CENTER for ECONOMIC JUSTICE | FAIR ACCESS FAIR TREATMENT

Comments of the Center for Economic Justice to the

NAIC Property Casualty (C) Committee

Regarding Reform of the National Flood Insurance Program and Reporting of Private Flood Insurance Experience in the Statutory Annual Statement

February 25, 2016

The Center for Economic Justice (CEJ) submits the following comments on the exposed proposal for capturing private flood insurance experience in the statutory annual statement. CEJ also submits a proposal for reform of the NFIP for discussion during the March 9, 2016 call of the Committee.

Proposal for Reforming the National Flood Insurance Program

Attached please find CEJ's testimony before Congress earlier this year which includes a proposal to transition the direct provision of flood insurance coverage out of the NFIP and into the state-based, private market system that exists for other residential and commercial property insurance.

Relying on the state-based insurance regulatory system to oversee the delivery of property insurance coverage for flood insurance by private insurers is the best way for Congress to move federal government expenditures and activities towards investments in resiliency and sustainability related to flood risk. There are four key actions needed by 2017 to get private insurers in the business of providing flood insurance and to get the federal government out of that business and, instead, focused on flood risk mitigation.

1. Get the NFIP out of the business of being a flood insurance company by requiring that residential and commercial property insurance policies sold by private insurers (and some state residual market insurers) cover the peril of flood. This requirement turns flood insurance back to the states – where all other property insurance products and markets are regulated – and back to private insurers, reinsurers and catastrophe modelers, who have the capability and capital to provide flood coverage more comprehensively and efficiently than the Federal government.

2. Transition the NFIP from a direct provider of insurance to a mega-catastrophe reinsurer, utilizing the successful model of Terrorism Risk Insurance Program

3. Address the affordability problem of flood insurance with federal, state and local assistance outside of the insurance system – no subsidies in insurance pricing – with an overwhelming emphasis on assistance for loss mitigation as the tool to create more affordable premiums.

4. Reauthorize the NFIP to continue sale of flood insurance during a finite transition period to coverage of flood risk in residential and commercial property insurance policies sold by private insurers and state residual markets, overseen by state insurance regulators.

CEJ's written and supplemental testimony, attached, explain the proposal and its benefits in more detail

Comments on Blanks Proposal

CEJ supports the addition of additional categories in the annual statement to capture private flood experience. We suggest the following changes to the proposal.

2.5 ~~Private~~ Flood Insurance Other Than NFIP or Creditor-Placed Flood: Primary or excess ~~Private market coverage (e.g., excess flood) for~~ flood insurance other than flood insurance provided ~~that is not offered~~ through the National Flood Insurance Program or through creditor-placed insurance.

.2.6 Creditor-Placed Flood Insurance: Primary or excess flood insurance provided through creditor-placed insurance policies

CEJ also recommends an addition to the Credit Insurance Experience Exhibit (CIEE). The CIEE currently provides for reporting of creditor-placed auto and creditor-placed home coverages. Creditor-placed home includes real property coverage for hazard, wind-only and flood perils. We recommend changing creditor-placed home to "creditor-placed for real property other than flood" and the addition of columns (single and dual interest) for creditor-placed flood for real property."

Discussion

It is likely that the majority of private flood insurance for real property was creditor-placed flood during the period 2008 to 2012 and remains a significant, if not majority, portion of private flood since. Data collection for creditor-placed flood is necessary for a complete picture of private flood insurance for real property. Absent data collection for creditor-placed flood, regulators, policymakers and the public will have a significantly incomplete assessment of the provision of private flood. Without separating out creditor-placed flood on the state pages, this form of private flood will be included in other lines of business, such as fire or allied lines, and remain unidentifiable for regulators.

Testimony of Birny Birnbaum
Executive Director
Center for Economic Justice

Before the

Subcommittee on Housing and Insurance
Committee on Financial Services
United States House of Representatives

"How to Create a More Robust and Private Flood Insurance Market Place"

January 13, 2016

Chairman Leutkemeyer, Ranking Member Cleaver and Members of the Subcommittee, my name is Birny Birnbaum. I am the Executive Director of the Center for Economic Justice, a non-profit consumer organization that advocates on behalf of consumers on financial service issues, with particular emphasis on the availability and affordability of essential insurance products. Thank you for the invitation to speak before the Subcommittee in today's hearing. The availability and affordability of flood insurance is a critical issue for individual and community well-being, economic development and a resilient and sustainable future. I have worked on these issues for over 20 years as an insurance regulator, consulting economist and consumer advocate.

Your invitation to testify asks whether the National Flood Insurance Program (NFIP), as it is presently constituted, represents an ideal model for the effective protection of residential and commercial property owners from damages related to flooding.

The answer to that question is a resounding no for a number of reasons. The primary problem of the NFIP is the multiple and conflicting goals that Congress has tasked the program with and the constraints and requirements Congress has placed on the program. The NFIP has been tasked, in whole or in part, with:

- Providing insurance coverage to individual homeowners and business for the peril of flood as an alternative to disaster relief;
- Promoting the sale of flood insurance with broadly-subsidized rates;
- Removing subsidies and moving to risk-based or "actuarial" pricing;
- Addressing repetitive claims for properties in high-risk areas;
- Addressing problems of affordability of flood insurance
- Identifying and mapping flood risk through an interactive process with local governments;
- Paying back past flood insurance losses that greatly exceeded revenues collected; and
- Promoting flood loss mitigation and prevention

With such varied and conflicting responsibilities and limitations, it is not surprising that the NFIP has been a poor flood insurance program.

The very first step for Congress to address problems with the NFIP is to clarify not only the role of the NFIP, but the goals for federal expenditures in the area of flood loss mitigation and disaster relief. The starting point for Congress and the federal government should be that the goal of federal expenditures for disaster relief and loss mitigation related to flood is to promote more resilient and sustainable homes, businesses, communities and infrastructure against the peril of flood. With this as the clear goal, then any proposals regarding the NFIP can be evaluated by asking – does this change promote resiliency and sustainability or not?

