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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.

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