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REPORT BY THE  
**Comptroller General**  
OF THE UNITED STATES

**Arson-For-Profit: More  
Could Be Done To Reduce It**

RELEASED

In this report, GAO discusses the extent to which the Federal Riot Reinsurance Program and the Fair Access to Insurance Requirements Plans, established by the States, provide incentives for arson-related insurance fraud, i.e. arson-for-profit.

Fair Access to Insurance Requirements Plans, authorized under Federal law, are privately owned organizations, which operate like private insurance companies, but are established by State legislation. These Plans provide essential property insurance in urban and other areas where the insurance industry will not.

Although these Plans operate under the supervision of States' insurance authorities, the Department of Housing and Urban Development Federal Insurance Administration reviews the Plans' operations to assure that essential property insurance is provided.

Although statistics are lacking, arson-for-profit is considered to be a serious problem in the Plans. GAO makes recommendations in this report to help reduce it.



GED-78-1  
MAY 31, 1978



COMPTROLLER GENERAL OF THE UNITED STATES  
WASHINGTON, D.C. 20548

B-171019

The Honorable Charles H. Percy  
Ranking Minority Member  
Permanent Subcommittee on Investigations  
Committee on Governmental Affairs  
United States Senate

Dear Senator Percy:

Your letter of August 2, 1977, requested assessment of the adequacy of current Federal programs dealing with the detection, investigation and prosecution of arson offenses. One of your specific concerns was the extent to which the Federal Riot Reinsurance Program and the Fair Access to Insurance Requirements Plans established by the States provide an incentive for arson-related insurance fraud. We reviewed the arson-related insurance fraud problem--arson-for-profit--in Fair Access to Insurance Requirements Plans and found that:

--Certain Fair Access to Insurance Requirements Plans are overinsuring property and creating an incentive for arson-for-profit.

--Fair Access to Insurance Requirements Plans need greater underwriting authority to deny or limit insurance coverage to high-risk property owners.

Appendix I contains the detailed results of our review.

Your questions concerning Federal research and development of arson detection techniques and arson investigator training; and Federal law enforcement agencies' activities to detect, investigate and prosecute arson offenses were provided in separate reports, (PSAD-78-88 dated April 24, 1978, and GGD-78-47 dated April 5, 1978, respectively). Your specific questions concerning Fair Access to Insurance Requirements Plans are answered in this letter.

We interviewed officials and obtained written information, regulations or operating policies from the Federal Insurance Administration and the National Fire Prevention and Control Administration in Washington, D.C.; nine Fair Access to Insurance Requirements Plans--Delaware, District of Columbia, Illinois, Maryland, Massachusetts, New York,

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Pennsylvania, Rhode Island, and Washington--six insurance companies, and two insurance industry trade associations. Appendix III contains a listing of organizations we contacted during our review.

Fair Access Plans and the Federal Riot Reinsurance Program are authorized under the Urban Property Protection and Reinsurance Act of 1968, as amended, (12 U.S.C. 1749 bbb et seq. (1976)). These Plans are privately owned and operated organizations, operating much like private insurance companies, but are established primarily by State legislation. The Plans provide essential property insurance to urban and other areas where the insurance industry will not provide coverage. Although Fair Access Plans operate under the supervision of the States' insurance authorities, the Federal Insurance Administration of the Department of Housing and Urban Development reviews Plan operations to assure that Plans are providing essential property insurance.

The Federal Riot Reinsurance Program, administered by the Federal Insurance Administration, provides private insurance companies riot reinsurance to protect them during riots against excess losses on company-insured properties. To purchase riot reinsurance, a company must be participating in a Fair Access Plan.

Both Fair Access Plan and insurance industry officials believe that arson-for-profit is a serious problem in the Plans, as well as in the private insurance market. The significance of the problem, however, could not be demonstrated because of the lack of specific data on the extent of the problem. Officials have indicated that inadequate investigation of arson cases by both local government and Plans, and the difficulty of proving the insured's involvement, are factors which allow arson-for-profit cases to go undetected. In certain cities in Massachusetts and Pennsylvania, investigations by two of the nine Plans we contacted have identified organized crime involvement in arson-for-profit.

According to Plan and insurance industry officials, one of the major incentives for arson-for-profit is overinsurance; providing an amount of insurance exceeding property market value. The District of Columbia, Illinois, and New York Plans are providing insurance to property owners without attempting to determine property values. As a result,

property owners may be insuring their properties for amounts exceeding property values and, therefore, create an incentive for arson. Officials from these Plans believe that it is meaningless and costly for them to establish property values at the time insurance is provided because, in the event of fire, the payment for the resultant claim is based on the property's actual cash value at the time of loss. Other Plans, however, were limiting coverage to the market value of the property at the time insurance was written.

Also, the Maryland, Massachusetts, and Pennsylvania Plans were generally providing insurance in amounts that property owners desired until a few years ago. These Plans now provide insurance coverage generally at market value thus attempting to provide only enough insurance to indemnify property owners for their losses. Plan officials believe that preventing overinsurance is an important step in reducing arson-for-profit in the Plans.

Many Fair Access Plan officials believe that the Plans are encouraging arson-for-profit by providing insurance coverage to almost everyone requesting it. Until the Plans get additional underwriting authority from the Federal Insurance Administration to deny, limit, or modify insurance coverage, certain Plan officials believe little can be done. One Federal Insurance Administration official, however, said that Administration regulations do not require Plans to insure everyone and that the Administration is more concerned that Fair Access Plans are not denying coverage unfairly or unnecessarily. Five of the nine Plans we visited are making or have recently made some changes concerning the conditions under which they will insure properties, but Plan officials agreed that additional changes can and should be made. Most Plans apparently, are not aware of changes that other Plans have made to reduce arson-for-profit.

Answers to your questions are summarized below.

1. How do Fair Access to Insurance Requirements Plans determine the amount of coverage to be given to a property owner? Can the owner insure for any amount he desires, even beyond fair market value?

The amount of coverage that Plans will provide varies. Some Plans base the amount of coverage to be given to a property owner on the market value of the property

using such values as owner's purchase price. The Massachusetts Plan, for example, uses tax assessed value, purchase price, and the most recent selling prices of properties in the neighborhood as found in real estate transfer directories. The Pennsylvania Plan will insure up to 150 percent of the purchase price if the amount of insurance is less than \$50,000. Of the nine Plans we visited, however, three (District of Columbia, Illinois and New York) generally provide property owners any amount of coverage they want without regard to property values. (See pp. 13-16 of app. I.)

2. Can the Fair Access to Insurance Requirements Plan refuse to insure for the full amount requested by the owner? Can it refuse coverage altogether?

Although Fair Access Plans can refuse to insure for the full amount requested, three of the nine we visited do not. Of the nine Plans, six do refuse to insure for the full amount requested if it is more than the Plan determines to be the property value. All the Plans that we contacted said that they can refuse coverage altogether, however, there are limited reasons for refusing. As a result, almost everyone is provided insurance. The Illinois Plan is refusing to insure only about one of every 100 applicants. Plan officials of seven of the nine Plans said that the Federal Insurance Administration requires them to insure almost everyone, although an Administration official said that this was not true. Program regulations appear to support the Administration's position. (See pp. 17-21 of app. I.)

3. Is there any provision for less-than-full payment on a claim if the insurer can prove that the insured allowed his property to deteriorate significantly before the damage in question?