The reason why resiliency and sustainability must be the overarching goal and guiding principle for restructuring the NFIP is that there is no insurance mechanism – public, private or public-private – that will be able to finance increasingly frequent and severe flooding. Stated differently, the only long-term solution to flooding is massive investment in flood loss mitigation. Such loss mitigation accomplishes three critical things –

1. Reduces the loss of life and property from flooding events;
2. Creates greater potential for insurance to cover the more manageable remaining flood risks; and
3. Reduces government expenditures on disaster relief in the future.

Loss mitigation and flood insurance are the essential foundation for individual, business, community and national economic security, economic development and national security. Investments in loss mitigation coupled with flood insurance mean that flood events cause less damage than in the absence of the mitigation and, when flooding does occur, more of the damage is insured. Lesser damage with flood insurance coverage means much quicker recovery by individual and businesses from the catastrophic event. From the perspective of a taxpayer looking at federal expenditures, those expenditures become far more than disaster relief, but are investments in resiliency and sustainability which mean fewer federal expenditures in the future for disaster relief that would otherwise be required.

Step 1 is Congressional clarity on the role of the NFIP and the Federal Government in flood prevention and flood disaster relief – and that role is to view federal expenditures as investments in resiliency and sustainability. Matched against this goal and operating principle, the current structure of the NFIP fails. The problems include

Relatively few homeowners and businesses purchasing flood insurance and consequently relying on disaster relief or savings to recover from flooding events.

The NFIP currently over 5.2 million policies in force[1] but many consumers in Special Flood Hazard Areas (SFHA – areas designated by FEMA as at higher risk of flooding) don't purchase flood insurance. The NFIP states that only 23.3% of homes in SFHAs have flood insurance. And even though many flood events occur outside of SFHAs, an even smaller percentage of consumers outside of SFHAs purchase flood insurance.

The absence of insurance for flood damage reduces the resiliency of homeowners and businesses. In its second report on flood insurance affordability, the National Academy of Sciences Committee on the Affordability of National Flood Insurance Program Premiums wrote:[2]

> A resilient community is one which has the capacity to "absorb change and disturbances," returning quickly to full function. One test of community resiliency is its ability to recover from a major flood.
>
> The disruptions most relevant to NFIP flood insurance are direct damages to property and its contents. Following a flood, property owners bear the responsibility for repair or replacement of damaged buildings. Residential structures may be damaged or destroyed, relocating population and disrupting community cohesion. In some cases, property owners may have the financial resources—either available funds or borrowing capacity—to move quickly to restore properties to pre-flood conditions. However, many if not most property owners are not in a position to finance major, unanticipated repairs, let alone complete reconstruction. The other means of dealing with flood damage are:
>
> - Abandon the property, either in full or in part;
> - Use post-flood disaster assistance (in the form of grants or low-interest loans) and other funds as needed to make needed repairs or replacements; or
> - In the case of properties covered by flood insurance, use insurance proceeds and other funds as needed to make needed repairs or replacements.
>
> The first option is, of course, the antithesis of resiliency. If this is the result for some number of properties throughout a community, then the structure and the function of the community are lost or, at best, seriously damaged.

[1] NFIP Presentation at PCI Flood Conference, 2015. http://www.pciaa.net/docs/default-source/default-document-library/tom-and-andy-show-wednesday-9-30am-salons-5-6.pdf?sfvrsn=2

[2] Affordability of National Flood Insurance Program Premiums -- Report 2 (hereafter "NAS Affordability Report 2") at page 31

> For any significant damage, it would appear that the property owner must bear the bulk of the financial responsibility. Clearly some may be unable to do so. Insurance can thus be resiliency enhancing in that it can make the funds needed for rebuilding available to disaster victims. In summary, reliance on disaster aid seems likely to produce only partial recovery and that only after some delay. For both reasons, some community resiliency is lost.
>
> Communities with high takeup rates can be expected to be more resilient than those, which rely on self-funding and government assistance. High takeup rates will be associated with not only more complete recovery of community structure and function, but also more timely recovery.

<u>Improper price signals to individuals and businesses making investment decisions about property purchases.</u>

Many NFIP policyholders – over a million, but the exact number is unknown – are presented a flood insurance premium that is less than cost of insuring the property – subsidized rates. The subsidized rates arise from several rating practices of the NFIP, some of which are required by Congress and some of which are not. Congress has mandated that some pre-Flood Insurance Rate Map (pre-FIRM) pay less than the risk-based premium. Congress has also mandated that certain properties are “grandfathered” at certain rates even if the information or environment has changed such that the risk-based rate would be higher for these properties. The NFIP calculates the aggregate amount of the subsidy for grandfathering, divides this amount by the number of non-Grandfathered policies and adds that amount to the non-grandfathered policies. Finally, the NFIP evaluates flood risk in SFHAs by dividing the properties into 30 groups ranging from lowest to highest risk. The NFIP then uses the average expected claim costs for all 30 zones for the claim cost, and subsequent premium, for properties in any of the 30 zones.

The NFIP rates would not meet state insurance regulation requirements that rates be not excessive, not inadequate and not unfairly discriminatory. Commissioner Kevin McCarty of the Florida Office of Insurance Regulation, in a letter to Florida State Senator Jeff Brandes wrote:

> Without data and further analysis though, we can say that the rates are unfairly discriminatory. NFIP has developed its rating based on multiple zones that are combined to determine rates, with 30 different A zones and separately 30 different V zones. Those zones are defined based on a theoretical determination of the probability of flooding (the V zones are more coastal). These are averaged together to charge one rate across the country. The averaging together of zones with different costs and charging one rate would be considered unfairly discriminatory from an actuarial perspective which would not pass scrutiny under Florida law.

Substantial subsidies within insurance rates – meaning substantial deviation from cost – based or risk-based pricing – means that consumers and businesses considering an investment in real property are not facing the proper price signals regarding the cost of maintaining and protecting that property. The result is that properties are built (and purchased) in areas of significant flood risk, but that risk is hidden by inadequate flood insurance prices. And when Congress tries to move away from those subsidies, many homeowners face the untenable situation of not being able to afford the risk-priced flood insurance or sell their now-devalued home.

