

The Influence of Sellers on Contract Choice: Evidence from Flood Insurance

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March 19, 2018

Abstract

We examine the ability of insurers to influence the coverage limit decisions of 180,000 households in the National Flood Insurance Program where all insurers sell an identical product at identical rates. About 12% of new policyholders overinsure, selecting coverage limits that exceed their home's replacement cost. Overinsuring is difficult to explain with traditional models of decision making under risk. The rate of overinsuring differs substantially across insurers, ranging from zero to one-third of new policies. Insurer effects are statistically significant after controlling for the insured's characteristics. Additionally, some insurers seem to encourage households to overinsure in percentage terms (e.g., buy 110% of replacement cost) while others encourage rounding up in dollars (e.g., to the next \$10,000). Finally, we find that insurers' distribution systems and commission rates influence whether their policyholders overinsure. Our results show that insurers help select households' flood insurance contracts.

Keywords: Insurance Demand · Flood Insurance · Catastrophe Insurance · Biased Advice

JEL Classifications: D81 · D83 · G22 · L14

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1 Introduction

Can insurers influence the contract choices of their policyholders? Economists model insurance decisions as a function of a consumer’s risk exposure and risk preferences (e.g., Arrow, 1974; Cohen and Einav, 2007). For many insurance decisions, however, the consumer has incomplete information and must rely on the seller to understand the risk and the insurance contract. This relationship is subject to agency conflicts, as sellers have incentives to overstate a contract’s benefits or to recommend suboptimal products (Anagol et al., 2017; Inderst and Ottaviani, 2009). Competitive markets would prevent this behavior, with sellers who endorse low-value choices increasing the risk of losing their customers (Bolton et al., 2007; Gravelle, 1993). Real-world insurance markets are not perfectly competitive, however, and agency conflicts may remain. Testing the influence of insurers on consumers’ contract choices often involves empirical challenges due to differences between insurers (e.g., credit rating) and the contracts they offer (e.g., coverage terms and pricing).

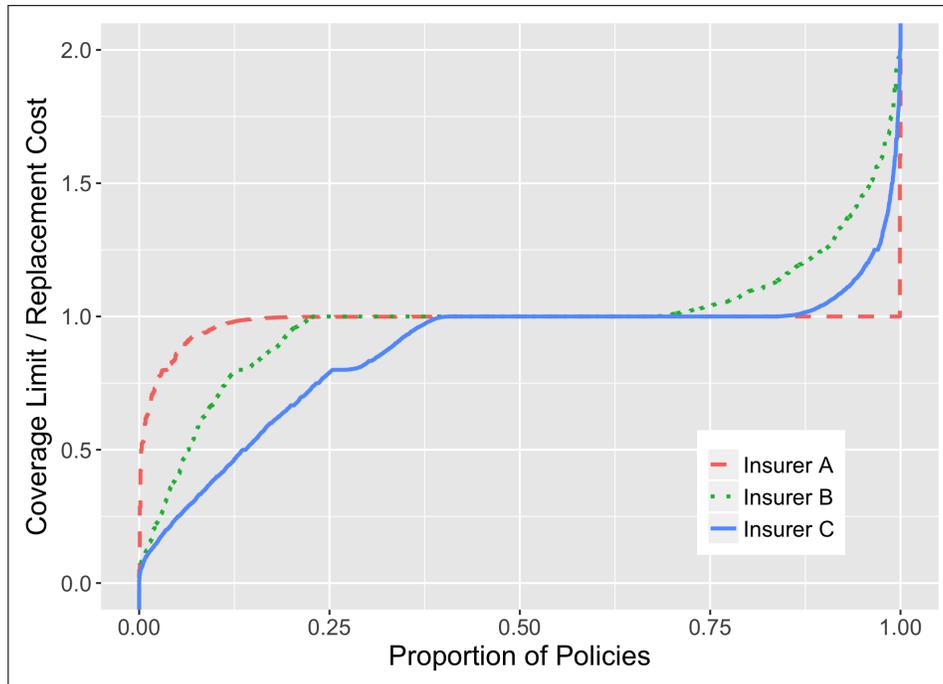
In this study, we examine a market setting that overcomes these empirical challenges—private insurers who sell residential flood insurance policies in the National Flood Insurance Program (NFIP). The U.S. federal government sets all terms of the insurance contract (e.g., premium rating, coverage options) and bears all claims risk. The NFIP incentivizes private insurers to sell these policies via commissions on the premium paid. Thus, the contracts in our study are identical in every sense except for the seller—an ideal setting to examine the ability of sellers to influence households’ contract choices.

Our analyses focus on *overinsuring*, where consumers select a flood insurance coverage limit higher than their home’s estimated replacement cost. The replacement cost is the cost to rebuild the home with materials of like kind and quality.¹ Overinsuring is a peculiar choice, as an insurance payment cannot exceed the total cost to rebuild the structure, whatever the selected coverage limit. Figure 1 is a motivating illustration of overinsuring across insurers. It shows the distribution of selected coverage limits (relative to estimated replacement cost) for policyholders of three large participating insurers. A ratio of 1 indicates full coverage, while a ratio above (below) 1 denotes overinsurance (underinsurance). The policyholders of Insurer A tend to purchase full coverage, and they never overinsure. The policyholders of Insurer B often overinsure, with more than 30% of policyholders purchasing excess coverage. Insurer C’s policyholders are the most

¹ Insurers use software to estimate replacement cost for the customer based on claims data and a home’s characteristics such as size, location, and construction materials. Deriving an accurate estimate of the home’s replacement cost is instrumental to the property insurance industry. The NFIP instructs sellers to use this software to provide the home’s estimated replacement cost to the policyholder when the flood insurance contract is originated (NFIP, 2006, p. 4-175).

likely to partially insure (about 40%), though approximately 15% overinsure.

Figure 1: Policyholder Coverage Limits for Three Insurers



Note: Figure shows the distribution of selected building coverage limits (relative to estimated replacement cost) for three large insurers in the National Flood Insurance Program. We selected these three insurers for purposes of illustration. A ratio equal to 1 indicates full coverage, while a ratio greater than (less than) 1 indicates overinsurance (underinsurance). The policyholders of Insurer A tend to fully insure (i.e., choose a coverage limit equal to their home’s replacement cost) and never overinsure. In contrast, more than 30% of Insurer B’s policyholders overinsure. Finally, about 40% of the policyholders of Insurer C partially insure and approximately 15% overinsure.

Compared to partial or full coverage, overinsuring is difficult to explain with any standard model of decision making (e.g., expected utility theory or prospect theory).² Incurring excess damage (i.e., experiencing a claim that exceeds the home’s estimated replacement cost) is possible but rare. Out of nearly 180,000 policies in our sample, excess damage occurs only 40 times—a rate of 0.02%. The mean amount of excess damage is \$6,872. This results in an expected loss per household of \$1.53. The cost of this excess coverage is expensive: overinsuring households pay an average of \$71.07 in additional premium for excess coverage, which is 4,645% of the expected loss. While excess coverage provides little value to households, insurers have several motives to recommend overinsuring, including larger commission revenue and managing the risk of errors and omissions lawsuits.

² Several factors might motivate a household to partially insure, including risk exposure, risk preferences, and institutional factors (e.g., purchasing only the amount required by the mortgage).

In our primary analysis, we examine whether the insurer selling the policy influences the likelihood that a household overinsures. Our baseline data include 179,917 new policies sold in 2010 by 48 insurers in all 50 states and 4 U.S. territories. While Figure 1 suggests notable insurer effects, the observed differences across insurers might be explained by characteristics of their policyholders or local markets. We strengthen our causal interpretation of insurer effects by modeling the likelihood that a household overinsures as a function of insurer fixed effects, controlling for detailed policy-level characteristics and geographic fixed effects. Over a number of specifications, we find that the likelihood a household overinsures depends significantly on its insurer. Sorting the insurer fixed effects by quartile, we find that a household whose insurer is in the highest quartile is, on average, 12.3 percentage points more likely to overinsure than a household purchasing from an insurer in the lowest quartile.

We also examine the specific guidance that insurers may use in recommending excess coverage. For example, an insurer might suggest selecting coverage limits that are 10% higher than the estimated replacement cost. We identify a small set of possible “rules” and test the three most prevalent rules. These three ultimately explain more than 50% of excess limits selected. The most common overinsurance limit is choosing the program maximum of \$250,000 regardless of the replacement cost, which describes 29% of excess limits. Half of overinsuring households choosing this limit have replacement costs below \$200,000, so they buy at least \$50,000 in excess coverage. The second most common excess limit rule is to set the limit at 110% of replacement cost, and the third most common is to select a coverage limit that equals the nearest \$10,000 increment above the replacement cost. Of the 48 insurers in our dataset, 18 appear to follow a single rule, reinforcing the conclusion that overinsuring is an institutional recommendation.

Finally, we consider how market conditions and firm characteristics may influence each insurer’s rate of overinsuring in a state. We find that commission rates are the most significant factor. Overinsuring is positively related to flood insurance commissions—a 1 percentage point increase in an insurer’s flood commission rate is associated with a 0.5 percentage point increase in the overinsurance rate. This relationship illustrates the conflict between agents and policyholders, with agents paid higher commissions more likely to sell excess coverage. We observe the opposite effect for non-flood commission rates (homeowners and auto), with a 1 percentage point increase in those commission rates associated with a 0.7 percentage point decrease in the flood overinsuring rate. One interpretation of this result is a substitution effect for an agent’s effort, with an agent deploying sales effort to the line(s) of business paying the highest commission. Interestingly, commission rates are a significant factor only for insurers who use “direct” agents (i.e., agents who are employed by the insurer) and not for insurers who primarily use “independent” agents (i.e., a

third-party agency who may represent multiple insurers). We also find initial results for competition, in that overinsuring rates are lower in states where many insurers sell federal flood policies.

Our paper contributes to the existing literature in several ways. Our main result shows that insurers help select households' flood insurance contracts. This finding creates questions regarding the extent to which a policyholder's insurance decisions reflect its risk preferences. Many of the foundational papers eliciting risk preferences from observed insurance choices (e.g., Barseghyan et al., 2013; Cohen and Einav, 2007; Sydnor, 2010) use data from a single insurer and so are unable to account for the insurer's influence. We add a new component to studies investigating demand for flood insurance (e.g. Botzen and van den Bergh, 2012; Browne and Hoyt, 2000; Kriesel and Landry, 2004; Landry and Jahan-Parvar, 2011) and catastrophe insurance (e.g. Grace et al., 2004; Kousky and Cooke, 2012). More generally, the paper adds to a behavioral literature on why consumer's insurance decisions differ from the predictions of standard models (which has already identified inertia, simplifying heuristics, information frictions, and other consumer-level factors, e.g., Abaluck and Gruber, 2011; Ericson and Starc, 2012; Handel and Kolstad, 2015).

Our study provides additional evidence on the ability of sellers to influence demand. In an investigation of wholesale used car auctions, Lacetera et al. (2016) find that the latent ability of auctioneers significantly affected the probability of a sale, the sales price, and the speed of a sale. Our analysis complements theirs, in that we demonstrate the ability of sellers to influence the quantity of a product demanded at identical unit prices. Similarly, Foerster et al. (2017) show that financial advisors have a large influence on investment portfolio allocation, more than many investor-level attributes. Our study can be interpreted as evidence of similar effects on consumer choice and risk attitudes. We show such effects at the *institutional* level, in contrast to the influence of individual auctioneers or financial advisors.

