CENTER for ECONOMIC JUSTICE | FAIR ACCESS FAIR TREATMENT

Comments of the Center for Economic Justice

to the NAIC Property Casualty (C) Committee

Draft "Principles for NFIP Reform"

August 17, 2016

The Center for Economic Justice offers the following comments on the draft "Principles for NFIP Reform."

The document lists some of the competing goals Congress has tasked the NFIP with:

- Encouraging flood insurance purchase, including affordable flood insurance premiums;
- Promoting national resiliency and flood loss mitigation, including flood mapping and mitigation assistance;
- Reducing taxpayer liability for the NFIP, including risk-based pricing;
- Protecting taxpayers by mandating flood insurance purchase for some, but not all borrowers with federally-backed mortgages.

The reason these are competing – and not complimentary – goals is because Congress has tasked FEMA to have the NFIP accomplish all these goals in ways that violate fundamental insurance principles. The result of tasking FEMA and the NFIP with these competing goals has been an extremely inefficient, high-cost flood insurance program with very low take-up rates and, consequently, lost incentives for flood loss mitigation, high uninsured flood losses and ongoing high federal disaster relief expenditures. The obvious path forward to achieving these goals is to:

1. Move the direct provision of flood insurance back to the states where all other property insurance is provided and regulated. Get the NFIP out of the direct provision of insurance and back to private insurers who can provide the coverage far more efficiently and at lower cost than the NFIP;

2. Mandate that flood insurance be part of all property insurance policies to promote risk diversification and to ensure widespread flood insurance coverage with the beneficial results of property owners facing and paying the fair amounts to protect properties from flood risk and, consequently, allowing fair assessments of loss mitigation investments. Such a mandate will result in much lower average prices for flood insurance because of reduced selling and claim settlement costs and because of risk diversification and will result in fairer treatment of all consumers on mandate to purchase.

3. Transform the NFIP from a direct provider of flood insurance to a mega-catastrophe reinsurer which will facilitate the private flood market by providing certainty of loss limits on catastrophic events while eliminating taxpayer liability for the NFIP direct flood program.

4. Provide federal funding for loss mitigation – including mapping, loss mitigation assistance and affordability assistance through loss mitigation investments – outside of the flood insurance pricing mechanism to allow risk-based pricing and focus FEMA and the NFIP on areas of their expertise. Recognize that funding for loss mitigation and mapping are investments in loss mitigation by all levels of government.

5. Address affordability outside of the insurance pricing system primarily through loss mitigation investments which lower the risk-based price of flood insurance. Eliminate subsidies for insurance premiums as a method to address affordability.

The draft "Principles for NFIP Reauthorization" ("document") fails spectacularly as a presentation of principles and as an approach to address the challenges facing taxpayers, property owners and the NFIP regarding flooding, flood insurance and NFIP losses. The document reads like a wish list from lobbyists for the insurers and agents making money off the NFIP at the expense of taxpayers. The document reveals none of the insurance and risk management expertise Congress and consumers would expect from state insurance regulators. As drafted, the document will marginalize state insurance regulators and the states from meaningful participation in the reform of the NFIP. The document is an appalling abdication of leadership by public officials on flood insurance issues.

The document presents a variety of actions as "principles" but which are, in fact, not principles.

"Reauthorize the NFIP for ten year." This is not a principle. Nor is "long-term reauthorization" a principle for NFIP reform. It is simply a recommendation to continue a failed program with ongoing taxpayer liability. Even worse, the other "principles" exacerbate taxpayer liability for the NFIP by encouraging non-rate regulated insurers to cherry pick the least risky NFIP policies while leaving taxpayers with a more financially vulnerable NFIP.

"Encourage greater growth in the private market as a complement to the NFIP." This is neither a principle nor a strategy for reform of the NFIP. The unstated, but obvious, intent is for the NFIP to become a residual market for the most risky flood insurance policies while allowing private insurers to write the most profitable flood insurance business. Given the current structure of the NFIP, the result will be greater taxpayer liability for a public insurance program charging premiums based on average risk (to achieve the Congressional mandate of affordability and greater participation) while insuring above-average risks. We are stunned that insurance regulators fail to acknowledge this fundamental reality of insurance markets and share this understanding with Congress. The document does not even mention, let alone discuss, the fundamental insurance concept and consequences of adverse selection.

"Support HR2901/S 1679." This is not a principle for NFIP reform, but a strategy for encouraging private insurers – non-rate regulated surplus lines insurers – to cherry pick less-risky NFIP policies while leaving the NFIP with above-average risk and average risk pricing.

