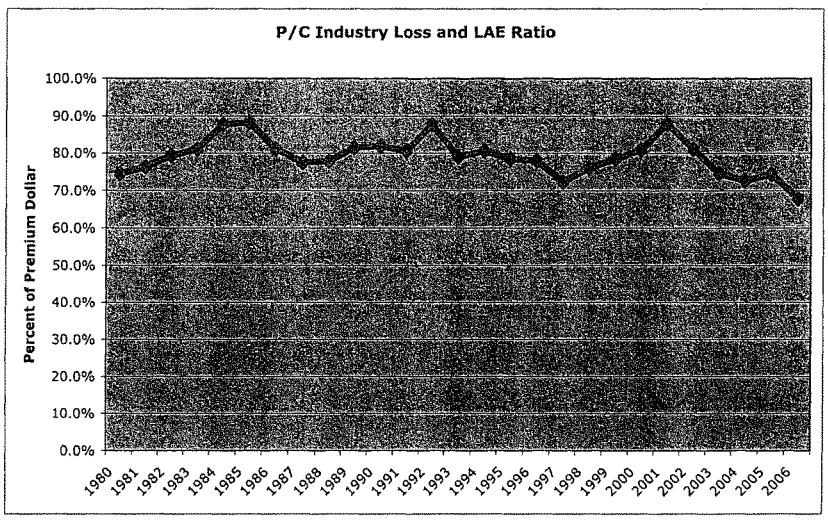
Insurer profits are assessed using several methods. First is the pure loss ratio. This is the percentage of the premium dollar that is or will be paid out to policyholders and other claimants as benefits after an insured event occurs. (Some of these losses remain held in reserve by insurers for future pay out.[2]) Another method of evaluating profitability is the loss and loss adjustment expense (LAE) ratio, which adds the cost of adjusting claims to the ratio. A third measure is the combined ratio, which includes all additional expenses (called "underwriting expenses") such as commissions and overhead to the loss and LAE. This figure shows how profitable the insurance venture was compared to the premiums collected, but excludes investment income that insurer's earn, which is very significant in some lines of insurance. Investment income derives from the investment "float" that is earned between the time premiums are paid to the insurer and when the insurer pays out losses. In some lines of insurance, such as fire insurance, this period is relatively brief, so the investment income earned is relatively small. In other lines, such as medical malpractice, the float exists for long periods of time, so the investment income is large. Profit can also be expressed in dollar terms. The final, overall profit, is called "net income" and includes federal taxes incurred.

Addendum A details 25 years of key profit, loss and surplus data for the property/casualty insurance industry. It reveals how remarkable recent profits are, despite hurricane and terrorist activity. Addendum B cites 20 years of data for the top ten property/casualty insurer groups, including the top stock company results for the first nine months of 2006. The following findings are apparent from this aggregate data:

- A.M Best's estimate of the full year combined ratio in 2006 is 93.3 percent. The Insurance Information Institute (III) estimates this ratio at 94.3 percent.[3] The higher number will be used for the purposes of this analysis. If underwriting expenses

[2] "Incurred losses" include paid losses plus reserves for known claims and even for unknown claims, called "incurred bur not reported" or IBNR reserves. Paid losses only include what was actually paid out. The profit figures discussed in this report are based upon incurred losses, including all reserves.
[3] Earlybird Forecast 2007, Insurance Information Institute, December 21, 2006.

(including policyholder dividends) hold at the 2005 level of 26.0 percent, [4] the loss and LAE ratio for 2006 will be 68.3 percent, the lowest ratio recorded since at least 1980. III itself says that the combined ratio is likely to be the lowest recorded in 51 years.[5] Astonishingly, if the 2005 LAE is observed in 2006, (13.1 percent)[6], the incurred losses would be 55.2 percent of premiums. This means that the property/casualty insurance industry is delivering only 55 percent of the premiums to claimants for every premium dollar paid, a very inefficient delivery of benefits to Americans. The loss and LAE ratio for the last 27 years, with its lowest point in 2006, follows:



- Using the operating ratio and reported results for the first nine-month of 2006,[7] pre-tax operating income is an estimated at $82.8 billion; a record high by a wide margin. The previous high was $47.3 billion in 2005, so the new record will shatter the old by $35.5 billion or 75.1 percent.

- Looking at the individual company data:

  (a) American International Group's loss ratio in 2006 for nine months is 50.9 percent, the lowest since at least 1987. The 1987 to 2004 average ratio was 68.7 percent. The 2006 loss ratio is almost 20 points below the insurer's long-term average. AIG is barely paying out half of the premiums it receives in benefits.

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[4] Aggregates and Averages, A. M. Best and Co., 2006 Edition.
[5] Earlybird Forecast 2007, Insurance Information Institute, December 21, 2006.
[6] Aggregates and Averages, A. M. Best and Co., 2006 Edition.
[7] 2006 – First Nine Month's Results, Insurance Information Institute, December 27, 2006.

(b) Allstate Insurance Group's loss ratio in 2006 for nine months is 43.5 percent, the lowest since at least 1987. This information is shocking given Allstate's moves to non-renew policies for tens of thousands of consumers in coastal states from Maine to Texas, especially in Florida, Mississippi and Louisiana. Allstate has also made very prominent efforts to convince Congress to provide a federal taxpayer subsidy for catastrophe coverage. The 1987 to 2004 average ratio was 66.8 percent. The 2006 loss ratio is more than 20 points below the long-term average. Paying out such a low percentage of premium (43.5 percent) to Allstate policyholders is simply not justifiable.

(c) St. Paul/Traveler's Group's loss ratio in 2006 for nine months is 46.8 percent, the lowest since at least 1987. The 1987 to 2004 average ratio was 65.4 percent. The 2006 loss ratio is almost 20 points below the long-term average.

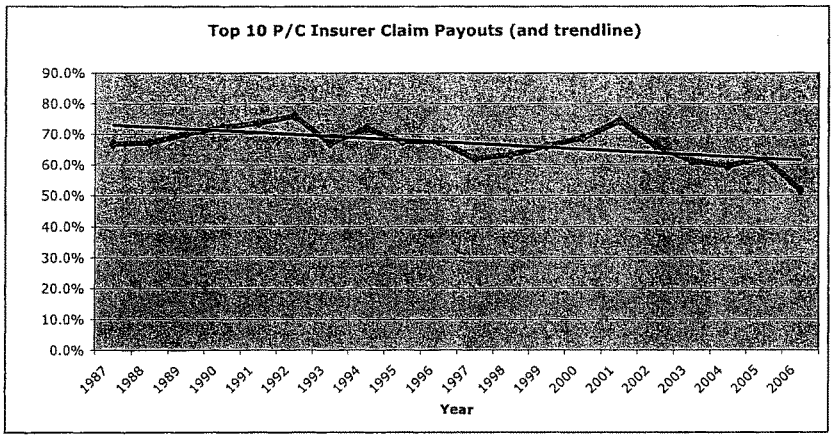
(d) Berkshire Hathaway Insurance Group's loss ratio in 2006 for nine months is 56.1 percent, the lowest since at least 1987. The 1987 to 2004 average ratio was 75.6 percent. The 2006 loss ratio is almost 20 points below the long-term average.

(e) Progressive Insurance Group's loss ratio in 2006 for nine months is 53.1 percent. Since 1987, Progressive had a loss ratio lower than this only once, in 2004 (at 51.9 percent.) The 1987 to 2004 average ratio was 55.8 percent, a meager pay out ratio over such a long period of time indicating that policies are significantly overpriced. The 2006 loss ratio is only 3 points below this extremely low long-term payout average.

(f) Hartford Insurance Group's (Hartford) loss ratio in 2006 for nine months is 53.2 percent, the lowest since at least 1987. The 1987 to 2004 average ratio was 65.0 percent. The 2006 loss ratio is more than 10 points below the long-term average.

By any measure, 2006 profits are excessive. The astonishingly low loss ratios reported above mean that consumers are receiving record low payouts for their premium dollars as insurers reap unprecedented profits. The average loss ratio for nine months of 2006 for the top six stock companies in the top ten-company list (mutuals do not supply quarterly info) is 50.6 percent. Moreover, as is obvious in the below graph, the trend in payouts is sharply down over the last twenty years, a period during most state insurance regulators have allowed consumer protections to erode significantly.[8]

[8] CFA tested this drop in benefits related to premiums to see if it could be attributed to a drop in investment income. Over the time frame studied, there was a three percent drop in investment income. Since insurers typically reflect about half of investment income in prices, CFA believes that the drop in investment income accounts for only 1.5 points of the 15 point drop. That is, investment income explains only about one-tenth of the drop in benefit payouts to consumers per dollar expended in insurance premium.



It is truly inappropriate for property/casualty insurers to be delivering only half of their premium back to policyholders as benefits.[9]

Mutual companies, which do not issue quarterly reports and therefore are not included in the data for 2006 tend to report somewhat higher loss data. The overall loss ratio for the mutual companies is likely to be about 5 percent higher than the stock companies, based on the long-term averages shown on the spreadsheet attached as Addendum B. Thus, the overall average payout should be about 53 percent, the figure used for 2006 in the above graph.

INSURANCE RISK DOES NOT JUSTIFY EXCESSIVE RETURNS

The common wisdom perpetuated by the insurance industry is that primary insurers need high profits to cover losses in a very risky sector of the economy. Insurers also claim that their shareholders should receive greater returns given the investment risk they assume. For example, the Insurance Information Institute says that, "considering the tremendous risk assumed by investors who back major insurance and reinsurance companies, the returns in most years are woefully inadequate," complaining that insurers in 2006 will just about match the 15 percent return on equity of the Fortune 500 "for just the second time in many years."[10] It is possible that reinsurance companies assume higher-than-average industry risk but this is certainly not true for the primary market. In fact, primary insurers have succeeded in eliminating or shifting most of their risk.

[9] Insurers contend that the loss adjustment expense is a benefit to consumers. Obviously, this is a "benefit" that does not go to the consumer or repair cars, doctor bills, etc. But even the loss and LAE ratio itself is at a record low for many decades, at under 70 percent, as shown in the chart in Addendum A.

[10] Earlybird Forecast 2007, Insurance Information Institute, December 21, 2006.

If one owns a property/casualty insurance company stock, one has, with few exceptions, bought into a low-risk business, lower in risk that the market in general. This is shown in ValueLine statistics, which assess the riskiness of particular stocks. One key measure is the stock's Beta, which is the sensitivity of a stock's returns to the returns a particular market index, such as the Standard and Poors 500. A beta between 0 and 1 represents a low-volatility investment, such as most utility stocks. A Beta equal to 1 matches the index, such as the returns yielded by an S&P index fund. A Beta greater than 1 is anything more volatile than average, such as most "small cap" funds.

Another measure of a shareholder's risk is the Financial Safety Index, with a range of 1 to 5, 1 being safest and 5 being least safe; 3 is an average risk.

A third measure is the Stock Price Stability assessment, reported in five percentile intervals with 5 signifying the lowest stability and 100 the highest stability. 50 is average stability.

Consider Allstate. At the same time the company has taken draconian steps to sharply raise premiums and/or cutback coverage for many homeowners in coastal areas , it has presented shareholders with very low risk:[11] Beta = 0.90; Financial Safety = 1, and Stock Price Stability = 95.

ValueLine posts results for 26 property/casualty insurers.[12] The simple averages for these carriers are: Beta = 0.97; Financial Safety = 2.4, and Stock Price Stability = 83.

By all three measures, property/casualty insurance stocks are of below-average risk, safer than buying an S&P 500 index fund. Therefore, long-term below-average returns for insurers should be expected given the low-risk nature of this investment. The low returns demonstrate that the capital market is performing efficiently by awarding below-average returns to a below-average risk industry.

Another measure of how property/casualty insurers have insulated themselves from risk is the extraordinary profits they have earned in recent years. In 2004, insurers posted their largest dollar net (after tax) profit in history ($40.5 billion) despite the fact that four major hurricanes caused significant damage in Florida. Insurers achieved another record of $48.8 billion in 2005, despite the unprecedented losses caused by hurricanes Katrina, Rita, and Wilma. 2006 profits are the highest yet because of low hurricane activity, excessive rates, the use of programs to systematically keep payments to policyholders low and other reasons discussed in this White Paper.

In 2007, the industry is on target for an approximately 20 percent return on policyholder

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[11] ValueLine, December 22, 2006 edition.

[12] The stocks are ACE Ltd., Alleghany Corp., Allstate Corp., American Financial Group, W.R. Berkley Corp., Berkshire Hathaway, Inc., CAN Financial, Chubb Corp., Cincinnati Financial, Everest Re Group, HCC Insurance, Hanover Insurance Group, Markel Corp., Mercury General, Ohio Casualty Corp., Old Republic International Corp., PMI Group, Inc., Partner Re, Ltd., Progressive Corp., PLI Corp., Safeco Corp., St. Paul/Travelers Group, Selective Insurance, Transatlantic Holdings, 21st Century Insurance Group and XL Group, Ltd.

surplus, not the 15 percent predicted by some in the industry. A.M. Best reported three quarters net income of $50.4 billion plus unrealized capital gains of $12.9 billion for a total of $63.3 billion -- which translates to about $84 billion for a full year. Policyholder surplus for 2006 was $423.1 billion at the beginning of the year, a return on equity of 20 percent.[13]

This aggregate data actually understates industry-wide returns on equity for several reasons:

1. Industry aggregate data includes information from mutual companies like State Farm with massive capitalization. As a non-public mutual company, State Farm has no need to achieve a target return on equity as it must only satisfy policyholders, not shareholders. State Farm had 7.6 percent of industry net income, compared to 11.9 percent of industry surplus. In other words, State Farm has much more capital than a typical insurer, dragging down apparent industry-wide earnings because of its massive capital base. If data on State Farm's return on equity is removed, the industry-wide average increases by more than half a percent.

2. Publicly traded insurers have achieved returns on equity in 2005 and 2006 that are much greater than the "Fortune 500" average. For example, Allstate reported a return on equity of 23 percent for the year ending on September 30, 2006. Progressive reported a nine month return on equity of 24.3 percent on mean surplus.

3. The property/casualty insurance industry is tremendously overcapitalized. It is bringing in too much capital to warrant a higher return on equity. The excess capital is evidenced not only by the low industry-wide premium-to-surplus-ratio mentioned below, but also by the premium-to-surplus ratios of the most profitable insurers. For example, Allstate and Progressive not only have premium-to-surplus ratios much greater than the industry average, but are also buying back their own stock because they have too much capital to reasonably or profitably deploy. In October of 2006, Allstate announced a new $3 billion share repurchase plan starting in 2007 that will "compliment" the $12.8 billion program that was completed at the end of 2006.[14] The fact that Allstate still has a stock buyback program in place at the same time it is sharply reducing or eliminating coverage because it says it is financially threatened by the risk of future weather catastrophes is stunning.

   Similarly, Progressive announced that it was buying back 1.1 million shares in April 2006. A representative of the investment firm Bear Sterns stated that the share repurchase was necessary because "both management and the board are working to address the company's significant excess capital position."[15] In August, Safeco announced a $1.4 billion repurchase for almost 20 percent of its outstanding shares.[16]

4. The industry method for calculating return on equity, as reported by A.M. Best,

[13] A.M. Best Special Report, October 2006.
[14] "Allstate Posts Solid Earnings," National Underwriter Magazine, October 19, 2006.
[15] "Progressive Announces Stock Split, Dividend," National Underwriter Magazine, April 24, 2006.
[16] "Safeco Increases Share Repurchase, Increases Dividend," National Underwriter Magazine, August 24, 2006.

underestimates the actual return. Insurer income is divided by the mean (i.e., average) amount of capital that insurers had available throughout the course of the year, rather than the amount of capital on hand at the beginning of the year. As the industry sharply increases its revenue throughout the year, more income flows into surplus. The use of this calculation method increases the amount of capital used to determine return on equity and appears to reduce the estimated return. If the return on equity were calculated using the amount of capital available at the beginning of a year, the return would be much higher.[17] Allstate's return on equity for the year that ended September 30, 2006 would be 25 percent rather that 23 percent if starting capital were used.

5. Proof that the investing in insurance companies represents a below-average risk is also found in the market action of the property casualty insurers stocks. Since June 17, 2002, the date S&P started to track insurance stocks, S&P 500 stocks have increased by 43 percent through year-end 2006, while the S&P Insurance Index[18], weighted down with life insurance stocks, increased only 33 percent. During that time, however, the value of Allstate's stock rose by 65 percent and Progressive's by 62 percent. The simple average increase of the property/casualty insurance company stocks in the S&P Insurance Index was 48 percent over that period, slightly higher than the S&P 500 and more proof that the property/casualty insurance industry overall does just fine with returns on equity less than that of the S&P 500.

INSURERS HAVE REMOVED OR SHIFTED RISK THROUGH LEGITIMATE AND ILLIGITIMATE MEANS

First, insurers have made intelligent use of reinsurance, securitization and other risk spreading techniques. Securitization doubled in 2006. One very innovative development that some insurers have pioneered to spread risk is to issue securities that couple the threat of a catastrophic event with the purchase of construction stocks that would likely increase in value if a catastrophic event occurs and the demand for construction increases. The use of this kind of creative approach to diversify risk is wise.

Second, after Hurricane Andrew, insurers changed ratemaking techniques by using computer models to project either 1,000 or 10,000 years of weather experience. While this caused huge price increases to consumers at the time, consumer leaders supported this change because insurers appeared to be genuinely surprised by the level of damage caused by Hurricane Andrew and promised that the models would bring long-term stability to prices. The model contained projections of periods of intense activity and very large hurricanes, as well as periods of little or no activity, and based rates on these estimates.

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[17] For example, if one invested $100 in a one-year certificate of deposit with a 10 percent interest rate, one would earn $10 in interest and have $110 in principal at the end of the year. However, if one calculated return on equity in the manner that the industry does, the same $10 in interest would represent only 9.5 percent interest ($100+$110)/2) or $10/$105.

[18] The index is made up of AFLAC, Allstate, AIG, Hartford, Jefferson Pilot, Lincoln National, Lowes, MBIA, MetaLife, NFIC, Progressive, Safeco, St. Paul/Travelers, Torchmark and UNUM.

However, Risk Management Solutions (RMS) and the other modeling companies have recently stopped using this scientific method to project storms over a 1,000 or 10,000-year period and are now using 1 to 5-year projections. This has caused at least a 40 percent jump in loss projections in Florida and the Gulf Coast and a 25 percent jump in the Northeast. This move reneges on promises made by insurers in the mid-1990s and will lead to rates that are excessive.

In fact, insurance rates on the coasts have soared for property risks, homes and businesses in the last year. At hearings held in Florida last year, home and business owners provided information about rate increases of ten-fold or more that they have been forced to pay, particularly by Citizen's Insurance Company, the state insurer-of-last-resort that has become the largest insurer in Florida.[19] The number of homes insured by Citizen's grew from 407,387 in December 2005 to 854,892 in October 2006.[20] A similar situation exists in Louisiana and other Gulf Coast states.

Third, insurers have sharply hollowed out the catastrophe coverage offered to consumers in recent years by placing a number of new requirements in policies:

- Deductibles of 2 to 5 percent have been imposed with little fanfare or notice. This reduction in coverage was accompanied in many cases by large rate increases.

- Caps on replacement costs. State Farm, for instance, caps payments for increased rebuilding costs at 20 percent. Other insurers allow no increased payments at all. A consumer who buys a $100,000 policy would receive only $100,000 to rebuild, even if the cost of repairs skyrockets after a storm due to increased demand for materials and labor. Costs can also increase when homeowners are required to make special repairs to comply with building codes that were enacted after a home was first constructed. For example, many municipalities require such code upgrades to comply with the National Flood Insurance Program if a home is more than 50 percent damaged by a flood. Given the surge in demand for home building and repair that occurs in the wake of a hurricane, and corresponding increases in prices, these changes significantly shift risk and costs to consumers.

- "Anti-concurrent-causation" clauses. This is the most draconian reduction of all that insurers have attempted to impose in recent years. It removes all coverage for wind damage if another, non-covered event (usually a flood) also occurs, regardless of the timing of the events. Under this anti-consumer measure, if a hurricane of 125-miles-per-hour rips a house apart but hours later a storm surge floods the property, the consumer would receive no reimbursement for wind losses incurred.

Given the cutbacks in coverage that have occurred in coastal areas, there is a serious question as to whether this diminished coverage is worth the even higher price that many consumers must pay. However, most consumers have no option but to purchase such coverage as it is required by lenders or law or both. Demand for insurance is relatively inelastic.

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[19] By law, the rates that Citizen's requires must be at least ten percent above those charged in the "voluntary" market.

[20] "An Overview of Florida's Insurance Market Trends," Florida Office of Insurance Regulation, 2006.

As cited above, insurers have claimed that they are facing higher risks because of a sharp increase in the number of people and amount of construction in areas of the country vulnerable to earthquake and hurricane disasters. This claim was investigated in 2006 by the Los Angeles Times investigated reporter Perter Gosselin, who wrote that:

> ...Key statistics don't support the argument....Census figures...show that the population of coastal and earthquake counties grew at an annual average rate of 1.56 percent between 1980 and last year. But they show that the U.S population grew at a reasonably close pace of 1.24 percent.

Gosselin interviewd Judith T. Kildow, director of the government-funded National Ocean Economics Program at California State University at Monterey, who said, "You simply cannot make the case from the numbers that America's coastal counties have grown at a disproportionately faster rate than the country as a whole over the last 25 years."[21]

Fourth, insurers have also shifted risk, sometimes onto taxpayers who subsidize state-run insurers-of-last resort, by non-renewing tens of thousands of homeowner and business properties. Allstate, the leading exemplar after Hurricane Andrew, is emerging once again as the company that has been most aggressive in refusing to renew homeowner's policies in the wake of Hurricane Katrina. After Hurricane Andrew, Allstate threatened to non-renew 300,000 South Floridians, leading the State of Florida to place a moratorium on such precipitous actions. Today, Allstate is non-renewing thousands of homeowners even on Long Island, New York and Cape Cod, Massachusetts. It has also announced that it will offer no new homeowner's policies in many states, from Connecticut to Delaware and has refused to write new business in large portions of other states, such as Maryland and Virginia. Other insurers have also cut back coverage on the nation's coasts (See Addendum C, for more information).

Insurers have become quite adept at convincing government to use tax dollars to help them avoid risk. Consider the federal Terrorism Risk Insurance Act (TRIA), the California Earthquake Authority, Citizen's Insurance in Florida, and wind "pools" in a number of other states. As stated above, the state pools have become the largest writers of insurance in some states. Such an arrangement allows insurers to "cherry-pick" these states, keeping the safest risks for themselves and shifting the highest risks onto the taxpayers of the state, thereby socializing high-risk, potentially unprofitable policies and privatizing the low risk, profitable business. This adverse result for policyholders and taxpayers is hardly surprising. It is akin to "solving" the health insurance crisis by requiring states to cover sick or terminally ill consumers, while the private sector writes coverage for young and healthy consumers. Allstate is also leading efforts at the federal level to create a taxpayer-backed program modeled on TRIA to reinsure the private market against the perils of wind and other weather damage.

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[21] "The New Deal – Insurers Learn to Pinpoint Risks – and Avoid Them," Peter Gosselin, Los Angeles Times, November 28, 2006.

INSURERS HAVE EASILY HANDLED RISK AND ARE OVERCAPITALIZED

In determining whether the property/casualty insurance industry is adequately capitalized, one must first examine the losses incurred for major catastrophe or terrorism events. According to the Insurance Information Institute, the top ten insured loss disasters for property were:

EVENT[22]	PRE-TAX DOLLAR LOSS	POST TAX DOLLAR LOSS
1. Hurricane Katrina, August 2005	$40.6 billion	$26.4 billion
2. Hurricane Andrew, August 1992	15.5	10.1
3. World Trade Center, Pentagon terrorist attacks, September 2001	18.8	12.2
4. Northridge, California earthquake, January 1994	12.5	8.1
5. Hurricane Wilma, October 2005	10.3	6.7
6. Hurricane Charley, August 2004	7.5	4.9
7. Hurricane Ivan, September 2004	7.1	4.6
8. Hurricane Hugo, September 1989	4.2	2.7
9. Hurricane Rita, September 2005	5.6	3.6
10.Hurricane Frances, September 2004	4.6	3.0

Source: Insurance Services Office (ISO); Insurance Information Institute. (Ranked on constant dollar cost to insurers)

Considering that property/casualty insurers now have surplus in excess of $600 billion, catastrophes of this size are very easy to manage.

Terrorism risk is an interesting case study. While insurers are rightly concerned about a huge event, such as a nuclear, chemical or biological attack, the actual terrorism events that have occurred so far have been easily managed by private industry. There were hundreds of terrorism events in America in the 20 years leading up to the September 11th attacks. In spite of this fact, insurers did not even bother to charge a separate price for terrorism coverage in their rating structures. September 11th changed this practice, but even that attack was a "small" insured event compared to the industry's mammoth capital and surplus, which has grown significantly since 2001. Yet, insurers convinced the federal government to provide free reinsurance that CFA estimates has represented about a seven-billion taxpayer subsidy to date.

Historically, the prime test for the solidity of the property/casualty insurance industry has been the ratio of net premiums written (NPW) to surplus, discussed above. Regulators became concerned about the financial soundness of an insurer if its ratio exceeded 3 to 1. The so-called "Kenney Rule," named after financial writer Roger Kenney, was that a safe insurer should not exceed about a 2 to 1 ratio. This guideline was introduced in the 1960s and served as the standard that insurers and regulators followed for many decades. More recently, analysts have recommended lowering the acceptable ratio to about 1.5 to 1, in recognition of some more

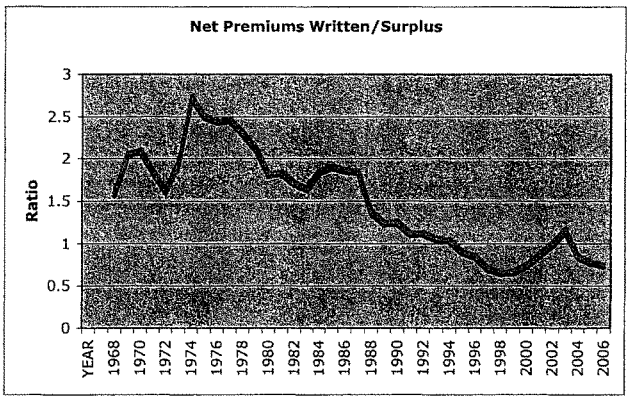
[22] The catastrophes were ranked by III based on size of loss in 2005 dollars, which we do not display here. What is displayed is the actual dollars in the year of the event. We calculate the post-tax figure by deducting the corporate tax rate of 35 percent.

extreme risks that insurers now face, such as catastrophic hurricanes and terrorist attacks. Net premium written to surplus ratios for almost thirty years are as follows:

YEAR	NPW/SURPLUS RATIO
1968	1.59
1969	2.07
1970	2.10
1971	1.85
1972	1.63
1973	1.97
1974	2.74
1975	2.52
1976	2.46
1977	2.47
1978	2.31
1979	2.13
1980	1.83
1981	1.85
1982	1.72
1983	1.66
1984	1.86
1985	1.92
1986	1.88
1987	1.86
1988	1.39
1989	1.25
1990	1.26
1991	1.13
1992	1.14
1993	1.08
1994	1.05
1995	0.91
1996	0.86
1997	0.72
1998	0.67
1999	0.68
2000	0.76
2001	0.88
2002	1.01
2003	1.17
2004	0.86
2005	0.79
2006	0.73

Source: Best's Aggregates and Averages, 1988/2006 Editions, Page 399. 2006 Estimated at 2.8 percent premium growth, Surplus up by estimated profit of $55B.

Property/casualty insurers have not exceeded the recommended 1.5 to 1 ratio of NPW to surplus in almost twenty years. The sharp downward trend in this key leverage ratio is very clear, demonstrating that the industry is now significantly overcapitalized. Here is a graphic display of these data:



MANY INSURERS NOW USE PROGRAMS DESIGNED TO SYSTEMATICALLY UNDERPAY CONSUMER CLAIMS

Insurers have also reduced their payouts and maximized their profits by turning their claims operations into "profit centers" by using computer programs and other techniques designed to routinely underpay policyholder claims. For instance, many insurers are using programs such as "Colossus," sold by Computer Sciences Corporation (CSC.)[23] CSC sales literature touted Colossus as 'the most powerful cost savings tool" and also suggested that the program will immediately reduce the size of bodily injury claims by up to 20 percent. As reported in a recent book, "...any insurer who buys a license to use Colossus is able to calibrate the amount of 'savings' it wants Colossus to generate...If Colossus does not generate sufficient 'savings' to meet the insurer's needs or goals, the insurer simply goes back and 'adjusts' the benchmark values until Colossus produces the desired results."[24] In a settlement of a class-action lawsuit, Farmers Insurance Company has agreed to stop using Colossus on uninsured and underinsured motorist claims where a duty of good faith is required and has agreed to pay class members cash benefits.[25] Other lawsuits have been filed against most of America's leading insurers for the use of these computerized claims settlement products.[26]

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[23] Other programs are also available that promise similar savings to insurers, such as ISO's "Claims Outcome Advisor."

[24] "From Good Hands to Boxing Gloves – How Allstate Changed Casualty Insurance in America," Trial Guides, 2006, Berardinelli, Freeman and DeShaw, pages 131, 133, 135.

[25] Bad Faith Class Actions, Whitten, Reggie, PowerPoint Presentation, November 9, 2006.

[26] Ibid.

Programs like Colossus are designed to systematically underpay policyholders without adequately examining the validity of each individual claim. The use of these programs severs the promise of good faith that insurers owe to their policyholders. Any increase in profits that results cannot be considered to be legitimate. Moreover, the introduction of these systems could explain part of the decline in benefits that policyholders have been receiving as a percentage of premiums paid in recent years.

CONCLUSION AND POLICY SOLUTIONS

The property/casualty industry has been remarkably successful in recent years in maximizing profit through rate increases, coverage reductions, inappropriate claims practices and the shifting of high risks onto taxpayers. As a result, insurers are underpaying losses as a percentage of premiums. In fact, insurers have significantly abdicated their corporate purpose as risk takers and sentinels for safety.

Proposed Policy Solution 1. States should strengthen weakened regulatory systems to gain control of excessive rates, inadequate coverage and claims abuses. CFA has proposed a comprehensive set of principals and standards for states to use to increase the consumer protections that they offer. (See Addendum D.)

In the near future, states should move to block RMS and other modelers from using short-term projections and require them to go back to the long-term projections they promised to use when these models were introduced in the mid-1990s. State regulators should also undertake research on the fairness of insurance rates similar to that done by California on home insurance and by the New York City Comptroller on auto insurance.

Coastal states should consider uniting to develop a coastal weather modeling system of their own, perhaps starting with the model developed by Florida State University. This model should be used to test the accuracy of projections developed by private modelers and to evaluate insurer rate requests to determine if they are excessive, inadequate or unfairly discriminatory.

If any insurer fails to market a line of insurance that it is selling elsewhere in all or part of a state, regulators should also consider convening hearings to determine if the insurer's license should be revoked for geographic discrimination, in not making insurance available to all or some of citizens of the state. Insurers should be required to fully document their actions in such cases by demonstrating, for example, why all residents of the state or a particular region do not qualify for insurance that is being sold elsewhere. Absent such a proceeding, it is very hard for regulators and the public to understand or accept as valid, for example, why an insurer would stop writing homeowner's insurance in an entire state where only some of the residents live along the coast.

CFA will be releasing comprehensive reports later this year on the severe problems that consumers face under the largely deregulated state system of insurance regulation, as well as an analysis of how state oversight has failed in recent years and what can be done to fix it.

Proposed Policy Solution 2. To solve the mounting coastal insurance crisis, policymakers should consider whether increasing rates, decreasing coverage and the turmoil created by large number of periodic non-renewals have gotten to the point where private insurers should not be offering catastrophe coverage at all.

For example, CFA and Americans for Insurance Reform have proposed creating a state fund in Florida to cover all wind risk in the state.[27] Such a program could save Florida taxpayers at least $3 billion a year through the more efficient delivery of insurance, the ability to build reserves tax-free and non-profit status. CFA estimates that overhead costs and profits would decline from about 45 percent of premium to only about 10 percent, a 35-point advantage. Further, the ability to build tax-free reserves would save the state the 35 percent corporate tax charge on the amounts of money earned by insurers from the wind premiums that remain at year-end. Such a plan should be directed by private insurance carriers determined through a competitive bidding process. The risk of large losses during the transition to a self-funded state plan should be borne by insurers if necessary, by assessing all property-casualty insurers for all lines in Florida during the period of time in which adequate reserves are built up. If wind coverage by itself is too narrow a base upon which to make such a program work, states should consider using the entire homeowners' insurance line. An interstate compact would allow a number of states to develop this sort of arrangement to cover homeowners' wind risk along the entire coast.