<u>Inadequate incentives for loss mitigation due to subsidized rates;</u>

Subsidized rates not only encourage real property investments in areas of great flood risk, but also reduce the incentives for loss mitigation investments. If the cost of effective loss mitigation is, say $10,000, a consumer facing a subsidized $500 flood insurance premium faces a different cost –benefit analysis than a consumer facing a risk-based $2,500 premium.

In this example, the first consumer will very likely not make the mitigation investment, meaning that the property is less resilient than it could be and the NFIP is more likely to pay claims or government is more likely to pay some form of disaster relief. With the second consumer, the $10,000 investment reduces the NFIP premium to $500, but the more resilient home now poses less risk for the NFIP and government and, most important, is far less susceptible to damage from a flood event.

<u>Federal expenditures for disaster relief that leave individuals and communities more susceptible to future loss instead of more resilient and sustainable.</u>

FEMA has worked hard to promote loss mitigation to prevent damage from flood events, recognizing that federal dollars spent on disaster relief which do not strengthen and fortify structures and infrastructure will not reduce federal expenditures on disaster relief for future events. But the pricing practices of the NFIP undermine FEMA's and our nation's efforts at building a more resilient and sustainable building stock and economy. Federal dollars spent on flood insurance subsidies encourage the kind of development that is more susceptible to damage from flood events. Instead of federal expenditures as investments in resiliency and sustainability, the federal expenditures on NFIP flood premium subsidies make increased future federal expenditures for disaster relief more likely.

<u>Subsidies for consumers who do not need financial assistance and lack of or inadequate government assistance for those who do need financial assistance to purchase flood insurance or invest in flood mitigation.</u>

The current system of subsidies within the NFIP flood insurance rates is the worst possible way to provide financial assistance to those consumers who cannot afford flood insurance because the broad-based subsidies go to policyholders regardless of their ability to afford the flood insurance premium. From an economic perspective, it is highly inefficient and, from an equity perspective, it is hugely unfair to provide subsidies to consumers who could and would pay their fair share.

In addition, the subsidies are so broad that there is no guaranty that even the subsidized price is affordable for many consumers. Stated differently, the NFIP subsidies don't take into account individual policyholder ability to pay, so there is no clear link between the subsidized flood premium and more consumers purchasing flood insurance. Subsidies are likely going to many who don't need the subsidy, while the subsidies are likely insufficient for others.

Subsidies by some taxpayers of other taxpayers in the offer of and cost to deliver flood protection.

The NFIP has argued in public forums that taxpayers are not subsidizing the NFIP and will not do so unless and until Congress forgives the $24 billion NFIP debt to the Treasury Department. Putting aside the fact that the NFIP has repaid little of the debt incurred for Katrina and later flood events, the fact is that the NFIP is also not establishing reserves as required by Congress. The current NFIP structure not only causes some NFIP policyholders to subsidize other NFIP policyholders, but causes taxpayers in some states to subsidize flood insurance purchased by taxpayers in other states.

Inefficient delivery of coverage for flood with additional administrative costs for private insurers to sell the NFIP policy separate from the standard residential or commercial property insurance policy.

The NFIP policy is a standalone flood insurance policy which a homeowner or business must purchase in addition to the residential or commercial property insurance covering fire and perils. This is a very inefficient approach to delivering flood insurance protection for several reasons. First, the requirement of a consumer to purchase a separate policy in addition to the homeowners policy is an impediment to the purchase of flood insurance. Second, the NFIP policy includes its own administrative, sales and claim settlement costs. The NFIP utilizes private insurers to sell and administer the NFIP policies and pays them a significant portion of the premium to do so – 15% of premium for agent commission for sales and 12% of premium for WYO operating expenses. The GAO, in one of its many reports on the NFIP, questioned whether the payments to WYO insurers are reasonable in comparison to services provided.[3]

> However, the reasonableness of FEMA's compensation to WYOs is unclear. As we found in 2009, FEMA does not systematically consider actual flood insurance expense information when it determines the amount it pays WYOs for selling and servicing flood insurance policies and adjusting claims. Rather, since the inception of the WYO program, FEMA has used various proxies for determining the rates at which it pays the WYOs. Consequently, FEMA does not have the information it needs to determine (1) whether its payments are reasonable and (2) the amount of profit to the WYOs that is included in its

[3] April 9, 2014 Letter from GAO to Representative Neugebauer, "Overview of GAO's Past Work on the National Flood Insurance Program," at page 14.

> payments. As part of our 2009 report, we compared expense payments FEMA made to six WYOs to the WYOs' actual expenses for calendar years 2005 through 2007. We found that the payments exceeded actual expenses by $327.1 million, or 16.5 percent of total payments made. We concluded that opportunities existed for FEMA to improve its oversight of the WYO program and ensure that payments to the participating insurance companies were based on actual company expenses, thereby improving the program's cost-effectiveness.

Third, the use of the NFIP of WYO insurers to settle NFIP claims creates a conflict of interest for the WYO insurer because the insurer is tasked with determining whether the claim is covered under the homeowners policy (which the WYO insurer would pay) or a flood claim excluded from the homeowners policy and covered by the NFIP (which the WYO insurer would not pay.) This arrangement led to major claim settlement disputes between consumers and private insurers following Hurricane Katrina. At best, the arrangement is inefficient because in many cases the cause of damage is unclear between wind and water.

<u>Lack of standard insurance consumer protections found in state regulation of residential and commercial property insurance.</u>

The state-based insurance regulatory system is over 150 years old and has a long record of overseeing insurance companies that sell property insurance, the policy forms and rates these companies use, the advertising and disclosures and sales practices of the insurers and their agents and the claims settlement practices of the insurers. A great body of insurance law, regulation and market regulation practice has developed for these property insurance products. While consumer advocates like my organization believe the state-based system can be significantly improved, the consumer protections provided the states are far greater than those that exist for NFIP insurance. The NFIP is outside of state insurance oversight with the result that activities like NFIP claim settlement do not have the same consumer protections as homeowners insurance claims.

Lack of a residual market for flood insurance, leaving force-placed flood insurance as the de facto residual market.

