



Consumer Federation of America

November 29, 2017

Principles for Reforming the National Flood Insurance Program

Dear Senator:

I write this letter on behalf of Consumer Federation of America (CFA) where I am the Director of Insurance. I was the Federal Insurance Administrator under Presidents Ford and Carter. In those positions, I helped to create and run the NFIP in the 1970s. I have also served as Texas Insurance Commissioner.

I have been involved with flood insurance since I ran the Program. Last year I worked on and participated in PBS's ("Frontline") and NPR's ("All Things Considered") extensive reporting on the NFIP for a report entitled "Business of Disaster" (May 24, 2016).

Consumer Federation of America (CFA) has developed principles by which consumers of flood insurance will measure the acceptability of any draft bill to reform the National Flood Insurance Program (NFIP). We wanted you to have these to inform your work as you draft legislation.

Prior to describing the principles, there are two matters of great concern to us that we want to alert you about.

1. CFA OPPOSES THE SENATE TAKING UP H. R. 2874, A DEEPLY FLAWED BILL

Before getting to the principles that we believe should inform your work in reforming the deeply flawed NFIP, we want you to be aware of our strong opposition to the House passed bill, H.R. 2874. We request that you not take up this awful bill but instead draft your own legislation. We attach our November 7, 2017 letter to the full House, which details the reasons for our opposition. The key concerns we raise with H.R. 2874 include:

- an improper approach to opening the program to private flood insurance activities (while we support allowing such activity, the House approach is dangerous to consumers and taxpayers);
- a provision allowing Write Your Own (WYO) insurers to cherry pick against the program using data, paid for by taxpayers, intended to be used to strengthen the NFIP, not undermine it;
- not requiring private insurers to collect surcharges to help pay for the mapping work, which obviously must be done to help private insurers know how to price the flood risk;
- state governments are unprepared to take over regulation of private flood insurers and unable to regulate surplus lines carriers, presenting a great risk to consumers; and,

- other matters detailed in the letter.

2. TIME IS EXCEEDINGLY SHORT FOR DEVELOPING REAL REFORM LEGISLATION, PARTICULARLY CONSIDERING THE LESSONS AS YET DEVELOPED FROM HURRICANES HARVEY, IRMA AND MARIA (HIM). WE SUGGEST AN AS-IS EXTENSION BE PASSED BY CONGRESS.

NFIP expires in less than a month, on December 8, 2017. That short time frame would make developing a bill difficult, even in the best of circumstances. But the timing of this legislative action could not be worse, given the recent HIM hurricanes. We do not yet know how the claims are being handled because the larger claims are still unresolved and the problems in claims handling (such as those that occurred involving the Superstorm Sandy) would not yet have manifested.

However, we know some of the key questions to ask: for instance, how come the market penetration was so low (e.g., about 15 percent of damaged homes in Houston had flood insurance)? We do not yet know how the fledgling private insurance market is doing with their first claims issues. There has been no “after-action” research by Congress into the lessons from these recent storms.

It is inappropriate to jump into long-term legislative “reform” when Congress simply does not have full knowledge of how the program preformed in these storms.

CFA believes that a short-term extension coupled with a Congressional charge to FEMA and GAO to study the lessons from the recent hurricanes and report back to Congress so that long-term reform legislation could be developed. It will take at least 6 to 9-months for claims practices to be fully understood. Then studies can be finalized. We suggest an extension to April 1, 2019.

PRINCIPLES FOR REFORM OF THE NFIP

CFA strongly supports Congress taking steps to allow private insurers to assume a significant amount of flood risk. However, involving the private insurance market on flood insurance requires careful planning since some proposals would expose consumers to extremely unfair practices and expose taxpayers to more risk for reasons we explain in this letter. Any increase in the role of private insurers must be accompanied with robust consumer protections.