Such an approach would allow private insurers to sharply lower their rates as wind coverage is removed from their policies. In fact, insurers would have virtually no excuses for unjustifiably increasing rates or reducing coverage in the future as the market would be considerably more stable.

Proposed Policy Solution 3. Congress should authorize states to use interstate compacts to create multi-state risk pools to cover wind risk. Such legislation should allow states to permit the accumulation of tax-free reserves if the funds collected are kept for the purpose of paying claims after wind disasters strike. Congress could also authorize some funding to help create these coastal pools. The federal government could also help fund the efforts by the states to development a computer weather risk model.

Proposed Policy Solution 4. Some experts have stated that federal policies may discourage the development of securities to cover catastrophic events. The federal government should undertake a study of federal laws and rules to ensure that securitization of risk is encouraged, not discouraged, by federal requirements, particularly tax policy. Aggressively pursing efforts to foster increased securitization of catastrophe risk is a far more favorable option for consumers and taxpayers than insurer efforts to provide more taxpayer subsidies.

[27] Other organizations releasing this report have not taken a position on this proposal.

CONSUMER TIPS

1. If possible, don't do business with a company that has a history of anti-consumer behavior. When purchasing or renewing a homeowner's policy, consumers can contact their state insurance departments to get information on companies in their areas that have sharply raised rates and cut back in coverage in recent years.

2. Carefully review policies at purchase or renewal to determine whether high out-of-pocket costs will be imposed. Consumers should look for special deductibles for wind damage, anti-concurrent causation clauses, limits on replacement costs, and other restrictions on coverage. Consumers should also determine whether the insurer will pay for any costs incurred if they are required to elevate their homes or make changes mandated by local building codes. Ask questions and get answers in writing before signing.

3. Consumers who live away from coastal areas should actively shop for better coverage and rates. Because insurance companies are overcapitalized, they are looking for new business in lower risk areas. Rate decreases and better coverage are possible.

4. Demand thorough oversight of insurer actions by state regulators. If consumers have a problem with rates or coverage, they should file an immediate complaint in writing with their state insurance agency and follow up for a response. Consumers should also contact insurance regulators to find out what they are doing to require that rates are fair and reasonable and that insurers are not unjustifiably withdrawing coverage.

Addendum A: Profits, Losses, Surplus for All Property/Casualty Insurers

YEAR	LOSS & LAE RATIO	POLICYHOLDERS SURPLUS	PRETAX OPERATING INCOME	GROSS NATIONAL PRODUCT	PHS as a % of GNP	YEAR	SORTED BY LOSS & LAE RATIO
1980	74.9%		$7.7	$2,945		2006	68.3%
1981	76.8%		$7.0	$3,234		1997	72.8%
1982	79.8%	$75.7	$4.6	$3,349	2.26%	2004	73.1%
1983	81.5%	$81.8	$2.7	$3,730	2.19%	2005	74.8%
1984	88.2%	$78.9	-$4.0	$4,070	1.94%	1980	74.9%
1985	88.7%	$93.1	-$5.6	$4,349	2.14%	2003	75.1%
1986	81.6%	$116.1	$5.4	$4,558	2.55%	1998	76.5%
1987	77.9%	$128.5	$13.8	$4,907	2.62%	1981	76.8%
1988	78.3%	$145.7	$15.9	$5,278	2.76%	1987	77.9%
1989	82.0%	$166.4	$10.4	$5,616	2.96%	1988	78.3%
1990	82.3%	$172.5	$11.2	$5,899	2.92%	1996	78.4%
1991	81.1%	$197.2	$13.8	$6,128	3.22%	1995	78.9%
1992	88.1%	$200.5	-$2.5	$6,513	3.08%	1999	78.9%
1993	79.5%	$224.8	$14.6	$6,822	3.30%	1993	79.5%
1994	81.1%	$237.8	$11.6	$7,257	3.28%	1982	79.8%
1995	78.9%	$284.7	$19.5	$7,560	3.77%	1991	81.1%
1996	78.4%	$311.9	$20.8	$8,036	3.88%	1994	81.1%
1997	72.8%	$384.1	$35.5	$8,500	4.52%	2000	81.4%
1998	76.5%	$423.4	$23.4	$8,971	4.72%	1983	81.5%
1999	78.9%	$428.1	$15.3	$9,558	4.48%	1986	81.6%
2000	81.4%	$400.2	$10.5	$10,008	4.00%	2002	81.6%
2001	88.4%	$374.4	-$12.8	$10,301	3.63%	1989	82.0%
2002	81.6%	$376.0	$8.4	$10,641	3.53%	1990	82.3%
2003	75.1%	$353.8	$35.5	$11,297	3.13%	1992	88.1%
2004	73.1%	$508.7	$45.4	$11,999	4.24%	1984	88.2%
2005	74.8%	$551.0	$47.3	$12,743	4.32%	2001	88.4%
2006	68.3%	$606.7	$82.8	$13,339	4.55%	1985	88.7%

Dollar figures in billions. Pretax Operating Income excludes some investment income.

Source: 2005 and earlier data from Best's Aggregates and Averages, 2006 Edition and earlier editions.

2006 data based upon an estimated 94.3% combined ratio (III Earlybird Forcast, December 21,2006)

26.0% expense and dividend ratio based on 2005 results

Surplus includes State Funds after 1997. Other figures calculated as nine month data * 4/3 to annualize.

GNP Data from US Dept. of Commerce/Bureau of Economic Affairs /2006 through September.

Addendum B: Profits, Losses, Surplus for Top 10 Property/Casualty Insurers

YEAR	INDUSTRY NET INCOME	Number 1 State Farm Loss Ratio	Number 2 AIG Loss Ratio	Number 3 Allstate Loss Ratio	Number 4 St Paul/Trav Loss Ratio	Number 5 Berk Hath Loss Ratio	Number 6 Nationwide Loss Ratio	Number 7 Progressive Loss Ratio
1987	$10.0	66.4%	71.6%	70.9%	64.1%	64.9%	72.7%	48.8%
1988	$12.3	70.6%	69.1%	71.0%	62.8%	66.2%	70.2%	52.1%
1989	$7.2	78.8%	67.7%	72.9%	65.6%	69.2%	72.7%	53.6%
1990	$8.0	77.4%	64.8%	75.2%	64.6%	93.8%	73.1%	48.9%
1991	$8.9	72.1%	68.9%	73.2%	65.2%	112.6%	69.6%	50.4%
1992	-$2.7	83.6%	71.0%	87.2%	74.9%	91.9%	73.6%	55.4%
1993	$10.5	70.4%	69.8%	68.3%	63.6%	70.4%	65.7%	52.9%
1994	$10.9	77.5%	69.9%	75.5%	64.1%	91.5%	66.3%	54.8%
1995	$20.6	70.8%	64.5%	66.8%	61.4%	67.9%	74.1%	61.8%
1996	$24.4	67.5%	66.6%	64.6%	69.2%	66.7%	71.2%	59.5%
1997	$36.8	60.4%	66.5%	58.2%	60.7%	62.5%	61.4%	57.7%
1998	$30.8	65.6%	68.0%	54.4%	64.9%	62.0%	64.8%	55.2%
1999	$22.0	67.8%	68.5%	59.6%	60.2%	77.7%	66.5%	62.3%
2000	$20.5	74.8%	65.3%	62.4%	61.8%	78.0%	73.5%	69.6%
2001	-$6.7	83.4%	71.9%	65.7%	74.9%	98.9%	68.4%	59.3%
2002	$9.1	74.7%	74.2%	62.8%	80.4%	69.0%	59.6%	57.4%
2003	$31.2	63.3%	64.3%	58.4%	60.0%	56.4%	58.2%	54.1%
2004	$40.5	60.2%	70.0%	57.0%	65.1%	58.6%	59.3%	51.9%
2005	$48.8	66.6%	72.2%	64.6%	60.0%	77.5%	58.0%	54.9%
2006	$59.9	NA	50.9%	43.5%	46.8%	56.1%	NA	53.1%
	87-05average	0.71152632	0.68673684	0.66773684	0.65447368	0.75563158	0.67310526	0.55821053

Source: Best's Aggregates and Averages, 1988 to 2006 Editions

Notes: Net Income is after tax and includes all investment income. 2006 estimated at 4/3* 9-months results from ISO.
Top ten 2006 P/C groups are displayed
Loss Ratio is pure losses incurred to be paid to consumers, not LAE
St. Paul and Travelers data is combined in the years before 2004.
Dollars in billions
2004 data for AIG estimated based upon Loss and LAE ratio of 77.6%.
2006 data: From published reports on insurer web sites - Mutual Insurers do not report quarterly
AIG 9 mos Loss and LAE = 64.1% less 2005 LAE Ratio of 13.2%
Allstate 9 mos Loss and LAE = 57.8% less 2005 LAE Ratio of 14.3%
St. Paul Travelers 9 mos Loss and LAE = 59.9% less 2005 LAE Ratio of 13.1%
Berkshire Hathaway 9 mos Loss and LAE = 56.8% (estimated) less 2005 LAE Ratio of 9.5%
Progressive 9 mos Loss and LAE = 66.3% less 2005 LAE Ratio of 13.2%
Hartford 9 mos Loss and LAE = 64.2% less 2005 LAE Ratio of 11.0%
2006 Data for 10 companies conservatively assumed based upon the data from 6 stock companies

Addendum B: Profits, Losses, Surplus for Top 10 Property/Casualty Insurers -- Continued

Number 8 Liberty Mut Loss Ratio	Number 9 Farmers Loss Ratio	Number 10 Hartford Loss Ratio	YEAR	Simple Loss Ratio Top 10 L/R	10 Company 5 yr moving Average	10 Company 3 yr moving Average	Average L/R Top 6 Stock Cos	6 Stock Co 5 yr moving Average	YEAR
82.7%	67.9%	63.2%	1987	67.3%			63.9%		1987
83.1%	68.9%	63.4%	1988	67.7%			64.1%		1988
85.8%	74.5%	65.5%	1989	70.6%		68.6%	65.8%		1989
84.3%	75.6%	68.9%	1990	72.7%		70.3%	69.4%		1990
83.9%	75.5%	69.2%	1991	74.1%	70.5%	72.5%	73.3%	67.3%	1991
85.2%	73.6%	67.4%	1992	76.4%	72.3%	74.4%	74.6%	69.4%	1992
82.2%	68.2%	63.3%	1993	67.5%	72.2%	72.6%	64.7%	69.5%	1993
73.5%	85.7%	64.8%	1994	72.4%	72.6%	72.1%	70.1%	70.4%	1994
72.9%	75.2%	65.9%	1995	68.1%	71.7%	69.3%	64.7%	69.5%	1995
72.3%	65.6%	78.3%	1996	68.2%	70.5%	69.5%	67.5%	68.3%	1996
72.6%	62.0%	62.3%	1997	62.4%	67.7%	66.2%	61.3%	65.7%	1997
75.5%	64.9%	61.6%	1998	63.7%	67.0%	64.8%	61.0%	64.9%	1998
73.4%	68.5%	61.8%	1999	66.6%	65.8%	64.3%	65.0%	63.9%	1999
74.8%	72.4%	60.0%	2000	69.3%	66.0%	66.5%	66.2%	64.2%	2000
85.2%	74.7%	66.1%	2001	74.9%	67.4%	70.2%	72.8%	65.3%	2001
68.1%	62.4%	60.1%	2002	66.9%	68.3%	70.3%	67.3%	66.5%	2002
64.0%	59.0%	79.9%	2003	61.8%	67.9%	67.8%	62.2%	66.7%	2003
63.9%	56.8%	58.2%	2004	60.1%	66.6%	62.9%	60.1%	65.7%	2004
60.9%	56.9%	56.0%	2005	62.8%	65.3%	61.5%	64.2%	65.3%	2005
NA	NA	53.2%	2006	52.0%	60.7%	58.3%	50.6%	60.9%	2006
0.76015789	0.68857895	0.65047368							

Addendum C: Reprinted from The Los Angeles Times, November 28, 2006

Insurance company cutbacks have left more than 1 million coastal residents scrambling to land new insurers or learning to live with weakened policies. As insurers retreat, states and homeowners are left to bear the biggest risks.

Massachusetts

During the last two years, six insurers have stopped selling or renewing policies along the coast, especially on Cape Cod, leaving 45,000 homeowners to look for coverage elsewhere. Most have turned to the state-created insurer of last resort. The Massachusetts FAIR Plan, now the state's largest homeowners insurer, recently received permission to raise rates 12.4 percent.

Connecticut

Atty. Gen. Richard Blumenthal has subpoenaed nine insurance companies to explain why they are requiring thousands of policyholders whose houses are near any water —coast, river or lake —to install storm shutters within 45 days or have their coverage cut or canceled.

New York

Allstate has refused to renew 30,000 policies in New York City and Long Island, and suggested it may make further cuts. Other insurers, including Nationwide and MetLife, have raised to as much as 5 percent of a home's value the amount policyholders must pay before insurance kicks in, or say they will write no new policies in coastal areas.

South Carolina

Agents say most insurers have stopped selling hurricane coverage along the coast. Those that still do have raised their rates by as much as 100 percent. The state-created fallback insurer is expected to more than double its business from 21,000 policies last year to more than 50,000.

Florida

Allstate has offloaded 120,000 homeowners to a start-up insurer and has said it will drop more as policies come up for renewal. State-created Citizens Property, now the state's largest homeowners insurer with 1.2 million policies, was forced to use tax dollars and issue bonds to plug a $1.6- billion financial hole due to hurricane claims. The second-largest, Poe Financial Group, went bankrupt this summer, leaving 300,000 to find coverage elsewhere. The state also has separate funds to sell insurers below-market reinsurance and cover businesses. Controversy over insurance was a major issue in this fall's election campaign, causing fissures in the dominant GOP.

Louisiana

The state's largest residential insurer, State Farm, will no longer offer wind and hail coverage as part of homeowners policies in southern Louisiana. In areas where it still covers these dangers, it will require homeowners to pay up to 5 percent of losses themselves before insurance kicks in. In a move state regulators call illegal and are fighting, Allstate is seeking to transfer wind and hail coverage for 30,000 of its existing customers to the statecreated Citizens Insurance.

Texas

Allstate and five smaller insurers have canceled hurricane coverage for about 100,000 homeowners and have said they will write no new policies in coastal areas. Texas' largest insurer, State Farm, is seeking to raise its rates by more than 50 percent along the coast and 20 percent statewide.

California

The state has bucked the trend toward higher homeowners insurance rates with three major insurers, State Farm, Hartford and USAA, seeking rate reductions of 11 percent to 22 percent. Regulators have begun to question whether insurers are making excessive profits after finding that major companies spent only 41 cents of every premium dollar paying claims and related expenses. Alone among major firms, Allstate is seeking a 12.2 percent rate hike.

Washington

Allstate has dropped earthquake coverage for about 40,000 customers and will have its agents offer the quake insurance of another company when selling homeowners policies in the state. Nationally, the company has canceled quake coverage for more than 400,000.

Sources: Risk Management Solutions (map); interviews with state insurance regulators

NOTE: Since the Los Angeles Times ran this recap of actions on the coasts, Allstate has announced it will stop writing new homeowner's insurance policies in many areas near the coast, including the entire state of Connecticut, the entire state of Delaware, and large portions of Maryland and Virginia. In California, several additional insurers have announced that they will be reducing rates. Regulators have begun to question whether insurers are making excessive profits after finding that major carriers have spent only 41 cents of every premium dollar paying claims and related expenses. Alone among major companies, Allstate is seeking a 12.2 percent rate hike, although the state insurance commissioner has suggested that the company may be required to lower rates and issue refunds for past overcharges instead. Regulators in California have more authority to question rates than in other states under Proposition 103, the voter-approved regulation system.

Addendum D: Consumer Principles and Standards for Insurance Regulation

1. **Consumers should have access to timely and meaningful information of the costs, terms, risks and benefits of insurance policies.**

- Meaningful disclosure prior to sale tailored for particular policies and written at the education level of average consumer sufficient to educate and enable consumers to assess particular policy and its value should be required for all insurance; should be standardized by line to facilitate comparison shopping; should include comparative prices, terms, conditions, limitations, exclusions, loss ratio expected, commissions/fees and information on seller (service and solvency); should address non-English speaking or ESL populations.
- Insurance departments should identify, based on inquiries and market conduct exams, populations that may need directed education efforts, e.g., seniors, low-income, low education.
- Disclosure should be made appropriate for medium in which product is sold, e.g., in person, by telephone, on-line.
- Loss ratios should be disclosed in such a way that consumers can compare them for similar policies in the market, e.g., a scale based on insurer filings developed by insurance regulators or independent third party.
- Non-term life insurance policies, e.g., those that build cash values, should include rate of return disclosure. This would provide consumers with a tool, analogous to the APR required in loan contracts, with which they could compare competing cash value policies. It would also help them in deciding whether to buy cash value policies.
- Free look period with meaningful state guidelines to assess appropriateness of policy and value based on standards the state creates from data for similar policies.
- Comparative data on insurers' complaint records, length of time to settle claims by size of claim, solvency information, and coverage ratings (e.g., policies should be ranked based on actuarial value so a consumer knows if comparing apples to apples) should be available to the public.
- Significant changes at renewal must be clearly presented as warnings to consumers, e.g., changes in deductibles for wind loss.
- Information on claims policy and filing process should be readily available to all consumers and included in policy information.
- Sellers should determine and consumers should be informed of whether insurance coverage replaces or supplements already existing coverage to protect against over-insuring, e.g., life and credit.
- Consumer Bill of Rights, tailored for each line, should accompany every policy.
- Consumer feedback to the insurance department should be sought after every transaction (e.g., after policy sale, renewal, termination, claim denial). Insurer should give consumer notice of feedback procedure at end of transaction, e.g., form on-line or toll-free telephone number.

2. Insurance policies should be designed to promote competition, facilitate comparison-shopping and provide meaningful and needed protection against loss.

- Disclosure requirements above apply here as well and should be included in design of policy and in the policy form approval process.
- Policies must be transparent and standardized so that true price competition can prevail. Components of the insurance policy must be clear to the consumer, e.g., the actual current and future cost, including commissions and penalties.
- Suitability or appropriateness rules should be in place and strictly enforced, particularly for investment/cash value policies. Companies must have clear standards for determining suitability and compliance mechanism. For example, sellers of variable life insurers are required to find that the sales that their representatives make are suitable for the buyers. Such a requirement should apply to all life insurance policies, particularly when replacement of a policy is at issue.
- "Junk" policies, including those that do not meet a minimum loss ratio, should be identified and prohibited. Low-value policies should be clearly identified and subject to a set of strictly enforced standards that ensure minimum value for consumers.
- Where policies are subject to reverse competition, special protections are needed against tie-ins, overpricing, e.g., action to limit credit insurance rates.

3. All consumers should have access to adequate coverage and not be subject to unfair discrimination.

- Where coverage is mandated by the state or required as part of another transaction/purchase by the private market, e.g., mortgage, regulatory intervention is appropriate to assure reasonable affordability and guarantee availability.
- Market reforms in the area of health insurance should include guaranteed issue and community rating and where needed, subsidies to assure health care is affordable for all.
- Information sufficient to allow public determination of unfair discrimination must be available. Zip code data, rating classifications and underwriting guidelines, for example, should be reported to regulatory authority for review and made public.
- Regulatory entities should conduct ongoing, aggressive market conduct reviews to assess whether unfair discrimination is present and to punish and remedy it if found, e.g., redlining reviews (analysis of market shares by census tracts or zip codes, analysis of questionable rating criteria such as credit rating), reviews of pricing methods, reviews of all forms of underwriting instructions, including oral instructions to producers.
- Insurance companies should be required to invest in communities and market and sell policies to prevent or remedy availability problems in communities.
- Clear anti-discrimination standards must be enforced so that underwriting and pricing are not unfairly discriminatory. Prohibited criteria should include race, national origin, gender, marital status, sexual preference, income, language, religion, credit history, domestic violence, and, as feasible, age and disabilities. Underwriting and rating classes should be demonstrably related to risk and backed by a public, credible statistical analysis that proves the risk-related result.

4. All consumers should reap the benefits of technological changes in the marketplace that decrease prices and promote efficiency and convenience.

- Rules should be in place to protect against redlining and other forms of unfair discrimination via certain technologies, e.g., if companies only offer better rates, etc. online.
- Regulators should take steps to certify that online sellers of insurance are genuine, licensed entities and tailor consumer protection, UTPA, etc. to the technology to ensure consumers are protected to the same degree regardless of how and where they purchase policies.
- Regulators should develop rules/principles for e-commerce (or use those developed for other financial firms if appropriate and applicable)
- In order to keep pace with changes and determine whether any specific regulatory action is needed, regulators should assess whether and to what extent technological changes are decreasing costs and what, if any, harm or benefits accrue to consumers.
- A regulatory entity, on its own or through delegation to independent third party, should become the portal through which consumers go to find acceptable sites on the web. The standards for linking to acceptable insurer sites via the entity and the records of the insurers should be public; the sites should be verified/reviewed frequently and the data from the reviews also made public.

5. Consumers should have control over whether their personal information is shared with affiliates or third parties.

- Personal financial information should not be disclosed for other than the purpose for which it is given unless the consumer provides prior written or other form of verifiable consent.
- Consumers should have access to the information held by the insurance company to make sure it is timely, accurate and complete. They should be periodically notified how they can obtain such information and how to correct errors.
- Consumers should not be denied policies or services because they refuse to share information (unless information needed to complete transaction).
- Consumers should have meaningful and timely notice of the company's privacy policy and their rights and how the company plans to use, collect and or disclose information about the consumer.
- Insurance companies should have clear set of standards for maintaining security of information and have methods to ensure compliance.
- Health information is particularly sensitive and, in addition to a strong opt-in, requires particularly tight control and use only by persons who need to see the information for the purpose for which the consumer has agreed to sharing of the data.
- Protections should not be denied to beneficiaries and claimants because a policy is purchased by a commercial entity rather than by an individual (e.g., a worker should get privacy protection under workers' compensation).

6. **Consumers should have access to a meaningful redress mechanism when they suffer losses from fraud, deceptive practices or other violations; wrongdoers should be held accountable directly to consumers.**

- Aggrieved consumers must have the ability to hold insurers directly accountable for losses suffered due to their actions. UTPAs should provide private cause of action.
- Alternative Dispute Resolution clauses should be permitted and enforceable in consumer insurance contracts only if the ADR process is: 1) contractually mandated with non-binding results, 2) at the option of the insured/beneficiary with binding results, or 3) at the option of the insured/beneficiary with non-binding results.
- Bad faith causes of action must be available to consumers.
- When regulators engage in settlements on behalf of consumers, there should be an external, consumer advisory committee or other mechanism to assess fairness of settlement and any redress mechanism developed should be independent, fair and neutral decision-maker.
- Private attorney general provisions should be included in insurance laws.
- There should be an independent agency that has as its mission to investigate and enforce deceptive and fraudulent practices by insurers, e.g., the reauthorization of FTC.

7. **Consumers should enjoy a regulatory structure that is accountable to the public, promotes competition, remedies market failures and abusive practices, preserves the financial soundness of the industry and protects policyholders' funds, and is responsive to the needs of consumers.**

- Insurance regulators must have clear mission statement that includes as a primary goal the protection of consumers:
- The mission statement must declare basic fundamentals by line of insurance (such as whether the state relies on rate regulation or competition for pricing). Whichever approach is used, the statement must explain how it is accomplished. For instance, if competition is used, the state must post the review of competition (e.g., market shares, concentration by zone, etc.) to show that the market for the line is workably competitive, apply anti-trust laws, allow groups to form for the sole purpose of buying insurance, allow rebates so agents will compete, assure that price information is available from an independent source, etc. If regulation is used, the process must be described, including access to proposed rates and other proposals for the public, intervention opportunities, etc.
- Consumer bills of rights should be crafted for each line of insurance and consumers should have easily accessible information about their rights.
- Insurance departments should support strong patient bill of rights.
- Focus on online monitoring and certification to protect against fraudulent companies.
- A department or division within regulatory body should be established for education and outreach to consumers, including providing:
- Interactive websites to collect from and disseminate information to consumers, including information about complaints, complaint ratios and consumer rights with regard to policies and claims.
- Access to information sources should be user friendly.
- Counseling services to assist consumers, e.g., with health insurance purchases, claims, etc. where needed should be established.

- Consumers should have access to a national, publicly available database on complaints against companies/sellers, i.e., the NAIC database.
- To promote efficiency, centralized electronic filing and use of centralized filing data for information on rates for organizations making rate information available to consumers, e.g., help develop the information brokering business.
- Regulatory system should be subject to sunshine laws that require all regulatory actions to take place in public unless clearly warranted and specified criteria apply. Any insurer claim of trade secret status of data supplied to regulatory entity must be subject to judicial review with burden of proof on insurer.
- Strong conflict of interest, code of ethics and anti-revolving door statutes are essential to protect the public.
- Election of insurance commissioners must be accompanied by a prohibition against industry financial support in such elections.
- Adequate and enforceable standards for training and education of sellers should be in place.
- The regulatory role should in no way, directly or indirectly, be delegated to the industry or its organizations.
- The guaranty fund system should be prefunded, national fund that protects policyholders against loss due to insolvency. It is recognized that a phase-in program is essential to implement this recommendation.
- Solvency regulation/investment rules should promote a safe and sound insurance system and protect policyholder funds, e.g., rapid response to insolvency to protect against loss of assets/value.
- Laws and regulations should be up to date with and applicable to e-commerce.
- Antitrust laws should apply to the industry.
- A priority for insurance regulators should be to coordinate with other financial regulators to ensure consumer protection laws are in place and adequately enforced regardless of corporate structure or ownership of insurance entity. Insurance regulators should err on side of providing consumer protection even if regulatory jurisdiction is at issue. This should be stated mission/goal of recent changes brought about by GLB law.
- Obtain information/complaints about insurance sellers from other agencies and include in databases.
- A national system of "Consumer Alerts" should be established by the regulators, e.g., companies directed to inform consumers of significant trends of abuse such as race-based rates or life insurance churning.
- Market conduct exams should have standards that ensure compliance with consumer protection laws and be responsive to consumer complaints; exam standards should include agent licensing, training and sales/replacement activity; companies should be held responsible for training agents and monitoring agents with ultimate review/authority with regulator. Market conduct standards should be part of an accreditation process.
- The regulatory structure must ensure accountability to the public it serves. For example, if consumers in state X have been harmed by an entity that is regulated by state Y, consumers would not be able to hold their regulators/legislators accountable to their needs and interests. To help ensure accountability, a national consumer advocate office with the ability to represent consumers before each insurance department is needed when national approaches to insurance regulation or "one-stop" approval processes are implemented.

- Insurance regulator should have standards in place to ensure mergers and acquisitions by insurance companies of other insurers or financial firms, or changes in status of insurance companies (e.g., demutualization, non-profit to for-profit), meet the needs of consumers and communities.
- Penalties for violations must be updated to ensure they serve as incentives against violating consumer protections and should be indexed to inflation.

8. Consumers should be adequately represented in the regulatory process.

- Consumers should have representation before regulatory entities that is independent, external to regulatory structure and should be empowered to represent consumers before any administrative or legislative bodies. To the extent that there is national treatment of companies or "one-stop" (OS) approval, there must be a national consumer advocate's office created to represent the consumers of all states before the national treatment state, the OS state or any other approving entity.
- Insurance departments should support public counsel or other external, independent consumer representation mechanisms before legislative, regulatory and NAIC bodies.
- Regulatory entities should have well-established structure for ongoing dialogue with and meaningful input from consumers in the state, e.g., consumer advisory committee. This is particularly true to ensure needs of certain populations in state and needs of changing technology are met.

From: HOME SYS-MASSMAIL
Sent: Tuesday, February 27, 2007 8:43 AM
Subject: Upcoming House Subcommittee Hearings

1. February 27, 2007

TO: Great Lakes Zone Employees

FROM: _____, Senior Vice President

SUBJECT: I: Upcoming House Subcommittee Hearings

On Wednesday, February 28, the House Financial Services Subcommittee on Oversight and Investigations will begin **hearings** to examine the insurance industry's response to Hurricane Katrina.

U.S. Representative Gene Taylor of Mississippi and Mississippi Attorney General Jim Hood are scheduled to provide testimony. As vocal critics of State Farm, their testimony will not accurately represent State Farm or our response to Katrina. Robert Hartwig, President of the Insurance Information Institute, will testify on behalf of the insurance industry.

No one from State Farm, nor any other insurance carrier, has been invited to testify. However, we will make every effort to respond and tell our story as appropriate.

Also that day, U.S. District Judge L.T. Senter will hold several **hearings** on the company's proposed settlement in Mississippi.

We anticipate increased media coverage as a result, and realize people you come into contact with may have questions. To help you respond, we will post the latest information on the **Keeping the Promise in the Gulf Coast** intranet site.

An article in this weekend's **New York Times** as well as three editorials from the Wall Street Journal (**Robin Hoods**, **Steal Magnolia**, **Senator Lott Floods the Zone**) and a piece from the **Chicago Tribune** have provided supportive commentary leading up to this week's events.

Thank you for your exemplary and continued dedication to our customers in the wake of these large-scale media events.

The New York Times – Front Page of Business Day
(B1 – top left, above the fold)

February 24, 2007
TALKING BUSINESS
A Contract Is a Contract, Right?
By JOE NOCERA

So what would you do if you ran State Farm's Mississippi operation?

Here is what you have been facing. A year and a half has passed since Hurricane Katrina. Although overshadowed by New Orleans, the Mississippi coast was hit hard, with tens of thousands of homes destroyed, resulting in 485,913 claims statewide. You are the largest home insurer in the state. Over 84,700 of those claims have come from your customers.

You think you've handled the disaster well. Didn't you rush 4,000 claims agents into the areas hit by Katrina? Haven't you settled all but a small percentage of claims? Haven't you paid around $1 billion in just the six Mississippi counties closest to the gulf?

And yet, instead of praise, you have become the object of scorn and anger. And, this being Mississippi, lawsuits. Not even three weeks after Katrina — three weeks, for crying out loud! — the state attorney general, Jim Hood, filed suit against you and four other insurers, and opened a criminal investigation.

Then the plaintiffs' bar started circling, led by the most famous and feared lawyer in the land, Richard F. Scruggs, who, unfortunately for you, happens to be a Mississippian who lost a beachfront home in the storm. Among his clients are Senator Trent Lott (his brother-in-law) and Representative Gene Taylor, both Katrina victims who were insured by State Farm. Not merely content to sue you, they have been making noises in Washington about the need to get tough on the insurance companies.

These last months have been nightmarish. At one key trial, the judge decided to find you liable without even sending the case to a jury — and then stuck you with $1 million in punitive damages. He has also made rulings that put you, in the words of Martin F. Grace, a professor of risk management at Georgia State University, "between a rock and a hard place." Meanwhile, the local newspaper, The Sun Herald, has been hammering you on a regular basis. The attorney general keeps upping the rhetoric. A pair of whistle-blowing sisters took documents and leaked them to Mr. Scruggs. Although they were forced to return the documents, Mr. Scruggs has been able to characterize them in ways that make you look greedier than an Enron executive. The two sisters are now consultants for Mr. Scruggs.

The judge, L. T. Senter Jr., would clearly like to get this all resolved, and so would you. So a few weeks ago, you settled Mr. Scruggs' s 639 cases for $79 million. And in an effort to placate both Mr. Scruggs and Mr. Hood — and ward off another giant round of lawsuits — you agreed to allow 35,000 claims that had been closed to be reopened. In return, Mr. Hood agreed to shut his investigation and lawsuit. But the judge said he had reservations about the settlement and asked for more information. It just never ends.

So I ask again: what would you do? Here is what State Farm did. It announced that the environment in Mississippi had become so untenable that the company was going to stop writing new home insurance policies in the state. "We don't want to turn our back on the state," said Mike Fernandez, State Farm's vice president for public affairs. "But it was a business decision we had to make, reluctantly." Well, maybe. Or maybe State Farm just couldn't take it anymore.

"This is not my first rodeo," said George Dale, who has been the insurance commissioner of Mississippi for 32 years. When Hurricane Camille hit in 1969, he continued, he was an assistant principal of a school he had to keep open so it could serve as a shelter for people who lost their homes.

