RISK: As flood threats rise, federal reform to diversify the insurance risk sinks  (Friday, April 12, 2013)

Evan Lehmann, E&E reporter

It was a few hours before Sharron Voorhees was scheduled to sign a new home loan when her bank canceled the closing appointment because she had private flood insurance.

Two more cancellations followed, both on the morning of her closing dates, based on the bank's concern that Voorhees had purchased coverage from Lloyd's of London rather than the U.S. government.

"It just doesn't look like a flood policy," a loan officer told her last fall.

For months, the retired lawyer from a low-lying section of San Diego, where flood coverage is required, argued with the bank to accept her private insurance as a condition of her refinancing. She felt that it offered better protection than the federal policy at a lower price.

Voorhees never got the loan.

"They said, 'Nope, nope, again, once again, we can't close the loan because your flood policy isn't any good.'" Voorhees said. "And I said, 'Well, what do you mean my flood policy isn't any good?' And they said, 'Well, it's not a FEMA policy.'"

Her venture into alternative insurance is a microcosm of Washington's failed attempts to reform a federal program that gobbles up huge chunks of the nation's flood risk, making it a matter of course that federal taxpayers shoulder almost the entire burden of the most expensive natural disaster damage, which is flooding.

The National Flood Insurance Program, run by the Federal Emergency Management Agency, issues between 90 and 99 percent of all residential flood policies in the United States, by most accounts. That means the public bears about $1.23 trillion in exposure to loss, with damage climbing as more powerful storms collide with increasing development along the U.S. coasts.

To many in Congress, Voorhees and others like her represent a glimpse of the future, in which citizens increasingly pick private insurers to carry more of the nation's flood risk. As federal budget control issues come to the fore, that vision may become more politically popular because it isn't just the oceans that are
rising: The federal flood program's debt climbed by $9.7 billion after the shock of Superstorm Sandy.

But there are a variety of obstacles that stand in the way of greater use of private flood insurance to absorb some of the damage, according to federal officials and industry members.

'Gun-shy' lenders

Some banks might be hesitant to accept anything except a federal flood policy because they fear it won't meet the legal requirement of being "equivalent" to the government coverage. This pushes banks against a wall of arcane insurance details, as they try to determine whether a building's foundation is covered from damage or whether an insurer can suddenly cancel the policy.

Shadowing those assessments are concerns about banking regulators and whether deviating from the details of a federal policy might bring their wrath. Regulators can impose fines and mete out other administrative punishments if mortgage lenders don't protect their assets from water damage.

There's also another component: Private insurers are so rare in the business that banks might not know what to do with them. Whom should they call to determine whether the insurer has enough cash to cover a flood? How can they assess a company's ability to protect the bank's collateral and customers? And how does the private plan compare with Washington's?

"The lenders are a little gun-shy because it's supposed to be equivalent-type coverage," said one senior FEMA official who is not authorized to speak publicly. "But it's real safe if they just say, 'All we're gonna take is the NFIP policy.' That's the safe and easy way out."

In the past, FEMA has contributed to the confusion. In a set of guidelines last updated in 2007, the agency listed six attributes that private coverage might display.

The description, meant to be only a ballpark portrayal, became interpreted as a rule, a strict definition of what a private company should look like. Only there was a problem: It didn't look like a private company.

For example, one of the attributes says a private policy should be "as restrictive" as its federal counterpart when canceling the policy. But the government never cancels its policies, no matter how many times a home is flooded. That's a high-water mark that private insurers can't match. Banks, meanwhile, are left to determine whether a private policy is "equivalent" to the public coverage.
'Plagiarism' thwarts Congress' intent

In legislation that revamped the flood program last summer, lawmakers tried to convince the banks that private insurance is an acceptable alternative to federal coverage. The law instructs banks to tell their customers that a private option is available. More importantly, it orders Fannie Mae and Freddie Mac, which influence bank behavior as mass purchasers of mortgages, to "accept private flood insurance" if it meets requirements.

So that was good, supporters say.

