



Statement
of
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on behalf of the
National Association of Mutual Insurance Companies
to the
Insurance, Housing and Community Opportunity Subcommittee
of the
House Financial Services Committee
hearing on
The National Flood Insurance Program

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The National Association of Mutual Insurance Companies is pleased to offer comments to the Insurance, Housing, and Community Opportunity Subcommittee on the National Flood Insurance Program (NFIP).

My name is Sandra G. Parrillo. I offer my testimony to the Subcommittee as the chairman of NAMIC and as the president and chief executive officer of The Providence Mutual Fire Insurance Company. As New England's oldest mutual fire insurance company, The Providence Mutual was chartered by the General Assembly of Rhode Island in 1800. Today we provide personal and commercial insurance protection to more than 65,000 policyholders in New England, New York, and New Jersey. The Providence Mutual currently employs approximately 75 individuals, is represented by over 300 independent agencies, and is based in Warwick, RI.

NAMIC believes that: (1) there are significant problems with the NFIP as it is currently structured and (2) the best solution involves reforming and optimizing the program. The views I will share with the Subcommittee are based on my own 34 years of experience in the property/casualty insurance industry and the perspective of over 1,400 NAMIC members.

Founded in 1895, the National Association of Mutual Insurance Companies (NAMIC) is the largest and most diverse property/casualty insurance trade association in the United States. Its 1,400 member companies write all lines of property/casualty insurance business and include small, single-state, regional, and national carriers accounting for 50 percent of the automobile/homeowners market and 31 percent of the business insurance market. We also have over a quarter of the companies that participate in the NFIP's "Write-Your-Own" program as members. NAMIC's membership truly represents a cross-section of the industry and has been proudly protecting its policyholders throughout North America for many years.

The Nature of Flood Risk

Insurance markets function best when certain conditions are met. For example individual exposures should be independent of each other (i.e., not correlated) and there should be a large number of individual risk exposures to allow the use of statistical predictions of future losses. Losses should be accidental or unintentional in nature and should be generally predictable, allowing insurers to set premiums properly. Insurers must be able to spread risk over a large enough pool and each insured must pay the cost of adding to the risk pool.

For some risks, however, private insurance markets are unable to provide sufficient coverage. Certain risks are uninsurable because they defy the conditions private markets require for operation. Flood risk is one of these unconventional risks. Adverse selection prompts only those who believe they are at risk of flooding to purchase insurance limiting the ability to properly pool risk. Flooding is extremely devastating and markets face serious problems providing coverage for these truly large and costly events. The fact that flooding involves a risk that is highly concentrated and correlated makes flood loss especially difficult to insure. In most lines of insurance (e.g., life, auto, fire insurance), the total amount in premiums collected and the total amount paid in claims are almost continuously in balance because claim costs for any given year

are relatively easy to predict. This is not the case with flood risk, which by nature tends to result in losses that are very low in some years and extremely high in other years. Additionally, unlike other traditional threats to property, flooding has historically been spatially confined and generally limited to specific geographic locations complicating an insurer's ability to widely spread the risk. Compensating for these challenges requires insurers to charge high premiums to cover the sizable cost of capital that they must hold in reserve to ensure they are able to pay all the claims that will be filed in high-loss years.

The nature of flood risk and the factors that affect its insurability are a recipe for adverse selection, whereby the only people willing to buy insurance are those with the highest levels of risk, and the pool of insureds consists solely of these high-risk individuals. Properly priced insurance (which takes into account the amount of surplus needed to pay claims in high-loss years) would be regarded by most potential purchasers as a "bad buy" – property owners who perceive that there is little likelihood they will experience loss due to flooding will conclude that the cost of purchasing insurance is not worth it. Consequently, the only people who would be interested in purchasing flood insurance would be those most likely to suffer a significant flood-related loss, and the cost to insurers of providing coverage for these properties would cause premiums to rise to unaffordable levels. Simply put, the nature of flood risk makes it virtually impossible to pool risk among a large enough population for private insurers to be able to offer a viable and affordable insurance product.