"The issue after that storm is exactly the same as it is today," he said. "If the wind came before the water, you had coverage. And if you had water before wind, you didn't."

What Mr. Dale means is this: homeowner insurance policies in this country do not cover flood damage. But they do cover wind damage. Most policies also have something called an anti-concurrent clause, which essentially says that if any of the damage is caused by "an excluded peril"— i.e., a flood — then the insurer does not have to pay off the claim, even though some of the damage might well be a result of wind.

There is something absurd about having to distinguish between wind damage and water damage. A destroyed house, no matter what the cause, is a tragedy, and people expect their insurance companies will come to their rescue. Why else would they have insurance? But insurance companies are not charities; they don't want to pay for something they don't cover. Yet when they say no, people understandably become upset.

Insurance companies do not cover floods for a reason: it would be prohibitively expensive. Instead, the federal government stepped in long ago and offered federal flood insurance, but only up to $250,000. Alas, at the time of Hurricane Katrina, only 16 percent of Mississippians had federal flood insurance, which is par for the course: most people, even in coastal areas, do not buy federal flood insurance. And even if they do, the insurance doesn't necessarily cover the cost of rebuilding a waterfront home. So after a big hurricane, especially in coastal areas subject to giant storm surges, it really does become a matter of deciding whether a house was destroyed by wind or by water.

Which is also why it is easy to see how this kind of dispute is ripe for litigation. In plenty of cases, it is easy enough to tell whether the damage has been caused by wind or water. But many of the houses on the coast were completely flattened: "slab cases" they are called, because all that remained was the slab. These are the cases that have caused much of the trouble.
State Farm contends that the most likely result of a slab case is that the house was overwhelmed by the storm surge, and therefore flooding was the cause. And the homeowners — and Mr. Scruggs and Mr. Hood — contend that the winds were so high that day that the homes were likely to have been flattened by wind before the storm surge arrived.

"There are cases where we were able to document some wind damage, and we paid something on those claims," Mr. Fernandez said. "But there were a number of cases where there was no specific evidence other than the comment of the insured saying he

believed there was wind damage. That's where you get on the slippery slope." He added: "This is not easy stuff. We are talking about people's lives."

I am actually making the situation sound saner than it is. And indeed, if all there was to the story were reasonable people contesting water versus wind, it would be sane. In general, that is how things have played out in Louisiana and Alabama, which don't have the same kind of litigious environment as Mississippi does.

That does not mean it is not tragic for those whose houses were destroyed by flood in those states, nor does it mean that there isn't something seriously wrong with an insurance system that forces these kind of water-wind distinctions. What it does mean is that the people in those two states aren't trying to abrogate the terms of the contract they've signed with their insurers. It is hard to see how an economy can function if contracts are not upheld.

But in Mississippi, the insurance contract has been largely tossed aside by the power of litigation — and the belief that the insurance companies, especially State Farm, should pay up no matter what the cause of the damage. Not that anyone is about to characterize it that way. Instead, they say they are merely trying to get State Farm to live up to the terms of its contract. But they have also worked to demonize the company until it is ready to throw up its hands and settle anything and everything, just to be done with it.

Mr. Hood's tactic has been to press on with his criminal investigation. "They are the worst actors down here," he told me, and went on to complain that the company had ruthlessly turned down wind claims using the anti-concurrent clause as its basis. He added that his investigation was focusing on "fraudulent denial of claims," which of course State Farm vehemently denies.

Mr. Scruggs, for his part, tried at first to persuade Judge Senter to toss out the standard flood exclusion. Although that tactic failed, the judge eventually began making rulings that gave Mr. Scruggs the upper hand. The judge has essentially ruled that the onus is on the insurance companies to prove water damage in slab cases, and if they can't prove it, they have to pay the claim. In effect, he tossed out the anti-concurrent clause, without ever quite saying so.

Mr. Scruggs has also raised the possibility that the company has tried to ensure that its engineering reports stress flood damage, while ignoring reports that were weighted toward wind damage. "They tried to create a pretense of scientific support for the claims by retaining engineering firms" that were captive to the company, Mr. Scruggs told me. "If the slab was caused by wind, a buzzer would go off that said, 'wrong answer!' " he added.

This strikes me as highly unlikely, and the handful of documents I saw that supposedly backed up these allegations looked pretty thin. What is far more likely is that State Farm, no matter how much it denies it, was tougher than its competitors about not paying claims where flood was the primary cause. And for that reason it has become Public Enemy No. 1 in Mississippi. It has also played hardball in court, which hasn't helped its image. (Late this week, it filed a motion asking Judge Senter to recuse himself from one of the big cases, on the ground that two of his employees are in disputes with insurance companies.)

Here's the real problem with situations like this one. Litigation can sometimes be useful as a tool to punish companies that have genuinely done wrong. Who would argue that the banks that aided the Enron fraud shouldn't have been sued?

But what appears to be happening here is something increasingly common in this litigation-mad society. Lawsuits, and the threat of lawsuits, are being used to get to a result that people want — even if it is not the result they originally agreed to. "This is not the first time we've had a huge social problem that requires a lot of money to fix — and the bill is being handed to the insurance industry," said Randy J. Maniloff, a lawyer with White & Williams who writes a blog on insurance issues.
Given the way things are playing out in Mississippi, it won't be the last time either.

Statement for the Record of
The Mortgage Bankers Association

Before the
Subcommittee on Oversight and Investigations
Committee on Financial Services
United States House of Representatives

Hearing on "Insurance Claims Payment Processes in the Gulf Coast after the 2005 Hurricanes"

Wednesday, February 28, 2007, 2:00 PM

Introduction
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.

The Mortgage Bankers Association (MBA)[1] represents both the residential and commercial real estate finance industries. Currently there is $9.84 trillion of residential mortgage debt outstanding and $2.845 trillion in commercial/multifamily debt outstanding. This debt finances the vast majority of single family homes, apartment complexes, office, retail and industrial buildings that house the families and businesses that are the engines for the nation's vibrant and diverse economy. Circumstances that would undermine the residential and commercial real estate finance market, such as the lack of insurance for natural catastrophes, would not only impact the residential and commercial real estate finance sectors, these impacts would ripple through the economy as buildings and homes became more difficult and costly to finance and purchase.

Typical commercial mortgages are made on an 80 percent loan to value ratio, which means that at the time of loan origination 80 percent of the property value is reflected in the mortgage held by the lender and the remaining 20 percent is owner's equity. Commercial real estate lending is typically non-recourse, meaning that in the case of a mortgage default the lender can only look to the underlying value of the property to recover its mortgage balance, not the assets of the owner. Because most commercial real estate lending is non-recourse, lenders have an acute interest in preserving and protecting asset value. In order to protect their interest in their commercial real estate assets, lenders place paramount importance on requiring and verifying that uninterrupted insurance coverage is in place for the life of the loan.

While residential lenders do have recourse against borrowers (depending on state law), the reality is that most borrowers are insolvent when the loan reaches foreclosure. As a result, the lender's only true means of recovering the debt is through the property.

Natural Disaster Catastrophic Insurance Market Conditions
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

[1] The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 500,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 3,000 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web site: www.mortgagebankers.org.

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, which has put a tremendous strain on state-operated insurance pools that serve as the insurer of last resort in these areas.

The distressed insurance market for natural disaster insurance has led to an insurance availability and/or affordability crisis in some states. Residential and commercial property owners have been saddled with alarming insurance price increases in hurricane prone 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 and detailed further in the accompanying MBA White Paper entitled *Natural Disaster Catastrophic Insurance – The Commercial Real Estate Finance Perspective* are the prevailing insurance market conditions that have created the insurance availability and/or affordability crisis in some parts of the country, including the Gulf Coast region.

- **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 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 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.

Residential and Commercial Natural Catastrophe Insurance Issues
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 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 percent 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, insurance company non-renewals of commercial and multifamily properties in hurricane-prone areas have been common.

- 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 cause 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 existing 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; and

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

Conclusion

We greatly appreciate the opportunity to provide our perspective on natural disaster catastrophic insurance to the Subcommittee. Through the hearing process, the Subcommittee is actively exploring solutions to the natural catastrophe insurance availability and or affordability crisis that is characteristic of hurricane prone areas inside and outside of the Gulf Coast. MBA stands ready to work with the Subcommittee to answer any questions that you might have regarding the real estate finance perspective on natural disaster catastrophic insurance issues.

Mortgage Bankers Association
White Paper

Natural Disaster Catastrophic Insurance

The Commercial Real Estate Finance Perspective

MORTGAGE BANKERS ASSOCIATION®
Investing in communities

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White Paper

Natural Disaster Catastrophic Insurance

The Commercial Real Estate Finance Perspective

MORTGAGE BANKERS ASSOCIATION®
Investing in communities

INTRODUCTION

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 purpose of this White Paper is to provide the information needed to develop a comprehensive understanding of the market forces shaping and influencing the catastrophic insurance market. This White Paper is intended to answer the following questions:

1. Have the recent natural catastrophes imperiled the insurance industry?
2. What are the types of natural disasters and what parts of the country do they impact?
3. Does the current regulatory framework impact the delivery of catastrophic insurance?
4. What are the categories of insurers and how do they operate?
5. Are current catastrophic insurance price spikes likely to remain?
6. What role does the reinsurance industry play in the availability and affordability of catastrophic insurance?
7. What are the impacts of the hard market (difficult or costly to obtain insurance) catastrophic insurance market conditions on borrowers, servicers, rating agencies, and CMBS investors?

REPORT ORGANIZATION

In order to answer these questions, this White Paper is divided into six sections.

1. **Catastrophic Events –** This section examines how catastrophic events are defined and provides a summary of the categories of natural disaster catastrophic events.

2. **Insurance Industry Structure** – This section examines the size and scope of the insurance industry and discusses the categories of insurance lines as well as insurance delivery business models.

3. **Insurance Industry Regulatory Framework –** This section examines how the various categories of insurers are regulated at the state and federal levels.

4. **Insurer Categories** – This section discusses the different categories of insurers and how they work together to provide a comprehensive insurance program.

5. **Impact of Hard Market for Catastrophic Insurance Conditions –** This section examines impact of difficult market conditions for the placement of property insurance on the various stakeholders in the commercial real estate transaction including borrowers, lenders, servicers, rating agencies, and investors.

6. **Summary of Findings –** Summary of key report findings.

CATASTROPHIC EVENTS

Defining a Catastrophic Event

In the insurance industry, a catastrophic event is narrowly defined as an event that results in insured losses of $25 million or more. This term was created by the Insurance Services Office Limited (ISO), which is a leading supplier of insurance loss data and standard policy language. In 1997, ISO increased the event size from $5 million to $25 million in order to be classified as catastrophic. This is the universally accepted definition by the insurance industry.

Exhibit 1 shows the categories of catastrophic events and their respective percentage of total catastrophic losses from 1985 through 2005 on an inflation-adjusted basis. Over this period, hurricanes and tropical storms accounted for 43.7 percent of total catastrophic losses. This percentage nearly doubles the nearest category, wind/thunderstorms, with 23.3 percent of total catastrophic losses. This category is comprised of heavy thunderstorms, tornados and hail storms. When combined, these two categories total 67.0 percent of all catastrophic losses, which indicates that wind related losses have been the dominant cause of catastrophic events. Also in this timeframe, 94.4 percent of all catastrophic events were attributed to natural disasters, as opposed to man-made disasters.

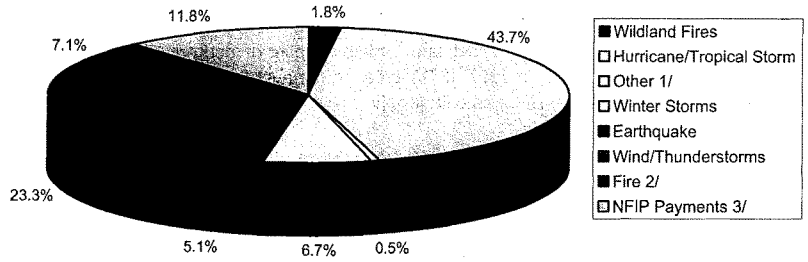
The scope of this White Paper is limited to an examination of catastrophic events caused by natural disasters. **Catastrophic events from terrorist attacks will not be examined.** Throughout the document, "catastrophic" and "catastrophe" will refer to natural disasters with losses of $25 million and over.

Drivers of Catastrophic Risk

Intuitively and in fact, the primary drivers for catastrophic risk are proximity to an area that is at risk for a natural disaster and the frequency in which the natural disaster is expected to occur. The concentration of property in catastrophic risk areas dictates the potential severity of damage. Take, for example, hurricanes -- the greater the concentration of property along hurricane-prone coastal areas, the greater the potential damage. For individual structures, the construction type and building materials play an important role in the loss severity. Exhibit 2 shows the coastal counties along the Gulf Coast and Eastern Seaboard. These counties are classified as coastal counties because their close proximity to the ocean makes them highly susceptible to damage caused by hurricanes or tropical storms.

Exhibit 3 shows the property concentrations within these coastal counties. Not all coastal counties have ocean frontage. For Gulf Coast and Eastern Seaboard states, 37.8 percent of their total property value is concentrated in coastal counties. For the nation, 16.5 percent of total property value is concentrated in coastal counties along the Gulf

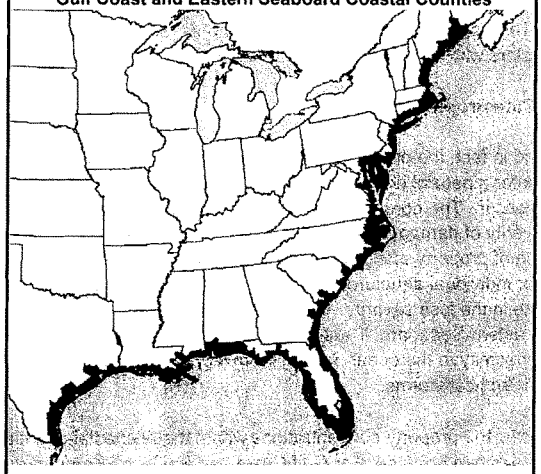
Exhibit 1
Inflation Adjusted
Catastrophic Insurance Losses
1985-2005



1/ Includes: riot, utility disruption and flood not covered by the National Flood Insurance Program.
2/ 96.2 percent of all Fire losses occurred during 2001, which includes the attacks of September 11.
3/ Percent is for total NFIP loss payments, not all losses may have occurred because of a catastrophic event.

Source: ISO, US Department of Homeland Security, Federal Emergency Management Administration

Exhibit 2
Gulf Coast and Eastern Seaboard Coastal Counties



Source: AIR International Corporation

Exhibit 3
Concentration of Real Estate
Gulf Coast and Eastern Seaboard

State	Total Coastal County Property Value	Total Property Value	Percent Coastal
Alabama	75.9	631.3	12.0%
Connecticut	404.9	641.3	63.1%
Delaware	46.4	140.1	33.1%
Florida	1,937.4	2,443.5	79.3%
Georgia	73.0	1,235.7	5.9%
Louisiana	209.3	551.7	37.9%
Maine	117.2	202.4	57.9%
Maryland	12.1	853.6	1.4%
Massachusetts	662.4	1,223.0	54.2%
Mississippi	44.7	331.4	13.5%
New Hampshire	45.6	196.0	23.3%
New Jersey	505.8	1,504.8	33.6%
New York	1,901.6	3,123.6	60.9%
North Carolina	105.3	1,189.3	8.9%
Rhode Island	43.8	156.6	28.0%
South Carolina	148.8	581.2	25.6%
Texas	740.0	2,895.3	25.6%
Virginia	129.7	1,140.2	11.4%
All Above States	7,203.7	19,041.1	37.8%
All Above States as Percent of Total U.S.	7,203.7	43,665.6	16.5%

Source: AIR Worldwide Corporation

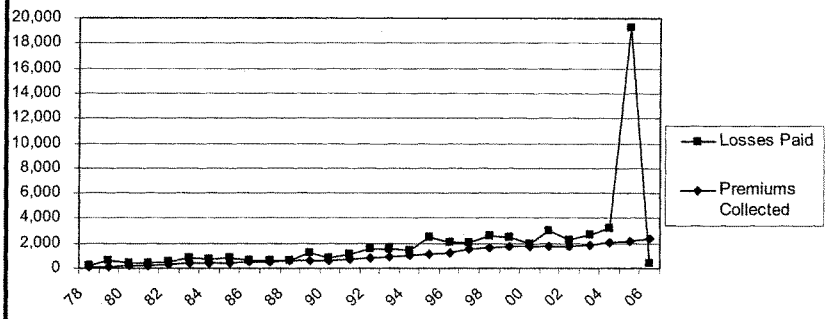
Coast and eastern seaboard. This represents a significant property concentration in hurricane-prone areas. Finally, if the frequency and or severity of catastrophic events are forecast to increase, the potential damage also increases. These are some of the factors that insurance companies take into consideration when underwriting and pricing insurance. Loss mitigation factors such as wind resistant construction are also factored into the pricing of insurance.

Flood

Flood related catastrophes are primarily insured by the National Flood Insurance Program (NFIP) and by excess flood insurance purchased from the private sector. The United States Congress established the NFIP with the passage of the National Flood Insurance Act of 1968. The NFIP is a federal program enabling property owners in participating communities to purchase insurance protection against flood losses in exchange for state and community floodplain management regulations that reduce future

flood damage. Flood risk is somewhat different from the other catastrophic risk categories in that it is not exclusive to certain geographic regions. Instead, flood risk is dictated by the location of a property within an established floodplain. Exhibit 4 shows the loss payments made by the NFIP from 1978 to mid-year 2006 and does not include losses paid by private insurers. The flooding caused by Hurricanes Katrina, Wilma and Rita are reflected in the severe spike in NFIP payments for 2005.

Exhibit 4
NFIP Premiums Collected and Losses Paid
1978 - 2006 1/
($Millions)



1/2006 data as of 6/30/06

Source: US Department of Homeland Security, Federal Emergency Management Administration.

Hurricane

In the *Defining a Catastrophic Risk* section, hurricanes were identified as the leading cause for catastrophic insurance losses. In fact, over the 1985 to 2005 timeframe, hurricane and tropical storm losses totaled $109.8 billion.[1] However, 72.6 percent of these losses occurred during 2004 and 2005, which offers further testament to the severity of the most recent hurricane experience. These loss numbers demonstrate the consequences of locating high intensity land uses along hurricane-prone coastal areas. Risk modeling firms have adjusted their risk models to reflect the increased frequency of

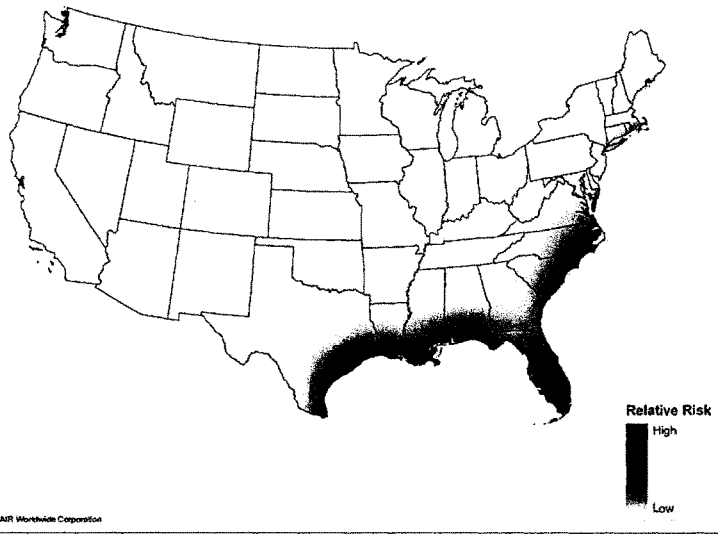
[1] ISO data provided on inflation adjusted basis. MBA used CPI to adjust numbers to actual dollars. All catastrophic loss data in this section, unless otherwise sourced, was provided by ISO.

hurricanes and the increased damage severity due to the growing concentration of developed property and increased value of properties in hurricane-prone areas.

Exhibit 5 shows the areas in the U.S. that are most prone to hurricanes. At greatest risk is the southern tip of Florida and the Gulf Coast area. The Carolinas are also at relatively high risk for a hurricane. Further north, the level of risk diminishes. However, the potential hurricane loss severity in the coastal New York and New Jersey areas is severe (over $100 billion) due to the concentration of high valued real estate in those areas.

Exhibit 5

Hurricane Risk in the United States



With six of the ten most costly hurricanes occurring in the past two years, insurance companies, rating agencies, and disaster modeling companies have carefully examined the impact of this dramatic upturn in both hurricane severity and frequency.[2] As indicated in the *Drivers of Catastrophic Risk* section, an important influence on the loss severity of the most recent hurricanes has been the high concentration of real estate value in hurricane-prone areas. This has been driven by long-term population migration trends to coastal areas, especially in the south. In fact, AIR Worldwide Corporation (AIR), a risk modeling company, predicts that every ten years the loss severity doubles for any given hurricane. This is driven by the following factors:

[2] Hurricane activity includes: Katrina, Wilma, and Rita in 2005 and Charley, Ivan, and Frances in 2004.

- Rapidly escalating pricing of existing real estate in hurricane-prone areas.
- Development of new housing and commercial structures are typically larger and more elaborate than existing development resulting in higher replacement costs.
- Migration patterns requiring continued large scale development of new residential and commercial structures in hurricane-prone areas.
- The surge of repair/replacement costs after a hurricane due to shortages in labor and building materials.

In addition to increased loss severity, the recent history of an increasing number of hurricanes making landfall every year must be accounted for in potential loss projections by the insurance companies. Land use development patterns are not only impacting the severity of hurricane damage they are also influencing the frequency of hurricane damage. As more and more property is developed in hurricane-prone areas, the greater the chance that any given hurricane will make landfall in a developed area.

Severe Thunderstorm

From 1985 to 2005, severe thunderstorms, which include tornados, hail, and heavy thunderstorms, caused catastrophic losses totaling $52.8 billion. Unlike hurricanes, thunderstorm-related losses were more evenly distributed over time. In fact, only 11.7 percent of total thunderstorm catastrophic losses occurred during 2004 and 2005. This is due to the fact that tornados and thunderstorms occur more frequently but have a lower loss severity than a hurricane.

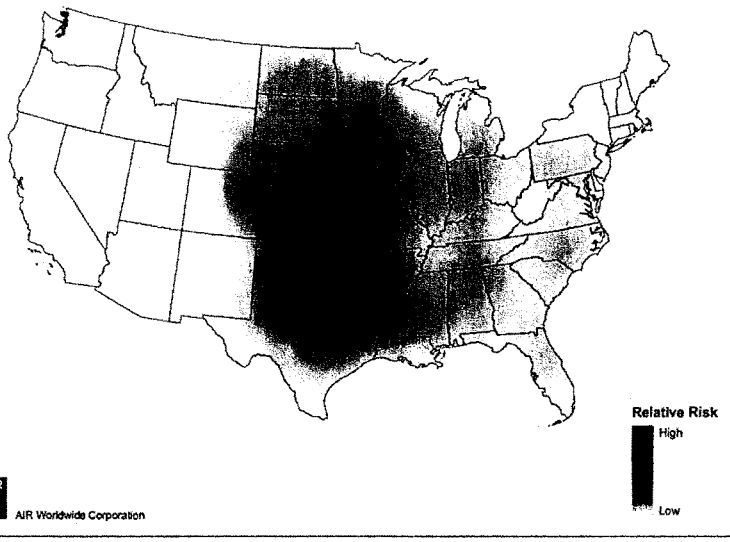
As indicated in Exhibit 6, thunderstorm risk is spread out over the central U.S. with the highest risk areas located in northern Texas, Oklahoma, Kansas, and Iowa. These areas are prone to tornados and are part of the "Tornado Alley" region.

Earthquake

Over the 1985 to 2005 period, catastrophic earthquake insured losses totaled $10.5 billion. However, 90.7 percent of this total was attributed to the Northridge earthquake in California. Unlike windstorm catastrophic events, earthquakes that result in catastrophic losses occur infrequently. During the same 20 year period, there were only six years when catastrophic earthquake events occurred. As demonstrated by the Northridge earthquake, which measured 6.7 on the Richter Scale, when a strong earthquake (6.0 to 7.0 on the Richter Scale) occurs in heavily populated areas, severe property damage results. However, major earthquakes (7.0 to 8.0 on the Richter Scale) have the promise of producing much more serious results. Modeling performed by AIR indicated that a major rupture of the Puente Hills fault in southern California could result in insured property losses of $140 billion and total economic losses of $500 billion. The large discrepancy between the insured loss and total economic loss is due to the low take-up rate for earthquake insurance in California, which means that most potential earthquake losses are not insured.

Exhibit 6

Severe Thunderstorm Risk in the United States



As indicated in Exhibit 7, the highest concentration of severe earthquake activity is in California and in portions of Arkansas, Missouri, Kentucky, and Tennessee located near the Mississippi River. Through a long series of earthquakes, California's earthquake exposure has been well documented. However, insurance companies and seismologists are expressing growing concern about the New Madrid Fault located along the Mississippi in southern states. Many parts of this region have sandy soil conditions that are especially vulnerable to earthquakes because the energy released during an earthquake diminishes the load carrying ability of the soil. This causes buildings constructed on such soils to be highly vulnerable to earthquake damage.

Winter Storm

Winter storm insured losses totaled $15.2 billion over the 1985 to 2005 period. Winter storm catastrophic losses were spread out fairly evenly over time. However, 1993, 1996, and 2003 were characterized by winter storm catastrophic losses in excess of $1.5 billion per year. During these three years, a total of 39.7 percent of all winter storm related losses occurred.

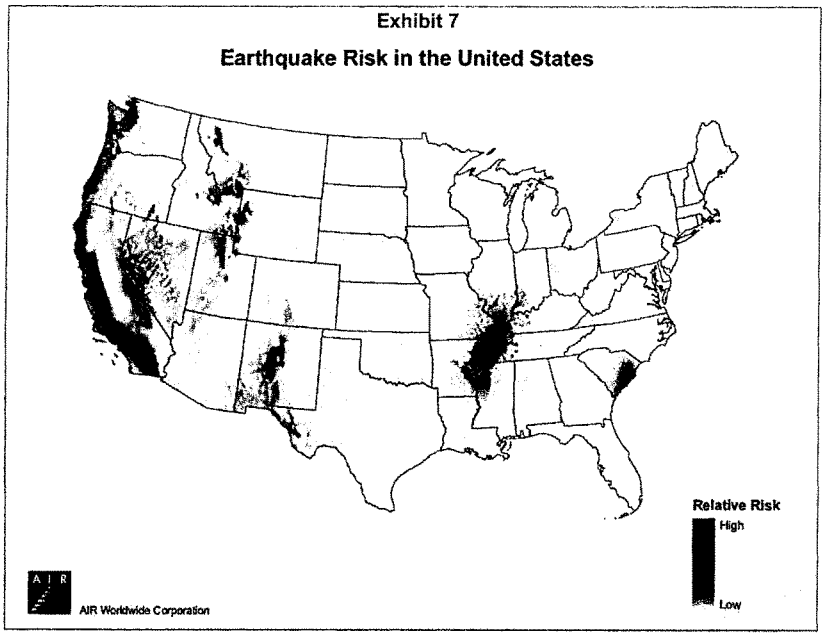


Exhibit 8 shows the areas with the greatest exposure to winter storms. Winter storms have different loss drivers throughout the country. These loss drivers include[3]:

- Nor'easters along the east coast
- Ice storms in the southeast, south-central, and Midwestern states
- Freeze conditions in the south-central states
- Windstorms along the west coast
- Lake effect snows along the Great Lakes
- Ocean effect snow along the Atlantic coastline

Wildfires

Wildfires resulted in insured catastrophic losses of $4.1 billion over the 1985 to 2005 period. The majority of these losses, 73.6 percent, occurred in 1991 and 2003 when massive wildfires destroyed portions of California. While many areas in the U.S. face significant risk from wildfires, the majority of historical losses from wildfire have occurred in California.

[3] *Shoveling Out: Modeling Complex Winter Storms*, AIR Worldwide Corporation, December 5, 2005.

Exhibit 8
Winter Storm Risk in the United States

The 2003 wildfires in southern California were the costliest in U.S. history. The region was scorched by at least 10 separate wildfire systems in October and early November. Together, they destroyed or damaged more than 2,800 structures in San Diego, San Bernardino, Ventura, and Los Angeles Counties. The two costliest were known as the Cedar Fire, in San Diego County, and the Old Fire, in San Bernardino County, which led to insured losses of $1.1 billion and $1 billion, respectively.[4] Exhibit 9 shows the simultaneous fires burning in Southern California during 2003.

Driving the potential for increased wildfire losses in the western U.S. has been the development of land in proximity to fire-prone wildland/urban interface (WUI) areas. A WUI is where structures and other known development meet or intermingle with undeveloped wildland or vegetative fuels[5]. A 2002 U.S. Fire Administration report indicated that 38 percent of new homes in the Western U.S. are being built adjacent to or intermixed with WUI areas.

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4 *Anniversary of the 2003 California Wildfires*, AIR Currents, AIR Corporation Worldwide, November 9, 2005.

5 *Federal Wildland Fire Policy* United States Department of Agriculture Forrest Service, Charted 1994, Revised 2001.

Exhibit 9
2003 Southern California Wildfires

Source: AIR Worldwide Corporation

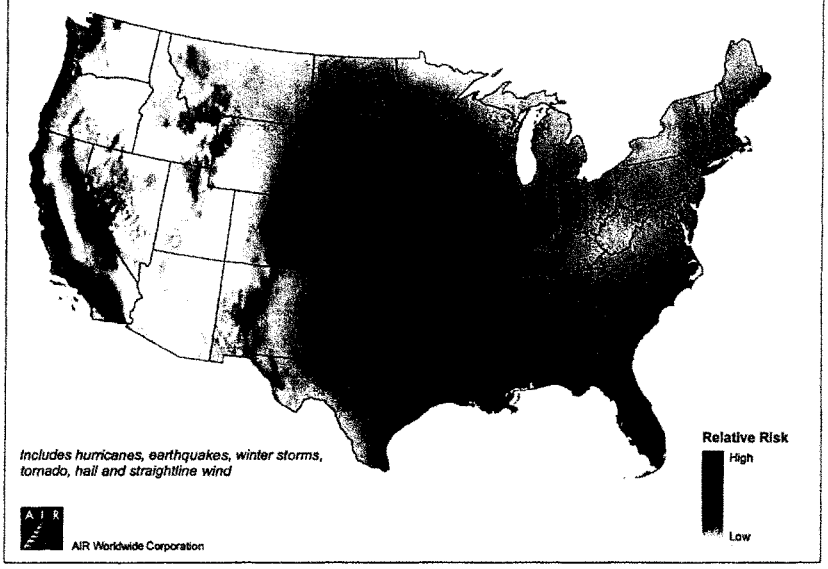
Other Risks

The ISO has created categories for other risks such as riot, utility disruption, volcanic activity, and flood not covered by the NFIP. Over the 1985 to 2005 period, all of these risks combined have comprised less than 1 percent of total catastrophic losses. Much national media attention has focused on the possibility of a worldwide pandemic involving the mutation of the Avian Flu virus (H5N1) that currently infects birds into a new virus that can be spread directly by human to human contact. With the focus of this White Paper on catastrophic risk impacting the collateral value of real estate, the potential of a pandemic from the H5N1 virus will not be examined. However, a pandemic would significantly impact the operations of a business because employees would be absent either because they were sick or observing a quarantine. Business continuity plans are currently being re-written by many companies to address the impact of a pandemic to their business operations.

Cumulative Catastrophic Risk

Exhibit 10 shows an aggregation of hurricane, earthquake, winter storms, tornados, hail and straight-line wind perils. Not included in Exhibit 10 are flood and wildfire perils. Nonetheless, the exhibit shows that catastrophic risk from various sources 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. As previously indicated, both earthquake and hurricanes have single event exposures that can exceed $50 billion. Given this potential loss severity, insurance companies, at the behest of the insurance company rating agencies, have carefully examined their aggregate exposure to all catastrophic risks. **In fact, insurance company rating agencies, when evaluating the credit quality of insurance companies, are performing portfolio stress tests that assume a major hurricane and earthquake take place within the same year. This chilling scenario has caused many primary insurance companies and reinsurance companies to cut back on their aggregate hurricane and earthquake catastrophic risk exposure.**

Exhibit 10
Natural Hazard Risk in the United States



INSURANCE INDUSTRY STRUCTURE

Size and Scope of the Insurance Industry

With worldwide annual premiums of $4.3 trillion in 2005, the insurance industry is one of the world's largest industries. In order to provide some perspective on the size of this number, only the economies of the U.S. and Japan, with GDPs of $12.5 trillion and $4.5 trillion respectively, have GDPs that are in excess of worldwide insurance premiums. [6] The insurance industry is a global industry with many of the largest insurance companies having worldwide insurance operations. Given the worldwide scope of the insurance industry, international insurance market conditions have the ability to impact the U.S. insurance industry.

