NMHC National Multi Housing Council

National Apartment Association

STATEMENT OF BRUCE C. STROHM,

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EQUITY RESIDENTIAL PROPERTIES TRUST

PRESENTED TO THE HOUSE FINANCIAL SERVICES COMMITTEE

OVERSIGHT AND INVESTIGATIONS SUBCOMMITTEE

CONCERNING

THE FEDERAL ROLE IN INSURING AGAINST ACTS OF TERRORISM

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The American apartment industry…working together for quality, accessible, affordable housing.

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My name is Bruce Strohm, Executive Vice President and General Counsel of Equity Residential Properties Trust, a publicly held apartment company headquartered in Chicago[1], and the largest apartment owner in America. It is my pleasure to submit this written testimony on behalf of the National Multi Housing Council/National Apartment Association's (NMHC/NAA) Joint Legislative Program. The National Multi Housing Council and the National Apartment Association represent the nation's leading firms participating in the multifamily rental housing industry. Our combined memberships are engaged in all aspects of the apartment industry, including ownership, development, management, and finance.[2] NMHC/NAA are a member of the Coalition to Insure Against Terrorism (CIAT).

The multifamily rental housing industry is a major part of American society. Nearly one-third of all American families rent their homes (whether apartment or single family homes) and one in five Americans live in an apartment. Rental revenues from apartments total almost $100 billion annually, and management and operation of apartments are responsible for approximately 500,000 jobs. According to the Small Business Administration, 98% of the companies that comprise the apartment industry are small businesses – many of them are family-run.

This statement will focus on five key points relevant to the apartment industry and the families it represents.

1. Terrorism insurance coverage can only be obtained for non-trophy properties for *unreasonably* low amounts of coverage for *unreasonably* high prices.

Equity Residential is currently closely reviewing available terrorist coverage options as part of our annual insurance renewal. Insurance experts informed us that the most likely amount of terrorism coverage available will cover only about 1% of our firm's total property value. This small percentage of insured property values is typical of large property owners, and may even be broader coverage than most commercial real estate owners enjoy, given the relatively lower risk exposure presented by Equity Residential's predominantly suburban assets.

The anticipated terrorist coverage is also very narrowly drafted. It would not cover attacks by foreign nationals operating on behalf of a foreign government, such as individuals linked to the "axis of evil" identified by President Bush. It would not cover bioterrorist attacks such as anthrax. It would not cover business interruption arising from government emergency closure of a property in the area of a terrorist attack, nor would it

[1] A member of the S&P 500, Equity Residential owns more than 1,000 properties in 36 states with over 214,000 apartment units. Over one million Americans every year live in Equity apartments. In 2001, Equity Residential was named one of America's most admired companies by Fortune magazine.

[2] The National Multi Housing Council represents the principal officers of the apartment industry's largest and most prominent firms. The National Apartment Association is the largest national federation of state and local apartment associations. NAA is comprised of 155 affiliates and represents more than 30,000 professionals who own and manage more than 4.5 million apartments. NMHC and NAA jointly operate a federal legislative program and provide a unified voice for the private apartment industry.

cover lost business income arising from the closure of a property to prevent future terrorist attacks.[3]

The terrorist coverage being offered in the marketplace is remarkably expensive, especially as there is no actuarial science to determine when and where acts of terror will occur next. Rates typically range from 3-7% of the value of the properties being covered with a total exclusion from coverage of any so-called "trophy" properties that may be more likely to be attacked. A typical premium for $100 million of non-trophy properties may range from $3-7 million. This cost is approximately 100 times the normal cost of property insurance.

Requiring narrowly drafted coverage for some acts of terrorism at rates approaching 100 times the normal cost of property insurance does not appear to me to be "commercially reasonable." At least one court has reached the same conclusion.[4]

<u>Our firm's ongoing search for effective, affordable coverage for acts of terror confirms for me that resident quality of life and the availability of housing at affordable rents would be significantly affected if apartment firms are required to carry the expensive but narrow terrorism insurance coverage now available in the market.</u>

To ensure the continued availability of affordable rental housing, capital markets' flexibility and federal government involvement are needed. Equity Residential and NMHC/NAA believe apartment firms should not be required to buy terrorist insurance coverage, which many mortgage lenders (with over $500 billion in multifamily mortgage credit outstanding) are demanding. Instead, housing providers should have the flexibility to take alternative approaches in coverage against terrorist risk, including going without coverage at some level, as firms typically do for acts of war.