The National Flood Insurance Program

Prior to the creation of the NFIP, flood losses were dealt with in a simple and direct fashion by the federal government. As noted in a 2002 report by the Federal Emergency Management Agency, "major riverine flood disasters of the 1920's and 1930's led to considerable Federal involvement in protecting life and property from flooding through the use of structural flood-control projects, such as dams and levees, with the passage of the Flood Control Act of 1936."

These projects proved to be a costly and generally ineffective solution. Despite billions spent by the federal government on flood control projects during that time the report noted that "the losses to life and property and the amount of assistance to disaster victims from floods continued to increase." Furthermore, the only assistance available to flood victims at that time was direct federal disaster aid, which also contributed to the high costs of a major flooding catastrophe. Congress began considering the potential for a national flood insurance mechanism as early as the 1950s, but quickly realized that the private market simply could not underwrite the highly concentrated and correlated risk of massive floods. In 1968, the federal government stepped in to create the NFIP to mitigate the exposure both to taxpayers as well as citizens in flood-prone areas. Congress sought to address the increasing costs of taxpayer-funded disaster relief by using premium dollars taken in every year to pay out any flood losses incurred by policyholders for the same year.

Originally, the only way property owners could purchase NFIP coverage was through specialized insurance agents. To increase take-up rates and streamline the claim handling process, the NFIP

in 1983 created a “public-private” partnership with private insurers known as the Write-Your-Own (WYO) program. The program utilizes private insurers to market, sell, and administer the Standard Flood Insurance Policy. These companies – WYO carriers – use their own agents and letterhead and deal directly with the policyholders while the federal government retains responsibility for underwriting losses. Over 90% of all flood policies are written through WYO companies. The partnership has proven to be remarkably successful in facilitating the prompt settlement of claims, even when faced with a very large volume of claims following extreme flooding events. For example, as of May 2006, more than 95 percent of the 162,000 claims for flood damage caused by the 2005 Gulf and Atlantic Coast hurricanes had been settled by the WYO companies.

Over the last 40 years, the NFIP has allowed millions of Americans to avoid serious financial losses brought about by disastrous flooding, and as of December 31, 2009, the program had 5.7 million policies in force. However, the NFIP has many flaws in its design and execution and is in need of serious reform in order to maintain a sound financial footing and better protect the American taxpayer. Subsidized premiums have been charged on a non-actuarial basis; development has increased the amount and value of property exposed to flood risk; take-up rates for those in need of coverage remain extremely low (under 30% of those that need flood insurance purchase it); and the recent severity of flood losses has demonstrated that the NFIP is not constructed to handle major catastrophic events. Although virtually self-sustaining for the 25 years prior, in 2005 the program incurred – and currently carries – almost \$20 billion in debt.

Optimization of the NFIP

Under the current circumstances, it is not surprising that policymakers would raise questions about the future direction of the NFIP. Clearly the status quo is unacceptable. However, I would urge caution to those who think we can do away with the program entirely. Nothing about the realities of flood risk has fundamentally changed and primary insurers are still unable to offer this coverage. The presence of a federal program is just as important today as it was 40 years ago. The phenomenon that led to the creation of the NFIP – the absence of a viable private flood insurance market – remains the fundamental problem, and there is no reason to believe that dismantling the NFIP would suddenly cause a private market to materialize.

The NFIP fulfills an important role, and with the right mix of reforms, the program can begin to address the problems of adverse selection, moral hazard, and financial instability that have plagued it in the past. Therefore we believe that the best, most effective, and viable option is optimization – maintaining the current NFIP framework while implementing reforms that address existing weaknesses.

First and foremost, the program must be reauthorized for the long-term. Constant reauthorization debates create uncertainty and can lead to lapses in the program as we saw in 2010. During these lapses, companies were not permitted to write new policies, issue increased coverage on existing policies, or issue renewal policies, and lenders and home buyers were prevented from closing on mortgage loan contracts. The NFIP should be reauthorized for an

extended period in order to bring stability to the program and instill confidence among consumers.