As indicated in Exhibit 11, in 2005, 33.4 percent of the total world insurance premiums were collected in the U.S., which has over twice the market share of Japan with a 13.9 percent world market share. The U.S. ranked sixth in terms of GDP spent on insurance. However, on insurance spending per capita, the United Kingdom was the only country with higher insurance spending.

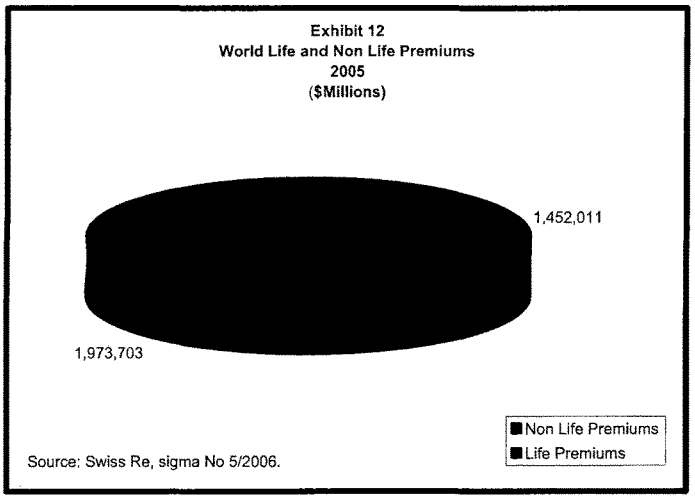
Exhibit 11
Top Ten Countries in Total Premium Volume
2005

Rank	Country	Premium Volume ($Millions)	Share of World Market	Premiums Per Capita ($)	Percent of Country's GDP
1	United States	1,142,912	33.4%	3,875	9.2%
2	Japan	476,481	13.9%	3,747	10.5%
3	United Kingdom	300,241	8.8%	4,599	12.5%
4	France	222,220	6.5%	3,569	10.2%
5	Germany	197,251	5.8%	2,311	6.8%
6	Italy	139,194	4.1%	2,264	7.6%
7	South Korea	82,933	2.4%	1,706	10.3%
8	Canada	78,723	2.3%	2,449	7.0%
9	Netherlands	61,073	1.8%	3,740	9.7%
10	Spain	60,275	1.8%	1,455	5.4%
Total World Market		3,425,714			7.5%

Source: Swiss Re, sigma No 5/2006.

Exhibit 12 shows the worldwide breakdown between life and non-life insurance policies. On a worldwide basis, the majority, 57.6 percent, of policies are written for life insurance.

[6] GDP data from World Development Indicators Database, World Bank, July 1, 2006.



In the U.S. the non-life category is separated between property insurance and casualty (general liability, auto liability, etc.) insurance. The U.S. and Worldwide percentage of life insurance premiums written were very close at 56.0 percent versus 57.5 percent respectively.

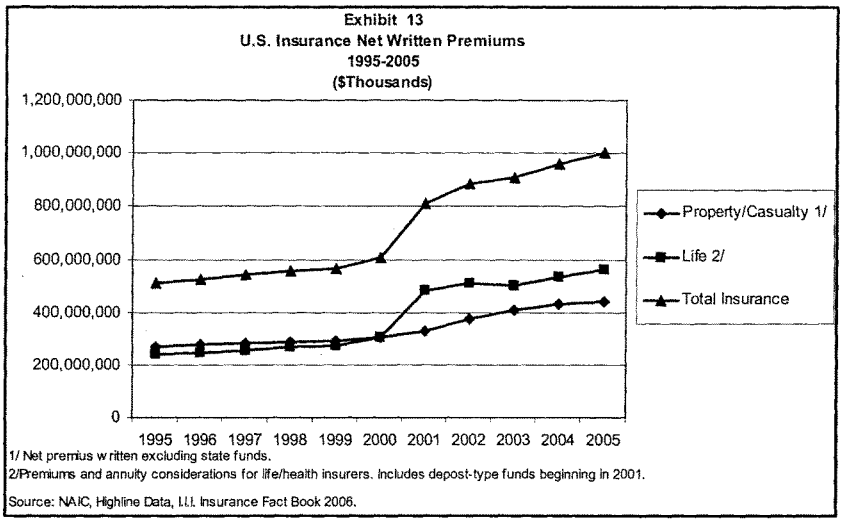
Insurance Industry Financial Performance

In the U.S., net insurance premiums written (total premiums less reinsurance contracts) increased from $511.1 billion in 1995 to $1.0 trillion in 2005, representing a 96.0 percent increase.[7] During this period property and casualty insurance net premiums increased by 64.7 percent, while life insurance net premiums increased by 130.7 percent. Shown in Exhibit 13 are net insurance premiums for 1995 to 2005.

Insurance companies generate revenue from two sources: underwriting income/losses and investment income/losses. Underwriting income/loss is the income stream associated with insurance premiums, losses, and expenses. Investment revenue/losses are generated by the investment of the insurer's policyholders' surplus in income-producing products such as bonds, stocks, real estate and other investments. Policyholders' surplus is the rough equivalent of an insurance company's net worth -- total assets minus total liabilities.

An important measure of the insurance industry's underwriting performance is the combined ratio. The combined ratio compares total insurance industry underwriting

[7] Total U.S. insurance premiums for 2005 in Exhibit 10, $1.0 trillion, is lower than $1.14 trillion for 2005 in Exhibit 11 because numbers represented in Exhibit 10 are for net premiums written (premiums less reinsurance payments).



expenses to total insurance earned premiums.[8] A combined ratio of over 100 percent indicates that underwriting expenses exceeded earned premiums and the insurance industry has experienced an underwriting loss. Likewise, a combined ratio of less than 100 percent indicates that the insurance industry has experienced an underwriting profit.

Shown in Exhibit 14 is the financial performance of the property and casualty insurance industry from 1994 to 2005. During this period, 2004 was the only year in which the insurance industry did not experience an underwriting loss. The combined ratios of greater than 100 percent reflect an underwriting loss.

However, the underwriting losses are countered by income generated from investing the policyholders' surplus. **In fact, 2001 was the only year in which policyholders' surplus investment income did not exceed underwriting losses. With the exception of 2001, the insurance industry has been profitable during the 1994 to 2005 period. However, the performance of each insurance company varies by its exposure to insured losses.**

In 2004 and 2005, the insurance industry experienced a return on average net worth of 9.4 percent for both years. For the 1994 to 2005 period, this performance was only exceeded in 1997 when return on average net worth was 11.6 percent. In addition, policyholders' surplus increased from $285.4 billion in 2002 to $427.1 billion in 2005. Despite the disastrous 2004 and 2005 hurricane seasons, the insurance industry is in overall good health. The ability of the insurance industry to absorb these losses and remain profitable speaks to its solid financial underpinnings. The financial performance of the reinsurance industry over the 1998 to 2005 period is shown in Exhibit 15.

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8 The combined loss ratio is calculated using the following formula: *((Losses + Loss Adjustment Expenses) + (Expenses))/(Earned Premiums)*

Exhibit 14
Property/Casualty Insurance Industry Financial Performance
1998-2005
($Billions)1/

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Combined Ratio 2/	108.4	106.4	105.8	101.6	105.6	107.4	110.1	115.9	107.3	100.1	98.3	100.9
Underwriting Income/(Loss)	(22.2)	(17.7)	(16.7)	(5.8)	(16.8)	(23.1)	(31.2)	(52.6)	(30.8)	(4.9)	4.3	(5.9)
Investment Income/(Loss)	33.7	36.8	38.0	41.5	39.9	38.9	40.7	37.7	37.2	38.6	40.0	49.5
Miscellaneious Income/(Loss)	0.1	0.3	(0.4)	(0.2)	0.2	(1.4)	0.4	1.1	(0.8)	0.0	(0.3)	0.1
Operating Income/(Loss)	11.6	19.5	20.8	35.5	23.4	14.4	9.9	(13.8)	5.6	33.8	44.0	44.5
Realized Capital Gains/(Loss)	1.7	6.0	9.2	10.8	18.0	13.0	16.2	6.6	(1.2)	6.6	9.1	9.7
Federal Income Taxes	2.4	4.9	5.6	9.5	13.6	5.6	5.5	(0.2)	1.3	10.3	14.6	11.2
Net Income After Losses	10.9	20.6	24.4	36.8	30.8	21.9	20.6	(7.0)	3.0	30.0	38.5	43.0
Return on Net Average Worth (GAAP)	5.6%	8.7%	9.3%	11.6%	8.5%	6.0%	5.9%	-1.2%	2.2%	8.9%	9.4%	9.4%
Dividends to Stockholders	6.3	(8.2)	(9.0)	(11.5)	(13.3)	(16.3)	(15.8)	(11.8)	(7.1)	(9.1)	(14.0)	(15.2)
New Funds	6.8	7.1	4.5	3.9	5.2	5.0	4.3	12.9	18.8	11.3	8.8	14.0
Unrealized Capital Gains/(Losses)	(1.8)	21.7	13.3	29.0	10.2	1.9	(18.5)	(18.0)	(20.8)	25.0	10.6	(3.2)
Miscellaneous Surplus Changes	(1.5)	(3.7)	(7.7)	(5.5)	(8.0)	(11.3)	(7.5)	(3.8)	1.8	4.4	0.5	(2.8)
Change in Year-End Surplus	8.1	36.7	25.5	53.0	24.8	1.0	(17.0)	(27.8)	4.2	61.6	44.3	35.8
Year-End Surplus	193.3	230.0	255.5	308.5	333.3	334.3	317.4	289.6	285.4	347.0	391.3	427.1

1/ ISO annual reports, report on two year basis. In instances when ISO revised financial performance data from the prior year, the revised data was used.
2/ Combination of loss ratio, loss payments/net premiums earned and the expense ratio, expenses/net premiums earned.
Combined loss ratio of under 1.0 indicates insurance industries expenses were less than premium income.
Source: ISO Insurance Financial Results1995 to 2005.

Exhibit 15
Reinsurance Industry Financial Performance
1998-2005
($Billions)1/

	1998	1999	2000	2001	2002	2003	2004	2005
Combined Ratio 2/	104.4	113.8	114.2	141.0	121.3	101.2	106.2	129.4
Underwriting Income/(Loss)	(0.9)	(2.8)	(3.6)	(10.8)	(6.4)	0.6	(1.8)	(7.5)
Investment Income/(Loss)	3.7	3.6	3.6	3.8	6.2	5.6	4.8	5.2
Net Realized Capital Gain/Loss	3.7	1.5	0.8	0.6	1.0	0.9	1.8	3.8
Other Income/Loss	0.1	(0.2)	(0.1)	(0.1)	(0.3)	(0.7)	(0.2)	(0.5)
Pre-Tax Income/Loss	6.6	2.1	1.1	(4.6)	0.7	5.2	4.5	1.0
Federal and Foreign Income Tax	1.8	0.7	0.1	(1.1)	0.0	2.1	1.4	(1.0)
Net Income/(Loss)	4.7	1.4	1.1	(3.6)	0.6	3.1	3.1	1.9
Year-end Surplus	26.5	24.4	24.5	25.1	42.1	55.9	61.2	67.0

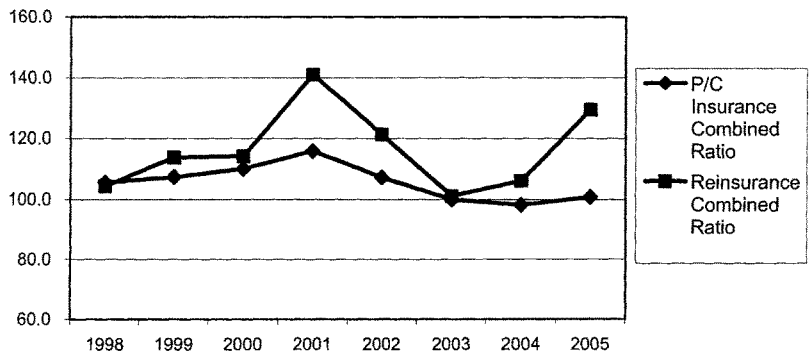
1/ Numbers stated in billions and rounded to nearest $100 million for comparison purposes to the Property/Casaulty Insurance Financial Performance Exhibit.
2/ Combination of loss ratio, loss payments/net premiums earned and the expense ratio, expenses/net premiums earned.
Combined loss ratio of under 1.0 indicates insurance industries expenses were less than premium income.
Source: Reinsurance Association of Amercia Reinsurance Underwrting Report 1998 - 2005.

Reinsurers sell insurance to other insurance companies. Reinsurance industry underwriting losses of $1.8 billion in 2004 and $7.5 billion in 2005 were caused by their exposure to hurricane related losses.

Despite these losses, the reinsurance industry had net income of $3.1 billion in 2004 and $1.6 billion in 2005. This shows that in aggregate the reinsurance industry was profitable in 2004 and 2005. However, for those reinsurers with large-scale hurricane exposure in the Gulf Coast and Florida, severe losses were the norm. This loss experience is reflected in reinsurance availability and pricing of hurricane exposure in 2006.

Exhibit 16 compares the combined ratios for the property and casualty insurance industry to the reinsurance industry. During 2001, 2002, 2004, and 2005, the combined ratios for the reinsurance industry were significantly higher than the property/casualty insurance industry. These higher combined ratios indicate that primary insurers (insurers that originated the insurance policy) were able to transfer through reinsurance agreements much of the liability associated with catastrophic events during these years. to reinsurers,

Exhibit 16
Property/Casualty Insurance Industry
Reinsurance Industry Combined Ratios
1998 - 2005



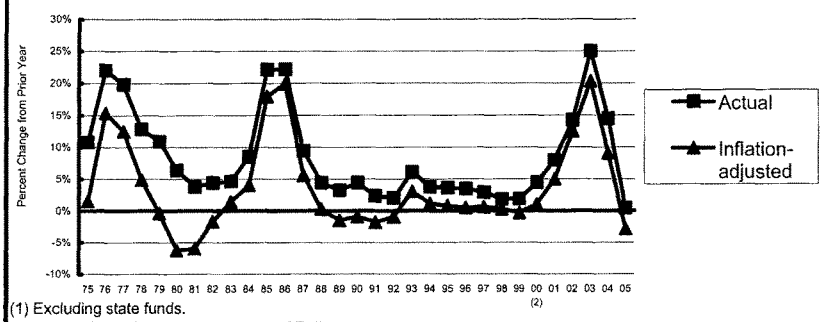
Source: ISO Insurance Financial Results 1994-2005, RAA Reinsurance Underwriting Report 1998-2005.

Insurance Market Cycles

Like the U.S. economy and other industries, the insurance industry experiences market cycles. Market cycles are characterized by differing insurance availability and pricing conditions. A hard market is characterized by rising insurance rates and more difficulty in placing insurance. During hard markets, insurance companies have the greatest

potential to increase profits due to rising insurance rates and reduced coverage for policyholders. A soft market is characterized by reduced or stable pricing with readily available insurance. As indicated in Exhibit 17, between 1975 and 2005 there were three hard market cycles.

Exhibit 17
Growth in Net Premiums Written
Property/Casualty Insurance
1975-2005 (1)



(1) Excluding state funds.
(2) Adjusted to reflect dissappearance of Reliance.
Source: NAIC Annual Statement Database, via National Underwriter Insurance Data Services/Highline Data; Insurance Information Institute.

This Exhibit shows hard market conditions peaking in 1976, 1986, and 2003, when net premiums written growth was at its highest. Hard markets end when increased capital enters the market place and brings more competition and reduced pricing. With the exception of catastrophic insurance, the overall insurance market would be characterized as soft, with plenty of capacity and steady pricing for most insurance lines. Although overall market conditions in the property and casualty insurance industry could be characterized as soft, individual insurance lines can be experiencing much different conditions. The insurance product lines comprising property and casualty insurance and the market conditions for property insurance lines impacted by catastrophic events are addressed below.

Categories of Insurance Product Lines

Shown in Exhibit 18 is a listing of the various lines or categories of property and casualty insurance. The insurance product lines with the greatest potential to be impacted by natural disasters include: private passenger auto, homeowners multiple peril, commercial multiple peril, reinsurance, fire, mortgage guarantee, ocean marine, and earthquake. In terms of net insurance premiums, these lines comprise 68.3 percent of the property and casualty insurance market.

Exhibit 18
U.S. Property/Casualty Insurance by Line 1/
Lines Prone to Catastrophic Events in Bold
2004
($Thousands)

Rank	Insuance Line	Net Premiums	Percent of Total
1	**Private Passenger Auto 2/**	**156,734,038**	**36.5%**
2	**Homeowners Multiple Peril**	**49,988,877**	**11.7%**
3	Other Liability 3/	40,720,856	9.5%
4	Workers Compensation	36,760,327	8.6%
5	**Commercial Multiple Peril**	**29,134,347**	**6.8%**
6	**Commercial Auto 2/**	**26,722,522**	**6.2%**
7	**Reinsurance**	**13,697,298**	**3.2%**
8	Accident and Health 4/	9,955,816	2.3%
9	Medical Mlapractice	9,129,530	2.1%
10	**Fire**	**8,316,595**	**1.9%**
11	Allied Lines 5/	8,307,595	1.9%
12	Inland Marine	8,215,433	1.9%
13	Other Lines 6/	4,601,096	1.1%
14	**Mortgage Guaranty**	**4,323,176**	**1.0%**
15	Surety	3,857,003	0.9%
16	Product Liability	3,395,002	0.8%
17	Financial Guaranty	3,115,495	0.7%
18	**Ocean Marine**	**2,827,554**	**0.7%**
19	Aircraft	2,180,122	0.5%
20	Farmowners Multiple Peril	2,118,462	0.5%
21	Boiler and Machinery	1,572,208	0.4%
22	Fidelity	1,309,335	0.3%
23	**Earthquake**	**1,098,392**	**0.3%**
24	Credit	806,449	0.2%
25	Burglary and Theft	138,837	0.0%
	Total All Lines	429,026,363	100.0%
	Total Subject to Catastrophic Events	292,842,799	
	Percent Subject to Catastrophic Events	68.3%	

1/ After reinsurance transactions, excluding state funds. Lines subject to catastrophes are bolded.
2/ AIG Companies data not included.
3/ Coverages protecting against legal liability resulting from negligence, carelessness or failure to act.
4/ Premiums from certain carriers that write primarily health insurance but file financial statements with state regulators on property/casualty rather than life/health basis.
5/ Includes multiple peril crop and federal flood.
6/ Includes international and miscellaneous coverages.

Source: NAIC, I.I.I. Insurance Fact Book 2006.

For commercial real estate the insurance lines that cover catastrophic events are commercial multiple peril, fire, reinsurance, and earthquake. Combined, these insurance lines account for 12.2 percent of the total property and casualty insurance market.

Commercial Real Estate Catastrophic Insurance Conditions

Since early 2006, professionals in the real estate finance, servicing, and insurance industries have reported a dramatic hardening of insurance market conditions for commercial buildings located in Florida and on the Gulf Coast. This differs significantly from the overall soft market conditions in the property and casualty insurance market. Numerous news articles have confirmed the hardening insurance market conditions and in the second half of 2006, these hard market conditions were being documented by insurance industry surveys and reports.

The Council of Insurance Agents and Brokers (CIAB) conducts a quarterly insurance pricing survey of its members and reported the following in its second quarter 2006 survey:

- **Brokers and agents reported that premium rates for coastal properties were up 300 to 500 percent - and some by even 600 percent - and that the impact was being felt as far as five miles inland.**

- **Brokers said higher property rates and deductibles and lower coverage limits were the industry standard during the last three months, with significant differences in the way catastrophe-exposed property risks were being underwritten.**

- "This market is changing daily," said a broker from the southwestern U.S. "Capacity is scarce, and it's a great concern that later in the year, there may not be any capacity left. I am referring to the southeast Gulf region and Texas in particular."

- "Rates are up 300 to 500 percent on commercial property and builder's risk," a broker from the southeast said. "Deductibles increased 200 percent, and (it is) also deductible by location, not by occurrence. In some cases, it makes it almost impossible to have a claim.

- **Capacity and pricing problems were not just confined to at-risk properties along the coast, the survey showed. Commercial earthquake insurance is increasing 50 to 100 percent for renewals, several brokers reported, and there are also significant increases in deductibles.**

- A significant number of agents and brokers cited concerns over capacity as among their top three market worries in the survey. More than half – 55 percent – listed capacity, compared to 40 percent who identified it as their top concern in the first quarter [2006] survey.

The survey information is compiled on a national and regional basis. For the nation, the Second Quarter Survey indicated that 43 percent of the agents noted increased commercial property insurance pricing. For the southeast region[9], 71 percent of the insurance agents reported increased pricing for commercial property insurance. In the southeast, 38 percent of the insurance agents reported commercial property increases of 50 to 100 percent, which is the maximum increase level in the survey. Nationwide, only 13 percent of the agents reported commercial property insurance increases in this category.

Aon Corporation (Aon), a leading insurance brokerage company, has compiled data on insurance industry capacity for wind and earthquake insurance and has also tracked property insurance rates. Aon includes hurricane and tropical storms in its definition of wind. For wind insurance, Aon estimated the pre-Katrina (prior to August 2005) wind insurance industry capacity from domestic and foreign insurers to be $2.0 trillion. Capacity is measured by the cumulative maximum insurance lines for wind damage. By July 2006, this overall level of wind insurance capacity had dropped to $1.0 trillion or a 49.6 percent decrease. This decrease is primarily attributed to London-based insurers reducing their capacity from $1.0 trillion to $400 billion.

However, this decline is more substantial when examining wind insurance coverage already in place. Pre-Katrina, active wind insurance lines totaled $1.3 trillion. As of July 2006, active lines of wind insurance had decreased to $495 billion, a 60.5 percent decrease. This decline was primarily attributable to London-based insurers reducing their active lines from $800 billion prior to Katrina to $220 billion as of July 2006.

For earthquake insurance, Aon estimates that total capacity decreased from $917.5 billion pre-Katrina to $671.0 as of July 2006, or a 21.6 percent decline. Once again, the London-based insurers were the primary factor behind the capacity decline by withdrawing $100 billion in earthquake insurance capacity during this period.

In terms of active earthquake insurance lines in place, there was a significant drop from $671 billion in active lines pre-Katrina to $398 billion in active lines as of July 2006. This sharp decline, 40.7 percent, is attributed to U.S. insurers' withdrawing of $118 billion in active insurance lines over this period.

Aon performed an analysis of its real estate clients with catastrophic risk exposure to determine trends in property insurance pricing, program limits and sublimits.[10] As indicated in Exhibits 19 and 20, both property insurance premiums and rates have increased sharply from July 2005 to July 2006. In June 2006, property insurance premiums had increased by over 75 percent when compared to August 2005. In July 2006, property rates had increased by over 70 percent when compared to December 2005.

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[9] The Southeast region is comprised of Alabama, Florida, Georgia, Kentucky, Louisiana, Mississippi, North Carolina, South Carolina, Tennessee, Virginia, and West Virginia

[10] Sublimits are insurance coverage limits that are below the overall coverage limits for specific perils such as wind, flood, and earthquake. Sublimits allow insurance companies to decrease their potential liability for an individual peril.

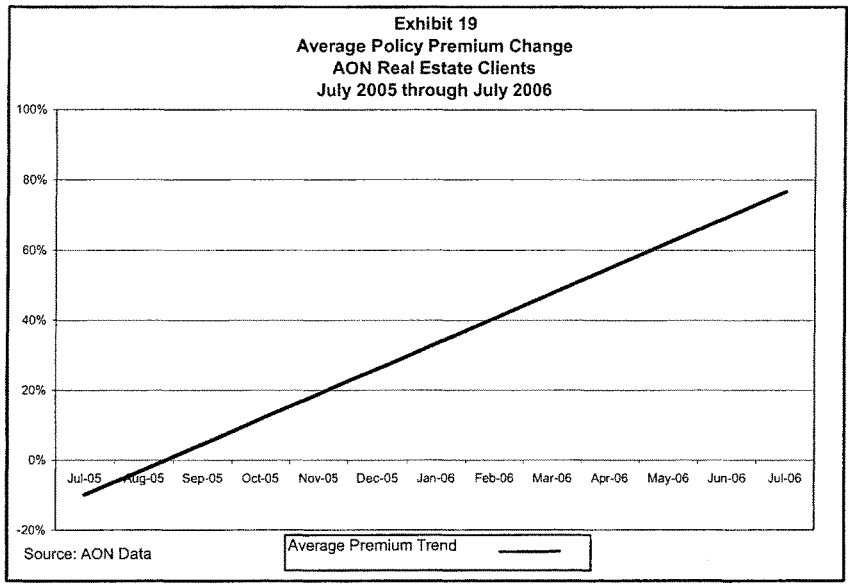


Exhibit 19
Average Policy Premium Change
AON Real Estate Clients
July 2005 through July 2006
100%
80%
60%
40%
20%
0%
-20%
Jul-05
Aug-05
Sep-05
Oct-05
Nov-05
Dec-05
Jan-06
Feb-06
Mar-06
Apr-06
May-06
Jun-06
Jul-06
Source: AON Data
Average Premium Trend

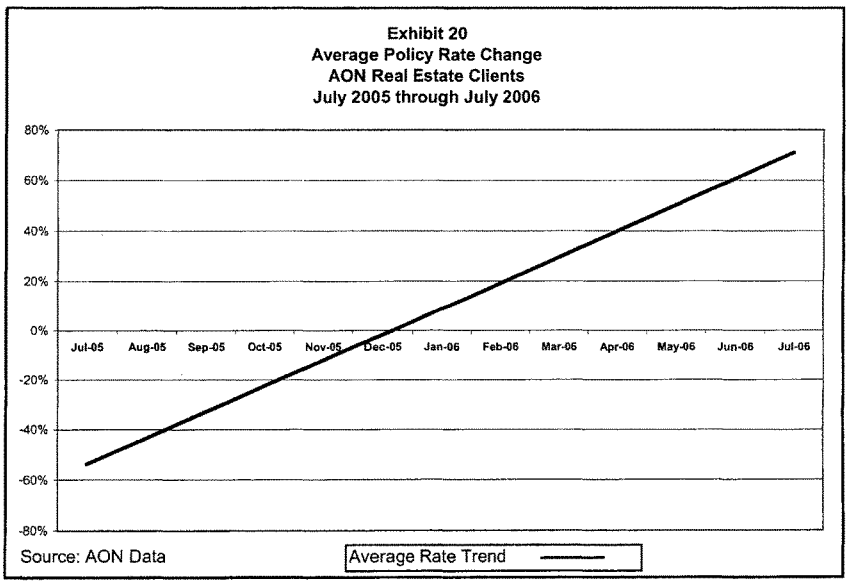
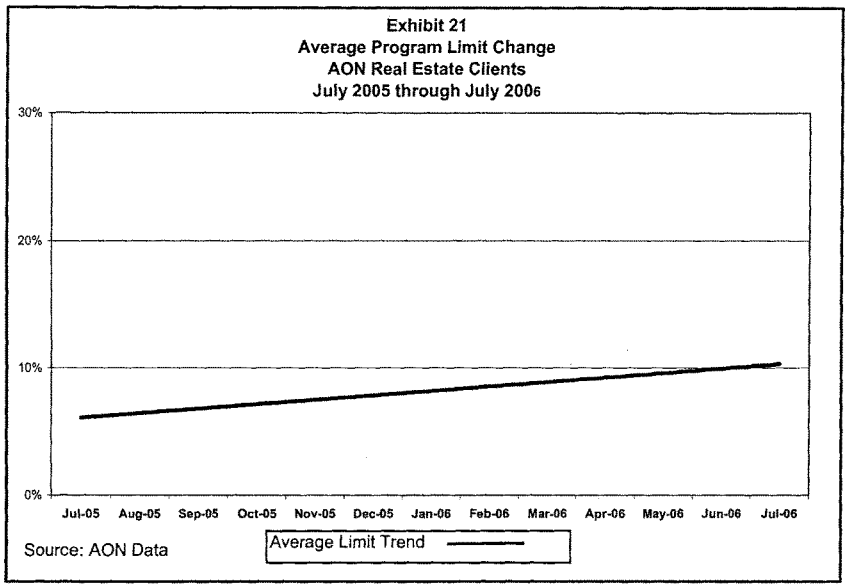


Exhibit 20
Average Policy Rate Change
AON Real Estate Clients
July 2005 through July 2006
80%
60%
40%
20%
0%
-20%
-40%
-60%
-80%
Jul-05
Aug-05
Sep-05
Oct-05
Nov-05
Dec-05
Jan-06
Feb-06
Mar-06
Apr-06
May-06
Jun-06
Jul-06
Source: AON Data
Average Rate Trend

However, as indicated in Exhibit 21, insurance program limits for Aon's real estate clients increased modestly from July 2005 to July 2006. However, Exhibits 22, 23, and 24 indicate that sublimits for wind, earthquake, and flood have decreased dramatically during the same period.



As indicated in Exhibit 22, sublimits for wind insurance have declined by over 30 percentage points between July 2005 and July 2006. As insurance companies raised concerns about earthquake exposure in California, the sublimits have declined by over 15 percent between October 2005 and July 2006 as indicated in Exhibit 23. Shown in Exhibit 24 is the precipitous decline in flood insurance sublimits for properties in high risk flood areas (Zone A).

As previously indicated, the insurance industry goes through natural hard and soft market cycles. Given these cycles, do the current catastrophic insurance hard market conditions represent a temporary market hardship or do they represent a paradigm shift in the insurance market? In the past, it was not unusual for hard market conditions to develop in reaction to a catastrophe. For example, immediately after the 1994 Northridge earthquake, insurers stopped writing earthquake coverage causing a capacity crisis and insurance premiums to spike. After several years of low earthquake losses, hard market conditions softened and insurers began offering earthquake insurance again.