How to Achieve a Strong Private Flood Insurance Market While Avoiding Consumer and Taxpayer Dangers

We believe that the focus of Congress in developing a private flood insurance market should be a plan that will, over the coming decades, achieve the long-term goal of ultimately having private insurers include flood insurance in their homeowners insurance policies as a standard coverage with mapping, mitigation, land-use control, and possibly some reinsurance backup for extreme events being the only remaining roles for the federal government. The transition to this fully private flood insurance program will take many years but every step to achieve this vision must be done carefully, making sure that the changes do not make the situation worse for taxpayers

and consumers (for instance by undermining the spread of risk in the NFIP and assuring that the private coverage is as complete as the NFIP to avoid increases in disaster relief). Congress must also make sure that the changes protect people who live in high-risk flood plains and who are forced to purchase flood insurance from abusive and unfair insurance scams.

Critical questions that must be answered as Congress considers how to encourage private insurers to take some, and ultimately all, of the existing flood risk covered by the program are: how the insurance part of the federal program could be phased out to spur more private risk taking (the idea to pick a date certain where all new construction in high-risk flood plains would be only underwritten privately is a good one, avoiding all cherry-picking and a clean way to make the transition); how low- and moderate-income homeowners and renters could be protected from rate shock and provided with a targeted subsidy to help them afford flood insurance while moving to fully actuarial prices in order to facilitate private insurer involvement and, what requirements should be kept in place and further improved regarding flood maps, mitigation and construction in local communities. The National Association of Insurance Commissioners (NAIC), has an important role to play in developing regulatory model laws as a new, more private flood insurance system emerges.

The Consumer Interest in Fixing the NFIP

CFA is often asked how a consumer group can favor moving the NFIP toward private insurance control and, thus, toward actuarial soundness, which will raise rates for some consumers. CFA strongly believes that both the program and the private market should set fair, actuarially sound rates that accurately reflect the potential loss risk (so long as Congress develops an explicit and targeted subsidy program for lower-income Americans written in the program as these higher rates are applied). Further, we believe sound pricing is critical in order to accurately signal to prospective homeowners and builders the dangers associated with developing areas of communities with high flood risk. Congress must act to make the true cost of flood insurance known to home buyers, even if they receive a subsidy, so they know the risk they are placing on their families and possessions.

Homeowners who buy new homes in areas that they think are safe from floods are harmed when old maps underestimate risk. Some are misled into believing their homes are safe from floods when they build or buy new homes built to the old map's 100-year flood estimates that are, in fact, far below the real 100-year elevation. These people and their families are at risk of being killed or injured if a storm hits, or of having their homes or treasured possessions destroyed. Facing higher premiums and being truly aware of the risk associated with this dangerous development is a blessing, not a curse, for these consumers and prospective residents.

Other homeowners will look at these inaccurate flood maps and think, "I don't need insurance, I am way outside the risk area." But they may in fact be well inside the area of high risk when the maps are old and development, erosion, climate change and other impacts have caused the 100-year flood to rise significantly, as those living on the Gulf found out the hard way during Hurricane Katrina. CFA's study of Hancock County Mississippi flood maps after Hurricane Katrina hit found that the average map (of 76 in the county) was 20 years old and 10 feet too low

in measuring the 100-year flood elevation.¹ Many home and business owners were misled into building unwisely, or not buying needed insurance, in the county where Hurricane Katrina hit, exposing the deeply flawed program's weaknesses in a most tragic way.

Targeted subsidies should be used to help low- and moderate-income people in flood-prone areas who cannot afford flood insurance. Just as it is improper for states to require auto insurance but then fail to ensure that lower-income good drivers can afford it, is improper for the federal government to require the purchase of flood insurance, as the NFIP does, and not help those who own reasonably safe structures but cannot afford the coverage. Those smart subsidies notwithstanding, it is improper to give broad, hidden subsidies to consumers and call such offerings "insurance." Targeted subsidies for those who are most in need would cost far less than the current mix of general subsidies, some of which appear not to have been authorized by Congress.