We would also add that the NAIC has been quite vocal about how state regulators do oversee surplus lines insurance – despite no rate or policy form oversight – and are fully able to protect consumers of surplus lines flood insurance. If this is the case, then state regulators should be ready to answer this question. If states are able to protect consumers purchasing surplus lines flood insurance without rate or form regulation of these surplus lines flood insurance policies, why do states need rate or form regulation for any property insurance product?

"Require FEMA to allow NFIP policyholders to cancel NFIP policies mid-term for a pro-rata refund."

"Require FEMA to share claims data with insurers and modelers."

"Require FEMA to eliminate the non-compete clause for WYO insurers."

These three items – clearly not principles – are bald give-aways to private insurers at taxpayer expense. These items make it easier for private insurers to cherry pick the least risky NFIP policies with the result that the NFIP becomes a residual market. Yet, the document never explains this obvious consequence to Congress. Nor does the document explain how the NFIP will avoid the death cycle of losing below-average risk customers as NFIP claim costs per exposure soar and as policy fees to cover mapping and loss mitigation increase as these expenses are spread over a smaller and smaller number of policies. The proposals in the document are stunning in their one-sided benefits to private insurers and agents and costs to taxpayers and certain property owners in special flood hazard areas.

Requiring FEMA to share claims date with insurers and modelers would make sense if private insurers were responsible for the provision of flood insurance. But, such a requirement to share claims data within the existing NFIP structure will result in private insurers being better able to offer insurance to the below-average risks while leaving the NFIP with the above-average risks.

CEJ has explained to the NAIC on several occasions that, because of the Congressional mandate to the NFIP to promote take-up and charge "affordable" premiums, the NFIP charges premiums based on average claim costs – averaged over 30 risk categories. The NFIP's pricing approach – averaging claim costs over a broad spectrum of risk – cannot work if private insurers can cherry pick the least-risky policies. Any serious discussion of NFIP reform and private insurer involvement must recognize this basic market reality. The document's "principles" neither recognize this reality nor address it. Rather, the proposals encourage and exacerbate cherry picking at taxpayer expense.

We support requiring the NFIP to share its claims data – if private insurers are required to include flood peril coverage as part of property insurance policies. Then, and only then, is the public provision of data matched with private insurer responsibilities.

The proposal for FEMA to eliminate the non-compete clause is another shocking proposal by insurance regulators. This proposal would allow the WYO insurers – who sell NFIP policies on behalf of the NFIP to review and keep less-risky properties on their own book while placing more-risky properties in the NFIP – encouraging adverse selection for the NFIP.

We note that the document contains no discussion or rationale offered for the "principles" related to encouraging private market flood. If the document did include a discussion, it would be interesting to see how insurance regulators explain and reconcile their proposals to facilitate adverse selection against the NFIP with reducing taxpayer liability for the NFIP and promoting loss mitigation since the adverse selection will increase the financial vulnerability of the NFIP and reduce funding for mapping and loss mitigation. It would also be useful for the document to explain the concept of adverse selection and why prevention of adverse selectin is a foundation of insurance risk management.

The remaining "principles" seem like a potpourri of ideas without any organizing principle.

"Encouraging a coordinated effort to increase the take-up rate; encourage consumer flood insurance education; ensure better compliance with mandatory purchase requirements."

These generic statements are uninformed by any of the behavioral economic research about insurance purchases or the actual experience of the NFIP. These statements suggest that state insurance regulators know nothing about the cause of low-take up or poor consumer understanding of flood insurance. Yet, the facts are well-known.

The low flood insurance take-up rate is caused by the fact that it is a separate purchase from other insurance and is only required in special flood hazard areas. It is well-known that most consumers do not understand that their property insurance policies do not cover flood, that a significant portion of flood events and flood losses occur outside of special flood hazard areas and that consumers are generally not able to assess the flood risk they face. It is also well-know that "education" has a very limited effect on actually increasing consumer understanding about flood insurance.

The obvious way to address these failures is to require private insurers to include flood in property insurance policies. This action would cause universal flood coverage, would provide consumers with the coverage they actually expect and would tie flood insurance pricing to flood modeling instead of FEMA maps. While the FEMA flood mapping activities are critical inputs into flood modeling, the process of creating and implementing FEMA flood maps for NFIP purchase is very long. Separating pricing from FEMA mapping activities would enable private insurers to rely upon timely flood modeling for pricing and eliminate arbitrary differences in purchase mandates due to special flood hazard areas boundary issues.

"Encourage careful consideration of affordability issues."