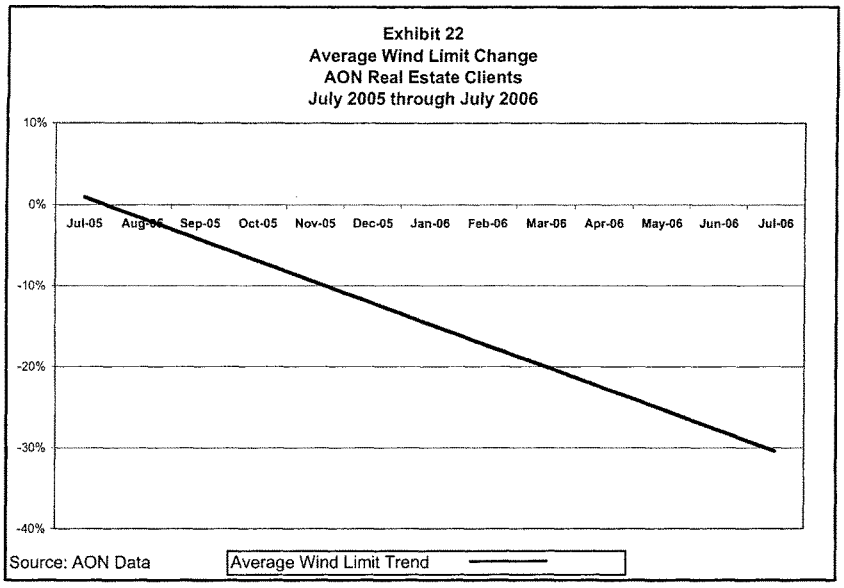


Exhibit 22
Average Wind Limit Change
AON Real Estate Clients
July 2005 through July 2006
10%
0%
-10%
-20%
-30%
-40%
Jul-05
Aug-05
Sep-05
Oct-05
Nov-05
Dec-05
Jan-06
Feb-06
Mar-06
Apr-06
May-06
Jun-06
Jul-06
Source: AON Data
Average Wind Limit Trend

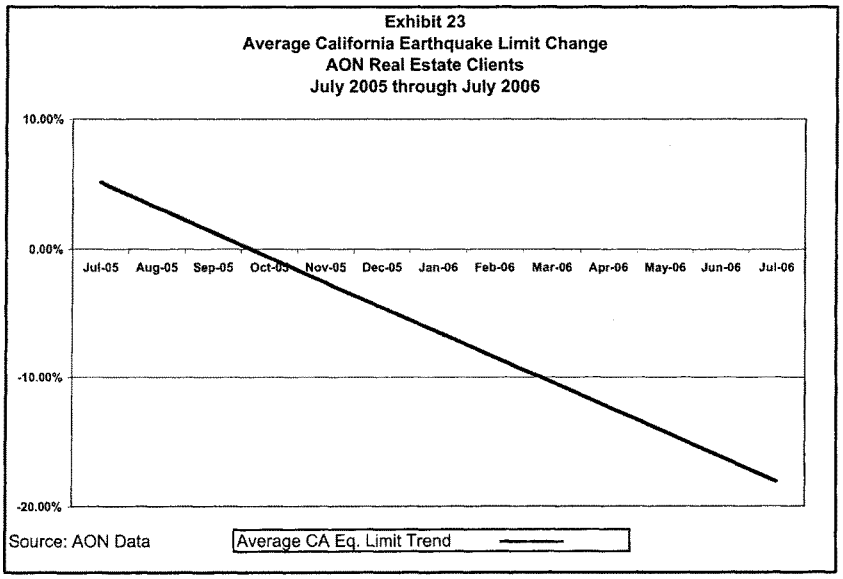
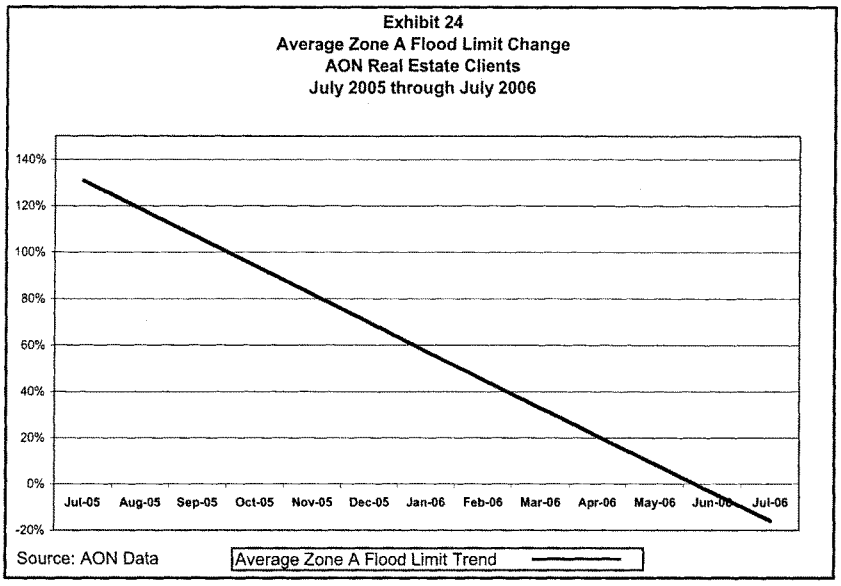


Exhibit 23
Average California Earthquake Limit Change
AON Real Estate Clients
July 2005 through July 2006
10.00%
0.00%
-10.00%
-20.00%
Jul-05
Aug-05
Sep-05
Oct-05
Nov-05
Dec-05
Jan-06
Feb-06
Mar-06
Apr-06
May-06
Jun-06
Jul-06
Source: AON Data
Average CA Eq. Limit Trend



However, there are several circumstances that indicate that when catastrophic insurance capacity returns, pricing may remain elevated over prior levels. Factors contributing to this scenario include:

- The recent severity and frequency of hurricane events has caused the insurance company rating agencies to revise their rating criteria for catastrophic risk.

- Insurance company rating agencies are stress testing insurance company portfolios for multiple hurricanes making landfall in the same year. Additionally, rating agency stress tests are also taking into account multiple source catastrophic events for the same year such as a major earthquake and hurricane.

- **Insurance rating agencies are also emphasizing overall catastrophic exposure in an insurer's portfolio and encouraging insurance companies to develop strong internal catastrophic risk management programs.**

- **These rating agency concerns have caused insurance companies to carefully analyze their concentration of catastrophic risk by peril category and in some instances rebalance their portfolios by cutting**

back on writing property insurance policies in catastrophe-prone areas. This is demonstrated by the recent reduction in capacity for both hurricane and earthquake insurance.

- The risk modeling companies are incorporating the most recent loss frequency and severity numbers into their hurricane models. The risk modeling companies are also taking into consideration post hurricane building supply and labor shortages. **This has caused the risk modeling companies to revise upward expected losses from hurricanes by 20 to 100 percent. Insurance companies have modified their catastrophe pricing structures to reflect these increased loss projections.**

These factors team to indicate that while catastrophic insurance pricing is likely to moderate after the current capacity crunch is resolved, 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.

In terms of insurance pricing, each insurance company establishes its own boundaries for high-risk hurricane areas. These boundaries can vary significantly from insurance company to insurance company. Consequently, pricing can vary by insurance provider because one insurance company may include a property within its high-risk boundaries while another does not. However, the general trend has been for insurance companies to include areas further inland and or further north in their high-risk category that had not been previously classified in such a manner. This reclassification has resulted in significant insurance rate increases for some properties.

INSURANCE INDUSTRY REGULATORY FRAMEWORK

Insurance Industry Regulation Background

The insurance industry is principally regulated at the state level. State versus federal regulatory jurisdiction for the insurance industry is a matter that has been contested in the court system for over 100 years. In the 1868 *Paul v. Virginia* decision, the U.S. Supreme Court concluded that the issuance of an insurance policy did not represent interstate commerce, and therefore fell outside of the federal government's legislative and regulatory authority. However, this ruling was reversed 76 years later in the 1944 *United States v. South-Eastern Underwriters Association* decision. In this case, the Court ruled that insurance represented interstate commerce. Reacting to this decision, in 1945 Congress passed the McCarran-Ferguson Act, which returned the regulatory jurisdiction of insurance companies back to the states and generally exempted the business of insurance from most federal laws provided there were state laws in effect to regulate insurance companies.[11] In 1999, the Gramm-Leach-Bliley Act allowed national bank subsidiaries to sell all types of insurance. However, this legislation also reaffirmed the role of the states as the regulator of insurance companies. In 2002, Congress passed the Terrorism Risk Insurance Act of 2002 (TRIA), which preempted state jurisdiction for "certified" acts of terrorism (foreign-source terrorist acts of over $5 million). Subsequent efforts by Congress to reform state jurisdiction for insurance regulation are examined in the *Insurance Regulatory Reform* section.

Role of the State in Insurance Regulation

Each state has an insurance regulatory structure led by an insurance commissioner. The role of the insurance commissioner is to enforce the insurance laws within a state and to oversee the operations of the state insurance regulatory agency (agency). The functions of the agency fall into the following categories:

- Consumer protections
- Licensing and capital requirements
- Solvency guarantee funds
- Rate and Form regulation

Agencies are involved in promoting and enforcing consumer protection measures. They also have the authority to take administrative actions against insurers that employ unfair insurance practices and serve as the advocate for protecting consumers against unfair insurance practices. Additionally, agencies will often work with policy holders and insurance companies to reach resolution over disputed insurance claims.

Insurance agencies are also responsible for licensing insurance companies in a state. Important terminology for licensing and insurance lines include:[12]

- Admitted Insurer – An insurance company licensed and authorized to do business in a particular state.

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[11] Testimony of Randal K. Quarles, Under Secretary for Domestic Finance, U.S. Department of Treasury Before the Senate Banking , Housing and Urban Affairs Committee on July 18, 2006.

[12] Glossary of Insurance Terms, Insurance Information Institute (http://www.iii.org/media/glossary/alfa.N)

- Non-Admitted Insurer – An insurer not licensed but authorized to do business in a particular state. States where an insurer is not licensed call that insurer non-admitted. Non-admitted insurers must be licensed in at least one state. They sell coverage that is typically unavailable from licensed insurers within the state.

- Surplus Lines - Property/casualty insurance coverage that isn't available from admitted insurers and must be purchased from a non-admitted carrier. Examples include risks of an unusual nature that require greater flexibility in policy terms and conditions than exist in standard forms or where the highest rates allowed by state regulators are considered inadequate by admitted companies. Laws governing surplus lines vary by state. However, every surplus lines carrier must be an admitted carrier in one state and must meet solvency requirements of that state. In the case of hard insurance markets, surplus line carriers serve as a pressure relief valve by providing policies that the admitted carriers do not have the capacity, nor desire, nor pricing flexibility to provide. Many states maintain a list of surplus lines insurance companies that are eligible to sell insurance within the state, while other states maintain a list of surplus lines insurance companies that are ineligible to sell insurance within the state.

- Domestic Insurance Company - Term used by a state to refer to any company incorporated there.

- Foreign Insurance Company - Name given to an insurance company based in one state by the other states in which it does business.

- Alien Insurance Company - An insurance company incorporated under the laws of a foreign country, as opposed to a foreign insurance company that does business in states outside its own.

In order to sell insurance, an insurance company must be admitted to sell insurance in at least one state. After the insurance company has been admitted in one state, it can then sell insurance on an admitted or non-admitted basis in other states. Domestic companies, those incorporated in the state, are automatically considered admitted carriers. Foreign and Alien insurance companies gain admitted status by complying with a state's licensing laws. Foreign and alien insurance companies can also elect to be non-admitted carriers and offer surplus lines insurance for the states in which they do not have admitted status.

However, all insurance carriers, including surplus lines, are subject to state requirements for capital and surplus. Each insurance company must meet minimum financial requirements in order to sell insurance on an admitted or non-admitted basis in a state.

Another important function of the agency is to establish solvency funds. Agency regulatory staff has the responsibility of monitoring the financial condition of all licensed insurance companies in their state and to take the necessary actions to improve the financial condition of poorly performing insurance companies. Agencies also administer guarantee funds through which the property/casualty insurance industry covers claims against insolvent insurers. Licensed insurers are required to participate in the guarantee funds and are assessed payments to cover any shortfalls in claims payments by insolvent insurers. Surplus line insurers do not participate in the guarantee funds.

Agencies are also responsible for rate and forms regulation of admitted insurance carriers. Although agencies have the authority to regulate insurance rates/forms, how this authority is practiced varies widely from state to state. Insurance rate regulation includes the following methods:

- Prior Approval - Agency to approve or not oppose the rate structure prior to it going into effect.
- Flex Rating - Insurance companies are allowed to price insurance with a specific range without requiring additional approval.
- File and Use – The rate becomes effective the date the rate structure is filed by the insurer with the state.
- Use and File – The insurer must file rates with the agency within a specified time period after the rate change has been in effect.
- State-Prescribed – The agency determines and promulgates the rates.
- No File/No Record Maintenance – No rate filings are required. Insurer can modify rates at any time.

National Association of Insurance Commissioners

The National Association of Insurance Commissioners (NAIC) is the organization of insurance regulators from the 50 states, the District of Columbia and the five U.S. territories. The NAIC provides a forum for the development of uniform policy when uniformity is appropriate. State insurance regulators created the NAIC in 1871 to address the need to coordinate regulation of multi-state insurers. The first major step in that process was the development of uniform financial reporting by insurance companies. Since then, new legislative concepts, new levels of expertise in data collection and delivery, and a commitment to even greater technological capability have moved the NAIC forward into its role as a multidimensional, regulatory support organization.

The mission of the NAIC is to assist state insurance regulators, individually and collectively, in serving the public interest and achieving the following fundamental insurance regulatory goals in a responsive, efficient and cost effective manner, consistent with the wishes of its members:

- Protect the public interest;
- Promote competitive markets;
- Facilitate the fair and equitable treatment of insurance consumers;
- Promote the reliability, solvency and financial solidity of insurance institutions; and
- Support and improve state regulation of insurance.

Through the Model Bulletin process, NAIC issues uniform policy guidance to state insurance commissioners. The NAIC assists agencies in mitigating insolvencies through administration of the NAIC Accreditation Program, which is a rigorous certification process that ensures that robust agency monitoring systems are in place for accounting, reporting, risk-based capital, financial examination, and reinsurance. In addition, regularly scheduled meetings provide a forum for agency officials to discuss current insurance-related issues. Although the insurance industry is regulated at the state level, the NAIC provides a coordination body where universal insurance issues can be addressed in a uniform and consistent manner.

INSURER CATEGORIES

Primary Insurers

The primary insurance company is the company originating the insurance contract and has the direct relationship with the policy holder or the policy holder's authorized representative. The primary insurer is contractually obligated to cover the losses prescribed in the insurance contract. The primary insurer can then enter into contracts with other insurance companies (reinsurance) to transfer a portion of or all of the risk being insured.

Reinsurance

Reinsurance is insurance for insurance companies.[13] Reinsurance serves the following functions:

1. Increases primary insurers capacity – State regulations limit the total amount of insurance that insurers can write (capacity) by the amount of policy holder surplus (assets – liabilities = policy holder surplus). Insurance company capacity is limited in two ways: (1) by the maximum percentage of insurance capacity that can be provided to a single client (usually 10 percent), and (2) by the relationship between total premiums collected and total policy holder surplus (usually 3:1 ratio). Reinsurance allows the primary insurer to move the premiums transferred to the reinsurer to be taken off the "books" of the primary insurer, which increases capacity by reducing the amount of premiums that are counted against the above regulatory limitations.

2. Stabilized underwriting results – Reinsurance allows the primary insurer to determine the total losses it is willing to accept for any insurance policy (net retentions). This allows the insurance company to precisely calibrate net retentions with its existing capital structure.

3. Protects against catastrophic losses – Catastrophic losses, such as hurricanes, that occur in an area where the primary insurer has a high concentration of policies could result in liabilities that could severely strain a primary insurer's ability to pay. Reinsurance allows the primary insurer not to have to account for the full payment of low frequency high severity events in their reserve structures.

4. Finances insurance company growth - By transferring premiums and liabilities to the reinsurers, the primary insurer frees up capacity to issue new insurance polices.

Reinsurance contracts fall into two broad categories: treaty or facultative. Treaty insurance covers a broad range of policy holders. The primary insurer and treaty insurer will agree upon policy terms that it will accept for reinsurance for a large number of policies. Provided that the policy falls within the acceptable policy terms, the treaty reinsurer will cover the policy.

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[13] Terminology and concepts for this section were obtained from *Reinsurance: Fundamentals and New Challenges, Fourth Edition*, edited by Ruth Gastel Gates, Insurance Information Institute, 2004. This book provides in-depth information on the concepts and structure of the reinsurance industry.

However, for facultative reinsurance the reinsurer accepts or rejects each policy on an individual basis. Facultative reinsurance is typically used for high value assets, such as commercial and multifamily real estate projects requiring individual underwriting. Facultative reinsurance typically covers a specific risk such as hurricane or earthquake.

Shown below are the categories of cost share formulas that are employed in treaty and facultative reinsurance contracts:

1. Pro Rata – The primary insurer keeps an agreed upon amount of the liability. There are two types of pro rata reinsurance contracts: quota share and surplus share. For a quota share agreement, the primary insurer keeps a fixed percentage of each policy. In this case, if the primary insurer retained 20 percent of the premiums, they would be responsible for 20 percent of the potential losses. Consequently, the primary insurer's liability is related to the size loss. However for a surplus share agreement, the dollar amount of the primary insurer's liability is stated in the reinsurance contract. For surplus share, the primary insurer's loss payment liability has no relationship to the size of the loss, provided that primary insurance company 's retention thresholds are exceeded, which is the case for quota share agreements. Reinsurer pricing of both pro rata and quota share contracts are tied to a percentage of total premiums collected.

2. Excess of Loss – The primary insurer is reimbursed for a specific loss that falls into a specified range. For example, an excess loss policy for a $100 million building could cover losses between $50 million and $100 million. The primary insurer would then be responsible for covering the first $50 million in losses. Excess of loss reinsurance contracts are priced based upon the characteristics of the risk being covered and its location in the insurance layering program, not as a percentage of the total insurance premium.

Over the past several years, "side car" contracts have been an important new source of capital to the reinsurance industry. These contracts allow investors such as hedge funds or speculative investor pools to partner with reinsurance companies to share in the profits and losses of reinsurance contracts without having to develop their own reinsurance facility and client base.

The amount of reinsurance purchased peaked in 2003, at $30.6 billion.[14] In 2004, the amount of reinsurance declined by 6.1 percent to $28.4 billion and further declined in 2005 by 12.0 percent to $25.3 billion. The severe hurricanes in 2004 and 2005 caused reinsurance companies to pull back in 2004 and 2005.

Layering

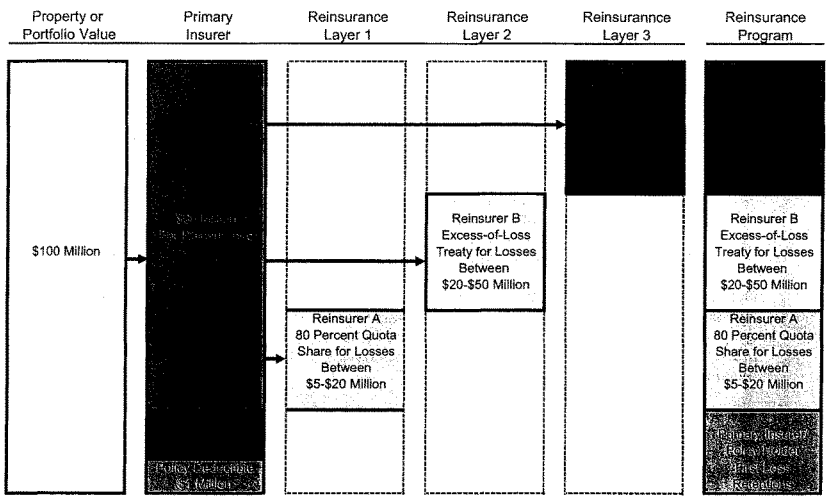
When an insurance company does not want to assume all the risk associated with an insurance policy, the insurer can share this risk with multiple reinsurers through the layering process. Insurance layering is a sophisticated process where different loss layers are apportioned to different reinsurance carriers. The layering approach allows reinsurers to specialize in various layers of risk. Some reinsurers specialize in low frequency, low payment events. These reinsurers assume the lower layers of the

[14] *Reinsurance Underwriting Report*, Reinsurance Association of America, 1998-2005.

insurance program. Other reinsurers specialize in low frequency, high loss events, such as catastrophic events and will assume the higher layers of the insurance program. This specialization allows for the efficient pricing of each layer of risk due to the reinsurer's experience gained from writing hundreds or thousands of similar policies. Some reinsurers have the expertise to cover all layers of the insurance program.

An example of how a layering program works is shown in Exhibit 25. The first layer loss is an 80 percent quota share in which the reinsurer will cover up to $12 million in losses and the primary insurer will cover up to $3 million in losses. The second layer is an excess-of-loss treaty with the reinsurer covering up to $30 million in losses.

Exhibit 25
Illustrative Reinsurance Layering Program



Potential Range of Loss Payments					
Policy Holder	$0-$1 Million	$0	$0	$0	$0-$1 Million
Primary Insurer	$0-$4 Million	$0-3 Million	$0 Million	$0 Million	$0-$7 Million
Reinsurer	NA	$0-12 Million	$0-$30 Million	$0-$50 Million	$0-$92 Million
Total					$0-$100 Million

The final layer is a facultative excess-of-loss contract that will cover up to $50 million in property damage starting after the $50 million loss threshold is reached. In this example, the maximum loss exposure was $1 million for the policy holder, $7 million for the

primary insurer and $92 million for the reinsurers. This example demonstrates how the primary insurer's maximum loss exposure can be greatly reduced by the reinsurance layering process. Although this example shows how reinsurance programs are structured, for actual high value commercial buildings or portfolios, the sophistication of the layering program is much greater with many more layers (5 to 20) and multiple participants (2 to 10) in each layer. Also in this example, the primary insurance company established the layering program. Depending on the needs of the organization, layering programs can be created by corporate insurance staff, primary insurers, and insurance and reinsurance brokers.

The severe hurricane-related losses experienced by many reinsurers during 2004 and 2005 have caused them to alter their business models. Wanting to spread out their overall risk, reinsurers are taking smaller loss exposure positions (thinner layers) on each property but in some instances have increased the number of projects that they are willing to reinsure. However, the net impact of these changes has been a decrease in overall capacity from 2005 to 2006 because the increased number of projects reinsured did not make up for the decline in the amount of risk being covered. This has caused difficulty for some property owners to place full insurance coverage in every layer of their insurance program. Given this new market reality, insurance companies and insurance brokers are working nonstop to place full insurance coverage for their clients. For those policy holders with significant hurricane loss potential, insurance brokers strongly advise policy holders to receive renewal commitments well in advance of insurance expiration dates.

Similar to primary insurers that want to spread out their loss exposure risk by purchasing reinsurance, reinsurers also spread out their loss exposure risk by purchasing reinsurance. The process of reinsurers purchasing reinsurance is called retrocession. Through the reinsurance and retrocession processes, insurance risk is distributed throughout the world. In fact, the top ten reinsurers in worldwide premiums are located in Germany, Switzerland, the U.S., England and Bermuda. Finally, some of the largest insurance companies wear many hats. Depending on the insurance policy, an insurance company could serve any of the following roles: primary insurer, reinsurer, or retrocessional insurer. Additionally, insurance risk is also spread out internationally by the primary insurer being domiciled in a foreign country or an alien insurer. Retrocessions have also decreased substantially.

Surplus Lines

Property/casualty insurance coverage not available from insurers licensed in the state, called admitted companies, can be purchased from a non-admitted carrier. Examples include risks of an unusual nature that require greater flexibility in policy terms and conditions than exist in standard forms or where the highest rates allowed by state regulators are considered inadequate by admitted companies. Laws governing surplus lines vary by state. During periods of hard insurance market conditions, surplus line insurers add insurance capacity that is not available from admitted carriers.

A significant peril for surplus lines policy holders is that these carriers do not participate in state-operated insurance insolvency funds. In the event that an insurance company becomes insolvent, the insolvency fund pays the outstanding insurance claims up to the state prescribed limit per policy. Surplus line carriers do not contribute to state insolvency funds. Consequently, in the event that a surplus line insurer becomes

insolvent, their policy holders would not be eligible for payment of unpaid insurance claims by the state insolvency fund. As discussed in the Insurance Industry Regulatory Framework section, there is an increase of consumer risk associated with surplus lines insurance because these insurance companies do not participate in state solvency funds.

Captives

Captives are a special insurance company set up by a parent company, trade association, group of companies, or risk-retention groups to insure the risk of the owner or owners. Risk retention groups are formed by companies in a common industry. The Product Liability Risk Retention Act of 1981 provided the legal framework for creating risk retention groups. As hard market conditions continue in the property insurance markets of hurricane-prone areas, the creation of captives for property insurance is likely to be strongly considered by organizations that have not been able to place property insurance. The downside of captives is that when losses exceed premiums, additional capital may have to be added by the companies comprising the captives. This provides for greater uncertainty about total loss exposure than a conventional insurance program where the maximum loss exposure (deductible) is clearly stated in the insurance contract.

An attractive alternative for organizations that do not want to go through the process of creating and operating a captive is to participate in a rent-a-captive program. A rent-a-captive is a captive operated by an existing insurance company that charges a fee for operating the captive with the company(s) participating in the captive providing the capital to cover any losses that exceed total insurance payments. The rent-a-captive operating company has no responsibility for loss payments.

Residual Market

The residual market provides insurance for risks that the insurance market is unwilling to accept. Insurance companies have the ability to accept or reject each insurance applicant. Because certain insurance applicants, due to negative loss history, exposure to a non-insurable peril, or a variety of other reasons, cannot obtain insurance, insurance regulators, as a matter of public policy, decided that these insurance applicants should have a mechanism for obtaining insurance. The voluntary market is the portion of the insurance market in which insurance companies are willing to place insurance. The opposite of this is the involuntary or residual market.

There are a variety of residual insurance programs for property owners. With 32 states with their own programs, the most popular residual insurance program is the Fair Access to Insurance Requirements Plans (FAIR Plans).[15] The concept of FAIR Plans was established following the passage of the Housing and Urban Development Act of 1968, a measure designed to address the conditions that led to the 1967 riots. FAIR Plans in Georgia, Mississippi, New York, New Jersey, and Massachusetts also include wind coverage. In 2004, FAIR Plans insured property valued at $400.4 billion. Any losses associated with FAIR Plans are made up for by special assessments to admitted

[15] *Residual Markets*, Insurance Information Institute, June 2006.

insurers (those insurers licensed to operate within the state) based upon their percentage of property insurance premiums written in the state.

Beach and Windstorm Plans (Beach Plans) are offered in designated portions of a state most susceptible to hurricane or other windstorm damage and are operated by property insurers in states along the Eastern Seaboard and Gulf Coasts for both residential and commercial properties. Beach Plans in Mississippi, South Carolina, and Texas are limited to wind and hail coverages. Property owners in eligible Beach Plan areas can either purchase property insurance from insurance companies or through the Beach Plan. However, due to the pullback of insurers willing to provide coverage in hurricane-prone areas, the coverage burden has increased for Beach Plans. In 2002, the Florida Legislature passed a law that combined the Florida Residential Property and Casualty Joint Underwriting Association (FRPCJUA) and the Florida Windstorm Underwriting Association (FWUA). This resulted in the creation of Citizens Property insurance Corporation (Citizens), which provides insurance to homeowners in high-risk areas and others who cannot find coverage in the open, private insurance market.

From December 31, 2005 to July 31, 2006, the number of Citizens' policies increased from 810,017 to 1,218,257. For this same period, the loss exposure for the properties insured by Citizens jumped from $210.6 billion to $343.0 billion, a stunning 62.9 percent jump in loss exposure over a seven month period. This increase was caused by the Poe Financial Group (Poe) insurance companies (Southern Family Insurance Company, Atlantic Preferred Insurance, Florida Preferred Property Insurance Company) being placed in receivership on June 1, 2006. With 325,500 insurance policies in place, Poe was one of the largest insurers in Florida. With operations limited to Florida, Poe was not able to recover from severe hurricane-related losses in 2004 and 2005.

However, Citizens had limitations for commercial property policy holders. For high-risk areas (primarily coastal areas), Citizens limited coverage for commercial properties to $1 million. For multifamily residential properties, full insurance coverage is available from citizens in high risk areas. Based on reports that insurance above $1 million was not available in non high-risk areas, Florida Insurance Commissioner Kevin McCarty activated F.S. 627.351 (5), the Florida statute that allows for the creation of a commercial property joint underwriting association (JUA). The first JUA meeting was held on August 25, 2006 and the plan to offer insurance policies for small businesses was announced. In this initial phase of the JUA, coverage will be limited to $1 million ($750,000 contents + $250,000 business interruption). The JUA is not part of Citizens. Last year, Louisiana implemented an insurance pool similar to Citizens and Texas is considering a similar plan. When there are insufficient premiums to cover underwriting losses, plans such as Citizens have recovery mechanisms that are paid for by policy holders and insurance companies. In addition, state funds are sometimes added to cover a portion of the losses thus lowering the recovery burden on policy holders and insurance companies.

In addition, states have set up insurance programs to cover other perils. The California Earthquake Authority (CEA) is a privately financed, publicly-managed entity that offers residential earthquake insurance to California homeowners, renters, condominium owners, and mobile home owners through its participating insurance companies. However, commercial property is not covered under the program.

A major limitation of the residual insurance programs is that they are limited to named perils such as hurricanes, tornados, earthquakes, etc. Property owners are required to obtain insurance from private insurers for perils that are not covered by the residual insurance program. In addition, state-operated residual insurance programs are not typically rated by insurance rating agencies. Borrowers, lenders and servicers must rely on the residual insurance program to meet its loss obligations.

Self Insurance Groups

Self insurance groups are groups from a similar industry that self insure each other's exposures for a specified risk. Thirty-seven states have authorized legislation for self insurance groups.[16] However, self insurance groups have been primarily created to cover workman's compensation issues.

Catastrophic Bonds

Catastrophic bonds (cat bonds) transfer risk from insurance companies to bondholders. Cat bonds are risk-based securities that pay high interest rates and provide insurance companies with a form of reinsurance to pay losses from a catastrophe such as those caused by a major hurricane. They allow insurance risk to be sold to institutional investors in the form of bonds, thus spreading the risk.[17]

The current hard reinsurance market for catastrophic risks is providing a financial incentive for insurance companies to consider cat bonds.[18] The issuing process has become more efficient in recent years, which has reduced the cost of issuing cat bonds, making them a more competitive risk sharing vehicle. Additionally, with over 70 cat bonds issued or in the process of being issued, insurance companies, risk modeling companies, and rating agencies have gained familiarity and comfort with cat bonds. In 2005, worldwide cat bond issuance was a record $1.99 billion.[19] However, this level of cat bond issuance represents only 7.9 percent of the $25.3 billion in net reinsurance premiums in the U.S. for 2005. Consequently, for the cat bond market to step into the role of replacing the decline in reinsurance capacity for catastrophic events, the level of cat bond issuance would have to increase dramatically. Given the tepid post-Katrina investor demand for cat bonds, this circumstance is unlikely.

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16 *Creative and Other Risk-Financing Options*, Insurance Information Institute, May 2006.

17 *Glossary of Insurance Terms*, Insurance Information Institute (http://www.iii.org/media/glossary/alfa.S/)

18 *The Booming ART Market*, S. Ming Lee, AIR Worldwide Corporation, 2006.

19 *The Catastrophic Bond Market at Year-End 2005, Ripple Effects from the Record Storms*, Guy Carpenter and Company, 2006.

IMPACT OF HARD MARKET FOR CATASTROPHIC INSURANCE CONDITIONS

Borrowers

Hard catastrophic insurance market conditions are having varying impacts on borrowers. Borrowers with large geographically diverse portfolios (over $100 million) have had less trouble placing catastrophic insurance, although sublimits for wind and earthquake insurance may have been reduced. For these borrowers, insurers have been able to place insurance coverage because of the modest aggregate exposure to catastrophic risk that a well diversified portfolio provides.

However, the story is quite different for borrowers with single properties or a portfolio of properties located in a single high risk hurricane market. For these borrowers, reports of property insurance rate increases of over 100 percent have been the norm, with some borrowers reporting increases of up to 600 percent. The private sector insurance market has almost completely dried up for multifamily buildings with wood roofs located within five miles of the ocean in Florida and in some Gulf Coast locations.

For borrowers experiencing dramatically increased insurance pricing, downward pressure has been put on the cash flow of their properties. These borrowers report that increased insurance costs teamed with increased utility and tax payments have significantly reduced the cash flow of their properties. The ability to pass these costs to tenants is dependent on the lease structure that sometimes caps expense reimbursement growth. Borrowers have also indicated that they are caught between a "rock and a hard place" when they are not able to comply with loan covenants because the only available insurance has catastrophic sublimits that are too low or the insurance company's rating is below the required rating.

For borrowers purchasing property, MBA members have reported that the high catastrophic insurance costs in Florida and the Gulf Coast have caused the delay or cancellation of some deals. Deals have been cancelled either because catastrophic insurance was not available or the pricing of the catastrophic insurance lowered debt service coverage ratios to unacceptable levels. The pullback in overall capacity is having a large impact on new financings in hurricane-prone areas because insurers have given existing accounts first priority and, after existing customers have renewed, very little capacity remains for new business.

Borrowers are working harder with their exiting insurer or insurance broker to place coverage. Layered Insurance programs have become much more complex as insurance companies wanting to spread out their risk on any given property are taking smaller pieces of reinsurance. This means that there are more participants in each layer of the insurance program. Where there may have been one or two participants in an insurance layer, there are now 3 to 10 depending on the insurance program size. This means that a borrower must work with their insurance company or insurance broker well in advance of the renewal date in order to line up the insurance program. Borrowers with insurance expirations in the third and fourth quarters should work closely with their insurance

company or broker well in advance of their expiration dates in order to "reserve" insurer capacity before it is allocated to other borrowers.

Lenders

For new loan originations or refinancings, many lenders are now requiring borrowers to secure property insurance in hurricane-prone areas prior to starting the lending process. This practice was brought about by some loans failing to close because of the borrower's inability to obtain property insurance in hurricane-prone areas. When property insurance is secured, lenders are first looking at the debt service coverage ratio to make sure that the loan meets underwriting requirements.