We also add to the literature on intermediaries and agency conflicts. There is substantial empirical evidence of agency conflict in the finance literature (e.g., Christoffersen et al., 2013; Mullainathan et al., 2012), but evidence of biased advice in an insurance setting is mixed. Interviews and surveys with agents have found no significant evidence of commissions inducing bias (Kurland, 1995; Cupach and Carson, 2002), while experiments have shown that consumers have a higher willingness to pay for insurance when purchasing from an agent paid on commission (Beyer et al., 2013). Anagol et al. (2017) conduct a field study to examine the selling behavior of life insurance agents in India. They find that agents recommend unsuitable products that confirm consumer biases to maximize their commission revenue. Their data are from "auditors" posing as Indian consumers, who recorded agents' recommendations. Thus, they do not observe choices made by consumers, but their findings explain trends in the Indian insurance market. Our study

complements theirs, though differs in focus, as we study the actual choices of U.S. consumers, but do not directly observe the the actions of sellers.³

Finally, our findings are consistent with existing evidence of differences across insurance distribution channels. Insurers using direct agents have often been compared to insurers using independent agents (see Hilliard et al., 2013 and Regan and Tennyson, 2000 for a review of institutional differences). Eckardt and R athke-D oppner (2010) determine that independent agents provide higher quality information to consumers, and other studies have found independent agents to provide higher levels of service and/or better customer satisfaction (e.g. Barrese et al., 1995; Eckardt, 2002; Trigo-Gamarra, 2008). Our finding that higher commission rates do not induce independent agents to sell excess coverage seems to align with the conclusions of these previous studies.

The remainder of this paper is arranged as follows. In Section 2, we discuss the institutional setting and describe the data we use in our analysis. Section 3 outlines the methodology and result for our primary result, significant differences in overinsurance between insurers. In Section 4, we consider a number of possible formulas insurers may use to suggest a limit relative to the calculated replacement cost. We offer a robustness check to potential selection issues in Section 5. We then investigate the ways in which insurers may incentivize agents to sell excess coverage in Section 6. Finally, we review our findings and discuss applications in Section 7.

2 Background

2.1 Institutional details

Standard U.S. homeowners insurance contracts exclude coverage for flood, so homeowners who wish to insure flood risk must purchase a standalone policy. More than 96% of residential flood insurance is underwritten by the NFIP (Dixon et al., 2006).⁴ At the end of 2017, five million NFIP policies were in force for a total insured value of \$1.3 trillion (FEMA, 2018).

Federal flood policies from the NFIP cover the home structure and contents with separate limits and deductibles. We focus our analysis on coverage for the home structure. The structure

³ It is important to note that seller behavior in our study is not necessarily subversive. While the additional quantity purchased in our study has an extremely low probability of being needed (see Section 2.4), sellers may truly believe the purchase is worthwhile, as detailed claims data are not publicly available.

⁴ While some insurers today offer flood coverage on a “nonadmitted” basis (not subject to state regulation), such coverage was rare in 2010 when our data were generated. In addition, entities such as Fannie Mae typically require that flood insurance be admitted.

covered includes the dwelling, additions or extensions, a detached garage, and attached appliances and fixtures (e.g., dishwashers, water heaters, built-in microwave ovens, etc.). It also covers debris removal and loss avoidance expenses. Several exclusions apply, including (1) land, trees, and shrubs, (2) finished basements, and (3) walkways, decks, and driveways. Consumers select a coverage limit up to \$250,000, in \$100 increments, and choose a deductible of either \$1,000, \$2,000, \$3,000, \$4,000, or \$5,000.⁵

Some homeowners are required to insure against flood, though this requirement has not been consistently enforced (Dixon et al., 2006). Homeowners with a mortgage from a federally-regulated lender are required to purchase flood insurance if their home is located in an area that federal flood maps estimate has more than a 1 percent annual flood probability (Zones A and V). The minimum limit for these households is the lowest of: (1) their home's replacement cost, (2) their outstanding mortgage balance, or (3) the \$250,000 program maximum (NFIP, 2007, p.41).

Private insurers sell NFIP policies by participating in the "Write Your Own" program. Participating insurers are responsible for selling and renewing policies, issuing contracts, and servicing flood claims. Compensation from the NFIP to participating insurers includes two allowances, an expense allowance and a commission allowance. The expense allowance averages 15.6% of collected premiums, and is based on the estimated costs of marketing, underwriting, and issuing the policy. The commission allowance, 15% of premiums, is intended to cover commissions paid to agents for selling activities. The NFIP also offers a 2% bonus for insurers who achieve an annual 5% growth in the number of policies written (allowance and bonus information from Michel-Kerjan, 2010a, p. 409). The commission allowance is paid to the insurer regardless of the commissions paid to agents; the insurer may pay more or less to agents for selling the flood policies. This structure creates variation in sales incentives across insurers, which we employ in our analyses.

Insurance agents must complete training to sell flood insurance (U.S. Congress, 2004). Training courses educate agents on flood zones, policy wording, underwriting, rating, and claims settlement. The NFIP also provides an extensive manual to agents selling flood insurance policies, with guidelines for data collection and underwriting (e.g., NFIP, 2010). This flood training is in addition to insurance agent licensure requirements: in all U.S. states, agents selling *any* type of insurance must pass an exam to be licensed, participate in continuing education, and complete ethics training (see NAIC, 2013, for additional details).

⁵ All contract details are from NFIP (2010). Coverages and exclusions are examples and are not a comprehensive list, details on pages POL 3-20. Limits and deductibles are outlined on pages RATE 1-2. Flood contracts also cover costs associated with updating damaged properties to comply with current flood management-related building requirements, subject to a \$30,000 limit, at an additional charge (Coverage D, pages POL 8 and RATE 14).

The NFIP instructs agents to determine the replacement cost of the applicant’s home using “normal company practice” during the application process (NFIP, 2006, p. 4-175). The insurance agent determines the home’s replacement cost using estimation software with information on the home such as square footage, location, home age, foundation type, and basement characteristics. Insurers may develop their own software, though many use products from third-party vendors such as CoreLogic or 360Value. Even though certain areas of the property are not covered by federal flood policies (such as finished basements), many replacement cost calculators include these items as input variables—so estimated replacement costs are a conservatively high estimate of the possible flood loss. Importantly, the policyholder may select any coverage limit up to \$250,000, regardless of the calculated replacement cost. However, the flood insurance contract caps payments at the least of (1) the limit stated in the declarations, (2) the replacement cost of the damaged property, or (3) the amount actually spent to repair or replace the damaged property (NFIP, 2010, p. POL 19).

Overinsuring intends to address the risk that flood damages exceed the home’s estimated replacement cost. This excess damage might occur because of limitations in the software used to calculate replacement cost (e.g., debris removal expenses) and/or unusually high costs to replace the home (e.g., skilled labor due to demand surge, as in Döhrmann et al., 2017). The seller almost certainly has better information on these risks than the household. We focus on overinsuring because households are likely to rely on their insurers’ guidance on whether (and how much) to overinsure. Other choices, such as deductible levels, may not rely on the insurer’s information to the same extent.

2.2 Data

Our data include all NFIP policies written in 2010, but we narrow our sample to focus our analyses and to strengthen empirical identification. Table 1 outlines the number of observations kept with each data cleaning step. We are interested in a households’ decision to (over)insure their home, so we exclude nonresidential policies and policies that only insure a home’s contents (which is intended for renters). We also limit our analyses to single-family homes, as households living in multi-family dwellings (e.g., townhomes or condominiums) may have less capacity to choose the terms of their flood insurance policies. We keep only policies with the ability to overinsure within the \$250,000 maximum program limit—the estimated replacement cost must be \$249,900 or below. We wish to observe active choices by consumers, so we drop renewals of existing policies and examine only new issuances in 2010. This filter also avoids problems with “legacy” replacement cost calculations, which may be outdated or inconsistently updated by the agent. We examine

only policies in areas designated “Zone A” on federal flood maps, which are homes with at least a 1% annual probability of flood, but are not exposed to storm surge. This zone is the largest in the flood program, comprising 55% of single-family unit policies with building coverage. We examine only this zone to ensure relatively homogeneous flood risk across policies, though our regressions include controls for property-specific risk factors within the zone. We also exclude policies with non-positive replacement costs. About 1.6% of policies are reported to have replacement costs of zero, which is a data error. We drop observations with insurers who sold fewer than 100 federal flood policies in 2010, as relatively few policies have a disproportionate influence on the estimated effects for those insurers.⁶

The flood insurance program directly issues policies in three cases, and we add data filters to include only the third case. The program directly issues policies if the contract (1) insures a “severe repetitive loss property,” (2) is a State Farm legacy contract, or (3) is originated by an independent agent that is not doing so on behalf of an insurer in the program. The NFIP designates a home a “severe repetitive loss property” if since 1978, it has (a) four claims of at least \$5,000 each or (b) total claims payments that exceed the value of the property (NFIP, 2011). If a flood causes an insured home to qualify as a repetitive loss property, the insurance renewal will be issued by the NFIP (rather than the original issuing insurer) and given a new policy number. Consequently, the policy appears as a new policy in our database even though it is likely considered a renewal from the household’s perspective. State Farm officially left the flood insurance program on October 1, 2010, but its agents continued to service the existing flood insurance policies that it had originated. The renewals on these contracts were given a new policy number and coded as new, NFIP-direct business in our database. Thus, by excluding repetitive loss properties and contracts issued after October 1, the remaining contracts coded as direct issuances from the NFIP are truly “new business” which are originated by independent agents. The resulting baseline sample includes 179,917 flood insurance policies.

The variables in our dataset were populated by insurance agents selling the policies. The agent originating the contract completed a standard NFIP form, which required characteristics of the policy (e.g., deductibles, coverage limits, premiums) and of the insured home (e.g., replacement cost, location, flood zone, age, elevation). Each of these variables is included in our database except for personally identifiable information—we observe the home’s ZIP code but not its street address or the name of the policyholder.

⁶Twenty-eight of the 76 insurers in our data issued fewer than 100 policies and so our baseline sample includes 48 insurers ($76 - 28 = 48$). The 100 policy threshold is an admittedly arbitrary cutoff, and we conduct robustness checks dropping insurers selling fewer than 300, 500, and 1,000 policies with no substantial difference in results.

Table 1: Data cleaning and filtering steps

| Data step | N remaining |
|---|--------------------|
| All policies in 2010 | 4,445,309 |
| Keep if residential | 4,174,842 |
| Keep if purchased building coverage (omit contents only policies) | 4,100,186 |
| Keep if single-family units | 3,727,896 |
| Keep if flood zone A | 1,963,393 |
| Keep if new policy (omit renewals) | 380,061 |
| Keep if replacement cost < \$250,000 | 249,335 |
| Keep if not a repetitive loss property | 248,567 |
| Keep if policy start date in January to September | 183,992 |
| Keep if replacement cost > \$0 | 180,982 |
| Keep if insurance group sells \geq 100 flood policies | 179,917 |
| Baseline Data | 179,917 |

2.3 Variables and descriptive statistics

Our data include characteristics of the home and its flood risk, which we use as control variables in our analysis. We define these variables in Table 2. Each of these is used by the NFIP in premium rating except for the home’s age.

We compare households who overinsure to those who partially insure and fully insure in Table 3. These statistics suggest that overinsuring and fully insuring households are similar. They are comparable in terms of home age, replacement cost, elevation, deductible choice, and contents coverage. Overinsuring and fully insuring households are also similar regarding whether their homes were built before federal flood maps were developed (pre-FIRM) and actions taken by their community to reduce flood risk (CRS score). Pre-FIRM homes tend to have higher expected flood damage as they were built before building codes to reduce flood risk were in force. Partially insuring households tend to differ as they have lower valued, older homes that are at greater risk (lower elevation, lower CRS score, more frequently pre-FIRM). Households who partially insure have higher median premiums (though their average is lower) than those who fully insure despite having higher deductibles and insuring their contents less often.⁷

Figure 2 shows the distribution of overinsuring rates across the 48 insurers in the baseline data. Ten percent of insurers have overinsuring rates below 2%; half have rates below 10%; and at the 90th percentile, 10 percent have overinsuring rates above 17%. The mean overinsuring rate across

⁷ Collier et al. (2017) examine the decision to partially insure in the flood insurance program using data from 2003 to 2009. They provide a similar table (their Table 4) and reach similar conclusions regarding differences between partially, fully, and overinsuring households.

