Consumer Federation of America

COMMENTS OF J. ROBERT HUNTER[1]
DIRECTOR OF INSURANCE
ON STEPS TO IMPROVE THE NATIONAL FLOOD INSURANCE PROGRAM (NFIP)

The NFIP is up for reauthorization this year. The Program has had very serious deficiencies and, particularly, has cost the taxpayers tens of billions of dollars while often encouraging unwise construction in the nation's higher-risk flood plains through below cost premiums and old maps not reflecting the impacts of development.

Consumer Federation of America (CFA) supports Congressional action to reauthorize the Program but is very concerned that such reauthorization be accompanied by significant reforms in order to make the Program more self-sufficient over time and reduce the risk of flood damage through better enforcement of the Program's land use aspects and use of actuarial rates for all construction in high-risk zones of the nation.

The first responsibility of Congress should be to do no harm in the reauthorization actions. While CFA agrees with some of the strategies being considered, such as a greater private insurance industry role in providing flood insurance, we find many serious problems with some of the proposals being considered in Congress to accomplish reform. Some ideas are inappropriate in concept and others are good ideas but the approach to achieving the change is inappropriate.

In this paper, we first analyze the "Draft Principles for Flood Insurance Reauthorization and Reform" issued by the House Financial Services Housing and Insurance Subcommittee in December, 2016. While we agree with some of the goals expressed in that document, we are alarmed at the damage to the Program that the implementation of some of these proposals would cause.

Problems with the Congressional Document "Draft Principles for Flood Insurance Reauthorization and Reform"

Long-Term Reauthorization

The document appears to call for a long-term reauthorization to head off frequent extensions and Program lapses. While this is a laudable goal the significant need for reforms to put the Program on a sound economic basis and getting the prices to actuarial levels and new construction in high-risk areas safer will, we believe, require several steps and, to date, only reauthorization gets Congress to pay attention and consider changes. Perhaps it is possible to have a longer-term extension if there was a

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way, such as requiring data and analysis every year, with firm, measurable goals that would trigger hearings and legislative action if goals were not being achieved.

NFIP Purchase Reinsurance

The idea of having the NFIP buy reinsurance from private reinsurers will cost taxpayers significantly, about 50% more in dollars on the amounts reinsured than if these private reinsurers were not involved. Obviously, reinsurers will not offer their protection unless they make money doing so. These reinsurers will, over time, require overhead costs and profit amounting to at least one-third of the premium. Theoretically, a reinsurer should be the largest source of capital present in the market. A small insurer goes to a large reinsurer or groups of reinsurers for cover. The U.S. federal taxpayer base is huge, dwarfing even a combination of all reinsurers in the world. NFIP does not need to go to the much smaller financial base of private reinsurance for protection. The idea of private reinsurance backing up the federal taxpayer is backwards of the normal, logical reinsurance arrangement. Private insurance needs to be at the bottom layers of the risk, not the top levels.

Passing Ross/Murphy Bill (Listed as a "Principle" in the House Draft Principles)

Passing Ross/Murphy's *Flood Insurance Market Parity and Modernization Act* contains proposals that are dangerous to consumers and to the long-term viability of the Program. CFA explained the problems of this approach in detail in our letter to the Senate late last year, which is attached as the Appendix to this paper. Among the more serious problems with the bill is allowing surplus lines insurers to write flood insurance (they are essentially unregulated on claims practices and policy language and, in the event of insolvency, have no guarantee fund backup such as that that licensed insurers have, leaving policyholders greatly exposed after a major flooding event) and by allowing private policies to be sold with no minimum coverage requirements, exposing taxpayers to greater disaster relief as insurers compete with each other by gutting coverage.

Allowing WYOs to Compete with the NFIP

The idea of eliminating the anti-compete clause from application to the WYO contracts will lead to massive cherry-picking against the NFIP, which will become even more financially unsustainable than it is now as a result. The discussion in the letter to the Senate in the Appendix explains a better way to get private sector involvement without opening the door to cherry-picking.

