The Future of Flood Insurance: A Growing Public-Private Partnership
INTRODUCTION
Floods are the most common and deadly natural disaster in the nation. In an attempt to provide consumers with available and affordable coverage for catastrophic flood losses, Congress established the National Flood Insurance Program (NFIP) in 1968. Managed by the Federal Emergency Management Agency (FEMA), this program provides federally-backed flood insurance to residents and businesses in voluntary participating communities throughout the country. Flood coverage is mandatory for anyone with a federally funded mortgage on a home in a high risk flood area.

Private insurers known as “Write Your Own” (WYO) companies partner with the NFIP to administer the federal flood program. WYO insurers do not underwrite risk or make underwriting profits, but they get an expense allowance for writing and administering these policies under their own names. The federal government is responsible for all program claims and costs. Flood coverage is identical among all WYO insurers and all rates are established by the NFIP, not the WYO companies. There are now 67 WYO companies, all of which are regulated by the states in which they sell flood insurance.

Two major concerns of the NFIP are its current financial condition and the structural weaknesses in the funding of the program. Since its inception, NFIP rates have not been actuarially sound by design; the rates for most insured properties, particularly in higher risk hazard zones, are subsidized below market rates. As a result, the flood program has long been undercapitalized, with a debt of about $20.5 billion now.

Despite this debt, FEMA makes every effort to ensure the prompt settlement of claims to NFIP policyholders. Shortly after claims from last year’s hurricanes were filed, FEMA advanced payments to claimants to help insured flood victims begin their recovery. As of March 15, 2018, the NFIP and WYO companies had paid $9.6 billion on all claims. And in 2017, FEMA obtained reinsurance, to help manage its flood exposure, extend its claims-paying ability and reduce the build-up of future debt.

Over the years Congress has regularly renewed and extended the NFIP; its latest reauthorization extends through July 31, 2018. The Biggert-Waters Flood Insurance Reform Act (2012) and the Homeowner Flood Insurance Affordability Act (2014), made landmark changes to move the NFIP towards risk-based rates. By eliminating certain rate subsidies to increase premium revenues, these laws were intended to make the federal flood program more financially sound and allow for greater private sector participation.
THE EMERGING PRIVATE FLOOD INSURANCE MARKET

Historically, flood was considered an uninsurable risk by the private market for a number of reasons including adverse selection whereby people most affected by flood would buy subsidized coverage, causing consumers in other areas to believe risk-based premiums were too high. It was also believed that catastrophic flood losses could negatively impact surplus and lead to private insurance company insolvencies. Regulatory hurdles also limit private insurers from competing with the NFIP since many lending and housing regulators did not recognize non-NFIP policies. As such, few private insurers offered stand-alone flood policies.

Since the passage of Biggert-Waters, the private sector has been more willing to include flood risk in their portfolios – even in coastal areas. It appears a growing desire exists to allocate capital to provide more flood insurance in a private competitive market environment.

Eighty-eight (88) private insurers are now offering stand-alone flood policies and are successfully competing with the NFIP. The 2017 direct written premium volume is $569.5 million, a sizable jump compared to $356.6 million in 2016. This large increase of 60 percent is due primarily to 39 new entrants within the last year.\(^2\) While most of the private market flood insurance has been on the commercial side, it is encouraging that more homeowners may soon have a choice in private market flood insurance. Florida and Pennsylvania have been at the forefront of encouraging the development of private flood insurance markets. Indeed, according to S&P Global, Florida and Pennsylvania are among the top 10 states with the fastest growing private flood insurance market in 2017. This is in no small part due to visionary regulatory activity.

\(^2\) S&P Global Market Intelligence; APCIA identifies new flood entrants in 2017 if their premium volume in 2016 was $0.
DIFFERENCES BETWEEN THE NFIP AND PRIVATE FLOOD INSURERS

There are many differences between NFIP and private flood insurance. For instance, the NFIP prohibits the denial of coverage to a “repetitive loss property.”\(^3\) Unlike private insurers, the NFIP does not generate loss reserves and since it is not set up to have a capital surplus to cover unexpectedly large events, it does not seek a rate of return for the capital use in the program.\(^4\) In contrast, private insurers must build reserves and capital to cover years of high losses. The NFIP insurance rates are not subject to Federal taxes, whereas private insurers must bear both Federal and foreign taxes.

Rates may vary between the NFIP and private insurers, depending in part on geographical location. A 2017 study by Milliman Inc. and KatRisk, a risk-modeling firm, estimated that flood insurance for roughly 7 out of 10 single-family homes across all flood zones cost less from private insurers than the NFIP.

Private insurers with experience responding to catastrophes, understand the current needs of consumers and the market, and can update programs as needed. Private insurers may also underwrite risks not typically covered by the NFIP. Along this line, the Insurance Services Office, Inc. recently launched a new program that enables insurers to set their own policy limits and provide optional coverage for risks not normally underwritten by the NFIP, such as, property damage to basements and business interruption.

Some insurers’ stand-alone flood policies may contain innovative provisions that respond to lender and borrower needs. Features that may appeal to lenders include backdating, gap policies, and automatic coverage that enhances a lender’s ability to tailor the coverage to its portfolio’s particular characteristics. Insurers’ streamlined services may also help reduce the costs incurred in complying with the mandatory purchase requirements. Further, insurers may have the resources to use new flood-risk assessment technology and data sources allowing a more granular look at flood risk.

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3 A “repetitive loss property” is any insurable building for which two or more claims of more than $1,000 were paid by the NFIP within any rolling ten-year period.
4 The NFIP collects only enough premiums to pay for claims in a typical historical year; hence, reserves have not been sufficiently built to meet unexpected large events. Biggert-Waters requires FEMA to begin building a reserve equal to 1 percent of total potential loss exposure.
NFIP V PRIVATE MARKET
The presence of additional private insurers may help increase the number of homes and businesses protected by flood insurance which may partly explain the steady decline in the NFIP policies. FEMA data shows that NFIP flood policies have dropped 10 percent, from 5.65 million in 2011 to 5.08 million in 2016. Critics of private market participation in the flood insurance arena frequently cite “cherry picking” as a concern. The allegation is that private companies will only take the most profitable policies from the NFIP. In fact, a CBO report on NFIP Soundness and Affordability indicates that premium shortfalls are largely due to underpricing policies in coastal counties. NFIP policies issued in coastal counties represent three-quarters of all NFIP policies nationwide. In the long-term, reducing the NFIP policy count will lessen the burden on taxpayers.

CONCLUSION
The private flood insurance market continues to grow. According to Deloitte, flood insurance is the largest area for property casualty insurance and reinsurance growth in the U.S., with billions in potential premiums. A larger private market means that consumers will have additional options for purchase of flood insurance. However, a financially sound federal program is still needed. Strong private-public partnerships between stakeholders should improve flood resiliency in the U.S.