Table 2: Home Characteristics

| Variable | Description |
|-----------------------|--|
| Basement | Describes the characteristics of the home’s basement or crawlspace. It takes 5 values: none, finished basement, unfinished basement, crawlspace, and subgrade crawlspace. |
| CRS Score | The community’s score on the Community Rating System (CRS). The CRS is a voluntary program that rewards communities for taking actions to mitigate flood risk beyond minimum NFIP requirements. Community actions reduce policyholder premiums by up to 45%. CRS score is the associated premium reduction, ranging from 0 (no mitigation) to 45 (maximum mitigation). |
| Elevation | An estimate of the elevation (in feet) of a policyholder’s home relative to the 100-year floodplain. Elevation data are available on 56% of baseline policies. |
| Elevation Certificate | Home elevation is sometimes estimated by communities; however, homeowners can also contract an engineer or surveyor to evaluate their homes. This variable can take 12 values depending on who assessed the elevation and when. |
| Flood zone | All households in the baseline survey are in flood Zone A. The A Zone is divided into 38 subcategories based on vulnerability (e.g., A1 to A30), which we include as dummy variables in our models. |
| Floors | Number of floors in the home, taking four possible values: 1, 2, 3 or more, or split-level. |
| Home Age | Age of the home, in years. |
| Mobile | Indicates whether the structure is a manufactured/mobile home. |
| Obstruction | Description for elevated buildings regarding the area and machinery attached to the building below the lowest floor. It takes 13 values, depending on the size of the area, whether it has permanent walls, and the presence/location of machinery (e.g., if it is elevated). We include dummy variables for these in our models. |
| Pre-FIRM | Indicates whether the home was built before federal flood risk maps were developed for its location. |
| Replacement Cost | The cost to replace property with the same kind of material and construction without deduction for depreciation. |

Note: NFIP (2010) provides additional information on these variables. Each of these variables is included as a control in our regression models in Sections 3, 4, and 5.

insurers is 11%. The figure also denotes the 15 largest insurers (by number of flood policies) from the remaining 33 insurers. The top 15 insurers write 91% of policies and generate 90% of total premiums in our baseline data. As the figure shows, the distribution of overinsuring rates for the 15 largest insurers aligns with the distribution for smaller insurers. We include all 48 insurers in our regressions in Sections 3 and 4, but only show the results for the top 15 insurers in the interest of space.

Table 3: Summary Statistics for Households who Partially Insure, Fully Insure, and Overinsure

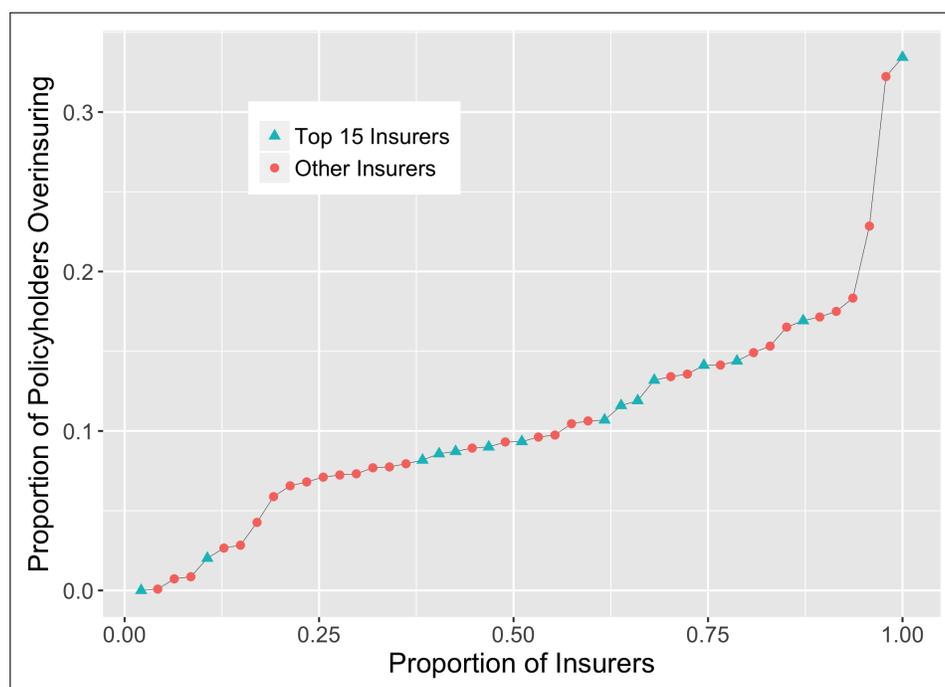
| | | Partially Insure | Fully Insure | Overinsure |
|---------------------------------|--------|------------------|--------------|------------|
| Observations | | 36,791 | 122,085 | 21,041 |
| <i>Home Characteristics</i> | | | | |
| Replacement Cost | Median | 139,000 | 150,000 | 150,000 |
| | Mean | 137,548 | 144,889 | 146,380 |
| | S.D. | 54,921 | 58,457 | 59,930 |
| Home Age | Median | 40.06 | 34.46 | 32.69 |
| | Mean | 41.47 | 33.74 | 33.33 |
| | S.D. | 23.45 | 20.13 | 19.96 |
| CRS Score | Median | 0.00 | 10.00 | 10.00 |
| | Mean | 6.76 | 11.34 | 10.63 |
| | S.D. | 8.76 | 8.99 | 9.10 |
| Elevation | Median | 1.00 | 1.00 | 1.00 |
| | Mean | 1.29 | 1.76 | 1.71 |
| | S.D. | 2.36 | 1.97 | 2.15 |
| Elevation Missing | | 0.70 | 0.37 | 0.35 |
| Pre-FIRM | | 0.72 | 0.56 | 0.53 |
| <i>Contract Characteristics</i> | | | | |
| Premium | Median | 526 | 502 | 556 |
| | Mean | 618 | 658 | 750 |
| | S.D. | 395 | 436 | 520 |
| Deductible = \$1,000 | | 0.62 | 0.71 | 0.70 |
| Deductible = \$2,000 | | 0.16 | 0.16 | 0.15 |
| Deductible = \$5,000 | | 0.21 | 0.12 | 0.14 |
| Has Contents Coverage | | 0.41 | 0.63 | 0.66 |

Note: Table compares characteristics of partial insuring, fully insuring, and overinsuring households in our baseline data. The Community Rating System (CRS) is a voluntary program that rewards communities for taking actions to mitigate flood risk beyond minimum NFIP requirements; larger numbers indicate more actions taken. Pre-FIRM indicates that a home was built before federal flood risk maps were developed for its location.

2.4 The value of overinsuring

In this section, we use ex-post claims data for the policies in our sample to calculate the expected value of overinsurance. We then compare this expected value to the additional premium charged to determine the value of excess coverage. The 179,917 policies in our baseline data ultimately resulted in 1,434 claims—an overall claim rate of 0.79%. All claims occurred between January 2010 and September 2011, as these are annual flood insurance policies originated between January and September 2010. There were 40 claims in which damages exceeded the home’s estimated replacement cost, so there was a 0.02% excess damage claim rate. Among households with claims,

Figure 2: Frequency of Overinsuring by Insurer



Note: Figure shows the distribution of overinsuring rates across the 48 insurers in the baseline data. The figure indicates the 15 largest insurers (by number of flood policies) with a triangle and the remaining 33 insurers with a circle. The top 15 insurers write 91% of policies and generate 90% of total premiums in our baseline data.

2.8% incurred damage that exceeded their home’s replacement cost.⁸

Table 4 shows characteristics of our baseline data, summarizing (1) all policies, (2) policies with claims of any amount, and (3) policies with claims incurring excess damage (i.e., damages that exceed the home’s replacement cost value). Thus, Column 3 is a subset of Column 2, which is a subset of Column 1. Households who experienced excess damage were slightly more likely to have overinsured, 0.15 versus 0.12 for all baseline policies. On average, policyholders who experienced excess damage selected higher coverage limits relative to their replacement costs.

Households with excess damage tend to have much lower replacement costs than other households. The average replacement cost estimate for homes with excess damage is \$49,179, compared to \$143,562 for all baseline policies. Over 93% of baseline policies have a replacement cost greater than \$49,179. Older homes have a higher overall claims probability, and a large portion of these homes were built before flood maps were developed. Homes with excess damage are newer than

⁸ Similar to homeowners insurance, a claims adjuster visits the affected home to assess damages. The adjuster’s assessment of the home’s value and total damages are independent of the contract’s coverage limit and the replacement cost estimated by the insurer.

the average home with a claim but are about as likely to have been built before flood maps were developed. Homes with excess damage are located in communities that have taken fewer actions to reduce flood risk (CRS Score of 1.38 for claims with excess damage versus 10.32 for all policies). Homes with excess damage are more elevated than the average home in the data (2 feet versus 1.7 feet), but we make this observation with some caution since elevation data are often missing for homes with excess damage.

Table 4: Summary Statistics for Policies, Claims, and Claims with Excess Damage

| | | All Policies | All Claims | Excess Damage Claims |
|---------------------------------|--------|--------------|------------|----------------------|
| Observations | | 179,917 | 1,434 | 40 |
| <i>Contract Characteristics</i> | | | | |
| Overinsurance Rate | | 0.12 | 0.11 | 0.15 |
| Cov. Limit / Replacement Cost | Median | 1.00 | 1.00 | 1.00 |
| | Mean | 0.95 | 0.88 | 1.01 |
| | S.D. | 0.23 | 0.29 | 0.23 |
| <i>Home Characteristics</i> | | | | |
| Replacement Cost | Median | 149,000 | 125,500 | 37,500 |
| | Mean | 143,562 | 127,009 | 49,179 |
| | S.D. | 58,010 | 60,366 | 46,074 |
| Home Age | Median | 35.32 | 45.42 | 35.27 |
| | Mean | 35.27 | 46.37 | 35.24 |
| | S.D. | 21.07 | 22.86 | 18.54 |
| CRS Score | Median | 10.00 | 0.00 | 0.00 |
| | Mean | 10.32 | 3.23 | 1.38 |
| | S.D. | 9.14 | 5.80 | 4.53 |
| Elevation | Median | 1.00 | 1.00 | 2.00 |
| | Mean | 1.70 | 0.76 | 2.00 |
| | S.D. | 2.05 | 2.76 | 3.52 |
| Elevation Missing | | 0.44 | 0.80 | 0.85 |
| Pre-FIRM | | 0.59 | 0.84 | 0.80 |

Note: Table compares characteristics of our baseline data, summarizing (1) policies, (2) policies with claims of any amount, and (3) policies with claims incurring damage greater than the home's estimated replacement cost. Thus, Column 3 is a subset of Column 2, which is a subset of Column 1. The Community Rating System (CRS) is a voluntary program that rewards communities for taking actions to mitigate flood risk beyond minimum NFIP requirements; larger numbers indicate more actions taken. Pre-FIRM indicates that a home was built before federal flood risk maps were developed for its location.

The average amount of damage above the home's replacement cost is \$6,782. The sample of excess damage claims is right-skewed with five claims between \$10,000 and \$20,000, three claims between \$20,000 and \$30,000, and a maximum of \$34,660. The median is \$3,416, and seventeen of the 40 excess damage claims were \$3,000 or less. We multiply the mean severity by the frequency

of excess damage to calculate the expected value of damages in excess of a home’s replacement cost:

$$\begin{aligned} E(Loss_{ExcessDamage}) &= \text{mean}(ExcessDamage) \times p(ExcessDamage) \\ &= \$6,871.55 \times 40/179,917 = \$1.53 \end{aligned} \quad (1)$$

where $p(\cdot)$ indicates the likelihood. Thus, a policyholder in our baseline sample has an expected loss from excess damage of \$1.53.⁹

We also calculate the amount that households pay for excess coverage. Our data include the insured home’s characteristics used in the contract premium formula (NFIP, 2010, Chapter 5). This information allows us to price any contract available to the household. We calculate the premiums for excess coverage as the difference between the premium that each overinsuring household paid and what it would have paid had it purchased a coverage limit equal to the home’s replacement cost.¹⁰

We find that overinsuring households pay a mean (median) additional premium of \$71.07 (\$24.00) for limits above replacement cost. Compared to selecting a coverage limit equal to the replacement cost, this additional coverage increases their premiums by a mean (median) of 14% (5%). Thus, the ratio of premiums to expected losses for the average overinsuring household is

$$\begin{aligned} Load &= \text{mean}(Premium_{ExcessCoverage})/E(Loss_{ExcessDamage}) \\ &= \$71.07/\$1.53 = 46.45 \end{aligned}$$

implying a premium loading for this excess coverage of 4,645%.¹¹

Even when buying limits above replacement cost, there is still a possibility that these excess

⁹ Expected loss might additionally be estimated at the policy level by conditioning on the home’s characteristics (e.g., its replacement cost). We are reticent to pursue policy-level estimates in our data; however, because the observations of excess damage are so few.