Generally, depreciation (deterioration) is considered in paying claims. In seven Fair Access Plan-States--none of which we visited--however, deterioration is not considered when settling claims for total property losses. Property owners are paid the full face amount of their policies. (See pp. 16-17 of app. I.) In four of the nine States that we visited, the basis used for determining the amount to pay under a claim is the property's "actual cash value" at the time of loss. Actual cash value is defined as replacement cost less depreciation.

Deterioration is, therefore, considered to some extent when settling claims in these States. Fair Access Plans, however, generally insure properties in economically declining neighborhoods in which replacement cost less depreciation can be much greater than the market value of the properties. In such cases, Fair Access Plan-insured property owners may be paid more than the market or sales value of their properties. In the other five States that we visited, other property values, such as market value, rental and economic value are considered, in addition to replacement cost less depreciation. Property owners in these States, therefore, are not likely to be overcompensated for fire losses. The above mentioned seven States that we did not visit use either the basis used in these five States or the actual cash value basis to settle claims for partial property losses thus, considering deterioration at least to some extent.

You also requested that we determine how the program could be altered to remove the incentive to destroy unprofitable or deteriorating but well-insured buildings. We believe that the Federal Insurance Administration should take a leadership role in helping Plans reduce arson in Plan-insured properties. We make recommendations to the Secretary of Housing and Urban Development for certain revisions in the Administration's regulations. (See app. II.)

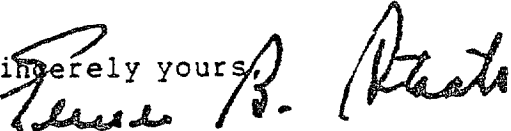
As requested by your office, we did not give the Federal Insurance Administration an opportunity to formally comment on this report. Its contents, however, were generally discussed with Administration officials, and their comments were included in the report as appropriate. As you requested, we will not distribute this report until just prior to your hearings or until you publicly announce its contents. At that time we will send copies to various standing committees in the House and Senate, such as Appropriations, Government Operations, and the Administration's legislative committees: Senate Committee on Banking, Housing and Urban Affairs and House Committee on Banking, Finance and Urban Affairs. We will also provide copies to the Secretary of Housing and Urban Development, the Administrator, Federal Insurance Administration, and the Director, Office of Management and Budget.

A detailed discussion on the results of our review is presented in appendix I and our conclusions and recommendations

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to the Secretary of Housing and Urban Development are presented  
in appendix II.

Sincerely yours,

A handwritten signature in cursive script, appearing to read "Russell B. Austin". The signature is written in dark ink and is positioned to the right of the typed name.

Comptroller General  
of the United States

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ABBREVIATIONS

FAIR	Fair Access to Insurance Requirements
FIA	Federal Insurance Administration
GAO	General Accounting Office



RESULTS OF GAO'S REVIEW OF ARSON-FOR-PROFIT  
IN NINE FAIR PLANS

BACKGROUND

In July 1967, the President, appointed the National Advisory Commission on Civil Disorders to investigate the origins of disorders. The Commission decided that a separate group of experts could deal more expeditiously with the insurance problem of urban core residents and businessmen. In August 1967 the Commission appointed the National Advisory Panel on Insurance in Riot-Affected Areas. The panel was to investigate the difficulties and high costs of obtaining insurance in riot areas or potential riot areas.

In its January 1968 report, the panel pointed out that there was a close relationship between urban blight and the availability of insurance and that failure to insure properties in decaying urban areas only increased the blight. The report also stated that cities must be revitalized and that insurance was a basic force in this effort. The panel found that there was a serious lack of property insurance in core areas of the Nation's cities and that this condition existed even before the riots of the 1960s. According to the report, the basic factor underlying the shortage of insurance in these areas was that insurance companies generally regarded business in these areas as relatively unprofitable. The added risk of riots had prompted some companies to state that continued deterioration of the situation would make them positively unwilling to provide insurance in urban core areas. The report also stated that properties must be considered on individual merit if fair access to insurance, without regard to location, was to be had by everyone.

The panel, however, pointed out that insurance companies were legitimately interested in profits and in maintaining their financial safety and stability and that States were already burdened with demands on their resources. As a result, the panel concluded that the solution to the urban core area insurance problem was a cooperative effort of all who were involved. The panel recommended therefore, that the insurance industry, in cooperation with States, establish in all States Fair Access to Insurance Requirements (FAIR) Plans. The Federal Government role would be that of providing reinsurance against extraordinary riot losses to insurance companies participating in FAIR Plans. The panel believed this would help eliminate riot risk as an impediment to insurance companies selling insurance in urban core areas.

FAIR Plans were established in 1968 when the Congress passed the Urban Property Protection and Reinsurance Act of 1968, as amended, (12 U.S.C. 1749 bbb et seq. (1976)). The act states:

"The Congress finds that (1) the vitality of many American cities is being threatened by the deterioration of their inner city areas; responsible owners of well-maintained residential, business, and other properties in many of these areas are unable to obtain adequate property insurance coverage against fire, crime, and other perils; the lack of such insurance coverage accelerates the deterioration of these areas by discouraging private investment and restricting the availability of credit to repair and improve property therein; and this deterioration poses a serious threat to the national economy; (2) recent riots and other civil commotion in many American cities have brought about abnormally high losses to the private property insurance industry for which adequate reinsurance cannot be obtained at reasonable cost, and the risk of such losses will make most lines of property insurance even more difficult to obtain; (3) the capacity of the private property insurance industry to provide adequate insurance is threatened, and the continuity of such property insurance protection is essential to the extension of credit in these areas; and (4) the national interest demands urgent action by the Congress to assure that essential lines of property insurance, including lines providing protection against riot and civil commotion damage will be available to property owners at reasonable cost."

The act further states that its purpose is to

"\* \* \* (1) encourage and assist the various State insurance authorities and the property insurance industry to develop and carry out statewide programs which will make necessary property insurance coverage against the fire, crime, and other perils more readily available for residential, business, and other properties meeting reasonable underwriting standards; (2) provide a Federal program of reinsurance

against abnormally high property insurance losses resulting from riots and other civil commotion, placing appropriate financial responsibility upon the States to share in such losses \* \* \*."

Although the act does not require that States establish FAIR Plans, twenty-five States, Puerto Rico, and the District of Columbia have. For those States that have established Plans, the act requires that they must be approved by, and administered under the supervision of, the States' insurance authorities, or be authorized or required by State law, and shall be designed to make essential property insurance more readily available in urban and other areas. A listing of FAIR Plans is included as appendix IV.

#### How FAIR Plans operate

Most of the FAIR Plans we visited operate similar to private insurance companies. These Plans write insurance policies under their own name and handle all policy holder claims. FAIR Plans are privately owned and operated organizations set up primarily by State legislation. FAIR Plans operate under the supervision of the States' insurance authorities and are subject to their approval for changes in operating procedures.

All profits and losses are shared by participating insurance companies in a given State. FAIR Plans generally offer insurance against fire and extended coverage (includes hail, windstorm, explosion, riot, civil commotion, and smoke), vandalism and malicious mischief. In calendar year 1976, all FAIR Plans combined wrote about \$18.9 billion of insurance on 751,441 insurance policies. About \$194 million in premiums were earned by the FAIR Plans on these policies.

A property owner may obtain insurance coverage directly from a Plan or have an insurance agent or broker obtain it for him. In either case, the FAIR Plan will generally inspect, or hire someone to inspect, the property at no cost to the owner before it will write a policy on the property. Usually, this inspection is solely to assess risk or fire hazard. After the inspection, the FAIR Plan must determine whether to write a policy on the property and the amount of coverage. If the FAIR Plan accepts the property, the property owner pays the FAIR Plan the insurance premium.