Mandatory Coverage

If mandatory coverage is repealed for commercial properties, the Disaster Relief program should be amended to not allow relief for properties that opt out of the program.

Phase out NFIP Coverage for Properties with high replacement cost values

The idea to phase out NFIP coverage for properties with replacement cost values over the program's coverage limits is an astonishing idea, if we understand the proposal. At current limits, all homes over $250,000 would not be covered at all by the NFIP, if we understand this "principle." What happens if such a home is flooded with no NFIP coverage? Will disaster relief be available to such properties?

How to include Private Insurers in Ways that Will Achieve a Stronger Program

There are ways to allow private insurers into the flood insurance market that would greatly minimize the risk of cherry picking. To transition to a private system, a starting place might be FEMA negotiating with the Write Your Own companies for the WYO's to take a small percentage of the risk of the actuarially rated policies they insure. They would then have an incentive to help ensure that the NFIP's actuarial rates are based on actual risk and not outdated flood maps or other factors that have undermined actuarial pricing in NFIP. Over time, the small risk these insurers bore at first could be gradually raised as they gained experience, increasingly allowing the federal government to play less of an insurance role and more of a mitigation role as well as a reinsurance role in the event of a major catastrophe. As the insurers write more of the risk, there will be an appropriate time to allow the insurers to compete with each other for the flood insurance business as part of their homeowners insurance contracts with the federal role becoming more and more a reinsurer of private flood carriers. State regulators should partner with FEMA immediately to determine, as this new program of private involvement grew, when various aspects of the insurance regulation of the program could be shifted over to the states.

Conclusion

CFA believes in the NFIP. As originally conceived and properly implemented, the Program would have become self-sustaining by now through the use of real actuarial rates without grandfathering, old maps and a myriad of other hidden subsidies being created. Home and business properties would have been built safely or not at all in very-high risk flood zones of our nation. Reform is desperately needed to put the program on the right track again.

We offer our cooperation and assistance to Congress as you struggle to make the NFIP sound and a Program that will minimize or even end taxpayer risk while giving people living in flood plains protection form the risk of flooding.

APPENDIX

Consumer Federation of America

To: U.S. Senate leadership

As a former Federal Insurance Administrator who ran the National Flood Insurance Program (NFIP), I am writing on behalf of the Consumer Federation of America (CFA) to warn you of the dangers to consumers that would arise if the Senate moves H.R. 2901, which recently passed the House, to become law.

We share the House concern that the current National Flood Insurance Program (NFIP) is too costly and actuarially unsound. We also agree that there is a role for private insurers and for state regulation in this insurance market. However, we also believe that allowing surplus lines insurers to write flood insurance, as the bill does, would put both consumers and taxpayers at great risk.

Risk to Consumers

There are many risks to consumers from the proposal to allow surplus lines carriers into the flood insurance market. The lack of meaningful state regulation is a primary concern.

Remarkably, the current legislation in Congress removes the 45-day notice of cancellation to consumers, which would allow private insurers to cancel a policy at will either immediately or with very short notice. This, coupled with the fact that the NFIP does not offer coverage until after 30 days have passed since application presents a real concern that consumers in flood prone areas could be made uninsurable for a month at the whim of their surplus lines insurer, perhaps in advance of an approaching storm. A regulated private insurer would presumably not be able to get away with placing short notice provisions in its regulated policy form if the state regulators are doing their job. But regulators are helpless in the case of surplus lines insurers since policy language is not regulated by the states for surplus lines carriers.

A second serious problem from the policyholder viewpoint is that if a surplus lines insurer goes bankrupt, the consumer has no access to any state guarantee fund that pays claims in the event of an insurer's insolvency. How is a consumer to know about that? Just imagine a small surplus lines carrier that was over-committed in Homestead, Florida when Hurricane Andrew hit, bankrupting several small insurers, to understand how big a problem this could be.