¹⁰ To assess the accuracy of our calculations, we calculate each household’s paid premiums given their contract choices such as building and contents coverage limits. We then compare our estimated premium to that actually paid by the policyholder. Our premium calculations are within \$1 of actual paid premiums for 92% of households (165,098 observations), and within \$10 for 98% of households. We limit the following analyses to the 165,098 households for which our premium calculations are within \$1.

¹¹ Our sample year of 2010 was a moderate year for floods—its claims were at the median for years 2000-2013. Households (and insurers) may instead be anticipating a year of severe storms when evaluating the price of excess coverage relative to expected loss. Thus, using policy data from 2010 may underestimate expected excess damage.

As a check, we also calculate $E(Loss_{ExcessDamage})$ using policy year 2012, which included losses from Superstorm Sandy. Sandy was the second-costliest recorded storm in the U.S. when it occurred. It also occurred shortly after our 2010 baseline sample, and so methods for determining the replacement cost in 2012 are likely similar to those in our baseline. Due to data availability in 2012, we must first calculate a baseline claim rate $p(Claim)$ and then multiply it by a conditional expectation of $p(ExcessDamage|Claim)$ to calculate the excess damage probability $p(ExcessDamage)$.

limits are insufficient. The average overinsuring household selects a coverage limit that exceeds their replacement cost by \$33,000, but about 20% of overinsuring households select an amount of excess coverage that is less than the \$6,872 average excess damage that we observe. Also, of the 40 claims with excess damage, only six households had purchased excess coverage. Of those six, three still experienced damages greater than their selected coverage limit.

In summary, we find that flood damage can exceed the home’s estimated replacement cost; however, managing this risk by overinsuring appears to be an expensive way to address it relative to the risk. The private insurance industry has developed ways to manage the risk of excess damage in other property insurance settings (e.g., an endorsement that guarantees the property’s replacement cost), but these methods are not currently employed in the NFIP.

3 Insurer effects

3.1 Methodology

In this section, we examine whether the insurer selling the policy significantly affects the likelihood that a household overinsures. The empirical test for these insurer effects is a regression model of whether household i overinsures $I(Over_i)$, as a function of insurer j fixed effects β_j and various policy-level controls \mathbf{X}_i . Our regression model for these primary results is the linear

We can then calculate the $E(Loss_{ExcessDamage})$ as follows:

$$\begin{aligned}
 E(Loss_{ExcessDamage}) &= p(Claim) \times p(ExcessDamage|Claim) \times mean(ExcessDamage) \\
 &= \frac{\# claims_p}{\# policies} \times \frac{\# excess claims}{\# claims_c} \times \frac{\sum \$ excess claims}{\# excess claims} \\
 &= \frac{8,266}{221,369} \times \frac{118}{3,467} \times \frac{\$1,690,886}{118} \\
 &= \$18.21
 \end{aligned}$$

The first term above is calculated using the 2012 flood *policy* dataset, which is missing several of the filtering variables outlined in Table 1. Namely, we cannot exclude repetitive loss properties or replacement costs above \$250,000 from this term. This constraint inflates the baseline claim rate compared to using the 2010 sample, because it includes repetitive loss properties. The second and third terms, however, are calculated from the 2012 flood *claims* dataset, which does allow us to filter by repetitive loss properties and replacement cost (hence the lower claim count for $claims_c$, from the claims data, than for $claims_p$, from the policy data). Neither dataset in 2012 allows us to exclude insurers issuing fewer than 100 policies.

Evaluating 2010 premiums relative the large expected excess damage calculated with 2012 claims, we find the implied premium load for excess coverage is 390% for the baseline sample ($\$71.07 \div \$18.21 = 3.90$). Thus, loads on overinsuring appear quite high even when using data exclusively from one of the costliest years in the program.

probability model:

$$\begin{aligned}
I(Over_i) &= \alpha + \beta_j + \mathbf{X}'_i \gamma + \varepsilon_i & (2) \\
I(Over_i) &= \alpha + \beta_j + \gamma_1 D(Basement_i) + \gamma_2 D(CRSscore_i) + \gamma_3 D(Elevation_i) \\
&+ \gamma_4 I(ElevationCertificate_i) + \gamma_5 D(FloodZone_i) + \gamma_6 D(Floors_i) + \gamma_7 HomeAge_i \\
&+ \gamma_8 I(HomeAge_i = Missing) + \gamma_9 I(Mobile_i) + \gamma_{10} D(Obstruction_i) \\
&+ \gamma_{11} I(PreFIRM_i) + \gamma_{12} ReplacementCost_i + \delta_k + \lambda_t + \varepsilon_i
\end{aligned}$$

where δ_k are location fixed effects (state or ZIP code) and λ_t are month fixed effects.¹²

In Equation (2), $I(\cdot)$ denotes an indicator variable and $D(\cdot)$ denotes a dummy set, which is a group of indicators representing discrete values of a variable. For example, $D(Floors_i)$ includes indicators for homes with one floor $I(Floors_i = 1)$, those with two floors $I(Floors_i = 2)$, etc. Table 2 describes each control variable. The home's age is missing for 0.3% of policies; in these cases, we record $HomeAge_i = 0$ and the indicator $I(HomeAge_i = Missing) = 1$. Home elevation is measured to the nearest foot relative to the 100-year flood plain. The dummy set includes an indicator variable for each foot (e.g., $I(Elevation_i = 1)$). It is bottom-coded at -5 such that all values below this are recorded as -5 and similarly top-coded at 10. It also includes an indicator if the home's elevation is unavailable. In the regression models in Table 5, we begin with the insurer fixed effects alone. In the subsequent regressions we add month and location fixed effects and "Controls" where $Controls = \{Basement, CRSscore, Elevation, ElevationCertificate, HomeAge, Mobile, Obstruction, PreFIRM\}$. In the final regression, we also add replacement cost.

Estimates of $\hat{\beta}_j$ depend on which insurer is excluded from the dummy set in Equation (2) (i.e., which insurer is the reference group). To adjust for this, we transform the estimated insurer fixed

¹² Modeling overinsuring with a linear probability model offers advantages over estimation using logit, probit, or similar strategies. First, our regressions include a large number of explanatory variables, and linear probability models are more robust in this setting, as methods that rely on maximum likelihood estimation may fail to find the globally-maximizing parameter values. Second, the insurer effects are straightforward to interpret in linear probability models.

effects by subtracting the estimate from the average effect across insurers¹³

$$\hat{\beta}_{norm,j} = \begin{cases} \hat{\beta}_j - \frac{1}{M} \sum_{m=2}^M \hat{\beta}_m & \text{for } j = 2, \dots, M \\ -\frac{1}{M} \sum_{m=2}^M \hat{\beta}_m & \text{for } j = 1 \end{cases} \quad (3)$$

where $j = 1$ denotes the omitted insurer

Our regression results in Table 5 report these transformed coefficients. The interpretation of these coefficients is now slightly different—each $\hat{\beta}$ is now in reference to the average insurer effect rather than to the omitted insurer. Thus, a coefficient of 0.1 for Insurer J would indicate that its policyholders are 10 percentage points more likely to overinsure than the policyholders of the average insurer in the data.

3.2 Results

We provide our estimation results in Table 5. These models examine insurer effects on the likelihood that a household overinsures. We have randomized the order of insurers (e.g., Insurer 1 is not necessarily the largest insurer). The models include insurer fixed effects for all 48 insurers in the baseline data, but we only report the results for the 15 insurers originating the most policies in the baseline data in the interest of space. The effects for the remaining 33 insurers are qualitatively similar to those of the top 15 and discussed in detail below (Figure 3).

Column 1 only includes insurer fixed effects. Column 2 includes insurer fixed effects, state fixed effects, month fixed effects and characteristics of the home as control variables. Column 3 replaces the state fixed effects in Column 2 with ZIP code fixed effects. Thus, in this model we compare insurer effects within a ZIP code, controlling for seasonal effects and features of the home that may affect its flood risk. Column 4 includes the same variables as Column 3, but adds replacement cost as an explanatory variable. Column 4 is our preferred model, but coefficient estimates do not appear to differ greatly between Columns 2, 3, and 4.

We prefer to include replacement cost as a control because insurers may pursue different income-based target markets within a ZIP code, which could influence our estimates of insurer effects. For example, suppose that higher income households tend to overinsure and Insurer 1

¹³ Lacetera et al. (2016) use this transformation in their analysis of auctioneer effects. We also adjust each estimate's standard errors to correspond with the transformed $\hat{\beta}$ coefficients.

specializes in higher income households relative to the average insurer. We might erroneously attribute higher overinsuring rates for Insurer 1 to the insurer's influence on policy choices when, in fact, they are due to customer differences. Our ZIP code fixed effects likely control for a substantial amount of the variation in income and wealth across households; replacement cost is likely the best variable in our data to proxy variations in household income and wealth *within* a ZIP code.

The results show that the insurer selling the policy significantly affects the likelihood that a household overinsures. We discuss the results from Column 4. The coefficients show the percentage point change in the likelihood of overinsuring if a household buys a policy from Insurer J relative to the average insurer in the baseline data. For example, suppose that a household decides to purchase flood insurance from Insurer 4. This household is 4.9 percentage points less likely to overinsure than if it bought a policy from the average insurer in the data. Instead, if the household purchases a policy from Insurer 2, it is 20 percentage points more likely to overinsure than purchasing from the average insurer and nearly 25 percentage points more likely to overinsure than if it used Insurer 4.

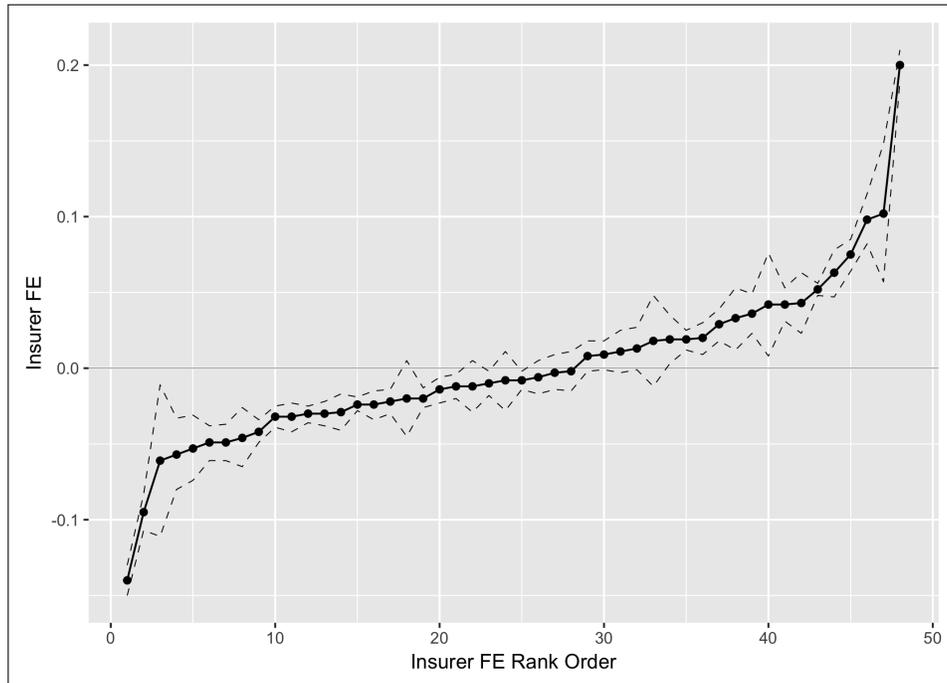
Figure 3 illustrates the results showing the insurer fixed effect coefficients for all 48 insurers using the coefficients from Column 4. We rank the insurers from lowest to highest coefficient and plot the 95% confidence intervals as dotted lines. Zero on the vertical axis represents the average insurer effect. Of the 48 insurers, 37 insurers have fixed effects that significantly differ from from zero: 11 are positive and 26 are negative. Compared to the policyholders of the average insurer, the policyholders of the top five insurers, those with the largest fixed effects, are at least 5 percentage points more likely to overinsure while those of the bottom five insurers are at least 5 percentage points less likely to overinsure.

