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NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES

Statement

of

National Association of Mutual Insurance Companies

to the

United States Senate

Committee on Small Business & Entrepreneurship

Hearing on

"No More Hikes: Small Business Survival Amidst Unaffordable Flood Insurance Rate Increases"

June 30, 2016

The National Association of Mutual Insurance Companies is pleased to offer comments to the United States Senate Committee on Small Business and Entrepreneurship on ”No More Hikes: Small Business Survival Amidst Unaffordable Flood Insurance Rate Increases.”

NAMIC is the largest property/casualty insurance trade association in the country, with more than 1,400 member companies representing 39 percent of the total market. NAMIC supports regional and local mutual insurance companies on main streets across America and many of the country’s largest national insurers.

NAMIC member companies serve more than 170 million policyholders and write more than $230 billion in annual premiums. Our members account for 54 percent of homeowners, 43 percent of automobile, and 32 percent of the business insurance markets.

Through our advocacy programs we promote public policy solutions that benefit NAMIC member companies and the policyholders they serve and foster greater understanding and recognition of the unique alignment of interests between management and policyholders of mutual companies.

NAMIC believes that there are a number of problems with the NFIP as it is currently structured. Many of those problems were intended to be addressed in reforms passed under the Biggert-Waters Flood Insurance Reform Act of 2012. NAMIC strongly supported some of those provisions, particularly moving towards actuarial, risk-based rates. NAMIC also supported language that would have allowed for lending institutions to accept private sector policies that would have met the mandatory purchase requirement of the NFIP. NAMIC opposed the delay and repeal of a number of those changes made when Congress passed the Homeowner Flood Insurance Affordability Act of 2014.

The Nature of Flood Risk

In order for insurance markets to function properly, certain conditions must be 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 more difficult to insure because they defy the conditions private markets require for operation. Flood risk is one of those. Adverse selection prompts only those who believe they are at risk of flooding to purchase insurance, which limits insurers’ ability to properly pool risk. 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.

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 predictable. 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 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 flood 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. The partnership has proven successful in facilitating the prompt settlement of claims, even when faced with a very large volume of claims following extreme flooding events.

Over the last 40 years, the NFIP has allowed millions of Americans to avoid serious financial losses brought about by disastrous flooding. 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; 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 over $20 billion in debt.

Clearly the status quo is unacceptable. Nothing about the realities of flood risk has fundamentally changed. Primary insurers are still unable to offer this coverage as the continuance of the NFIP offering subsidized rates prevents companies from offering policies at rates that are simultaneously risk-based and competitive with NFIP subsidized rates. As actuarial risk-based NFIP rates began to be implemented in accordance with the Biggert-Waters Flood Insurance Reform Act of 2012, a few private sector companies began to offer policies. Many WYO Companies also began to research and prepare to potentially offer private sector policies. However, when members of Congress passed the Homeowners Flood Insurance Affordability Act of 2014, which delayed and repealed the movement towards actuarial rates, private sector development halted. That repeal, coupled with potential rate restrictions at the state level, continues to prevent the development of a private marketplace for flood insurance.

Charge Actuarially Sound Rates

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.

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 taxpayer-financed risk management program that disproportionately benefits a relatively small segment of the U.S. population.

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.

The NFIP must begin charging risk-based rates if it is to have any chance of being a solvent program. Moreover, the implementation of risk-based NFIP rates is a prerequisite for private insurers to be able to offer private sector flood policies. 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. 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. Congress should consider other ways to address the problems of affordability caused by the onset of sudden, substantial rate increases.

Provide Means-Tested Assistance to Property Owners for Whom Risk-Based Rates Would Create Genuine Hardship.

According to the GAO, nearly 80 percent of subsidized properties are located in counties that rank in the top 30 percent nationwide with respect to average home value. Fewer than 1 percent are located in the 30 percent of counties with the lowest average home values. Unless Congress intends for taxpayer-subsidized flood insurance to become a permanent middle-class entitlement, not all subsidized property owners should continue to enjoy discounted flood insurance rates. An across-the-board, four-year delay for BW-12 will continue flood insurance subsidies for homeowners who not only can afford incremental rises in their premiums, but also should fully realize the risks they face.

Instead, lawmakers should take a more targeted approach to easing the pain for those who truly cannot afford it. One way would be to create a flood insurance voucher program that targets the minority of subsidized property owners for whom risk-based rates would be truly unaffordable. Such a program could be modeled on the Section 8 Housing Choice Voucher program currently administered by the Department of Housing and Urban Development. Under this program, local public housing agencies collect information and data to assess need and determine voucher amounts. This same data could be used to determine eligibility and voucher amounts that would be made available to property owners who could not otherwise afford their flood insurance premium. Importantly, the voucher amount should not be "baked into" the flood premium; rather, it should be designed so that each voucher recipient sees the risk-based rate to which the voucher amount is applied, thus enabling the voucher recipients to be fully aware of the actual flood risk that he or she faces. While means-tested assistance should focus on low income policyholders, a case could also be made for potential policyholders that operate small businesses out of their homes.

Provide Low-Interest Loans or Grants to Finance Property Owners' Investment in Mitigation.