The vast majority of states have what is known as a "residual market insurer" for those consumers unable to find insurers willing to sell property insurance to the consumer. These residual markets, often called FAIR plans, are state-based insurers or insurance mechanisms that serve as insurers of last resort for consumers unable to find insurance is the "voluntary" market. In some states and during some periods, the residual market has grown very large as private insurers have retreated – as was the case in Florida where the insurer of last resort, the state-run Florida Citizens, grew to become the largest insurer in the state. Residual markets are an important consumer protection because they provide insurance when the voluntary market is unwilling to do so.

There is no residual market for flood insurance – the NFIP is both the primary insurer and market of last resort. While the NFIP will rarely refuse to issue an insurance policy, many consumers who are required to have flood insurance fail to purchase the NFIP policy or other voluntary flood policy. The result is that, if these consumers have a mortgage, the mortgage lender/servicer will force-place flood insurance and charge the homeowner for the force-placed coverage. Force-placed flood is effectively the residual market for flood insurance, but the coverage is not comprehensive (no coverage for personal property/contents or additional living expense) and is very expensive due to the reverse competitive nature of force-placed insurance markets.

Private property insurer and state residual market coverage of flood is not a panacea for force-placed flood insurance, since the lenders/servicers often have a financial interest in force-placing insurance. But, a residual market alternative could help.

Why Don't Private Insurers Write Flood Insurance?

Some private insurers do write flood insurance. Insurers selling force-placed insurance offer force-placed flood coverage as well as force-placed hazard for residential and commercial properties. Much of the force –placed flood is written through admitted insurance companies while some is written by surplus lines insurers. Auto insurers also cover damage to vehicles from flood.

Notwithstanding these examples of private insurers offering flood coverage, insurers who sell residential and commercial property insurance typically exclude flood as a covered peril. Why don't these insurers provide flood coverage? The short answer is they don't have to. The substantive reasons insurers offered over 40 years ago are no longer compelling – lack of information to evaluate flood risk and inability to spread risk concentrated in flood zones. Today, insurers have or could obtain information to evaluate flood risk and have the ability to spread risk by including flood coverage in all policies. However, excluding a low-frequency, high-severity peril – that means that flooding doesn't happen often, but can cause massive damage when it does – is a long-standing practice of insurers to manage risk and, particularly important for publicly-held insurers, a way to ensure smooth earnings for investors.

Other impediments to private insurers offering flood coverage have been competing with subsidized rates of the NFIP, lack of reliable data on flood risk and lack of reinsurance. The situation, however, has changed. Most importantly, there are now much greater and better data on flood risk. Catastrophe modelers produce flood models, just as they produce the hurricane and wildfire catastrophe models used by insurers. There is also much more information available about building structure and elevation to go along with enhanced data on flood risk. And, although over a million NFIP policyholders received subsidized rates, there are millions of NFIP policyholders who now pay more than risk-based rates a private insurer would charge.

There has been more interest recently by surplus lines insurers to sell flood insurance policies in competition with the NFIP. Surplus lines or nonadmitted insurers can be distinguished from admitted insurers in the following ways.

Admitted insurers are licensed by a state insurance department to sell certain types of insurance in the state. These insurers are subject to regulatory requirements for filing and approval of policy forms (the insurance contract) and rates, are subject to the state's consumer protection laws regarding unfair trade practices and unfair competition and participate in the state guaranty fund system (which pays claims in the event the admitted insurer becomes insolvent). The state guaranty fund system is a critical part of the state policyholder protection framework.

In contrast, surplus lines insurers are not licensed by state insurance departments. Rather, the state insurance departments regulate surplus line agents who are authorized to place coverage with a surplus lines insurer on a list of acceptable insurers. Surplus lines policy forms and rates are not subject to regulatory oversight and surplus lines insurers do not participate in state guaranty funds.

Most states have a requirement that a surplus lines agent cannot place coverage with a surplus line insurer if that coverage is available in the admitted market. One common requirement is for a surplus lines agent to seek coverage from two or three admitted carriers and document the declinations before placing the coverage with a surplus lines insurer.

The Way Forward

As an economist who has studied insurance markets for over 20 years, I understand the power of market forces to promote efficient delivery of essential financial products to consumers. I also understand and have seen how government can effectively intervene in insurance markets when those markets are not competitive. In many instances, regulatory intervention in insurance markets promotes more competitive markets by empowering consumers and setting a level playing field among insurers. And in some instances, private markets are unwilling or unable to provide necessary insurance products. However, flood insurance is not one of those products – private insurers can offer flood insurance and can do so more efficiently and effectively than the NFIP. Stated differently, there is a long-established state-based insurance regulatory system that has overseen property insurance for 150 years and this state-based system of largely private insurers can and should offer property insurance covering the peril of flood.

Relying on the state-based insurance regulatory system to oversee the delivery of property insurance coverage for flood insurance by private insurers is the best way for Congress to move federal government expenditures and activities towards investments in resiliency and sustainability related to flood risk. There are four key actions needed by 2017 to get private insurers in the business of providing flood insurance and to get the federal government out of that business and, instead, focused on flood risk mitigation.

1. Get the NFIP out of the business of being a flood insurance company by requiring that residential and commercial property insurance policies sold by private insurers (and some state residual market insurers) cover the peril of flood. This requirement turns flood insurance back to the states – where all other property insurance products and markets are regulated – and back to private insurers, reinsurers and catastrophe modelers, who have the capability and capital to provide flood coverage more comprehensively and efficiently than the Federal government.

2. Transition the NFIP from a direct provider of insurance to a mega-catastrophe reinsurer, utilizing the successful model of Terrorism Risk Insurance Program

3. Address the affordability problem of flood insurance with federal, state and local assistance outside of the insurance system – no subsidies in insurance pricing – with an <u>overwhelming</u> emphasis on assistance for loss mitigation as the tool to create more affordable premiums.

4. Reauthorize the NFIP to continue sale of flood insurance during a finite transition period to coverage of flood risk in residential and commercial property insurance policies sold by private insurers and state residual markets, overseen by state insurance regulators.