The legislation would allow surplus lines insurers to enter this market and possibly gain significant market share. However, these insurers are not regulated by the states in any meaningful way. Unlike consumers with auto or homeowner claim or other complaints who can seek a remedy from their state insurance department, consumers with flood insurance through a surplus lines insurer would be unable to seek effective assistance from their state since surplus lines carriers' claims and other practices are not regulated by the states. We remember, for example, that after the 1992 Los Angeles riots, surplus lines insurers not only went bankrupt but some simply walked away from claims, leaving many small businesses without coverage and forced into bankruptcy. The California Insurance Department reported that, in the wake of that tragic event, one-quarter of small businesses, many of them minority-owned, were unable to reopen after the riots because of this surplus lines debacle.

The bill would also put consumers at risk in several other ways: It would not give states the ability to regulate surplus lines policy language related, for instance, to clarity of minimum coverage requirements. The bill no longer requires the private insurers to offer coverage at least as strong as the NFIP so it is open season for "competing" with the NFIP by gutting coverage. If a surplus lines insurer wrote ambiguous or even clearly misleading policy language there is no way for the state or FEMA to stop that under this bill. As former Texas Insurance Commissioner I can attest that state regulation of forms frequently finds and removes many misleading, unclear, unfair, illegal, and ambiguous clauses from policies prior to their use. That option is not available for surplus lines policies sold in your states.

The state insurance departments cannot help a consumer of a surplus lines carrier who denies or delays payment on a legitimate flood claim. The states cannot make sure rates are not excessive, inadequate or unfair like they do in other lines of property/casualty insurance. If a surplus lines insurer sells policies with very low coverage at clearly excessive prices, you are handcuffed.

<u>Risk to Taxpayers</u>

The Senate should be deeply concerned that the legislation would allow private insurers, including surplus lines carriers to cherry pick against the NFIP, leaving taxpayers with responsibility for covering the worst risks. Insurers would seek to identify "overpriced" policies (and because of reserve rules imposed by Congress there will be many of these) that take into account the need of the NFIP to fairly price policies for everyone and also cover past losses. The NFIP then would increasingly be left with the highest risk policies, increasing the need for federal subsidies and/or higher NFIP prices to cover losses for a higher risk portfolio of properties. If prices were raised to make up for this shortfall, that would open the door for even greater cherry picking by the private insurers, creating a death spiral of higher losses and premium charges for the NFIP.

There are ways to allow private insurers into the flood insurance market that would greatly minimize these risks. To transition to a private system, a starting place might be FEMA negotiating with the Write Your Own companies for the WYO's to take a small percentage of the risk of the actuarially rated policies they insure. They would then have an incentive to help ensure that the NFIP's actuarial rates are based on actual risk and not outdated flood maps or other factors that have undermined actuarial pricing in NFIP. Over time, the small risk these insurers bore at first could be gradually raised as they gained experience, increasingly allowing the federal government to play less of an insurance role and more of a mitigation role as well as a reinsurance role in the event of a major catastrophe. As the insurers write more of the risk, there will be an appropriate time to allow the insurers to compete with each other for the flood insurance business as part of their homeowners insurance contracts with the federal role becoming more and more a reinsurer of private flood carriers. State regulators should partner with FEMA immediately to determine, as this new program of private involvement grew, when various aspects of the insurance regulation of the program could be shifted over to the states.

How Will Congress Warn Unsuspecting Homeowners Considering Buying a Surplus Lines Insurers Flood Insurance Policy?

If HR 2901 becomes law you have a duty, in our opinion, to warn consumers of the dangers of purchasing a surplus lines carriers flood insurance product. Consumers need to know what the lack of guarantee association protection means, particularly in the event of a major catastrophe. They need to be aware of the lack of regulation of policy language, price and claims practices. They need to be particularly aware of the cancellation provision so that they make sure it is well over 30 days to give them the chance to obtain NFIP coverage at a time that does not leave a gap in protection during storm season. They need to know the danger of policy language that would allow a surplus lines carrier to cancel immediately or with very short notice is a storm was predicted to hit in a few days. In short, consumers need to know that these policies do not come with the same protections against unfair practices that state insurance departments are normally able to provide when customers buy insurance policies from regulated, licensed insurers.