Mitigation measures, such as elevating structures, have been proven to protect properties from damage caused by flooding. Here again, some property owners will lack the financial resources to pay for such measures. Thus, Congress should consider creating a program that would make financing available to property owners for whom investing in mitigation would be truly unaffordable. Such a program could operate in concert with the voucher program described above. Mitigation tools are a much better method of assisting homeowners who live in flood prone areas. Not only does every $1 spent on mitigation save $4 in the long run, but it forces homeowners to confront reality in understanding the risks they face.

Give Small Businesses the Tools to Invest in Mitigation

Beyond providing assistance to property owners and small business owners to pay actuarially sound rates, one of the best ways we can ensure the long-term sustainability of the nation's small businesses is through the creation of a national strategy for investing in mitigation and resilience. Over the last thirty years, we have seen a shocking rise in the frequency and severity of natural disasters, including flooding events. For instance, from 1976 to 1995, there were an average of 39 major federal disaster declarations per year, but from 1996 to 2015, that number had risen to an average of 121 declarations per year. This is especially important to note in light of the fact that according to the National Federation of Independent Businesses, about 30% of small businesses never reopen following major disaster declarations.

But despite the rise in the number of disaster declarations, the nation's federal disaster system remains fragmented, and heavily skewed towards reactive post-disaster spending rather than thoughtful long-term investing, putting our small businesses at risk. This has been clearly illustrated in recent years, as the GAO found in a report released last year that from 2011-2014, FEMA spent 14 times more on post-disaster mitigation than on pre-disaster measures. This approach flies in the face of a study by the National Institute of Building Sciences which shows that every $1 spent on mitigation ahead of a disaster saves $4 in recovery costs. In light of our federal disaster system fostering a "wait and see" approach, the GAO found that the most effective way to reduce losses is through pre-disaster mitigation and the facilitation of strong building codes through a package of incentives.

In an effort to help small business and home owners by shifting disaster policy away from how it is currently formulated, in 2011, NAMIC created the BuildStrong Coalition. The Coalition, a group of architects, firefighters, emergency managers, contractors and code officials, all dedicated to building homes and businesses more resiliently in the face of the rising number of extreme weather events, released a report last fall titled "End the Cycle of Destruction: The U.S. Should Invest More before Disasters through a National Mitigation Strategy." The report echoed the GAO's findings in highlighting a number of principles that should be the core of a national, comprehensive strategy for investing in mitigation.

Working with members of Congress following the release of the report, NAMIC and the Coalition helped turn those principles into a legislative package, introduced in the House on May 10, as the National Mitigation Investment Act, H.R. 5177. NAMIC believes two other pieces of legislation, The Disaster Savings and Resilient Construction Act of 2015, H.R. 3397,

and The Disaster Savings Account Act, H.R. 2230, are also critical to incentivizing mitigation on a broad scale at the state, local, and individual level in a comprehensive and efficient manner. A description of each bill is below.

The National Mitigation Investment Act, H.R. 5177

The first effort in Congress to create a national strategy for investing in mitigation, H.R. 5177, introduced by Rep. Carlos Curbelo (R-FL) and Albio Sires (D-NJ), will reform federal disaster policy and protect the nation's small businesses by creating incentives for states that adopt and enforce modernized residential and commercial building codes while creating a new pilot-program designed to equip states and localities to enforce strong codes. While many states and communities have model building codes in place, their practical effectiveness is often negated by a lack of resources to properly enforce them. This program will provide grants to states and localities to defray these costs. H.R. 5177 also creates a study, commenced through the National Advisory Council, to examine costs and losses from natural disasters, identify how disaster assistance is being used, and determine ways to best mitigate ahead of catastrophes. The panel created to perform this study will include representatives of the property/casualty insurance industry.

The Disaster Savings Account Act, H.R. 2230

The Disaster Savings Account Act, introduced by Rep. Dennis Ross (R-FL), would allow eligible individuals, including small business owners, to deduct up to $5,000 contributed to a designated "disaster savings account." An eligible individual is defined as any individual who owns a home in the U.S. that is insured. A disaster savings account would be a trust created in the U.S. exclusively for the purpose of paying disaster mitigation expenses of the trust's beneficiary.

The Disaster Savings and Resilient Construction Act of 2015, H.R. 3397

Introduced in 2015 by Rep. Tom Reed (R-NY), the Disaster Savings and Resilient Construction Act of 2015 would provide a tax credit to owners of qualified residential and commercial property that meet the 2009 or later International Code Council Standards, has received the designation of FORTIFIED for Safer Living/Business from the Institute for Business and Home Safety, and was constructed within three years following the occurrence of a disaster. In the case of qualified residential property, homeowners can receive up to a $3,000 credit, and for qualified commercial property, business owners can receive up to $25,000.

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 substantial 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. In tandem with much-needed reforms to the NFIP, one of the most effective ways we can protect our small businesses from increasing flooding and flood insurance rates is through a national

strategy for investing in mitigation that incentivizes and gives tools to small business owners to make pre-disaster investments in resilience. NAMIC thanks the Committee and we look forward to working with Congress on continued reforms to the NFIP and options for a private marketplace for flood insurance.