Given the hard market conditions for catastrophic insurance, lenders are faced with the challenge of meeting their insurance underwriting requirements with full replacement cost insurance either unavailable or unaffordable (or both) in some areas. Borrowers not able to obtain full replacement cost insurance coverage are looking to lenders to accept more creative insurance programs that include letters of credit and other alternative risk transfer products. Alternative risk transfer products were examined in the *Insurer Category* section and include: self insurance, captives, and risk retention groups. Recently, borrowers have been using wind probable maximum loss (PML) studies to modify insurance coverage requirements. A PML study for wind provides the estimated maximum loss from a hurricane or other windstorm event. Borrowers have attempted to use the PML value for full amount of property value requiring insurance coverage instead of the full replacement cost of the building. Thus far, CMBS rating agencies have been dubious of PML studies and have not accepted them. Lenders specify which alternative transfer products are acceptable.

Portfolio lenders have some flexibility regarding acceptable insurance structures which allows them to accept alternative risk transfer products. The alternative risk transfer products accepted by portfolio lenders are dependent on the underwriting requirements, specifics of the deal, and the relationship with the borrower. However, for loans that are intended to be securitized, the insurance requirements must be in conformance with the loan documents and the pooling and servicing agreement (PSA). This provides much less flexibility for accepting alternative risk transfer products.

Servicers

Given the catastrophic insurance capacity crunch, some servicers have been encouraging borrowers in hurricane-prone areas to obtain renewal commitments far in advance of the insurance expiration date. For hurricane or earthquake-prone areas, servicers are working with borrowers to ensure that the insurance coverage offered at renewal meets loan covenant requirements. **Decreasing catastrophic sublimits coupled with increasing deductibles are areas of concern for both borrowers and servicers.**

MBA members report that the vast majority of borrowers have been able to obtain property insurance that meets the loan covenants. Force-placed insurance has been a rarity and has been required for borrowers primarily in Florida that have not been able

to obtain insurance because of capacity issues. These borrowers tend to be single loan borrowers or have small portfolios concentrated in hurricane-prone areas. Borrowers with geographically dispersed commercial real estate portfolios are reporting less difficulty in obtaining catastrophic insurance.

Servicers are reporting dramatic insurance rate increases for force-placed coverage. Should the number of force-placed insurance policies dramatically increase, servicers will be faced with capacity issues as well. Consequently, because of capacity issues for the servicer and cost issues for the borrowers, force-placed insurance does not represent a long-term solution for the catastrophic insurance capacity shortage.

For Florida, servicers are reporting that forced-place insurance providers are requiring moratoriums, insurance caps, or are pulling out of the state completely. These actions often occur with very little notice.

Unlike portfolio lenders who have the flexibility to address the individual circumstances of each loan, CMBS servicers are required to enforce loan document and PSA requirements. PSA's typically specify that full replacement cost insurance must be in place by an insurer with a BBB credit rating (typically BBB, but lender can specify a higher or lower rating) or better and the deductible must be below a certain threshold, typically 5 percent. **Given the difficult catastrophic insurance market conditions, servicers have been seeking enhanced flexibility in dealing with borrowers who have difficulty in obtaining property insurance that meets all of the PSA requirements.**

In the past, loans that were not able to meet insurance requirements were automatically sent to the special servicer, as a technical default under the loan documents, which initiated a special servicer fee (typically 1.0 percent of the loan balance) that would be taken from proceeds to investors. Servicers have been seeking flexibility on the assessment of this fee when the only reason the loan was transferred to the special servicer was the lack of insurance.

Recently, the rating agencies have been showing more flexibility in how servicers can deal with loans that have had difficulty in meeting PSA mandated insurance requirements. In the *US CMBS and CRE CDO Second Quarter 2006 Review,* Moody's addressed the issue of servicer flexibility in dealing with the challenges of the hard market conditions for catastrophic insurance:

> Servicers are also asking for the flexibility to deal with this very difficult market, including the option to grant waivers from loan documents language (similar to a formula developed during the terrorism insurance crunch). This approach could lessen the frequency and severity of the nasty litigation that plagued many pools with terrorism insurance issues. Moody's believes that servicer flexibility is a good thing, when structured the right way. We will be working with servicers and issuers on pooling and servicing agreement language (PSA) that strikes the right balance between recognizing the reality of the market and protecting the bondholders' investment.

Servicers are identifying those properties in serving portfolios that are in locations at risk for difficulty in obtaining insurance coverage and have been working with these borrowers well in advance of insurance expirations to make sure that commitments for insurance renewals are in place. For those properties unable to meet the PSA-mandated insurance coverage, servicers are working with these borrowers to find alternatives that will allow them to be in compliance with the PSA. Troublesome areas have included:

- Only being able to obtain coverage from insurance companies with investment ratings below PSA requirements.
- Insurance deductibles that are above the PSA requirements.
- Not being able to obtain full replacement cost insurance for catastrophic events.
- Substantial increases in hurricane related windstorm pricing.
- Insurance premiums have increased sufficiently for some properties causing them to be placed on the Watch Lists because of reduced debt service coverage ratios.
- For some properties, insurance coverage is not available to the borrower for any price.

As a last resort, force-placed insurance has been used in a limited number of cases. Fortunately, forced-placement has been extremely limited.

Some servicers have reported increased costs due to the fact that they have added new or temporary staff to actively monitor and work with borrowers that are in high-risk hurricane areas to make sure that insurance coverage remains in place. This brings back memories of the period between September 11, 2001 and the passage of the Terrorism Risk Insurance Act in November 2002, when insurance renewals excluded terrorism insurance, which caused an enormous loan document compliance problem for borrowers and servicers.

Rating Agencies

Rating agencies involved in rating CMBS have also expressed concern about rising windstorm insurance pricing and the impact of this pricing on the debt service coverage ratios for properties with securitized loans. Using its database of securitized properties, Dominion Bond Rating Service, Inc. performed analysis for debt service coverage ratios based upon differing property insurance escalation levels. Shown in Exhibit 26 are the results of this analysis. The product categories that are most susceptible to increased property insurance payments are office, multifamily and full service hotel. When insurance rates are doubled for these product categories, the debt service ratio falls below 1.2, which raises concerns for the rating agencies. The remaining product categories: anchored retail, weakly anchored retail, unanchored retail and self storage, have debt service coverage ratios that fall below 1.2 after insurance premiums are tripled. Retail leases typically have pass through to tenants for insurance payments.

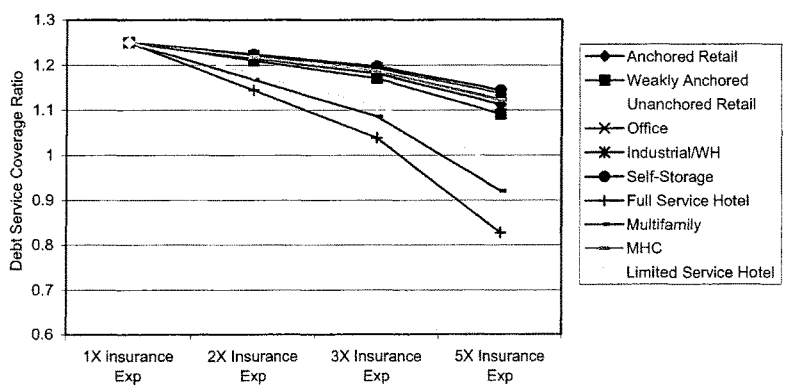
In the *US CMBS and CRE CDO Second Quarter 2006 Review,* Moody's raised the concern that movement away from full replacement cost insurance policies could have "serious" credit implications.

Moody's indicated the following approach to loans with inadequate windstorm insurance:

> When cases of inadequate windstorm insurance are presented, Moody's will look closely at the concentration in pools of properties in the tier 1 [highest risk] windstorm areas and will be assessing how much of an equity cushion (using Moody's values) is available to each possibly inadequately covered property. If there is inadequate coverage, or troubling language is found in the insurance provisions of the loan documents, Moody's may adjust its subordination levels accordingly, tapered in magnitude down the capital stack.

Moody's also indicated that underwriting assumptions for hurricane-prone properties for insurance payments will need to be "adjusted upwards" if insurance payments remain at their current increased levels. The hard catastrophic insurance market has caught the attention of the rating agencies; they are poised to take active measures to protect the credit quality of CMBS pools should insurance policy's fall below full replacement value. Given this priority, the investment grade purchasers of CMBS should have little worry

Exhibit 26
Impact of Insurance Rate Increases on
Debt Service Coverage Ratios



Source : Dominion Bond Rating Service, Inc.

that any pool losses associated with hurricane events would impact investment grade bonds. In order to protect their first loss position, many B piece investors also serve as the special servicer in CMBS transactions. In this position, these investors tend to monitor very closely insurance renewals for CMBS pools in which they have a B piece interest.

Investors

Thus far, the rating agencies have been enforcing the industry requirement for full replacement value insurance coverage for properties that are part of a securitization pool. However, investors, particularly B piece buyers, are actively monitoring this situation.

One B piece investor has reported that out of its 9,000 loan CMBS portfolio, only nine loans have required force-placed property, windstorm, or earthquake insurance. In most of these cases, the reason for force-placed insurance is that the borrower is unable to obtain the required insurance. The borrowers holding six of those loans, with an aggregate principal balance of $40 million, have continued to pay the premiums for the force-placed policies. Three of the loans, totally approximately $15 million, have been transferred to the special servicers as a result of the borrowers' failure or refusal to pay for the force-placed insurance. This B piece investor is working proactively with servicers to monitor the status of renewals on properties in high-risk locations.

As indicated by Moody's, loans that are included in a pool without full replacement cost insurance coverage or have "troubling" language, may be required to have increased subordination levels. This could increase the size of the B piece tranche in a securitization. At this point, B piece buyers will have to carefully examine the hurricane or other catastrophic risk exposure of the loans without full coverage and factor this into their modeling and decision process for purchasing an interest in a B piece pool.

Summary

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.

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STATEMENT OF THE NATIONAL ASSOCIATION OF REALTORS®

The Subcommittee on Oversight and Investigations of the House Committee on Financial Services Hearing

"Insurance Claims Payment Processes in the Gulf Coast after the 2005 Hurricanes"

Wednesday, February 28, 2007

REALTOR® is a registered collective membership mark which may be used only by real estate professionals who are members of the NATIONAL ASSOCIATION OF REALTORS® and subscribe to its strict Code of Ethics.

The NATIONAL ASSOCIATION OF REALTORS® (NAR) welcomes the opportunity to present our views on insurance issues at this Subcommittee on Oversight and Investigations hearing. There is much to be learned in the aftermath of Hurricane Katrina, especially the importance of having adequate -- and understandable -- property insurance. NAR believes that Congress should adopt a comprehensive approach to natural disaster planning and preparedness. NAR supports a comprehensive natural disaster policy that will ensure the availability and affordability of property insurance. In addition, natural disaster policy should encourage personal responsibility, promote mitigation measures, and strengthen critical infrastructure (e.g., levees, dams, bridges, etc.).

The Need for Insurance

Events of the past few years have left many homeowners and commercial property owners with inadequate or non-existent insurance coverage. There are a variety of reasons: high cost of insurance, high deductibles, and lack of available insurance products in the competitive marketplace. Recent natural disasters have led a number of insurance companies to cancel policies and pull out of markets because they fear that a significant loss could severely impact them.

A strong real estate market is the linchpin of a healthy economy, generating jobs, wages, tax revenues and a demand for goods and services. In order to maintain a strong economy, the vitality of residential and commercial real estate must be safeguarded.

The issue of available and affordable insurance in disaster-prone areas is a matter of serious concern to REALTORS®. We cannot stress enough that the ultimate victims of this insurance crisis – and let us assure you that in many states in the Southeast, it is a crisis – are

consumers frustrated in their attempt to realize the American Dream of homeownership. The insurance availability and affordability crisis in the Gulf Coast region extends beyond homeowners' insurance and touches virtually every aspect of the real estate market. Many of NAR's commercial members have reported problems obtaining commercial property and casualty insurance during the brokerage of commercial real estate. Insurance is a key component to financing the purchase of real estate. The limited availability of insurance threatens to slow the investment in commercial real estate which could, in turn, further delay the rebuilding of our storm-ravaged coasts.

The inability to obtain affordable homeowners' insurance is a serious threat to the residential real estate market. Not only does it imperil the market for single family detached homes, but condominiums, co-operatives and rental units are affected as well. New home purchases, resale transactions and housing affordability are affected in the following ways:

- **Homeowners' insurance is a necessary component in securing a mortgage and buying and selling a home.** If a potential homebuyer is unable to obtain or afford the required insurance, the sale will not be completed. As a result, potential homebuyers are priced out of the market.
- **Homeowners' insurance is tied directly to the cost of owning a home.** If a homeowner is unable to maintain insurance required by a mortgage lender, the mortgage is in default. If disaster insurance coverage is optional, potential buyers may choose not to purchase a home because the insurance they need is too expensive. Others may choose to go unprotected.
- **Insurance costs impact rent levels.** Insurance costs incurred by multi-family property owners are ultimately passed on to tenants through higher rents. This impacts housing affordability, particularly for low-income renters and buyers.

Many of NAR's commercial members in the gulf coast and coastal regions have reported problems with commercial insurance availability and affordability. Members have experienced large increases in premiums, and in some cases, a complete lack of availability. Our commercial members are involved in all aspects of commercial real estate: property management, commercial leasing, sales brokerage, and general real estate advisory services. They have seen first-hand how the insurance climate has affected local economies and the commercial real estate markets.

Members have seen premiums increase dramatically -- in some cases more than four fold with concurrent increases in deductibles and decreases in coverage. These changes put the property owner at greater financial risk to recover from losses, while also affecting property values. Dramatic insurance increases often cannot be passed on to tenants. For example, in the multifamily housing sector, the ability to pass on increased insurance costs in the form of higher rent is limited by rent stabilization laws and strict limits imposed on federally subsidized landlords. The retail sector faces similar problems because lease arrangements are often negotiated with the tenants. These leases may cover more than one year and may include limitations on the amount of expenses that may be passed on to the tenant. Thus, when insurance costs rise from $0.10 to $0.50 cents per square foot, the landlord must absorb most of the increased costs.

Often it is the smaller property owner that suffers. They cannot offset the increases in insurance costs with lower insurance costs in other parts of the country, nor are they able to negotiate a lower multiple property rate. In commercial real estate, there is a point at which insurance becomes unaffordable -- when insurance expenses are so high that the property no longer generates income. This problem forces many owners to sell their property.

The National Flood Insurance Program

The National Flood Insurance Program (NFIP) is an important program that protects homeowners in flood-prone areas. NAR supports changes to the NFIP that will ensure the long-term viability of the program.

Accurate flood maps are the cornerstone of the NFIP. NAR supports adequate funding of FEMA's map modernization program to ensure that flood maps are updated and maintained. NAR also believes that the federal flood insurance program should impose "full risk" premiums for flood insurance on repetitive loss structures that have repeatedly (i.e., more than two occurrences) suffered insured flood losses and have declined a reasonable offer of mitigation funding from FEMA, except in states which have been granted a federal exemption. Flood maps help communities develop flood management strategies, implement more effective land use and building codes, develop disaster preparedness plans, and incorporate disaster planning into regional economic development strategies. We urge Congress to work with FEMA to update these maps as quickly as possible.

We believe that the mandatory purchase requirement under current law must be enforced. Homeowners with mortgages held by federally-regulated lenders whose homes are located in a special flood hazard area are required to purchase and maintain flood insurance. If a property owner fails to obtain and maintain this coverage, their lender is required to purchase this coverage on their behalf and bill the borrower. FEMA should increase enforcement of this requirement, which would increase premium revenue to the National Flood Insurance Program as well as further reduce the costs of a flood event to the federal government.

Having a viable NFIP is a first step, but more needs to be done.

A Comprehensive Natural Disaster Policy

NAR supports the creation of a federal policy to address catastrophic natural disasters that:

1) Protects property owners by ensuring that simple, transparent, and comprehensive insurance coverage is available and affordable, with premiums being reflective of the risk involved;
2) Acknowledges the importance of personal responsibility of those living in high-risk areas to undertake mitigation measures, including the purchase of adequate insurance, and provide adequate incentives where appropriate;
3) Emphasizes the importance of adequate building codes and smart land use decisions and proper enforcement of both by local and state governments;
4) Recognizes the role of States in maintaining a viable insurance marketplace while acknowledging the limitations of the marketplace and identifying the proper role of government intervention in cases of mega-catastrophes; and
5) Reinforces the proper role of government to invest in and maintain critical infrastructure including levees, dams, and bridges.

NAR believes that now is the time for Congress to address a comprehensive natural disaster policy that includes natural disaster insurance. The inability to obtain affordable homeowners' insurance is a serious threat to the residential real estate market – and thus, our economy, in several ways. Because homeowners' insurance is a necessary component in securing a federally-related mortgage, an otherwise creditworthy potential homebuyer who cannot obtain the required insurance is priced out of the market. If an existing homeowner is unable to maintain insurance required by a mortgage lender, the mortgage is in default. In lease situations, insurance costs incurred by landlords are ultimately passed along to tenants in the form of higher rents.

NAR supports the creation of a federal natural disaster program that will prevent future disruptions in insurance markets and promote available and affordable homeowners' insurance in disaster-prone areas.

Congress has, with varying levels of interest, debated and voted on natural disaster policies since the 1990s. In the 109th Congress, no one approach emerged as a front-runner. NAR supports the efforts of members of Congress who have introduced and co-sponsored legislation to address this critical issue. We encourage a healthy and vigorous debate during the 110th Congress that leads to sound and productive legislation.

The issue for NAR is simple: homeowners and commercial property owners need insurance to protect themselves, their families and their property in case of catastrophe. If insurance is not available or affordable, many may choose to go without insurance – precisely the decision many Californians have made due to the high cost of earthquake insurance. If "the big one" hits, and people are not insured, then the American Taxpayer, that is to say everyone in the country, will pay. NAR believes that people who bear risk should pay a fair share – by obtaining and maintaining adequate insurance coverage.

It is in the best interests of all Americans to have a comprehensive federal natural disaster policy that includes aggressive mitigation, assumption of risk, and affordable and available insurance for homeowners and commercial property owners. Having a comprehensive natural disaster policy that addresses the concerns of property owners, taxpayers and the proper role for government is essential in the coming years. There is no guarantee that 2007 will be as benign as 2006. The question is not whether there will be another Katrina-like event in size and scope of destruction, but when. As we have learned, it is far less costly to prepare ahead of time than

to fund recovery efforts. Research has shown that, for every $1 spent on mitigation, results in a post-event savings of $4.

This issue is an extremely important one to NAR, REALTORS®, homeowners, commercial property owners, and taxpayers. NAR looks forward to working with the Committee on Financial Services and Members of Congress on this important issue.

Thank you.

Financial Services Committee

Feb 08, 2007

Dear Erika,

I spoke with you today regarding my Katrina insurance horror story. I am sending the details and exhibits in this Email. I waive any confidentiality regarding this correspondence.

My home at 6400 Lakeshore Rd, Lakeshore, MS 39520, was severely damaged by Hurricane Katrina. I immediately notified my insurance company, USAA, of my loss and claim. They stalled me for several weeks (and many phone calls) by saying that USAA had only one person qualified to handle claims in Mississippi and that person would contact me soon. I thought this was a strange way to run an insurance company.

Someone did contact me five weeks later and stated I was not covered for anything because I was not covered for wind or hail damage. I requested formal notification of this and they sent me a letter of explanation on October 11, 2005.

[See: USAA Letter #1]

In March 2006, I read over my policy and noticed under **Coverage D-Loss of Use** I was eligible for some coverage from my policy.

[See USAA Letter Exhibit #2]

I then called USAA and spoke to many representatives over a two week period. USAA tried to run me "around and over." I enclose a portion of the letter I wrote the President of USAA, Robert G. Davis, describing my experience dealing with his agents after I discovered USAA's letter of Oct 11, 2005 was a misrepresentation:

*..... "Although my coverage does contain an exclusion for wind it also contains an exemption to that exclusion allowing for losses under **Coverage D.** USAA did not assist me, although able to do so under the exclusion which I found six months later, on my own and with USAA representatives denying it's existence for that period.*

After I noted the exemption to the exclusion I contacted USAA and after a morning of calling, being put on hold, bumped from rep to rep, I spoke to Sherry Rocha, in the Mobile office, who said it had been determined the loss was due to flood which wasn't covered. I asked if she had a report since this conflicted with their original letter of Oct, 11, 2005. I got several answers to my question, including yes, no and maybe. When I asked for a copy of any information regarding the determination, she said she would send me some photos. Only one showed a "flood line" which was drawn in the margin of the fax I received. I presume someone made the flood determination from a desk because if you see my exhibits there is no such flood line. USAA's flood line is not accurate and cannot be proved. Why the subterfuge?

*Next I called USAA claims again and asked for a supervisor. After holding for several reps, a Mr. Dunk denied there existed a form HO-94MS, which describes the **Coverage D** exception to the wind damage clause, even though I held one in my hand and read it to him four times.*

Next I received a call from Rhonda Costely, a USAA Representative from Mobile. She informed me that Mr. Dunk was a brand new employee and didn't know anything. Yet she still denied the existance of ***Coverage D.*** *Finally after many phone calls and seven hours she admitted an exemption existed. But now Ms Costley shifted the blame to flood damage. I wasn't covered, she said, because my house was 100% flood damaged. She could determine from her desk that it was all flood damage, no wind damage. I mention the tornados in the Waveland area. I mentioned Sherry's "flood line" and asked her, how with no mark on the outside wall could someone without a report, without seeing it and without any other confirmation could determine all the damage was flood. Ms Costley said USAA hired the best experts to make this determination. I asked again for a report, since it was obvious Sherry just drew the line minutes before. I have requested the expert reports, none have been sent."*

Erika, I enclose this excerpt because I believe it tells the story of how my claim was "handled" and shows the callous arrogance of USAA when they see a threat to their bottom line. Davis and USAA never responded to my letter nor sent an expert's report.

I did receive a letter from USAA explaining that I am not covered under **Coverage D** because my house was damaged by flood to the exclusion of anything else, wind, tornado, etc.

[See USAA Letter Exhibit #3]

I believe USAA was also deceptive in the manner which they tried to present "exclusive" flood damage. I enclose the photo which Sherry Rocha from USAA sent me earlier to substantiate their proof of flood damage.

The above faxed photo is all USAA would provide. As you can see it is of very poor quality and is noted only with a line and a comment "flood line." It seems difficult if not impossible to determine it's veracity.

Below are three photos I took which clearly show no flood line. These were taken 6 days before USAA's photos. If you look at the photo taken of the side you can clearly see hurricane, wind debris damage to the siding. And you can note no damage to the air conditioner which should have been damaged or stained according to USAA.

No Flood Line

Scrapes from flying debris. Indicative of wind damage. No damage to A/C

No Flood Line

This sequence of photos shows to me and everyone who has seen them that USAA's photo is inaccurate if not fraudulent. It appears there is no flood line, and USAA will not provide me with a clearer photo or a report.

You may use this letter and it's exhibits to any purpose you wish. I would be more than happy to travel to Washington and testify at my own expense. I can be reached at cell phone # 978-395-1926 or 508-646-9929. Please notify me if you need any more information or clarification of the exhibits.

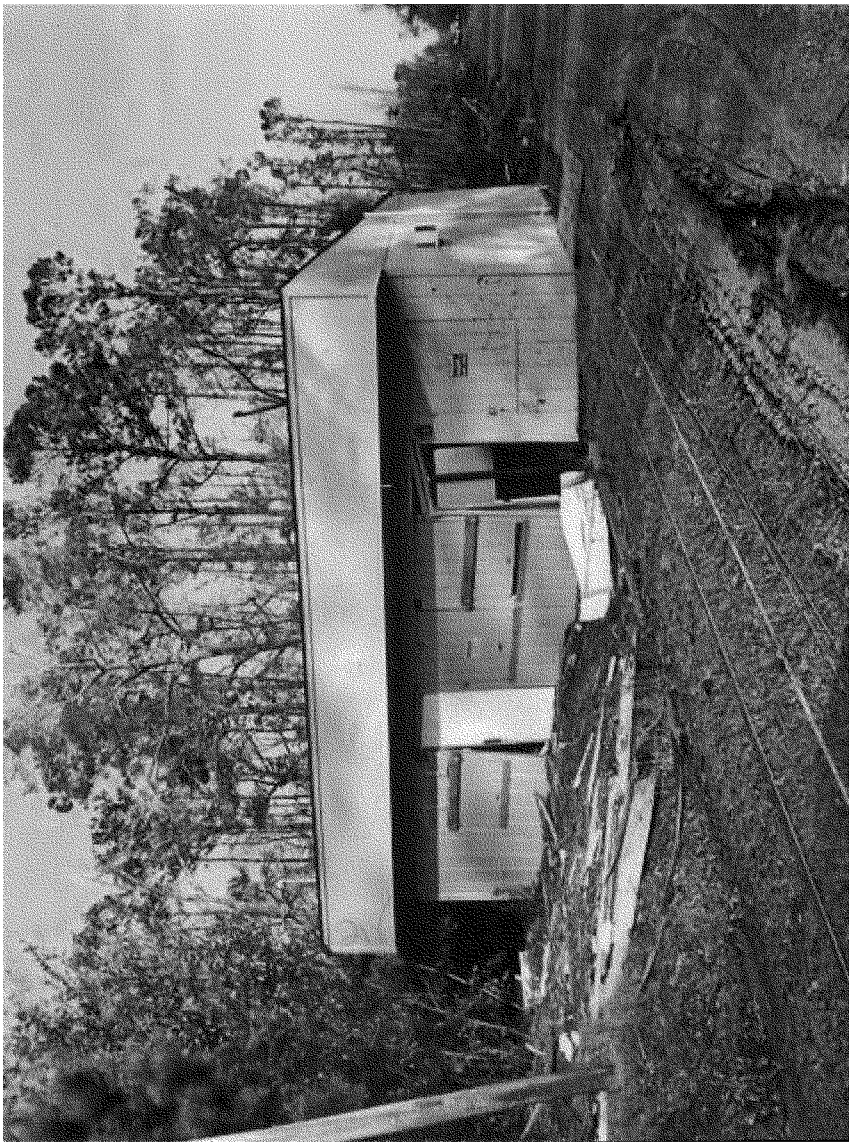
Jeffrey H Rose

PO Box 1111

6400 Lakeshore Rd.

Lakeshore, MS 39558

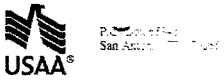
Email ajstephans@verizon.net



Flood Line

4 Rose_Jeffrey (3) 09/17/2005 Flood damage

Letter # 1 from
USAA
10/11/05
Denial Due to wind
for "any loss"



October 11, 2005

JEFFREY H ROSE
PO BOX 5115
FALL RIVER MA 02723-0414

Policyholder : Jeffrey H Rose
Reference Number : 85-02-70-90A
Date of Loss : 8-29-2005
Place of Loss : 6413 LAKESHORE RD
BAY SAINT LOUIS, HANCOCK, MS 39520

Dear Mr. Rose:

This letter is in regard to the claim that was presented to us for wind damage to the above location. Your Homeowners policy with USAA on this property contains an exclusion for wind and hail damage.

Unfortunately, we will be unable to assist you with any loss resulting from this recent claim.

Sincerely,

SERO Internal Catastrophe Unit
United Services Automobile Association

USAA 00085 02 70

HO-94MS (05

THIS ENDORSEMENT CHANGES YOUR POLICY. PLEASE READ IT CAREFULLY.

WINDSTORM OR HAIL EXCLUSION
Mississippi

SECTION I - PERILS INSURED AGAINST

Coverage for the peril of windstorm or hail is deleted. However, we do cover for loss of use under COVERAGE D.

SECTION I - EXCLUSIONS

The following exclusion is added:

16. Windstorm or Hail.

However, this exclusion does not apply to direct loss by fire or explosion resulting from windstorm or hail.

Except as specifically modified in this endorsement, all provisions of the policy to which this endorsement is attached also apply to this endorsement.

Exhibit #2
See Section 1
Loss of use
covered if by
wind/hail

Copyright, USAA, 2002. All rights reserved.
Includes copyrighted material of Insurance Services Office, Inc., with its permission.

Post Office Box 659464
San Antonio, TX 78265
USAA®

CERTIFIED MAIL
RETURN RECEIPT REQUESTED
AND REGULAR US MAIL

March 19, 2006

Exhibit #3
USAA now sees
no wind damage

Jeffrey H. Rose
PO Box 1111
Lakeshore, MS. 39558-1111

Policyholder: Jeffrey H. Rose
Reference Number: 850270-037
Date of Loss: August 29, 2005
Loss Location: 6400 Lakeshore Rd., Bay Saint Louis, MS.

Dear Mr. Rose:

This letter is in regard to the claim that was presented to us for Additional Living Expense Coverage. After our re-evaluation, we do not see any wind damage that would have caused your home to be uninhabitable due to wind.

Therefore, we are regretfully unable to make any payments under ALE coverage. However, we will pay the Prohibited Use and refrigerated products for the specific dates of August 29, 2005 through September 11, 2005. Please contact our office with the information for this time period for payment.

ALE is covered under your Homeowner's policy when your dwelling is not fit to live in as a result of a peril insured against. We have completed our investigation. It was determined that flood was found to be the cause of your home not being fit to live in. Damage caused by flood is excluded by your Homeowner's policy.

Please refer to your HO-93 Homeowners Policy, page 2, 3, and 8 of 17 and note the following:

SECTION I – PROPERTY COVERAGE

COVERAGE D – Loss of Use

The limit of liability for Coverage D is the total limit for all the coverages that follow.

1. **Additional Living Expense.** If a loss covered under Section – I makes that part of the residence premises where you reside not fit to live in, we cover the necessary increase in living expenses incurred by you so that your household can maintain its normal standard living.

Order Code RL33892

CRS Report for Congress

Post-Katrina Insurance Issues Surrounding Water Damage Exclusions in Homeowners' Insurance Policies

February 27, 2007

Rawle O. King
Analyst in Industry Economics
Government and Finance Division

Prepared for Members and Committees of Congress

Congressional Research Service

Post-Katrina Insurance Issues Surrounding Water Damage Exclusions in Homeowners' Insurance Policies

Summary

In the aftermath of Hurricanes Katrina and Rita, homeowners in Louisiana, Mississippi, and Alabama have protested what they view as inappropriate obstacles to the payment of their property damage insurance claims. When insurance adjustors and damage experts assessed the properties damaged by the 2005 storms, they were faced with the issue of allocating damages between wind (a covered loss) and flood (an excluded loss). The delays and economic uncertainty that this activity has engendered have raised financial and legal issues for insurers, as well as homeowners and businesses along the Gulf Coast region.

The solution for some of the insureds has been to litigate with their insurers under a variety of legal theories with the objective of avoiding the standard "water damage" exclusion — a move that would arguably allow insureds to receive coverage for water damage under their homeowners' policies. Many of these theories rely on the principle that any ambiguity in the insurance policy should be construed in favor of the policyholder. In addition, even where the water damage exclusion is enforced, difficult factual and legal disputes have arisen relating to the allocation of damage between covered wind damage and excluded flood damage.

In the aftermath of the devastating 2005 hurricane season, three broad policy issues for the 110th Congress have emerged related to post-Katrina economic uncertainties: (1) the massive insured and uninsured property losses and their impact on Gulf Coast property insurance markets and rebuilding after Katrina, (2) assertions that insurers have shifted the cost of damages onto the federal flood program and U.S. taxpayers, and (3) unreliable government flood maps that are used in decision making by homeowners for purchasing insurance.

Post-Katrina insurance claims litigation and the economic uncertainty it generates for consumers and insurers raise concerns about the volatility in the legal environment in terms of post-event judicial interpretations in the scope of insurance coverage. Questions include What should be done to mitigate the economic consequences of future floods? Are the American people and policymakers ready to address perceived weakness in the U.S. floodplain management policy? Should the nation forgo development of its floodplains (a new policy initiative) or continue along the current path embodied in the NFIP?

Finally, insurance analysts have observed that a large percentage of those eligible to buy federally subsidized flood insurance do not. What could or should be done about this? These and other policy questions might be examined in the 110th Congress.

This report will be updated as events warrant.

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Post-Katrina Insurance Issues Surrounding Water Damage Exclusions in Homeowners' Insurance Policies

Introduction

Hurricane Katrina, the storm surges it produced, and the subsequent levee failures caused devastating flooding in communities located along the Gulf of Mexico Coast. Katrina's winds destroyed or substantially damaged many of the properties located on the Mississippi Gulf Coast, as well as property located further inland from the immediate coastal areas. Tens of thousands of homes and businesses in Louisiana, Mississippi, and Alabama were damaged as a direct result of Katrina's storm surge. Many thousands more homes were condemned and left empty due to exposure to days and even weeks of soaking in often-contaminated flood waters.