In addition to long term re-authorization we recommend a package of key reforms designed to achieve five essential objectives:

- 1. Charge Actuarially Sound Rates and Eliminate Subsidies**
- 2. Update and Improve the Accuracy of Flood Maps**
- 3. Increase Take-Up Rates**
- 4. Discourage Repetitive Loss Properties**
- 5. Improve Management and Correct Operational Inefficiencies**

Charge Actuarially Sound Rates and Eliminate Subsidies

Inadequate rates that do not reflect the actual costs of living in a flood-prone area are the source of many of the NFIP's problems. In the original NFIP legislation, Congress tasked FEMA with setting rates to meet the "objective of making flood insurance available where necessary at reasonable rates so as to encourage prospective insureds to purchase such insurance." The program was structured to subsidize the cost of flood insurance for existing homes, while charging actuarially sound rates for newly constructed properties built after the introduction of flood insurance rate maps. It has been estimated that, on average, the premiums charged for these older properties are 60 percent less than the amount that would be considered actuarially sound.

Moreover, it is doubtful that the rates charged for properties built after the advent of flood maps comport with most private insurers' conception of "actuarially sound." The price for NFIP flood insurance is relatively low—on average nationwide, property owners pay only \$2.64 per \$1,000 of flood coverage, or \$528 per year for \$200,000 in coverage. This average is constant across all states, including highly flood-prone states, which sustained major flood losses during the 2004, 2005, and 2008 hurricane seasons. Insofar as these rates do not reflect the true cost of providing coverage, the NFIP bears less resemblance to insurance than to a targeted public spending or risk management program.

Just as inadequate rates fail to reflect the true cost of providing coverage, they also fail to reflect the actual risks of living in a flood-prone area. This has the effect of encouraging poor land use and development in high-risk areas, thereby increasing the total potential losses that will be incurred in the event of a flood. During the 40-plus years that the NFIP has been in place, there has been a large population increase in flood-prone coastal states, which now account for a very large portion of the NFIP portfolio. In Florida, for example, the population has increased from 6.8 million in 1970 to nearly 18.5 million in 2009. During the same period, there was a seven-

fold increase in the number of NFIP flood policies in force and now more than two-thirds of NFIP policies are located in just five coastal states.

An updated rating system should include the following:

- Elimination of subsidized rates (implicit as well as explicit);
- Immediate institution of risk-based rates for non-primary residences, repetitive loss properties, and business properties;
- Tiered structure that reflects differences in risk based on updated maps;
- All new policies should charge actuarially sound, risk-based rates;
- Under certain circumstances, areas significantly impacted by changes in mapping could be eligible for phase-ins of actuarial rates;
- Once risk-based rates are in place, credits should be given for mitigation efforts.

The NFIP must begin charging risk-based rates if it is to have any chance of being a solvent program; under the current structure there is no chance that the program will ever repay the debt it accumulated in 2005. However, the move to actuarially sound rates is likely to be painful due to the higher premiums that will have to be charged in many instances. For those property-owners who need assistance, flood vouchers might be offered on a means-tested basis to help mitigate the costs. Any subsidies that the government believes are necessary must be independent of the NFIP and fully transparent. Subsidies cannot continue to be hidden within the insurance mechanism, and homeowners should be fully aware of the real risks of where they live.

Update and Improve the Accuracy of Flood Maps

Flood maps must be updated based on the best available science, with the goal of ensuring that NFIP flood maps accurately reflect the risks caused by flooding. Increasing and maintaining the accuracy of flood maps is essential to the operation of an effective flood insurance program. The power of newer technologies must be harnessed to provide program officials and property-owners, as well as rescue workers and land development officials, with the most accurate information possible.