When losses occur the FAIR Plan pays the property owner. At the end of the year, the total losses (claims) paid, added to the costs to administer the FAIR Plan, has usually exceeded

the premiums collected and other income, resulting in a financial loss. This loss is passed on to private insurance companies participating in the FAIR Plan. The Federal Government has no financial involvement in FAIR Plans.

All the States that we visited require all insurance companies selling fire and related lines of insurance in these States to participate in the FAIR Plan, thereby sharing in FAIR Plan profit and losses. Three States with FAIR Plans allow insurance companies to participate voluntarily. In States requiring participation, each insurance company's share of the loss is based on its percentage of the total fire insurance premiums collected in the State. A company collecting 20 percent of the total insurance premium dollars, therefore, has to pay 20 percent of the FAIR Plan losses.

FAIR Plans have generally not been financially successful. According to financial statements they have submitted to FIA as of September 30, 1977, only 5 of the 27 Plans show a profit since they began operating. The California (\$652,000) and Georgia Plans (\$431,000) have the highest underwriting profits from inception to September 30, 1977. The New York and Michigan FAIR Plans have the highest underwriting losses from inception to September 30, 1977; \$68.5 and \$60.5 million, respectively. Appendix IV shows the underwriting profit or loss of each of the 27 FAIR Plans as of September 30, 1977.

#### Riot reinsurance

The Federal Government's role is to (1) offer, through FIA, riot reinsurance to the private insurance companies that participate in FAIR Plans whether voluntarily or mandatorily, (2) periodically review each Plan and the methods and practices by which such Plan is being carried out in the areas and communities where it is intended to operate to (a) assure that such Plan is effectively making essential property insurance readily available in such areas and communities and (b) identify any aspects of the operation or administration of such Plan which may require revision, modification, or other action to carry out the purposes of the reinsurance act of 1968.

Riot reinsurance insures the companies against excess losses that they would sustain during riots or civil disorders. Riot reinsurance covers properties insured in the private market by these companies and not FAIR Plan-insured properties. Insurance companies pay a nominal reinsurance premium, two cents per hundred dollars of reinsurance, to FIA and agree to bear riot-related losses themselves up to a stipulated percentage of their total premiums earned from

selling fire and related lines of insurance to private property owners within a State. This percentage is generally 2.5 percent of an insurance company's premiums. According to an FIA official, 2.5 percent of an insurance company's earned annual premiums from fire and related lines of insurance has covered most of the riot-related losses that insurance companies have incurred to date. It would therefore appear, that private insurance companies, not FIA, have paid most of the riot-related losses that have occurred to date in those States that have a FAIR Plan. FIA has collected over \$100 million of riot reinsurance premiums from private insurance companies and paid excess riot-related losses of about \$12 million from inception of the riot reinsurance program to September 30, 1977.

#### ARSON-FOR-PROFIT

FAIR Plan and insurance industry officials believe that arson-for-profit is a serious problem in FAIR Plans as well as in the private insurance market. Also, two FAIR Plan officials in Massachusetts and Pennsylvania said that organized crime is involved in arson-for-profit in certain cities. The significance of the arson-for-profit problem in FAIR Plans, however, could not be demonstrated because of lack of statistics.

#### What is arson?

A September 1976, United States Department of Commerce-sponsored report prepared by Battelle Columbus Laboratories, "ARSON: AMERICA'S MALIGNANT CRIME", defined arson as "The crime of maliciously burning the building or the property of another, or of burning one's own for some improper purpose, as to collect insurance."

The National Fire Protection Association <sup>1/</sup> identifies at least eight categories of arson including

- fraud fires which usually are to collect insurance because the value of the insured structure and/or contents is less than the value of the insurance;
- political fires set to dramatize an issue or other similar reason;

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<sup>1/</sup>A nonprofit technical and educational organization which promotes the science and improves the methods of fire protection and prevention.

- pyromaniac fires set for thrills;
- crime cover-up fires;
- spite fires (revenge, jealousy or anger);
- vanity fires set so that the arsonist can appear as a hero in taking countermeasures;
- "psycho" fires committed without any rational motive; and
- vandalism fires set by individuals or groups who are looking for excitement without premeditated motive.

#### Significance of the problem

Although statistics on the various categories of arson are not available from anyone we met (nor did they know of any such statistics available from other sources) information from the Illinois Advisory Committee on Arson Prevention states that insurance fraud--burning-for-profit--may be the number one motive for arson.

The Battelle report stated that current trends in arson are worsening and that urban fire departments estimate that as much as half of all city fire losses are from fires set on purpose. These fire losses, according to the report, may have an impact on the economy each year of as much as \$10 billion through higher insurance premiums, higher prices for what is not burned, lost jobs and higher taxes. In addition, as many as 1,000 lives are lost to arson each year, according to the report. Information published by the Property Loss Research Bureau, an insurance trade association representing about 115 companies, states that since the early 1950s arson losses in the Nation have increased tenfold.

Information obtained from the American Insurance Association, an insurance industry trade association, shows that about \$1.5 billion of the total \$3.5 billion of insurance losses paid by the industry in 1976 resulted from arson/incendiary fires. This is the latest data we could obtain. An Association official said that no one really knew the extent of the arson problem nor how heavily organized crime was involved.

Although arson-for-profit may be a problem in FAIR Plan-insured properties, private insurance companies, are experiencing most of the arson-for-profit, according to some Plan

officials. FAIR Plan officials, however, do not know how much arson or arson-for-profit the Plans are experiencing.

Apparently, one of the reasons the insurance industry is experiencing most of the arson or arson-for-profit is because FAIR Plans write only a small percent of the fire insurance being written in many States. Pennsylvania and New York Plan officials said they write about 2 and 5 percent, respectively, of the total in their States. The Washington FAIR Plan sells less than one-half of one percent (about \$500,000) of the fire and related lines of insurance sold in the State. The latest statistics available for Washington show that losses from arson or suspected arson were about \$2 million in 1976. Also, in Texas, where there is no FAIR Plan arson losses in Houston alone in 1977 were an estimated \$10.3 million. The Houston fire marshal said he believed that about 50 percent of the dollar loss from fires in Texas was arson-for-profit related.

Although a FAIR Plan may write a small percent of the policies in a State, the Plan's portion of the State's arson losses may be greater than its portion of the fire insurance written in that State. A Massachusetts FAIR Plan official estimated that 40 percent of the arson in the State was FAIR Plan-related, even though the Plan writes only 15 percent of the State's fire insurance.

#### Problems affecting arson-for-profit

The insurance industry, insurance trade association and FAIR Plan officials with whom we met pointed out numerous problems affecting the arson-for-profit problem. Some of these problems were of a local nature and some were related to State law or requirements. In addition to Federal regulations, FAIR Plans must generally operate under the same State laws that regulate private insurance companies. Some of the problems mentioned by officials with whom we met, follow.

--There is little real incentive for the insurance industry to do anything about arson. One insurance company official said that even if property owners can be proven guilty of committing arson, the insurance companies must still pay mortgages on the property. Insurance companies have also adopted an attitude that money should probably not be spent to investigate suspected arsonists because the chances of conviction are only about one percent, and the suspects may sue the companies for punitive damages. Another insurance company official told

us that from a financial point of view it did not make sense in many cases to try to prosecute, and that it was less expensive to pay the claims. We noted that a September 1977 study <sup>1/</sup> on fires in urban areas states that at the present time, property owners contemplating arson can feel secure in the knowledge that they have in excess of a 98-percent chance of not being convicted and, until this is changed, the threat of prosecution will have little preventive effect.