CFA is preparing a Consumer Alert for this very purpose. I attach a draft of CFA's Alert for your information and use as you see fit. Of course, we believe that a far better outcome would be if Congress approached flood insurance reform with these concerns in mind in the first place and request that you do not pass HR 2901 in its current, deeply flawed form.

Sincerely,

J. Robert Hunter

J. Robert Hunter, FCAS, MAAA
Director of Insurance

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Consumer Federation of America

CONSUMER ALERT!

INSURANCE FROM AN UNLICENSED "SURPLUS LINES" INSURANCE COMPANY CAN BE RISKY FOR CONSUMERS

Buying Insurance is confusing enough. What is actually covered? What is a fair price? Will the insurance company pay my claim?

It is now important to ask one other question: *Is your insurance company fully licensed in your state?* If not, you could face several serious problems, including:

- → If an unlicensed insurer goes bankrupt, consumers have no access to any guarantee fund to protect you. If you have a claim, you are out of luck.
- → The claims practices of an unlicensed insurer are not regulated. The insurer could deny claims inappropriately or cut payments unfairly and the consumer has nowhere to go but to court. The state insurance department has no authority to help.
- → An unlicensed insurer faces no regulation to make sure its policy language is fair and clear. If the insurer wrote ambiguous (or even clear) language that let it deny what would normally be legitimate claims, there is no protection for consumers through the state insurance commissioner.
- → An unlicensed insurer's rates are not regulated. Rates can be excessive or unfair. Licensed insurers may not charge excessive, inadequate or unfair prices.

How do I know if I'm at risk?

People most at risk are the less sophisticated insurance buyers, which include most individuals and small business owners. Whenever buying insurance, make sure to ask if the company offering a policy is licensed in your state. If not, beware!

Also, ask if the insurer is a “surplus lines” insurer. These companies are not licensed in your state and you have few if any consumer protections. A surplus lines insurer is often licensed or admitted in one state but operates in other states without a license. These insurers are known as "non-admitted, unlicensed *foreign* insurers." There are also surplus lines insurers based outside the U.S. and not licensed in any state; these are known as "non-admitted, unlicensed *alien* insurers."

A relatively new and very troubling development for consumers is the passage of state laws that allow insurers to operate as surplus lines insurers even in the state where they are licensed, adding even more confusion and danger for consumers.

If you have any doubt about the status of your insurance company, call your Department of Insurance to determine if the company is a surplus lines or otherwise unlicensed before you buy a policy.

NOTE: TO BE ADDED IF HR-2901 BECOMES LAW:

Flood insurance a particular concern

Congress has just allowed unlicensed surplus lines insurers to sell flood insurance beginning (add date). The bill does not remedy the serious problems cited above that make surplus lines policies dangerous for consumers to buy. The policies do not have to offer coverage equal to that available through the National Flood Insurance Program (NFIP). The policy language used by surplus lines insurers is not vetted by the state regulators, nor are the rates the surplus lines insurer reviewed by the state. If you have a claim, the state insurance department cannot help you if you are mistreated.

Worst of all are these two extremely dangerous facts about the new flood insurance law:

1. If the surplus lines insurer miscalculates and goes bankrupt after a large flood, a person holding a flood insurance policy from that insurer will be unable to collect on their policy and no guarantee fund stands behind such policies.

2. Remarkably, Congress removed the requirement for a private insurer selling flood insurance to provide at least 45-days notice when canceling a flood insurance policy. The reason this is dangerous to consumers is that, if a flood policy was cancelled, a replacement policy from the NFIP has a 30-day waiting period before it becomes effective. If a surplus lines insurer canceled a homeowner or small business owner with no of very short notice and a flood occurred shortly thereafter, the policyholder could face a period of no coverage through no fault of their own.

Consumers purchasing flood insurance should be very wary of buying it from a surplus lines insurer.