Table 5: Insurer Effects on the Likelihood That a Household Overinsures, 15 Largest Insurers

| | (1) | (2) | (3) | (4) |
|------------------|----------------------|----------------------|----------------------|----------------------|
| Insurer 1 | -0.001 (0.004) | -0.018*** (0.003) | -0.020*** (0.004) | -0.020*** (0.003) |
| Insurer 2 | 0.226*** (0.010) | 0.198*** (0.003) | 0.193*** (0.005) | 0.200*** (0.005) |
| Insurer 3 | -0.015*** (0.004) | -0.020*** (0.004) | -0.012*** (0.004) | -0.012*** (0.004) |
| Insurer 4 | -0.088*** (0.003) | -0.056*** (0.005) | -0.049*** (0.006) | -0.049*** (0.006) |
| Insurer 5 | 0.008** (0.003) | -0.012*** (0.003) | -0.008** (0.003) | -0.008*** (0.003) |
| Insurer 6 | 0.061*** (0.004) | 0.053*** (0.001) | 0.052*** (0.002) | 0.052*** (0.002) |
| Insurer 7 | -0.021*** (0.007) | -0.033*** (0.002) | -0.029*** (0.004) | -0.030*** (0.004) |
| Insurer 8 | 0.011*** (0.002) | -0.018*** (0.005) | -0.023*** (0.005) | -0.024*** (0.005) |
| Insurer 9 | 0.033*** (0.005) | 0.014*** (0.003) | 0.021*** (0.003) | 0.019*** (0.003) |
| Insurer 10 | 0.036*** (0.006) | 0.013*** (0.005) | 0.018*** (0.005) | 0.020*** (0.005) |
| Insurer 11 | -0.018*** (0.006) | -0.015*** (0.003) | -0.009** (0.004) | -0.010** (0.004) |
| Insurer 12 | -0.022*** (0.005) | -0.026*** (0.002) | -0.022*** (0.003) | -0.024*** (0.002) |
| Insurer 13 | 0.024*** (0.007) | -0.003 (0.005) | -0.006 (0.006) | -0.006 (0.006) |
| Insurer 14 | -0.108*** (0.002) | -0.139*** (0.006) | -0.142*** (0.005) | -0.140*** (0.005) |
| Insurer 15 | -0.026*** (0.005) | -0.029*** (0.002) | -0.032*** (0.003) | -0.030*** (0.003) |
| Replacement Cost | No | No | No | Yes |
| Controls | No | Yes | Yes | Yes |
| Month FE | No | Yes | Yes | Yes |
| Location FE | No | State | ZIP | ZIP |
| Clustered SE | No | Insurer | Insurer | Insurer |
| N | 179,917 | 179,917 | 179,917 | 179,917 |
| R-Sq | 0.017 | 0.034 | 0.109 | 0.112 |

Note: Dependent variable is whether a household overinsures (selects a coverage limit greater than the home's replacement cost). Regressions are linear probability models, follow Equation (2), and include insurer fixed effects for all 48 insurers in the baseline data. We normalize fixed effects following Equation (3). Table reports the results for the 15 insurers originating the most policies in the data in the interest of space. Column 1 only includes insurer fixed effects. Column 2 includes insurer fixed effects, state fixed effects, month fixed effects and characteristics of the home as control variables. Column 3 includes insurer fixed effects, ZIP code fixed effects, month fixed effects, and home characteristics. Column 4 includes the same variables as Column 3, but adds replacement cost as an explanatory variable. Column 1 reports Huber-White robust standard errors; Columns 2 to 4 report robust standard errors clustered by insurer. Stars *, **, and *** denote statistical significance at the 0.10, 0.05, and 0.01 levels, respectively.

Figure 3: Plot of insurer fixed effect estimates



Note: The rank of the fixed effect estimate is plotted on the x-axis, ranked from smallest to largest. The fixed effect estimate is plotted on the y-axis where zero equals the average insurer effect. Dotted lines represent a 95% confidence interval around the normalized estimate.

4 Insurers' specific guidance for overinsuring

In this section, we examine insurer effects on the exact excess limit selected. Given that a household chooses to overinsure, what coverage limit should it choose? If consumers choose a limit based on their own preferences and beliefs, the selected excess coverage limits should be random across insurers (after controlling for policyholder characteristics, location, etc.). Since insurers influence whether households overinsure (Section 3), they might also make specific limit recommendations to households.

Examining the distributions of absolute and relative excess limits, we identify three possible “rules” insurers might use to recommend limits. Figure 4 illustrates each. The most common rule is to purchase the program maximum of \$250,000, which describes 29% of overinsuring households. This rule is the most costly; overinsuring households adopting this “choose \$250K” rule pay an average additional premium of \$100 for excess coverage. The large spike in Panel A of Figure 4 shows the prevalence of the \$250,000 limit among households who overinsure and that some overinsuring households choose limits of \$200,000 and \$150,000. Panel B of Figure 4 shows

the replacement costs of overinsuring households with \$250,000 coverage limits. Half of these households have replacement costs of \$200,000 or less; one in five is buying at least \$100,000 of excess coverage. The second most common potential rule is to purchase 110% of the replacement cost, which describes 18% of overinsuring households (Panel C). Households adopting this “increase 10% rule” spend \$27 on average on excess coverage. The third most common potential rule is to purchase a coverage limit that equals the nearest \$10,000 increment above the replacement cost. For example, a household with a \$200,000 replacement cost and one with a \$201,000 would each select a coverage limit of \$210,000 using this rule. This rule explains the behavior of 8% of overinsuring households. Panel D shows that while rounding up by \$10,000 is the most common version of this “round up” rule, households also commonly round up by \$20,000, \$30,000, or \$40,000. Households adopting the “round up \$10K” spend \$13 on average on excess coverage. In total, the “choose \$250K,” “increase 10%,” and “round up \$10K” rules explain 50% of coverage limits of overinsuring households.¹⁴

We show the prevalence of each excess coverage rule for the top 15 insurers in the baseline data in Table 6. These insurers are numbered in the same order as our main results in Table 5 (e.g., Insurer 1 represents the same insurer in both tables). The table suggests that some insurers are especially likely to adopt certain rules. For example, 41% of overinsuring policyholders of Insurer 2 select the maximum allowable coverage limit of \$250,000, while nearly half of the overinsuring policyholders of Insurer 13 purchase a coverage limit of 110% of their replacement cost.

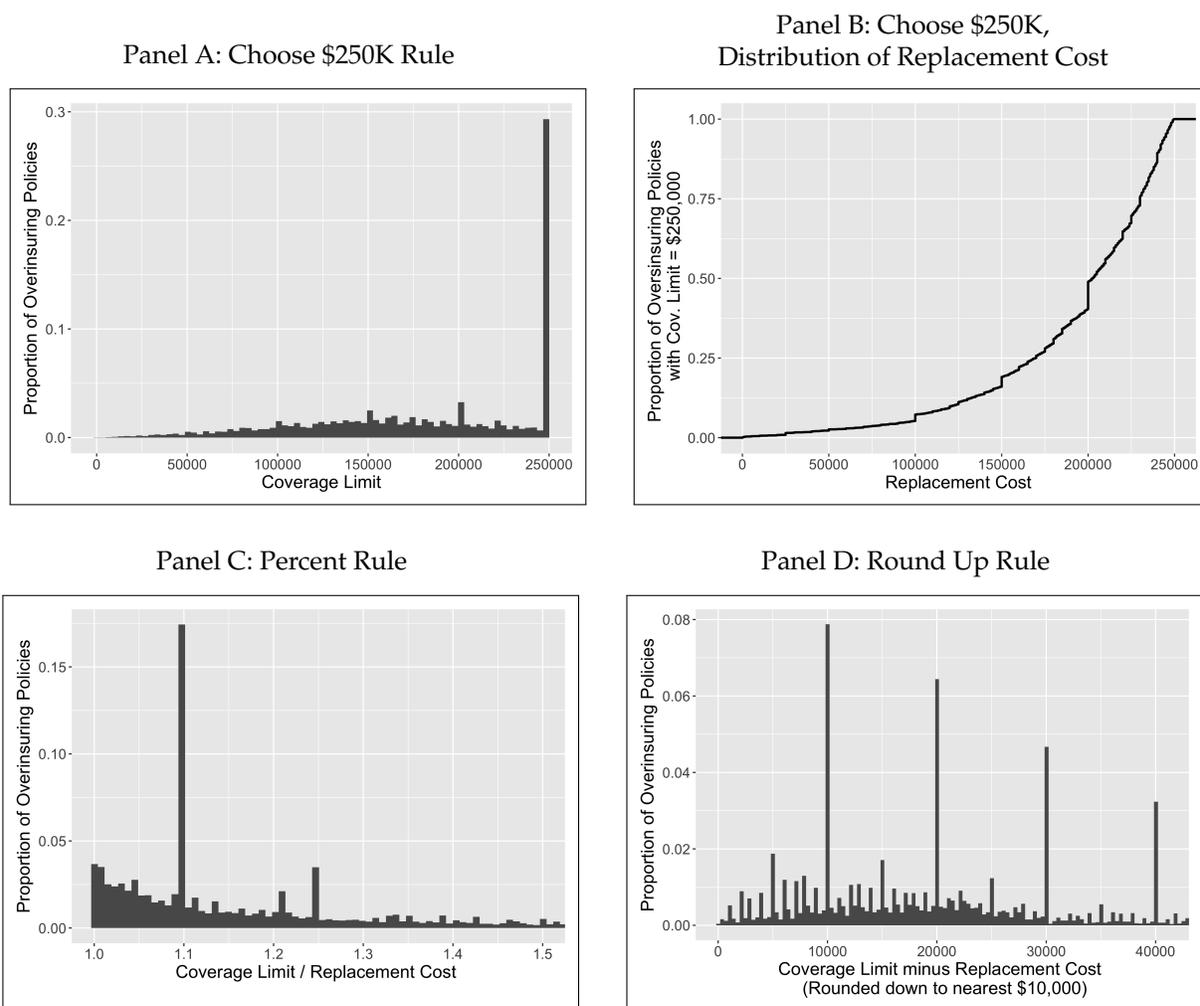
The observed differences in Table 6 might be due to unobserved differences in policyholders and local markets, so as we do in Section 3.2, we control for these factors in our regression analysis. Our dependent variable is an indicator for whether policy i 's limit is consistent with the rule, and we follow the methodology outlined in Section 3.1 and Equation (2). These regressions use our preferred model (shown in Column 4 of Table 5) and so include controls for a home's replacement cost, other characteristics of the home, ZIP fixed effects, and month fixed effects. We transform the insurer effect coefficients in each regression using Equation (3) so that each uses the average

¹⁴ The “increase 10% rule” is a specific example of selecting some percentage point increase in the replacement cost. Excluding households who select the \$250,000 maximum, 32% of remaining overinsuring households have a coverage limit that is some 5 percentage point increment (i.e., 105%, 110%, 115%, etc.) of their replacement cost (“percent rule”).

The “round up \$10K” rule is a specific example of purchasing some round value (e.g., \$5,000) above the replacement cost (“round up rule”). Excluding households who select the “choose \$250K” or “percent rule”, 28% of remaining overinsuring households have a coverage limit that is rounded to some \$5,000 increment above the replacement cost.

Some coverage limits could be explained by more than one rule, which is why the combination of the rules sum up to less than their parts, describing 50% of excess coverage limits rather than 55% ($29\% + 18\% + 8\% = 55\%$). For example, either the “increase 10%” or the “round up \$10K” rules could lead an agent to recommend a household with a \$100,000 replacement cost purchase a \$110,000 coverage limit. Thus, this coverage limit would be coded for both rules; our regressions below identify which possible rule(s) each insurer uses. The “choose \$250K” and broader “percent” and “round up” rules (beyond our selected 10% and \$10,000 values) explains 66% of coverage limits for overinsuring households.