- Officials from seven FAIR Plans, as well as other officials, said that prosecutors generally did not want to take an arson case because arson was so difficult to prove.
- We were told that police departments in some cities consider arson investigation a fire department matter, and that the fire departments regard arson a crime and, therefore, a police matter. As a result, arson does not get much attention from either department.
- State laws or requirements in some cases hinder efforts to control arson. Perhaps the requirement mentioned most concerned the basis for paying claims. Some States require that the "actual cash value" <sup>2/</sup> of a property at the time of the loss be used as the basis for paying a claim without consideration of market value of a property. This provides an incentive for arson according to the Battelle report, because it can overcompensate owners which have properties with higher actual cash values than market values. The actual cash value concept for paying claims may also have an adverse effect when insurance policies are written in that it sometimes results in overinsuring. For example, Illinois FAIR Plan officials told us that they generally give property owners the amount of insurance requested without determining the property's value. This is done because in the event of loss, the owners will receive payment based on the actual cash value of the property at the time of loss, not its value at the time the insurance was written. The September 1976 Battelle report recommended that the

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<sup>1/</sup>A National Fire Prevention and Control Administration-funded study called "FIRES IN RESIDENTIAL NEIGHBORHOODS: A SURVEY OF CAUSES AND LOCAL EFFORTS AT PREVENTION".

<sup>2/</sup>This is generally defined as replacement cost less depreciation.



National Association of Insurance Commissioners 1/ "specifically study the impacts of state laws which may compel insurance companies to pay insurance claims greater than the market values of insured properties". We were told that the Commissioners plan to meet in June 1978, to discuss the Battelle report recommendations.

--The Privacy Act was mentioned by almost everyone with whom we met as a problem hindering arson investigation. Many FAIR Plan officials said that if the fire department wanted information from FAIR Plan files concerning property owners or property, because of the Privacy Act, the fire department would have to subpoena the information. Also, an insurance company cannot make other companies aware of information or share information concerning a suspicious policy holder, according to FAIR Plan and insurance company officials. Ohio, however, has passed a law requiring insurance companies (and the FAIR Plan) to provide information to fire and other public investigative personnel on demand. The insurance industry has also taken action through the American Insurance Association to share information concerning fire losses. The Property Insurance Loss Register, a nationwide fire loss history file, has been established to contain information on every fire claim that has been filed with insurance companies subscribing to the register. As of January 1978, insurance companies writing about 75 percent of the fire and related lines of insurance in the Nation had subscribed. According to the American Insurance Association, this history file will help identify insurance fraud, including

--purchase of duplicate insurance from two or more companies and full claims payment from both companies for the same loss,

--known major arson and property fraud rings, moving with impunity from city to city, and

--publicly known criminals and arsonists concealing true ownership of intended fraud fire property through "straw" ownership or listing themselves as mortgagees.

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1/An association representing State insurance departments or authorities.

Arson-for-profit in FAIR Plans

FAIR Plan officials believe that arson-for-profit is a problem in FAIR Plans. These officials, however, were not able to provide us statistics showing how serious the problem is. Although the cause(s) of about 28 percent of the fires in Illinois FAIR Plan-insured properties were not determined, the Metropolitan Chicago Loss Bureau, <sup>1/</sup> which settles Plan claims did make an analysis of Plan claims paid in calendar year 1977. The Bureau statistics show that 33 percent (685) of the Plan fire claims were incendiary (arson and arson-for-profit). These claims totaled about \$7.7 million, or 37 percent of the amount of all claims received. The Bureau was able to identify evidence of owner involvement in the fires in 11 percent of the FAIR Plan claims--or 18 percent of the known incendiary fires claims' amount. In addition, according to the Bureau, the FAIR Plan also received 593 claims totaling about \$6.6 million during 1977 for fires for which the cause was not determined. The Bureau did not know how many of these claims resulted from incendiary or arson-for-profit fires.

Arson-for-profit statistics are difficult to develop. FAIR Plan and insurance industry officials have indicated that investigations of suspicious fires by local fire and police departments are sometimes inadequate, and that some FAIR Plans do not adequately investigate arson cases. Arson can be proven in many suspicious fires, but proving owner involvement is difficult, according to these officials.

The Massachusetts FAIR Plan does have several people under indictment for arson, including suspected organized crime figures. FAIR Plan officials said that five FAIR Plan-insured properties had burned that were owned by organized crime or in some way related to organized crime. One fire resulted in a loss of over \$400,000. FAIR Plan officials said they could not prove that this fire was arson but that they believed it was. These officials also said that crime rings other than organized crime were also involved in arson-for-profit in the Boston area. One crime ring identified last year was responsible for several known arson fires, and one official said that although numerous

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<sup>1/</sup> A privately supported, nonprofit organization that supervises adjustment of property claims for its 125 member insurance companies.

arrests had been made, this was only the "tip of the iceberg". The private investigators hired by the FAIR Plan uncovered evidence that there was much more arson-for-profit in the Boston area, as well as other areas, but did not pursue these other cases because of manpower and funding limitations. FAIR Plan officials said that they had paid about \$900,000 for three large arson investigations in the Boston area. The investigators told us that insurance companies, as well as the FAIR Plan, were experiencing arson-for-profit losses in the Boston area.

The September 1977 study on fires in urban residential neighborhoods, funded by the National Fire Prevention and Control Administration, states that arson has become one of Boston's most serious crimes. The study also points out that to a great extent, fire is devastating Boston's neighborhoods because someone profits from it. According to the study, those who profit not only profit from the fire itself but from the whole cycle of deterioration that always precedes it. The study also states that while the pattern of fraud seems to be premeditated, financial hardship or the sudden attraction of getting a financial windfall can also lure otherwise honest property owners to disinvest in their property and allow it to be torched. The fuel that keeps fires raging in Boston's neighborhoods is insurance money, according to the study.

As noted earlier, one Massachusetts FAIR Plan official estimated that 40 percent of Massachusetts arson was FAIR Plan related; the Plan writes about 15 percent of all the fire insurance written in Massachusetts. About 57,000 FAIR Plan policies were in force in Massachusetts as of September 30, 1977.

The Pennsylvania FAIR Plan has also had arson-for-profit fires that involved organized crime. The FAIR Plan had a listing of arson or suspicious fire losses, most of which occurred in 1976 and 1977, that totaled \$1.8 million. FAIR Plan officials told us that the arson-for-profit evidence for some of these losses was circumstantial and arson could not be proven in a criminal court. Payment of the claims, however, can and have been denied in civil courts using such evidence.

Although arson-for-profit may occur as a result of many different situations, a typical case would involve the following circumstances. A property is purchased at a very low price. A few improvements are made, or merely started, to justify an increase in the property's insurable value.

The property may be "sold" to a fellow conspirator at an artificially inflated price; the true owner may become the mortgagee. An insurance policy for an amount substantially greater than the market value is then obtained. Shortly thereafter, a fire destroys the property. In one instance, in a Massachusetts FAIR Plan investigation, property purchased for \$1,000, was covered by a \$25,000 insurance policy. A suspicious fire resulted and the FAIR Plan paid a claim of \$16,000 on this property.