<u>Benefits of Requiring Coverage for Flood as Part of Residential and Commercial Property Insurance Policies</u>

There are a number of benefits to requiring the peril of flood be included in residential and commercial property insurance policies currently sold by private insurers (and some state residual market insurers). These benefits include:

1. ***More efficient and lower-cost delivery of flood coverage than through a separate NFIP policy.*** By adding flood to the other covered perils in existing property insurance policies, private insurers can deliver that coverage with less administrative and claim settlement cost than the NFIP. As discussed above, the NFIP pays a significant portion of NFIP policy premium to WYO insurers as commission and operating expense and the NFIP incurs its own expenses for

issuing and administering policies. Including flood in existing property insurance policies will eliminate a significant portion of the administrative expense not only because the costs of a second policy are eliminated, but because the remaining administrative costs will be subject to competitive market forces instead of WYO insurers simply taking close to 30% of the NFIP premium with no relation to costs incurred by these insurers.

A second and equally important efficiency would be in claims settlement. Instead of the NFIP paying a WYO insurer to determine whether a loss was the result of wind covered by the WYO's policy or flood covered by the NFIP policy, an insurer settling a claim for a property insurance policy which covers flood will simply settle the claim. Instead of multiple parties involved in the claim settlement process, it will be the private insurer who sold the policy subject to a long-established state-based regulatory system of consumer protections for insurance claims settlement practices.

2. ***Accurate prices to consumers and businesses making investment decisions on the purchase of real property.*** By including flood in property insurance policies overseen by state insurance regulators, the prices for insurance will be subject to cost-based pricing requirements – rates must not be excessive, inadequate or unfairly discriminatory. Accurate risk-based pricing is essential to enable consumers and businesses to make informed decisions about the true cost of purchasing and maintaining the property purchased. In addition to other problems, subsidized rates don't do consumers or businesses a favor because they mask the true cost of the property and leave the consumer or business in an untenable position when the subsidy is removed.

3. ***Cost- or Risk-Based Prices provide the proper economic signals for investments in loss mitigation.*** With subsidized rates, cost-effective investments in loss mitigation do not appear cost-effective. Cost-based prices are essential for greater investments in flood risk mitigation.

4. ***Unleash the expertise of private insurers, reinsurers and catastrophe modelers on flood risk identification and mitigation.*** United States' property insurers have had little involvement in flood risk mitigation efforts because they have little or no "skin in the game." This is in sharp contrast to property insurers in other developed countries who actively and aggressively partner

with government to promote and implement flood risk mitigation strategies. In 1968, when Congress passed the National Flood Insurance Act, it may have been the case that private insurers did not have the capability to insure flood risk. That is not the case today. The property casualty industry is very well capitalized, reinsurers are eager to cover flood risk, alternative capital (catastrophe bonds and insurance-linked securities) now exists and catastrophe modelers are fully capable of modeling flood risk as they do for hurricane, wildfire and other perils. Moreover, these private market participants are better capable of keeping flood maps current to changing flood risk – information essential for proper insurance pricing and for maximizing loss mitigation investments.

5. ***Private sector incentives for flood risk mitigation.*** For decades, a private insurance advisory organization has performed fire safety ratings for communities around the country, ranking the capabilities of communities and their fire departments on fire safety and fire response. These fire safety ratings are a factor in property insurance rates and provide incentives for communities to invest in fire protection since these investments result in lower property insurance rates for community members. By moving flood insurance out of the NFIP to private insurers, this same type of private sector community flood risk rating could provide the same beneficial results as fire safety rating.

6. ***All consumers and businesses will have coverage they expect and pay their fair share for that coverage.*** Under the current law, only certain properties in certain areas are required to have flood insurance with the result that far too many consumers and businesses are uninsured for flood risk. Flooding events over the past ten years, in particular, show that flood occurs in areas other than those designated as Special Flood Hazard Areas. By requiring flood be part of property insurance coverage, flood risk will be provided to all with the result that consumers and businesses will not be surprised to discover their property insurance policies exclude the coverage they expected.

In addition, the pricing of flood insurance protection can be more equitable and transparent. It would be more equitable because consumers and businesses in very low risk areas will pay very little – but they will pay something to reflect the small risk. Consumers and businesses in high-risk areas would be charged more for flood insurance coverage – providing better price signals on the cost of maintaining the real property and the cost-effectiveness of mitigation investments. Affordability issues will remain, but those issues will be addressed not by skewed pricing in the insurance system, but by means-tested assistance, discussed below. Cost-based pricing by private insurers – with required disclosure to policyholders – is more transparent and fair than the current system of hidden subsidies by some NFIP policyholders of other NFIP policyholders and by some taxpayers of others.

7. ***Promote more resilient consumers, businesses and communities.*** By having far more flood insurance in place, consumers, businesses and communities will be better able to quickly recover from damage caused by flooding events.

8. ***Promote a larger, more diversified risk pool.*** With flood as part of property insurance policies, private insurers can diversify flood risk across multiple perils and across the entire country. This greater risk diversification means greater ability and willingness of reinsurers and alternative capital to support primary insurers.

Transition the NFIP from Direct Insurer to Mega-Catastrophe Reinsurer

One aspect of flood risk that holds back private insurers is the low-frequency, very high severity of flood events. This means that flooding events don't happen very often – compared with auto collisions or house fires, for example – but when floods do occur, the damage (and insured loss if flood is a covered peril) can be huge. While insurers can and do handle catastrophe risk by diversifying across multiple perils and broad geographic distribution of policies and by purchasing reinsurance and other forms of catastrophe protection like catastrophe bonds, the potential for a flood event causing massive damage does deter private insurers from insuring flood risk. To address this concern and to promote private market sale of flood insurance, Congress should transform the NFIP from a direct provider of insurance to a reinsurer for mega-catastrophic flood events – the same model as the successful Terrorism Risk Insurance Program (TRIP). TRIP is a federal program that provides reinsurance for mega terrorist events with the federal government's responsibility beginning only after private insurers have incurred a certain level of claims/losses from a terrorist event.