Figure 4: Coverage Limit Rules for Overinsuring Households



Note: Panel A is a histogram showing the coverage limits selected by overinsuring households. Panel B is the cumulative distribution of replacement costs for households who overinsure by selecting a \$250,000 coverage limit. Panel C is a histogram showing the ratio of coverage limits to replacement cost for households who overinsure. Panel D is a histogram illustrating the "round up" rule for overinsuring households. The horizontal axis shows the selected coverage limit minus the home's replacement cost, rounded down to the nearest \$10,000 increment (e.g., a home a \$201,000 replacement cost one with a \$200,000 would each treated as \$200,000). Thus, the highest peak in the histogram at \$10,000 shows that households adopting this rule most often select a coverage limit by rounding their replacement cost to the next increment of \$10,000.

insurer as the reference group. While the incidence rates for the rules in Columns 3 to 5 of Table 6 only include overinsuring households, our regressions include the entire baseline sample.

We provide the regression results in Table 7. All 48 insurers in the baseline data are included in the regression, though we only report the top 15 insurers. The ordering of insurers corresponds to the previous results (i.e., Insurer 1 represents the same insurer here and in Tables 5 and 6).

Table 6: Prevalence of Most Common Overinsuring Rules, 15 Largest Insurers.

| | Over Rate | Overinsuring Households | | |
|----------------|-----------|-------------------------|--------------|----------------|
| | | Choose \$250K | Increase 10% | Round up \$10K |
| Insurer 1 | 0.11 | 0.22 | 0.03 | 0.08 |
| Insurer 2 | 0.33 | 0.41 | 0.04 | 0.09 |
| Insurer 3 | 0.09 | 0.25 | 0.04 | 0.07 |
| Insurer 4 | 0.02 | 0.11 | 0.15 | 0.04 |
| Insurer 5 | 0.12 | 0.21 | 0.05 | 0.09 |
| Insurer 6 | 0.17 | 0.20 | 0.02 | 0.13 |
| Insurer 7 | 0.09 | 0.30 | 0.07 | 0.14 |
| Insurer 8 | 0.12 | 0.33 | 0.28 | 0.06 |
| Insurer 9 | 0.14 | 0.26 | 0.21 | 0.07 |
| Insurer 10 | 0.14 | 0.35 | 0.03 | 0.10 |
| Insurer 11 | 0.09 | 0.15 | 0.02 | 0.14 |
| Insurer 12 | 0.09 | 0.26 | 0.27 | 0.09 |
| Insurer 13 | 0.13 | 0.14 | 0.48 | 0.06 |
| Insurer 14 | 0.00 | 0.00 | 0.00 | 0.00 |
| Insurer 15 | 0.08 | 0.21 | 0.04 | 0.11 |
| Total Baseline | 0.12 | 0.29 | 0.18 | 0.08 |

Note: The column “Over Rate” shows the percent of policyholders overinsuring for each insurer. Columns 3-5 show the proportion of overinsured policies using the given rule. “Choose \$250K” indicates that overinsuring households select the program maximum of \$250,000, “Increase 10%” indicates selecting a coverage limit that is 110% of the replacement cost, and “Round up \$10K” indicates selecting a coverage limit by rounding up to the next \$10,000 above the replacement cost (e.g., a household with a \$200,000 and one with a \$201,000 would each select a coverage limit of \$210,000).

As with the previous results on insurer effects (Section 3.2), we find that a household’s insurer significantly affects the likelihood that it adopts a specific level of excess coverage. For example, the policyholders of Insurer 2 are 9 percentage points more likely to choose the program maximum of \$250,000 than the policyholders of the average insurer in the data. Also, the policyholders of Insurer 13 are significantly more likely than average to purchase 110% of their replacement cost (Column 2), but are significantly less likely to use one of the other rules relative to the average insurer’s policyholders.

This analysis provides further evidence that rather than consumers, insurers’ institutional policies are directing these limit choices. It also highlights the arbitrary nature of these rules—our analysis of the claims data shows that there is no more reason to choose a limit 10% higher than replacement cost than to round up to the nearest \$10,000 increment.

Table 7: Insurer Effects on Rules for Overinsuring, 15 Largest Insurers

| | (1) I(Choose \$250K) | (2) I(Increase 10%) | (3) I(Round up \$10K) |
|------------------|-------------------------|------------------------|--------------------------|
| Insurer 1 | -0.003 (0.003) | -0.007*** (0.001) | -0.003*** (0.001) |
| Insurer 2 | 0.090*** (0.003) | 0.000 (0.001) | 0.015*** (0.001) |
| Insurer 3 | -0.004** (0.002) | -0.004*** (0.001) | -0.003*** (0.001) |
| Insurer 4 | -0.007** (0.003) | -0.001 (0.002) | -0.005*** (0.001) |
| Insurer 5 | -0.009** (0.003) | -0.003** (0.001) | -0.001 (0.001) |
| Insurer 6 | 0.003* (0.002) | -0.008*** (0.001) | 0.010*** (0.000) |
| Insurer 7 | 0.000 (0.002) | -0.005*** (0.001) | -0.000 (0.001) |
| Insurer 8 | -0.003** (0.001) | 0.017*** (0.002) | -0.006*** (0.001) |
| Insurer 9 | 0.002 (0.002) | 0.022*** (0.002) | -0.000 (0.001) |
| Insurer 10 | 0.014*** (0.003) | -0.006*** (0.002) | 0.003*** (0.001) |
| Insurer 11 | -0.007*** (0.002) | -0.011*** (0.003) | 0.003** (0.001) |
| Insurer 12 | -0.007*** (0.002) | 0.016*** (0.001) | -0.002** (0.001) |
| Insurer 13 | -0.024*** (0.002) | 0.049*** (0.002) | -0.006*** (0.001) |
| Insurer 14 | -0.049*** (0.002) | -0.015*** (0.003) | -0.014*** (0.001) |
| Insurer 15 | -0.015*** (0.001) | -0.004** (0.002) | -0.004*** (0.001) |
| Replacement Cost | Yes | Yes | Yes |
| Controls | Yes | Yes | Yes |
| Month FE | Yes | Yes | Yes |
| Location FE | ZIP | ZIP | ZIP |
| Clustered SE | Insurer | Insurer | Insurer |
| N | 179,917 | 167,808 | 179,917 |
| R-Sq | 0.126 | 0.061 | 0.077 |

Note: Dependent variables reported in column headers. “Choose \$250K” indicates selecting the program maximum of \$250,000, “Increase 10%” indicates selecting a coverage limit that is 110% of the replacement cost, and “Round up \$10K” indicates selecting a coverage limit by rounding up to the next \$10,000 above the replacement cost (e.g., a household with a \$200,000 and one with a \$201,000 would each select a coverage limit of \$210,000). Models follow Equation (2), with the coefficients adjusted as in Equation (3) and include insurer fixed effects for all 48 insurers in the baseline data. Tables report the results for the 15 insurers originating the most policies in the data in the interest of space. In Column 2, we limit observations to households who can feasibly implement the “increase 10%” rule given the program maximum limit of \$250,00—all households in that regression have replacement costs that do not exceed \$227,000 (as $110\% \times \$227,000 = \$249,700$). Standard errors are robust and clustered at the insurer level. Stars *, **, and *** denote statistical significance at the 0.10, 0.05, and 0.01 levels, respectively.

5 Are insurer effects explained by household selection?

Our identification strategy assumes that households are comparable across insurers, after controlling for features of the policyholder (e.g., location, age of the home). However, suppose that households' risk preferences affect both their choice of insurer and their decision to overinsure. Because we do not account for risk preferences, we might incorrectly attribute their decision to overinsure to their insurer. In this context, a household might choose a homeowners or auto insurer based on its risk-based characteristics (e.g., its credit score, capital reserves), and also purchase its federal flood insurance through this insurer because of economies of scope. In this section, we discuss two points which lead us to conclude that this household selection argument is an unlikely explanation for the large insurer effects that we observe.

First, our results in Section 4 indicate that the specific coverage limit that overinsuring households select varies by insurer. No standard model of decision making would predict that policyholders with a certain set of risk preferences would select into Insurer 9 and would also tend to choose a limit 10% above their replacement cost, while policyholders selecting Insurer 10 would prefer to round up by \$10,000.

Second, as an additional analysis we examine markets where households may be unable to choose the insurer originating their flood contract. About 3% of policies ($n = 5,207$) in our baseline sample are in a ZIP code in which a single insurer originated all the policies. We re-estimate our regression of the likelihood that a household overinsures using this restricted sample. Insurer effects should disappear if they are the result of a households' choice of insurer since households in this sample may have limited choice of insurer; however, persistent insurer effects in the restricted sample would add to evidence that insurers are guiding overinsuring.

We find that the insurer effects persist in our regressions using the restricted sample. Typically, the coefficients in the restricted sample are consistent in significance and sign and of similar magnitude to those in the baseline sample. The detailed regression results are in Online Appendix B. In sum, households' preferences may influence their choice of insurer, but do not seem to explain the large insurer effects in our data.

6 Mechanisms driving heterogeneity

Thus far, we have shown that insurers influence whether households overinsure (Section 3) and that they appear to provide specific guidance for the excess coverage that they select (Section 4).

Here, we examine insurers' characteristics to explain the variation in overinsuring rates across insurers. We propose four broad mechanisms by which insurers may incentivize agents to increase the likelihood that their policyholders overinsure. We evaluate the relationship between each mechanism and the insurer's rate of overinsuring in a given state (for state k , the proportion of insurer j 's flood policies that are overinsured).

Managerial control: Insurers selling via "direct" agents (who represent a single insurer) often have more managerial control over their agents than those selling via "independent" agents (who may represent multiple insurers).¹⁵ This control may take various forms, including setting sales goals and training or educating agents (Hilliard et al., 2013). Insurers using direct agents may thus induce their agents, who are their employees, to sell excess flood coverage without needing other incentives. We include an indicator variable for insurer j primarily selling via direct agents, $DirectInd_j$.

Financial incentives: Insurers may motivate their agents to recommend excess coverage by paying higher commission rates. We define commission rates as commissions and brokerage expenses divided by direct premiums written for insurer j in state k . We calculate commission rates for federal flood ($FloodCommRate_{jk}$) and non-flood personal lines ($OthCommRate_{jk}$, which includes auto and homeowners insurance). Direct agents generally receive lower commissions than independent agents (Regan and Tennyson, 2000), so we interact commission rates with $DirectInd_j$.

Market power: The largest insurers in a particular market may use their influence to sell excess coverage limits. We define market power for a particular line of business as the proportion of state k 's total direct premiums written by insurer j . We calculate market share for federal flood ($FloodMktShare_{jk}$) and for non-flood personal lines (auto and homeowners, $OthMktShare_{jk}$) in our analysis.

Competition: Competitive markets may offer fewer opportunities for an insurer or agent to recommend excess limits, as competitors may warn consumers against excess coverage to earn their business (Bolton et al., 2007, makes a similar proposal regarding biased financial advice). Thus, we expect more competitive markets to have lower rates of overinsuring. We measure competition by the number of insurers selling federal flood insurance in state k , $NumFloodInsurers_k$.

¹⁵ Insurers use two general distribution systems to sell their policies, direct writing and independent agency. Direct writers are insurers whose agents are permitted to sell for a single insurance company. These agents include exclusive (or captive) agents, direct sales via phone or internet, managing general agents, or career agents. Independent agents represent multiple insurance companies. These include (non-exclusive) agents, brokers, and general agents. Insurers may use multiple systems to sell their policies, but report their "primary" system to A.M. Best (2010) during the rating process, which is the information that we use in our analysis. Hilliard et al. (2013) provide a detailed account of the similarities and differences between these distribution systems.