Property Insurance Plans Service Office 1/ officials said that FAIR Plans are not accomplishing their intended objective of revitalizing urban core areas. Instead, they said, the program is having the opposite affect. Slum landlords many times walk away from burned buildings without making repairs with the insurance money received as a result of fires. When a landlord walks away without making repairs, the whole neighborhood begins to deteriorate, according to these officials. The cities are helpless to do anything because property owners cannot be located or, if they are located, they cannot be forced to make necessary repairs. In some instances, the repair costs may exceed the market value of the property and, therefore, there is no financial incentive for the owner to make repairs. Nonowner-occupied property held for investment purposes poses the greatest risk of arson-for-profit--about double the rate of owner-occupied properties--according to these officials.

#### AMOUNT OF INSURANCE AND THE BASIS FOR PAYING CLAIMS

Three of the nine FAIR Plans we contacted were generally providing insurance coverage in amounts the owner requested, without regard to the actual value of the property. FAIR Plan and insurance industry officials we interviewed believe this results in overinsuring property which is a major incentive for arson-for-profit. Five other FAIR Plans providing owner-requested amounts of insurance in the past subsequently changed their underwriting criteria to limit coverage to the property's market value. One FAIR Plan official said that by eliminating overinsurance and the incentive for arson, his Plan had reduced its losses substantially.

FAIR Plans generally insure properties in economically declining neighborhoods in which replacement cost less

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1/ A national association representing all FAIR Plans.

depreciation is much greater than the market value of the property. In four of the nine States that we visited, FAIR Plans as well as insurance companies are required to pay losses at replacement cost less depreciation, thereby providing policy holders with an incentive for arson.

In addition, 20 States require FAIR Plans and insurance companies, to pay property owners the face value of their policies in the event of a total property loss. These payments can result in financial gains to the owners because the amount the owners are paid exceeds the market value of the property.

### Overinsurance

The amount of insurance FAIR Plans are willing to write on properties differs among FAIR Plans. Three of the nine FAIR Plans we contacted generally provide the amount of insurance the property owners request without attempting to determine the property's actual or market value. As a result, properties can be insured significantly above their actual market values by the District of Columbia, Illinois and New York FAIR Plans.

Various FAIR Plan and insurance industry officials have stated that overinsured properties provide great incentives for arson to property owners. Various studies have also concluded that overinsurance is a significant factor in the arson problem. The September 1977 report from the National Fire Prevention and Control Administration-funded study, for example, states that arson-for-profit will be difficult to contain as long as buildings can be easily overinsured and the risk of being convicted of arson is so low. The report also states that insurance companies recognize the problem but have done little to stop it because there is no built-in disincentive to stop it. According to the report, the only sure response to this problem is tighter regulation by State insurance commissioners and refusal by these commissioners to allow increases in FAIR Plan rates as long as FAIR Plans cannot show conclusively that they are making more than a token effort at preventing arson through overinsurance. As long as reinsurance companies can pass on arson losses through rate increases, they are unlikely to take action addressing the problem.

Also, the Battelle Laboratories September 1976 report on arson states that there is a need for a reexamination of the insurance underwriting practices and regulations that impact on arson. According to the report, one basic problem is that of avoiding too much insurance on a property.

According to District of Columbia, Illinois and New York FAIR Plan officials, these FAIR Plans generally sell property owners any amount of insurance they request because claims must be paid based on the actual cash value of the property at the time of the loss. Illinois and New York Plan officials said that it was therefore, meaningless, time consuming and sometimes costly to establish property value at the time insurance is written. An Illinois FAIR Plan official said that determining the value of property at the time of insuring it would be too costly, requiring an appraisal. The cost to have the property appraised would in some cases exceed the insurance premium collected from the property owner. As a result, the FAIR Plan does not appraise properties or attempt to determine their value.

According to FAIR Plan officials, the Massachusetts, Maryland, Pennsylvania, and Rhode Island Plans had been providing coverage in the past based on amounts requested by the owners rather than limiting coverage to market values. These plans subsequently changed their underwriting criteria to limit coverage to market values because they believe that older practices were overinsuring properties and, thereby, providing an incentive for arson.

Massachusetts law also requires that insurance claims be paid based on properties' actual cash values. The Massachusetts FAIR Plan, however, does not let this dictate the amount of insurance it will write on property. The Massachusetts Plan, which has had a serious arson problem, is now assuring that properties are only insured in amounts up to their fair or market values--generally the amount for which the property could be sold. Massachusetts FAIR Plan officials said that there are a number of ways to determine the fair market value of a property without paying for a costly professional appraisal. They stated that no precise market value determination can be made but that an approximate market value can be determined. One indicator they use is the selling prices of properties recently sold in the neighborhood. This can be obtained easily from published real estate transfer directories. Other indicators of property values used by the Massachusetts Plan are purchase price and tax assessed values. FAIR Plan officials said, however, that they had not operated under this new policy long enough to measure the impact it will have on arson.

The Maryland and Pennsylvania FAIR Plans now attempt, to some degree, to limit the amount of insurance they will sell on a given property. A Maryland FAIR Plan official told us that, as a result of an analysis of FAIR Plan losses, the

Plan's underwriting criteria was revised for investor-owned, nonowner-occupied habitational properties. He also, said that about 83 percent of the FAIR Plan's losses were from these kinds of properties. The FAIR Plan's analysis showed that in many instances the amounts of insurance coverage being requested bore no relationship to the actual cash value of the properties. The analysis also pointed out that the practice of giving an owner more insurance than the actual cash value of his property as the FAIR Plan had been doing had necessitated settlement of claims by the FAIR Plan where the cost of repairs exceeded the actual cash value of the property.

The primary change that the Maryland Plan made in 1976 was to try to bring the amount of insurance in line with property values. The FAIR Plan official said that the Plan started challenging applicants that wanted more insurance than the Plan thought it should provide based on a number of factors including, the original cost of the building to the insured (applicant), the economic value, age and condition of the building, market value, depreciation and deterioration and repairs and renovations made. Although property owners and public insurance adjusters, according to the FAIR Plan official, were very upset with the new criteria, the number of fires in properties covered by the new policy decreased substantially. During the first 6-month period (May 1976 to October 1976) operating under the new criteria the number of losses were reduced substantially. The FAIR Plan official attributed the decrease to the new underwriting criteria.

Until their policy was changed in 1974, the Pennsylvania FAIR Plan also provided insurance in amounts requested by the owners, according to Pennsylvania FAIR Plan officials. These officials said current Plan practice is to provide insurance at the market value of the property but the Plan will insure up to a value of 150 percent of purchase price, if the total insurance coverage is less than \$50,000. Also, if it is an active business, the FAIR Plan will provide a greater amount of insurance than the purchase price of the property. The Pennsylvania FAIR Plan does not make or have property appraisals made to try to establish property values because it is too expensive, according to FAIR Plan officials.

Fees collected by insurance agents and brokers may also affect the amount of insurance requested. Massachusetts and New York FAIR Plan officials told us that property owners often go through agents and brokers to get insurance, instead of applying directly to the FAIR Plan. FAIR Plan officials said that fees collected by agents and brokers, who are responsible for a significant portion of the insurance these

Plans write, are based on the amount of insurance that FAIR Plans and insurance companies write on properties. For example, agents and brokers providing insurance through the New York FAIR Plan get a 10-percent commission on the amount of insurance obtained. This practice, combined with the fact that some FAIR Plans are providing insurance in virtually any amount requested, could, in our opinion, result in overinsuring properties, thus, creating arson incentives.