Ways to Allow Private Insurance Markets to Develop While Minimizing Consumer and Taxpayer Risk

CFA has contemplated ways to allow private insurers into the flood insurance market that would greatly minimize the problems discussed above, and we would be pleased to participate in a process for further development of these ideas. As an introduction to our thinking, a starting place for the transition to a private flood insurance market might be (1) 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 and (2) picking a date certain where all new construction in high-risk flood plains would be only underwritten privately (this would avoid all cherry-picking and a clean way to make the transition). If the WYO taking risk plan were used, the risk these insurers bear could be gradually raised as the companies gained experience, increasingly allowing the federal government to play less and 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 reduced to a reinsurer of private flood carriers. State regulators should be asked by Congress to partner with FEMA 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.

State Insurance Regulators Must Establish Laws to Protect Consumers Prior to Expansion of Private Insurance Market Involvement

State architecture of private flood insurance market has not yet been established and is necessary to ensure that consumers and taxpayers are protected during this change in the marketplace. Any bill should require that, as the NFIP moves toward more private sector involvement and the

¹ "An Examination of the National Flood Insurance Program," testimony of J. Robert Hunter, Director of Insurance, CFA before the Committee on Banking, Housing and Urban Affairs of the U. S. Senate, October 2, 2007.

http://consumerfed.org/archives/elements/www.consumerfed.org/file/finance/Hunter_Testimony_Insurance_Reform_10-30-07.pdf

migration of regulation moves back to the states, that state architecture is developed and must address critical components of the transition. Such architecture should include regulations to prevent a loss of consumer protections during the transition, address solvency in high-risk flood markets, and include controls on unfair methods of competition such as unfair policy language, as well as other consumer protections.

Turning the Market over to Surplus Lines Carriers to Increase Private Insurance Involvement is Dangerous to Both Consumers and Taxpayers

We support greater involvement of private insurers in the NFIP, but some of the draft bills allow unregulated surplus lines insurers to write flood insurance. There are many risks to consumers from any proposal to allow surplus lines carriers into the flood insurance market.

Surplus lines insurers are not regulated by the states in any meaningful way. Unlike consumers with auto or homeowner claims 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. These small businesses were then forced into bankruptcy. The California Department of Insurance reported that, in the wake of that event, one-quarter of small businesses, many of them minority-owned, were unable to reopen because of this surplus lines debacle.

Consumers would receive virtually no protections from state insurance departments if a surplus lines carrier denies or delays payment on a legitimate flood claim. The states cannot make sure rates are not excessive, inadequate or unfairly discriminatory 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, insurance departments are handcuffed. If low levels of coverage are sold by surplus lines insurers – for example, policies with high deductibles or various exclusions built into the policies – the states could not remedy that and that would expose taxpayers to significant increases in disaster relief payments to fill the coverage gaps.

Another problem with the ability of surplus lines carriers to write low coverage flood insurance policies is the unfair competition that would develop both to competing private insurers and the NFIP. A surplus lines insurer that, for instance, crafts a policy with 50 percent of the coverage removed by exclusion, could sell that policy for, say, 60 percent of the NFIP rate, making a huge profit while exposing taxpayers to greater risk. This is the worst kind of cherry-picking, in which an insurer deceptively acquires the best risks – exposing those homeowners to insufficient coverage after a disaster – and leaves the riskiest properties to the NFIP – exposing those homeowners to a spiral of higher premiums (and taxpayers to ever-increasing subsidy costs).

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 or appreciate the true cost of taking that risk? To imagine how profound this lack of guarantee would be, just imagine if a small surplus lines carrier had grabbed a portion of market share in Baton Rouge and was now

overcommitted where there were at least 140,000 homes damaged by the disastrous flooding of 2016. This also increases the taxpayer's exposure.

