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Private Flood Insurance—Be Aware of The Risks

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(Editor's Note: This article was written by Chris Heidrick for the benefit of FAIA members and is used with permission. Our thanks go to Chris for his tireless work on behalf of FAIA.)

The use of private flood insurance policies for risks in the Special Flood Hazard Area (A and V zones) has increased substantially over the past year. The Biggert-Waters Flood Insurance Reform Act of 2012 (BW12) created this opportunity as some pre-FIRM premiums increased by 1,000 percent or more when full risk rates were applied. On March 21, 2014, The Homeowner Flood Insurance Affordability Act (HFIAA) was signed into law. HFIAA provides a great deal of relief for many of the properties most severely impacted by BW12, but it also creates E&O risks for agents. Until FEMA fully releases guidance on HFIAA, we will not know all of the specific impacts. This article reviews some of the potential risks of writing private flood insurance.

Before writing a new private flood insurance policy, the agent should verify that the lender will accept the coverage. Some lenders have created a form for the agent to sign, attesting that the private policy provides coverage that is “at least as broad” as the NFIP policy. AGENTS SHOULD NOT SIGN THIS FORM. These forms give the lender the opportunity to transfer responsibility for their own lack of diligence to the agent, and could result in an E&O exposure for uncovered losses or the lender’s potential regulatory risks. As lawmakers work on legislation to increase the use of private flood insurance, they should include language that will address this concern.

Currently, most private flood policies are either an endorsement to a homeowners policy or a stand-alone policy written by a non-admitted insurer. It is unlikely that an endorsement to a homeowners policy will satisfy lender requirements. This could be for many reasons, but the most obvious is the cancellation provision. An NFIP policy can only be cancelled for specific reasons outlined in the NFIP manual, but a homeowners policy (and all accompanying endorsements) can be cancelled by the insured for any reason at any time. This more-broad termination provision provides less certainty to the lender as the insured can cancel the homeowners policy mid-term, exposing the lender to uncovered losses and regulatory penalties.

Some stand-alone policies can mirror the provisions of the NFIP and for some risks the premium may be lower than the NFIP. However, since non-admitted insurers can adjust rate and coverage without OIR (Office of Insurance Regulation) approval, large fluctuations in price can occur. Under HFIAA, NFIP rate increases are capped at 18 percent for a policy covering a primary residence and 25 percent for a policy covering a non-primary or non-residential risk. Many factors can impact pricing of non-admitted policies, most notably supply and demand of capital. The reinsurance markets are currently flush with capital, but if that changes private flood insurance premiums could increase quickly and dramatically. What’s more, SB542 allows admitted insurers to set rates each year without state approval until October 2019 and those admitted insurers will need to rely heavily on reinsurance, just like the non-admitted insurers, to write a catastrophic exposure such as flood. Therefore, a stand-alone flood policy that may be offered by an admitted insurer at some point in the future may still leave significant uncertainty regarding renewal pricing. It is worth noting that the same cost-of-capital challenges that limit the availability of wind insurance in the wind pool will also limit the availability of flood insurance in the Special Flood Hazard Area.

HFIAA includes a provision that makes an NFIP policyholder ineligible for a subsidized rate if the policyholder leaves the NFIP unless the policy is no longer required by a lender. FEMA has not yet released guidance or an effective date for this provision. If that effective date is retroactive, as some portions of BW12 were implemented retroactive to the date the law was signed, policyholders who leave the NFIP for a private insurer could permanently lose subsidized rates. Even though those rates will continue to increase for the foreseeable future, they will do so predictably, as opposed to the private market where availability and affordability cannot be predicted. Consider this scenario:

> Mrs. Client has a pre-FIRM policy in the AE flood zone at an annual premium of $2,800 with a lender listed. At the agent’s recommendation, Mrs. Client moves from the NFIP to a private insurer at a premium of $1,700. Two years from now the private insurer either significantly increases premium or non-renews Mrs. Client for “exposure management.” Had Mrs. Client stayed with the NFIP, the renewal premium would have been about $3,900. However, since Mrs. Client left the NFIP and the coverage was still lender required, she now needs an Elevation Certificate to re-enter the program and the new premium is $10,716.

In this case, we would hope other private insurers are available and offer better alternatives to the NFIP, but there is no certainty that will be the case. After Superstorm Sandy, premiums for excess-flood policies spiked for most insurers. Wouldn’t we have expected the same to have occurred for primary flood policies, particularly if rates can be set without OIR approval?

Private flood insurance is no silver bullet. It can be a great alternative when all of the stars align, but without further guidance from FEMA on HFIAA, without some form of regulatory protection from lenders asking insurance agents to “certify” that private policies meet some standard, and without a track record to help agents determine how availability and affordability may be impacted after a catastrophic event, these policies can be very dangerous. Agents should use extreme caution in the use of private flood insurance.

For further reading on private flood insurance, see our article *Private Flood Insurance* in FAIA's Education Library.