#### Actual cash value

Illinois FAIR Plan officials told us that actual cash value has been defined as replacement cost minus depreciation. According to these officials, payment of insurance claims at this value sometimes requires them to pay property owners more than the market value of their property (more than that for which the owners could sell their properties). Properties in older urban areas suffering economic decline are more likely to have market values that are significantly below the actual cash values (replacement cost less depreciation) and are located in areas in which FAIR Plans generally provide coverage. Both FAIR Plan and insurance company officials told us that this difference between market value and actual cash value is a real incentive for "torching" run down property.

Other States that require use of the actual cash value basis to pay property insurance claims have recognized that use of this value alone could result in paying property owners more than the market value of the property. As a result, courts in these States require that actual cash value be determined using the "broad evidence rule". This rule allows insurers to consider, in addition to replacement cost minus depreciation (actual cash value), other values in determining a fair amount to pay property owners whose properties have been destroyed by fire. Such other values include the rental value, the market value, and the economic value of property. Proponents of the broad evidence rule believe that using all these values will help assure that property owners will not be overcompensated for fire losses.

#### "Valued policy" States

Twenty States have passed laws, often called the "valued policy law", to discourage insurance companies and FAIR Plans from selling--and protect consumers against buying--more insurance than is needed to fully compensate property owners for total property losses. FAIR Plans are operated in seven of these States. Generally, this law requires insurers, in case of a total property loss, to pay property owners the



face amount of the policies regardless of property market value. This may reduce the incentive for insurers to over-insure property especially property in economically declining areas. None of the FAIR Plans we visited were in States that had a valued policy law, so we do not know what impact it has on arson in FAIR Plan-insured properties. Even though this law may help to reduce overinsuring and remove arson incentives, it may create an incentive for arson in areas where property values are declining. Property value would be established at the time the policy is written but this value could rapidly decline. Property owners would have incentives to burn their properties knowing that they would collect the face amount of their insurance policies, not the actual cash value of the property at the time of the loss.

NEED FOR GREATER AUTHORITY  
TO DENY OR LIMIT COVERAGE

FAIR Plan officials that we contacted believe that Plans are operating in a manner that encourages arson-for-profit. These officials, as well as insurance industry officials with whom we met, contend that, FAIR Plans provide insurance to almost everyone due to FIA's attitude that no one should be denied insurance coverage. All FAIR Plans we visited expressed the need for more flexibility in their underwriting prerogatives which would provide greater authority to deny insurance or otherwise limit coverage and thereby provide a means of reducing arson-for-profit.

Some of the specific problem areas FAIR Plan and/or insurance industry officials mentioned were

- inability to consider the applicant's character,
- requirement to provide immediate coverage before properties can be inspected, and
- need to revise FIA's required 30-day notice before policies can be cancelled.

FIA does encourage FAIR Plans to control arson through the underwriting process, and FIA's regulations do not require FAIR Plans to provide insurance to everyone, according to an FIA official. The official could not provide us with information as to what specific actions have been taken by FIA to help FAIR Plans reduce arson.

The Urban Property Protection and Reinsurance Act of 1968, as amended, which authorized FAIR Plans states that one of the purposes of the act is to "encourage and assist the various State insurance authorities and the property

insurance industry to develop and carry out statewide programs which will make necessary property insurance coverage against the fire, crime, and other perils more readily available for residential, business, and other properties meeting reasonable underwriting standards" (underscoring added). The act also states that the Congress finds that "responsible owners of well-maintained (underscoring added) residential, business, and other properties in many" urban areas "are unable to obtain adequate property insurance against fire,\* \* \*". The act further states that FAIR Plans may vary from State to State because of local conditions but all Plans shall contain provisions that no risk shall be denied insurance coverage unless, among other things, there has been a determination that "the risk does not meet reasonable underwriting standards at the applicable premium rate". Apparently, the Congress did not intend that Plans insure every property in urban core areas.

In addition, FIA regulations do not apparently require that all properties be insured. These regulations state that after a FAIR Plan inspects property it must promptly notify the applicants that it agrees to write coverage or that it declines to write coverage because the property does not meet reasonable underwriting standards, stating the specific information that constitutes the basis for this determination. The regulations state further that reasonable underwriting standards for declining properties must be relevant to the perils against which insurance is sought including

- physical condition of the property;
- the property's present use, such as extended vacancy or improper storage of flammable materials; or
- other specific characteristics of ownership, conditions, occupancy, or maintenance that violate the law or public policy and that result in a substantially increased exposure to loss.

Illinois FAIR Plan officials told us that FIA's interpretation of "reasonable underwriting standards" was such that FAIR Plans had to insure just about any property with little concern about risk. They said that there were generally only three reasons under which they could refuse insurance:

- if previous unrepaired fire damage exists,
- if the property owner has been convicted of arson, or
- if the property is vacant.

These officials said that they are refusing insurance to only about one applicant out of every 100 that applies for property insurance.

Pennsylvania and Washington FAIR Plan officials also told us that FIA requires them to insure undesirable risks. These officials said that the best way to prevent arson losses is to be careful in underwriting and not insure all applicants. The Pennsylvania FAIR Plan originally accepted all applicants but recently has attempted to reduce its losses by denying coverage to poor risks. The State insurance department has approved these efforts. Pennsylvania FAIR Plan officials believe that their Plan has been given more flexibility in its underwriting than other Plans have. They said, however, that FIA has put pressure on the States to grant all applicants insurance. The Pennsylvania officials also said that if FIA encouraged States to give FAIR Plans greater perogatives to deny or limit coverage, State insurance authorities would grant FAIR Plans greater flexibility.

A Washington FAIR Plan official said that FIA has criticized him for being too selective as to properties that he insures. He said that FIA could reduce the incentive for arson if it would permit FAIR Plans to be more selective. He said also that FIA is pushing FAIR Plans to insure everything, including high-risk properties, and at a reasonable rate.

Officials of the Property Insurance Plans Service Office said that FIA was discouraging FAIR Plans from being selective in underwriting. Insurance industry, FAIR Plan and Service Office officials mentioned an October 1977, letter from FIA to the Massachusetts FAIR Plan manager as indicative of FIA's attitude towards fighting the arson-for-profit problem in FAIR Plans. The letter stated that "\* \* \* 'arson for profit' can be successfully attacked, as you have so ably demonstrated, through post-claim review and vigorous prosecution of the culprits as opposed to attempts to combat it through screening and selection practices\* \* \*". FAIR Plan, Service Office, and industry officials disagree with this and said that this attitude indicated a disregard for lives that are lost and millions of dollars of property damages that result from arson.

One insurance company official who serves on a Plan's board of governors told us that he thought that the standards for underwriting in FAIR Plans were very low. According to this official, these low standards result in losses which are passed on to insurance companies and, ultimately, to property owners buying insurance from these companies. He also said that FAIR Plans have increased the incidence of arson-for-profit because if these Plans had not been established

many of the properties being burned could not get insurance and, therefore, no incentive to burn them. According to this official, one thing that could be done to improve FAIR Plans' arson records, is to allow the Plans to be more selective as to the properties they insure.

#### Character of the insured

FAIR Plans do not have the same perogatives that insurance companies have, according to FAIR Plan and insurance industry officials. For example, an insurance company can decline to insure an individual after he has had a suspicious fire. Pennsylvania Plan officials said that the insurance company will pay the claim without contesting it and then refer the individual to the FAIR Plan for insurance. The FAIR Plan cannot refuse to insure this individual, according to a Pennsylvania FAIR Plan official.

FAIR Plan and insurance company officials believe that factors other than location must be considered by FAIR Plans before writing insurance, as is done in the insurance industry.