The legislative proposals that allow surplus line carriers to offer flood insurance would put consumers at risk in several other ways as well, including:

If a surplus lines insurer wrote ambiguous or even clearly misleading policy language there is no way for a state or FEMA to prevent or clarify its implementation. As former Texas Insurance Commissioner, I can attest that state regulation of forms frequently finds and removes misleading, unclear, unfair, illegal, and ambiguous clauses from policies prior to their use. That option is not available for surplus lines policies sold in the United States today. Presumably, legislation could be written to authorize more comprehensive state regulation of surplus lines, but that is unlikely to be undertaken by Congress under McCarran-Ferguson Act conditions.

Congress could fix some of these problems by requiring all private insurers to offer coverage at least as strong as the NFIP.

A related problem comes with the inevitable cherry picking against the NFIP that these surplus lines carriers would conduct. Congress should understand the danger to economic viability of an insurer from adverse selection. Insurers would target customers with "overpriced" policies (and because of reserve rules currently 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.

It is vital that Congress require private insurers to have at least a 45-day notice of cancellation to consumers. If Congress does not do that, then surplus lines and other private flood insurers could 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 effectively monitoring forms filed with the states. But regulators are helpless in the case of surplus lines insurers since policy language is not regulated by the states for surplus lines carriers.

Prevent WYO Companies from "Cherry Picking" Risks before Removing Non-Compete Rules

Allowing WYO companies to compete for policies could benefit the overall market so long as these insurers are participating in the full market and not just cherry picking the lowest risk properties. If the WYOs are unfairly selling to only extremely low risks it will leave the NFIP in a death spiral of having to raise rates due to adverse selection, which would further weaken NFIP without strengthening the overall protection of homes in flood prone areas. The non-competes clause in WYO contracts should only be removed when standards are in place to protect against

“cherry picking.” It would be very inappropriate for FEMA to pay WYO companies to collect and store data that could then be used against NFIP to select out only the very lowest risks and undermine the NFIP. An example of a requirement that might help lower the adverse selection problem for the NFIP could be that risks taken out of NFIP by a private insurer meet a test of percentage take-outs being similar across risk zones and not just in low-risk areas.

Private Insurers Should be Required to Collect the Same Surcharges as NFIP Uses

CFA strongly supports a provision that treats private policies the same as NFIP policies with respect to surcharges. It is absolutely vital that the private carriers collect the fees needed to help fund mapping (without which the private rates could not be made) and mitigation activities (which are important for risk reduction purposes). They should also help pay down the debt if surcharges are used to do that. To not require the same surcharges creates unfair competition in the flood insurance market and undermines the long-term viability of the mapping/mitigation/taxpayer protection goals of Congress.

The Danger of Allowing Private Insurance to Count as “Continuous Coverage”

Continuous coverage opens the taxpayer to high risk. If a private insurer writes a lot of low coverage policies in, for example, Key West, and a storm is approaching, can the private sector insurer cancel immediately and NFIP must offer continuous (presumably full) coverage? Congress should do two things if a continuous coverage rule is to work effectively while protecting abuse. Congress should keep the 45-day cancellation requirement and should require private coverage, including by surplus lines insurers, to be equal to NFIP coverage.

All Subsidies should be Removed from the NFIP and only a Subsidy for Low and Moderate-Income Americans who cannot Afford the Insurance should be Established

Rates in an insurance program must be actuarially sound. The use of subsidies not targeted on the low- and moderate income (LMI) population have caused great damage to both consumers and taxpayers (who just ate \$16 billion of NFIP losses a with much more loss to be eaten later). Consumers are hurt by being misled into building or purchasing unsafe homes in high-risk flood plains.

Grandfathering is a particularly egregious subsidy, totally undermining this “insurance” program by giving subsidies to not just the poor but to the ultra-rich inhabiting barrier islands with grand views and even grander losses when the inevitable flood arrives.