Our insurer data are from the National Association of Insurance Commissioners (NAIC) financial statement state pages (Statutory Page 14), except for $DirectInd_j$ (which is from A.M. Best (2010)) and $NumFloodInsurers_k$ (which is from the flood insurance data). In addition to the above descriptions of each variable of interest, we provide more detailed definitions in Online Appendix A. All 50 U.S. states are included in this section of our analysis, but we exclude territories due to data availability. We also exclude eleven observations where the insurer reported flood commissions greater than 30% of flood premiums written, as that is outside of the maximum allowance paid by the NFIP (Michel-Kerjan, 2010a). This is likely due to small samples, as ten of these excluded observations report fewer than fifteen policies sold in 2010. Our full sample in this section represents 35 insurers issuing 167,177 policies, 92.9% of the baseline sample (Section 2.2). Our empirical model is

$$\begin{aligned}
OverRate_{jk} = & \alpha + \beta_1 Direct_j \\
& + \beta_2(Direct_j \times FloodCommRate_{jk}) + \beta_3(Direct_j \times OthCommRate_{jk}) \\
& + \beta_4(Indep_j \times FloodCommRate_{jk}) + \beta_5(Indep_j \times OthCommRate_{jk}) \quad (4) \\
& + \beta_6 FloodMktShare_{jk} + \beta_7 OthMktShare_{jk} + \beta_8 NumFloodInsurers_k \\
& + \mathbf{X}'_{jk}\gamma + \varepsilon_{jk}.
\end{aligned}$$

The controls (\mathbf{X}'_{jk}) include nine variables. Flood-specific variables include insurer j 's premiums written for federal flood in state k as a share of total premiums and the natural log of the mean estimated replacement cost for insurer j 's flood insurance policyholders in state k . We also include a dummy variable for insurers who report positive direct premiums written for flood insurance but no flood commissions.¹⁶ Paying zero flood commissions may have a substantially different implication than paying very small flood commissions (e.g. the insurer may increase other commission rates when flood insurance is also sold). Controls which are not specific to flood insurance include logged total assets, logged firm age, and dummies for A.M. Best financial strength rating. We also include dummy variables for publicly-traded insurers, insurers organized as mutuals, and insurers who report zero direct premiums written for any homeowners or auto insurance.

We specify one model with no fixed effects and another with state fixed effects. The model without fixed effects allows us to include a comparison of market conditions across states, while the fixed effects model compares insurers within a state (though by construction, must omit the number of flood insurers in a state, since it does not vary across insurers). In all models, con-

¹⁶ Approximately 7.8% of our insurer-state observations report zero commissions for flood insurance. Three insurers comprise 62 of the 67 observations with zero flood commissions, and those three insurers report positive commissions for auto and homeowners insurance. Thus, we do not believe this to be a data error.

Table 8: Summary stats for insurer characteristics

| | Mean | Median | Min | Max | SD | N |
|--------------------------------|--------|--------|--------|--------|-------|-----|
| <i>Variables of interest</i> | | | | | | |
| Overinsurance rate | 0.106 | 0.067 | 0.000 | 1.000 | 0.147 | 857 |
| Direct | 0.447 | 0.000 | 0.000 | 1.000 | 0.497 | 857 |
| Commission rate - flood | 0.141 | 0.150 | 0.000 | 0.281 | 0.079 | 383 |
| Commission rate - home/auto | 0.115 | 0.109 | 0.000 | 0.329 | 0.077 | 383 |
| Independent | 0.553 | 1.000 | 0.000 | 1.000 | 0.497 | 857 |
| Commission rate - flood | 0.169 | 0.177 | 0.000 | 0.283 | 0.075 | 474 |
| Commission rate - home/auto | 0.139 | 0.159 | 0.000 | 0.462 | 0.087 | 474 |
| Market share - flood | 0.052 | 0.031 | 0.000 | 0.467 | 0.060 | 857 |
| Market share - home/auto | 0.032 | 0.008 | 0.000 | 0.317 | 0.055 | 857 |
| Number of flood insurers | 18.110 | 18.000 | 10.000 | 28.000 | 3.636 | 857 |
| <i>Controls</i> | | | | | | |
| Flood ins share of total prems | 0.197 | 0.039 | 0.000 | 1.000 | 0.318 | 857 |
| Mean replacement cost (\$100K) | 1.351 | 1.378 | 0.100 | 2.454 | 0.327 | 857 |
| Public | 0.600 | 1.000 | 0.000 | 1.000 | 0.490 | 857 |
| Mutual | 0.307 | 0.000 | 0.000 | 1.000 | 0.461 | 857 |
| Rating | 5.189 | 5.000 | 0.000 | 6.000 | 0.816 | 857 |
| No flood commissions reported | 0.078 | 0.000 | 0.000 | 1.000 | 0.269 | 857 |
| No home/auto prems | 0.089 | 0.000 | 0.000 | 1.000 | 0.284 | 857 |
| Firm total assets (\$B) | 72.0 | 16.6 | 0.1 | 285.3 | 84.7 | 857 |
| Firm age | 119.6 | 108.0 | 13.0 | 216.0 | 52.0 | 857 |

Note: Summary statistics by insurer-state observation. Commission rates are broken out by Direct and Independent because we interact commission rates with distribution system in the regression. Direct, public, mutual, rating, firm age, and firm total assets are measured at the national level. Rating is scaled from 0 to 6, with 0 being a rating of “Not rated” and 6 being a rating of “A+.” Number of flood insurers takes the same value for all insurers in a state. We report firm age, firm total assets, and mean replacement cost as raw values for summary purposes but include the logged values in our regression.

tinuous variables are mean-centered to address collinearity between flood and non-flood lines of business. We cluster standard errors by insurer.

We report summary statistics for the raw values of all variables in Table 8. Commission rates are lower for direct writing insurers, and direct writers comprise approximately 45% of observations. The mean (median) flood market share is approximately 5.2% (3.1%), which is skewed by certain insurers who capture a very large market share (up to 46.7%).¹⁷ While approximately 9% of the insurers in our sample do not offer homeowners or auto insurance (and thus have 0% market share in non-flood lines), those insurers with a large market share in flood also tend to

¹⁷Notably, this is in a state with only 210 flood policies. Examining only states with at least 500 policies, the maximum flood market share is 32.5% with a mean of 4.8%.

have a large share of the non-flood market (with a Pearson correlation of $\rho = 0.423$). The number of insurers selling federal flood insurance in a state ranges from 10 to 28, and the states with the fewest policies also tend to have fewer insurers competing in the market. Replacement cost is reported as the mean for each insurer-state observation, with an overall mean of \$135,100. Insurers at the extremes of this distribution appear to have small samples—the minimum and maximum of \$10,000 and \$245,400 (respectively) are both insurers who sold only one policy in the state. With our sample restricted only to insurers who sold at least 20 policies (our “restricted sample” as described below), the minimum is \$35,000 and the maximum is \$188,000 (the mean is approximately the same, at \$134,000).

We report the results of our regression analysis in Table 9. We show results for the full sample in Columns 1 and 2, which requires only that insurer j sells at least 100 policies nationwide. Our “restricted sample” in Columns 3 and 4 includes only insurer-state observations with at least 20 flood policies sold (we examined alternative thresholds of 10 and 50 policies for robustness, with similar results). Columns 2 and 4 compare insurers within the same state by adding state fixed effects to the base model reported in Columns 1 and 3. We omit our competition measure (*NumFloodInsurers*) from regressions with state fixed effects as it takes the same value for all insurers in a state.

Commissions explain the variation in overinsuring rates across insurers and states in each of our regressions. Flood commission rates are positive and significant for insurers who sell through direct agents (*Direct* \times *FloodCommRate*), but not for those selling via independent agents. Non-flood commission rates are negative and significant, again for direct writers only (*Direct* \times *OthCommRate*). This may be a substitution effect between flood and other personal lines, where high commissions for home and auto insurance will lead agents to dedicate more effort to those lines and expend less effort on selling excess flood coverage.

We also observe some effect of competition. The coefficient on *NumFloodInsurers* is negative, indicating that higher levels of competition are associated with lower rates of excess coverage. This result warrants some caution as it may be due to omitted local conditions (such as the probability of a flood) that are associated with both overinsuring rates and the number of participating insurers. Making more confident causal statements regarding competition and overinsuring requires additional data and is a compelling topic for future research.

We do not find a significant effect for managerial control (as proxied by *DirectInd*)—in our sample, overinsuring rates do not differ between distribution systems. This result is interesting when combined with the insignificant effects of commission rates for insurers using independent agents. One interpretation of this result is that independent agents are just as likely to recommend

Table 9: Mechanisms driving overinsuring

| | Full sample | | Restricted sample | |
|--------------------------------------|----------------------|----------------------|----------------------|----------------------|
| | (1) | (2) | (3) | (4) |
| <i>Direct</i> | 0.014 (0.015) | 0.022 (0.017) | 0.032* (0.017) | 0.029 (0.019) |
| <i>Indep</i> × <i>FloodCommRate</i> | -0.126 (0.167) | -0.104 (0.180) | -0.046 (0.179) | -0.035 (0.198) |
| <i>Direct</i> × <i>FloodCommRate</i> | 0.458*** (0.154) | 0.506*** (0.133) | 0.481*** (0.110) | 0.545*** (0.119) |
| <i>Indep</i> × <i>OthCommRate</i> | -0.146 (0.127) | -0.123 (0.115) | -0.070 (0.080) | -0.087 (0.079) |
| <i>Direct</i> × <i>OthCommRate</i> | -0.711*** (0.120) | -0.659*** (0.108) | -0.694*** (0.153) | -0.709*** (0.162) |
| <i>FloodMktShare</i> | -0.222** (0.103) | -0.069 (0.090) | -0.063 (0.080) | -0.003 (0.057) |
| <i>OthMktShare</i> | 0.376*** (0.109) | 0.309*** (0.102) | 0.169 (0.118) | 0.183 (0.112) |
| <i>NumFloodInsurers</i> | -0.005*** (0.002) | | -0.003*** (0.001) | |
| Controls | Yes | Yes | Yes | Yes |
| FE | None | State | None | State |
| Clustered SE | Insurer | Insurer | Insurer | Insurer |
| N | 857 | 857 | 436 | 436 |
| R-Sq | 0.137 | 0.207 | 0.465 | 0.553 |

Note: The dependent variable is insurer j 's overinsuring rate in state k . Regressions follow Equation (4). Columns 1 and 2 are our base sample, excluding only insurers writing fewer than 100 policies nationwide. Our restricted sample in Columns 3 and 4 exclude insurer-state observations with fewer than 20 new flood policies. Controls include the proportion of insurer j 's total premiums attributed to federal flood in state k , A.M. Best financial strength rating, log of net total assets, log of firm age, log of mean replacement cost in the state, and dummies for publicly-traded insurers, mutual insurers, flood-only insurers, and insurers who report zero flood commissions. Stars *, **, and *** denote statistical significance at the 0.10, 0.05, and 0.01 levels, respectively.

overinsuring as agents of direct writers, but their reasons for doing so may be different. Market shares also do not consistently affect overinsuring rates, though the positive and significant coefficient on *OthMktShare* in the full sample hints that insurers controlling a larger share of the local insurance market may have a greater ability to influence households regarding whether to overinsure.

7 Conclusion

Households face a complex, high-stakes problem in selecting an insurance contract, and we believe that this complexity leads to the contract decisions that we observe. Households must weigh premiums paid today against conditional future payments in rare states of the world. Often, the household has never experienced these rare states and may know little about their likelihood. Insurers and their agents offer guidance in the sales process, but this advice may differ substantially across sellers. Households may be unable to recognize bad advice and purchase contract features that are of low value or that are inconsistent with their risk preferences.

We examine the ability of insurance companies to influence households' flood insurance decisions. Specifically, we investigate overinsuring—choosing a flood insurance limit in excess of the structure's estimated replacement cost. We show that the likelihood of purchasing excess flood coverage varies significantly based on the insurer selling the policy, even when controlling for policyholder characteristics. Further, a household's insurer affects the likelihood that it adopts a specific excess coverage limit. Some insurers appear to systematically advise purchasing the maximum program limit (\$250,000), others suggest rounding up from the replacement cost in percentage terms (e.g., 110%), and others recommend rounding up in dollar amounts (e.g., to the next \$10,000). Households purchasing from insurers who use "direct" agents are more likely to overinsure if their insurance agent is paid a higher flood insurance commission rate. We also observe a substitution effect for those same insurers—overinsuring rates are lower when non-flood commissions are high. Initial evidence at the state level also points to a competition effect in that overinsuring rates tend to be lower when more insurers participate in the flood insurance market.

Our findings are economically significant and have implications for the broader market. For about 165,000 new flood insurance policies in our baseline data, consumers paid total additional premiums of \$1,187,149 for \$561 million in total excess coverage limits.¹⁸ We selected our sample in the interest of empirical identification in our analysis; these 165,000 policies represent only 3.7% of the total federal flood insurance policies in force in 2010. Thus, the amount paid for excess coverage each year is likely several orders of magnitude greater than what we observe in our baseline sample. While our study focuses on federal flood insurance for robust comparisons across insurers, other lines of insurance (such as auto and homeowners) may also be subject to sellers recommending coverages that offer little value.