According to one insurance company official, the original purpose of FAIR Plans was to provide insurance in those instances where the insurance industry would not "solely because of where the property is located". He said that FAIR Plans, therefore, should be granted all of the perogatives of the industry except location.

Illinois FAIR Plan officials said that FAIR Plans need to evaluate not only the property but the property owners as well. Although these officials said that the owner's attitude is important, they do not obtain information concerning this matter. Some of these other factors, often referred to as "moral hazards", concern the character and attitude of insureds and would include such information as the person's or company's financial condition, tax arrearages, housing code violations, use being made of the property and the insured's history of fires. Use of some of this information would require access to city records. As an example, Plan officials cited city inspection records on an owner's violation of building codes, the length of time the violations have remained uncorrected, and renter complaints.

Officials of two FAIR Plans noted that such information may not be readily available because the city government may not cooperate, the cost to get the information may be too expensive, or it may be illegal for the FAIR Plan to get the information.

However, certain FAIR Plans are now receiving data from the city governments and using it in their underwriting activities. For example, the New York FAIR Plan has access to local tax records and building violations and have included in their underwriting criteria, provisions that allow them to deny coverage to individuals for unpaid taxes and building violations.

Certain FAIR Plan and Service Office officials stated that insurance could not be denied to an individual with a history of fires even if the fires were found to be suspicious in nature. According to FAIR Plan officials, one FAIR Plan denied coverage to a property owner who was under indictment for arson. FAIR Plan officials stated that the case was appealed to the State insurance authority, and the FAIR Plan was required to provide the insurance. FAIR Plan officials indicated that only a convicted arsonist can be denied insurance by a FAIR Plan. New York FAIR Plan officials also mentioned that insurance could not be denied to an individual with a number of fires nor could he be otherwise penalized. These FAIR Plan officials feel that this type of person, if not involved in suspicious fires, is at least negligent and should be penalized, perhaps through the use of a deductibility clause in the policy--increase the amount property owners must pay toward any losses.

Pennsylvania FAIR Plan officials stated that if a known organized crime figure had a suspicious fire and the FAIR Plan was resisting the claim on that property, the FAIR Plan could not deny insurance coverage on other property to the same individual. These officials indicated that they were now attempting to justify the need for such authority with their State insurance authority.

Other information on "moral hazard" may be available from sources other than local governments, including the insured. These would include the history of fire claims and the financial condition of the insured or his business.

We believe that FAIR Plans could receive city government and other information which would assist in evaluating owners and their attitudes.

FAIR Plans want to change the  
insurance cancellation requirement

Seven FAIR Plans we visited complained about the FIA required 30-day notice before a policy can be cancelled. Illinois, New York, Massachusetts and Pennsylvania FAIR Plan officials, as well as insurance company officials with whom we met, said that this requirement was unreasonable in cases

where it is known that an insured building is going to be burned. A Massachusetts FAIR Plan official said the requirement was costly. For example, he said that the FAIR Plan once spent about \$10,000 to provide 24-hour security for a building for 30 days after giving notice of cancellation. None of the FAIR Plans had statistics to show dollar losses or the number of properties that had burned during the 30-day period following issuance of a cancellation notice.

FIA's 30-day cancellation requirement for FAIR Plans is generally a longer period than most States require for insurance companies. For example, the State of Rhode Island has a 5-day cancellation requirement applicable to the insurance industry while the Rhode Island FAIR Plan, until last year, was required to give a 30-day notice. After the Rhode Island State insurance department appealed to FIA, FIA granted the FAIR Plan authority to cancel an insurance policy after giving a 5-day notice, provided the State insurance department approved each case. The Massachusetts FAIR Plan has since asked FIA to grant it the same authority.

Illinois and New York FAIR Plan officials told us that a 5-day requirement, in their opinion, would be very helpful to them. Illinois and New York have asked FIA to waive its 30-day cancellation requirement under certain circumstances. The New York Plan's request was not granted because it did not, according to FIA, show that the existing requirement was inequitable or caused undue hardship to the Plan. Illinois' request was granted where specific conditions existed but, according to FIA, the Illinois legislature in 1975, passed into law a 30-day cancellation requirement which included the FAIR Plan. An Illinois insurance department official said that the 1975 law did not apply to the FAIR Plan. FAIR Plan officials, however, said that their counsel had determined that the Plan did have to comply with this law.

The September 1977, National Fire Prevention and Control Administration-funded study on fires in urban residential neighborhoods states that insurance coverage on abandoned buildings should be terminated more quickly. As soon as abandonment occurs in these structures, the time frame before a major fire occurs can be measured in a matter of days, according to the study.

#### Providing insurance before inspecting property

The New York and Massachusetts FAIR Plans are required to provide insurance on properties before they have an opportunity to inspect the properties. This practice, which is

required by the New York Plan's board of directors, results in a large number of policies being cancelled after the FAIR Plan has had an opportunity to inspect the properties. If the FAIR Plan decides not to accept the property a 30-day notice of cancellation is issued, as required by FIA. This gives property owners at least 30 days of full insurance coverage regardless of the property's condition.

Massachusetts FAIR Plan officials said that about 25 percent of the insurance written monthly (about 1,000 policies) is immediate-type coverage--coverage before inspecting the property. According to these officials, this practice is required by State law.

#### FAIR Plan actions

Within the last few years FAIR Plans began to realize the seriousness of the arson-for-profit problem. Suspected arson fires are being analyzed by some FAIR Plans to try to determine why these fires occur so that corrective actions can be taken to prevent them. The Massachusetts and Rhode Island FAIR Plans appear to have done more than any of the other Plans we visited to try to control the arson problem. Most of the changes they are making or want to make do not require FIA's approval. They feel that underwriting prerogatives are available for FAIR Plans to use. Recent actions the Massachusetts and Rhode Island Plans have taken or have proposed include

- use of Plan-imposed deductibles;
- right to decline insurance on certain idle and/or unoccupied properties;
- right to decline insurance on buildings in which any combination of the following exists: (1) failure to pay real estate taxes for three or more years; (2) failure to furnish heat, water, or public lighting for 30 consecutive days or more; (3) failure to correct conditions dangerous to life, health or safety; or (4) failure to supervise building(s) in accordance with public law; and
- use of a 5-day cancellation notice instead of the FIA 30-day requirement.

Massachusetts and Rhode Island FAIR Plan officials told us that they had not operated under these new practices long enough to measure the impact they will have on arson. They believe that these practices will eliminate some of the arson-for-profit in FAIR Plans.

We discussed with an FIA official the FAIR Plans' concerns regarding the need for additional underwriting perogatives and flexibility to deny insurance under certain circumstances. The FIA official said that FAIR Plans were not required to insure everyone and, specifically mentioned that there was no FIA requirement that property owners under indictment for arson or those with a history of suspicious fires be insured. He also said that FIA had sent some arson-related information to FAIR Plans and/or State insurance departments although officials from the FAIR Plans we visited said that they had not received any guidance from FIA concerning the arson problem. Except for correspondence concerning four FAIR Plans' requests to use a 5-day cancellation notice instead of FIA's 30-day notice, FIA could not provide us with any arson-related information that had been sent to FAIR Plans. The FIA official said that FIA's role concerning FAIR Plans is not that of telling the Plans how to operate. FIA's concern is that insurance under FAIR Plans is not denied unfairly to those needing it, according to this official, and that the individual States must directly supervise the FAIR Plans.



CONCLUSIONS AND RECOMMENDATIONSCONCLUSIONS

FAIR Plan and insurance industry officials believe that arson-for-profit is a serious problem in the FAIR Plans as well as in the private insurance market. Due to the lack of specific data, the significance of the problem cannot be demonstrated.