Congress must develop a subsidy for those who need one, the LMI. With that in place, there is no need for any other subsidies in the program. With this in place, NFIP can become what the original intent of Congress was – a true insurance program, paying its own way and priced to make unwise construction in high-risk flood plains pay very high premiums. Congress should not put an absolute cap on premiums, like \$10,000, since that would encourage some very wealthy people to build homes in extremely risky places and get a subsidy from the taxpayers to do it.

Having NFIP Purchase More Private Reinsurance

The idea of having the NFIP buy reinsurance from private reinsurers will cost taxpayers significantly, about 50 percent 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. That translates into a rate increase of at least 50 percent. 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 this much smaller financial base of private reinsurance for protection. The idea of private reinsurance backing up the federal taxpayer is the reverse of the normal, logical reinsurance arrangement. Private insurance needs to be at the bottom layers of the risk, not the top levels. Ultimately, as we work toward more of a private sector role, the private insurers should be taking the low levels of risk, starting with the first dollar of claims, and the government's role should become the reinsurer of very large events, perhaps, if cost-effective, with private reinsurers taking an intermediate layer of risk.

Allowing Some Credit for Obtaining an Elevation Certificate

This concept gives a one-time rate credit (e.g., \$500) to obtain elevation data. This appears to be a dangerous provision since a cottage industry of trying to get everyone to seek flood rate relief (for free) will certainly develop in areas where there are many flood-prone homes. This idea is understandable but some way to control likely rampant abuse of taxpayer dollars must be developed before being put into law.

Data Sharing should Benefit the Public and Public Agencies, not Just Private Insurers

FEMA is providing aggregated data about NFIP claims. But the private insurers should also share their claims data and should be required to do so. All such data should be made public but personally identifiable information must be kept private. Private insurer data is necessary for Congress, FEMA and the public to understand what is really happening in the new private market. Data must be sufficient to answer questions such as these: Are insurers cherry-picking risks and thereby undermining the overall program? Are insurers only writing in low risk areas? Are insurers providing appropriate levels of coverage? Undoubtedly many other important questions could be addressed with a mutually beneficial data sharing approach.

Take a Stand for Better Mapping and Community Enforcement of Flood Risk Land Use and Construction Requirements

As noted above, FEMA has been woefully behind on the updating of flood maps. Congressional action should be directed to put pressure on FEMA to keep maps current and for GAO or some federal body to periodically examine whether communities are actually enforcing NFIP required land use measures.

Consumers and Taxpayers Need Forward Thinking on Affordability

Grandfathering is a key reason for rate inadequacy and this approach to subsidies should not be allowed to continue. The practice of grandfathering flood policies undermines affordability of flood insurance, as it requires higher overall rates to make up for the grandfathering shortfall. However, grandfathering might be allowed only in exceptional cases such as a building built in accordance with a map later found to be in error. Grandfathering should not be allowed in cases of simple map updates reflecting changed conditions that are expected such as increase in flood levels from new construction or climate change. The current system of paying for the shortfall in premiums due to grandfathering by cross-subsidy from other NFIP policyholders cannot stand if private insurers are writing flood insurance. The overpriced NFIP policies are easy targets for "cherry-picking" by the private market, leaving the cost to be borne by taxpayers. Congress must enact smart subsidy strategies that are separate from the insurance program and aimed more precisely toward low- and moderate-income families and others who need a transition period to adjust to actuarially defensible rates. No other subsidies should be allowed.

Brief Review of S. 563

CFA generally supports the concept of increasing private sector involvement in flood insurance as incorporated in S. 563, but we have extensive concerns as addressed in our July 18, 2017 letter and briefly described below:

The bill appears to require private insurers to use the same limits of coverage as the NFIP uses. This is a relief to us since other drafts seem to allow lesser coverage. Our concern, however, is that the bill does not seem to control for possible exclusions and other coverage limitations that could be included in a flood insurance policy being offered by a private insurer. The coverage should be required to be the same, including no exceptions, exclusions or other limitations not in the NFIP policy.