A federal flood reinsurance program should have even higher trigger points – the level of losses at which the federal reinsurance steps in – than TRIP because reinsurers and alternative capital seem far more interested and willing to provide coverage for flood than for terrorism. It is essential that the trigger for federal reinsurance payments not be too low and crowd out willing reinsurers and alternative capital. In addition and unlike the TRIP, the NFIP as a mega-catastrophe flood reinsurer should charge a fee or premium for the reinsurance provided.

Address Affordability Issues Outside of Insurance Pricing With Overwhelming Emphasis on Loss Mitigation to Reduce Financial Burden

There is and will be a need for financial assistance to some consumers who cannot afford the cost of flood insurance coverage as the price of that coverage moves to the risk-based price. By requiring flood coverage as part of property insurance policies sold by private insurers and state residual markets, the cost of that coverage should be significantly less than it would be for a risk-priced NFIP policy because of the efficiencies of including flood in an existing policy instead of selling a second policy. But, the risk-based cost of flood coverage will still be greater than present for some consumers and unaffordable for many.

There is a need for financial assistance to those who cannot afford flood insurance. That financial assistance must be governed by four operating principles:

1. ***Financial assistance should be provided only to those who do not have the income or wealth to afford the required insurance.*** Taxpayers paying for government expenditures should not be asked to subsidize insurance for those who have the income and wealth to afford the required insurance.
2. ***Financial assistance should not be provided through distortion of insurance prices by subsidized rates.*** As discussed above, cost-based pricing is essential for moving towards more resilient and sustainable homes, business and communities.
3. ***Financial assistance should overwhelmingly be provided through grants and loans for loss mitigation as a way to lower insurance premiums.*** The key role of government at all levels should be to partner with insurers, homeowners and businesses to invest in loss mitigation as the key path to building more resilient and sustainable structures and to reduce government spending on disaster relief in the future. Financial assistance for loss

mitigation which reduces the insurance premium because of lower risk of loss should be emphasized over grants or payments to insurers to cover the cost of insurance premiums because such payments have a similar impact as subsidizing rates – distortion of the price of insurance and the cost of protecting and maintaining real property.

4. ***Financial assistance should be a partnership between government, insurers and policyholders.*** The involvement of insurers is essential because it is the discounts for loss mitigation efforts which effectively finance the loss mitigation and because insurers are in the position of facilitating loss mitigation financing by, for example, offering multi-year policies which might match the term of a loss mitigation loan.

<u>Reauthorize the NFIP to continue sale of flood insurance during a finite transition period</u>

The NFIP comes up for reauthorization in 2017. More time is needed to transition the sale of flood insurance from the NFIP to private insurers offering flood coverage as part of standard residential and commercial property coverages. I estimate that three years will be needed once Congress establishes the requirements of our flood insurance proposal. If, by 2017, Congress passed and the President signed the required legislation, the NFIP would need to be reauthorized until 2020 during the transition period to private market responsibility for flood insurance protection. States would need to clarify and establish requirements for flood coverage in residential and commercial property insurance policies and insurers would need to file policy forms and develop rates reflecting the flood risk. Reinsurers and catastrophe modelers would need to develop their flood-related products. And, most important, FEMA, or whichever agency Congress determines should be responsible, needs to develop the programs and partnerships for identifying consumers in need of financial assistance and delivering the assistance is a variety of ways, including partnerships with state and local governments and insurers.

Comments on H.R. 2901, the Flood Insurance Market Parity and Modernization Act

As we have seen over the past decade, the Congressional changes to the NFIP has lurched from efforts at longer-term reform to responses to current crises – with the responses to current crises often contributing to bigger problems down the road. H.R. 2091 is a response to a current issue – federal agencies have been slow in promulgating rules regarding private flood insurance and surplus lines insurers see an opportunity to pick off NFIP policies that are mispriced or overpriced due to the NFIP rating practices.

H.R. 2091 will not address the longer-term problems of the NFIP, will not meaningfully promote private market participation in the sale of flood insurance and will create bigger problems in the future when flood events occur. In addition, the legislation effectively tasks state insurance regulators with oversight of the federal requirement for flood insurance, but removes the key requirement in current law that the insurance be subject to standard state-based insurance regulatory requirements.

H.R. 2091 adds an option for lower coverage amounts. Instead of the minimum coverage amount for certain NFIP policies being the lesser of replacement cost or NFIP maximum coverage amount, the legislation makes the minimum coverage the lesser of unpaid principal balance, replacement cost or the NFIP maximum coverage amount. First, it is unclear that lenders will lower their requirements for coverage in response to this change. Lenders routinely require more than the minimum required flood coverage and have force-placed flood insurance for the difference between the NFIP coverage amount and the coverage amount required by the lender/servicer.[4]. Federal agencies and the United States are on record arguing that the coverage requirements of 42 USC 4012a(a) are minimums and not ceilings on coverage amounts that lenders may require.[5]

More important, the "benefit" of a lower premium today will be long forgotten when a flooding event occurs and the homeowner has inadequate coverage to repair her home.

---

[4] For example, see "Adding Insult to Injury: Lenders force homeowners into costliest flood coverage," Syracuse.com, May 13, 2012 at
http://www.syracuse.com/news/index.ssf/2012/05/adding_insult_to_insurance_len.html

[5] See "Brief for the United States as Amicus Curiae" in No 11-2030 United States First Court of Appeals, Kolbe v BAC Home Loans Servicing, et al.

If the homeowner is unable to afford the insurance premium for the needed replacement coverage, then he or she is unlikely to be able to afford the large out of pocket to make up the difference between repair costs and insurance proceeds. This is an example of a short term fix creating a longer-term problem because the inadequate insurance coverage means, at best, inadequate repairs leaving the home more susceptible to future damage and, at worse, the homeowner losing the home. It is inconsistent with the primary goal of promoting greater resiliency and sustainability.

H.R. 2091 attempts to encourage private market provision of flood insurance by eliminating state regulatory oversight of private residential flood insurance by defining "private flood insurance" to include surplus lines insurers and also by eliminating federal oversight by removing the current consumer protection requirements for private flood insurance, the authority and responsibility of federal agencies to implement those requirements in a regulation and the authority of the Government Sponsored Enterprises (GSEs) to establish standards for the claims paying ability of insurers providing flood insurance on mortgages the GSEs own or insure.