But flexibility by capital markets and government agencies toward terrorism coverage on its own is not sufficient. Given the state of the market we have recently experienced, we believe that federal government funding is also needed to ensure that the supply of terrorism coverage for rental housing is adequate in scope as well as fair in price.

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[3] The issue of insurance coverage for costs arising from emergency closures is one of many still being disputed by insurance companies and their insureds after the closure of Reagan National Airport following September 11. <u>Wall Street Journal</u>, February 19, 2002.

[4] A judge in Hennepin County District Court in Minneapolis granted the owner of the Mall of America a temporary restraining order last week to prevent a lender from forcing the mall to buy a separate terrorism insurance policy as a condition of its lending agreement. The mall's owner said the lender was able to find limited terrorism coverage for the mall but that the coverage was inadequate and expensive, costing three times what the owner pays for all property insurance on the mall. That amount would be "a commercially unreasonable sum, which will only increase the financial burden on the mall's tenants, many of whom are small business owners," the owner said. "Insuring Against Terror Costly: Mall of America Feels Repercussions," <u>The Washington Post</u>, February 26, 2002, E1.

We believe the better policy is to have the American public – not a smaller group of ratepayers – assume the risk of terrorist attacks. Other countries at risk for terrorism have already adopted this practice. Particularly in a time of war, when Secretary of Defense Rumsfeld and the American public feel that another terrorist attack is likely, we should join those countries that protect their consumers and businesses with a national terrorism insurance program.

2. Both apartment owners and renters will be adversely affected by the failure to enact federal subsidies covering acts of terrorism.

Even before the horrible events of September 11th, apartment owners began to experience rate increases on property and general liability coverage of 50% to 100%. The extra costs of terrorism insurance, most of which is demanded by mortgage lenders, will severely impact apartment owners and result in increased rents to renters. In absolute terms, coverage costs in 2001 reached levels not seen in more than a decade. For example, one Florida property NMHC/NAA are familiar with is experiencing annual insurance costs totaling over $720 per unit, not including the extra costs of terrorism coverage. That is some $60 per month in operating costs, or a remarkable 10% of rental revenues on one property! As a percentage of revenues, insurance costs for the industry's leading apartment owners of 2.5% to 3% of revenues on a total cost of risk basis are more typical today. Translated into a per-unit basis, total insurance costs for these leading apartment owners can be as high as $250-$300 per year – $20-$25 per month in higher rent – on a property with $888 monthly rents, about the industry mean. Anecdotally, we understand that owners of smaller portfolios, including many rent-restricted, affordable housing portfolios, may be experiencing significantly higher rates than that.

How are rental housing providers responding? To mitigate the impact of insurance increases on the rents our residents pay, long before September 11, Equity Residential and many apartment firms were implementing enhanced risk management programs and taking higher deductibles. Renter's insurance and stronger risk management audits are some of the key components found in many firms' risk prevention programs, including Equity Residential. Tighter risk management programs only go so far, however, and so the largest and best-run apartment providers are managing the new market reality by taking higher deductibles. The $5,000-per-occurrence property deductible that was common as recently as a year ago is a thing of the past today for many firms. Instead, deductibles have jumped 500% and more at some of the best-run firms.

Smaller housing providers, unfortunately, lack the financial capacity of larger firms to assume higher deductibles. They also have less flexibility in negotiating better rates and coverage from their insurers. Finally, these smaller firms have less negotiating leverage with their lenders. As a result, these smaller firms must pass along a greater portion of higher insurance rates to these residents in the form of higher rents. All three factors have special implications for the cost and availability of affordable housing. <u>Since the country's affordable housing is predominantly delivered by small business apartment owners, special attention is needed to ensure that insurance requirements set by the Department of Housing and Urban Development (HUD) and capital markets do not require apartment owners to insure against terrorist risks that are very remote at best.</u>

3. A federal terrorism insurance solution should provide real relief for renters and small business apartment owners alike.

Recognizing that the legislative year is short and that a great deal of work was accomplished late last year to resolve key differences, we believe that remaining disputes should be resolved as quickly as possible so that legislation can move to conference. We are concerned that disagreements have been a major reason why, as one ratings agency recently wrote, it is "increasingly unlikely that meaningful reform will emerge at the federal level."[5] Substantive disagreements can be resolved - they should not be grounds for failing to move legislation to conference.

We commend the House Financial Services Committee for moving helpful legislation through the House of Representatives. We strongly encourage the Senate to bring consensus legislation to the floor for debate, up or down votes on the litigation management and other controversial provisions, and a motion to go to conference to resolve key differences between the House and Senate bills.