"But then somebody plagiarized," said another FEMA official. Lawmakers inserted FEMA's troublesome six-step guidance into the legislation, turning what was meant to be guidance into "black-letter law."

"Plagiarism is not a good idea in college ... [and] it makes lousy law," the official said. "The guidance language they put into the law actually made it worse -- made it harder [for lenders to accept private coverage]. They should have said, 'Banks should accept private insurance.'"

Still, it's not as if insurance companies are scrambling to write flood coverage but can't. One reason the government program was enacted in 1968 was because the industry was leery of wading too deeply into the risk-prone business.

Craig Poulton says he's different. He owns a brokerage firm in Salt Lake City that sells a novelty: residential flood insurance underwritten by Lloyd's of London. Poulton, who counts Voorhees as a customer, says he can compete with the federal flood program and win. That is, if banks would accept his policies.

"It's been virtually impossible for us to make headway," said Poulton, who believes that perhaps half of his policies are accepted by mortgage banks. Most of his customers are people who don't have a mortgage or who live in communities that haven't subscribed to the National Flood Insurance Program.

Poulton believes that just 1 percent of the U.S. flood market is handled by private insurers. He claims that half of it is in his books, a modest number of customers that reaches perhaps "a few thousand."

It's unclear how much of the market belongs to private companies, but experts say it could be between 5 and 10 percent.

**Insurers get billions, without any risk**

The flood law enacted last year might help expand private coverage, Poulton said, though he lamented the inclusion of "a kind of crazy mistake" -- the outdated FEMA guidelines that he believes were designed to protect the federal program
from private competition. He worked with lawmakers to include the language supporting private policies.

His fear is that banking regulators will ignore Congress' intent.

Although just a handful of companies go head to head with the government flood program, about 90 private insurers are involved in another way: They sell federal coverage for a fee, but the risk remains with the taxpayers.

The "Write-Your-Own" program, or WYO, was launched in the 1980s as a way to expand flood coverage. The companies sell the policies and assess, or adjust, losses after a disaster. But claims are paid by the federal program. The companies were paid $6.6 billion between 1998 and 2008, according to Erwann Michel-Kerjan, a researcher at the Wharton School of the University of Pennsylvania. That amounts to about one-third of the premiums collected by the program.

Poulton believes that's one reason there are so few private competitors. It was more attractive just to write the policies without assuming any of the risk. "In one brilliant stroke called WYO, they eliminated any impetus, any motivation for private insurers in the U.S. to engage in flood insurance," Poulton said. "One stroke. WYO. Boom! It's over."

Lloyd's of London is not eligible for the WYO program because it's not a domiciled U.S. insurer.

No short-term fix

Eli Lehrer, president of the R Street Institute, a Washington-based research group, believes it's crucial to shift some of the government's climbing flood exposure to private insurers.

But he cautions that bankers might have good reasons to choose federal coverage over the Lloyd's policy. It might come down to efficiency. If it's too burdensome for banks to vet private policies, then that may be a market distortion. A company that overcomes those challenges might find an opportunity to compete.

"It's hugely important to work to shift exposure off of the federal government," Lehrer said. "But certainly nobody expected it to happen overnight. And not everything that shifts exposure is, by that alone, virtuous. If there are real concerns or real administrative burdens in shifting exposure, then that has to be fixed."

As for Voorhees, she sought to rescue her loan application last fall by offering to switch back to the federal flood program, which she had held for 14 years before finding the Lloyd's policy.
By then, the bank, Ally Financial Inc., had canceled her application.

"Nobody would talk to me," Voorhees said. "I was like a pariah."

For its part, Ally Financial is largely owned by the government -- at 74 percent -- after accepting $17.2 billion in the 2009 bailout of General Motors and Chrysler. It stopped writing home loans last year after sending its mortgage subsidiary into bankruptcy.

When asked about its past policy on accepting private flood insurance, a spokeswoman said, "Ally no longer has a mortgage servicing operation, so [I] don't think we are suited to answer your question."

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