The result of these changes is to facilitate the sale of private flood insurance by surplus lines insurers. I understand that the logic behind this approach is that admitted insurers are not willing to write private flood insurance, but surplus lines insurers would be if requirements – such as comparability with the NFIP policy or claim settlement requirements – were relaxed. The story continues that once surplus lines insurers are offering private flood insurance, admitted insurers will become more comfortable with selling private flood and proceed to do so. I have seen no empirical evidence to remotely suggest admitted insurers will do as suggested. I am not aware of a personal lines insurance product or coverage which migrated from surplus lines to admitted carriers because of market forces. I have seen surplus lines insurers write business that admitted insurers would have written and I have seen personal lines business migrate from the admitted market to surplus lines when permitted to do so.

The actual result of these changes will be for surplus lines insurers to cherry-pick NFIP policies that are currently overpriced due to the NFIP's broad rating scheme and loadings for contingency and reserves. Earlier I explained how the NFIP evaluates flood risk across 30 risk groups within a SFHA with group 1 being the highest elevation relative to Basic Flood Elevation and group 30 being lowest (and, consequently most exposed to damage from a flood event). The

NFIP does not charge different rates for each of the 30 groups, but averages the expected claim costs across all groups in the SFHA. The surplus lines insurers will cherry-pick the policies in the risk groups below the overall average, leaving the NFIP with the policies in the above-average risk groups. While the surplus lines insurers take the profitable, lower-risk policies, the NFIP will become even more financially vulnerable as its premium revenue will decline more than its risk exposure. While the states have an interest in affordable insurance for residents, the states don't have an interest in ensuring sufficient revenue for the NFIP.

In addition to creating larger problems for the NFIP in the future, the legislation sets the table for more problems for consumers who purchase the surplus lines policies when an event occurs. As discussed above, states do not regulate surplus lines policy forms, which means that a surplus lines policy can contain exclusions that a regulator would never approve in a policy filed by an admitted carrier. A surplus lines policy might contain claim settlement provisions an admitted carrier could not include in its policy form. And surplus lines insurers' rates are not subject to any regulatory oversight. Consumers will not be aware of these differences and limitations – particularly since the legislation removes the consumer disclosures currently required – until a flood event occurs and the consumers face unexpected claims denials or hurdles or, far worse, the surplus lines insurer is financially impaired, unable to pay claims and three is no guaranty fund protection for the policyholder.

Market forces will not cause surplus lines insurers to charge cost-based rates; rather, the surplus lines insurers will charge rates that just beat those of the NFIP even if the cost-based surplus lines rates should be much less. Insurance markets are generally not competitive – consumers rarely have the information and market power to discipline insurers on coverage or prices and rely on state insurance regulators to ensure policy forms (which spell out coverage and claim settlement procedures) are not unfair, deceptive or misleading and to ensure rating practices are fair and not unfairly discriminatory. Flood insurance markets, in particular, are not competitive, so unleashing unregulated insurers on vulnerable consumers is a recipe for disaster.

Thank you for the opportunity to testify today.

February 2, 2016

Representative Blaine Luetkmeyer, Chairman
Representative Emanuel Cleaver, Ranking Member
Subcommittee on Housing and Insurance
Financial Services Committee
United States House of Representatives

By Email

Re: Supplemental Comments to January 13, 2016 Hearing, "How to Create a Robust and Private Flood Insurance Marketplace?

Chairman Luetkmeyer and Ranking Member Cleaver,

Thank you again for inviting me to speak to the subcommittee on flood insurance issues on January 13, 2016. I write to supplement my testimony with comments on issues raised during the hearing.

GSE Authority to Establish Claims Paying Ability of Flood Insurers is Not Insurance Regulation and Does Not Replicate or Usurp State Insurance Regulation

The NAIC testified that that the provisions in the Biggert Waters Act regarding authorizing the Government Sponsored Enterprises to establish criteria for the "financial solvency, strength or claims paying ability of private insurance companies:"

> "This is highly problematic as banking and housing regulators neither have the expertise nor the experience to regulate insurance companies or insurance markets. This also results in duplicative and potentially inconsistent regulatory requirements for insurers and serves as a disincentive for private insurers to consider writing flood insurance coverage."

The NAIC testimony is incorrect. The GSEs already establish the claims-paying ability of insurers – for hazard insurance as well as flood insurance – by simply requiring that the insurers have minimum financial strength ratings from rating agencies. For example, Fannie Mae's Servicing Guide sets out property (hazard) insurance and flood insurance requirements for the type and amount of coverage as well as rating (financial strength) requirements of insurers:

> The property (hazard) insurance policy for the insurable improvements of the property securing any first lien mortgage loan must be written by a carrier that meets one of the following rating requirements, even if it is rated by more than one of the rating agencies.
> **Rating Agency Rating Category**
> A.M. Best Company, Inc. Either a "B" or better Financial Strength Rating in *Best's Insurance Reports*, or an "A" or better Financial Strength Rating and a Financial Size Category of "VIII" or greater in *Best's Insurance Reports Non-US Edition*. Carriers providing coverage for co-op projects must have a general policyholder's rating of "A" and a Financial Size Category of "V" in *Best's Insurance Reports*.
>
> Demotech, Inc. "A" or better rating in *Demotech's Hazard Insurance Financial Stability Ratings*.
>
> Standard & Poor's "BBB" or better Insurer Financial Strength Rating in *Standard & Poor's Ratings Direct Insurance Service*.

Clearly, the GSE's authority and ability to establish requirements for the claims-paying ability of hazard and flood insurers is reasonable and necessary for the GSE's to protect the properties serving as collateral for the loans the GSEs own or insure. This authority clearly has not and does not replicate or usurp state financial solvency regulation. The NAIC's testimony in this regard is not only incorrect, but calls into question the NAIC's understanding of the mortgage markets. The NAIC's testimony that "banking and housing regulators neither have the expertise nor the experience to regulate insurance companies or insurance markets" is particularly ironic given both the NAIC's misunderstanding of this provision in the Biggert Waters Act and the banking and housing regulators' action to stop the abuses in lender-placed insurance markets in the absence of action by the NAIC or all states other than New York, Florida and California.

