Flood Market Expansion and NFIP: Solvency Unleash the private markets to solve the coverage gap

- **Cherry Picking? Happy Harvesting**

Over 90% of America's homes that are at moderate to extreme risk of flooding are uninsured for flood insurance. At the same time, the near-monopoly federal NFIP program is losing billions and is way overdue for technology and process overhauls. The solution to both of these problems; the coverage gap and NFIP fiscal insolvency, is in the expansion of the private flood insurance market.

Expanding the market for private flood insurer growth will provide consumers with better prices and more coverage options. Contrary to some statements about "cherry picking" creating risk for the NFIP, in fact the expansion of the private market is significantly reducing the potential losses to FEMA via the NFIP.

Current situation

The NFIP is currently unprofitable and has no path to get out of the hole. The NFIP has posted a 121% loss ratio over the past 15 years, paying out $9.4 Billion more in claims than it took in through earned premiums. 2019 data, not yet available, will only enhance this negative trend, due to large losses from spring floods, Imelda, and Dorian. Even without taking into account the administrative costs of operating the NFIP, the program would need significant rate increases to achieve break even status, the most basic measure of financial solvency. Losses within the NFIP have created a $36.5 Billion debt, according to the GAO, which is paid by, you guessed it, the American taxpayer. Despite that, significant political opposition exists to rate reform, as many consumers in the program have limited ability to absorb an increase in their premiums.

The largest factor in the NFIP's precarious financial position is that it has over 90% market share. As a result, any storm anywhere will create dramatic losses to the NFIP. If the storm(s) hit high density areas such as south Florida, southeast Texas, New Jersey, Virginia Beach, as only a few of many examples, then the losses will be an enormous financial calamity as well as a human tragedy.

How we got here

As background, flooding is what is called a low frequency, high impact event. There is an element of randomness, some call it luck, that has storms or flood events hit certain communities and not others. The fact is that it is truly random, but over hundreds of years of storms every location will be affected. Floods occur in all 50 states and DC. Due to the infrequency, the random landing points, and the high impact, when the NFIP was established in 1968 there was no way for insurers and reinsurers to adequately estimate the risk. As a result, flood insurance became a single provider market through the NFIP. It was an extremely beneficial government program that over the years has allowed people and businesses to build or rebuild in coastal and river-adjacent areas with confidence.

In the last few years, a number of key technology changes occurred that gave insurers and reinsurers the tools to effectively estimate flood risk. In particular, high speed computing enabled advanced simulations, resulting in predictive risk models. Data providers aggregated huge amounts of data in cloud-based repositories, accessible in real time via application programming interfaces (API) calls. Buyers also changed, expecting online purchasing through Amazon-like user interfaces. Collectively, these have changed the future look of the flood insurance market by bringing real time quoting, automated purchase without an elevation certificate requirement, improved technology, and most importantly an expansion of the market to many in non-mandatory zones.

Monopoly Money

When I started in business, we were in the last days of the AT&T monopoly. Universal complaints abounded of fixed prices, limited options, and technological stagnation. People hated that they could "have any color phone they wanted, as long as it was black".

Today, the NFIP is the Ma Bell of 2020. Coverage limits are below the average home construction prices in many states, resulting in mandatory underinsurance (a hidden risk to many homeowners). Even FEMA admits their pricing is not actuarially sound. High value homes are subsidized by low value homeowners, if anything the inverse of what one might design. Optional coverages, such as replacement cost, temporary living expenses if evacuated from your home, and others simply don't exist in the NFIP. Private market flood companies are filling the gap with better pricing than the NFIP, better coverages, and simple processes for quote and bind.

A Word About Cherry Picking

Alarmists shriek about how private flood insurers will only write business to the profitable parts of the NFIP, leaving the program in more debt. A recent article headline said: "Insurers cherry-pick homes, leaving flooded ones for feds". It went on to cite the "starkest data comes from Florida, which has…seen the number of private policies soar to 83,000 from roughly 37,000 in June 2017".

Most would consider the expansion of the flood market, which means that homes that have been uninsured have bought flood insurance and are now protected by private companies rather than federal debt, a very good thing. Shifting the risk of loss away from the federal government, i.e. you and me, to private insurers is a great outcome. These insurers, some of the largest and most stable companies on earth, diversify risk across the globe using 250- and 500- year loss models.

Most significantly, the number one factor in reducing NFIP losses is to reduce NFIP policy aggregation. Sell less policies in congested areas, allow diversification across multiple companies, and losses are reduced. It is Statistics 101.

A real example is Florida Citizens, the state government-owned homeowners insurance provider of last resort in the state of Florida. After the severe storms of 2004/05, Citizens grew to be the largest insurer in the state. CEO Barry Gilway instituted a program of "depopulation" to reduce the aggregation and overall financial risk to the state residents, allowing private insurers to select policies that they would inherit and transfer to their insurance. Despite an outcry of the risks of private insurer cherry picking, the end result as of late 2019 is that Citizens reduced its policy count from a high of nearly 1.5M down to 443K, while actually reducing its loss ratio at the same time. In other words, allowing the private markets to cherry pick the policies they wanted actually improved the results of Citizens and reduced the risk to the Florida taxpayer.

A Solution Awaits

The first step in resolving the NFIP aggregation problem, and thereby reducing the risk of enormous NFIP losses every year, is the establishment of a healthy and diverse private market. There are currently private flood providers in every US state and DC, and the numbers have accelerated since 2017. Best estimates are that the private market has on the order of 500,000 residential policies. These policies are backed by large, private global reinsurers, such as Lloyd's, MunichRe, SwissRe, and many others.

A few years ago, FEMA announced its "moonshot" goal of doubling the number of flood policies in the US by 2022. Attaining this goal is an important financial and social initiative that will require an ecosystem of a strong NFIP coupled with a vibrant and diverse private market. This type of ecosystem exists in most states already in the homeowners and auto spaces; it is just new to flood.

A future step is to create a process of risk transfer to the private markets, allowing private companies to step up and assume policies from the NFIP. Similar to the Florida Citizens examples, this will reduce NFIP exposure and create a much deeper pool of global insurance capacity to enter the US flood market. For the consumer, it will also bring a wave of new pricing, coverage options, and process improvement to expand the market even further.

Who Wins?

Shockingly, everybody wins. The consumer wins with additional choice, prices, and coverages. Insurers win with new market opportunities (and jobs). The NFIP, FEMA, and the Federal Government win with lowered risk and an expanded base of insured homes and businesses in the US, taking financial risk off the government and allowing better focus for relief and recovery resources. The taxpayer wins with reduction or even elimination of the hidden subsidy of the NFIP that has amounted to tens of billions of dollars in recent years.

Allow private insurers to work to the benefit of the consumer, and the result will be a stronger market with reduced risk.