The availability of new technology has given FEMA the ability to better evaluate flood exposure in every region of the country, but the more accurate maps made possible by this technology will inevitably raise protests from residents who are suddenly informed that their home is located in a floodplain. Not only will they face the prospect of having to purchase flood insurance (which may be expensive assuming actuarial rates are charged), but some evidence suggests that homes designated as being in a floodplain suffer a loss in value. Elected officials will likely face pressure from constituents and interest groups to postpone the starting date of the new maps or to attack their credibility.

These considerations have led NAMIC to endorse a new mapping protocol developed by the SmarterSafer coalition,¹ of which NAMIC is an active member. The coalition's proposal contains the following elements:

- Establishment of a council to develop updated and accurate flood maps. This new body – the **Technical Mapping Advisory Protocol (TMAP) Council** – could be composed of the following members:
 - Federal Emergency Management Agency
 - U.S. Geological Survey
 - Department of the Interior
 - National Oceanic and Atmospheric Administration
 - A data management expert
 - U.S. Army Corps of Engineers
 - A flood/stormwater management representative
 - Department of Agriculture's Natural Resources Conservation Services
 - A state emergency management representative
 - U.S. Fish and Wildlife Service
 - National Marine Fisheries Service
 - A recognized professional surveying association or organization
 - A recognized professional mapping association or organization
 - A recognized professional engineering association or organization
 - A recognized professional association or organization representing flood hazard determination firms;
- The TMAP Council should have a balance of state, local, federal, and private members.
- The Council should consult with stakeholders through at least four public meetings annually, and seek input of all stakeholder interests including:
 - State and local representatives
 - Environmental and conservation groups
 - Insurance industry representatives
 - Advocacy groups
 - Planning organizations
 - Mapping organizations
- Within one year, the TMAP Council should propose new mapping standards that ensure the following:
 - Maps reflect true risk, including graduated risk that better reflects risk to each property. This does not need to be at the property level, but should be at the smallest geographic level possible—whole communities should not be mapped together without taking into account different risk levels.
 - Maps reflect current land use and topography and incorporate the most current and accurate ground elevation data.

- Determination of a methodology for ensuring that decertified levees and other protections are included in maps and their corresponding flood zone reflect the level of protection they confer.
- Maps take into account best scientific data and potential future conditions (including projections for sea level rise)
- TMAP should continuously function, reviewing the mapping protocols, and making recommendations to FEMA when they should be altered.
- Within six months of TMAP recommending new mapping protocols, FEMA should begin updating maps based on the recommendations.
- Within five years from the implementation of the mapping protocols, all flood maps should be updated according to the new protocol.
- NAMIC believes the TMAP process would facilitate development and adoption of accurate maps. Speedy adoption of these updated flood maps is essential to ensure that the individuals and businesses in flood-prone areas can get the protection they need and we owe these people and the American taxpayer no less.

Mapping technology has significantly improved since the 1970s. Putting off the adoption of updated flood maps does a disservice to those citizens living in flood-prone areas who in the end, risk losing their homes and their lives.

Increase Take-Up Rates

Insurance is inherently dependent on the “law of large numbers,” thus the insurance mechanism works best when everyone participates in the program. Currently only 20 to 30 percent of individuals exposed to flood hazards actually purchase flood insurance. To make matters worse, many of those who purchase flood insurance do so only after suffering damage from a flood, then allow their policies to lapse after several years have passed during which they experienced no flood loss. The program must take steps to address this adverse selection and increase these numbers dramatically in order to properly pool the flood risk and achieve financial soundness. There are several possible ways to improve these take-up rates:

- Stiffer penalties could be imposed on financial institutions that either fail to require flood insurance coverage for mortgages on properties in flood-prone areas, or allow the policies to lapse. Although owners of properties located in special flood hazard areas are required to purchase and maintain flood coverage as a condition of obtaining a federally backed mortgage, experience suggests that enforcement of this rule is spotty at best. For example, following a Vermont flood in 1998, FEMA discovered that of the 1,549 homes that were damaged by the flood, 84 percent lacked flood insurance, even though 45 percent were required to have flood coverage in place. Apparently mortgage lenders had done little to ensure that the mandatory flood insurance purchase requirement was met.
- Require homeowners in flood-prone areas to sign a “Disaster Relief Waiver” stipulating that they forfeit their right to disaster relief in the event they choose not to purchase flood insurance. This requirement should apply to all homeowners, not just those with

federally backed mortgages, and would serve to disabuse property owners of the expectation that generous federal disaster relief will be available to flood victims and therefore they need not purchase flood insurance.