HR 2091 Will Leave the NFIP in a More Vulnerable Financial Condition and Reduce Funding for Flood Mapping, Loss Mitigation and NFIP Reserves and Treasury Loan Repayment

Congress has tasked the FEMA and the NFIP with numerous goals for flood insurance, including, among others:

- Encourage purchase of flood insurance
- Reduce subsidies and move to actuarial rates
- Work with stakeholders to map floodplains
- Promote loss mitigation

Several of these goals have affected the structure of NFIP rates. When the NFIP sets its rates, it evaluates its risk exposure in flood zones in 30 categories, ranging from lowest flood risk (and expected claim cost) to highest. In an effort to meet Congressional intent to broaden flood participation, the NFIP averages the expected claims for the 30 risk categories to develop a single rate across all 30 classes instead of setting 30 different rates which would range from lower than average to higher than average.

In the homeowners insurance market, an insurer could not do this type of broad risk averaging because another insurer would come into the market and offer less-than-average rates for consumers with less-than-average risk. The insurer offering only the broadly-averaged rate would suffer "adverse selection," meaning that it would end with above-average risks (as the below-average risk move to the other insurers) while charging the average rate. With HR2091, this is what would occur to the NFIP as surplus lines insurers identify the below-average risks and charge less than the NFIP.

The NFIP premium charge to policyholders includes a policy fee to pay for, among other things, flood mapping activities – activities essential for flood loss mitigation efforts. Reducing the number of NFIP policyholders will result in either fewer funds for these activities, a higher policy fee for the remaining policyholders or both.

In response to Congressional requirements, there is another component beside the policy fee in the NFIP premium which a surplus lines insurer would not need to include in its flood premium – the amounts included for the NFIP reserve and to pay back the loan from the Treasury Department for past NFIP claims. As with the funding for mapping, a reduction in the number of NFIP policyholders means that the amounts collected for NFIP reserves and loan repayment are reduced, the reserve assessment (and NFIP premium) must increase, or both.

As the above discussion makes clear, HR 2091 allows surplus lines insurers to cherry-pick the least risky NFIP policyholders resulting in adverse selection for the NFIP. As the NFIP policyholder base shrinks, the funding for flood mapping, reserves and loan repayment will also shrink. Even if the NFIP attempts to increase the policy fee and reserve amount to cover the shrinking base, then more policyholders will find cheaper policies from private insurers – with the result that the NFIP will be far more financially vulnerable as premium reductions far outpace risk/exposure reduction. This is known as the death spiral.

The proposal set out in my testimony – to require flood be covered as part of the standard residential and commercial property insurance policies with the NFIP moving out of the business of direct provision of flood insurance and into the role of catastrophe reinsurer – is the only meaningful way to move flood insurance to the private sector under state-based regulatory oversight without saddling the federal government – and eventually taxpayers – with endless flood insurance costs.

State Insurance Commissioners' Consumer Protection Authority and Ability to Protect Consumers Purchasing Surplus Lines Insurance is Very Limited

The NAIC testified that state insurance regulators have authority to protect consumers who purchase surplus lines products. However, that authority is very limited and will likely result in consumer complaints with surplus lines flood insurance. Insurance commissioners' authority with surplus lines insurance consists largely of:

- Accepting a surplus lines insurer as eligible in the state. The attached recent bulletin from the Alaska Division of Insurance illustrates this authority. Insurance department oversight of the financial condition of surplus lines insurers is different and less thorough than the financial oversight of admitted insurers.

- Licensing surplus lines agents who issue the surplus lines policies for surplus lines insurers.

- Establishing and enforcing due diligence requirements to ensure surplus lines policies are not issued for types and lines of insurance available from admitted insurers.

Insurance regulators lack authority over surplus lines insurance in several key areas.

- No review and approval of policy forms. For example, state regulator would approve a mandatory arbitration provision and ban on class arbitrations in a homeowners insurance policy. Yet, a surplus lines insurer could not only include such claim settlement requirements in a surplus lines policy, the surplus lines insurer could specify the arbitration take place in the home jurisdiction of the surplus lines insurer – which may be Bermuda or the United Kingdom. The NAIC testified that state insurance regulators have authority to enforce unfair claim settlement practice and unfair and deceptive trade practice laws committed by surplus lines agents and insurers. But it is unclear what authority the NAIC was referring to in this regard if, for example, the surplus lines policy form – over which the insurance commission has no authority – contains unfair or deceptive provisions.

- No review and approval of rates. About seventeen states and District of Columbia have recently issued bulletins advising insurers that "price optimization" is not permitted in establishing rates and premium charges for auto and homeowners. Price optimization refers to a practice of using non-risk related factors – such as a consumer's willingness to accept a higher rate – to set the premium charge. Price optimization violates state law requirements that rates be cost-based and not unfairly discriminatory. Insurance regulators have no authority to stop this or other abusive rating practices on surplus lines policies.

- No guaranty fund protection. Surplus lines insurers do not participate in state guaranty funds, which are organizations created to pay claims in the event the insurer becomes insolvent and is unable to pay the claims on its policies. Mr. Kelley testified that it is impractical for surplus lines agents to participate in state guaranty funds. This "impracticality" may be because surplus lines insurance was intended to address unique coverages, generally for commercial – not personal – insurance. The issue of whether surplus lines insurers should or should not participate in state guaranty funds is irrelevant – the fact remains that surplus lines insurers do not participate in state guaranty funds, with the result that there is no policyholder protection in the event the surplus lines insurer is unable to pay its claims. Mr. Kelley also testified that surplus lines insurers were financially strong and rarely failed. The same is true for admitted insurers – they are financially strong and rarely fail. But the purpose of a guaranty fund is to protect the consumer for that rare event.

In summary, state insurance commissioners lack most of the authority they have to protect consumers purchasing policies from admitted carrier for consumers purchasing policies from surplus lines insurers.

Thank you again for the opportunity to testify on these important flood insurance issues.

Birny Birnbaum

Birny Birnbaum
Executive Director