Providing insurance in an amount exceeding property value is considered an important incentive for arson-for-profit. Of the nine FAIR Plans we contacted, three are providing insurance to property owners without attempting to determine the property values, thus providing owners the opportunity to overinsure. Officials from the three Plans believe it meaningless and costly to determine value at the time insurance is provided because claims are paid on the basis of property value at the time of loss. Other FAIR Plans, however, are now establishing property value when insurance is provided and attempting to limit coverage to that value. Using a number of values, such as purchase price, selling price of similar properties in the immediate area, and tax assessed values property value can be reasonably estimated. Guarding against overinsuring removes an important incentive for arson-for-profit.

In case of fire, claims are paid at actual cash value or replacement cost less depreciation. Insurance proceeds based on this value can provide property owners more than the market value of their properties. This is an incentive for arson-for-profit which does not exist in States that have adopted the "broad evidence rule," allowing consideration of other property values, such as market, rental, and economic values.

Many FAIR Plan officials believe Plans are encouraging arson-for-profit by providing insurance to almost everyone who requests it. Certain FAIR Plan officials believe there is little they can do until FAIR Plans receive additional underwriting authority from FIA to deny, limit or modify insurance coverage. Other FAIR Plans we visited are making or have recently made changes in their underwriting criteria. We believe that some of these changes would be useful to other FAIR Plans. Because there is little communication among the FAIR Plans, however, the Plans are not aware of all that others are doing to control arson. FAIR Plan officials agreed that more can and should be done to provide greater underwriting flexibility to FAIR Plans.

FAIR Plan officials believe that the character and attitude of the insured should be considered in the Plan's determination to grant coverage. Such information would include the owner's history of fires, his personal or business's financial condition, tax arrearages, and other moral hazard factors.

Seven of the FAIR Plans we visited disagreed with FIA's requirement that a 30-day notice must be given before a policy can be cancelled. FAIR Plan officials believe the requirement is unreasonable when the Plan knows an insured building is going to be burned. The 30-day requirement is generally longer than most States require for insurance companies. Some FAIR Plan officials have suggested a 5-day requirement which has been approved by FIA for the Rhode Island FAIR Plan, subject to case-by-case approval by the State insurance department.

#### RECOMMENDATIONS

We recommend that the Secretary of Housing and Urban Development direct the Administrator, Federal Insurance Administration to revise FIA regulations to:

- Require that all FAIR Plans establish property value at the time of underwriting and eliminate the practice of giving property owners any amount of insurance desired.
- Require all FAIR Plans to obtain and consider information concerning the character of the property owner in its determination of insurability, as the insurance industry does.
- Permit FAIR Plans to use a 5-day cancellation notice with State insurance department approval in each instance.

We also recommend that the Administrator discuss the desirability of adopting the broad evidence rule basis with State insurance authorities in those FAIR Plan-States that require insurance payments at actual cash value without consideration of market value.

LISTING OF ORGANIZATIONS  
GAO CONTACTED

Department of Housing and Urban Development:

Federal Insurance Administration  
Washington, D.C.

Department of Commerce:

National Fire Prevention and Control Administration  
Washington, D.C.

Fair Access to Insurance Requirements (FAIR) Plans:

District of Columbia Property Insurance Facility  
Washington, D.C.

Illinois FAIR Plan Association  
Chicago, Illinois

Joint Insurance Association  
Baltimore, Maryland

Massachusetts Property Insurance Underwriting  
Association 1/ and

Rhode Island Joint Reinsurance Association 1/  
Boston, Massachusetts

New York Property Insurance Underwriting  
Association  
New York, New York

Insurance Placement Facility of Pennsylvania 2/ and

Insurance Placement Facility of Delaware 2/  
Philadelphia, Pennsylvania

Washington FAIR Plan  
Seattle, Washington

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1/ These two FAIR Plans' operations are being managed by a joint management team in Boston, Massachusetts.

2/ These two FAIR Plans' operations are being managed by a joint management team in Philadelphia, Pennsylvania.

Property Insurance Plans Service Office  
Philadelphia, Pennsylvania

Insurance trade associations:

American Insurance Association  
New York, New York

Property Loss Research Bureau  
Chicago, Illinois

Insurance companies:

Unigard Insurance Company  
Seattle, Washington

SAFECO Insurance Group  
Seattle, Washington

Hartford Fire Insurance Company  
Chicago, Illinois

Underwriters Adjusting Company  
New York, New York

Pennsylvania National Mutual Casualty  
Insurance Company  
Harrisburg, Pennsylvania

State Farm Insurance Companies  
Austin, Texas

Other organizations:

The New York Board of Fire Underwriters  
New York, New York

Texas Insurance Advisory Association  
Austin, Texas

Insurance Crime Prevention Institute  
Evergreen Park, Illinois

Insurance Information Institute  
Seattle, Washington and  
Austin, Texas

Metropolitan Chicago Loss Bureau  
Chicago, Illinois

State Board of Insurance  
Austin, Texas

Arson Investigation Unit  
Seattle Fire Department  
Seattle, Washington

Fire Marshal  
Houston Fire Department  
Houston, Texas

FAIR PLANS

Number of Policies Issued and  
Underwriting Profit or Loss  
From Inception to September 30, 1977

	<u>Number of policies issued</u>	<u>Underwriting profit or loss (-) (note a)</u>
California FAIR Plan Association	655,117	\$ 652,000
Connecticut Insurance Placement Facility	87,323	-15,174,000
Insurance Placement Facility of Delaware	39,779	-911,000
District of Columbia Property Insurance Facility	136,932	-621,000
Georgia Underwriting Association	25,730	431,000
Illinois FAIR Plan Association	405,929	-41,638,000
Indiana Basic Property Insurance Underwriting Association	21,145	256,000
Iowa FAIR Plan	11,963	-586,000
Kansas All-Industry Placement Facility	36,282	-1,135,000
Kentucky Property Insurance Placement Facility	68,594	-4,229,000
Joint Insurance Association (Maryland)	349,803	-4,642,000

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a/ Profit or loss from writing insurance; excludes interest earned from investments.

## APPENDIX IV

## APPENDIX IV

	Number of policies issued	Underwriting profit or loss (-)
Massachusetts Property Insurance Underwriting Association	329,008	-\$52,419,000
Michigan Basic Property Insurance Association	820,269	-60,498,000
Minnesota Property Insurance Placement Facility	19,352	-2,479,000
Missouri Property Insurance Placement Facility	258,853	-12,315,000
New Jersey Insurance Underwriting Association	366,545	-34,684,000
New Mexico Property Insurance Program	2,282	236,000
New York Property Insurance Underwriting Association	1,187,962	-68,537,000
North Carolina Insurance Placement Facility	64,159	-4,425,000
Ohio FAIR Plan Underwriting Association	163,012	-12,615,000
Oregon FAIR Plan Association	3,990	-565,000
Insurance Placement Facility of Pennsylvania	448,926	-13,058,000
Puerto Rico Fire & Allied Lines Underwriting Association	1,316	298,000
Rhode Island Joint Reinsurance Association	57,927	-7,270,000
Virginia Property Insurance Association	121,607	-2,831,000

## APPENDIX IV

## APPENDIX IV

	<u>Number of policies issued</u>	<u>Underwriting profit or loss (-)</u>
Washington FAIR Plan	17,889	-\$ 446,000
Wisconsin Insurance Plan	71,467	-2,555,000

(06804)