Privatization of Flood Insurance

If you asked any insurance executive team if they would be interested in an untapped, $3 billion insurance market, you would likely garner the attention of many insurance carriers. In today’s economic environment many insurance enterprises are innovating new products and technologies to improve profitability and competitive strength. The privatization of flood insurance may provide a real growth opportunity for the right companies.

Historical Overview of Flood Insurance

In 1968 the United States Congress created the National Flood Insurance Program (NFIP) to provide flood insurance to property owners since many private insurers were exiting the market place due to adverse selection and insufficient premiums to cover the risk. The NFIP is backed by the Federal Emergency Management Agency (FEMA) in support of communities which created a mitigation plan for those homes in designated flood areas. The intent of the program was to reduce the overall cost of flood insurance to property owners by incentivizing community flood risk management programs and to pool the risk nationally.

What has changed?

Congress intended the NFIP to be self-sustaining from premiums collected from policyholders. However, since the catastrophic claims associated with Hurricane Katrina in 2005 and, more recently, Super Storm Sandy in 2012, the NFIP has incurred a $24 Billion deficit. (Refer to Figure - 1 for an illustration of historical premiums and claims data of the NFIP).

In response to the continuing deficit, Congress passed the Biggert-Waters Act of 2012 ("Biggert-Waters") with four objectives: 1) generate a more risked based premium rate structure; 2) establish a payment schedule to eliminate the $24 billion NFIP deficit; 3) update and remap flood zones; and 4) generate updates to mitigation programs.

By 2013 the impact of the Biggert-Waters began to take effect. Due to the risked-based approach to


Figure 1 – Flood Industry Losses Paid and Premiums Earned by Calendar Year

![Figure 1 – Flood Industry Losses Paid and Premiums Earned by Calendar Year](image-url)
underwriting, many property owners saw their premiums skyrocket. Timing was particularly bad since homeowners were also experiencing depressed home values lingering from the recent recession in 2008/2009.

Congress again took action and passed the Homeowners Flood Insurance Affordability Act of 2014. This act repealed and modified Biggert-Waters by 1) limiting premium rate increases; 2) providing a refund of previous rate increases under certain circumstances; and 3) requiring FEMA to draft an actuarial based affordability study due to the United States Congress to consider many factors including the impact of increased premium rates, mapping updates, and actions to mitigate flood risk.

Further, the National Association of Insurance Commissioners (NAIC) Catastrophe Insurance Working Group is now studying the potential privatization of flood insurance with the goal to provide a report in time for the NAIC’s 2014 Fall National Meeting. Many members of the working group have encouraged implementation of a risked-based premium rate structure for private insurers. For more updates in regards to the Catastrophe Insurance Working Group’s progress, refer to the Dixon Hughes Goodman Insurance Services Group Industry News | April 2014 – NAIC 2014 Spring Meeting Newsletter.

Where are we today?

The current flood insurance industry is a $3 billion industry. Many in the industry believe the time may be right for private insurers to consider entering the market in select areas. Flood insurance presents a tremendous growth opportunity for the property and casualty industry. However, with the incentives to grow premium dollars also comes the uncertainty for insurers to take on flood risk. For flood to be a profitable service, the product will require significant political reform as well as appropriate underwriting discipline by insurance carriers. Overall, the Government Accountability Office has reinforced the theme that the NFIP needs to charge full-risk rates and encourage private sector involvement in their report released in January 2014.

One concern with the privatization of flood insurance is the creation of an insurer of last resort model. This model could create a take-out method of policies, leaving only those higher risk policies within the NFIP for FEMA to back, creating more uncertainty if the NFIP program could sustain only those high risk policies.

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Considering the Opportunity

There are several considerations for those assessing the opportunity to underwrite flood insurance:

**Premium Revenue vs. Profitability**

Historical evidence suggests the ability to charge premiums rates to cover the full risk of flood losses may be unaffordable to many property owners. Generally, only 20 to 30 percent of those who need flood insurance actually buy it\(^8\). Those who purchase flood insurance tend to be those who live in flood prone areas creating the risk of adverse selection. Certain parts of the country, while in a flood plain, have lower flood frequency and severity rates as compared to other parts of the country. It is these lower frequency and severity areas where insurers may have the best opportunity to write profitable business. (Refer to Figure - 2 for an illustration of top ten states with policies in force through the NFIP\(^9\)).

**Underwriting Capacity / Breakeven**

As with any line of business, companies will need to understand the related regulatory and surplus requirements to write flood. The size of the program must also be considered to evaluate various breakeven and profitability scenarios and the associated risks. Leverage ratios and loss ratios will have to be considered for regulators as well as for insurer ratings from A.M. Best and others.

**Concentration**

Companies need to consider the concentration of flood policies. Management will need to understand the flood market more in depth to understand the risk concentration they are willing to take on. The struggle today is the lack of available data in the flood industry to pin-point the more profitable areas for diversification. This could require enhancements in computer modeling in the private sector.

**Litigation Appetite**

Historically, flood policies have been susceptible to higher claims litigation associated with bifurcating the responsibility of the claim under the terms of coverage between wind and flood. Insurers will need to be cognizant of the delays that can be associated with litigated flood claims as well as the cost. Super Storm Sandy spawned significant litigation associated with flood versus wind claims that has impacted both the NFIP and private insurers a like. These litigation risks may cause delays in reinsurers reimbursing cedents timely leading to potential cash flow concerns.

**Premium Pricing with Little History**

Insurance carriers and reinsurers may find pricing flood risk to be challenging knowing that politicians in Washington have recognized a historical problem with pricing the risk of flood insurance. Private insurers

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\(^8\) Source: SNL Knowledge Center, “Privatizing Flood Insurance: Challenges and Opportunities”, http://center.snl.com/Programs/webinar.aspx?id=4294970342

and reinsurers may experience similar results until the industry becomes more stable. Further, insurers will need to consider if their current reinsurance structures are adequate to effectively mitigate catastrophic risk.

**Distribution**

The struggle private insurance carriers may find is the correct network of agents and most effective commission structure. Currently under the NFIP, agents enjoy commissions averaging 30%. In contrast, insurance agents receive roughly a 10% commission for homeowner's premiums. Without changes in the compensation model, this will likely incent agents to place property owners in a FEMA backed program rather than a private insurance carrier.

**Data Collection**

Companies should evaluate if their systems have the capability to process appropriate data. Flood premium and claims may need to be bifurcated from other coverage types for internal evaluation and analysis. With limited accessible historical data it may be a challenge for actuaries to develop reliable loss estimates initially. Further, companies should evaluate if their current infrastructure has the necessary capacity to process additional policies.

**Regulatory Environment**

There is currently debate regarding the premium approval process as well as the responsibilities of state insurance regulators versus FEMA backed programs in the event of receiverships and liquidations. Insurance carriers are wondering if state guaranty fund assessment charges are necessary for privately issued flood policies. In Florida specifically, politicians are considering the need to have flood policies supported by the Florida Insurance Guaranty Fund as opposed to the NFIP\(^\text{10}\).

**Mortgage Lenders Concerns**

With the uncertainty of the private flood insurance market, mortgage lenders may be reluctant to approve flood insurance coverage from private insurers. Evaluations of the insurance carriers’ financial strength will likely be considered.

**Summary**

Political and industry debate is sure to continue as the privatization of flood insurance continues to be considered. However, with appropriate underwriting, risk selection and pricing, the opportunity for underwriters is significant.

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\(^{10}\) Source: The Florida Current, “Flood bill bounces out of House and back to Senate”, http://www.thefloridacurrent.com/article.cfm?id=37424536
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