CENTER for
ECONOMIC
JUSTICE

FAIR ACCESS
FAIR TREATMENT

Proposal of the Center for Economic Justice to

Reform the National Flood Insurance Program by Returning Flood Insurance to the States

Presentation to the National Association of Insurance Commissioners

April 5, 2016

The current National Flood Insurance Program (NFIP) is a deeply flawed approach to providing and promoting protection of residential and commercial property owners from damages related to flooding. 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 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 –

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

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

1. Relatively few homeowners and businesses purchasing flood insurance and consequently relying on disaster relief or savings to recover from flooding events.
2. Improper price signals to individuals and businesses making investment decisions about property purchases.
3. Inadequate incentives for loss mitigation due to subsidized rates;
4. Federal expenditures for disaster relief that leave individuals and communities more susceptible to future loss instead of more resilient and sustainable.
5. 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.
6. Subsidies by some taxpayers of other taxpayers in the offer of and cost to deliver flood protection.
7. 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.
8. Inadequate oversight by the NFIP of its partners and contractors, including the Write-Your-Own insurers.
9. Lack of standard insurance consumer protections found in state regulation of residential and commercial property insurance.
10. Lack of a residual market for flood insurance, leaving force-placed flood insurance as the de facto residual market.

The Way Forward

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. Provide seed funding for states which want to establish non-profit, tax-exempt catastrophe funds for public provision of insurance or reinsurance.

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.

Benefits of Requiring Coverage for Flood as Part of Property Insurance Policies

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. All consumers and businesses will have coverage they expect and pay their fair share for that coverage.
2. More efficient and lower-cost delivery of flood coverage than through a separate NFIP policy – efficiencies in sales, administration and claims settlement.
3. Lower costs through a larger, more diversified risk pool.
4. Financial assistance targeted to those in need and to investments in sustainability and resiliency.
5. State-based consumer protections for sales and claims settlement by insurance departments who have over 100 years of experience and the regulatory infrastructure in protecting consumers and addressing market failures.
6. More transparent and accurate prices to consumers and businesses making investment decisions on the purchase of real property, including the proper economic signals for investments in loss mitigation.
7. Greater opportunity to utilize the expertise of private insurers, reinsurers and catastrophe modelers on flood risk identification and mitigation.
8. Promote more resilient consumers, businesses and communities.
9. Shift federal expenditures towards investments in sustainability and resiliency, saving taxpayers and consumers money and loss of life and property in the future.

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

As a result, the NFIP rates are broadly averaged over 30 risk categories. Such broad risk averaging is not possible with private market entrants because another insurer will 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, surplus lines insurers are invited to cherry-pick the better-than-average risks and leave the NFIP with the worse-than-average risks.

In addition, 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.

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.