4. To ensure the continued availability of affordable housing at affordable rents, HUD should update its insurance requirements.

In the absence of Congressional action, the market is not standing still. However, greater attention is needed from HUD to address the impact of the changed market for multifamily insurance on affordable housing operating costs and the provision of housing at affordable rents.

To their credit, Fannie Mae and Freddie Mac appear to be listening to the apartment and commercial insurance markets closely. These firms realize insurance markets for multifamily collateral have changed significantly since early 2001. In response, they have updated key insurance requirements for deductibles and underwriter ratings on new and existing debt to ensure that insurance requirements reflect current market realities. Without this leadership and proactive response, smaller-portfolio owners and owners of rural, affordable apartment housing in particular would have no real choice among underwriters. Thanks to the agencies' response, renters of agency-funded affordable properties are not paying needlessly high rents for over-insured properties.

HUD continues to study the issue some months after hearing from and subsequently meeting with a broad coalition of industry housing groups. Absent additional guidance from the agency, some HUD-insured lenders have begun to force-place narrow, expensive terrorism coverage on aging HUD-insured properties in areas not generally considered to be at risk of terrorist attack. If courts have found force-placing on large commercial shopping malls to be commercially unreasonable, then the case against force-placing terror coverage on older, rent-restricted properties well outside of central business districts would appear to be even stronger. Limited operating funds should not go to needlessly over-insure against very remote terrorist risks.

As a result of this force-placing, apartment renters in affordable properties are paying higher-than-necessary rents because insurance requirements on HUD-insured loans

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[5] Moody's Special Comment, "Insurers Face the Challenge of a Post September 11th World, January 2002, 5.

have not been updated to reflect new market norms. Force-placing terrorist coverage significantly drives up the cost of operating affordable properties and provides minimal benefit. When force-placed terrorist coverage is added to existing 100% rate increases, the availability of affordable housing is threatened.

HUD does not need to wait for Congressional action to provide the relief HUD-insured renters and owners need from the costs of terror insurance. <u>Instead of permitting lenders to force-place terror coverage pending HUD clarification, HUD should immediately provide guidance to its mortgagees and participating owners to make clear that the absence of terrorism coverage does not constitute technical default on HUD-insured loans</u>. HUD should also commence a study of the state of the property and general liability insurance markets for affordable housing and report its results to the general public. This information will further afford the opportunity for Congress and industry together to intelligently address the availability of affordable housing in light of today's increased terrorist risks.

5. Exorbitant insurance costs will decrease the building of affordable housing, severely impacting renters and construction jobs.

Construction of apartment communities has added roughly 250,000 new apartment homes in each of the past three years. The value of the new construction has averaged more than $17 billion annually, providing jobs to more than 200,000 workers.

In addition, apartment demand is rising as a result of changing demographics. Recent data support the notion that an increasing number of households now prefer apartment living, even though they could afford to buy a home. Fully 41 percent of renters surveyed in the 2001 Fannie Mae National Housing Survey say they rent "as a matter of choice" and not out of necessity. This is up significantly from 32 percent in 2000 and 28 percent in 1999.[6]

The important apartment market of under-30 households will grow by half a million between 2000-2005 and another million from 2006-2010. This is a marked change from the 1990s, when this group fell more than 1.6 million. At the other end of the spectrum, the Census Bureau says the number of "empty-nest" households (married couples at least 45 years of age without children in the home) will increase over 5 million by 2010. While most will be homeowners, many will choose apartment living for its convenience, location, and social opportunities. Finally, immigration continues to expand, and new immigrants are predominately renters. The 1990s saw the second largest wave of immigration ever, and the current decade should surpass it.

An increasing population, decreases in new apartment buildings, and exorbitant insurance premiums are a recipe for higher rents and operating costs for apartment renters and owners alike.

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[6] New Data Suggest Apartment Living Is Becoming More Popular: "Renter By Choice" Households Growing, Aug. 29, 2001, NMHC Release, http://www.nmhc.org/Content/ServeContent.cfm?IssueID=10&ContentItemID=1007.

In conclusion, higher rents and small business operating costs, resulting from a thin market for commercial insurance for acts of terrorism, are real. We commend this committee and its leadership for seizing the opportunity to advance the debate by moving this important legislation through the House of Representatives. We encourage the Senate to proceed soon with up-or-down votes on the few, but significant differences, and bring its approach to conference. Surely we do not need to wait for another attack to occur before Congress acts.

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