The non-substantive statement is an abdication by state insurance regulators on flood insurance affordability and the best methods to address such affordability concerns. The document does not even reference the common proposal to address affordability through loss mitigation investments instead of subsidies to premium. We are truly baffled by the NAIC's refusal to engage in affordability issues – on flood and auto insurance.

"Consider requiring a study on alternative approaches to the flood insurance program structure."

After years of work examining NFIP reform issues, the document proposes a study on NFIP reform. Is this truly the best that state insurance regulators can come up with? What makes this last paragraph even worse than state regulators simply having no ideas about how to structure a flood insurance program to actually achieve the broader goals of increased resilience, loss mitigation, broad flood insurance purchase and affordability mechanism is the idea that one idea might be turning the NFIP into a residual market when all the "principles" in the document are intended to turn the NFIP into such a residual market at taxpayer expense.

As supporters of state-based insurance regulation, we urge the NAIC not to further embarrass the states by adopting this document. Attached please find true principles for NFIP reform developed by CEJ which could form the basis for a true NAIC contribution to the NFIP reform debate.

Center for Economic Justice Summary Proposal for NFIP Reform

1. **Flood Coverage Included In Residential And Property Insurance Policies – Phase Out NFIP As Direct Provider Of Flood Insurance**

Benefits:

- More resilient and sustainable buildings and infrastructure because of broader -- near universal – flood insurance coverage
- Reduce cost of providing flood insurance coverage by eliminating administrative costs of second policy, eliminating claim costs of adjusting wind versus flood claims; reducing average claim costs by dramatically increasing the diversification of risk.
- Provide same state-based consumer protections for flood as exist for all other property insurance, including oversight of sales, policies and claims settlement.
- Raise risk awareness of consumers and meet consumers' expectations of coverage by proving flood coverage that matches coverage provided for other catastrophic perils.
- Eliminate future federal taxpayer liability for flood insurance
- Re-orient federal expenditures from subsidies for non-resilient, unsustainable structures to investments in loss mitigation for those needing financial assistance.
- Greater reliance on and use of private capital and market forces for financing disaster relief and promoting loss mitigation partnerships.
- Risk-based pricing to better enable consumers and businesses to make rational investments in properties and to fairly present the costs and benefits of loss mitigation investments.

How to Accomplish:

Option: Establish Phase-Out Date for NFIP as Direct Provider of Insurance, Requiring States to Take Action

Option: Establish Congressional Mandate for All Perils Policy by Date Certain or Trigger Undesirable Consequence for the States, e.g. All Property Insurance Regulation Reverts to the Federal Insurance Office.

2. **Reauthorize NFIP for Three (to Five) Years to Transform NFIP from Direct Provider of Insurance to Mega-Catastrophe Reinsurer modeled after the TRIA.**

Benefits

- Assist states in ensuring private insurer coverage of the all-perils property insurance policy by providing certainty on private insurer exposure to flood.
- Facilitate private reinsurer participation in flood insurance by phasing in a larger threshold for federal flood reinsurance

3. **Provide Seed Funding for States Wishing to Create Tax-Exempt State or Multi-State Insurance, Catastrophe or Catastrophe Reinsurance Funds**

Benefits

- Assist states in addressing market failures or reluctance of insurers to offer all-perils policies.

4. **Federal Funding for Flood Loss Mitigation and Other Necessary Financial Assistance for Consumers and Businesses Facing Affordability Problems. Task HUD and FEMA Jointly with Evaluating Financial Need and Delivering Financial Assistance. Provide Cash Assistance for Premium Payment Only if Loss Mitigation Investments are Not Cost-Effective and for No More Than Ten Years.**

Benefits

- Transition federal expenditures from subsidies that undermine sustainability and resilience goals for those not in need of financial assistance to targeted financial assistance to only those in need.
- Re-orient federal expenditures towards investments in resilience and stability, reduce taxpayer liability and burden, reduce disaster relief expenditures in the future.

5. **Federal Funding for Flood Mapping Outside of Flood Insurance Premiums**

Benefits

- Provide reliable funding stream for risk management data essential for assisting private market provision of flood insurance and for federal and state loss mitigation, disaster recovery and national security needs.
- Dedicated funding outside of flood insurance premiums needed and desirable after transition of provision of flood insurance from NFIP to States.

6. **Forgive NFIP Debt Upon – and Only Upon – Transition of Provision of Flood Insurance from the NFIP to States**

Benefits

- Recognition that NFIP cannot raise premiums sufficiently to retire debt without entering a death spiral of premium increases that reduce NFIP revenues and ability to repay debt.
- Recognize that NFIP-incurred debt represents disaster relief and Congressional mandates for subsidies.