PRIVATE LESSONS

THEY WERE ONCE JUST A DROP IN THE BUCKET, BUT PRIVATE MARKETS FOR FLOOD INSURANCE ARE GAINING TRACTION. ARE THEY VIABLE?

By Jacquelyn Connelly

After Hurricane Sandy hit the Northeast in October 2012, H.R. 41 increased the NFIP's borrowing authority from $20.7 billion to $30.4 billion in order to pay related claims. Now, the NFIP owes $24 billion to the U.S. Treasury, according to FEMA officials.

Congress has asked for additional investigation into the potential for flood insurance privatization in both Biggert-Waters and the Homeowner Flood Insurance Affordability Act of 2013. And just this summer, both the House and Senate introduced bipartisan legislation aiming to increase the availability of private flood insurance policies as an acceptable alternative to the NFIP.

Is momentum growing for a private flood market? And more important, is flood privatization possible?

A handful of private insurance companies in Florida seem to think so—and have already announced their intentions of not only writing flood insurance on their own paper rather than as WYO participants in the NFIP, but also charging lower rates than FEMA.

"I think for the very first time, private flood is becoming a mainstream true alternative to the NFIP," says Evan Hecht, CEO of The Flood Insurance Agency and Private Market Flood, both located in Gainesville, Fla. (see IA tablet app for more information). "The public is scared to death of what FEMA's going to do with rates because when they administered Biggert-Waters, they blew it. You can't take somebody's rate from $800 to $18,000 overnight."

"The stage has been set for companies to do this," agrees Richard Koon, deputy commissioner at the Florida Office of Insurance Regulation. "From what we've seen so far, they can do it and they believe they can make money."

Potential for Private

A recent study from Deloitte, "The potential for flood insurance privatization in the U.S.," outlines 10 potential privatization models (see IA tablet app for more information), with the "capital market" and "reinsurance" angles topping the ease of implementation list. In the former, capital markets would offer additional avenues—in conjunction with the use of private primary insurance and/or reinsurance—to help spread risks through securitization via sale of cat bonds to investors.

"The NFIP itself could float catastrophe bonds to try to spread some of its risk into the private sector," explains Sam Friedman, co-author of the study and research leader for insurance at the Deloitte Center for Financial Services. "With the low interest rates that are still out there, these securities are very attractive to investors because they offer above-market returns."

The "reinsurance" model could take a similar "layered approach," Friedman says—a viable strategy because for the most part, the NFIP has collected more in premiums than it has paid out in claims for most of its existence. It's only devastating cat years like 2004, 2005, 2008 and 2012 that have been "killers" for the NFIP's bottom line, Friedman says. "In the years when the NFIP is not collecting enough premiums to cover the claims, having a catastrophic layer of reinsurance in place or having cat bonds in the market could cushion the blow—while allowing the private market to profit in the majority of years where claims are manageable for NFIP to handle on its own."

Another contender? The "opt-out" model, in which a homeowners insurance policy includes flood coverage automatically, but insureds have the option to refuse it. Adding what Friedman calls a "hammer" might make the opt-out model even more effective: consumers that opt out of flood coverage would not be eligible for federal flood relief in the event of a disaster.

"There's some skepticism about whether there's the political will to make that happen when you have these horrible scenes of people floating on their couches," Friedman says. "But under the current system, we may be enabling an expansion of the exposure to taxpayers by making it more affordable for people to live in areas that are subject to flood. There may be a psychology at work here that they don't really need to pay for insurance up front because they believe the government will take care of them on the back end."

Obstacles in the Way

Chris Heidrick, principal of Big "I" agency Heidrick & Company Insurance and Risk Management Services, LLC in Sanibel, Fla., is a self-described "private market person." But he's "not convinced that the NFIP will ever be fully replaced by the private market."

As an agent, Heidrick is most concerned with a few questions that could help protect his clients, his business and the economy: Will a client be able to leave the NFIP for the private market and then return to the NFIP without losing subsidized rates, assuming they were eligible? And if Heidrick places a client with a private flood insurance company, what will happen to those rates vs. the NFIP's in

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the short- and long-term?