- The NFIP should be given a renewed mandate to improve and expand its public education programs to ensure that more people are made aware of the program and the benefits of having flood insurance coverage to protect their properties.

Discourage Repetitive Loss Properties

A recent Congressional Budget Office study revealed that there are currently about 71,000 NFIP-insured “repetitive loss properties,” which represent just 1.2 percent of the NFIP portfolio but account for 16 percent of the total claims paid between 1978 and 2008. Moreover, roughly 10 percent of these repetitive loss properties have received cumulative flood insurance claim payments that exceed the value of the home. American taxpayers should not be forced to subsidize a small sub-set of NFIP policyholders who continue to rebuild in high-risk areas.

A reformed NFIP would include a system to ensure repetitive loss properties are not a drain on the program. Options to achieve this goal include:

- A buyout program. A prioritized list of properties for buy out – those that have had the largest payouts from the program – could be created and purchase offers made. If a reasonable buyout offer is made (based on appraisals) and a repetitive loss property owner refuses, that property could be prohibited from purchasing flood insurance through the NFIP.
- Make owners of repetitive loss properties ineligible for NFIP coverage if they choose to rebuild in the same place following a loss from a flood.
- Make owners of repetitive loss properties ineligible for disaster relief.

Improve Management and Correct Operational Inefficiencies

The GAO’s report² on at-risk federal operations highlighted the deficiencies in FEMA’s data tracking capabilities. The report found that FEMA lacks clear procedures for monitoring contracts and claims records, despite the investment of \$40 million over seven years for new systems. FEMA needs to be held accountable for both establishing and executing these procedures so the program can better monitor the flood situation. One of NAMIC’s recommendations to improve take-up rates is a stronger enforcement of mandatory purchase and maintenance of flood insurance requirements by mortgage lenders. While lenders must take steps to ensure greater compliance, responsibility lies with the NFIP for monitoring policy data and coordinating enforcement with the lenders. To achieve this goal, FEMA must develop and institute clear procedures for monitoring contracts and claims records, effectively communicating with lenders and triggering enforcement actions for non-compliance.

Conclusion

The NFIP is in need of significant reforms in order to continue providing flood protection to those who need it. As a practical matter, there is no private residential market for flood insurance and efforts to create one will continue to be frustrated by rate regulation, adverse selection, and capital constraints. However, other proposals that seek to explore a risk-bearing role for the private sector in the NFIP may have merit and should be given due consideration. For example, ceding a portion of the NFIP's risk to the private sector through reinsurance and catastrophe bonds could reduce taxpayer exposure to future debt.

In sum, the objective of any reform legislation should be to maintain and optimize the current flood insurance program. We believe that optimization is the best way to balance the many goals of the reform effort: fiscal soundness, affordability of insurance, adequate coverage for those at risk, floodplain management (reduction of flood hazard vulnerability), economic development, individual freedom, and environmental protection.

I would like to thank the subcommittee for its work on the discussion draft of the Flood Insurance Reform Act of 2011 that was recently circulated. We believe that the proposed bill takes several positive steps forward and coincides with NAMIC's five fundamental objectives outlined in this testimony. We look forward to working with the committee on these and further suggestions for ways that the current structure can be maintained and optimized.

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¹ Smarter Safer Coalition Flood Proposal, February 22, 2011. www.SmarterSafer.org

² Government Accountability Office; GAO-11-278 *High-Risk Series. An Update*, p. 167-170