Private insurers should be freely allowed to expand, but not contract, the NFIP level of coverage. Coverage less than NFIP is a prescription for greater taxpayer disaster relief payouts.

The Definition of Private Insurer clearly allows surplus lines insurers to write coverage. The dangers to consumers and taxpayers of use of surplus lines insurers is discussed extensively above.

The bill allows for private insurers to count as "continuous coverage" under NFIP rules. This is dangerous for the reasons expressed in our July 18, 2017 letter.

Review of S. 1368

CFA generally supports S. 1368. We raise the following concerns and identify provisions that we support:

The bill has a very interesting and innovative way of helping lower-income people afford flood insurance that CFA supports.

The bill offers cost savings but one such savings measure gives up interest to the Treasury on the debt for 6 years. While not a savings to taxpayers, other savings in the bill are significant. The bill limits WYO payments to 22.46 percent of premium for selling, writing and servicing flood

insurance policies. This is a savings from current WYO levels (but still much higher than homeowners insurers costs, which were less than 17 percent in 2015 according to the NAIC).

The bill requires that WYO insurers pay agents “not less than 15 percent.” Fifteen percent is a high commission rate. Homeowners insurers paid agents only 12.6 percent in 2015 according to NAIC data. Since some insurers do not use agents or have agents in house with much lower payment than 15 percent this provision should be reconsidered. The bill also would charge private entities the cost of the Flood Insurance Rate Maps FEMA provides, CFA support this.

The bill limits premium and other cost increases to 10 percent a year. This is true regardless of the wealth of the homeowner, which is unnecessary. These limits should be reconsidered and the subsidies for affordability limited to and targeted at those needing such help.

The rather complex approach to determining site-specific flood risk information and making information on the site’s cost of damage at various flood risk levels from a ten-year to a 500-year flood is very interesting and would be very helpful for homeowners and prospective homeowners to grasp the real risk they face. Explaining the full risk rate and comparing that to the rate being charged is very important information that would be very useful for consumers to have.

Expanded appeals on Base Flood Elevations could help consumers redress any mapping wrongs, but the methods outlined seem excessively costly and may allow too many subjective factors to be brought into play (e.g., vegetation, ditches, etc.)

The bill requires claims decisions to be made on 30-days, with a possible 15-day extension in “exceptional circumstances.” We support a limit, but wonder, particularly in cases of huge floods like Katrina, if the dates are too restrictive.

Appeals are also expanded for those receiving claims denials or have other claims-related problems. This is a good idea generally, except that the 90-day limit on a decision with a deemed approved drop-dead end to the process may be too short in very complex cases. Perhaps, an exception could be created for complex time-consuming cases.

The bill also makes all claims-related documents available to a consumer upon request. A very good idea.

The bill increases transparency of the vendor costs paid out by WYO companies, including claims adjusters and engineers. This is a good provision that CFA supports.

CFA supports the idea of ending any manipulation of engineering reports created as part of a claim process. This was a serious problem during both Katrina and Sandy and must be resolved.

The bill includes an “Accountability of Underpayments” provision where the Administrator could find, on audit, that claims have been underpaid by WYO companies or private insurers. This is a good idea. But the amounts determined to be underpaid and collected by the Administrator are deposited into the National Flood Insurance Fund. We suggest an alternative approach in which these amounts would be paid to the underpaid homeowners/claimants and only deposited in the Fund if, for some reason, the homeowners cannot be determined or located.

Conclusion

CFA requests that Congress carefully consider our comments in this letter, which we have crafted to assist you achieve greater private sector participation with protection of consumers and taxpayers. We trust that our ideas will help Congress avoid several serious problems that some of the draft bills we have reviewed would create. We stand ready to work with you in any way that helps you achieve these important goals.

Sincerely,

A handwritten signature in black ink that reads "J. Robert Hunter". The signature is written in a cursive style with a large, stylized initial "J".

J. Robert Hunter
Director of Insurance