"It's going to be easier for me to guide my clients when I see that the private insurers have a little more momentum and there's some history on how they're going to react after a catastrophic event," Heidrick says. "It's not all about price, because the private flood insurance markets—especially those that are excess and surplus lines—have freedom of rate and form, which means anything can happen."

Heidrick also believes flood insurance privatization has bigger implications than many people realize, especially considering the unlikelihood that private companies will sustain grandfathering—an NFIP practice Heidrick says adds stability and certainty to real estate and other markets outside the insurance industry. "It's kind of like owning a piece of real estate means you've lost a game of hot potato," he says. "I have trouble envisioning what actually happens if grandfathering goes away."

That's because even if private companies are able to improve the technology—"the NFIP is using very antiquated data and very antiquated models," Koon says—flood map accuracy will always be difficult to pin down.

Heidrick saw the implications of this issue firsthand during Biggert-Waters, when three of his clients planned to build on three different pieces of land that shared one common theme: Each parcel was located in the AE flood zone, and the line between it and the VE flood zone was the street in front of the parcel.

"All three came to me and said, 'What should I be thinking about in terms of insurance before I build?'" Heidrick says. "I had to tell them build to the VE zone specifications, because if that line moves 30 feet in the wrong direction at some point in the future, flood premiums would go from about $1,000 to about $10,000. Because of the uncertainty, none of them built. Because none of them built, 300 people didn't get to work."

But the biggest obstacle may be the regulatory environment for private flood insurance, which as of press time remains unclear. Sens. Dean Heller (R-Nev.) and Jon Tester (D-Mont.) and Reps. Dennis Ross (R-Fla.) and Patrick Murphy (D-Fla.) have introduced S. 2381 and H.R. 4558, the "Flood Insurance Market Parity and Modernization Act of 2014." The bills aim to remove excessive restrictions placed on insurance companies by the federal government for the issuance of private flood insurance and would give the states more flexibility to license and regulate private flood insurance.

While remaining a steadfast supporter of the NFIP, the Big "I" supports S. 2381 and H.R. 4558 and wants to work with Congress to see that private flood insurance remains an acceptable alternative to the NFIP.

E&O RED FLAGS

Potential E&O pitfalls are another concern for agents as the private flood market is poised to expand says, Chris Heidrick, principal of Big "I" agency Heidrick & Company Insurance and Risk Management Services, LLC in Sanibel, Fla.

For example, paragraph B in section 100239 of Biggert-Waters states that a private flood policy must be "at least as broad" as the NFIP—a requirement that is "very interpretable," Heidrick says. If a regulator determines a private policy is not "at least as broad" as the NFIP, the lender risks substantial fines.

Why is it an issue for independent agents? Heidrick explains that some Florida lenders have agreed to take on private flood insurance policies, but require the agent to sign a form that certifies the policy meets the Biggert-Waters requirements—passing along the responsibility to the agency level. "As an agent, I don't want to take that regulatory risk," Heidrick says. "I don't want to open the door for a bank to come back and say 'I was fined because you said this was ok. Make it right.'" —J.C.

Opportunities Abound

Roadblocks aside, flood privatization could present serious business opportunities for independent agents—especially since so much of the NFIP is currently controlled by the direct and captive channels, according to Hecht.

"Up until now, everybody had only one program," Hecht says. "If I'm a direct writer, I understand I'm in trouble if I can only offer you a $2,000 flood premium and the independent agent down the road can offer you one for $1,400. I may not only lose the flood—now I may lose the homeowner and the auto and all the rest of it."

"It's all about the birth of choice," Friedman agrees. "You're the more-than-one-company agent—this is right in your wheelhouse. So there are challenges, but competition is good."

Heidrick is "encouraged" that flood privatization could work—eventually. "I see potential for a measured and balanced depopulation of the NFIP," he says. "I just don't see everything changing overnight. Biggert-Waters is an example of what happens if you try to push it too fast."

And while Hecht believes private flood policies and government policies will co-exist for a long time to come, "in the foreseeable future, the private market is going to start to take a significant percentage of those government policies," he says. "If the general public had ultimate faith that FEMA was going to keep the rates affordable and pay all their claims, it would have been a lot more difficult for the private market to take a foothold. FEMA opened the door. So let the competition come in—it will make us better."

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