The Subcommittee on Housing and Insurance

November 19, 2014 Hearing:

Opportunities for a Private and Competitive Sustainable Flood Insurance Market

Testimony of Don Brown

Chair Neugebauer, Ranking Member Capuano, and members of the subcommittee – thank you for having me here today. My name is Don Brown and I currently work as a lobbyist representing insurance and reinsurance companies in the state of Florida. Previously, I served in the Florida House for 8 years and I was an insurance agency owner for 28 years.

When the NFIP was established, flood was generally considered an uninsurable peril and few private companies were willing to write the risk. There was no loss history, no models for flood, and generally the insured knew much more about their potential for loss than the insurance company.

Flood is no longer an uninsurable risk and the private market is no longer unwilling to write flood. Just the opposite is true. There are several reasons for this development.

In the last few years, commercial flood models have been developed that, along with mapping and geocoding technologies, have given insurance companies a wealth of information regarding flood risk. There's been an influx of capital into the reinsurance and insurance arena – and that capital is interested in underwriting flood risk.

These developments provide new options for consumers when buying flood insurance.

Additionally, after the huge losses incurred by the NFIP during Hurricane Katrina and superstorm Sandy, it's become apparent that it's not necessary or desirable for the Federal government to take on all of the flood risk. It's better for U.S. taxpayers to have that risk borne by private companies – and it's better for consumers if they have options when buying flood insurance. Please see:

http://nj.gov/governor/news/news/552013/approved/20130501c.html

One additional consumer benefit to the development of a private flood market is that it is regulated by state insurance departments who have a long history of consumer protection as their very foundation.

As a former legislator, I believe the role of government is to remove obstacles to private companies and to give consumers additional options when insuring their homes. I believe there will always be a need for a program like the NFIP – but there's plenty of flood risk out there that can be written by private companies – and I can tell you that many of my clients are eager to write flood policies.

Unfortunately, insurance agents and banks have expressed concern with current Federal law that need to be addressed. Banks question if the flood policies written by private carriers will satisfy the mortgage requirement for homes located in a high-risk flood zone. Agents are concerned about E&O exposure for selling policies that might not meet the Federal mortgage requirement and the potential exposure if the agent sells a policy that negatively impacts the insured's ability to get subsidized NFIP coverage in the future.

There are at least three obstacles to a vibrant private flood market, however.

<u>The first obstacle</u> is that the law currently permits several different Federal agencies to regulate flood companies, and the policies they issue, to determine if those companies and policies satisfy the requirement to buy flood insurance for homes in high-risk zones with a federally backed mortgage. These agencies could issue different requirements, even years from now, that would throw the private market in to disarray.

Additionally, these Federal agencies would be superseding the states' role in regulating private insurance companies. This uncertainty is stifling the market for private flood insurance by creating uncertainty. H.R. 4558 addresses this problem by clarifying that if a company is approved by the insurance regulator of their domicile, then coverage is acceptable for homes located in a high-risk zone and with federally backed mortgages.

Please allow me to expand briefly on the notion that uncertainty can be an impediment to the formation of a healthy private flood insurance market.

What the flood insurance market needs more than anything else is: CAPITAL!

So, what are the impediments to Capital formation in this market space? To answer that question it might be helpful to reference Frank H. Knight's landmark book: ***Risk, Uncertainty, and Profit*** (1921). In his book Dr. Knight defined the difference between Risk and Uncertainty like this:

1. Risk is present when future events occur with measurable probability
2. Uncertainty is present when the likelihood of future events is indefinite or incalculable

When the probability of risk can be quantified there is a clear path forward. When uncertainty prevails and future events are indefinite or incalculable then the path forward is clouded and forward progress slows or, in extreme cases, stops altogether.

Dr. Knight goes on to explain that, in addition to uncertainty about our natural environment (in this case the weather), political and regulatory uncertainty can also impede private capital formation.

The following, now famous quote, expresses a concern over the unknown in a different way: "…there are known knowns; there are things we know we know. We also know there are known unknowns; that is to say we know there are some things we do not know. But there are also unknown unknowns—the ones we don't know we don't know."—*Donald Rumsfeld*

How do people, including capital investors, weigh risk versus uncertainty? Consider a famous experiment that illustrates what is known as the Ellsberg Paradox. There are two urns. The first urn, you are told, contains 50 red balls and 50 black balls. The second one also contains 100 red and black balls, but the number of each color is unknown. If your task is to pick a red ball out of either urn, which urn do you choose? Most people pick the first urn, which suggests that they prefer a measurable risk to an immeasurable uncertainty. This condition is known to economists as ambiguity aversion, a kind of fear or paralysis in the face of the unknown or it could also be called "the inherent fear of the unknown."

Today the greatest impediment to capital formation in the private flood market is political, legislative and regulatory uncertainty.

The second obstacle is that currently the law requires that private insurers offer coverage at least as broad as the NFIP for it to be accepted by banks. The issue is that "coverage" is defined by the law to include exclusions, conditions, and deductibles. Deductibles are not usually considered part of "coverage" when discussing a policy of insurance.

As someone who's sold insurance policies for decades, I can tell you that when I discuss "coverage" with a customer – I'm usually talking about exclusions and conditions precedent – not the point at which the coverage attaches. The problem is that the way the law is drafted; it's unclear if private companies can offer consumers additional options regarding deductibles and still have the policy considered to be comparable coverage to the NFIP and therefore accepted by the banking industry. The term "deductible" should be removed from the law so that consumers have a wide variety of options on how to structure deductibles when purchasing flood insurance.

The third obstacle is what I'll call "grandfathering" of subsidized rates for NFIP consumers that go to a private carrier. H.R. 3370 that you all just passed clarified that the rate subsidy stays with the property – so even if a house is sold, the new owner gets the benefit of the same rate and glide path that the current owner had. Under current law, it's not clear how the NFIP would rate a policy when a property moves from the NFIP to a private carrier and then wishes to come back to the NFIP. As an insurance agent, I can tell you that I'd be concerned about moving a customer from the NFIP to a private carrier if I wasn't sure whether or not the customer would lose their subsidized rate should they want to return to the NFIP. Clarifying that a customer could return to the NFIP on the same glide path that they are currently on would make me feel more comfortable selling a private flood policy.

There is one additional "potential" obstacle – a new tax on global reinsurers. Testimony offered in November 2013 before this Subcommittee at a hearing on "The Future of Terrorism Insurance expressed concern over the Neal-Menendez bill, H.R. 3157. During that hearing Representative Ross asked Kean Driscoll, CEO of Bermuda-based Validus Re, the following question: "Would [H.R. 3157] limit the capacity or capability of insurers and reinsurers to take on more risk from terrorism or flooding (TRIA and NFIP) and thus be counterproductive to our long term goals of reducing the size of government insurance programs?" Responding Mr. Driscoll said: "Yes. Reinsurers need to be able to pool risk to gain diversification. Any limits on affiliate reinsurance would impede global risk pooling and would fragment group capital and would impede market development and likely *increase consumer prices* (emphasis added)." Notwithstanding the unprecedented capital inflow to the global catastrophe market over the last several years, a new tax could mute that positive development.

In conclusion, I want to thank the committee for all the work they've done on flood insurance to date. Amazing progress has been made and I really do feel that there's an opportunity for a vibrant private flood market – there's just a few tweaks that need to be made to current law.

Thank you for your time and for inviting me to testify before you.

I'm happy to answer any questions you might have.