Modern homeowners' and business owners' policies are often issued on an "open perils" or "special causes of loss" basis which provides that all direct physical loss or damage to insured property is covered except as specifically excluded. Some policies are still issued on a "named perils" or "specified perils" basis by which the insurer promises to insure covered property only if damaged by listed perils and subject to certain exclusions. Under either approach, damage by wind is typically covered while water damage from flooding, wind driven water, storm surge, seepage or through openings in the building (not cause by other damage) is typically specifically excluded.

There are three main reasons that insurers utilize exclusions: (1) the excluded peril or property is more appropriately insured under a different insurance product or through an optional coverage (e.g., exclusion in property policies for earthquake and mobile equipment); (2) insurance is not an appropriate vehicle for transfer of a particular risk (e.g., exclusions in property policies for failure of appropriate maintenance); or (3) the peril or property presents an unacceptable hazard to the insurer (e.g., exclusions in property policies for nuclear or contamination event). The water damage exclusion is thought to be the result of the first and third reasons. For many homeowners and small businesses, the only explicit insurance coverage against flood damage is underwritten by the National Flood Insurance Program (NFIP), but homeowners have not participated in sufficient numbers for various reasons, as required by law.[1]

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[1] See Lloyd Dixon, Noreen Clancy, Seth A. Seabury, "The National Flood Insurance Program's Market Penetration Rate: Estimates and Policy Implications," *Rand Corporation*, Mar.13, 2006, located at [http://www.rand.org/pubs/technical_reports/

Because of water damage exclusions and underutilization of available NFIP coverage, a significant number of the thousands of properties damaged or lost through Hurricanes Katrina, Rita, and Wilma were uninsured. These storms have spawned numerous class actions and other litigation concerning insurance coverage for losses. Both uninsured and underinsured property owners have focused on the water damage exclusions in homeowners' policies, maintaining that they apparently should be made whole through government flood insurance, homeowners' insurance, some combination of both, or the government, depending on each person's particular insurance coverage.

For example, the Insurance Services Office (ISO) commercial policy wording (CP 10-30-04 02) with respect to the flood exclusion provides the following:

> *We will not pay for loss or damage caused directly or indirectly by any of the following. Such loss or damage is excluded regardless of any other cause or event that contributes concurrently or in any sequence to the loss....*
>
> ***
>
> *(1) Flood, surface water, waves, tides, tidal waves, overflow of any body of water, or their spray, all whether driven by wind or not:*
>
> *(2) Mudslide or mudflow;*
>
> *(3) Water that backs up or overflows from a sewer, drain or sump; or*
>
> *(4) Water under the ground surface pressing on, or flowing or seeping through;*
>
> > *(a) Foundations, walls, floors or paved surfaces;*
> >
> > *(b) Basements, whether paved or not; or*
> >
> > *(c) Doors, windows or other openings.*
>
> *But if water, as described in g(1) through g(4) above, results in fire, explosions or sprinkler leakage, we will pay for the loss or damage caused by that fire, explosion or sprinkler leakage.*

Insurers take the position that these policies do not provide coverage for water damage resulting from such events as levee breaches or storm surge because of the policy exclusion. For example, the standard homeowners' insurance policy language does not specifically identify "storm surge," but insurers insist that the breadth of the water damage exclusion encompasses such damage.

Insurance coverage disputes and litigation over the policy exclusions have ensued between policyholders and their insurers. The key coverage issue has been and will be whether damage or destruction to properties along the coastal regions was

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[1] (...continued)
2006/RAND_TR300.pdf].

caused by winds (typically covered under homeowners' policies) or by the flooding accompanying the storm (typically excluded under homeowners' policies). With Katrina, the possibility exists that either wind or flood caused damage — either separately or working in combination. Disputes over causation are inevitable. Hundreds of millions and perhaps billions of dollars in potential insurance coverage will rest on the outcome of decisions rendered in the courts.

On February 14, 2007, Mississippi's largest provider of homeowners' insurance, State Farm Fire and Casualty Company, announced plans to suspend sales of new policies in the state because of what the insurer claims is an increasingly unpredictable business and legal environment.[2] The decision is not expected to affect existing policyholders. A State Farm representative stated that the decision to curtail writing new policies was a business decision to protect corporate assets in response to an adverse legal and political environment in the state.[3]

State Attorney General Jim Hood responded to State Farm's announced plans by unveiling a legislative proposal to the state's Governor, insurance commissioner and the public that would compel insurers to continue writing policies in the state. The proposal, which is based on similar legislation enacted in Florida, would require insurers writing auto insurance in the state to provide homeowners' and commercial insurance if they sell those policies elsewhere in the United States.[4]

Following the State Farm announcement, the concern raised by insurance regulators and policymakers is what to do about other insurers who might decide to retreat further from the Gulf Coast region because of the uncertainty of pending legal battles. Consumer advocacy groups expect other insurers to follow State Farm's lead as a way to apply political pressure on the Mississippi courts and legislature to deal with the insurance coverage issue.[5]

This report provides an analysis of post-Katrina insurance issues in Louisiana, Mississippi, and Alabama, particularly as they have related to (1) the magnitude and impact of flooding, (2) the way private insurers settle claims, (3) the types and scope of policies and coverage, and (4) how courts have determined whether coverage exists under property policies when both covered and uncovered risks combine to cause a loss. The report does not provide legal advice, nor is it a definitive assessment of the applicable law in each jurisdiction.

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[2] Steve Tucker, "State Farm Halts New Mississippi Business," *National Underwriter Online News Service*, Feb. 14, 2007.

[3] Mark E. Ruquet, "Hood Calls State Farm on Bullying Tactics," *National Underwriter Online News Service*, Feb. 16, 2007.

[4] In addition to signing the new catastrophic insurance legislation, the Florida Governor signed an emergency order suspending the right of insurers to cancel and non-renew pending full implementation of the new law. The Florida Insurance Council, an insurance company trade group, initially challenged the validity of the Governor's order, but later withdrew the legal challenge. Events in Florida are not discussed in this report.

[5] Joseph B. Treaster, "State Farm Ends New Property Coverage in Mississippi," *New York Times*, Feb. 15, 2007, p. C2.

The Issues

Overview

Private insurers play a central role in the functioning of the U.S. economy not only because of their risk-transfer function, but also because of their ability to provide relatively easy access to sources of capital. Instability in the availability and price of coverage, interruptions in the payment of claims immediately after a disaster, and the large numbers of uninsured or underinsured Americans have led to pressure for government intervention in property insurance markets. In the wake of Katrina's massive flooding and uninsured property losses, specific concerns have been expressed in Congress not only about making sure that every insurance claim owed is paid, but also that there is a Gulf Coast insurance market after all the litigation is concluded.

In 1983, as a result of adverse court decisions in which insurers were forced to pay flood-related claims that insurers did not believe they were responsible to pay, the property and casualty insurance industry revised its policy language in the exclusions in homeowners' policies. Today, almost all homeowners' policies have a water damage exclusion with anti-concurrent causation language[6] which, according to insurers, should have eliminated coverage for flooding including from storm surge and levee breaches. Not all water is excluded, just the water damage described in the exclusion. There are still several instances in which water damage is covered, such as when the pipes in a home freeze and burst, when a roof is ripped off the home and rain water comes in, or the fire department hoses down the house.

Particular policy phrases and their interpretation frequently are at the center of insurance-based litigation. The central question is how the courts will interpret the water damage exclusion or whether they will rule in favor of the claimants, forcing insurers to pay billions of dollars to repair flood damage. Certain other insurance-related issues have arisen, such as concerns that some insurers inappropriately billed the federal flood insurance program for claims that should have been paid by the insurers' wind policies.[7]

Some Members of the 110th Congress support efforts to investigate the Katrina claims practices of insurance companies that contract with the National Flood Insurance Program.[8] Others support legislation creating a federal catastrophe fund backed by state funds to shore up the private insurance industry in the event of a mega-catastrophe. Still other Members support the repeal of the insurance industry's

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[6] The term "anti-concurrent causation language" refers to language that is typically inserted in an insurance policy to make it as clear and unambiguous as possible that a specific risk is not covered. Insurers use this type of language in contracts in an attempt to prevent policyholders from seeking coverage for losses they never intend to cover.

[7] Matt Brady, "U.S. Representative Taylor Seeks Probe of Insurers," *National Underwriter Online News Service*, Jan. 12, 2007.

[8] Arthur D. Postal, "Gulf Congressmen Attack Insurers on Many Fronts," *National Underwriter Online News Service*, Jan. 19, 2007.

limited federal antitrust exemption to address what they insist is an anti-competitive industry. The exemption from federal antitrust laws has allowed collaboration in the industry, such as development of standardized policy forms.[9]

The Louisiana, Mississippi, and Alabama Departments of Insurance, like those in other states, have a right of review and approve policy forms before use. As with all other states, Louisiana and Mississippi have for many years reviewed and approved flood and related water exclusions.

Departments of Insurance have also undertaken efforts to advise residents that most personal and commercial property insurance policies do not cover flood and that a national program (NFIP) is available to meet flood insurance needs. This frequent communication effort includes fact sheets and press releases (Louisiana — 2002, 2003, 2004, 2005; Mississippi — 2000, 2002; Alabama — 2002, 2004, 2005).

In addition, the federal government through the NFIP has for years undertaken a multi-media campaign to advise homeowners and business owners that most insurance policies do not cover flood — but that federal coverage is available. For homeowners' insurance, federal flood insurance is typically less than $1,000 per year (although pricing varies depending on the value insured and location of the property). For businesses, the federal flood insurance premium is typically a couple of thousand dollars, again depending on the amount of coverage and location of the property.

Litigation between policyholders and their insurers over the interpretation of "water damage" exclusion and the "anti-concurrent causation" clauses could continue for months and even years. The outcome of legal disputes will likely determine how losses are eventually apportioned among the National Flood Insurance Program (NFIP), private insurers, individuals, and businesses.[10]

Impact of Hurricane Katrina on Insurance Markets

In the aftermath of Hurricanes Katrina, Rita, and Wilma, three broad issues have emerged related to post-Katrina economic uncertainties:

- the massive insured and uninsured property losses and their impact on Gulf Coast property insurance markets and rebuilding after Katrina;

- assertions that insurers have shifted the cost for damage to the federal flood program and FEMA for U.S. taxpayers to pay the bill — i.e., potentially huge uninsured property losses and the denial of thousands of Katrina wind claims where insurers invoked the "water

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[9] For a brief discussion of what the McCarran-Ferguson Act does and does not cover, as well as some McCarran-related legislation in the 109th Congress, see CRS Report RL33683, *Courts Narrow McCarran-Ferguson Antitrust Exemption for 'Business of Insurance ....,"* by Janice E. Rubin.

[10] Bill Mellander, "Payouts Hinge on the Cause of Damage," *New York Times*, Aug. 31, 2005, p. C5.

damage exclusion" and "anti-concurrent causation" clause in homeowners' policies;

- unreliable government flood maps that are used by homeowners, lenders, and realtors to determine whether flood insurance was needed.

First, Hurricanes Katrina, Rita and Wilma resulted in massive property losses for both private insurers and the National Flood Insurance Program (NFIP). In addition, the total value of uninsured property damage and business interruption caused by Katrina has been estimated at $135 billion.[11] Congress has already appropriated $109 billion for disaster relief and recovery aid to affected communities, plus more than $8 billion in tax relief.[12]

Table 1 shows that private insurers paid $58.4 billion in insured property damages caused by Hurricane Katrina, Rita, and Wilma. This amount does not include claims filed under the NFIP. Insurers are still assessing losses in terms of how they will affect ultimate claim payments for losses in 2005, including the total cost of litigating and settling "wind v. flood" cases.

Table 1. Ten Most Costly Catastrophes in the United States

Rank	Date	Peril	Insured Loss ($ millions)	
			Dollars When Occurred	In 2006 dollars
1	Aug. 2005	Hurricane Katrina	$40,600	$41,910
2	Aug. 1992	Hurricane Andrew	15,500	22,272
3	Sept. 2001	World Trade Center, Pentagon Terrorist Attacks	18,800	21,401
4	Jan. 1994	Northridge, CA earthquake	12,500	17,004
5	Oct. 2005	Hurricane Wilma	10,300	10,632
6	Aug. 2004	Hurricane Charley	7,475	7,978
7	Sept. 2004	Hurricane Ivan	7,110	7,588
8	Sept. 1989	Hurricane Hugo	4,195	6,820
9	Sept. 2005	Hurricane Rita	5,627	5,809
10	Sept. 2004	Hurricane Frances	4,595	4,904

Source: Insurance Services Office (ISO); Insurance Information Institute.

Table 2 shows Hurricanes Katrina and Rita caused a record 226,419 flood insurance claims of which 164,615 individual claims were paid. Some 62,849

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[11] Council of Economic Advisers, *Economic Report of the President*, Feb. 2007, p. 120.

[12] Matt Fellowes and Amy Liu, "Federal Allocations in Response to Katrina, Rita and Wilma: An Update," *The Brookings Institutions*, located at [http://www.brookings.edu/metro/pubs/20060712_katrinafactsheet.pdf#search=%22community%20development%20block%20grant%20and%20katrina%20flood%20relief%22].

damaged homes were not covered by flood insurance and 58,413 claims were closed without payment. According to the Federal Emergency Management Agency (FEMA), as of February 2007, the NFIP paid $18.8 billion in claims payments — an amount that far exceeds the aggregate amount of claims paid in the history of the program.

Table 2. National Flood Insurance Program Data for Hurricanes Katrina and Rita
(As of January 5, 2007)

State and Disaster Number	Number of Flood Insurance Claims Received	Number of Homes Damaged Without Flood Insurance[a]	Number of Household Individual Claims Fully Paid	Number of Flood Insurance Claims Closed Without Payment
Florida, DR-1602	9,021	733	5,814	3,070
Louisiana, DR - 1603	177,827	32,768 [2]	127,330	47,942
Mississippi, DR 1604	19,006	26,716	17,159	1,519
Alabama, DR - 1605	5,725	1,743	5,123	557
Texas, DR-1606	3,930	889	1,721	2,111
Louisiana, DR-1607	10,910	N/A[b]	7,468	3,214
Total	**226,419**	**62,849**	**164,615**	**58,413**

Source: FEMA Office of Federal Affairs

Notes:
a. Data are as of March 28, 2006;
b. Louisiana disaster numbers DR-1603 and 1607 combined.

Unprecedented losses in the NFIP have led to unprecedented borrowing from the U.S. Treasury. Most of the $18.8 billion was borrowed from the U.S. Treasury, and must be repaid with interest. The Congressional Budget Office calculates that FEMA is unlikely to repay the funds borrowed to pay 2005 hurricane-related claims withing the next 10 years.[13] Consequently, the 110th Congress might be called upon to overhaul the National Flood Insurance Program in order to address: (1) program's financial solvency; (2) indebtedness to the U.S. Treasury; (3) magnitude of uninsured flood damage due to the widespread noncompliance with the mandatory flood insurance purchase requirements; and (4) controversy surrounding the practice of contracting with private insurers for policy adjusting and servicing.

Second, Hurricane Katrina damaged or destroyed thousands of homes and businesses that were covered for wind damages, but not water damage. Insurers have

[13] See Letter from Donald B. Marron, Acting Director of Congressional Budget Office, to Honorable Judd Gregg, Chairman, Committee on the Budget, May 31, 2006, located at [http://www.cbo.gov/ftpdocs/72xx/doc7233/05-31-NFIPLetterGregg.pdf].

reportedly denied thousands of Katrina wind claims by assigning all Katrina damages to flooding covered by the NFIP and not to their own windstorm policies. Insurers say they are simply invoking the "water damage" exclusion and "anti-concurrent causation" clause in homeowners' policies. Policyholder advocates claim insurers have a conflict of interest because they are able to shift the cost for damage to the federal flood program rather than to themselves. Further, insureds doubt whether FEMA provides proper oversight of NFIP's Write Your Own (WYO)[14] insurers to ensure they are fulfilling their contractual obligations to fairly adjust flood claims, particularly those involving combined wind and water damage. Finally, critics charge that, while the states have a role in regulating the claims adjusting process, the "Unfair Claims Practices" statutes are not being adequately enforced by the states.

On the other side of this issue, many homeowners who were eligible for low cost NFIP flood coverage (including those required by law to purchase it) declined this available coverage despite state and federal educational efforts. Many insurers — and several recent editorials — assert that policyholders' claims of flood coverage under homeowners' policies with flood exclusions are post-event rationalizations for poor personal planning decisions.

Researchers have suggested that millions of families are now living in flood-prone areas without adequate insurance protection. This is despite that fact that structures in areas with at least a 1% chance of flooding in any given year — the so-called "100-year" flood or Special Flood Hazard Areas (SFHAs) — are required to have flood insurance if they have a loan from a federally insured or regulated lender. The insurance must be in an amount of at least equal to the outstanding principal balance of the loan or the maximum available under the NFIP, whichever is less.[15] This requirement is based on two federal laws: the Flood Disaster Protection Act of 1973[16] and the National Flood Insurance Reform Act of 1994.[17]

According to a Rand Corporation nationwide study, about 49% of single-family homes in SFHA are covered by flood insurance (the market penetration rate), with substantial variations across geographic regions.[18] In addition, about 1% of

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[14] WYO insurers are private insurers who have agreed to sell and service NFIP policies, and adjust flood insurance claims under a contractual agreement with FEMA.

[15] These property owners or loans include (1) loans from federally regulated lending institutions; (2) loans that are purchased by the Federal National Mortgage Association (Fannie Mae) or the Federal Home Loan Mortgage Corporation (Freddie Mac); and (3) property owners who receive federal financial assistance for acquisition or construction purposes in SFHAs in communities that participate in the NFIP.

[16] P.L. 93-234; 87 Stat. 975.

[17] P.L 103-325; 108 Stat. 2255.

[18] See Lloyd Dixon, Noreen Clancy, Seth A. Seabury, "The National Flood Insurance Program's Market Penetration Rate: Estimates and Policy Implications," *Rand Corporation*, Mar. 13, 2006, located at [http://www.rand.org/pubs/technical_reports/2006/RAND_TR300.pdf]

homeowners in non-SFHAs purchase flood insurance coverage.[19] The purchase of flood insurance is voluntary outside SFHAs.

Researchers have explored factors influencing insurance purchase decisions.[20] They include the following:

- Millions of homeowners incorrectly believe that their standard homeowners' policies automatically provide coverage against flooding, when in fact an additional flood policy is needed.

- People have misperception of risk and tend to underestimate their chances of being disaster victims and do not purchase flood insurance. They have difficulty dealing with probabilistic information for small likelihood events because they need a context in which to evaluate the data.[21] Homeowners might think it is not a good investment when comparing the insurance price of coverage per dollar against their estimate of the probability of total loss, which they assume approaches zero.

- There are economic disincentives to buying flood insurance because of "free" federal and charitable disaster assistance and the tax-deductibility of flood losses.[22] Property owners often believe that disaster relief (i.e., Small Business Administration (SBA) low interest loans and grants) will compensate them for flood losses.

- The NFIP can undercompensate for losses given the high property (and land) values for coastal properties and the NFIP's maximum coverage of $250,000 for structure and $100,000 for contents.

- Property owners sometimes self-protect or self-insure — a substitute for formal insurance — by, for example, elevating their property above the base flood elevation (BFE), which serves to reduce both the probability of loss and the size of the potential costs.

- Homeowners might simply cancel their flood coverage without lenders taking action.

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[19] Ibid.

[20] Howard Kunreuther, "Has the Time Come for Comprehensive Natural Disaster Insurance?" in *On Risk and Disaster: Lessons from Hurricane Katrina*, Roland J. Daniels, Donald F. Kettle, eds. (Philadelphia: University of Pennsylvania Press, 2006), p. 175.

[21] Howard Kunreuther and M. Pauly, "Rules Rather than Discretion: Lessons from Hurricane Katrina," *Journal of Risk and Uncertainty*, 2006, vol. 33, pp. 101-116.

[22] Howard Kunreuther and M. Pauly, "Neglecting Disaster: Why Don't People Insure Against Large Losses?" *Journal of Risk and Uncertainty*, 2004, vol. 28, pp. 5-21.

- Homeowners with mortgages issued by non-federally regulated lenders are not subject to the mandatory flood purchase requirements.

In response to low levels of compliance with the mandatory purchase requirements and the financial challenges facing federal insurance program, some insurance market analysts have proposed an overhaul of the NFIP to address these and other programmatic issues.[23] Although FEMA does have an interest in ensuring high levels of compliance, the agency must rely on federally regulated lenders, government sponsored enterprises (GSEs), and federal agencies that provide financial assistance for construction and acquisition of property in SFHAs to implement and monitor compliance with the mandatory purchase requirement. Some propose requiring all U.S. homeowners to purchase flood insurance, possibly the way liability insurance is required for automobile owners.

Third, thousands of residents along the Gulf Coast who relied on government flood maps to determine who must buy flood insurance were arguably unaware of their actual flood risk and uninsured when Hurricanes Katrina, Rita, and Wilma struck. An issue for the 110th Congress, therefore, might be to decide what to do about flood maps that may be incorrectly measuring risk and, therefore, not capturing the nation's exposure to flood risk. Critics of FEMA's flood map modernization efforts say these activities have been underfunded and lack focus.

Many people in Hurricane Katrina's path did not have flood insurance because, according to government flood maps, they were not in a floodplain and did not need coverage. On October 18, 2005, the Department of Homeland Security's Inspector General released a report that raised concerns about the accuracy of flood maps.[24] The report concluded that outdated flood maps placed homeowners and residents at physical and financial risk because many people living in high-risk areas did not know of the dangers and, therefore, might not have chosen to participate in the NFIP.

Again, according to Rand Corporation, about one-third of all flood claims occur outside of SFHAs, yet only 1% of property owners residing in these areas purchase flood insurance from the NFIP. Communities in harm's way might not be adequately enforcing strong building codes or land use zoning ordinances, which would have reduced the amount of wind-related damage.

In the case of New Orleans — a city that experienced massive flooding and an historic 29-foot storm surge — FEMA flood maps incorrectly made the assumption that levees and flood walls would withstand the storm surge and protect the residents

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[23] For more information on flood insurance reform see CRS Report RL33689, *Flood Insurance Reform: Analysis and Comparison of 109th Congress Bills: (H.R. 4973 and S. 3589)*, by Rawle O. King.

[24] Office of Inspector General, Department of Homeland Security, "Challenges in FEMA's Flood Map Modernization Program," Report No. OIG-05-44, Sept. 2005, located at [http://oversight.house.gov/Documents/20051018124029-72925.pdf].

from flooding.[25] Many property owners in Katrina-impacted areas outside government-designated flood zones whose homes were destroyed were not subject to the mandatory purchase requirement and, therefore, did not have adequate coverage. Efforts are underway at FEMA under its flood map modernization program to develop accurate digital flood plain maps that are consistent in terms of data collection standards and analytical methods.

Post-Katrina Economic Uncertainty for Policyholders and Insurers

In the aftermath of Hurricanes Katrina and Rita, thousands of homeowners in Louisiana, Mississippi, and Alabama face significant obstacles in getting their property damage insurance claims paid. When insurance adjustors and damage experts assessed properties damaged by the 2005 hurricanes, they were faced with the issue of allocating damages between wind (a covered loss) and flood (an excluded loss). The ambiguity and economic uncertainty that this activity has engendered has raised financial and legal issues for insurers, as well as homeowners and businesses along the Gulf Coast region. The solution for some of the insureds has been to litigate with their insurers, seeking to declare the "water damage exclusion" clause in their policies unenforceable — a move that would arguably then allow insureds to receive coverage for flood damage under their homeowners' policies. Allocating damages between covered wind damages and excluded flood damages has become a question of fact to be decided by the courts.

Issues of Contention. Insurers attempt to separate the wind damage (covered) from the flood damage (excluded) through physical examination of the location. In many areas of New Orleans, for example, the house contains a clear water-line with no or minimal roof damage. Along the Mississippi coast, many homes are completely destroyed with only a slab remaining. In those cases, the factual investigation turns on an analysis of weather conditions and the construction of the home to determine the extent of wind damage that occurred prior to the destruction of the home by excluded storm surge. Policyholders and insurers can have different views on these facts which result in litigation.

From the industry's perspective, claims are settled in the same manner they always have been with regard to the water damage exclusion that they assert has been well known among homeowners and state regulators for years. Insurers have argued that they settle claims fairly and in accordance with policy language and the historical treatment in court cases of storm surge associated with flooding during a hurricane. This is why, insurers insist, the federal government offers flood insurance. In addition, insurers note that they did not cover, and therefore price, the flood risk in the homeowners' policies, and hence did not set aside appropriate loss reserves to pay such claims.[26] Further, insurers maintain that the uncertainty associated with the court's *ex post* re-interpretation of insurance policy terms and language substantially

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[25] Peter Whorisky, "Risk Estimates Led to Fewer Flood Policies," *Washington Post*, Oct. 17, 2005, p. A 1.

[26] Ibid.

increases their risk — i.e., paying flood insurance claims after the loss without actuarially accounting for this event before the loss could jeopardize their financial solvency. If they raise rates to reflect the increased risk, their customers will pay more for coverage that is now provided by the NFIP.

Policyholders and their advocates have charged that insurers rely upon the "flood exclusion" and anti-concurrent causation policy language to not pay claims on homes damaged by a combination of wind and flood. From their perspectives, insistence on the unenforceability of the "flood exclusion" and the anti-concurrent clause is consistent with "reasonable expectation" since they thought they had "full protection."

Post-Katrina insurance claims litigation and the economic uncertainty it generates for consumers and insurers have raised at least four interrelated policy issues for the 110th Congress: insurance coverage disputes; disaster and the law; flood plain policy; and insurance reforms.

Insurance Coverage Disputes. There may be congressional oversight and investigations into the handling of Katrina-related insurance claims, and possible legislative efforts to modify the industry's antitrust exemption under the McCarran-Ferguson Act of 1945[27] and state supervision and regulation of the business of insurance. Members of the 110th Congress have the option to address the volatility in the legal environment in terms of post-event judicial interpretations in the scope of insurance coverage and legislative or regulatory "lock-ins" of capacity in the months and even years after a storm. After Katrina and Rita, for example, in states like Florida and Louisiana, the insurance commissioners declared a state of emergency in the state's insurance market and suspended certain statutes and regulations regarding policy cancellations, non-renewals, reinstatements, and claim filings. These emergency declarations have had the effect of "locking in" the investor capital that stands behind the policies sold in the state. Some insurance experts have suggested that legal and regulatory volatility tends to discourage rather than encourage the retention and expansion of capital commitments in the affected states.

Disasters and the Law. Katrina demonstrates apparent gaps in the legal system and its ability to respond to events of this magnitude. This issue is important if communities are to be able to rebuild and recover in a timely manner after a major catastrophe. In the short term, Congress might consider oversight and investigation hearings into post-Katrina insurance claims issues and the regulatory impact this could have on the insurance market. In the long term, businesses, including the insurance industry, rely on a predictable legal regime that will operate efficiently in an emergency situation. In anticipation of another Katrina-sized natural disaster, Congress has the option to consider the enactment of a nationwide body of "disaster law"so the nation might be better prepared to rebuild and recover after a major catastrophe.[28]

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[27] P.L. 79-15; 59 Stat. 33

[28] See Daniel A. Farber, "Disasters and the Law: Katrina and Beyond" (Aspen Publishers:

(continued...)

U.S. Floodplain Management Policy. What should be done and not done to recover from flood damage and mitigate the consequences of future floods? The aftermath of a disaster often presents the opportunity to address multiple long-standing problems. After Hurricane Katrina, the floodplain policy response seems to have been to build "bigger and better" flood protections systems — i.e., take a nationwide inventory of the structural flood controls (levees), reinforce and strengthen them, and expand requirements for insuring residual risks behind levees and dams. History (1920s-1960s and 1993 Midwest floods) has showed that relying on structural means of controlling floods, such as building levees and dams, is not always the best flood control policy. Two broad policy options have been suggested that would (1) surrender land to the water, a new idea that would require forgoing development of floodplains and property buyouts; or (2) continue along the current path embodied in the NFIP (i.e., risk assessment or mapping, floodplain management, and insurance protection), but strengthen zoning laws and construction standards, modernize flood maps, and enforce existing mandatory flood insurance purchase requirements.

Insurance Reforms. A large percentage of those eligible to buy federally subsidized flood insurance do not. The NFIP subsidizes insurance rates for about 26% of policies, generally high-risk buildings built before NFIP floodplain regulations were established in their community. As a long-standing public policy, the federal government forgoes significant premium income because of policy subsidies. Moreover, losses associated with subsidized properties account for 25% to 30% of all claims losses. What is the solvency and regulatory impact of massive Katrina-related flood losses on the NFIP? How effective has the program's mandatory flood insurance purchase requirement been in increasing market penetration and reducing future flood losses?

Insurance Policy Language and Coverage

Private insurers generally do not cover the flood hazard because of the problem of adverse selection,[29] and the perceived unprofitability and volatility of this line of insurance due to the absence of tools for technical risk rating or portfolio diversification. Since 1968, this gap in coverage has been filled by the purchase of federally subsidized flood insurance. Many homeowners incorrectly believe that their standard homeowners policies automatically provide coverage against flooding, when in fact an additional flood policy will be needed.

This section provides an analysis and comparison of both federal flood insurance and the NFIP's standard homeowners' insurance policy, and the nature and types of the insuring clauses, including the "water damage" exclusion provision.

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[28] (...continued)
2006.)

[29] Adverse selection is the tendency of people who have a greater perceived probability of loss than does the average person to seek insurance.

Federal Flood Insurance

Federal flood insurance is available to residents only in communities that agreed to institute floodplain management strategies designed to reduce future flood losses. The federal government established certain minimum building and development standards for floodplain construction that the communities have to adopt in order to participate in the NFIP. Under the National Flood Insurance Act of 1968,[30] the federal government is required to map the nation's floodplain. In order to do so, FEMA determines flood risk through various sources specific to each community. This flood risk information is then delineated by zones on Flood Insurance Rate Maps (FIRMs).[31] The area of flood hazards on these maps is the Special Flood Hazard Area (SFHA), which is defined as an area of land that experiences a 1% chance of being flooded in any given year (also known as the base flood or 100-year flood).

Standard Flood Insurance Policy (SFIP). The NFIP offers three Standard Flood Insurance Policy (SFIP) forms: Dwelling Policy; General Property Policy; and Residential Condominium Building Association Policy. The *Dwelling Policy* is used to insure residential structures and their contents and is issued to homeowners (including those in condominium units, manufactured mobile/trailer homes, townhouse structures, and timeshares), residential renters, or owners of residential buildings containing two to four units. The Dwelling Form offers coverage for building property, up to $250,000, and personal property (contents), up to $100,000. Contents coverage must be purchased separately.

The *General Property Policy* is issued to owners of residential buildings with five or more units, owners or lessees of nonresidential structures, such as hotels, apartment buildings, schools, commercial structures, cooperative associations, and their contents. Coverage is available up to $500,000 for non-residential buildings and their contents.

The *Residential Condominium Building Association Policy* (RCBAP) is issued to residential condominium building associations to cover the entire building under one policy. The policy covers all units, improvements within the units, and personal property owned in common. Eligible structures under the RCBAP include high-rise and low-rise condominium buildings and condominium associations.

The SFIP is not a *guaranteed replacement cost policy* that pays the to rebuild regardless of the limit of liability in the event of a total loss. Instead, the SFIP policies pay the replacement cost of actual damages, up to the policy limit. In other words, flood insurance does not pay more than the policy limit.

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[30] P.L. 90-448, 82 Stat 573.

[31] In order to assess a community's flood risk which is delineated on FIRMs, FEMA uses historical flood data, including the community's rainfall and river-flow, topography, wind velocity, tidal surge, flood-control measures, development, and other factors.

NFIP's Definition of a Flood. The NFIP defines a flood as

> general and temporary condition of partial or complete inundation of two or more acres of normally dry land area or of two or more properties from: overflow of inland or tidal waters, unusual and rapid accumulation or runoff of surface waters from any source, mudflow, or collapse or subsidence of land along the shore of a lake or similar body of water as a result of erosion or undermining caused by waves or currents of water exceeding anticipated cyclical levels.