Our results have important policy implications. First, we highlight households' susceptibility

¹⁸ We base this calculation on the 92% of policies in our sample for which we can accurately calculate their premiums using the program's premium rating equations.

to guidance in making complex financial decisions. Insurance choices are one of many consequential household financial decisions, and research in other complex domains suggests a similar susceptibility (e.g., in financial planning, Christoffersen et al., 2013; Foerster et al., 2017). Improved risk communication and decision making guidelines, from independent public or private organizations (e.g., the Consumer Financial Protection Bureau or the Insurance Information Institute), may help households evaluate the quality of advice and identify suboptimal recommendations.

Second, sellers providing advice also may benefit from better information. In our setting, agents may not be aware of the low value of excess coverage. Intermediaries face a number of competing motivations, including to (1) add value to their customers, (2) maximize their commissions, (3) minimize the risks of errors and omissions lawsuits, and (4) properly represent their contracted insurer.¹⁹ When the optimal contract is unclear because the underlying risk is not well understood, an intermediary may rely more on motivations (2), (3), or (4) to make a recommendation. Educating sellers about the underlying risk and ensuring they have the tools to provide high-quality advice may improve households' insurance decisions.

Managing flood risk is a complex, economically significant problem, and one that is projected to increase due to rising sea levels, more frequent severe storms, and urbanization. Only a third of residential properties in the "100 year" flood plain (with a 1% annual flood probability) currently insure (Wright, 2017). The size of that flood plain is projected to increase by at least 40% by the year 2100 (AECOM, 2013). *How* to communicate information about (evolving) flood risks and provide effective guidance to households and intermediaries remains an open question and a critical topic for future research.

¹⁹ Even though (1) and (2) are the source of agency conflict between agents and policyholders, these motivations are not necessarily mutually exclusive. Insurers and agents often manage a multi-year, multi-product business relationship with consumers. The structure of this repeated game encourages cooperation (e.g., providing good advice to customers). Cooperation with a long-term focus may benefit all parties in the transaction.

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Online Appendix A Variable definitions

Here, we provide further details on the variables we use in the Section 6 analysis. Insurer financial data are from annual statements insurers report to state regulators, which are aggregated by the National Association of Insurance Commissioners (NAIC). We collect state-level data from “Page 14” of the annual statement. Commission rates and market share are both calculated using Direct Premiums Written (*DPW*), which is the gross revenue generated from selling a policy, without subtracting premiums ceded to a reinsurance company (the NFIP, in the case of federal flood insurance). Commission rates are based on Commissions and Brokerage Expenses (*Comms*), which is defined by the 2010 NAIC instruction manual to include:

all payments, reimbursements and allowances, on direct writings, computed as a percentage of premiums for production, management, or other services to:

- *Managers*
- *Supervising General Agents*
- *General Agents*
- *Regional and District Agents*
- *Local Agents*
- *Office Agents*
- *Brokers*
- *Solicitors*
- *Other producers and agents*

This specifically excludes salaries, allowances and payments not computed as a percentage of premiums, contingent commissions, premium taxes, commissions received for special services such as loss adjustment and inspection, and a number of other items. Thus, we believe that our measure of commission rates accurately represents the premium-based compensation insurers pay to their agents for selling policies.

We examine commission rates and market share separately for each insurer’s federal flood and non-flood lines of business. The NAIC defines “Federal Flood” as, “coverage provided by the Federal Insurance Administration (FIA) of the Federal Emergency Management Agency (FEMA) through insurers participating in the National Flood Insurance Program’s (NFIP) Write Your Own (WYO) program.” No other products or programs are included in this definition, so this should accurately represent the amount of flood written by WYO insurers.²⁰ We define non-flood personal lines as Homeowners Multiple Peril, Personal Auto Physical Damage, and Personal Auto Liability

²⁰We observed a few instances of insurers who issued flood policies according to our NFIP dataset reported zero DPW from Federal Flood. We investigated this extensively, finding circumstantial evidence that affiliated insurers accounted for the policies via a different subsidiary or shifted the income to a different year. Because we cannot be certain why, we excluded policies sold by those insurers from our analysis in Section 6.

lines of business. These were the largest non-flood personal lines in property-casualty insurance in 2010, comprising 14.6%, 14.6%, and 20.9% of total property-casualty premiums, respectively.

We explicitly define our variables of interest in Table 10.

Table 10: Variables of interest for mechanisms generating heterogeneity.

| Variable | Name | Calculation | Exp. sign |
|-------------------------|----------------------|---|---------------|
| Overinsurance rate | $OverRate_{jk}$ | $= \frac{\sum_l I(Over_{ijk})}{\sum_l NumFloodPols_{jk}}$ | Dependent var |
| Managerial control | $Direct_j$ | $= 1$ for direct response $= 0$ otherwise | (+) |
| Fin. incentives (flood) | $FloodCommRate_{jk}$ | $= \frac{\sum_l Comms_{jkl}}{\sum_l DPW_{jkl}}$ where $l \in \{\text{Federal Flood}\}$ | (+) |
| Fin. incentives (other) | $OthCommRate_{jk}$ | $= \frac{\sum_l Comms_{jkl}}{\sum_l DPW_{jkl}}$ where $l \in \{\text{Auto, HO}\}$ | (+) |
| Market power (flood) | $FloodMktShare_{jk}$ | $= \frac{DPW_{jkl}}{\sum_j DPW_{jkl}}$ where $l \in \{\text{Federal Flood}\}$ | (+) |
| Market power (other) | $OthMktShare_{jk}$ | $= \frac{\sum_l DPW_{jkl}}{\sum_{jl} DPW_{jkl}}$ where $l \in \{\text{Auto, HO}\}$ | (+) |
| Competition | $NumFloodInsurers_k$ | $= \sum_j I(NumFloodPols_{jk} > 0)$ | (-) |

Note: The subscripts indicate insurer j in state k writing line of business l . *Comms* is direct Commissions and Brokerage Expenses and *DPW* is Direct Premiums Written. The "Auto" line of business above includes personal auto liability, property damage, and no-fault. The homeowners multiple-peril line of business is abbreviated "HO." *DirectInd* is determined from the primary distribution system listed in A.M. Best's 2010 *Key Rating Guide* (self-reported by insurers). *OverRate* and *NumFloodInsurers* are based on policy data from the NFIP. All other data are from the NAIC annual financial statements.

Online Appendix B Supporting analysis on household selection

This section provides additional details on the analysis in Section 5 regarding whether the insurer effects that we observe are a result of household selection—that a household’s risk preferences affect both its choice of insurer and its decision to overinsure. Because we do not account for risk preferences, we might incorrectly attribute a household’s decision to overinsure to its insurer.

We re-estimate our regression of the likelihood that a household overinsures, restricting the sample to policies in ZIP codes in which all policies are written by a single insurer. About 3% of policies in the baseline sample are in this restricted sample ($n = 5,254$). We assume that households have few or no choices regarding their flood insurer in this restricted sample, reducing the potential influence of a household’s choice of insurer on the analysis. The most-represented ZIP code in the restricted sample has 15 policies. In 75% of cases, there is only one policy in the ZIP code. This structure challenges the use of our preferred model, which includes ZIP code fixed effects; instead, we use state fixed effects (which are shown for the baseline sample in Column 2 of Table 5). Five insurers in the baseline sample are not included in the restricted sample as they are never the only seller of flood insurance in a ZIP code.

We are interested in two aspects of the results. First, we examine whether insurer effects exist in the restricted sample. Insurer effects should disappear if they are the result of a households’ choice of insurer since households have limited choice of insurer in the restricted sample. Second, we examine whether the insurer effects are similar in sign and magnitude in the restricted sample to those in the baseline sample. We do not expect the same level of significance since the sample is much smaller. To facilitate comparisons, we select Insurer 8 as the reference insurer because it has the same rate of overinsuring (12%) in the baseline and restricted samples.²¹ Homes in the restricted sample may differ from those in the baseline sample. For example, these homes may be in less densely populated areas. Thus, similar insurer effects in the two regressions would add to evidence that insurers are guiding overinsuring.

Table 11 shows the results for the largest 15 insurers, which are representative of the remaining insurers. Our discussion here is in reference to all insurers in the regressions. Column 1 shows the coefficient estimates for the baseline sample; Column 2 shows the estimates for the restricted sample. Typically, the estimates in the restricted sample are consistent in significance and sign and of similar magnitude to those in the baseline sample. For example, among the top 15 insurers, the policyholders of Insurer 2 are the most likely to overinsure in both samples. The insurer effects also rank similarly across samples, with a Spearman rank correlation of 0.46 ($p < 0.01$, and a Pearson correlation of 0.56, $p < 0.01$).

We do observe some differences in the insurer effects across regressions. For five insurers (out of the 43 in both regressions), the insurer effects are each statistically significant, of different sign, and are significantly different from each other. For example, Insurer 13 has a positive, significant coefficient in the baseline sample, a negative, significant coefficient in the restricted sample, and these coefficients significantly differ from each other ($\chi^2 = 89, p < 0.01$). Such differences might

²¹ The purpose of our main analyses (e.g., in Section 3.2) is to compare insurer effects in a single regression, leading us to normalize the insurer effects so that they are in reference to the average insurer (Section 3.1). Instead, in this analysis we compare coefficients across regressions and so use a single insurer as a reference group, as the average insurer effect might change across regressions.

emerge from households' preferences or other unobserved characteristics in these models (e.g., differences in risk between the restricted and unrestricted samples). We conclude that households' preferences may influence their choice of insurer, but do not seem to explain the large insurer effects in our data.

Table 11: Insurer Effects, Policies from ZIP Codes with a Single Insurer

| | (1) Baseline Sample | (2) Restricted Sample |
|-----------------------------------|------------------------|--------------------------|
| <i>Reference Group: Insurer 8</i> | | |
| Insurer 1 | −0.000 (0.006) | 0.010 (0.009) |
| Insurer 2 | 0.222*** (0.006) | 0.157*** (0.015) |
| Insurer 3 | −0.001 (0.008) | −0.016 (0.011) |
| Insurer 4 | −0.038*** (0.009) | −0.047*** (0.010) |
| Insurer 5 | 0.007 (0.005) | −0.013 (0.011) |
| Insurer 6 | 0.071*** (0.005) | 0.064*** (0.010) |
| Insurer 7 | −0.016*** (0.005) | −0.029*** (0.009) |
| Insurer 9 | 0.031*** (0.006) | 0.022 (0.014) |
| Insurer 10 | 0.034*** (0.008) | 0.018 (0.017) |
| Insurer 11 | 0.002 (0.006) | −0.028** (0.011) |
| Insurer 12 | −0.009* (0.005) | −0.022* (0.012) |
| Insurer 13 | 0.016*** (0.002) | −0.125*** (0.016) |
| Insurer 14 | −0.119*** (0.002) | −0.124*** (0.018) |
| Insurer 15 | −0.009* (0.005) | 0.039*** (0.013) |
| Replacement Cost | Yes | Yes |
| Controls | Yes | Yes |
| Month FE | Yes | Yes |
| Location FE | State | State |
| Clustered SE | Insurer | Insurer |
| N | 179,917 | 5,254 |
| R-Sq | 0.036 | 0.086 |

Note: Dependent variable is whether a household overinsures. Models follow Equation (2) and include insurer fixed effects for all insurers in the sample, though we only report the results for the 15 insurers originating the most policies in the interest of space. The models include insurer fixed effects, state fixed effects, month fixed effects and characteristics of the home as control variables. Tables Column 1 shows the results from our baseline sample; the “Restricted Simple” in Column 2 only includes policies from ZIP codes in which a single insurer originated all the policies. We use Insurer 8 as the reference group as its policyholders have a similar rate of overinsuring in the baseline sample and restricted sample, 12% in both cases, facilitating comparisons across the columns. Regressions report robust standard errors clustered by insurer. Stars *, **, and *** denote statistical significance at the 0.10, 0.05, and 0.01 levels, respectively.