The SFIP covers physical damage to the building or personal property "directly" caused by a flood. It does not cover: damage caused by moisture, mildew or mold; loss of currency and valuable papers such as stock certificates; living expenses such as temporary housing; and, financial losses caused by business interruption or loss of use of insured property.

Standard Homeowners' Insurance

The property insurance industry uses standardized policy language to provide uniformity in coverage and consistency in legal outcomes. The basic forms are developed and written by the Insurance Services Office Inc. (ISO).[32] The standard homeowners' insurance (HO) policy that ISO publishes combines various personal insurance protections which can include losses on the home, its contents, loss of its use (additional living expenses), as well as liability coverage in the event the homeowner is sued and found legally responsible for damages.

There are seven types of ISO standardized HO forms in general and consistent use. Of these, HO-3 is the most common policy, followed by HO-4 and HO-6. Others that are less used are HO-1, HO-2, HO-5, and HO-8. The HO-3 is a special homeowners policy — called *open- perils* — that covers all perils except those specifically excluded by the policy such as earthquakes, floods, *Acts of God*, or war. Special insurance can be purchased for these possibilities, including flood insurance and earthquake insurance. The HO policy might also contain options, called *riders*, *floaters*, or *endorsements,* that can provide additional coverages for such items as art or coin collections for an additional premium.

State insurance departments are responsible for reviewing and approving all insurance policy forms and rates before the policy can be lawfully used by an insurer. The approval process includes an examination of every word, sentence, and paragraph in the policy. Before the regulators are given the policy form for approval, however, it is standard practice in the industry for insurers to consult with actuaries and insurance underwriters to develop the policy language so that pricing is commensurate with the related coverage. Economic efficiencies are realized in this activity by utilizing certain industry organizations, like the ISO, to develop the specific provision in standard-form insurance policies and to file with the each state insurance department so that individual insurers can use them without expending

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[32] The Insurance Services Office, Inc. (ISO) is an insurance organization that provides statistical information, actuarial analyses and consulting, policy language, and technical services to insurers.

money and time that would be required to get the policy forms approved in every state in which they operate.

By standardizing the HO policy, insurers hope that court interpretations of standard coverage forms provide consistent treatment of claimants. Thus, when a court determines the meaning of a word, phrase, or clause in a standard coverage form, that interpretation triggers a rewrite or adjustment to the policy language.

Insuring Clauses. Property and casualty (p/c) insurance policies are classified by causation, and contain in their insuring clauses the words, "loss caused by..." or their equivalent. The insuring clause in the HO-3 policy is a statement of the promises the insurer makes to the insured as far as what perils and exposures are covered; it varies greatly from policy to policy. The problem is that when an insured cause (wind) joins with one or more additional causes (flood), which may be uninsured or may be insured under a separate contract, *concurrent causation* can be said to exist. It is this concurrent causation that has generated so much litigation surrounding the "wind v. flood" legal disputes. Litigation arises as to whether the damage was caused by an insured event or by an event which is either excluded from coverage or not within the scope of the policy.

Named-Perils v. Open-Perils Policies. Property policies come in several types, including commercial and homeowners. These policies are further divided by the type of risks insured: *named-peril risk* or *open-peril risk*. Named risk policies insure against physical loss or damage caused by various risks specified in the policy (e.g., fire, lightning, explosion, windstorm or hail, smoke, aircraft or vehicles, riot or civil commotion, vandalism, sprinkler leakage, sinkhole collapse and volcanic action).

Open-peril policies, on the other hand, insure against physical loss or damage caused by any risk that is not excluded or limited by the policy. The distinction between named-peril and open-peril policies becomes especially important in litigation. Under the named-peril policies, courts have held that a policyholder must first prove one or more of the named perils caused a loss. Insurers must then prove that the loss is excluded in the policy. Under an open-peril policy, the policyholder must prove damage occurred to the insured property. Insurers must establish that an excluded risk caused the loss.

In some litigation addressing the water damage exclusion, plaintiffs have contended that the water damage should be covered because it resulted from storm surge, which was not a specifically excluded peril. A recent federal court decision held that "storm surge" was within the policy definition of "flood" and the exclusion should apply.[33] In another case involving water damage but that specifically covered winds or hail, the court denied the insurer's motion to dismiss, hold that there was coverage for all damage caused by wind, and wind-driven rain, but that losses directly resulting from storm surge were excluded by the water damage exclusion.[34] Applying Mississippi law in the *Tuepker* case, the judge also held that the

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[33] Buente v. Allstate Prop. and Cas. Ins. Co., 2006 WL 980784 (S.D. Miss. 4/12/2006).

[34] Tuepker v. State Farm Fire and Cas., 2006 WL 1442489 (S.D. Miss. 5/24/2006).

exclusionary language in the policy was invalid to the extent that it did not allow for consideration of the proximate cause (covered wind or uncovered water) of the insured's damage;[35] and further that, at trial, if the insured could prove its damage was sustained as a result of covered perils, its claim would be paid.[36]

Open-perils policies cover many perils not covered by named-perils policies; consequently, the open-perils policy provides broader coverage than a named-perils policy, and carries a higher premium. Whether the policy is open-perils or named-perils, however, the coverage it provides will have exclusions. Exclusions are an integral part of every insurance policy. The flood peril, in particular, is excluded from HO policies because it is unusual and requires a separate rating.

Water Damage Exclusion. In the event of hurricane-related flooding, the question of the cause of damage, whether wind *or* water or wind *and* water is of considerable importance.[37] The reason is that flood exclusion language has been a standard feature of homeowners' insurance policies since around 1968, when the federal government's National Flood Insurance Program (NFIP) was established. Homeowners' policies generally exclude coverage for flood damage. Insurers have not priced and, therefore, not collected premiums to pay for flood coverage.

An insurance policy usually specifies what causes — called "hazards" or "perils" — are covered. It also specifies what effects — called "losses" or "damages" — are covered and which perils and losses are excluded from coverage. The insurance industry defines an "exclusion" as a provision in an insurance policy that eliminates coverage for certain risks, people, property, classes, or locations. The insurance policy language that specifically excludes flooding is found in the "Perils Insured Against" and "Exclusions" section of the standard homeowners' policy.

Claims Adjustment, Causation, and Policy Language Interpretation

Two broad sets of post-Katrina claims-adjustment issues may be relevant to the 110th Congress. *First* is the alleged adverse impact on insureds of computerized claims settlement systems and products. Public interest advocacy groups have alleged that the insurance industry uses computer programs, such as "Colossus" sold by Computer Sciences Corporation (CSC) or "Claims Outcome Advisor" sold by the Insurance Services Office (ISO), to systematically underpay homeowners claims.[38]

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[35] Ibid.. at *4.

[36] Ibid., at *6.

[37] The controversial issue involving the allocation of damage between wind and water is not present in the commercial insurance marketplace because these policies do cover both flood and water damage. To the extent an issue might arise, it is with respect to sublimits for damage from flood. For example, a commercial building could be insured for $200 million but with a $30 million sublimit for flood.

[38] See J. Robert Hunter, *Property/Casualty Insurance in 2007: Overpriced Insurance,*

(continued...)

Their argument is that these systems allow insurers to calibrate the amount of savings they want to generate to the detriment of their insureds.

Claims adjustment under the NFIP is different from that in the private homeowners' insurance market. The adjustment of federal flood insurance claims is conducted by property and casualty insurers who write and service NFIP policies and claims under a contractual agreement with the NFIP's Write Your Own (WYO) Program. Over 95% of NFIP's policies are written under this program. Private insurers enter into a "Financial Assistance Subsidy Arrangement" whereby they agree to issue flood policies in their own names and take responsibility for policy administration, claims processing, marketing, and sales. Private insurers handle all claims issued in their names, and adjust and settle flood loss claims consistent with their general claims practices. In adjusting flood insurance claims, which are binding upon the federal government, a WYO insurer is authorized to use staff adjusters or independent contractors selected and supervised by the company. The WYO insurer also determines when and how adjusters will be compensated for their work on flood claims.

WYO insurers typically receive an expense allowance for policies written and claims processed, and the federal government assumes total financial responsibility for underwriting losses. Insurers retain 15% of premiums written to cover commissions and salaries of agents and brokers. They are also reimbursed for marketing, operating, and administrative expenses. The expense ratio of the WYO appears to be about one-third of premiums.[39]

On January 18, 2006, the Collins Center for Public Policy issued a report that raised several specific concerns involving contracting with private insurance companies for NFIP policy claims adjusting and servicing. The issue paper indicated (1) WYO insurers had no financial incentive to adjust claims in the best interest of the NFIP because the federal government pays all claims, and (2) the existence of conflicts of interest for WYO insurers and their agents when they attempt to adjust possibly competing claims against flood insurance offered by NFIP, and claims against their own policies for wind or other coverage.[40]

Critics have charged that the NFIP appears to have few systemic checks and balances to ensure that it is being administered correctly. FEMA has responded to this charge by noting that WYO insurers are subject to certain standards and oversight as detailed in the NFIP's "Write Your Own Program Financial Control Plan Requirements and Procedures Manual." WYO insurers, for example, must comply with monthly financial and statistical transaction reporting requirements. They are subject to a review of operations — claims, underwriting, customer service,

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[38] (...continued)
Underpaid Claims, Declining Losses and Unjustified Profits, Jan. 8, 2007, located at [http://www.centerjd.org/free/mythbusters-free/CFA_070108.pdf].

[39] See Collins Center for Public Policy, *Issue Paper: National Flood Insurance Program*, located at [http://www.fldfs.com/PressOffice/Documents/RetrieveDocument.asp?DocumentID=%7B115A82E4-01B1-44C6-874D-6950E134524D%7D].

[40] Ibid.

marketing, and litigation activities — every three years to assure that each company is meeting its performance objectives and adhering to program standards and policies. In addition, WYO insurers are subject to a "Biennial Claims Audit" every two years, and a "Claims Reinspection Program" that randomly reviews a percentage of WYO insurers' claims settlement practices.

Congress may debate the WYO claims adjusting issue given that, under legislation passed in the 109th Congress, the Department of Homeland Security Inspector General is required to investigate and report to Congress by April 2007 on whether insurers under the WYO Program improperly attributed damages from Hurricane Katrina to flooding covered under the National Flood Insurance Program rather than to windstorms covered by such insurers.[41]

Second is the issue of *causation* in the homeowners' claims adjustment process — a major source of insurance-coverage disputes between policyholders and their insurers: i.e., whether a loss was caused by winds (typically covered under homeowners' policies) or flooding accompanying the storm (typically excluded under homeowners' policies). Causation is the key factor involved in the water damage exclusion and the "wind versus flood" legal disputes in Louisiana and Mississippi.[42]

Homeowners insurance claims are typically paid if the loss is caused by a covered peril or, in the case of "all risk" (open-perils) policies, a peril that is not expressly excluded. If the loss is caused by multiple factors (mixed cases), such as wind that is covered and flood that is not, claims adjustment becomes more challenging. Both wind and flood, for example, might have worked together to cause the loss; one may have followed directly from the other, or the two may have arisen independently. In either case, the causal nature of the relationship between the perils has resulted in legal disputes between policyholders and their insurers. In order to resolve these mixed cases, the courts have developed various tests for situations in which an excluded peril and a non-excluded peril contributed to the loss, with the most prominent being the "efficient proximate cause" doctrine and the "concurrent causation" doctrine.[43]

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[41] Department of Homeland Security Appropriations Act of 2007, P.L. 109-295; 120 Stat. 1357.

[42] Causation issues may extend beyond the question of windstorm versus flood. For example, damage to buildings may be linked to pre-existing structural deficiencies or to outside forces such as vandalism. Mold in buildings may have been there before any flooding. Yet another issue is damages resulting from the levee break. A key question is: What is the chain of causation? The breach of a levees built by government authorities would presumably involve two entirely independent causes that combine to result in loss or damage, but neither set the other in motion. In this case, "coverage under a policy is equally available to an insured whenever an insured risk constitutes simply a concurrent proximate cause of the injuries." Policyholders have been able to argue successfully that while a policy might exclude flooding, it did not exclude the independent concurrent cause of negligence in design or maintenance of levees. In other words, because the loss resulted from the occurrence of an excluded hazard *and* a covered hazard, it should be covered.

[43] Seth A. Tucker and Ann-Kelley Kemper, "Hurricane Katrina Insurance Coverage Issues,"

(continued...)

Causation Battles Over Hurricane Katrina Claims

The exact application of causation doctrines — "concurrent causation," "proximate cause," "efficient proximate cause," and "anti-concurrent causation" — in the context of Hurricane Katrina claims will depend on the type of insurance policy owned by the claimant, the facts of the claim, and the case law in the pertinent jurisdiction. Insurance lawyers have observed that every legally disputed case has unique features with different fact patterns and different levels and types of coverage that apply to each policyholder.

The next four sections examine causation doctrines or "rules of insurance policy interpretation" that could be used in understanding the tension between intended meaning in policy language and interpretation of certain provisions.

Concurrent Causation. Claimants' attorneys have focused considerable attention on finding ways to overcome decades of legal precedent supporting the flood exclusion. The principle of concurrent causation holds that if two causes combine to produce a loss or damage, and one of the two causes is excluded (e.g., flood) and the other is covered (e.g., windstorm), the loss will be covered absent policy wording to the contrary.[44] "Proximate cause" and "efficient proximate cause" are variations on "concurrent causation."

Proximate Cause. The proximate cause concept is particularly important in the "chain of causation" arguments involving wind versus flood claims following a major hurricane. Under the proximate cause concept, if a policy covers fire, not only is the direct damage by fire covered, but the collateral smoke damage — as well as damage from the water used by firefighters — is treated as a loss by fire. The key is that the damage must actually have been caused by the fire and any collateral damage that did not break the "chain of causation."

Proximate cause may impose limits on scope of legal liability because determining the cause of a loss can only be based on what is administratively possible and convenient, i.e., it may not be determinable with precision. For example, assuming that hurricane winds destroyed the roof or walls of a home or caused a levee to be overtopped or damaged. Whether the resulting flooding damage would be covered because it was considered due to the proximate cause of wind is not necessarily certain.

Efficient Proximate Cause. Given the uncertainty of determining actual "proximate cause," the efficient proximate doctrine is used by some courts to allocate losses when damage results from a combination of both covered and excluded

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[43] (...continued)
Covington & Burling, Oct.4, 2005, located at [http://www.cov.com/files/Publication/0a096d9d-4741-4cd3-bee7-7359422c2a3a/Presentation/PublicationAttachment/61063844-2886-44d8-bac4-7f5c3bbecafe/oid27267.pdf].

[44] See Doug Simpson's weblog, *Unintended Consequences: Flood Insurance and Exclusions, Proximate and Concurrent Causation*, located at [http://www.dougsimpson.com/blog/archives/000464.html].

causes. Thus, in the event of multiple causes for a loss, the efficient proximate cause doctrine allows payment under the policy if the non-excluded cause is the *dominant* cause of the loss (i.e., the one that sets the others in motion), notwithstanding that an excluded peril may have contributed to the loss.[45]

Attorneys and the courts frequently utilize the "but for" rule in determining how far back the chain of causation should go." The rule, as applied to the "wind-v.-flood" coverage dispute, says that "but for" the particular event (e.g., wind), the loss experienced by the plaintiff would not have occurred, even when the loss and the covered event are separated by a chain of events that include floods.

As in any insurance coverage litigation involving whether coverage should be available when both covered (wind) and excluded (flood) losses are part of a chain of events, there are differences of opinion on the proper scope of the efficient proximate cause doctrine, particularly whether the cause is considered a minor or major factor in producing the injury or damage.

Anti-Concurrent Causation Clauses. In response to the successful use of the concurrent causation arguments and the courts' reinterpretation of the flood exclusion language that has led to unanticipated exposures, insurers have sought to draft, file, and get state approval of policy language to make it as clear and unambiguous as possible that no damage due to flood is covered. Hoping to avoid the unexpected consequences of future adverse court decisions, insurers sought to implement industry-standard language designed to cover "all risks" not specifically excluded by the contract language. The "anti-concurrent causation" doctrine was designed to prevent the theory of concurrent causation from providing coverage for losses never intended to be covered by standard property insurance policies. Plaintiffs' attorneys, however, frequently argue that the exclusions are in violation of public policy.

Generally speaking, and notwithstanding some federal court decisions to the contrary, the efficient proximate cause doctrine has been adopted by the highest courts of Mississippi, Louisiana, and Alabama.[46] Courts in these three states have interpreted the doctrine to allow policyholders to recover for hurricane-related losses where their evidence showed that wind was the proximate cause of the damage, even if flooding contributed to the loss. To attempt to defend against the claim, insurers must counter the insured's evidence with evidence tending to prove that the proximate and efficient cause was one that falls outside of the coverage of the insurance policy.[47]

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[45] For expert commentary on causation in insurance contract interpretation, see *The Enigma of Causation in Insurance Contract Interpretation*, Kenneth S. Wollner, [http://www.irmi.com/Expert/Articles/2004/Wollmer01.aspx].

[46] Western Assurance Co. v. Hann, 78 So. 232 (Ala. 1971); Glens Falls Ins. Co. of Glens Falls, N.Y. v. Linwood Elevator, 130 So. 2d 262, 270 (Miss. 1961); Evans Plantation, Inc. V. Yorkshire Ins. Co, 58 So. 2d 797, 798 (Miss. 1952); Roach-Strayhan-Holland Post No. 20, American Legion Club, Inc. v. Continental Ins. Co. of N.Y., 112 So. 2d 680 (La. 1959).

[47] See, e.g., Broussard v. State Farm Fire and Casualty Company, Civil Action No. 1:06cv6-

(continued...)

And recently decided cases, specifically in Mississippi, suggest that the federal courts will enforce the flood exclusion to the extent the damage is caused by flood, not wind and rain, but will not enforce anti-concurrent causation language where it would eliminate coverage for otherwise covered damage.[48] In addition, because insurers bear the burden of proving allocation of loss between wind/rain (covered) and flood (excluded), insurers will likely be held liable for paying all Katrina damage for which the cause of loss cannot be definitely established.[49]

Unfair Claims Practices State Laws

In addition to the application of the efficient proximate cause doctrine to uphold or not uphold coverage in favor of policyholders, most states and jurisdictions have regulations and rules on claims handling that provide certain protection to policyholders. Most states have adopted a version of the National Association of Insurance Commissioners (NAIC) *Model Unfair Claims Practices Act* that governs how insurers must deal with claimants. These statutes require insurance companies to handle claims with good faith and fair dealing. Insurers, for example, must pay claims according to standards of practice, which is within 30 days after receipt of a "Proof of Loss" — i.e., a legal document that states the amount the policyholder is claiming under the policy. In the course of insurance litigation, the interpretation of specific insurance statutory and regulatory provisions comes into play. Lawsuits frequently arise alleging insurer violation of specific provisions (e.g., unfair claim settlement practices, delay in settling claims, etc.).

Summary of Katrina Litigation

Katrina spawned hundreds of lawsuits against insurance companies,[50] most challenging insurers' reliance on the water-damage exclusion and the anti-concurrent causation language in homeowners' policies to deny property damage claims. Among the issues is the extent to which the anti-concurrent causation language is consistent with or contrary to the settlement law in a given state. This section provides a brief, narrative summary of major legal activities related to Katrina insurance claims disputes.

"Valued Policy" Statutes and Related Litigation

Policyholders typically use the "valued policy" statutes to gain coverage in cases where both wind and water caused damage to the property. Valued Policy statutes

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[47] (...continued)
LTS-RHW (S.D. Miss. 1/11/2007) (on cross-motions for judgment as a matter of law).

[48] E.g., Leonard v. Nationwide Mutual Ins. Co., 438 F. Supp. 2d 684 (S.D. Miss. 2006).

[49] *Broussard, supra.*

[50] Daniel Hays and Susanne Sclafane, "Mississippi Negotiating Katrina Settlements: Deal With State Farm Reportedly Near," *National Underwriter: Property & Casualty*, Jan. 15, 2007.

require insurers to determine the value of the property being insured at the time a policy is written and to pay that full value to the insured when there is a total loss caused by a covered peril. The insured is not required to prove the value of the damaged property. A building is considered a total loss when the necessary repair costs are more than 50% of the value of the building.

Both Louisiana and Mississippi have enacted "valued policy" statutes:

The Louisiana Valued Policy statute provides that

> Under any fire insurance policy insuring inanimate, immovable property in this state, if the insurer places a valuation upon the covered property and uses such valuation for purposes of determining the premium charge to be made under the policy, in the case of total loss the insurer shall compute and indemnify or compensate any covered loss of, or damage to, such property which occurs during the term of the policy at such valuation without deduction or offset, unless a different method is to be used in the computation of loss, in which latter case, the policy, and any application therefore, shall set forth in type of equal size, the actual method of such loss computation by the insurer.

The Mississippi Valued Policy statute provides that

> No insurance company shall knowingly issue any fire insurance policy upon property within this state for an amount which, taken with any existing insurance thereon, exceeds a fair value of the property, nor for a longer term than five years. When buildings and structures are insured against loss by fire and, situated within the state, are totally destroyed by fire, the company shall not be permitted to deny that the building or structures insured were worth at the time of the issuance of the policy the full value upon which the insurance is calculated and the measure of damages shall be the amount for which the building and structures were insured.

Mississippi has an instructive precedent regarding the water damage exclusion. Under Mississippi common law, where there is damage caused by both wind and rain (covered loss) and flood (excluded loss), the amount due under the policy will generally depend on the proximate and efficient cause of the damage (i.e., hurricane wind), even if other "non" covered causes also contributed to the loss.[51]

A Florida case found that that state's Valued Policy statute did, in fact, require payment of the face amount of the wind-insurance policy because the insured property was damaged — at least in part — by a covered peril (wind).[52] The special concurrence in *Mierzwa* would have required that the "proximate cause" of the damage be the covered peril (wind) (and not merely, as the majority held, that it be *some part* of the cause of the damage), but agreed with the majority result because

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[51] See Grace v. Lititz Mutual Insurance Co. 257 So. 2d 217 (Miss. 1972).

[52] Mierzwa v. Florida Windstorm Underwriting Association, 877 So.2d 774 (Fla. App. 2004).

the concurrer found such "proximate cause."[53] The Florida statute, however, was amended after the *Mierzwa* decision to specifically allow for the pro rating of damages caused by both a covered and a non-covered peril except "if the covered perils alone would have caused the total loss."[54]

Several cases from Louisiana have been filed, presumably seeking to rely on *Mierzwa*, attempting to get insurers to cover their damages — notwithstanding that the Louisiana valued policy statute is directed specifically at fire insurance policies.

Other Litigation

A suit filed in Mississippi Chancery Court by the Mississippi Attorney General in September 2005 against State Farm Fire and Casualty Company and other insurers sought to enforce the insurance policies issued by defendant insurers. Although the defendants, who maintained that the policies exclude coverage of damages caused by flooding, attempted to have the case removed to federal court on the ground that it involved litigation concerning a federal program (the insurers are WYO issuers of flood insurance policies pursuant to the NFIP), the United States District Court for the Southern District of Mississippi, on reconsideration of an earlier Order to remand the case to the state court, affirmed the Order, stating

> [Defendants] have attempted to create federal jurisdiction out of what is essentially ... 'the interpretation of the terms of private [homeowners'] insurance policies, tradition ally a function of state law.'[55]

State Farm agreed to a proposed settlement of the case, in conjunction with a pending, private, proposed, class-action suit,[56] and the settlement was concluded on January 23, 2007. Not only was the proposed class denied,[57] the court rejected the settlement on several grounds:

> The proposed settlement agreement establishes certain absolute limits on class members' potential recoveries that may be inconsistent with my prior rulings. ... The agreement [pursuant to which the insurer's liability is limited by the amount of recovery under separate flood-damage policies] does not provide for any exception for situations in which the fair market value or the actual cash value

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[53] 877 So. 2d at 781-2.

[54] *See* West's F.S.A. § 627.702(1)(b), effective 6/1/2005.

[55] Hood v. Mississippi Farm Bureau Insurance Company, 2006 WL 3802170 (S.D. Miss. 2006), *quoting* from the earlier Order issued by Judge Tom S. Lee.

[56] Woullard v. State Farm Fire and Casualty Co., Docket No. 1:06cv1057 (S.D. Miss.). Available at [http://www.mssd.uscourts.gov/Insurance%20Opinions/ch06cv1057order0126.pdf].

[57] "The plaintiffs have alleged that 'many hundreds, if not thousands, of individuals and/or entities have asserted claims or have potential claims' against State Farm. Neither the plaintiffs nor State Farm has given the Court any information from which the Court can determine with any reasonable degree of certainty how many policyholders are within the proposed class or how many policyholders have each of the eleven types of policies identified." *Id.*

> of the insured property is equal to or greater than the combined limits of flood coverage limits and the coverage limits in the State Farm policies.[58]

In addition, the court was bothered by State Farm's "indirect control" over the claims handling procedure because the appointment by State Farm of a Special Master to oversee the process would impinge on a function "that is exclusively within the prerogative of the Court."[59] Moreover, the complexity of the claims procedure, which would have prevented the effective participation of many claimants; the court's discomfort with "sending a large number of policyholders into the process of binding arbitration when none of these individuals have ever agreed to participate in that procedure"; and the fact that

> the resolution of the state court actions brought by the Mississippi Attorney General purports to incorporate or rely upon an arbitration program administered by this Court

were considerable obstacles that led to the court's rejection of the settlement.[60]

There are other, private, ongoing cases in both Mississippi and Louisiana challenging insurers' interpretations of policies relied upon for protection against hurricane-related damage. A list of the opinions or orders in those cases[61] is available on the website of the U.S. District Court for the Southern District of Mississippi, as the cases have been consolidated on the docket of that court.[62] All of the cases involve some permutation of the wind v. water/flood equation.

Criminal Investigation of Insurer's Claim Handling Practices

The Attorney General of Mississippi began a criminal investigation into State Farm's handling of Katrina claims. A grand jury was seated to hear the charges that focused on the wind v. water debate. Using documents provided by whistleblowers who worked for an insurer, and the state's Unfair Claims Practices statute, Hood alleged insurers defrauded policyholders by manipulating engineering reports to deny claims. On January 23, 2007, as part of the settlement with State Farm on the class action litigation, Hood ended the criminal investigation, opting instead to handle the matter in civil court and in Congress. He supports congressional oversight and investigation on this matter and national insurance reform.[63]

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[58] *Id.*

[59] *Id.*

[60] *Id.*

[61] Descriptions of the litigation of those cases is contemplated in a forthcoming addendum to this report.

[62] *See* [http://www.mmssd.uscourts.gov/insurance.htm].

[63] Michael Kunzelman, "Ex-State Farm Adjusters Tell Mississippi Grand Jury of Katrina Claims," *Associated Press*, jan. 23, 2007, located at [http://www.insurancejournal.com/news/southeast/2007/01/23/76104.htm]

Legislative Response

Three sets of bills — H.R. 920; H.R. 1081/S. 618, and H.R. 537/S. 292 — have been introduced in the 110th Congress to address post-Katrina insurance coverage issues. These measures would:(1) enhance insurance reform of the NFIP (H.R. 920); (2) establish a bipartisan commission to study the Gulf states' insurance market in Katrina's aftermath and make recommendations to Congress regarding the availability of insurance for catastrophic risks (H.R. 537/S. 292); and (3) repeal the insurance industry's limited exemption from federal antitrust laws to make the industry more competitive (H.R. 1081/S. 618).

On February 8, 2007, Representative Gene Taylor introduced the *Multiple Peril Insurance Act of 2007* (H.R. 920), which would create an all-peril policy that covers both wind- and water-related damages for both homeowners and small businesses under the NFIP. The legislation seeks to expand coverage offered by the NFIP from flood only policies to include flood and wind perils. H.R. 920 is also designed to reduce complexity in claims adjusting associated with wind and flood loss segregation; and enhance wind insurance availability and reduce prices.

On February 16, 2007, Senator Patrick Leahy introduced the Insurance Industry Competition Act of 2007 (S. 618/H.R. 1081), which would amend the McCarran-Ferguson Act of 1945 to give the Federal Trade Commission and the Justice Department oversight over ensuring that insurers comply with federal antitrust laws. The McCarran Ferguson Act allows collaborative industry practices like the development of standardized policy language which makes it easy for consumers to compare policies and prices.

On January 12, 2007, Senator Bill Nelson introduced the Commission on Catastrophe Disaster Risk and Insurance Act of 2007 (S. 292/H.R. 537) to create a federal bipartisan commission to study catastrophe insurance markets in Katrina's aftermath and make recommendations to Congress regarding the availability of insurance for catastrophic risks. The commission would establish a forum for both the insurance and consumers to address post-Katrina insurance issues.

Finally, the 109th Congress enacted the Department of Homeland Security Appropriations Act of 2007 that included a provision that directed the DHS Inspector general to investigate and report to Congress on whether insurers under the NFIP's Write-your-Own program improperly attributed damages from Hurricane Katrina to flooding covered under the National Flood Insurance Program rather than to windstorms covered by such insurers.

The section of the DHS Appropriations Act reads as follows:

> ...the Department of Homeland Security Inspector General shall investigate whether, and to what extent, in adjusting and settling claims resulting from Hurricane Katrina, insurers making flood insurance coverage available under the Write-your-own program pursuant to section 1345 of the National Flood Insurance Act of 1968 (42 U.S.C. 4081) and subpart C of part 62 of title 44, Code of Federal Regulations, improperly attributed damages from such hurricane to flooding covered under the insurance coverage provided under the national

flood insurance program rather than to windstorms covered under coverage provide by such insurers or by windstorm insurance pools in which such insurers participated...the Department of Homeland Security Inspector General shall submit a report to Congress not later than April 1, 2007, setting forth the conclusions of such investigation.[64]

Concluding Observations

Several concluding observations could be made.

- One major problem that has been identified is that the NFIP flood coverage and the private market wind coverage are provided under separate coverage forms, many times by separate insurers and often through separate distribution mechanisms. Congress might choose to focus on the identified problem: flood and wind coverages do not intersect. The NFIP's WYO program (which places nearly all NFIP coverages) works today because the flood policy is typically sold by the same personal lines agent and through the same personal lines insurer that offer the basic property policy. The challenge for policymakers and insurers is to develop a better coordination between flood and wind coverage.

- A major problem with the current system of flood risk mapping is the incorporation of the latest information on risk. When there is evidence that risk levels are rising or that risk was previously underestimated, it can be difficult to get the appropriate adjustments approved. As an illustration, climatologists have observed that the nation is in a period of higher hurricane activity and rising sea levels. The NFIP's coastal storm surge flood zones at any return period may extend further inland than are shown on the official FEMA flood maps. As a result, the construction of buildings at dangerously low elevations will continue to be permitted. In 2006, FEMA announced it was in the process of issuing new flood maps for the City of New Orleans and areas of Mississippi. Until such time as these maps are available, FEMA has issued Advisory BFEs, which direct areas "protected by levees to elevate substantially damaged homes and businesses to 3 feet above the highest adjacent existing grade on site or the current BFE on the flood insurance rate map, whichever is higher."

- NFIP has a low level of market penetration. Despite a requirement that many policyholders purchase NFIP coverage, a much lower than expected number do. Many of those that claim "wind / flood" issues appear to be attacking the private insurance policy's flood exclusion because the policyholder did not purchase NFIP coverage. Congress faces relatively low levels of participation in the NFIP.

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[64] P.L. 109-295, 120 Stat. 1357.

- Is there a need for a national catastrophe insurance solution? The media has made references to affordability issues "from Texas to Massachusetts." One solution offered is to have the federal government assume the wind risk (H.R. 920) and displace private business in all 50 states. In Illinois, for example, wind cover is cheap and plentiful. Some question: Why does Illinois need to disband its well functioning system as part of a nationalization of wind insurance? The real problem seems localized, but consumer advocacy groups have proposed a solution that appears much bigger.

- Government insurance only appears cheaper than private insurance. Federal insurance programs like any of the state catastrophe funds or federal insurance programs appear cheaper up front than they really are. Because government can use taxpayer capital without compensating the taxpayer, government can provide an up-front cost of insurance that is "actuarially sound" for much less than private insurers. This is how the NFIP has functioned to date. Now, there is a call on the taxpayer's capital in the form of a $22 billion deficit. Analysts ask: How was the taxpayer compensated for taking that risk? If NFIP was a private company, then it would have had to acquire capital from investors and/or reinsurers — and pay them for that capital. Government can implicitly tax the taxpayer pre-event by shifting the risk to large future post-event expenditures, thereby denying taxpayers compensation for that risk. In this way, government can make insurance appear cheap on the front end but with enormous post-event costs.